The high cost of "HERD MENTALITY"

Tim Leech analyses the current approaches used by regulators to prevent the next wave of corporate malfeasance. He suggests that more than a few approaches to regulatory reforms suffer from what he calls "herd mentality" and a lack of serious research to determine if the benefits to stakeholders are worth the massive costs imposed on public companies.

Over the past 30 years there have been waves of "bad" corporate behaviour involving elements of herd behaviour that resulted in new laws and regulatory actions to address what were perceived at the time as pervasive problems. The waves include serious corporate malfeasance in the mid 1980s on the part of a relatively small number of companies in the US. This resulted in the formation of the Committee of Sponsoring Organizations (COS0) Treadway Commission in the US, better known as the Treadway Commission. This led to the issuance of the world's first "control framework", the 1992 COSO Internal Control Integrated Framework (COSO 92). This was followed by a broader wave of fraudulent reporting and corporate misbehaviour around 2000, which culminated in the enactment of the Sarbanes-Oxley Act of 2002 and initiation of formal CEO and CFO certifications on accounting control effectiveness.This wave, in turn, was followed by the stock options back-dating scandal involving hundreds of public companies (still a relatively small percentage of all public companies). Most recently we've had the global financial crisis of 2008 which involved a considerably larger number of companies that brought about a massive wave of regulatory intervention in the form of new bank regulation rules, the Frank Dodd Act in the US, and new Securities and Exchange Commission (SEC) proxy disclosure rules that require companies to disclose how the company's board of directors oversees the effectiveness of the company's risk management processes.

These events in the US were sometimes accompanied by similar instances of corporate malfeasance in other countries, which, in turn, resulted in new corporate governance laws and regulations in Canada, Australia, Europe including the UK, and elsewhere.

Simply stated, a form of herd mentality driven by the behaviour of a relatively small number of "bad" executives/companies evoked a range of regulatory responses to improve corporate governance. The US focus on creating the appearance of taking highly visible steps to reduce similar events in the future was emulated by other countries fearing that their capital markets would be perceived as unreliable and risky by current and prospective investors – countries that didn't want to be seen as being left behind by the herd.

Unfortunately for investors, the relatively small percentage of corporate malfeasance and neglect resulted in the US in the imposition of SOX 404 reporting on "control effectiveness" by CEOs, CFOs for all public companies, and, for larger public companies, of even more expensive parallel control effectiveness certifications by external auditors. Other countries around the world, including Canada, Japan, and elsewhere, emulated the US and passed new laws that call for CEO/CFO representations on control effectiveness but do not require auditors to give parallel representations. Fortunately, in the UK there was less pressure to follow the US lead to enact costly CEO/CFO/auditor opinions on internal control effectiveness. The UK chose to take another route, calling for companies to report on whether they are or are not complying with the Combined Code. The UK herd was pointed in another direction.

The failure rate of SOX 404 control effectiveness opinions from CEOs, CFOs, and external auditors in the US to date has been shockingly high – as high as one in eight at the peak in 2006, evidenced by the need to restate financial stations previously certified as having less than a remote chance of a single material error. There continues to be regular ongoing illustrations of high profile SOX 404 control effectiveness certification failures (eg the majority of companies at the heart of the 2008 global financial crisis, MF Global, and others). Most recently, the global financial crisis of 2008, largely attributed to deficient risk management and board risk oversight, has exposed the fact that the majority of the companies at the root of the crisis had all been certified by their CEOs, CFOs, and auditors as having "effective" controls in accordance with the dated and largely obsolete 1992 COSO integrated control framework, including risk management controls.

It is important to recognize that the reactions of regulators around the world are representative of a strong form of herd mentality. The regulatory reforms ushered in by SOX 404 in 2002 and those created following the global financial crisis of 2008 were applied to the entire herd to address problems in only a small percentage of the flock. The broad brush Congressional/SEC regulatory responses in the US have been supported by other "herd leaders", including COSO, the Institute of Internal Auditors (IIA), external auditors, consultants, software vendors, attorneys, and related support industries that have emerged to support these broad brush regulatory responses.

The problems that evoked the regulatory responses described above were indeed serious and unquestionably did inflict trillions of dollars of harm on investors and other stakeholders. What is unfortunate is not that there was a regulatory response, but that the regulatory response herd leaders and their support herd leaders appear to show little interest in studying whether the massively expensive corrective actions imposed actually correct the problems targeted. Companies, their boards of directors, shareholders, and other stakeholders are asked to accept, largely on faith, that the benefits of the broad brush regulatory interventions are actually effective and exceed the massive regulatory compliance costs. An article filed by the author with the SEC and Congress titled *Preventing the next wave of unreliable financial reporting: why US Congress should amend SOX 404* (Leech and Leech 2011) provides more details on the weaknesses of the SOX 404 herd intervention in the US.

450 SHEEP JUMP TO THEIR DEATHS IN TURKEY

ISTANBUL, Turkey (AP) — First one sheep jumped to its death. Then stunned Turkish shepherds, who had left the herd to graze while they had breakfast, watched as nearly 1,500 others followed, each leaping off the same cliff, Turkish media reported. In the end, 450 dead animals lay on top of one another in a billowy white pile, the *Aksam* newspaper said. Those who jumped later were saved as the pile got higher and the fall more cushioned, *Aksam* reported. The estimated loss to families in the town of Gevas, located in Van province in eastern Turkey, tops $100,000, a significant amount of money in a country where average GDP per head is around $2,700. Source: ***www.usatoday.com/news/offbeat/2005-07-08-sheep-suicide_x.htm***

HERD MENTALITY DEFINITION

The term herd mentality is the word herd, meaning "group of animals," and mentality, implying a certain frame of mind. However the most succinct definition would be: "how large numbers of people act in the same ways at the same times".

Herd behavior is distinguished from herd mentality because it applies to all animals, whereas the term mentality implies a uniquely human phenomenon. Herd mentality implies a fear-based reaction to peer pressure which makes individuals act in order to avoid feeling "left behind" from the group. Herd mentality is also sometimes known as "mob mentality". Source: ***http://en.wikipedia.org/wiki/Herd_mentality***

To date there have been no serious attempts in the US to determine if the imposition of CEO and CFO reporting on control effectiveness imposed by SOX 404 (a), accompanied by external auditor control effectiveness representations (SOX 404(b)), actually produces more reliable financial statements for investors. Similarly, although there is now a widespread global push to force companies to adopt enterprise risk management (ERM) by regulators, credit agencies, institutional investors, and others through a range of tactics, there is limited real evidence that ERM, at least in the current "supply driven/risk-centric" form adopted by the majority of companies, will prevent another global financial crisis (see Leech 2012 for more details).

Unfortunately for shareholders, the majority of US listed public companies appear willing to follow the regulatory response herd leaders without any real challenge or demand for tangible evidence that they are choosing the right path. Few companies and few of the myriad associations that represent their interests like the National Association of Corporate Directors, Financial Executives Institute, IIA, American Institute of Certified Public Accountants, and others have called for, or supported, any serious efforts to study the effectiveness of the regulatory solutions imposed; nor do they show much interest in lobbying the government for more effective and less costly regulatory regimes for addressing the performance shortfalls. Complaining loudly about the cost of these new compliance regimes without any regard for tackling the serious problems that led to the regulatory intervention does not demonstrate much in the way of corporate social responsibility.

Perhaps Officers and boards of directors see following the rules imposed by regulators in response to the waves of corporate malfeasance as something that they must all do, regardless of whether it makes any sense – much like the herd of sheep that followed its leaders over the cliff in Turkey described in the news piece referenced above.

Senior executives and boards should take the time to study the root causes that resulted in across-the-board regulatory interventions and the actual effectiveness of the costly solutions imposed by regulators. Tangible efforts should be made to identify more effective solutions to the real problems and to convince the US government to enact better, more efficient, and effective corporate governance rules. Other countries around the world that have emulated the US regulatory path, including Canada, Japan, and others, would likely follow the US lead.

Although the UK has opted not to follow the US decision to require costly and ineffective opinions on accounting control effectiveness from CEOs, CFOs, and external auditors, it has been equally remiss in not carefully studying the costs and actual effectiveness of regulatory responses in the UK. Hundreds of UK companies now religiously update their "risk registers" each year to comply with rules calling for reports on the effectiveness of their risk management processes. There is little evidence that slavish adherence to the widespread practice of developing and maintaining risk registers is, in fact, resulting in better corporate governance. The only good news is that many of those companies creating and maintaining risk registers are spending a small fraction of the money public companies in the US are spending on complying with SOX 404 requirements to report on control effectiveness.

Following the lead of well-intended but misguided herd leaders that requires companies to adopt untested and ineffective corporate governance practices – practices that create the illusion of remedial action but don't actually work well – is massively costly to investors, even fatal in some instances. Investors take comfort in the direction the herd is heading, assuming, often with no basis in fact, that the herd must be heading in the right direction. Unfortunately, all too often, the regulators and organizations like the SEC, COSO, the Ontario Securities Commission in Canada, and others are heading in sub-optimal, sometimes fatal direction. Herd behaviour with little regard for whether the direction taken is optimal is certainly not in the best interests of the global village.

References

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