Challenges in Corporate Governance:
The Role of Corporate Directors in Overseeing Financial Reporting

The Challenges in Corporate Governance project is one of the activities of the Governance Program at the Institute for Corporate Responsibility at the George Washington University School of Business. The project examines the issue of what policies are associated with good corporate governance and promotes a dialogue on how those policies are translated into practice. The project is co-directed by John Forrer, Director of the ICR Governance Program and Dr. Cynthia A. Glassman, an ICR Senior Research Scholar.

On March 31, 2014, ICR conducted its eighth program on Challenges in Corporate Governance. This program was sponsored jointly with C-LEAF, the Center for Law, Economics & Finance at GW Law School. Previous panels have addressed how corporate directors deal with new rules, the importance of diversity on Boards, and the role of directors with respect to risk management, executive compensation, CEO succession, and setting the tome at the top.

In this continuing series, our distinguished panel focused on the role of corporate directors in overseeing financial reporting. The panel was moderated by **Cynthia Glassman.** Dr. Glassman served as an SEC Commissioner from 2002 to 2006, including Acting Chairman during the summer of 2005, and served as Under Secretary of Commerce for Economic Affairs from 2006 to 2009. Currently, she is a Director of Discover Financial Services, where she serves on the Audit and Risk Committee, and Navigant Consulting, where she serves on the Nominating and Governance Committee and the Compensation Committee. She is a Trustee of the SEC Historical Society and the Washington Tennis and Education Foundation and is a member of the Advisory Board of C-LEAF. She has spent over 40 years in the public and private sectors focusing on financial services regulatory and public policy issues.

The panelists were:

- **Candace Duncan,** the former Managing Partner of the Washington Metro Area of KPMG and has worked with numerous public company Audit Committees. Ms. Duncan is a proven business leader with a long record of significant achievements and “firsts” in her life and in her career at KPMG LLP, the U.S. audit, tax and advisory firm. She was the first woman to be admitted into the KPMG partnership in Virginia and has served in a variety of leadership roles, including the first woman to become managing partner of the Washington Metro Area offices. Prior to this role, Ms. Duncan served as the Midatlantic Area managing partner for Audit and as the Audit partner in charge of the firm’s Virginia business unit. Candy also served as a member of KPMG’s Board of Directors and as chair of the firm’s Nominating Committee and Partnership and Employer of Choice Committee.

- **Daniel Goelzer,** currently a partner at the law firm of Baker & McKenzie, was a founding member of the Public Company Accounting Oversight Board (PCAOB), where he served from 2002 to 2012, including serving as Acting Chair from August of 2009 through January of 2011. Mr. Goelzer specializes in matters involving the Securities and Exchange Commission (SEC) and the PCAOB. His practice areas include corporate governance; compliance with SEC disclosure and financial reporting requirements; the auditor/public company relationship; and financial institution regulatory issues, with a focus on global asset custody. From 1983 to 1990, Mr. Goelzer served as General Counsel of the Securities and Exchange Commission.

- **Roger Millay,** currently Vice President and Chief Financial Officer of Towers Watson and has 12 years’ experience as a public company CFO. Before the firm’s merger with Towers Perrin in 2010, he held the same position at Watson Wyatt. Roger, a certified public accountant, has more than 30 years of finance and accounting business experience. Earlier experience includes roles with Arthur Young & Company, GE

Capital, Airgas, Inc., and Discovery Communications. Roger is a member of the Board of Governors of the Folger Shakespeare Library and a Trustee and Chair of the Audit Committee of the College Foundation of the University of Virginia.

- **Follin Smith,** the Chair of the Audit and Risk Committee of Discover Financial Services and is a member of the Boards of Directors of Kraft Foods, Ryder Systems, Inc. and Discover Financial Services. She is a member of the Davidson College Board of Trustees and of the CenterStage Board of Trustees. Until May 2007, Ms. Smith was Executive Vice President and Chief Financial and Chief Administrative Officer of Constellation Energy Group. With $19 billion 2006 revenues and $15 billion in equity market capitalization, Constellation Energy is the nation's largest competitive supplier of power and one of the largest nuclear generators in the country.

In a public company, owned by a large and diverse set of shareholders, the role of the Board of Directors is to oversee management in order to protect the interests of the shareholders. The Board is elected by the shareholders and has a fiduciary duty to them. Their key duties are:

- **A duty of care – which means they are expected to get sufficient information and fully deliberate on Board decisions**
- **They also have a duty of loyalty, which means they must act in the best interests of the shareholders and the company**
- **They must act in good faith**
- **And they must maintain confidentiality of any information that has not been disclosed to the public.**

Their roles of the directors include:

- **Review of Corporate strategy**
- **Developing a plan for CEO succession**
- **Setting appropriate tone at the top**
- **Setting CEO and other senior executive compensation**
- **Overseeing compliance and risk management**
- **Overseeing financial reporting**

For context in addressing the Board's role in overseeing financial reporting, the panel began with a short history,[1] beginning with the Securities Act of 1933, which was passed in reaction to the stock market crash in 1929. The Act required an independent public or certified accountant to attest to the accuracy of financial statements of public companies. These accountants were then liable for misleading statements or omissions of fact. In 1934, the newly formed Securities and Exchange Commission created Form 10, later known as form 10-K, for permanent registration of existing securities. It included both financial and non-financial data about public companies.

[1] Various documents from the SEC Historical Society website provided background for the historical overview

However, it wasn't until the 1970s that Audit Committees of the Board became prevalent. That was likely in reaction to public statements by the NYSE and the SEC. In 1972, the SEC endorsed the establishment of Audit Committees composed of independent directors for all publicly held companies and a few years later asked the NYSE to add the requirement to its listing standards. The apparent goal was to bolster the independence of the auditor, since that independence was fundamental to the concept of reliable external audits. Having an independent auditor also provided a communications channel - separate from management - for Audit Committees to receive information about the company. According to the Conference Board, only 24% of their members had an Audit Committee in 1967. By 1977, that percentage had risen to 90%.
The internal audit function arose in the late 1970s, after the Foreign Corrupt Practices Act (FCPA) of 1977 required public companies to have systems of internal control over their accounting procedures.

Fast forwarding to the accounting frauds at the beginning of this century -- Enron, Worldcom, Adelphia, and Tyco, among others, --Congress passed the Sarbanes-Oxley Act, or SOX, in 2002. Among its many provisions, SOX provided that stock exchanges could not list companies unless the company met certain requirements, including:

- **The audit committee members had to be independent**
- **The audit committee was responsible for the appointment, compensation, retention, and oversight of any registered public accounting firm issuing an audit report or providing other audit or attest services for the company.**
- **The registered public accounting firm had to report directly to the audit committee.**
- **The audit committee had to have procedures for handling complaints regarding questionable accounting or auditing matters,**
- **The audit committee had to have the authority to hire independent counsel or other advisors and be provided with appropriate funding.**

SOX also created the Public Company Accounting Oversight Board, the PCAOB, whose mission includes the responsibility "to oversee the audits of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports." In carrying out its mission, the PCAOB registers public accounting firms, regulates and inspects them, and sets auditing standards for the profession.

Finally, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) passed in 2010 in reaction to the financial crisis and "Great Recession" has expanded the scope of issues that Audit Committees must address, especially those of financial services companies.

With that overview, our panel began the discussion of how Audit Committees meet the challenge of overseeing the accuracy and integrity of a public company's financial reporting, especially the annual 10-K, which has evolved substantially from its origins in the 1930s The panelists represented the range of key participants involved in ensuring the integrity of financial reporting at public companies and included a CFO, an external auditor, an Audit Committee Chair, and a former member of the PCAOB.

The discussion highlighted the relationships among the different roles represented and the importance of communication, integrity and trust.

The principal responsibility for developing well-controlled financial statements that comply with laws and regulations lies with company management. It is management's role to identify and manage key risks. The actual gathering of the financial information is conducted by the CFO and his/her staff. SOX requires that the CFO, along with the CEO, must certify -- subject to civil and potentially criminal penalties - that the 10-K is accurate and complete and that they have established adequate internal controls over public disclosure. To sign that certification, CFO needs to be confident in the capabilities and commitment of the people and processes involved in the development of the annual and quarterly financial reports. For most public companies, especially with diverse lines of business or geographic locations, the issues are broad and complex, and can create challenges.

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The CFO typically works with a team to consolidate the financial reporting, tax requirements and accounting issues that that roll up from the various parts of the organization. The CFO's role is to make sure that the proper management systems and organizational structure are in place with the appropriate people involved to effectively govern the process needed to accomplish the reporting objective within the tight timeframe of filing deadlines. The CFO's role includes probing at all levels to identify and resolve issues that arise as well communicating information as appropriate to others in senior management, the Audit Committee, the full Board, and shareholders. A strong culture of accountability, integrity, and tone at the top is key to creating the right environment for the CFO to effectively perform his/her duties.

The role of the external auditor is to determine if the financial statements are "fairly stated" and give a true picture of the financial health of the company. The auditor is responsible to the capital markets and is hired by, and reports to, the Audit Committee of the Board. The auditor reviews the information provided by the CFO's team and works through any differences of opinion regarding accounting treatment to secure an agreed upon decision. The auditor signs off on year-end numbers and also performs reviews of the quarterly financial statements.

The auditor typically meets with the Audit Committee at least once a quarter, at which time they describe the work they have undertaken and any unusual issues that have arisen. The auditor also spends a lot of time in discussions with management. Again, integrity is critical to the process. One reason auditors have refused to work with a firm or would resign from an engagement is that management does not provide accurate and truthful information.

The Audit Committee Chair and Committee members, on behalf of the full Board, oversee how management develops and prepares the financial statements. Members of the Audit Committee are typically expected to be financial literate, and the company must disclose whether or not - and if not, why not - the Audit Committee has at least one member who is a "qualified financial expert", as defined by the SEC. The Audit Committee typically meets in person or by conference call 10 or more times a year, and they review all public financial filings to make sure they are appropriate and in good order. Their goal is to help make sure there is a well-controlled process that prevents problems from arising in the company's financial reporting, compliance with laws and regulations, and risk taking and, ultimately, to avoid surprises. In that role, they receive input from various executives who are each responsible for building a culture of doing the right thing within the company.

The greatest share of the Audit Committee's time is spent with the CFO and the controller or chief accounting officer to discuss such topics as emerging business risk, significant accounting estimates where judgment is involved, and accounting for unusual transactions. The Audit Committee also meets with the General Counsel and Chief Compliance Officer to understand all of the laws and rules with which the company must comply and make sure there are checks and balances to insure compliance. The Chief Risk Officer provides input on risks facing the company, especially focused on quantifiable risks. The Chief Information or Technology Officer provides information on such issues as cyber security or a major technology system change. The Internal Auditor objectively reviews and tests the effectiveness of controls, independent of the management that creates them, and is a powerful safeguard for the company. As employees of the company, the internal audit group may face tensions as they evaluate and suggest improvements in the control environment of others in the company. To protect the independence of the head of internal audit, the Audit Committee typically is involved in the performance review and pay decisions for that officer.

Finally, as an independent third party, the external auditor is the last check for feedback on any difficult issues or judgments in the financial reports. The external auditor also helps the committee members understand best practices, alerts them to any unusual accounting practices, and highlights evolving issues under consideration by, for example, the SEC, FASB (Financial Accounting Standards Board) or the PCAOB.

Typically, the Audit Committee will also meet in Executive sessions (i.e., with no other members of management present) with each of the senior management individuals noted above, as well as the external auditor, which enables candid discussion of any concerns or discomfort the individual may have regarding the firm's financial reporting, controls and processes, or risk taking.

Simply put, the panel agreed that the frequency of Audit Committee meetings and the length of time of those meetings have increased enormously over this period, due to increased business complexity, more stringent regulatory requirements, accounting changes and documentation expectations. Internal audit and compliance staff has grown substantially, and the cost of external audits has increased as well.

The PCAOB, created with the passage of SOX in 2002, oversees the audits of public companies by setting and enforcing audit standards. While the PCAOB does not directly oversee or regulate Audit Committees, it wants to make sure that Audit Committees have the information they need to carry out their duties. To that end, the PCAOB has set standards for the information to be provided by the external auditor to the Audit Committee. These information standards include, for example, the audit strategy, any special factors that were considered, significant or unusual transactions, and difficult or contentious issues that arose during the audit. In recent years, expected communications from the auditor to the Audit Committee have increased significantly. In evaluating the auditor, the Audit Committee should evaluate whether the auditor has met the communication standards.

As part of its inspection function, the PCAOB reviews how the audit firm performs its engagements. Red flags for the PCAOB include unusual accounting treatment, issues regarding the firm's ability to continue as a going concern, and questionable judgments or assumptions. In rare instances, the PCAOB review may identify an issue that was not raised in the company's audit. Also, the PCAOB may interview Audit Committee Chairs to elicit feedback on the external auditor.

Another important issue discussed was how a concern or problem gets conveyed to the CEO and the full Board. Generally, the view was that open communications, trust, and transparency are critical to be able to deal with such issues or problems quickly and effectively. Specifically for example, if the problem is a material accounting issue, the CFO would be expected to raise it with the CEO as soon as the matter surfaced, followed by a call to the Audit Committee Chair. Then, as the nature of the problem became clearer, it would be brought to the attention of the full Audit Committee, and then to the Board by email or a conference call.

The panel then addressed the question of the role of the Audit Committee in overseeing risk management at a public company. The oversight of risk management has become particularly important in the aftermath of the financial crisis and the “Great recession.” Many financial institutions, in particular, have created a separate Risk Committee of the Board. Some nonfinancial companies have also instituted a Risk Committee of the Board. The Risk Committee focuses on nonfinancial risks. It is a challenge, however, to designate what is covered by the Risk Committee and what remains under the purview of the Audit Committee. To some extent, the determination depends on the industry and the specific expertise of Board members. Nevertheless, there may be some unavoidable overlap and tensions between the roles of the two committees.

Finally, the panel discussed the changes that have taken place in financial reporting oversight in the last 10 to 15 years. Simply put, the panel agreed that the frequency of Audit Committee meetings and the length of time of those meetings have increased enormously over this period, due to increased business complexity, more stringent regulatory requirements, accounting changes and documentation expectations. Internal audit and compliance staff has grown substantially, and the cost of external audits has increased as well. It is not possible to oversee effectively the financial reporting without the increased time, effort, and expense. Examples of issues demanding additional attention include compliance with FCPA, anti-money-laundering, supply chain issues such as conflicts minerals disclosures, and labor practices. Further, expectations for oversight of vendors used for outsourcing have grown substantially.

The panel also agreed that in the post-Enron, post-SOX environment, Corporate Directors are much more inclined to ask probing questions and push back against management if appropriate answers are not forthcoming. The importance of the Audit Committee executive sessions was also noted as an important factor in the changing culture at public companies. Further, incentives to manage short-term earnings have been limited by longer-term incentive plans for compensation of senior management.

While the panel agreed that, over time, the processes used to generate financial reports have been improved, there was discussion regarding whether the benefits outweigh the costs. In particular, to the extent that the Board’s time is absorbed by focusing on details, they may be missing the bigger picture and shortchanging the time spent on significant strategic issues.