New accountability for corporate audit committees
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NEW Accountability FOR

Regulators put the burden of improved external audits on corporate directors.

The responsibilities of corporate audit committees are increasing in both number and complexity. This trend was well under way prior to the Enron debacle and will likely continue because of it.

Today's audit committees must meet strict criteria and adhere to rigid rules established by the Securities & Exchange Commission (SEC), the New York Stock Exchange (NYSE), and the National Association of Securities Dealers (NASD).

The growing body of rules is largely the result of recommendations formulated by the SEC's "Blue Ribbon Committee on Improving the Effectiveness of Audit Committees" and the AICPA (American Institute of Certified Public Accountants) Public Oversight Board's "Panel on Audit Effectiveness."

Public companies and stock exchanges have, in large measure, formally acted on the recommendations, presenting audit committees with a host of new, important concerns. Now audit committee members are likely to find their role in financial reporting increasingly prominent. Most are, more than ever before, true "corporate watchdogs" of the financial reporting community.

Former SEC Chairman Arthur Levitt initiated these reforms with his groundbreaking 1998 speech "The Numbers Game" in which he criticized corporate financial statement preparers and the independent accountants who audit financial statements. Levitt outlined a 10-point "action plan," which proved to be a significant harbinger of regulatory changes governing audit committee composition and responsibilities.

As a result, the SEC issued new and amended rules in its "Final Rule: Audit Committee Disclosure," which requires companies to make a series of disclosures in an audit committee report that must appear in the annual proxy statement of the corporation (see "A Summary of the Required Disclosures in an Audit Committee Report", p. 54).

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Corporate Audit Committees

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AUDIT COMMITTEE INDEPENDENCE

The NYSE imposed the requirement that audit committee members of its listed firms "have no relationship with the Company that may interfere with the exercise of their independence from management and the Company." The NYSE *Listed Company Manual* elaborates on relationships that could be deemed to compromise the independence of audit committee members. It further notes that audit committees of listed firms are to be composed solely of independent members.

The NASD likewise imposed new independence rules, some of which are more stringent, such as disqualifying directors from serving on the audit committee because of conflict of interests. For example, an attorney director can't serve on the audit committee if more than 5% or $200,000 of his/her firm's revenue is generated from the company on whose board he/she serves.

Moreover, the NYSE now requires its listed companies to attest to the financial literacy of each member of the audit committee, with criteria for assessing such literacy to be determined "in the Board's business judgment." The NYSE also requires at least one member of the audit committee to possess financial expertise, where the assessment is at the discretion of the board members. In addition, audit committees must consist of a minimum of three members.

The NASD's new rules in this area are similar to those of the NYSE. For example, they require that all members of the audit committee "be able to read and understand fundamental financial statements" and that at least one member have "past employment experience in finance or accounting, requisite professional certification in accounting, or other comparable experience or background." Like the NYSE, the NASD requires audit committees to consist of a minimum of three members.

While it seems intuitive that, given the scope of their

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financial oversight responsibilities, most audit committees already satisfy the basic financial literacy requirements of the NYSE and NASD, boards of directors must be careful not to assume the obvious. Making sure audit committee members have financial expertise is easy to do and crucially important.

INDEPENDENCE OF EXTERNAL AUDITORS

The Independence Standards Board (ISB) was created in 1997 through an agreement between the SEC and the AICPA and was disbanded in July 2001 after finishing its work, most of which was incorporated into the SEC's new auditor independence rules adopted in November 2000. The ISB issued Standard No. 1, "Independence Discussions with Audit Committees," which says that, at least annually, an auditor shall:

a. "Disclose to the audit committee of the company (or the board of directors if there is no audit committee), in writing, all relationships between the auditor and its related entities and the company and its related entities that in the auditor's professional judgment may reasonably be thought to bear on independence;
b. Confirm in the letter that, in its professional judgment, it is independent of the company within the meaning of the [Securities] Acts; and
c. Discuss the auditor's independence with the audit committee."

THE **SEC** HAS TAKEN AN **AICPA Auditing Standard** AND IMPOSED IT ON THE AUDIT COMMITTEE.

As you can see, the ISB Standard places responsibility with the independent auditors. But the SEC now requires audit committee members to address the issue of external auditor independence. The SEC's requirements pertaining to "Audit Committee Disclosure" specifically address the audit committee's responsibility in terms of the ISB Standard and require the audit committee to state (within its proxy statements) whether it has received from the auditors the independence disclosures required by ISB Standard No. 1 *and discussed with the auditors the auditors' independence.* Thus, it isn't sufficient for audit committees to merely acknowledge receipt of the auditors' independence disclosures; rather, the audit committee must speak to these disclosures in the proxy statement.

In addition, the SEC formally adopted new rules that "modernize the requirements

A SUMMARY OF THE REQUIRED DISCLOSURES IN AN Audit Committee Report*

1. A statement saying the audit committee is satisfied with the independence of the external auditors. This statement should include the fact that discussions with the external auditors were undertaken, culminating in a letter from the external auditors describing any relationships between the external auditors and the company that may diminish the external auditor's independence—in accord with Independence Standards Board Standard No. 1, "Independence Discussions with Audit Committees."
2. Attest that the audit committee communicated with the external auditors both in private and in the presence of the company's management in a manner and scope so as to comply with the AICPA's Auditing Standards Board's Statement on Auditing Standards (SAS) No. 61, "Communications with Audit Committees," as amended. SAS No. 61 requires that the communication include a discussion and review of the findings of the examination of the company's financial statements.
3. Indicate that the audit committee reviewed the financial statements of the company with management and the external auditors.
4. Recommend, based on all of the above procedures, the inclusion or exclusion of the audited financial statements in the annual filing with the Securities & Exchange Commission.

** This report must appear in the annual proxy statement of the corporation.*

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Enron's Audit Committee and the New Requirements

The main reason for mandating new rules for audit committees is to increase the quality of financial reporting. How well did Enron's audit committee satisfy these new requirements?

LITERACY/EXPERTISE

According to Enron's proxy statement pertaining to the May 1, 2001, shareholder meeting, all six members of the audit committee are "able to understand fundamental financial statements." This indicates that all members are financially literate. The proxy statement also indicates that at least one member qualifies as an expert in accounting or financial management. In fact, one member is a retired accounting professor, and another is a chartered accountant. By virtue of employment experience in high-level positions, two other members seem to qualify as experts under the new requirements. Last, one member appears to have expertise in the commodities market, a market that Enron participated in.

INDEPENDENCE

Enron's proxy statement states that all audit committee members are independent of the firm. Yet one member received a monthly fee of $6,000 for providing additional services to the firm. According to NYSE rules, this member can still be considered independent if, in the Board's judgment, the fee does not impair the member's ability to act independently.

COMMUNICATION WITH EXTERNAL AUDITORS

One of the new requirements is for the audit committee to discuss the quality—not just the acceptability—of the accounting principles used by the firm. The proxy statement does indicate that the committee and external auditors discussed all required matters per SAS No. 61, but no specific mention is made concerning the quality of the accounting principles used. In addition, the proxy states that the audit committee did discuss the auditing firm's independence as required under ISB Standard No. 1.

SUMMARY

As we show, Enron's audit committee was in compliance with the new audit committee requirements. But this may not indicate that the new requirements are ineffective at preventing misleading financial reporting. Rather, it shows that even the best internal control system can't prevent misleading financial reporting if the system is overridden.

for auditor independence" in three areas: 1) investments by auditors or their family members in audit clients, 2) employment relationships between auditors or their family members and audit clients, and 3) the scope of services provided by audit firms to their audit clients. Highlights of the new rules include a requirement for companies to disclose in their proxy statements certain information about nonaudit services provided by the company's auditors during the preceding fiscal year—such as fees paid for an audit, information technology, and all other services provided by their auditors during the preceding fiscal year. Also, companies must state specifically if the audit committee has considered "whether the provision of the nonaudit services is compatible with maintaining the auditor's independence."

The new SEC rules also identify nine nonaudit services that are viewed as inconsistent with auditor independence (seven had already been restricted by the AICPA, the SEC Practice Section of the AICPA, or the SEC). For example, an audit firm can perform up to 40% (measured in terms of hours) of an audit client's internal audit function. The new rules also address auditors' conflicts of interest. Inter-

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estingly, the new rules significantly *narrow* the scope of audit firm employees and relatives whose client relationships have traditionally been viewed as potentially compromising the auditor's independence. In contrast to the previous rules in this area, the new rules limit restrictions primarily to those firm employees or partners who work on the audit or who can influence the audit.

QUALITY OF ACCOUNTING PRINCIPLES

In one of its recommendations, the Blue Ribbon Committee called on the Auditing Standards Board of the AICPA for auditing standards that would require a company's outside auditor to discuss with the audit committee the auditor's judgment about the quality—not just the acceptability—of the company's accounting principles as applied in its financial reporting.

The Auditing Standards Board responded with Statement on Auditing Standards (SAS) No. 89, "Audit Adjustments," and SAS No. 90, "Audit Committee Communications." SAS No. 89 requires that financial statement adjustments resulting from the annual audit be booked in their entirety—without regard to whether the adjustments are individually or collectively material. The outside auditor is required to inform the audit committee of any adjustments that management fails to record.

SAS No. 90 amended sections of previously issued auditing standards SAS No. 61, " Audit Committee Communications," and SAS No. 71, "Interim Financial Information," to specifically require outside auditor review of interim financial statements prior to their release in Form 10-Q. SAS No. 90 further requires the outside auditor to discuss with the audit committee the auditor's judgments about the quality—not just the acceptability—of the company's accounting principles.

In response to Blue Ribbon Committee recommendations, the SEC requires companies to state in their audit committee reports published in the proxy whether the audit committee has "reviewed and discussed the audited financial statements with management." More specifically, the SEC's "Final Rule: Audit Committee Disclosure" requires audit committees to state whether "the audit committee has discussed with the independent auditors the matters required to be discussed by SAS No. 61, as may be modified or amended."

In other words, the SEC has effectively taken an Auditing Standard (which requires certain actions on the part of independent auditors) and imposed the same responsibility on the audit committee. And now because of SAS No. 90, proxy statement disclosures must specifically address the nature of these "accounting principle quality" discussions.

INTERIM FINANCIAL STATEMENTS

In his "Numbers Game" speech, Levitt expressed concern over the pressures companies face to meet Wall Street's interim earnings projections. Such pressures, he argued, sometimes lead to "earnings management" practices. Acting on Levitt's concern, the Blue Ribbon Committee recommended that the SEC require outside auditor review of interim financial information prior to the filing of Form 10-Q. The SEC did just what the Committee recommended.

Even before this requirement, the Big 5 public accounting firms had subjected their clients' interim statements to auditor review; in fact, review of interim statements was a condition of the audit engagement. Thus, for audit committees who are accustomed to interacting with the Big 5, the new SEC requirement presents nothing new. But for audit committees who have traditionally enlisted the services of non-Big 5 firms, the requirement could mean more frequent communication with the outside auditors and a greater level of involvement in the financial reporting process.

Overall, audit committees must now take a more active (and proactive) role in matters they may previously have viewed with relative passivity. You could argue that audit committees have become the "pseudo auditors" of the new millennium. More than ever before, audit committees truly are the "corporate watchdogs" of financial reporting. Their enhanced role should improve corporate financial reporting and thereby make the capital markets more efficient. But more accountability may still be ahead for audit committees. ■

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