Enhancing Policies and Procedures of the Audit Committee

By Charles H. Baker and Kristen M. Dunker

In late 1999, the Securities and Exchange Commission and the U.S. stock exchanges adopted new rules and standards to improve disclosure relating to the function of audit committees and to enhance the reliability and credibility of financial statements of public companies. As the problems of Enron and other companies have unfolded in recent weeks, the reliability and credibility of public company financial statements have come into question. While much of the blame has been placed on executives and independent auditors, many have criticized the board of directors, and particularly the audit committee, which is designed to play a critical role in a public company’s financial reporting system by overseeing and monitoring management’s and the independent auditor’s participation in the financial reporting process. The criticism does not lie with the sufficiency of the current rules and standards of the SEC and the U.S. stock exchanges relating to audit committees, but rather with audit committees’ lack of understanding of what their duties are and that these committees should be more aggressive and vigilant in carrying out their duties.

In light of Enron and current guidance from the SEC, many public companies are re-evaluating the procedures and practices of their respective audit committees and reconsidering the protections the audit committee should provide. Public companies and analysts are focusing on: (i) the composition of the audit committee; (ii) the audit committee’s role in managing the relationship between the company and its independent auditor; (iii) the audit committee’s procedures for identifying and evaluating potential problems; and (iv) the audit committee’s review and evaluation of critical accounting policies.

The Composition of the Audit Committee

Having the right directors on the committee, with the right mix of knowledge, judgment, independence, and commitment is key to the committee effectively carrying out its responsibilities. Much media attention has been focused on the individuals who made up Enron’s audit committee. Certain critics are asking questions about the individual committee members’ independence, including how much Enron stock they owned, and their financial sophistication. The following are some steps to take to ensure the optimal audit committee composition:

- Make sure committee members are non-employee, independent directors;
- When filling board vacancies consider CFOs and other financial executives with requisite sophistication regarding financial matters; and
- In order to arm committee members with an appropriate knowledge of financial reporting and company financial systems, implement an orientation for new committee members and ongoing training for all committee members.

Managing and Evaluating the Relationship between the Company and its Independent Auditor

The following is a list of proactive steps that the audit committee should undertake to properly manage and evaluate the relationship between the company and its independent auditor:

- Recommend to the board of directors the selection, retention or, termination of the company’s independent auditor;
- Evaluate the performance of the independent auditor on an ongoing basis and consider rotating accountants on a periodic basis;
- Review the experience and qualifications of members of the company’s internal audit team;
- Discuss with the independent auditor the quality of the company’s financial and accounting personnel;

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• Discuss with management the responsiveness of the independent auditor to the company’s needs;
• Implement company guidelines for hiring employees of the outside auditor who previously worked on the company’s account; and
• Consider separating auditing and consulting work. In order to avoid the perception that auditor independence has been compromised, some companies are deciding that, as a matter of policy, they should not have any ties to their independent auditor beyond the audit function.

Undertaking these steps will help ensure that both management and the independent auditor are doing their jobs and that the company is working with the right auditing firm. It is important that the audit committee minutes accurately reflect that consideration was given to each of the tasks listed above.

Identifying and Evaluating any Potential Problems
A few years ago, Warren Buffett proposed questions an audit committee should ask its independent auditors: (i) if the independent auditor were solely responsible for preparation of the company’s financial statements, would they have been prepared differently, in either material or non-material ways? If so, the auditor should explain both management’s position and its own; (ii) if the auditor were an investor, would he have received the information essential to understanding the company’s financial performance during the reporting period?; and (iii) is the company following the same internal audit procedures that the auditor would follow if he were CEO? If not, what are the differences and why?

The audit committee should meet with auditors, outside the presence of management, quarterly and ask questions such as those listed above in order to identify any potential problems. The questions and answers should be accurately documented in audit committee minutes.

Reviewing and Understanding the Company’s Critical Accounting Policies
In December of 2001, the SEC issued a release entitled “Cautionary Advice Regarding the Quality of Disclosure about Critical Accounting Policies” (Release No. 33-8040, December 12, 2001). “Critical” accounting policies are defined to include those most important to the portrayal of a company’s financial condition and results of operations, and they require management’s most difficult, subjective, or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain. In this statement, the SEC encourages public companies to include in their Management’s Discussion and Analysis of Financial Condition and Results of Operations this year, full explanations, in plain english, of their critical accounting policies.

Further, the SEC announced on February 13, 2002, that it intends to propose changes in corporate disclosure rules as the first in a series of steps designed to improve the financial reporting and disclosure system. One of these proposed changes is to require disclosure of critical accounting policies in MD&A. The SEC has indicated that it intends to move far more rapidly than it has in the past, with new rules likely to be enacted within months, which means that it is very likely that the disclosure of critical accounting policies will be mandatory for 2002 annual reports. It is important that audit committees begin the process of understanding these policies and consider including the disclosure in the company’s 2001 annual report.

In recent articles, Harvey Pitt, chairman of the SEC, discusses the role that the audit committee should undertake in connection with evaluating a company’s critical accounting policies. The committee should understand why critical accounting policies were chosen, how they have been applied, and that the disclosure fairly presents the company’s financial status. The audit committee should carefully review the critical accounting policy disclosure that will appear in the MD&A and should meet with both management and the independent auditors for questions and/or clarification of these policies.

Conclusion
In order to enhance investor confidence in company financial reporting and the stock market generally, companies should be re-evaluating the policies, procedures, and practices of their audit committees. The practical suggestions enumerated above should be helpful in that regard.

Please feel free to contact us if you would like assistance in reviewing the policies and procedures of your audit committee or with implementing any of the suggestions in this Client Alert.

Charles H. Baker, (212) 318-6250 or charlesbaker@paulhastings.com;
Barry A. Brooks, (212) 318-6077 or barrybrooks@paulhastings.com;
Thomas L. Fairfield, (212) 318-6432 or thomasfairfield@paulhastings.com;
William F. Schwitzer, (212) 318-6400 or williamswc@paulhastings.com;
Michael L. Zuppone, (212) 318-6906 or michaelzuppone@paulhastings.com; or
Kristen M. Dunker, (212) 318-6467 or kristendunker@paulhastings.com.