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Audit Committee Alert: Some Additional Procedures

Federal securities law and state corporation law protect directors who rely on the advice of outside experts in such matters as law and accounting. In the performance of their duties of diligence, monitoring the performance of management and monitoring disclosure, directors can rely on experts as to whom the directors have no reason to doubt competence or loyalty. However, if there is a question about either competence or loyalty, the protection may be lost.

The Enron/Andersen situation, and other recent problems of the big-five accounting firms, give rise to a concern that a court may in a future lawsuit against the directors of a corporation that has accounting or disclosure problems of the Enron type find that the directors, particularly the directors who were members of the audit committee, needed to do more than just accept the expertise of its accountants on the basis that they were a big-five firm. Further, such a court might also question whether the directors did enough to assure loyalty and absence of conflicts if they did not establish rules to regulate the corporation's hiring of partners or managers of the accounting firm.

Accordingly, in addition to the matters referred to in our earlier audit committee memoranda, we recommend that the audit committee establish procedures for a review of the competence of the key partners and managers of the accounting firm who are responsible for the audit. This should be done each year and be reflected in the minutes of the audit committee and reported to the full board. The audit committee should review (1) the resumes of the key partners and managers, (2) a description of the quality control procedures the firm has established and (3) a report from the firm describing any material issues raised by the most recent quality control review of the firm and describing the steps the firm has taken to deal with any reported problems. In cases where the review raises questions that the committee does not feel are adequately answered, it may be desirable to consult an accounting professor or other totally independent accountant to assist in the review.

To deal with the loyalty issue, we recommend that the directors adopt a formal policy of not hiring from the accounting firm any partner or manager who worked on the corporation's account during the past three years. With respect to existing corporate employees who were previously partners or managers of the accounting firm, the audit committee should request that the corporation's general counsel conduct a review and advise the committee as to whether any special steps should be taken. This too should be reflected in the minutes of the audit committee and reported to the full board.

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