Corporate Board Elections and Internal Controls

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Questions and answers, chaired by Myles V. Lynk

Myles V. Lynk: I want to have a little dialogue within the panel before we open it up. Let me just open with a question to Alan Beller. When Professor Coffee spoke, he spoke about the fact that one size doesn't necessarily fit all and there should be a refinement going forward of different audit methodologies or different control methodologies. Is that something that the Commission is willing to look seriously at?

Alan Beller: I would actually say that the Commission is not only willing to look at it seriously, I think we actually thought our rule contemplated it. The SEC rule is a very open-ended, and I think the debate about principles-based versus rules-based is largely a sterile one. I think you've got to figure out what works in a particular area, but the SEC rule is, in conventional terms, pretty principles-based. Companies are obligated to have internal controls that provide reasonable assurances of materially accurate financial reporting. That's what it says. The release says you have to have reasonable levels of documentation. I think we contemplated that. I guess I took John's comment as meaning both of two things. One is, one size doesn't fit all in terms of size; little companies versus big companies have very different control structures, and that's one reason we gave more time for the little companies, again, because I don't think we're confident that the community has that down yet. But also, different kinds of companies need different kinds of controls to reach that reasonable level of assurance. A global financial institution and a global smokestack-manufacturing company have got very different control structures and they both meet our standards. I don't think there's anything in our rule that would remotely keep that from happening. I can hear an argument that there's some stuff in AS2 that would maybe do that.

Myles Lynk: Let me ask David Devlin; in your talk you discussed the various control regimes already in place for publicly-traded companies in Europe. How do your clients or the clients of your members look forward, to the extent that they've exempted themselves from the filing requirement today, they soon will, if they want to continue to be registered in the U.S., come under that requirement? What types of adjustments are they projecting they'll have to make to comply with § 404?

David Devlin: It's a bit difficult to generalise because two or three things, which I didn't perhaps mention in my talk, are, first of all, that those control reporting requirements in Europe apply more widely often than just to listed companies. Mostly it's listed companies but if you go to, say, France, it applies far more generally than that. So, if you like, the level of ambition in Europe is to cover more than just public companies. It's a bit like audit. We have, I think, seven million audits in Europe; statutory-required audits that extend way beyond just listed companies. As regards European filers heading to the delights of Sarbanes-Oxley, that depends where they're coming from. If you went to London, and London isn't too heavily represented here today, I think you'd hear a very strong argument that with their Turnbull materials, which are a fraction of the size in terms of guidance for either directors or auditors, they get there to a large degree. Now, they don't have the same degree of minutely prescriptive detail as to what auditors have to do, I think it's about 15 pages as against 150 plus and presumably that means it's more principles-based, but whether it meets things like the very exacting documentation standard, you'd have to wonder. Whether it meets the particular tests of material weakness identification in the very prescriptive and rigid manner that is laid down by the PCAOB which at least gives predictability, I don't know. It depends on the judgements of the Boards of those individual companies have made within the scope of Turnbull.

The third thing that's almost certainly very different for most European companies is the disclosure question. As I understand it, the reaction to disclosures of internal control problems that have been made in terms of share price, which is always the most important driver on these things, has varied. There seems, I gather, from what I've heard previously, to be some ability on the part of investors to discriminate, that they aren't too shocked if a very big operation turns out to have some, let's say, deferred maintenance or something but if you get beyond a few issues and they already have a doubt or two about the company's financial reporting, maybe that's a different story. So, I think European companies reactions will vary. It depends where their starting point is. It depends on the attitude you previously had and what rules you were operating to.

Alan Beller: I'll just say one thing to that that I think is very important. I agree, when you put Turnbull and COSO on a scale, Turnbull's a lot thinner. For those of you who wonder about COSO, I would direct you to our website, actually to the small-business testimony of October where Larry Rittenberg, who was probably the single person most responsible for COSO and is heading up the taskforce, is currently trying to give some guidance for smaller public companies. His testimony to the Smaller Public Company Advisory Committee includes a very vigorous presentation that COSO is very principles-based. But we would expect U.K. companies to start with Turnbull. I agree with you, it doesn't answer the questions that David raised that I think are very important questions, but we would expect foreign companies to start with the control framework that they've developed in their own countries and not to take COSO off the bookshelf.

John Coffee: Of course it was a fascinating panel, but I want to raise one thing because it came up over and over again and this is a topic where I have to be a bit of a pessimist. Generally in these discussions you hear some powerful examples that talk about moving out of the swamp of the rule-based system and up to the sunny high lands of a principles-based system and, of course, we all like principles more than we like rules but here's the problem. The U.S., and I'll ask you to confirm this, is a high-litigation environment. There are over 1200 securities class actions pending in the federal courts right now and I could give you a painful list of major Big Four accounting firms that have reached settlements in the range of something over $100 million. When you face that kind of litigation exposure, just saying the standard is to be reasonable is not very attractive because that means that ultimately a fact-finder, a judge or a jury, is going to sit there with potentially billions of dollars of liabilities deciding whether you were reasonable. The moment you have a high-litigation environment, I think naturally all of the professionals, auditors and other agents of the corporation are going to want safe-harbour rules for protection and safe-harbour rules wind up looking like a telephone book. So, we have, I think, a paradox here. At least there's a policy dilemma. We're not going to convince the Congress or anyone else, against the backdrop of high financial irregularity in the late 1990s, they should repeal the anti-fraud laws or the securities class action but with that kind of litigation environment I'm a little pessimistic that we can ever have a purely principle-based system that tells the auditor or others to do things that are reasonable. I think you're going to have to have a significant component of rules to give any kind of protection and certainty. I ask that as a question. Others live with this on a day-by-day basis, so they can respond.

Charles Gerdts: Yes, I would agree with that and I would also, picking up on Alan's point about are we rules-based or principles-based, what we I think find, unfortunately in the litigation context is that we're a little bit of both. As I look back on litigation, and you think of the concept of materiality, materiality looks like one thing the day before the problem and it looks entirely different two years later and that is a "principle" that has been a real engine towards some of the litigation that John describes.

Question: Steve Lehman, SVP & Principal Legal Counsel, Corporate, Reuters America LLC: This follows very nicely, I think, on the point that you just made and it goes to the whole panel, I think, but primarily Alan Beller and Professor Coffee. You both mentioned, I think, that things went maybe a little overboard, especially down at the process level, the detail level, in terms of how much companies did in responding to § 404 and to the PCAOB regulation around it. I think Professor Coffee said that there were something like 1900 material weaknesses that were reported in the 3000 10-Ks that have been filed since. Has anybody done an analysis? This is a little bit more by feel than anything else – do you feel that the material weaknesses were themselves a little bit overreported? Were people getting too deep into the weeds when they were saying what was wrong and not staying up at the high level? Kind of what happened with risk factors, I think, is probably the question. Or do you think that there's an appropriate level of disclosure going on in material weaknesses?

Alan Beller: The answer is we've begun to try to catalog the disclosures. I think others are ahead of us. I think Glass, Lewis & Co. has recently put out a study. I think others are as well. I think we're more likely to take advantage of the work done by others than we are to put our resources into that kind of a study ourselves, although I think we'll be very disappointed if we can't take advantage of it because I think we need that information. My own view is it parallels a little bit with what I said before about entity-level controls versus process- or transaction-related controls. I have a gut feeling that some of the transaction- or process-related stuff is at a pretty low level. I think we're in an environment where you're likely to see more overreporting than underreporting by people who are trying to tell a straight story and I think that will continue for some period of time. Beyond trying to get the assessment process right, I think you're never going to hear us discouraging disclosure at too low a level unless it gets just confusing. I think the important disclosure issue for us, and we've been saying this really loudly since about January, is if you have a material weakness or more than one, it's really important to explain what it is and put it in context. Don't pretty it up; don't paint the pig. But put it in context, make sure that investors really understand what it means. I think the measured market reaction there has been to various kinds of disclosure in that area suggested that message has gotten through both to companies and to investors. The flipped way I have put it is the disclosure by a company that it's not a weakness in internal control is the starting point for an investor's analysis and not the ending point. I think that's the message we're trying to get across.

John Coffee: I agree with everything that Alan says, and I don't mean this to be a criticism of § 404, but I think the question that doesn't get framed well in these kinds of debates is, what causes financial irregularity. Sarbanes-Oxley is there because the U.S. had an explosion of financial irregularity in 1998 and 2002 and by the GAO study at least 10% of all public and listed companies announced at least one restatement. So, 10% of at least one, that's the tip of the iceberg. There was much more below that. What caused that? I think the question of what caused that should go into what kind of internal-control systems you need. The best studies – and there are some very interesting empirical studies – now suggest… They've done controlled studies and they've taken otherwise similar companies, companies of the same industry group, same capitalisation size, these restated, these didn't restate. The number-one factor in firms that restated their financial results is the chief executive officer had an extraordinary amount of in-the-money stock options. The ratio is like 30 million of those that restated to two million of those who didn't restate, a 15:1 ratio. I think that in looking at what kind of controls you need, you should start with what kind of vulnerabilities, what kind of pressures, there are. Thus, a European company that uses no equity compensation probably doesn't need to worry about the same revenue-recognition problems that a U.S. company, paying all its senior management in stock options, should be worrying about daily. So, again, I think what kind of system of controls you have should start from what kind of pressures there would be to distort income or assets. In Europe it's probably going to be more private-benefits control, a very different kind of monitoring process.

Alan Beller: There is a lot of Sarbanes-Oxley which obviously is directed at misstatements due to fraud, for lack of a better term. Section 404 internal controls can deter fraud. Internal controls might make it easier to find it quicker. I actually don't think that the principal benefit of good internal controls is fraud detection. I think the principal benefit of good internal controls is so that companies that don't traffic in fraud have a higher degree of reliability in getting their numbers right. That doesn't take away, indeed maybe that heightens the need for a good cost-benefit analysis, it heightens the need to make sure you're looking at the right things, but some of the poster children for fraud would not have been stopped by good internal controls because management just would have overridden them.

Question: David Schraa, Director Regulatory Affairs, Institute of International Finance: This is a very different kind of question and maybe a little inelegant to follow what was just said but putting together some things that Mr. Baxter said this morning, and I think a subtext of this discussion, I've had a lot of discussions with both European and American companies, financial institutions, in the last couple of months in which they have expressed concern that both very senior management and especially boards are getting dragged into too much detail, especially with respect to internal controls and operational risk, etc. and that, as a result, they are being distracted from their overall strategic and monitoring functions and I wonder if Alan Beller and maybe Pierre Delsaux or somebody from both sides of the Atlantic would say a bit about that.

Pierre Delsaux: Clearly it's an important question. Basically, if you have a company, if you run a company, normally you should run the company just for making profit and just to get the return to your investors. It's true that you have to define the balance between basically what is your main task and the controls you have to put into place to be sure that you can achieve this main task. To come back to the discussion we've had, I believe to some extent the situation in Europe is different, for instance, because the systems of litigation are completely different. We don't have exactly the same risk of high suits being brought against a company or against auditors, or at least a less limited …risk. So, I would say that this aspect is certainly different. The structure of the company, as we say, the shareholding, is also different in Europe compared to the situation in the States. Finally, we have decided – and I don't want to discuss the principles-based or rules-based approach because it's not the most important point, but clearly the logic we are following in Europe is to some extent to leave a certain margin of flexibility to the companies themselves to find the appropriate solution and to find the appropriate balance. So, to come back to your question, I would say that in Europe, by leaving this flexibility to companies on the way they want to organise internal controls, to some extent it's more for them to decide what is more important. It's up to the chief executive officer to decide what they want to put in place to take into account their particular situation. Some of them might make the wrong choice but it's their choice and that's the difference, probably, compared to the U.S. situation.

One last aspect, since I've been given the floor, there's a problem which we are also studying in Europe is this question of maybe possibly limiting auditors' liability because that's another part of the debate also and finding some mechanism maybe to limit auditors' liability is something which we consider to be important and we are going to launch a study by the end of this year on these important questions. Obviously I don't know what will be the final outcome and what we are going to propose but that's certainly a topic which we consider to be very important, even despite the fact that the situation in Europe with respect to controls is different from the situation in the States.

Alan Beller: I would ask that question of Paul. I'm willing to assume that you would say your management spent too much of its time – your board, your audit committee, your top financial management – in the first year focusing on internal control and that that took away time from running the business. If you say no, you're the only financial manager who said no to that question that I've talked to all year.

Paul Saffert: No, it's clearly a huge distraction. We may have compounded a little bit at Allianz because we told all of our Board members that if their part of the company failed in SOX they got no bonus, no matter what the performance of their unit was.

Alan Beller: When I say the cost in the first year was too high I very much include the burden on management. I think the first-year exercise overly distracted management. I'm hoping the second-year exercise is better and I'm hoping the third-year exercise is better than that. I'd say one other thing about the management-burden issue. One of the reasons we deferred for small companies one more year was dollars-and-cents cost but at least as important a reason was what the co-chair of the advisory committee we've set up on smaller public companies calls the mindshare problem. When you've got a little company and you put them through a not terribly well-defined exercise which, unfortunately, this still would be for them, the burden on the management and on the board of a smaller company is something we just weren't willing to do for another year.

Question: Erich Kandler, Partner, Deloitte Austria: Just a quick thing. It's pretty obvious that Sarbanes-Oxley is a catch-up for past deficiencies. At least from my point of view, some of that could have been out there earlier. It's been enforced with tremendous speed and rigour, as we've seen in the U.S. and swept all the way over to Europe. I was wondering if maybe the people on the panel have a feeling or an idea of what is the actual consequence. What is the benefit of the Sarbanes-Oxley internal controls § 404 to the ultimate investor? Is it the assumption that we're having more going concerns in the long run? Is there a true return to that? The only thing we've seen so far is serious deficiency and the CFO is gone or no bonus, in your case. What's the actual outcome of all that? I'm curious to hear a little bit what's happening here because we are getting maybe something similar, hopefully not that bad, in Europe and I wonder what the return to us and the capital market is at the end of the day.

John Coffee: Let me give you the academic answer and then Alan will give you the more real-world answer. Essentially, the more financial results are credible and reliable, the lower the cost of capital and I think reducing the cost of capital benefits everyone in society, not just investors. You have a more efficient system.

If you don't trust financial results, you're going to demand a higher rate of return. Thus I think the SEC has always got one historic mission, to increase investor confidence because that reduces the cost of capital.

Pierre Delsaux: Certainly I agree with these principles. The paradox obviously in the Sarbanes-Oxley is basically you told us it's not to fight against fraud. So, it's basically to force companies to do things which are good for themselves but why do you need an external obligation to do so?

Alan Beller: Because 10% of companies since 1997 or 1998 have had to restate their numbers and John is right, if investors take that into account, even if those companies are not acting fraudulently, the cost of capital goes up. My job is to get the cost of capital down consistent with investor protection.

Question: Jean-Aymon Massie, Chairman of the French Corporate Governance Association: Thank you, Mr. Delsaux, for the role of the audit committee in the future for these internal controls and financial communication. My question is for Mr. Devlin. Do you think the internal control is efficiency on some point, like the evaluation of the oil and gas reserves? Remember that is not audited by the auditors. They are not controls certified by the auditors. About the gearing of the company, the ratio to that, about the agenda or programme of the share buy-back and the shares to be destroyed at the end of the year, that is the responsibility of SEC, of the regulator. Another point is about amortisation of goodwill after the merger, pooling of interests or other processes, all these facts could be notified in that research of the company and perhaps a profit warning disturb the shareholders. Thank you very much.

David Devlin: Just to recap what I understood to be behind the question, which is that internal control reporting may address issues which are not touched by auditors. You mentioned oil and gas reserves as an example. Indeed. And then the possibility of errors in financial reporting resulting from that or other control failures or wrong application of accounting rules. So far as I understand it, the application of 404, is intended to make sure that those controls which could have a bearing on the reported financial position or the result are carefully looked at, are documented, and are rigorously examined by the management in the first step, are overseen by the audit committee who have their responsibilities and the thing that is unusual about Sarbanes-Oxley, at least one of the things that's unusual – is that there is an express duty on auditors to report publicly on the management's assertion as to the effectiveness of internal control. Now, whether you like 404 or you don't, nobody can doubt that it's a very serious effort to improve the quality of financial reporting and at the SEC Round Table my personal impression was that whatever about the complaints about the costs, (which I think I would just take as a visitor – and I'm not getting into that debate) but there was no doubt at all that people believed that it helped the reliability of financial reporting. Board members appeared to think that they had grounds for more confidence in what they were told by their management and investors felt that what the company and indeed the auditors, said all helped them to feel a bit better. So, what people wanted to do was to keep the benefits but trim the costs and everything I've heard today says that is on the menu although, as Bill McDonough said, it's a work in progress and Alan Beller has said much the same. So, if we look at this in Europe, if we look today, we would hear a great deal of complaint about cost but we might not be so clear about benefits and what I'm anxious to do from the European point of view is to have a measured careful debate. We don't want to jump on this bandwagon until we've seen more experience and, crucially, until we've recovered from the introduction of IRFS, if ever we do, when we might have some time to devote to this. But if we get IRFS wrong, you can be sure that internal control over financial reporting is going to go shooting up the agenda. So, watch this space.

Alan Beller: One of the important internal controls is getting GAAP right, properly applying the principles. Indeed, one of the discussions that's gone on between the Board and the Office of the Chief Accountant and the Division of Corporation Finance at the SEC and the auditors is, is a material misapplication of an accounting principle a per se material weakness? I'm not going to put words in Charles's mouth but there are auditors who would say the answer to that question is yes. If a company misapplies GAAP, that's a material weakness. I think the Board's tendency, frankly, is to go to the same place. Mine, frankly, is not. I don't think you've necessarily got a failure in a system that's reasonably designed to get to the right answer just because you get the wrong answer, but that's clearly one of the principal areas of internal control.

Charles Gerdts: And the only thing I would add to that is that sometimes the accounting firms get there because the PCOAB gets there.

Alan Beller: Yes. I'm not going to disagree with that.