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Audit Committees: The Views of the Chief Accountant of the SEC

In a March 7, 2002 speech, Robert Herdman, the Chief Accountant of the SEC, set forth his views of the way an audit committee should function. The following outline summarizes those views.

1. “Audit committee members simply must ask the tough questions of management and of the internal and external auditors. And, they have to understand the sometimes highly complex information and results put before them.”

2. The audit committee “should have the power to hire and fire the auditors.”

3. The “auditors should look to the audit committee [and not management] as the client.”

4. The “audit committee must evaluate the competence and independence of the external auditors.”

5. The “audit committee members need to probe to find out the nature and extent of issues that management and the auditors gave considerable attention to. It is not enough to merely be told there were no reportable disagreements.”

6. The audit committee should oversee and use its judgment with respect to the company hiring key audit firm personnel into key positions.

7. The audit committee should understand and assess the effectiveness of the internal audit. “And when internal and external auditors suggest improvements in controls, there should be compelling reasons why they are not adopted.”

8. The audit committee should consider the size “of the audit fee as a way to monitor whether the scope of the work is sufficient.” The audit committee should compare the fees disclosed in the proxy statements of peer group companies.

9. “The audit committee should ask for and receive frank assessments of the competence of financial management.”

10. “Audit committees should be the champions of corporate codes of conduct and, in particular, should be wary of granting exceptions to these codes.”

11. “The audit committee must be given direct, unfettered, independent access to management, internal auditors, and external auditors. The audit committee must be able to communicate in confidence with these three groups independently of each other.”

12. “[A]udit committees need to engage in proactive discussions with company management and outside auditors regarding key accounting judgments.”

13. "Audit committee members cannot walk away if they don't understand a material transaction, the economics, or the accounting behind that transaction, no matter how complex. And here it's the overall presentation and economic effect that absolutely must be understood, with as much supporting details as necessary and appropriate."

14. "[I]n understanding critical accounting policies, it is important to be able to explain the range of results that would be followed, if alternate accounting methods had been used, and why the particular method was chosen."

15. Borrowing from Warren Buffett, the audit committee should discuss and document in the minutes these three questions to the auditor:

    a) "If the auditor were solely responsible for preparation of the company's financial statements, would they have been prepared in any way different than the manner selected by management? The audit committee should inquire as to both material and nonmaterial differences. If the auditor would have done anything differently than management, an explanation should be made of management's argument and the auditor's response.

    b) "If the auditor were an investor, would he have received the information essential to a proper understanding of the company's financial performance during the reporting period?

    c) "Is the company following the same internal audit procedure that would be followed if the auditor himself were CEO? If not, what are the differences and why?"

16. "Audit committee members must make the time, and take the time, to achieve an adequate understanding of what the company's financials represent, to have enough time to consult with outside counsel and experts if necessary, to ask the tough and incisive questions, and to obtain answers that make sense. As such, an effective audit committee requires a commitment of quality and quantity time: quality time in that they will give the critical corporate governance and accounting and disclosure issues their full attention, and quantity of time to allow thorough deliberations and discussion. This means that proper upfront planning, conduct of meetings and follow-up are essential.

    It also means that spending an hour together three and four times a year probably is not sufficient. The critical accounting policy exercise . . . outlined above undoubtedly requires more time than that alone. Reading the financial statements and MD&A for clarity and understandability, for purposes of making a recommendation to the full Board, requires more time than that alone."

M. Lipton