

December 8, 2000

New Burdens for the Audit Committee:  
The Revised SEC Rules on Auditor Independence

The SEC has again imposed new duties on audit committees. Less than a year after the adoption of some of the recommendations of the so-called Blue Ribbon Committee, the SEC has now added new duties and disclosure requirements. The cumulative effect of these actions is greater exposure to shareholder strike suits, greater difficulty in recruiting directors and greater difficulty in having directors serve on audit committees, with no significant increase in the quality of financial statements and no real increase in protection against fraud. These new obligations result from the SEC's inability to effectively police accounting standards and to reach a satisfactory resolution on the division of accounting and consulting services within accounting firms. They reinforce the concerns we expressed last year following the issuance of the Blue Ribbon Committee Report: that the SEC is making the audit committee into the super-cop of accounting, by improperly shifting responsibilities to audit committees from the external auditors and management which have the core competencies to resolve these difficult issues. (See our June 11, 1999 memorandum, "A Cautionary Approach to the 'Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees'".)

The SEC's new rules on auditor independence (Release No. 34-43602, November 21, 2000) require new disclosures in proxy statements filed after February 5, 2001, including:

- Aggregate fees billed for the most recent fiscal year for each of the following categories of services:
  - audit and review of the company's financial statements,
  - financial information systems design and implementation services performed by the company's principal accountants, and
  - all other services provided by the company's principal accountants
- Whether the audit committee has considered whether the provision of non-audit services described above is "compatible with maintaining the principal accountant's independence"

The SEC asserts that the rule does not impose additional legal requirements on the audit committee, but merely establishes standards against which to benchmark the audit committee's exercise of business judgment. However, the SEC acknowledges that the new rule, in conjunction with the changes adopted by the SEC and the exchanges last year, "should encourage auditors, audit committees and management to conduct robust and probing discussion on all issues that might affect the auditor's independence." The SEC independence standard combines a very detailed but non-exclusive list of activities or relationships that may not be

undertaken by the company's principal accountants, with a general standard that an accountant is not independent if the accountant is not, or if a reasonable investor knowing all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement. Since the new SEC rules seek to define independence as a matter of both fact and appearance, it becomes a very difficult task for the audit committee to determine the "compatibility" of non-audit services with independence. The scope of the audit committee's responsibilities in considering the impact of non-audit services on the auditor's independence is suggested by the SEC's endorsement in its Release of the following factors, offered by the Panel on Audit Effectiveness, for an audit committee to consider:

- whether the service facilitates the performance of the audit, improves the client's financial reporting process, or is otherwise in the public interest;
- whether the service is being performed principally for the audit committee;
- the service's effects on audit effectiveness and on the quality and timeliness of the company's financial reporting process;
- whether the service would be performed by audit personnel and specialists who also provide recurring audit support and whether such performance would enhance the audit personnel's knowledge of the company's business and operations;
- whether the audit personnel's role in performing the service would be inconsistent with the auditor's role;
- whether the audit firm's personnel would be assuming a management role or have a mutuality of interest with management;
- whether the auditors would be in effect auditing their own numbers;
- whether the project must be started and completed very quickly;
- whether the audit firm has unique expertise in the service; and
- the size of the fee.

The additional responsibilities imposed on audit committees in the last year, combined with the audit committee's on-going financial, compliance and oversight duties, impose a substantial burden on audit committee members, particularly in the case of large companies with multinational operations. Companies will face increased difficulty in recruiting or retaining audit committee members with enough time, expertise and dedication to be effective. In response to these developments, we recommend that companies consider taking several steps:

1. *Enhance compensation for audit committee members.* The new responsibilities that the audit committee must now shoulder will require a substantial time commitment, in many cases well over one hundred hours per year. Service on an audit committee will usually involve substantially more time than service on other board committees. We suggest companies recognize this burden and enhance compensation for audit committee members.
2. *Assign a member of the general counsel's office to work with the audit committee.* The rules adopted over the last year impose complex responsibilities on audit committee members. Moreover, given the increasing importance of accounting standards in the SEC's agenda, more rules may be implemented in this area. Thus, it is important that the audit committee build expertise and experience. A member of the general

counsel's office would help audit committee members to keep abreast of the current regulatory regime and would provide institutional knowledge to assist the audit committee members in accomplishing their work.

3. *Require advance approval by the audit committee of the provision of non-audit services by the principal accounting firm.* The audit committee must make a difficult determination, considering all of the relevant facts and circumstances, of whether non-audit services are compatible with the auditor's independence. To provide effective oversight, we recommend that companies establish a policy requiring advance audit committee approval of each non-audit service provided by its principal accounting firm that exceeds a specified dollar threshold (for example, 10% to 15% of the total auditing fees). Alternatively, some companies may consider precluding the accounting firm from providing any non-audit services to the company.

Although the SEC last year provided a limited safe harbor for the required audit committee disclosures in the proxy statement, including whether the audit committee has received auditor disclosure regarding the auditor's independence and discussed with the auditor the auditor's independence, the SEC failed without explanation to extend the same safe harbor to the additional disclosure regarding the consideration of non-audit services. This is an oversight that should be corrected by the SEC.

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