

October 18, 1999

Audit Committees - Some Observations

The SEC initiative to “improve” audit committees has resulted in new rule proposals by the SEC and the NYSE. The proposals are summarized and commented upon in our October 15 memo. This memo highlights our serious concerns with some of the proposals.

Cold Comfort. The requirement that the proxy statement contain a report from the audit committee that nothing has come to its attention that would lead it to believe there were material misstatements or omissions in the company’s financial statements goes beyond conformity of the financial statements to GAAP. Where there are significant issues, the audit committee may want independent legal and accounting advice with respect to this certification. We can even envisage the audit committee engaging another firm of accountants to review the certifying firm’s work papers.

Lawsuits, Real and Strike. Despite the limited safe harbor proposed by the SEC, there will be an increase in lawsuits against audit committee members. Perhaps the D&O insurance carriers will develop special policies or riders to cover some or all of this exposure. In any event, audit committees will need to develop and implement special procedures to establish that they met the new standards and protect their reputations.

Financial Literacy. The requirement that all audit committee members be financially literate, and that one member have accounting or related financial expertise, limits the talent pool of director candidates. The extra responsibilities of the audit committee may ultimately result in a bifurcated board with the audit committee members focusing mainly on accounting issues and devoting far more time to their duties than the other directors.

Auditor Independence. The greatly increased attention to independence of the auditor and the new audit committee disclosure requirements regarding auditor independence may motivate audit committees to avoid any definitional issues and restrict the audit firm from providing consulting and other services to the company. Perhaps mandating such separation and insisting on real independence is all that is necessary to assure reliable financial reporting. A truly independent auditor, applying SEC approved accounting principles, is far more likely to assure reliable financial reporting than the convoluted system mandated by the proposed rules.

Tension. The proposed rules change the role of the audit committee from that of a safety valve for the outside auditors and monitor of management’s financial reporting and compliance to that of a special board of assurance with respect to the accuracy of the financial reporting. To meet the requirements of the proposals, the audit committee (probably assisted by its own accounting and legal advisors) will, in many cases, be involved in a continuous process with the management of the company and the outside auditor. Is this feasible? Is this desirable? Even if it improves financial reporting, will it result in serious diversion of management’s attention to the detriment of the business of the company?

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