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AUGUST 2002 ■ $4.95

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Empowering the Watchdog

By Richard L. Wise and John J. Whyte

Who is your company's ultimate guardian of investor interest and corporate accountability?

THE CHOICE OF THE SUBTITLE IS STRICTLY INTENTIONAL. It is, in effect, a question that dictates its own answer. If you do not have a ready answer, you soon will because, in the post-Enron era, there is a new paradigm for investor protection and corporate accountability. Further, it presents a trap for corporate directors – especially "independent" directors who may be unaware of the breadth of what soon is likely to become a new legal mandate, and, thereby, a source of extensive exposure.

Audit committees long have been part of the traditional framework of corporate governance. Traditionally, membership on this committee reflected an acknowledgment of the senior status of independent directors whom the board wished to honor and to allow to serve on a senior, executive committee. Often this was more a matter of form than substance.

'Nods and Winks'

THE SEEDS OF CHANGE WERE SOWN IN the summer of 1998 when SEC Chairman Arthur Levitt excoriated a process that, in his words, had become "a game of nods and winks" involving the analysts, the auditors and those in charge of a corporation's affairs. Levitt lamented that "integrity may be losing out to illusion."

Commenting on five "hocus-pocus" categories that were flagrant distortions of the financial reporting process, Levitt introduced a nine-point plan that included the requirement that corporate audit committees take responsibility for their companies. Levitt also called for audit committees to "function as the ultimate guardian of investor interests and corporate accountability."

The New York Stock Exchange and the National Association of Securities Dealers, responding to his call-to-arms, established a Blue Ribbon Committee on improving the effectiveness of corporate audit committees. After extensive hearings, meetings and research, the committee released a 71-page report, *Improving the Effectiveness of Corporate Audit Committees*, which set forth 10 far-reaching recommendations regarding the conduct of audit committees, and five guiding principles for audit committee best practices (see sidebar).

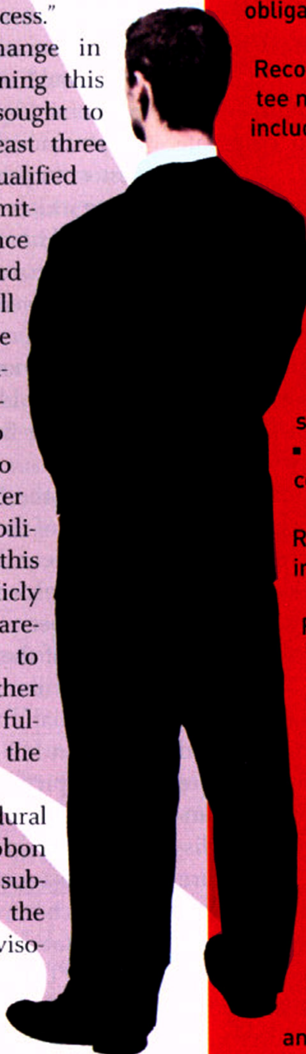
In traditional corporate fashion, the Blue Ribbon Committee's recommendations were politely hailed as "important," long-overdue changes and were given lip service by the vast majority of reporting corporations. In fairness, at the time no one probably anticipated financial reporting would reach the egregious levels exhibited in the Enron and other infamous, recent situations. Yet today, Levitt's Cassandra-like warnings, echoed in the Blue Ribbon Committee's report, are hauntingly prophetic.

There are sound reasons why companies should begin to live up to the spirit, as well as the letter, of the Blue Ribbon Committee's recommendations: They will result in the establishment of a new model for audit committee performance and director liability. Although these are only recommendations, and therefore not legally mandated requirements, it is likely that they will soon become so. Corporate directors will discover that the standard for judging their performance will have been set and that these committee recommendations will serve as the benchmark against which their personal actions will be measured in the future.

In structure, the Blue Ribbon Committee endeavored to set apart the audit committee as one support of a "three-legged stool" of checks and balances that would mandate transparent reporting and financial statements that are not misleading. It went even farther, however, determining that the "audit committee must be 'first among equals' in this process ... and hence the ultimate monitor of the process."

This is a daunting change in responsibilities. In fashioning this standard, the committee sought to establish a panel of at least three directors who were truly qualified to serve on the audit committee by their independence from the balance of the board and management in all respects, and who were specifically literate in financial matters. To institutionalize this process, they also directed audit committees to adopt a full written charter governing their responsibilities and processes. Indeed, this "charter" was to be publicly available and annual shareholders' meetings were to address the issue of whether the audit committee had fulfilled its obligation during the prior year.

After establishing procedural safeguards, the Blue Ribbon Committee specified the substantive independence of the audit committee and its advisory role toward management and its auditors. First, it required the out▶



Audit Committee Best Practices Defined

The Blue Ribbon Committee established five guiding principles for audit committee best practices. These in turn were used to create 10 specific recommendations. Where appropriate, the principles and recommendations below are quoted verbatim.

The first principle defines the audit committee's key role: "The audit committee, the first among equals, oversees the work of the other actors in the financial reporting process ...

"From this basic understanding of the relevant roles and responsibilities of each participant in the process, the audit committee will be in a position to devise appropriate questions on how each participant carries out its functions. These questions should not be merely a 'checklist' of standard questions to be asked each year, but should be tailored to a company's particular circumstances."

The remaining four principles call for independent communication with internal and external auditors, candid discussions with management and auditors, and diligent and knowledgeable committee members.

The recommendations themselves fall into three categories. The first three recommendations deal with audit committee member qualifications. The second two concern the procedural safeguards of the audit committee. Recommendations six through eight deal with relations between the audit committee and auditors, while recommendations nine and 10 impose disclosure obligations upon the audit committee.

Recommendation One creates a new definition of "independence" for committee members. Instances evidencing lack of independence of management include:

- Being employed by the corporation (or any affiliates) during the past five years.
- Accepting any compensation from the corporation (or any affiliates) other than for board service or under a tax-qualified retirement plan.
- Being a member of the immediate family of an individual who has been employed within the past five years by the corporation (or any affiliate) as an executive.
- Being a partner (or controlling shareholder) or executive officer of any other (for-profit) business to which the corporation made or received any significant payments within the past five years.
- Being employed as an executive of another company, where any of the corporation's executives serves that company's compensation committee.

Recommendation Two states the audit committee should consist solely of independent directors (large companies only).

Recommendation Three says audit committee members should have "accounting and/or related financial expertise – where 'expertise' signifies past employment experience in finance or accounting, requisite professional certification in accounting, or other comparable experience or background which results in the individual's financial sophistication, including being or having been a CEO or other senior officer with financial oversight responsibilities."

Financial "literacy" signifies the ability to read and understand financial statements, including balance sheets, income statements and cash flow statements. Companies should have a minimum of three audit committee members, each of whom is financially literate.

Recommendation Four states the board should adopt by vote a formal written charter specifying the "scope of the committee's responsibilities, and how it carries out those responsibilities, including structure, processes ▶

side auditors to be ultimately accountable to the audit committee in addition to its responsibilities to the board.

The audit committee would be responsible for hiring and firing the auditor, but it also was directed specifically to ensure the full independence of the auditor. In this regard, a crucial issue for audit committees in the future will be the extent of fees earned by the auditing firm for "consulting" work.

More difficult, however, is the recommendation that the auditors discuss with the audit committee their judgments, not just about the acceptability of the accounting principles applied in financial reporting, but also about the quality of such principles. The Blue Ribbon Committee required such discussions to include issues involving the clarity of the disclosures, the degree of aggressiveness or conservatism, and anything else that may be relevant.

The committee insisted that the requirement should be fulfilled "in a way to encourage open, frank discussion and to avoid boilerplate." Further, the audit committee was to be involved in the interim financial statement preparation – preferably prior to any public announcement of financial results – and it was required to open up a clear channel of communication with those involved in the audit process with respect to any disagreements between management and the auditors.

Finally, the Blue Ribbon Committee requested that audit committees submit a letter with each annual report disclosing whether or not it had had a discussion of the quality of accounting principles with the auditors, whether the "outside auditors have discussed with the audit committee ... [their] judgments of the quality of those principles as applied," and whether the members of the audit committee themselves have discussed that information separately so that they believe "that the company's financial statements are fairly presented."

The five principles cited at the end of the Blue Ribbon Committee's report make it clear that the audit committee cannot function effectively unless it is permitted to have direct and regular access to the auditors. Also, the audit committee, or at least its chair, must be able to discuss with the auditors – without management present – any reservations that it may have.

The committee quoted Harvard Business School professor John Hinsey, who urged that the dialogue "should provide the audit committee with insights into the 'whats and whys' behind the numbers and the process." The audit committee was then charged with seeking to verify management's compliance with the processes and procedures. The Blue Ribbon Committee even went so far as to recommend that, when circumstances dictate, "management should help the audit committee retain independent legal counsel and/or financial advisors."

Startlingly Untraditional

THE REALITY OF THIS PROCESS, HOWEVer, is that while this new system of "checks and balances" mirrors the framework of the U.S. Constitution, American businesses do not have a respect for the concept of "the loyal opposition." This audit committee structure represents a new paradigm for American corporate governance.

It suggests that, to be effective and carry out its role, the audit committee, in a startlingly untraditional way, may well be at odds with policies that management may prefer and perhaps even with the remainder of the board itself. Further, while management may have conflicts resulting from bonus programs that are oriented to quarter-over-quarter stock prices and individual audit partners may be conflicted by the need to protect large consulting fees, audit committee directors must also deal with the issue of their own independence when conflicted by compensation in the form of stock or options.

Clearly, technical compliance with accounting rules no longer will be good enough for the audit committee. There might be regular occasions when management may not want a particular disclosure because the very disclosure would defeat the basic reason for instituting a "technically" permitted transaction in the first place.

It is precisely at that point where the Blue Ribbon Committee would require the audit committee to dig in its heels and insist upon such disclosure. It is unlikely that "big bath" accounting charges, the maintenance of "cookie jar" reserves or "materiality" tricks, along with creative acquisition accounting, could be permitted absent a strong dissent disclosed to the investors and shareholders in the financial statements.

What will this mean for the political collegiality that is supposed to exist in the traditional boardroom? Will audit committee directors be able to maintain their seats in the face of such strong differences with management or other board members?

Should the audit committee directorship be an independent position requiring professional audit committee members who act much like outside auditors? Our assumption is that the latter requirement, although feasible, is not currently necessary.

However, obtaining independent legal and financial advice from professionals who could audit the audit committee is recommended. This is not only so that it may assure the board in general and investors in particular that the committee is doing its job, but so that committee members will know that they are not exposing themselves to severe liability by virtue of having served in this position.

Under current circumstances, it is blatantly obvious that this independent advice should not come from the Big Five accounting firms or from corporate SEC counsel.

From the "best practices" recommendations of the Blue Ribbon Committee it seems clear that the Enron debacle could not have occurred had the audit committee been doing its job. The litigious nature of the American investing public likely will result in the imposition of severe liability on future audit committees that fail to heed both the letter and the spirit of the Blue Ribbon Committee's recommendations in their oversight activities.

The magnitude of the risk in undertaking such an obligation should not be understated: It poses a legal trap for the unwary board member who takes a cavalier approach to such responsibilities.

Companies should adopt not only a

carefully crafted charter, but also detailed work programs and checklists to carry out the charter; calendars to execute the programs; guidelines and interpretations; and up-to-date tailored corporate and accounting educational research materials.

Further, the Blue Ribbon Committee's recommendation that, for listed companies with a market cap of $200 million or greater, at least one audit committee member have "accounting or related financial management expertise," should apply to all listed companies. All members should possess these skills and at least one member should also have a strong background in and understanding of the audit and financial presentation processes.

One may argue that the inclusion of these guidelines and recommendations are at the leading edge of today's best practices. However, a failure to observe such matters tomorrow may likely be nothing less than pure negligence.

These mechanisms and the good business judgment that resulted in an individual's being elected to an audit committee in the first place should be sufficient, in most cases, to give the investing public the oversight protection to which it is entitled. We use the term "investing public" because it might become a standard requirement in major loan transactions that the audit committee deliver such a letter of compliance to the lenders of a corporation on an annual basis.

In light of Enron and subsequent fiascos, and the Blue Ribbon Committee's recommendations, how could lenders not require it? How could a company refuse?

We are in a new time of financial reporting innovations. By embracing these requirements, we can better ensure the accountability and reliability of the system. By rejecting them, we acquiesce to a proliferation of Enron-type situations and the potential for loss of corporate self-governance. ■

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and membership requirements."

The charter must be reviewed and reassessed for adequacy on an annual basis. Significantly, the Blue Ribbon Panel did not "recommend mandating every detail to be included in the guidelines for every audit committee. There are too many variables amongst the multitude of different corporations comprising our economy."

Recommendation Five requires the audit committee to disclose in a corporation's proxy statement for its annual meeting whether it has, in fact, adopted a formal written charter, and whether it has satisfied its responsibilities under the charter during the prior year. The contents of the charter must also be disclosed in the annual report every three years. "Such transparency is at the heart of good governments ... and also acts as a disciplinary measure on the committee ... Disclosure will guide the committee to responsible practices, as sunlight generally does."

Recommendation Six states the "outside auditor is ultimately accountable to the board of directors and the audit committee, as representatives of the shareholders, and [these] representatives have the ultimate authority and responsibility to select, evaluate and, where appropriate, replace the outside auditor." In this regard, "the audit committee, as the delegate of the full board, is responsible for overseeing the entire [audit] process."

Recommendation Seven says the "audit committee is responsible for ensuring its receipt from the outside auditors of a formal written statement delineating all relationships between auditor and the company [and] also responsible for actively engaging in a dialogue with the auditor with respect to any disclosed relationships or services which may impact the objectivity and independence of the auditor, and for taking, or recommending ... appropriate action to ensure the independence of the outside auditor."

Recommendation Eight requires that the company's outside auditor specifically "discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the company's accounting principles as applied ... [The] discussion should include such issues as the clarity of the company's financial disclosures and the degree of aggressiveness ... of the company's accounting principles and underlying estimates and other significant decisions made by management in preparing the financial disclosures. ... This requirement should be written in a way to encourage open, frank discussion and to avoid boilerplate."

Recommendation Nine requires that the audit committee send a letter to be included in the company's annual report to shareholders disclosing whether or not (a) management has reviewed the audited financial statements with the audit committee, including the quality of the accounting principles as applied and significant judgments effecting the company's financial statements; (b) the outside auditors have discussed with the committee their "judgments of the quality of those principles as applied under the circumstances; and (c) that the audit committee members have discussed among themselves without management or the outside auditors present, the information" so disclosed, and the audit committee believe "that the company's financial statements are fairly presented in conformity with general accepted accounting principles ... in all material respects."

Recommendation 10 calls on the auditor to discuss quarterly reports before the 10-Q filings. Further, there should be discussions "with the audit committee, or at least its chairman, and a representative of financial management" about certain other significant matters, "including significant adjustments, management judgments and accounting estimates significant to accounting policies and disagreements with management."