

## Regulatory balance: a dialogue with John White

### Introduction

On September 5, 2007, members of the Audit Committee Leadership Network (ACLN) met for the network's 15th stand-alone meeting. Members began by considering registrants' relationships with the Securities and Exchange Commission (SEC) and then discussed increasing audit committee effectiveness.<sup>1</sup>

For further information about the network, see "About this document" on page 9.

During their meeting members participated in a dialogue with Mr. John White, director of the Division of Corporation Finance at the SEC. During the discussion, members focused on the following areas:

- **Working with the Division of Corporation Finance to reduce restatements**
- **Improving teamwork and processes**
- **Other matters: IFRS, Section 404, new CD&A disclosures**

Collectively, audit chairs participating in the meeting sit on the boards of over 30 large-, mid-, and small-cap public companies. Members who participated in the meeting include:

- Denny Beresford, Audit Committee Chair, Kimberly-Clark
- Dick Harrington, Audit Committee Chair, Xerox
- Roland Hernandez, Audit Committee Chair, Wal-Mart
- Judith Richards Hope, Audit Committee Chair, Union Pacific
- Laban Jackson, Audit Committee Chair, JPMorgan Chase
- Marie Knowles, Audit Committee Chair, McKesson
- Oscar Munoz, Audit Committee Chair, Continental Airlines
- Chuck Noski, Audit Committee Chair, Microsoft and Morgan Stanley
- Pam Patsley, Audit Committee Chair, Texas Instruments
- Sandy Warner, Audit Committee Chair, General Electric Company

Other members participating in the discussion included:

- Tom Flannery, Partner, Audit Committee Communications, Ernst & Young
- Steve Howe, Americas Managing Partner, Ernst & Young

*ViewPoints* reflects the network's use of a modified version of the Chatham House Rule whereby names of members, guests, and company affiliations are a matter of public record, but comments made by members before and during meetings are not attributed to individuals or corporations. However, Mr. White has permitted his comments to be attributed. Mr. White's comments represent his personal opinions and not the official position of the SEC or the opinions of its staff.

<sup>1</sup> See Audit Committee Leadership Network, "Increasing audit committee effectiveness," *ViewPoints*, October 19, 2007. Available at [http://www.tapestrynetworks.com/documents/Tapestry\\_EY\\_ACLN\\_Oct07\\_View18.pdf](http://www.tapestrynetworks.com/documents/Tapestry_EY_ACLN_Oct07_View18.pdf).

## Executive summary

In February 2007, members of the Audit Committee Leadership Networks in North America and Europe participated in a joint summit in Washington, DC. In that meeting, SEC chief accountant Conrad Hewitt and deputy chief accountant Julie Erhardt joined members for a discussion on the future of financial reporting. One of the key themes that emerged from the discussion was the “rationalization” of the regulatory environment and the role of the SEC.<sup>2</sup> Rationalization would result in more “streamlined and efficient” regulations and decision making, which would help create more efficient capital markets.

In September 2007, U.S. network members met with John White, the director of the SEC’s Division of Corporation Finance (Corp Fin), in New York to continue the dialogue on regulatory balance. The specific issues that network members found most important are highlighted below, with more detailed discussion on the following pages:

- **Working with the Division of Corporation Finance to reduce restatements** *(Page 3)*

Both Mr. White and network members expressed concern about the number of financial restatements and discussed ways to reduce them, given that investors and capital markets have not reacted to the majority of restatements to date. Building a stronger relationship between registrants and the Division of Corporation Finance is of particular importance to members. Members believe an early and constructive dialogue with staff could lead to the emergence of alternatives to a restatement, such as revision or disclosure. Mr. White drew attention to SEC efforts to simplify accounting complexity and recommended that companies develop a relationship with one of the 11 assistant directors in Corp Fin who has responsibility for the review process for registrants in a particular industry. The assistant directors are an important point of continuity between a registrant and the Commission staff.

- **Improving teamwork and processes** *(Page 5)*

Many audit chairs have commented on the growing distance they sense between public companies and the SEC. During the meeting, several members suggested that consideration be given to a regulatory model more similar to that adopted by other regulatory bodies, such as the Federal Reserve Board. Members were interested in supporting Mr. White in his desire to improve Corp Fin’s processes to make the Division more user friendly and transparent and so improve its teamwork with various stakeholders.

- **Other matters: IFRS, Section 404, new CD&A disclosures** *(Page 6)*

Mr. White also discussed three items on the SEC’s agenda for 2007 and beyond. First, he spoke of the significance of introducing International Financial Reporting Standards (IFRS) into the U.S. capital markets. Second, he noted that changes to the regulations governing Section 404 of the Sarbanes-Oxley Act (SOX) would reduce audit costs and urged audit chairs to raise this as they review audit plans for 2008. Third, he assured members that the SEC’s review of the first year of implementation of the new compensation discussion and analysis (CD&A) disclosure requirement was unlikely to result in significant

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<sup>2</sup> Ernst & Young and Tapestry Networks, “Enhancing trust and competition in global capital markets,” *ViewPoints*, April 6, 2007. Available at [http://www.tapestrynetworks.com/documents/Tapestry\\_EY\\_Summit\\_View1\\_Apr07.PDF](http://www.tapestrynetworks.com/documents/Tapestry_EY_Summit_View1_Apr07.PDF).

amendments of past disclosures. Comments were mostly forward looking and directed towards next year's disclosures.

## Working with the Division of Corporation Finance to reduce restatements

In June, the SEC Advisory Committee on Improvements to Financial Reporting was created to address restatements and other issues.<sup>3</sup> The number of restatements is enormous: Audit Analytics reported that there were 1,876 restatements in 2006 (though the number for large accelerated filers decreased from 242 in 2005 to 196 in 2006).<sup>4</sup> Similarly, Glass, Lewis & Co. reported that “about one out of every 10 public companies filed a restatement last year, compared with one for every 12 in 2005.”<sup>5</sup>

### Common commitment to reduce restatements

Both Mr. White and network members expressed concern about the number of financial restatements and discussed ways to reduce them. Mr. White told members, *“That is something I am very focused on.”* Members expressed their view that the SEC does not enter into sufficient dialogue with registrants early enough in the process to enable a restatement to be avoided.

Members would like to see a dialogue about financial statement revision that falls short of restatement. One member commented, *“I would like to see a more constructive dialogue on how the company reached the position it did, rather than taking an early position against it.”* Another audit chair said that currently *“audit committees [and] external and internal auditors work together on a view. The SEC simply states that view is wrong, and there is no dialogue on gray areas. There is reluctance by the SEC to dialogue on what would be the best decision for investors.”*

However, not all members agree fully with this analysis. One audit chair said, *“[For my company,] there is a dialogue with the SEC. It's very constructive and we've achieved a lot ... With smaller registrants, it's not quite the same ... there is an opportunity to improve dialogue.”*

Mr. White pointed out that sometimes companies are not entirely helpful in the way they frame the nature of the dialogue with the SEC: *“Reports to the board from the chief legal officer are often couched in confrontational language. From an audit committee perspective, you should look at our comments as a positive: our people look at all the companies in your industry, and they can give the board of directors an outside perspective on the company.”*

Members fear that restatements are now so common that the majority no longer evoke a response from the market. One member commented, *“My observation is that [a company's] auditors and lawyers ... pursue the path of least resistance that happens to have the most visibility [ending] in restatements ... However, those restatements encourage the SEC to believe it is right on the accounting issues.”*

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<sup>3</sup> For more information on the Advisory Committee on Improvements to Financial Reporting, see <http://www.sec.gov/about/offices/oca/acifr.shtml>.

<sup>4</sup> Melissa Klein Aguilar, “Study: SOX Helps Cut Restatements,” *Compliance Week*, March 20, 2007. Available to subscribers at [http://www.complianceweek.com/index.cfm?fuseaction=article.viewArticle&article\\_ID=3175](http://www.complianceweek.com/index.cfm?fuseaction=article.viewArticle&article_ID=3175).

<sup>5</sup> Glass, Lewis & Co., “The Errors of Their Ways,” February 27, 2007, 1. Available at <http://www.pbs.org/nbr/pdf/GlassLewis-Errors.pdf>.

Mr. White reported that an internal SEC review has shown that *“very few restatements come out of our [Corp Fin] review process. Under 5% are connected to our reviews. They are not the direct triggering event for restatements.”*

Mr. White gave three reasons for the number of restatements:

- First, he suggested that many restatements were simply the consequence of implementing Sarbanes-Oxley and *“came out of [Section] 404 reviews and accounting firms being more risk averse.”*
- Second, a large number of restatements flowed from the SEC guidance on lease and leasehold accounting rules.
- Third, Mr. White raised the issue of accounting complexity, saying, *“Many of restatements were not the result of scienter.<sup>6</sup> They were not intentional; instead companies just got it wrong when they tried to get it right. Something is wrong with the system.”*

The SEC Advisory Committee on Improvements to Financial Reporting, which will make recommendations within 12 months, is also exploring the problem of accounting complexity. Mr. White also said he intended to focus on restatements within Corp Fin.

## **Developing a relationship with the Division**

Mr. White reminded members of the mission of Corp Fin, which *“mostly looks at periodic filings and M&A transactions. SOX gave us a mandate to review all public companies every three years, and we actually review large caps more often. We review 4,500 public companies each year from a total of about 12,000.”*

The Division is organized into 11 groups by industry, all based in Washington, DC. Each industry group is headed up by an assistant director (AD). The ADs *“are the key people with responsibility for a company, and they sign off on the comment letters. They have been there a long time (some up to 25 years) and know their industries.”* Each of the 11 groups also has a senior associate chief accountant. The actual review of a company is conducted by accounting and legal examiners, together with a reviewer who is senior to the examiners.

Mr. White advised members on working with the Division: *“My prior approach [in private practice] was not to go around people but to go through people. If you don’t like the answer, ask to invite the [next most senior] person up the chain to the meeting. The AD relationship is an important thing to develop.”*

However, one member observed, *“The staff become more defensive as you escalate,”* and described how *“a phone call with three people becomes a meeting with 17 people. We need more dialogue before things become difficult. There need to be steps to build rapport.”*

Another member wondered, *“Is dealing with Corp Fin enough, or do we need to have a relationship with the OCA [Office of the Chief Accountant] as well? Does the AD communicate with [chief accountant Conrad] Hewitt’s people to have an SEC-wide view?”*

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<sup>6</sup> In criminal law, the term “scienter” (Latin for “having knowledge”) refers to a defendant’s knowledge that his or her acts were illegal or his or her statements were lies and thus fraudulent. Source: Law.com/dictionary.

Mr. White responded, *“From a relationship standpoint, Corp Fin is organized by industry group, and your assistant director is likely to provide continuity. In contrast, OCA is organized by GAAP [U.S. Generally Accepted Accounting Principles] subject matter expertise. It’s relatively seamless between Corp Fin and OCA. Day-to-day reviews are in Corp Fin. Most of the accountants in the SEC are in Corp Fin.”* He said that Corp Fin took the lead on issues to do with *“presentational or [Regulation] S-X<sup>7</sup> issues,”* but that the OCA determined the definition of U.S. GAAP. *“There are no disagreements or turf battles between OCA and Corp Fin. There’s almost always someone from both groups present in any meeting with a company.”*

### Improving teamwork and processes

Many members have commented on the growing distance they sense between public companies and the SEC. During the meeting, several members of the Audit Committee Leadership Network in North America contrasted their relationship with the SEC with their experiences with other regulatory bodies, such as the Federal Reserve Board (the Fed) and the Office of the Comptroller of the Currency (OCC).

One audit chair said, *“You’ve seen the OCC and Fed model of regulation. It’s a good model. I can pick up the phone and speak to them about all issues. It’s an open dialogue. If we do something wrong, of course they come down on us. There is no way to have that dialogue with the SEC, so you can’t head off an issue before it becomes a hurricane. With the Fed, you feel you had your day in court. With the SEC, you can’t figure out what they want to get done until it’s all over. [If the relationship was there,] we could head off a lot of problems.”*

For his part, Mr. White has called for teamwork among the SEC, boards of directors, and company management, noting that a strong relationship between public company boards and the SEC is fundamental to the SEC’s role as an investor advocate.<sup>8</sup> During the meeting, Mr. White outlined his desire to make Corp Fin more user friendly and more transparent. Mr. White, who lives in New York, said that he endorses the motto of the New York Police Department – *“courtesy, professionalism, and respect”* – for the SEC. One member responded positively to this, saying, *“Teamwork, transparency, courtesy, professionalism, and respect are the building blocks of a relationship.”*

Another member, voicing skepticism about the possibility of teamwork with the SEC, said, *“This organizational-behavior question is very interesting. We think someone’s success at the SEC may be about winning [restatements].”* Mr. White responded, *“Not that I’ve seen. If there are any performance measures, they are about getting [the job] done. For example, on IPOs, it’s beating the 30-day target to get the initial comment letter out. Performance measures are time based.”* The SEC’s annual report publishes the time it takes Corp Fin to get out initial comment letters as a key performance statistic. The target is 30 days, and in recent years they have hit around 27 days.<sup>9</sup>

<sup>7</sup> Regulation S-X governs the requirements for financial statements under the Securities Act of 1933 and the Securities Exchange Act of 1934.

<sup>8</sup> John White, “An Expansive View of Teamwork: Directors, Management and the SEC.” Speech at the Practising Law Institute’s Fourth Annual Directors’ Institute on Corporate Governance, September 25, 2006. Available at <http://www.sec.gov/news/speech/2006/spch092506jww.htm>.

<sup>9</sup> Securities and Exchange Commission, *2006 Performance and Accountability Report* (Washington, DC: Securities and Exchange Commission, 2006), 47. Available at <http://www.sec.gov/about/secpar/secpar2006.pdf>.

## Other matters: IFRS, Section 404, new CD&A disclosures

In the final part of the discussion, Mr. White raised three items on the SEC's agenda for 2007 and beyond: International Financial Reporting Standards (IFRS), changes to the regulations governing Section 404 of SOX, and the SEC's review of the first year of implementation of the new compensation discussion and analysis (CD&A) disclosure requirement.

### IFRS in the United States

On August 7, 2007, the SEC published a "concept release" – a document seeking input regarding public companies' interest in being able to prepare financial statements either in accordance with IFRS or U.S. GAAP.<sup>10</sup> This release comes close on the heels of the SEC proposal regarding the elimination of the requirement that foreign private issuers reconcile their statements with U.S. GAAP.

Commenting on these two issues, Katrina Kimpel, a professional accounting fellow at the SEC, remarked, "the Concept Release describes the Commission's past consideration with respect to reducing disparity between the accounting and disclosure practices of the United States and other countries as a means to facilitate cross-border capital formation while providing adequate disclosure for the protection of investors and the promotion of fair, orderly, and efficient markets."<sup>11</sup> The comment period for the release closes on November 13, 2007.

Mr. White was optimistic that IFRS would play a role in the U.S. capital markets in the future: "*We started into this because of wanting to eliminate the reconciliation requirement for FPIs [Foreign Private Issuers]. That's going to happen. The U.S. piece is more long term and more controversial. Comment on it. Tell us what you think.*" Among the challenges Mr. White anticipates is "*a major getting-ready education process.*"

Given that over 100 countries already use IFRS, U.S. companies may want to develop a higher level of understanding of them and their advantages and disadvantages. At least one company on whose board a network member sits has had a board meeting to review a financial statement prepared according to IFRS to identify issues, should the company decide to drop U.S. GAAP in the wake of a future SEC decision.

Commenting on the SEC's potential role interpreting IFRS for both FPIs and U.S. companies, one member asked, "*How should U.S. companies think about this? What is the benefit? I think foreign registrants may look back at reconciliation as the good old days now that the SEC will be interpreting IFRS.*" Mr. White replied, "*From a review standpoint, we already have to look at IFRS for FPIs. We talk to securities regulators in the home countries all the time ... we have some of the best IFRS people around at the SEC, as we have just looked at all the IFRS filings.*"

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<sup>10</sup> For more information on the SEC's concept release, see <http://www.sec.gov/rules/concept/2007/33-8831.pdf>.

<sup>11</sup> Katrina Kimpel, "Opening Remarks of the SEC Meeting," July 25, 2007. Available at <http://www.sec.gov/news/speech/2007/spch072507kk.htm>.

## Section 404

Over the past two months, the SEC finalized and approved the terms of its management guidance on Section 404, which provides management with the opportunity to conduct “top-down, risk-based evaluation of internal control over financial reporting.”<sup>12</sup> The SEC also approved Auditing Standard No. 5 (AS5), which will replace Auditing Standard No. 2 and is intended to increase the independence and judgment of the auditor over management attestation.<sup>13</sup>

Members do not anticipate these changes will greatly impact their companies. Many noted that the successful implementation of Auditing Standard No. 2 was the difficult part. However, members are interested in learning whether the SEC is seeing any positive changes as a result of the new approach and how success will be measured. Mr. White commented, *“We – the PCAOB and the SEC – really believe that management guidance and AS5 will make [Section 404] less expensive to implement. When you talk to your external auditor about the audit plan for next year, you should expect it to cost less.”*

## New CD&A disclosures

The SEC’s intention for the CD&A disclosure was to give investors “material information about the compensation objectives and policies for named executive officers without resorting to boilerplate disclosure.”<sup>14</sup> While he acknowledged the good-faith efforts of companies to comply with the new CD&A, Mr. White has noted a lack of analysis by some companies.<sup>15</sup>

Members expressed curiosity about the advice likely to come from the SEC for the 2008 proxy season and were also interested in the SEC’s view of the plain-English standard as exemplified by the narrative portion of the disclosure. Mr. White said that CD&A is *“the topic du jour in the newspapers.”* He commented that in the SEC’s review of over 300 CD&As, *“we did not make many comments per company. We are now waiting for responses. They are mostly forward-looking suggestions for next year. These are regular Corp Fin reviews – not a big deal.”*

Mr. White went on to comment on performance targets and plain English. *“On the performance target issue: that was fought over at the time the rule was made. You need to disclose or meet the competitive-harm standard, and then provide the alternative disclosure. That was the compromise between investor*

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<sup>12</sup> Securities and Exchange Commission, *Commission Guidance Regarding Management’s Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934* (Washington, DC: Securities and Exchange Commission, 2007), 1. Available at <http://www.sec.gov/rules/interp/2007/33-8810.pdf>.

<sup>13</sup> Securities and Exchange Commission, *Public Company Accounting Oversight Board; Order Approving Proposed Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements, a Related Independence Rule, and Conforming Amendments* (Washington, DC: Securities and Exchange Commission, 2007). Available at <http://www.sec.gov/rules/pcaob/2007/34-56152.pdf>.

<sup>14</sup> Securities and Exchange Commission, *Executive Compensation and Related Person Disclosure* (Washington, DC: Securities and Exchange Commission, 2006), 29. Available at <http://www.sec.gov/rules/final/2006/33-8732a.pdf>.

<sup>15</sup> John White, “Keeping the Promises of Leadership and Teamwork: The 2007 Proxy Season and Executive Compensation Disclosures.” Speech to the 27th Annual Ray Garrett Jr. Corporate and Securities Law Institute, May 3, 2007. Available at <http://www.sec.gov/news/speech/2007/spch050307jww.htm>.

*groups and companies. We will challenge you to justify it. There were lots of comments on plain English, and you will see more on all this in our report.*<sup>16</sup>

## Conclusion

Audit chairs, company management, and regulators continue to struggle to define the optimal relationship among themselves in the wake of the changes brought about by Sarbanes-Oxley and the financial accounting scandals of the early 2000s. At the end of candid and thoughtful discussion, Mr. White remarked that a continuation of the dialogue with audit committee chairs could help the Division of Corporation Finance in its quest to become more user friendly. In particular, feedback on the process by which the Division conducts its reviews of companies' securities filings, together with broader but practical suggestions for improving teamwork with the SEC, would be welcome.

## Appendix: Short bio for John White

John White is the director of the Division of Corporation Finance at the U.S. Securities and Exchange Commission.

Since joining the SEC in March 2006, Mr. White has led the staff in the Commission's adoption of final rules for executive compensation disclosure, Internet access to proxy materials, and deregistration by foreign private issuers and has played a key role in the Commission's efforts to improve the implementation of the internal control provisions of Section 404 of the Sarbanes-Oxley Act, including its recent adoption of management guidance and approval of the Public Company Accounting Oversight Board's new Auditing Standard No. 5.

Ongoing projects include review of new 2007 executive compensation disclosures; consideration of the proxy process, proxy voting, and shareholder proposals; possible acceptance of IFRS; proposals to improve capital raising and reporting for smaller issuers; and development and promotion of interactive data.

Prior to joining the staff, Mr. White was a partner for over 25 years at Cravath, Swaine & Moore LLP in New York, where he represented public companies and their financial advisers on a wide variety of matters, including public financings, public reporting obligations, corporate governance issues, restatements, and other financial crises. John received his JD from New York University School of Law and his BS in accounting from the University of Virginia. He is currently serving as chairman of the Securities Regulation Institute, affiliated with Northwestern University School of Law.

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<sup>16</sup> Securities and Exchange Commission, *Staff Observations in the Review of Executive Compensation Disclosure* (Washington, DC: Securities and Exchange Commission, 2007). Available at <http://www.sec.gov/divisions/corpfin/guidance/execcompdisclosure.htm>. See also John White, "Where's the Analysis?" Speech to the 2nd Annual Proxy Disclosure Committee, October 9, 2007. Available at <http://www.sec.gov/news/speech/2007/spch100907jww.htm>.



## About this document

The Audit Committee Leadership Network is a group of audit committee chairs drawn from leading North American companies committed to improving the performance of audit committees and enhancing trust in financial markets. The network is convened by Ernst & Young and orchestrated by Tapestry Networks to access emerging best practices and share insights into issues that dominate the new audit environment.

*ViewPoints* is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management, and their advisers as they endeavor to fulfill their respective responsibilities to the investing public. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues.

*The views expressed in this document represent those of the Audit Committee Leadership Network. They do not reflect the views nor constitute the advice of network members, their companies, Ernst & Young, or Tapestry Networks. Please consult your counselors for specific advice. Ernst & Young refers to all members of the global Ernst & Young organization, including the U.S. member firm of Ernst & Young LLP.*

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