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Governance, Regulation and the SEC

By Ronald Kral, CPA, CMA, CGMA
Managing Partner of Candela Solutions LLC

Not understanding your regulators is akin to getting married without knowing your spouse. There will be some surprises; however, adequate due diligence prior to the regulatory marriage is strongly advised. All businesses are subject to some degree of regulation, and the courts have confirmed that ignorance is not a good defense to fend of allegations of non-compliance. Officers and directors need to be especially astute of their obligations to creditors and investors, including regulators charged with protecting investors such as the U.S. Securities and Exchange Commission (SEC).

For example, when Michael J. Koss, CEO and former CFO of the Koss Corporation, violated SEC rules and regulations[1] he was ordered to reimburse the Koss Corporation $242,419 in cash and 160,000 of options pursuant to Section 304 of the Sarbanes-Oxley Act. The violations related to a wide-range of accounting fraud conducted by the Company's former Principal Accounting Officer and former Senior Accountant resulting in materially inaccurate current, quarterly and annual reports being filed with the SEC. The bonus reimbursement, together with Mr. Koss's previous voluntary reimbursement of $208,895 in bonuses to Koss Corporation represented his entire fiscal year 2008, 2009 and 2010 incentive bonuses. Not only was Mr. Koss personally held accountable for the regulatory violations, but the company faced a barrage of legal fees and negative press that weighed on their reputation.

Accepting key regulators as significant stakeholders to a company's success is embedded in the definition of corporate governance. Companies must strive for a culture of awareness through education and appropriate actions to stay within the good graces of regulators. Indeed, an organization's reputation is closely aligned with the success of dealing with regulations within the context of defining governance.

Corporate Governance Defined

Corporate governance, although a simple concept, can be challenging to fully grasp and implement. While there are many definitions of corporate governance, I define it as:

The decision making process of directing, managing and monitoring a corporation with the goal of creating shareholder value while addressing the interests of stakeholders such as: customers, communities, creditors, employees, suppliers, and regulators.

[1] Koss Corporation filed with the SEC current (8-Ks), quarterly (10-Qs), and annual reports (10-Ks) with the SEC that were materially false and misleading. According to the SEC Complaint, Mr. Koss "*knowingly or recklessly provided substantial assistance to Koss in its failure to keep accurate books, records and accounts, and in its failure to devise maintain a system of internal accounting controls, thereby aiding and abetting Koss' s violations of Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act [15 U.S.C. §§ 78m(b)(2)(A), 78m(b)(2)(B)].*"

The first part of this definition draws attention to decisions at the board, executive management and auditing (both internal and external) levels. A breakdown in any level can spell disaster. Consequently, companies need to have clear information, accountability, performance metrics and controls in place to make decisions in the best interest of owners.

Healthy independence is a central concept of governance. The “big-three” of directing, managing, and monitoring a company is analogous to the U.S. Constitution. The Constitution divides the powers of government into three branches, legislative, executive and judicial. Distinct roles are spelled out for each branch to keep the others in check. Corporate governance is not an exact parallel since the Constitution states that no single branch is to have ultimate power to control the whole. In the business world the board of directors, by definition, has ultimate authority of a company. However, there are many similarities as independence is woven into the fabrics of both the Constitution and sound corporate governance.

The second part of the definition should remind organizations that their success hinges on stakeholders. A stakeholder is an individual or organization who affects or can be affected by a company's actions. This is where corporate responsibly comes into play by integrating stakeholders' interest into the company's strategies, policies and actions. Companies are encouraged to draw into their governance process key stakeholder groups to develop “win-win” legal scenarios in an effort to generate revenue, create operating efficiencies, attract capital, and best reach objectives. Upon meeting objectives, companies are rewarded with;

- a stronger public image,
- greater customer loyalty,
- reduced employee turnover,
- healthy vendor relationships,
- more favorable capital options, and
- a lowered risk of adverse regulatory actions.

It is the last of these bullets that is the focus of this article – regulation.

Regulation

The concept of regulation is likely as dated as the dawn of mankind. Regulation is "controlling human or societal behavior by rules or restrictions[2]." Indeed in the book of Genesis, which is the first book of the Jewish Torah and the Christian Bible, God plants a garden and sets man there "to work it and watch over it," permitting him to eat from all the trees in the garden except the Tree of Knowledge of Good and Evil. This restriction, from arguably the earliest writings of mankind, is regulation by definition.

Regulation can take many forms. For business purposes it typically relates to legal rights and restrictions promulgated by government authorities. Government regulation attempts to produce outcomes which might not otherwise occur. It is a form of coercive action that has costs for some and benefits for others. When the collective societal benefits of regulation exceed costs, it is generally considered effective and

[2] Bert-Jaap Koops et al. Starting Points for ICT Regulations, Deconstructing Prevalent Policy One-liners, Cambridge University Press, Cambridge: 2006, p. 81

efficient. However, it is the differing interpretations of “societal benefits” that has led to countless historic wars and debates. One of those on-going debates has centered on the size and power of the SEC.

Creation of the U.S. Securities and Exchange Commission

Back to the definition of corporate governance, it is the context of “stakeholders” that is of most relevancy to a deeper dive of government regulation. An organization’s success is often directly tied to successfully responding to applicable rules and regulations. In the United States, while there are various governmental agencies at the state and federal levels to help protect investors, one clearly rises to the forefront and that is the U.S. Securities and Exchange Commission (SEC). Congress established the SEC through Section 4 of the Securities Exchange Act of 1934, codified as 15 U.S.C. § 78d.

The Act of 1934 was a complementary act to the Securities Act of 1933 that regulates original securities issues. The Act of 1934 regulates the secondary trading of those securities and collectively the two acts are referred to as United States federal securities law. The SEC was created to enforce federal securities law, including those enacted since 1934 such as the Sarbanes-Oxley Act of 2002 or significant portions of the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010.

The SEC’s Mission and Independence

The mission of the SEC is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.[3] This definition is consistent with the premises of:

- The laws and rules governing U.S. securities are intended to protect all investors, whether large institutions or private individuals;
- Investors should have access to certain basic facts about an investment prior to buying it, and as long as they hold it;
- Investors should be afforded a common pool of knowledge to use to judge for themselves whether to buy, sell, or hold a particular security; and
- Only through the steady flow of timely, comprehensive, and accurate information can people make sound investment decisions.

A Trend of More SEC Regulation

According to the SEC’s FY 2013 Congressional Budget request, the SEC has regulatory responsibility for approximately 35,000 entities. This consists of reviewing the disclosures and financial statements of more than 9,100 reporting companies; as well as direct oversight of 11,700 investment advisers, 9,700 mutual funds and exchange traded funds (ETFs), and close to 4,500 broker-dealers. This is a significant increase over the last decade. Between 2001 and 2005, Congress more than doubled the SEC’s funding level to increase the SEC’s workforce in response to the enactment of the Sarbanes-Oxley Act of 2002. The SEC experienced relatively flat budgets during the next couple of years followed by another upward trend beginning in 2009. President Obama's proposed budget for FY 2013 was released last month, which would appropriate $1.566 billion to the SEC. It calls for the full amount requested by the SEC, and an increase of $245 million above the agency's FY 2012 appropriation. If approved, it would permit the SEC to add approximately 676 positions, 191 of these positions earmarked for the SEC’s enforcement program.

[3] SEC website at http://www.sec.gov/about/whatwedo.shtml

This trend is not expected to ease anytime soon, especially with the passage of the Dodd–Frank Wall Street Reform and Consumer Protection Act (Pub.L. 111-203, H.R. 4173) signed into law by U.S. President Barack Obama on July 21, 2010. It is the most sweeping change to financial regulation in the United States since the Great Depression. The Act consists of sixteen titles within 2,319 pages. Considering the number of pages in relationship to the 67 pages of the Sarbanes-Oxley Act of 2002, one must wonder what unintended consequences loom. By one law firm's count[4], it requires that regulators create 243 rules, conduct 67 studies, and issue 22 periodic reports.

Regulatory Considerations for Companies

Regulatory requirements and trends need to be understood and acted upon to stay within the good of regulators, such as the SEC. Public companies are advised to take SEC laws and regulations seriously and leverage sound controls to help ensure compliance. Every organization is subject to some degree of regulation ranging from taxation compliance to employment law to industry specific regulation, such as the Food and Drug Administration or the Environmental Protection Agency. It is imperative for organizations to expand upon their risk management practices to take into consideration the ever changing regulatory landscape. The regulatory landscape is increasing in complexity, largely due to a volume surge in governmental rules and regulations. Companies must acquire the expertise to fully understand requirements and ramifications.

It is important to identify and keep track of all applicable regulations to your company. The number of jurisdictions and businesses that a company operates in is typically correlated with the number of laws and regulations applicable. Since ignorance is not a good excuse for non-compliance, it is imperative to know your regulators, their hot buttons, and who to talk to as questions arise. Gaining a robust comfort level of the regulatory landscape is something that should not be short-changed when crafting a budget and identifying resources. A leading practice is to create a risk matrix of key regulations and the probability and significance of associated failures and successes. This should be reviewed at management and board meetings to confirm if adequate resources are devoted to high risk areas.

Remember that disclosing accurate, timely, and complete information to the SEC and other regulators is not an option, but rather an obligation to owners and creditors. A misstep can be costly both in terms of a company's reputation and adverse legal actions. Keys to success are education, understanding regulatory objectives and associated risks, and having effective controls to deliver upon regulatory requirements. If there is a weakness in any one of these areas, now is the time for action.

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Ron Kral is the Managing Partner of Candela Solutions LLC, a public accounting firm with a national focus on governance, SEC compliance, and internal auditing. He is an educator, advisor, and internal auditor for boards and management teams. Ron is a member of 4 of the 5 COSO sponsoring organizations; the AICPA, FEI, IIA, and IMA. He can be reached at rkral@CandelaSolutions.com.

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[4] Davis Polk. (9 Jul 2010). Summary of the Dodd–Frank Wall Street Reform and Consumer Protection Act, Passed by the House of Representatives on June 30, 2010

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