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How audit committees should work

A. A. Sommer
How Audit Committees Work

by A.A. SOMMER, JR./Chairman, SEC Advisory Committee on Corporate Disclosure

It has been suggested that the accounting portions of the Foreign Corrupt Practices Act represent one of the most massive and widespread intrusions of the government into the process of corporate governance that has yet occurred. That may be a slight overstatement, but there is no question that it represents a new tool in the hands of the SEC. That the SEC is going to utilize these powers is obvious. What is of concern to everyone involved in the process of corporate governance is what will be required as a result of these new demands. And among those people, obviously, are corporate directors.

What are the concerns of directors? Since I am on two audit committees myself, I believe I have more than a passing interest in the subject. There is no question that everyone involved in the corporate community has a responsibility for maintaining accurate information concerning a firm's assets and operations. The chief executive officer has it. The board of directors has it. And the auditors have a responsibility, as well.

However, it seems to me that the literature being developed for directors has been very abstract, much too general, and grossly unrealistic. We need a clear, simple, more precise answer to what one can reasonably expect from a board of directors in regard to internal controls.

Let me try to put those statements into some sort of perspective. First, many are losing sight these days of the fact that internal controls constitute only one of many problems that directors and management must deal with. Internal controls, one might even say, are not a director's major responsibility. His major responsibility, in my eyes, is to monitor the management of the company—to make sure that the company functions in an effective, economic fashion, producing goods and services and earning a profit.

The second proposition that I would spotlight is that there are general rules that govern the manner in which corporate directors must meet their commitments; and the rules with regard to internal controls are no different than those with regard to other areas of directorial responsibility. Directors must be apprised of how to fulfill these newly defined responsibilities. And they must be guided by those who are in the best position to do so—namely, outside counsel, outside auditors, and to some extent the internal audit staff and the chief financial officer.

My final proposition is that in this day, when there is considerable pressure upon corporations to include on their boards people who may not have financial sophistication, the problem of internal controls should be explained to the board—and even to the audit committee—in very basic, very simple terms.

The Board's Role

Now, let's relate the general rules that govern directors to this whole problem of records and controls. Most corporation laws today speak of the board of directors as managing the corporation. But everybody knows that that doesn't mean what it says. What it really means is that they are there to monitor management. They are to review what management is doing. They are in some areas to direct management. But they are not going to be involved in the day-to-day running of the company, nor in the day-to-day implementation of internal control systems. Specifically, they should participate in developing the objectives of the corporation, they should help determine whether or not the objectives are reasonable, and they should review whether or not those objectives are being met.

There is much involved in this, of course. There is the accountability of the corporation to its shareholders, to its employees, to the SEC, and to the communities in which it operates. The shareholders, of course, are at the core of this entire process. They are the ones whose money is at stake, and they are the principal body to whom accountability must be directed.

Now, how does the monitoring by directors impact the problem of internal controls? I have read some literature that suggests that the outside directors, and more particularly the audit committee, should become involved in the day-to-day implementation of internal controls. I would hope that is not the law. It is management's responsibility to establish and operate the internal control system, just as it is management's role to develop manufacturing facilities and a sales capacity. The outside director's responsibility is to oversee this, which includes a monitoring responsibility for the financial side of the business. And a part of that financial side, the reporting side of the business, involves the integrity of internal controls.

Now, what does that mean? What do directors actually have to do? I'm not going to give you a litany of steps
to insure that directors will be above criticism for the manner in which they perform this monitoring function. But I will suggest to you some of the things that they should do.

First of all, the concept of internal controls may need to be handled almost at the level of a Dick and Jane presentation. This may be offensive to some people who are quite familiar with controls. But the fact is that today there is a desire on the part of many companies to appoint to the board of directors people whose disciplines are not financial disciplines, not even business disciplines.

For example, these directors should understand whether or not the particular company has a system; for there is a difference between "internal controls" and "a system of internal controls." A "system of internal controls" implies a clear and complete set of reporting and authorization responsibilities. The system will generally be committed to writing, and there will be people responsible for updating it. It will be organized. There will be accountability within the system, and the pieces will fit together.

Second, the directors ought to know who has the ultimate operating responsibility for the internal control system and how he conceives of his responsibility. How well can he articulate what it is he thinks his job is?

The directors, unless the duty is to be delegated to the audit committee, must also determine whether or not the person responsible for internal controls is competent. Is he a leader? Is he able, for example, to pick skilled people?

Another item to determine is whether or not there is adequate staffing. That is a serious problem today. I am on the boards of companies that are experiencing great difficulty—largely due to the introduction of the Foreign Corrupt Practices Act—in hiring people for their internal auditing staffs. There is fierce competition for people that have competence in this area.

What is the responsibility of directors in their internal control monitoring function? Briefly, they must exercise due care, which means that they must conduct themselves in the fashion in which an ordinarily prudent man would conduct himself in handling his own affairs. Those who are not lawyers may think this is a terribly general standard, but every effort that I know of to flesh it out in a meaningful way has foundered. Such efforts have ended up with either an additional four or five general rules or rules so particular that they become ridiculous. In any event, no director can guarantee that an internal controls system is going to work, or that the corporation's conduct is in compliance with the law, for that is not the standard against which a director is to be measured.

The Audit Committee's Role

Since it has become increasingly common to delegate certain board responsibilities to one committee or another, the audit committee has come into sharp focus. My own opinion is that boards are tempted to delegate too much responsibility to audit committees. Indeed, there is a great deal of controversy today about whether or not a person on an audit committee assumes greater responsibilities and must conform to higher standards than non-committee directors. I would suggest that the standard is not different, but that there is a difference in the weight of responsibility.

An audit committee member receives greater insight into certain problems of a company than do other directors, and he must utilize that knowledge in carrying out his duties on the audit committee. That's com-
Common sense. Anybody who has a fiduciary responsibility must use the knowledge that he gains, as well as the knowledge that he brings to the task, in carrying out his responsibilities.

What about the duties of the non-committee member? Can he rely upon the audit committee? Yes, he can, as long as he has used reasonable care in the selection of the people who are on the audit committee, and as long as he supervises them in a reasonable fashion. If he exercises such care, but nevertheless the audit committee acts irresponsibly, he is not held responsible. But obviously, if the audit committee's lack of responsibility becomes a subject of litigation, there is going to be a spotlight on the care which the non-committee members did exercise.

Why would the board delegate the monitoring of internal controls to the audit committee, if it is so important? There are several reasons. One of them is simply the economy of time. Directors today in complex companies cannot be expected to familiarize themselves with all facets of a company's business. The result has been that large companies like General Motors and General Electric have developed a rather sophisticated committee system that fosters a delegation of responsibilities. This is not to suggest that the directors on those committees can be indifferent to the matters before those committees, but it does mean that they are not expected to have as great a knowledge in the areas in which those committees are operating. If a director of General Motors had to become familiar with every facet of the company's business, for example, it would obviously be a far more demanding job than it presently is, and it might be correspondingly more difficult to secure high caliber people to serve in that role.

Another reason the board delegates responsibility to an audit committee is that it provides an opportunity to utilize the skills and experience of certain people who are members of the board. There is a growing tendency to draw upon retired accountants as directors, for example. They make, in my estimation, absolutely superb members of audit committees, because, among other things, they know what internal controls are.

Indeed, when a board selects the members of an audit committee, it should tilt in the direction of people who have such financial sophistication. One might wonder whether or not this is a good policy. Shouldn't there be a rotation policy on committees? Yes, but I think that the integrity of the financial reporting process should require that the people who have the particular competence be the ones to serve on that committee.

That audit committees consist only of independent directors is a very desirable thing. It's a lot easier for an audit committee without members from management to sit down with the internal auditor and the outside accountant and say: Is anybody in management interfering with you? Is anybody pulling back on you? Are you sufficiently staffed? Have you run into trouble with budgetary considerations? Do you feel you're getting enough money?

Now, what should the audit committee of the board do? First of all, it should be recognized that it is going to be dependent upon members of the management team. Its members cannot go down into the bowels of the corporation and ferret out deficiencies in the internal reporting system. I think it's unreasonable to expect them to do that. Whom do they rely upon? I think they largely rely upon the internal auditor, and this is why I have placed so much emphasis on getting to know him and having confidence in his ability and his integrity. Of course, the audit committee must rely as well on the external auditor, who has the responsibility of reporting to management any deficiency in controls that is discovered in the course of the audit. Obviously, the audit committee should be apprised of anything that is found at that time. Indeed, the external auditor should be interrogated regularly by the audit committee—or the board, if there is no audit committee—concerning what he has found.

As I mentioned, the board members, and especially audit committee members, should understand what internal control is all about. They should know what system exists in the company and be familiar with it. They should determine if there is a manual on internal controls. Is it kept up to date? And does the system reflect problems that have recently emerged? Is it a static system or is it updated? How long has it existed, and when was it last reviewed? And finally, how competent are the people who run it?

How does an audit committee actually monitor the fiscal activities of a company? First, I believe the internal auditor should report to the committee as well as to the chief executive officer. Suggestions have been made that he should report only to the audit committee. I think that is a mistake, because the CEO is responsible, too, for an internal control system.

Incidentally, at one company I am acquainted with the audit committee reviews the bonus of the head of internal auditing. In fact, it also reviews his entire compensation, so that management can place no pressure upon him through these means.

Either the audit committee or the board—for simplicity's sake, let me refer only to the audit committee—should meet periodically with the internal auditor. In a sizeable company, there should probably be two or three
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meetings a year. In addition, there ought to be periodic reports from the internal auditor concerning what his team is doing—what audits they are conducting internally, what divisions they have been to, what problems they have identified.

Shortly after the Foreign Corrupt Practices Act was enacted, I received a report from the internal auditor of one of the companies on whose board I serve. In several places, it spoke of serious deficiencies in the controls of this division or that operation. I called the auditor up, and I suggested that while that kind of language was appropriate in private meetings, I certainly didn't want to see it in his report. If such documents with such language ever came into the possession of certain people in the government, we would have a problem. What he really meant, I must add, was not that there were serious deficiencies in the sense in which you and I would understand it, but that there were problems that had to be dealt with.

What about the external auditor? Clearly, matters should also be reviewed with him periodically. How often would depend upon the size of the company, the complexity of its internal controls, and the letter that the external auditors prepare and submit to management with regard to internal controls and other matters.

It is important that the audit committee follow up whatever recommendations the external auditor makes concerning the strengthening of internal controls. On the boards I serve, we do this systematically. We go over recommendations item by item after the receipt of a letter, and we determine whether there has been compliance. If there appears to be some sort of an impasse among the internal auditor and his people, the external auditor, and management, we explore the situation, try to ascertain where the merit lies, and discuss how the various parties are going to resolve the issue.

In some cases, of course, it simply is not practical to implement suggestions with regard to internal controls. Since the balancing of costs and benefits is a management responsibility, I think that an audit committee should generally heed management in such situations.

Of course, one of the things that an audit committee should do is see to it that the internal control function is adequately staffed. I know of one instance in which the audit committee chairman went to the CEO, when he learned that the budget of the internal control function had been cut in accordance with a general cost cutting program, and said, in effect, "You can't do it. We're not going to let you cut back this function, particularly when internal controls are as sensitive a topic as they now are."

The audit committee should discuss with the internal control people the frequency with which they do internal audits at various divisions of the company. On one audit committee on which I serve, the chief financial officer of a very large company has been steadily pressing for a faster cycle than is current, and I think it is going to happen.

I have attempted here to indicate the methods that the board and the audit committee can use to monitor a company's internal controls. It is not intended as a checklist. Briefly, the concept of internal controls must be communicated to board members today at a very basic level. The capability of the person in charge of internal controls—and his staff—must then be evaluated by the board. While the audit committee may have direct responsibility for overseeing the internal controls, all board members should exercise due care both in the selection of the committee members and in
reviewing the work of the committee. It is also desirable that these audit committee members be independent directors, not part of the management team. The audit committee is going to be dependent on the internal auditor, in any event, for much of the information it seeks. The internal auditor should report to the committee as well as to the CEO. The external auditor will also assist the audit committee in overseeing internal controls.

The last major point is that an audit committee report should be presented at every board meeting. Its chairman should report the current status of internal controls. If nothing meaningful has come to the committee's attention since the last board meeting, it may have no report. In this fashion, board members not on the audit committee can carry out their monitoring responsibilities required by the Foreign Corrupt Practices Act.

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Who Is Responsible to the Audit Committee?

by W. DONALD GEORGEN/Vice Chairman, Board of Directors, Touche Ross

The primary responsibility for developing, implementing, and monitoring a system of internal controls lies with management. Many companies have formed an internal audit function to act as a management surrogate in monitoring compliance. In other words, they have created a vehicle to see if their rules are being followed. That is looking at it from the management level. When you are looking at it from the board level, in the broadest corporate sense, the internal audit function becomes part of the internal control system. Then, who should be the surrogate of the audit committee or the board? Mr. Sommer would say primarily the internal auditor, and I think we might have a small disagreement on that particular point. We at Touche Ross say the principal surrogate for the audit committee should be the external auditor. He should be the one that gathers and evaluates evidence of what the company and the company's internal auditor have done. And the external auditor should be the one to present this evidence to the audit committee—with an evaluation and appropriate recommendations.

I like to draw the analogy that the external auditor serves as the diagnostician. You go to a doctor, who performs an examination, and he says, I think you should come in for some elective surgery. And he offers the reasons for it. But it is you who evaluate the reasons—you may even get a different opinion—and it is you who make the decision. In the area of internal control, it is the board which makes the final decision.

At Touche Ross, we also believe that the external auditor has responsibility to play more than a passive role in evaluating internal controls. That is, when the external auditor comes before the audit committee, he needs to do more than simply respond to questions: yes, no, maybe, never. The external auditor has the responsibility to assess whether or not the audit committee is evaluating the basic systems and has been informed about the primary areas of risk and what the basic controls are to protect against those risks.

Now, the fact that the audit committee should look to the external auditor as the primary surrogate does not preclude it from also looking to the internal auditor—or any other source that the committee believes can provide facts that would help in making its evaluation. The same analogy holds true for the external auditor. Although he is primarily responsible to the audit committee, he should also have a working relationship with management on a day-to-day basis.

I make these points in response to the furor over some of the remarks by SEC Chairman Harold Williams, in which he discussed whom the internal auditor should be responsible. I think that, in substance, I am in accord with what Mr. Sommer has discussed here.

To review, the internal auditor is primarily responsible to management; it is the vehicle management uses to evaluate systems and check for compliance. Whereas the external auditor is primarily responsible to the board or to the audit committee. In the final analysis, however, this distinction isn't really that important, since the audit committee should have access to internal audit whenever it desires, and management should always have free and open contact with the external auditor.