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Statement of Roger G. Coffin
PACOB Roundtable
Communications with Audit Committees
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I appreciate the opportunity to participate in the PCAOB's Roundtable Discussion on the Proposed Auditing Standard Related to Communications with Audit Committees. My name is Roger Coffin; I am the Associate Director of the John L. Weinberg Center for Corporate Governance and Associate Professor of the Practice at the University of Delaware. The John L. Weinberg Center for Corporate Governance is one of the most distinguished corporate governance centers in academia. The year 2010 marks the Center's tenth year anniversary, and we remain dedicated to our mission and goals—to provide a forum for the study of corporate governance, to educate through teaching, programs and research, and to promote thoughtful reform by bringing together the business, judicial, legal and academic communities in an neutral, non-partisan context, in which ideas can be created, developed and shared.

The Sarbanes-Oxley Act of 2002 fundamentally altered the nature of the relationship of the external auditor with the audit committee of a public company. The PCAOB's Proposed Standard seeks to further refine the nature of that relationship by enhancing the relevance and effectiveness of communications between the auditor and the audit committee. I am supportive of this overall goal and therefore am generally in support of the Proposed Standard. I believe that an independent and informed board is one of the pillars of sound governance, a hallmark of the system of governance developed in this country over the past century and a half. Independent boards subject to open and fair elections are the most effective agents for the protection of investors and as guardians of shareholder interest. These concepts also form the underpinning of contemporary governance theory.

By seeking to enhance the richness of the communication between the external auditor and the audit committee, the PCAOB admirably and correctly focuses on the ability of an independent director to oversee the audit process. The relationship between the board, through the audit committee, and the external auditor, is perhaps the most important advisory relationship a company can have. Inherent in the board-auditor/advisor relationship is the concept of negotiation, through which the attainment of the best possible result for shareholders is attained through a collaborative but also an "adversarial"

process--in that an engaged board should be able to probe, question, and when appropriate, challenge the process or the results.

In order to achieve this result, boards of directors, in discharging their fiduciary duties, should have the freedom and ability to exercise judgment free from overly restrictive or process oriented requirements. The PCAOB in moving forward on the Proposed Standard, and indeed any federal agent crafting rules applicable to public companies, should proceed with caution as to not tip the scale too far to the side of rules and mandated process, lest the fulfillment of those requirements subsume the very activity itself the rule seeks to enhance. There is, I believe, a subtle but important distinction between an auditing standard applicable to the regulated profession of auditors and a rule which would reach into the boardroom and govern director behavior. The former is the proper province of the PCAOB's Proposed Standard, the substance of which I endorse. The latter is an area in which the PCAOB should tread lightly, so as to not stifle the proper exercise of independent director judgment. The trick is in achieving the proper balance between the two. Federal auditing standards, once adopted, are not simple matters to change--yet effective boards must be flexible and able to adapt quickly to changing circumstances.

Through the public comment process, and in the course of this Roundtable, the PCAOB has and will receive detailed comments regarding the specific auditing and accounting implications the Proposed Standard may have. In light of the thorough record being developed in this regard, I believe it would be more useful to the PCAOB to focus my comments on the corporate governance implications of the proposal, and to offer thoughts on how the Proposed Standard may interact with modern corporate governance theory and the fiduciary expectations required of board members of public companies.

Our system of corporate governance has enabled the development and growth of the nation's economy, has encouraged economic innovation, engendered advances in technology and science, and has created capital markets which are broad, deep and resilient. It is built on a framework of interlocking dependencies and relationships, including the shareholder—board—management dynamic and the interplay between state and federal law. Like any functioning system, corporate governance reforms and reinvents itself continually, as its component checks and balances need tweaking or in some cases, recalibration. The recent experiences in the Financial Crisis of 2008 demonstrated how distortions in risk taking and management proved costly to many individuals, companies, and the economy itself. Corporate governance's ability to assimilate new practices is, in my view, critical to its vibrancy and success. We are currently in such a phase, where standing practices are being re-evaluated and reformed.

In order to appreciate current thinking, a brief review of history is instructive. In the earliest days of the corporate form in this country, boards of directors were often comprised of large shareholders, who were elected or appointed by their fellow shareholders to oversee management and to act as stewards of the corporate trust. As a result, early boards of directors received little or no direct compensation for their board service—oversight of their investment was considered both a duty and a reward. Thus early boards were, in a very real sense, oversight mechanisms to protect their own and others investments and provide a check on the agency problems associated with management's day to day conduct of the business of the corporation.

As the country entered a period of growth from the teens and twenties into the post-war period, a different shareholder class emerged—one which was diffuse, "atomistic", and geographically disperse. The phenomena called the "separation of ownership and control" by Adolf Berle and Gardiner Means in their seminal 1932 book "THE MODERN CORPORATION AND PRIVATE PROPERTY" was evident. Small shareholders had little influence over the affairs of the corporation, had little or no ability to exert meaningful oversight over management, nor were they able to easily replace directors or CEOs.

Management, seeking to exert an obvious self-interest in the nature and composition of the body which would serve to oversee them, dominated the board selection process. Unlike the initial stages of the American corporation, shareholders no longer had the ability to sit on the board of the companies they owned, and a class of "management captured" boards developed—board of directors consisting of numerous insiders, together with others considered sympathetic to the CEO and management. This condition existed for some time in this country, and corporations were able to grow and prosper despite this systemic flaw. While boards were losing their effectiveness as an oversight mechanism due to compositional dysfunction, the capital markets, and the takeover markets in specific, served as a surrogate. Weak or poorly performing companies were subject to takeover or management change.

However, in the mid to late 1980s, a variety of legal and structural processes changed the rules of the game. The effectiveness of poison pills and staggered boards served to insulate management from the takeover market as an accountability mechanism. Many boards lost independence, and in fact, several large public companies ran into difficulties as a result. From this period an increased awareness of the linkage between good corporate governance and firm performance was highlighted.

Contemporaneously, shareholders were re-aggregating in the form of large institutional investors, who were equipped with the ability to seek improvements in sound board practices. These institutions were required to vote their proxies in order to discharge their fiduciary duties. In many respects, the modern corporate governance movement began at this time. The last twenty-five years has been characterized by the drive to return boards directors to the original oversight role and away from the advisory role boards had devolved to over time.

I review this history because it gets us to where we can identify the attributes of sound modern corporate governance theory: independent boards properly incented with equity compensation (but no other financial ties to the corporation) and subject to open, fair and regular elections, are the best protection available to investors in a public corporation.

The reformation of the audit profession and the audit committee itself under Sarbanes-Oxley was a significant step along this journey—and relates directly to the first pillar of governance theory—board independence. The reforms contained in the listing standards of the exchanges and the recently adopted Dodd-Frank act have cumulatively served to dictate specific requirements regarding the composition of the compensation and the nominating and governance committees. This is not to suggest that the independence of these committee members is not important or meaningful to investor protection—it is—but rather to suggest that the PCAOB should consider the effect of the Proposed Auditing Standard against this background.

More specifically, it is important to remember that nothing in the reforms adopted in Sarbanes-Oxley or Dodd-Frank have diminished the legal mandate of the board to act as independent fiduciaries for shareholders. These responsibilities are delineated by state corporation laws, including Delaware General Corporate Law Section 141(a). Section 141(a) states, in part, the "business and affairs of … a corporation shall be managed by or under the direction of a board of directors…." (Delaware law is used as an example because of the majority of US corporations are incorporated in Delaware).

DGCL section 141(a) as amplified by the common law of the state vests the board with broad responsibilities to exercise board judgment, even in cases where shareholder majority votes may indicate a differing view. In fact, in the 2008 case of CA Inc. v AFSCME, the Delaware Supreme Court invalidated a shareholder initiated by-law amendment where the by-law would have the effect of eliminating the board's ability to exercise its judgment required by section 141(a) and case law. Such a by-law, it was ruled, eliminated board discretion, and consequently was invalid under Delaware law.

The takeaway from this case and the prevailing law guiding section 141(a) is that once elected, a board of directors should, and are indeed duty bound to, exercise independent thinking and judgment. Not even the owners of the corporation, its shareholders, can or should diminish this important obligation. In my assessment, federal regulations, including those promulgated by the US Securities and Exchange Commission should exist within the framework of these fiduciary responsibilities. Similarly, the Proposed Standard should seek to define the expectations of the external auditor, while not displacing the role of the board.

It is unquestioned that in the years since the adoption of Sarbanes-Oxley, the time commitment required of board members, and in particular audit committee members, has increased as process and requirements have grown. I raise the concern, and ask the PCAOB to consider, the extent to which the oral or most likely written communications required by the Proposed Auditing Standard, and the inevitable processes that will develop around those communications, may serve to diminish the board's ability to act as the independent bargaining agents that governance reform seeks. Where every communication with the auditor is mandated, and therefore in danger of becoming scripted, an audit committee moves further down the continuum toward being a group functioning largely to comply with federal mandates than one acting in the independent manner suggested by fiduciary theory and law.

As with a compensation committee, part of the value of the audit committee lies in its ability to "bargain" with the external auditor or to engage in, as the Proposed Auditing Standards puts it, two-way communication with the auditor. Will there be time for a typical audit committee member to digest the information required by the proposal (in addition to all the committee's other roles and responsibilities) within the context of a normal board meeting agenda? To engage in meaningful two way communication with the auditor there must be some incentive for the board to go beyond the red letter requirements of the rules. Will precious committee time be consumed by the process of the auditor going through each item in the Proposed Standard in exacting detail?

These are the balancing considerations I urge the PCAOB to consider as it completes the comment process and the analysis of this Roundtable. It is of course possible to have meaningful two way

communication between boards and auditors, where the auditor is subject to specific mandates, but the board, not being subject to PCAOB jurisdiction, is not. I recommend the PCAOB consider carefully the impact these standards will have on the board itself, and view that impact through the prism of state fiduciary duties, and modern corporate governance theory. In this way, the PCAOB can consider where on that continuum they would like the proposal to rest.

Thank you for the opportunity to share these remarks with you. I would be happy to answer any questions you may have, or to work with the staff going forward as the Standard becomes finalized.