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■ CORPORATE GOVERNANCE

Mitigating the Impact of a Material Weakness on the Election of Directors

A company's disclosure of a material weakness in internal controls over financial reporting can result in audit committee and other board members receiving negative voting recommendations from the proxy advisory firms. There are, however, steps the company can take to mitigate the impact of such recommendations.

By Jodi A. Simala and Candace R. Jackson

Where companies have disclosed repeated or ongoing material weaknesses in internal controls over financial reporting, or where a company's first material weakness requires a restatement of its financial statements, audit committee and other board members can receive negative voting recommendations from proxy advisory firms. There, however, are targeted disclosure and shareholder outreach strategies that mitigate the impact of material weaknesses on the election of directors.

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Relevant Viewpoints

Institutional Shareholder Services 2019 U.S. Proxy Voting Guidelines

When poor accounting practices have been identified, including fraud, misapplication of GAAP or material weaknesses, Institutional Shareholder Services (ISS) will determine, on a case-by-case basis, whether to recommend a withhold/against vote for audit committee members and potentially the full board of directors. In making its determination, ISS will consider the severity, breadth, chronological sequence and duration, as well as the company's efforts to remediate or take corrective action.

Glass, Lewis & Co. 2019 US Proxy Paper™ Guidelines

Glass, Lewis & Co. (Glass Lewis) typically defers to the judgment of the audit committee when assessing its decisions and actions and generally votes in favor of audit committee members. The quality of the financial statements and earnings reports and the effectiveness of internal controls generally serve as the barometer on which Glass Lewis assesses the audit committee. However, where accounting fraud, failures to timely file financial reports, financial statement restatements or material weaknesses occur, Glass Lewis may recommend a vote against all members of the audit committee.

Where a material weakness has been reported since the last annual meeting or is ongoing from a prior year and has not yet been corrected, Glass Lewis's policy is to consider whether to vote against all members of the audit committee. Glass Lewis takes into consideration the transparency of the audit committee report in the proxy statement in making its determination.

Mitigating the Impact of a Material Weakness on the Election of Directors

Proxy Disclosure

If proxy advisory firms view a company as transparent with shareholders, and the material weakness does not have a significant impact on the financial statements, it is possible that the proxy advisory firms will not make negative voting recommendations for the audit committee members.

ISS and Glass Lewis will only rely on a company's public disclosures in making voting recommendations, and Glass Lewis's voting guidelines specifically consider the transparency of the audit committee report in making its determination. It is important, and ideal, for companies to be proactive and use the proxy statement or other filings with the U.S. Securities and Exchange Commission (SEC) as an opportunity to address the material weakness in detail to avoid the negative voting recommendation. The audit committee report should answer these key questions:

- *What is the scope of the material weakness?* If the material weakness is limited to a very narrow issue (*e.g.*, accounting for income taxes or the proper classification of cash received from suppliers), be sure to highlight this fact.
- *Did the material weakness result in a restatement of the financial statements? Are the affected audited financial statements still fairly presented?* If the accounting errors resulting from the material weakness were immaterial and led to immaterial revisions of the financial statements, emphasize that a restatement was not required and the financial statements continue to be reliable.
- *Is the auditor's opinion affected?* If the auditor's opinion on the audited financial statements considered the material weakness and the material weakness did not affect the opinion on the financial statements, this is a good fact to clarify.
- *What steps has the audit committee taken in response to the discovery of the material weakness?* Disclose whether the audit committee engaged an advisor to conduct an independent investigation into the accounting errors. An independent investigation overseen by the audit committee demonstrates the audit committee's engagement and the seriousness with which the issue has been addressed.
- *What is the company's remediation plan, and what steps has the company taken to be transparent with shareholders?* Because transparency is a significant factor in avoiding a negative voting recommendation, it is important that the proxy statement not only explain the material weakness, remediation plan and other efforts being taken to improve internal controls, but also include references to the previous Form 10-K, Form 10-Q and Form 8-K disclosures that have been made to date. If the material weakness continues to be ongoing, explain what is required before the company will consider it remediated (*i.e.*, passage of time).

Additional Soliciting Material

Additional soliciting material (which can take a variety of forms, such as a proxy supplement, letter to shareholders, slides, script or talking points) can be used to provide shareholders with information about a material weakness to the extent not covered in the proxy statement. These materials must be filed with the SEC on EDGAR and posted online with the annual report and proxy statement by the date first used. In practice, this disclosure can have a positive outcome on the voting results, even when a company initially fails to address the material weakness in the proxy statement so as to avoid receiving negative voting recommendations from the proxy advisory firms.

For example, ISS recommended a vote against the members of one company's audit committee when the company did not address the material weakness in its proxy statement. The company filed additional soliciting material strongly disagreeing with the ISS recommendation and making the case for why shareholders should vote for the audit committee members. The company explained that the scope of the material weakness was limited to its income tax accounting and that the errors were immaterial and did not require a restatement of the financial statements, which continued to fairly present the company's financial condition and results of operations.

In addition, the company highlighted the transparency of its previous disclosure about the steps it was taking to remediate and enhance its internal controls, and reiterated those plans. The company also emphasized that its audit committee members were all qualified and that the committee had been vigilant in its oversight of the company's financial reporting and remediation efforts. The voting results showed that the ISS recommendation had a minimal negative impact on the final results for the audit committee members, each of whom was re-elected.

Similarly, after another company failed to address a material weakness in its proxy statement, Glass Lewis recommended a vote against its audit committee members. The company also filed additional soliciting material emphasizing that the material weakness was related to a very narrow issue. The company pointed out that it was the audit committee's oversight and decision to appoint the company's auditor that led to the discovery of the deficiency. The company then highlighted in detail the significant experience, skills and expertise of each audit committee member. Although the audit committee members received more votes against their election than other directors, the impact was small, and each was re-elected.

Shareholder Outreach

A proactive plan to engage in shareholder outreach is also helpful where a vote against directors has been recommended by the proxy advisory firms. A proxy solicitor can help a company to identify those of its large shareholders that do not strictly follow ISS or Glass Lewis recommendations and to make sure that these shareholders understand the nature of the material weakness, its impact on the financial statement, and the company's corrective efforts.

It is important to note that some institutions will not engage with companies during the proxy solicitation season due to workload and other constraints, so it is recommended that shareholder outreach be done as a supplement to (and not in place of) the preparation of additional soliciting material. In fact, the additional soliciting material can facilitate shareholder engagement because the material can be emailed to the company's contact at an institutional investor who might be too busy to schedule a telephone call or meeting but might be willing to read or pass along the material to others within the organization who are responsible for proxy voting.

Role of the Audit Committee

Generally, an audit committee does not participate in the design and evaluation of internal controls but does have a responsibility to oversee the audit and the financial reporting process. It is important that audit committees do not simply rely on the audit of the company's internal controls to identify significant deficiencies and material weaknesses before they result in a misstatement. In 2015, the Public Company Accounting Oversight Board (PCAOB) issued a communication to audit committees, *Audit Committee Dialogue*,[1] that reported that many audit opinions concluding that a material weakness had been identified had been issued concurrently with (or after) the company's disclosure of the related accounting error. In some cases, the error came to the company's attention from outside of the financial reporting process entirely, through a regulatory investigation or whistleblower activity.

The PCAOB recommended that audit committees proactively engage auditors in dialogue to help ensure that audits of internal controls achieve their objective to identify material weaknesses before a material misstatement occurs. Questions that the PCAOB recommended audit committees ask auditors include:

- What are the points within the company's critical systems processes where material misstatements could occur?
- How has the audit plan addressed the risks of material misstatement at those points?
- How will the auditor determine whether controls over those points operate at a level of precision that would prevent or detect and correct a potential material misstatement?
- What is the auditor's approach to evaluating the company's controls for significant unusual transactions or events, such as the acquisition of assets and assumption of liabilities in a business combination, divestitures, and major litigation claims?
- If the company enters into a significant or unusual transaction during the year, how will the auditor adjust the audit plan, including the plan for testing internal controls related to the transaction? For example, how would the company's acquisition of a significant enterprise during the third quarter affect the audit plan for the year? How might the auditor's materiality assumptions change?

Where a company or its auditor has identified a potential material weakness, the PCAOB recommended that the audit committee ask key questions of the auditor, including:

- What has been done to probe the accuracy of its description?
- Could the material weakness identified be broader than initially described?
- Could it be an indication of a deficiency or material weakness in another component of internal control?

Note

1. *https://pcaobus.org/sites/digitalpublications/audit-committee-dialogue.*