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How to Make Audit Committees More Effective

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As we enter the 1980s, boards of directors are no longer facing the important question of whether or not to establish an audit committee. Nearly every significant corporate board in the U.S. already has one. In fact, 97 percent of the member companies of the American Society of Corporate Secretaries that responded to a 1978 survey on this issue (on behalf of the New York Stock Exchange) said that they had such a committee. No, the real question facing corporate boards today is how to make these audit committees more effective.

Having observed the evolution and the increasing responsibilities of the corporate audit committee over the past 25 years, I have been impressed that the typical committee functioned rather routinely and perhaps somewhat superficially for a long time. Only in the past decade has an awareness of the committee's responsibilities and its role in corporate governance been heightened.

In the early 1970's there was a rash of well publicized bankruptcies and management frauds. In more recent times there has been a rather large number of bribery and questionable-payments cases relating to foreign operations. Legislation such as the Foreign Corrupt Practices Act and an increased interest in and regulation of financial reporting by the SEC have prompted a great number of heretofore inactive audit committees to recognize and to take more seriously the broader scope of their duties. The intent of this article is to consider those factors which I believe contribute significantly to an effective audit committee process. In examining my personal experiences, I can conclude that audit committees and the audit process are generally most effective if five elements are present:

- A qualified and committed membership.
- A clear definition of committee responsibilities.
- Management support of the audit process.
- A constructive role by the external auditor.
- An objective and independent external auditor.

A Committed Membership

It is easy to conclude that all members of the audit committee should, ideally, be financially oriented in order for the committee to be most effective. How else can members not trained in accounting and auditing be expected to understand such matters as accounting principles and procedures, generally accepted audit standards, control systems, FASB pronouncements, and the reporting rules of the SEC or other regulatory bodies?

However, because an audit committee depends largely on the independent public accountant to apply the generally accepted accounting principles and to conform with the rules and regulations governing financial reporting and disclosure, I do not believe that such financial expertise is required. The committee, however, should understand the alternative methods available for applying accounting principles and for developing financial statements and footnote disclosures.

There are certain attributes, I believe, which eminently qualify persons for audit committee membership, regardless of accounting or financial background.

- An awareness of the nature of the audit process.
- A general knowledge of business
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and a general understanding of the corporation's business, policies, and goals.

- The ability to ask substantive and challenging questions directed to the heart of the corporation's activities.
- The sensitivity to perceive the management environment as it relates to controls and the audit process.

Audit Process Awareness: It is not realistic to expect audit committee members to be professionally knowledgeable about auditing. However, it has been my experience that those who understand the audit process and who can interpret audit results and accountants' opinions are able to ask substantive questions of both the external auditor and the company's financial management.

An audit committee member also must appreciate the importance of a competent financial management and controller function, and a sound internal control system. Without either, the integrity of both the financial reporting process and corporate asset protection should be seriously questioned.

With this background, audit committee members are in a position to challenge the scope of an audit and, for example, to satisfy themselves that the auditor did not neglect significant areas in terms of absolute dollars or of unusual risks or exposures. Also, they can challenge management's response to external and internal auditor comments about control weaknesses or deviations from prescribed procedures. Such challenges by the audit committee may lead to questioning the capabilities of both the financial management and the external and internal auditors.

General Business Knowledge: Audit committee members, like every other director, must understand the business of the corporation. They should be aware of the business' high risk areas and possess a grasp of its more unique aspects, particularly if the corporation is in a specialized industry. Such knowledge is essential in challenging the audit scope and in satisfying the committee that the auditor is, in fact, responsive to changes in the business.

There has been a number of instances, undoubtedly, where the audit committee has influenced the auditor to adjust his general scope plan to take into account specific areas where risks or loss exposures were judged to be significant.

Substantive Questions: Audit committee members are particularly effective, I have observed, if they combine their intellectual curiosity or challenging natures with an understanding of the corporation's business. Specifically, I have been impressed by those members with chief executive officer backgrounds who possess the ability to cut through a mass of trivial matters and inquire about significant and sensitive issues, such as reporting lines, monitoring activities, inventory shrinkage, delegation of authority policies, credit approval, evaluations of financial personnel and internal auditors, and computer security. These people know that if the management control environment isn't sound, normal audit procedures cannot be effective, nor can a worthwhile opinion of the corporation's financial statements result.

Sensitivity to Management: Audit committees must be alert to symptoms of either management domination or, at the other extreme, apathy. The chief executive officer can be a strong-willed person who dominates those around him, including top financial officers. Financial personnel often do not effectively assert themselves, nor are they sufficiently persuasive in obtaining the chief executive officer's support in areas where judgments must be made, such as accounting policies and procedures, control system development, providing for an adequate financial support staff, and the evaluation of certain assets. In such cases the external auditor's job is most difficult, but if he is not satisfied with the ultimate resolution of issues by top management, he must report his judgments to the audit committee.

Audit committee members can effectively discharge their responsibilities if they are sensitive to the top management environment and to the importance that the chief executive officer ascribes to his financial organization and the audit process. However, members must be alert to significant disagreements between top management and auditors, and they should be particularly attentive to the behavior of the external auditor in difficult situations. In such situations, it is important that the auditor meet privately with the audit committee and that the committee be assured of the auditor's professional objectivity. I have witnessed situations where, through their lack of perception of the management environment, audit committee members have made it more difficult for the auditor to do his job.

Committee Responsibilities

The effectiveness of the audit committee also can be strengthened if the committee's responsibilities for appraising the effectiveness of audits and the independence of the external auditor are clearly defined and understood by each committee member. These committee responsibilities include:

• Recommending the appointment of an external auditor, including a
review and approval of his past work, independence, and general audit plan.

- Reviewing the corporation's interim and annual financial statements, including the appropriateness of accounting policies and financial reporting practices and procedures.
- Reviewing the audit results, including comments from the external auditor about the effectiveness of the internal control systems, accounting procedures, and financial reporting systems. A letter from the external auditor to management and the audit committee—summarizing the more pertinent and significant observations, evaluations, and recommendations emanating from the audit process—can be helpful to the audit committee.
- Reviewing the internal audit function, its organization, activities, and audit results.
- Reviewing the corporation's program to assure compliance with the Foreign Corrupt Practices Act.
- Reviewing and evaluating the financial organization.
- Establishing a provision for the exchange of information with the external and internal auditors.

Management Support

No audit examination can be as effective as it should be without management support of the audit process. Without a willingness by management to be candid and to share significant financial information with past, present, or future ramifications, an audit cannot be effective or, in extreme circumstances, be performed at all. In fact, Touche Ross has resigned from several client engagements in which, despite extraordinary efforts, our firm did not receive adequate management support in the audit.

There are a number of techniques that top corporate managements have devised to establish communications with the external auditor and to stress to everyone in the corporation the importance that management attaches to the role of the auditor and to the audit process.

Several years ago, for example, Mr. Donald Perkins, then chairman and chief executive officer of Jewel Companies, Inc., developed what I believe is an effective means for management-auditor communications in his company. Mr. Perkins created what is now referred to as "the forum," a meeting at the end of each quarter that includes himself, the president, the financial vice president, corporate controller, director of internal audit, and two partners from the company's public accounting firm. In the past year, the chairman of the audit committee also has attended to take advantage of this opportunity for a more in-depth exposure to the audit process.

The agenda for "the forum" includes, at a minimum, an interpretation by management of the operating results for the quarter, with an in-depth discussion of any significant deviations from plan, systems, or control. Also on the agenda is a report on current activities and audit results by the external and internal auditors. At the end of the meeting, the corporate financial management personnel are excused and there is an opportunity, first, for the internal audit director, and, then, for the external auditors to have a private discussion with the chairman and president. Such meetings encourage a sharing with the external auditors of confidential plans which are important to the audit process.

The audit committee, as well as the external auditor, should look for evidence of environmental controls, as I like to describe them. In addition to open communication lines, such controls include corporate policies governing the business practices to be followed. Code of conduct and conflict of interest policies are essential in today's business environment, as are budgetary controls. In larger companies, an internal audit function supported by top management is critical. Actions by top management in monitoring corporate policies, in investigating significant deviations from prescribed policies and procedures, in responding to external and internal audit findings, and in timely communication of unusual events or emerging operating problems with the external auditor and the board all indicate that environmental controls are present in a corporation. The audit committee and the external auditor must be prepared to adjust their approach if they are not satisfied with the controls developed by top management.

The External Auditor

Also adding to the effectiveness of the audit committee is an understanding by the external auditor of the importance of his working with the board of directors through the audit committee.

In dealing with management, as well as in relating to the audit committee, I strongly believe that the auditor's role should be constructive in identifying issues or areas of concern at an early stage and in recommending appropriate solutions. His attitude should not be that of an adversary. Management's relationship with the external auditor should be based on respect for his professional capabilities, but not on close personal or social ties.

Through the right kind of professional relationship with top management, it should be reasonably easy for the external auditor to increase
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greatly the effectiveness of the audit committee. First, working with management, the external auditor should be satisfied that all significant items of concern are placed on the agenda for discussion with the audit committee. These matters could include instances where:

- The judgment of management, legal counsel, or others has been relied on to a considerable extent in the audit process.
- Internal control weaknesses have been detected.
- Inadequacies in the financial organization have been observed.
- Certain accounting principles have been applied where alternatives were available.
- The accounting should be explained relative to an acquisition.

Secondly, I believe the external auditor should suggest presentations to the audit committee which he believes are of value in developing its opinions about the effectiveness of the audit process and about management's posture regarding the importance of controls. Such presentations also are of value in providing insights about the quality of financial personnel, as well as of the internal and external auditors. Such presentations might include:

- A review, analysis, and evaluation of a major internal control system covering, perhaps, the sales-accounts receivable cycle, or the purchasingAccounts payable cycle, or inventory accountability.
- A review of the corporation's program to assure compliance with the Foreign Corrupt Practices Act.
- A review of the internal audit function, and
- An evaluation of the management controls of the corporation.

One such audit committee presentation is being developed at an American Hospital Supply Corporation, a major multinational company which I serve. Our firm is developing a series of presentations in which major control systems of the corporation will be evaluated.

As a result of such presentations, and the free interchange of observations, suggestions, and recommendations that inevitably follow, audit committee members are in an excellent position to evaluate the effectiveness of both the internal and external audit functions.

Both presentations and the give-and-take discussions that generally follow give audit committee members an indication of the external auditor's knowledge of the corporation, the depth of his understanding of the control systems, the logic he uses to evaluate control systems, the sensitivity of his approach to important areas of the business, and his recognition of the risk areas of the corporation. The free-flowing discussions following such presentations can give the audit committee members an indication of the professionalism of the external auditor, the freshness of his approach in challenging the effectiveness of control systems, and his objectivity and independence of management.

Objectivity and Independence

The Cohen Commission on Auditors' Responsibilities stated in its report issued in January 1978 that the board of directors with outside members and an audit committee, when appropriate, is the best vehicle for achieving and maintaining a balanced relationship between the external auditor and management. Chairman Harold Williams of the SEC has stated repeatedly that audit committees are necessary to "insure and enhance" the independence of the external auditor.

From my perspective as a practicing accountant, I believe that the audit committee makes it easier for the auditor to do his job well. And, conversely, the help that the external auditor can give to the audit committee can strengthen its effectiveness. On the other hand, I believe it is important for the audit committee to judge the professional objectivity of the external and internal auditors. This is a critical element for the integrity of the audit process.

The notion that disclosure of total professional fees and non-audit fees in proxy statements is helpful to investors in judging independence is disturbing to me. Independence and professional objectivity can be impaired by many factors, but not by the stock holdings of or the non-audit services provided by the external auditor. The audit committee can and should satisfy itself about the auditor's independence on a much broader scale, and it should be alert to certain symptoms which can result in an impairment of independence or work that is less than professional in quality. These symptoms include:

- Evidence of domination by a strong-willed CEO or top financial officer.
- Lack of respect by management for the opinions and judgments of the auditor.
- Lack of interest by management in seeking professional counsel when unique transactions occur.
- Inability or unwillingness by the auditor to assure that a balanced presentation is made to the audit committee when alternative accounting policies or applications are possible — or when heavy reliance is placed on judgments of top management or those of outside experts.
A CHAIRMAN'S VIEW

Why Do We Concentrate on Rutabagas?

by DONALD S. PERKINS/Chairman
Executive Committee
Jewel Companies, Inc.

In the supermarket business, we offer a wide variety of products, but when we advertise and display them, we try to remember what is important to our customers—meat and potatoes, not rutabagas.

All of the words written, all of the conferences held, all of the thought given to auditing and controls in corporate life today are not the meat and potatoes of our business. We must be careful to maintain our perspective. Excessive concentration on controls will detract from the most important business functions—the development of people and the productive employment of human and financial resources.

I wonder if we would be in the difficult position that we are in today with respect to foreign competition if the SEC and others in Washington spent as much time worrying about the creation of corporate assets as they do about auditing them. I wonder if we'd have as much of a problem with business credibility in our country today if managements and boards gave as much attention to the auditing of human attitudes and individual development as they do to the auditing of income statements and balance sheets. We are in danger of losing our perspective—of concentrating too much on rutabagas and too little on meat and potatoes.

To me, one of the ironies of the recent suggestions by the SEC regarding internal controls is that at virtually every audit committee meeting I have attended, committee members have asked external and internal auditors for their up-to-date evaluations of the company's accounting talent and control systems. Please notice that the word talent precedes systems. When weaknesses exist, they become a topic for discussion. When weaknesses persist, they lead to changes in people. That sort of inquiry and follow-up fulfills the stewardship responsibility of a corporate director without inviting the legal battles that are likely to ensue if we go public with a statement that implies more perfection than human beings can realistically achieve.

If it ever should be appropriate to report weaknesses in internal accounting controls, such reporting should have two attributes: the weaknesses should be both material and uncorrected at the time of reporting. Otherwise, the discussion might be described as an overreaction to what most companies perceive as a nonproblem.

Should independent auditors be asked to comment on the adequacy of internal controls? If any member of a board or audit committee is required to represent the adequacy of accounting controls, the independent auditor's opinion will be solicited and included in the minutes of the meeting. Such questions are being asked and answered regularly.

I personally like rutabagas, but in the world of business, it seems wise to maintain a healthy perspective about the relative importance of auditing assets compared with that of creating them, as well as to maintain a healthy perspective regarding the importance of people in relation to controls in the building of a successful enterprise.