Public Institutions Must Enhance Audit Committees In the Wake of Corporate Scandals

By Kip A. Weissman

As the operating environment for financial services companies has become ever more complex, it has become increasingly difficult for boards of directors to monitor the accuracy of banks' financial reports. At a minimum, such financial reports must take into account new forms of assets and liabilities, a high level of financial volatility and a bewildering array of securities, regulatory and accounting requirements.

Given the difficulty of this task, particularly for publicly held institutions subject to Securities and Exchange Commission reporting rules, it is no surprise that more boards of directors of financial institutions are using independent audit committees to review the details of their institution's financial reports.

This trend has been exacerbated by an increase in regulatory requirements that apply to audit committees. In particular, during the last three years, the SEC along with the New York Stock Exchange, the American Stock Exchange and the NASDAQ have implemented a series of new rules on audit committees including requirements that:

- all companies listed on the major exchanges have audit committees consisting solely of "independent," or non-employee, directors;
- all audit committees of listed companies have charters;
- all public companies with audit committees include a report of such committee in their annual proxy statements; and
- all public companies with audit committee charters include charters in their proxy statements at least once every three years.

The Perfect Storm

As a result of a lethal combination of massive corporate accounting scandals, a plummeting stock market and unprecedented concerns regarding our national security, the President signed into law on July 30, the Sarbanes-Oxley Act of 2002, the most far-reaching securities legislation since the Depression. At about the same time, the SEC and the major exchanges implemented a series of new requirements (and proposed requirements) designed to strengthen public companies' financial reporting, corporate governance and accountability to investors.

The goal of these various new initiatives was to restore faith in the U.S. capital markets and to increase investor confidence in the accuracy of public company financial reporting. In an effort to achieve these goals, the drafters of these new standards have granted new powers to audit committees and elevated them to a corporate governance status that is nearly equal to that of boards of directors and bank management.

Under the new standards, the audit committee must assume new responsibility for the company's relationship with its outside auditors. In particular, the committee now has sole authority to select a public company's independent auditing firm and to negotiate appropriate terms. In addition, the audit committee will be expected to assess the qualifications and independence of a company's independent auditing firm and approve the provision of any non-auditing services by such firm.

Perhaps the most important aspect of the new standards for audit committees is the enhancement of a committee's role in a company's overall public disclosure. In particular, the new standards include audit committee consideration of "critical accounting policies," "alternate treatments of financial information within generally accepted accounting principles," and "real time" financial disclosure. The new standards also recommend audit committee review of a company's internal audit procedures, "disclosure controls" and related party transactions.

The new standards also set forth new requirements with respect to audit committee composition. In particular, the standards significantly strengthen the committee members' independence requirements and almost totally prohibit any related party transactions between audit committee members and the company. In addition, the new standards substantially increase competency requirements for audit committee membership. For instance, the NASDAQ requires that all audit committee members be able to read and understand their company's financial statements at the time of their appointment. The NYSE requires that a company has (and the SEC requires disclosure as to whether a company has) at least one "expert" on the audit committee with experience in the preparation or audit of the financial statements of "generally comparable issuers." I expect that many publicly held community banks will find it difficult to comply with this requirement.

The new standards also significantly increase record-keeping requirements for audit committees. In particular, each audit committee must establish procedures to receive and respond to, on a confidential basis, any concerns and complaints regarding the company's financial reporting or accounting.

Finally, the new standards encourage audit committees to use outside advisors (including counsel) and require the company to pay for any such third-party assistance.

Building a Safe Harbor

In light of the above, each public company's board and audit committee should undertake a thorough review of its policies and procedures to ensure compliance with the new standards. Because so many of these standards are subject to future study and rule making by Congress, the SEC and the major exchanges, it will be important for audit committees to reassess their procedures over the next several years on a regular basis.

As the first step in their review, the board and the audit committee should assess the independence and qualifications of committee members. With respect to independence, the committee should consider: (i) any transactions between the company and the member (or the member's family), the member's business or any corporation or other organization controlled by the member, (ii) any current or former employment, or advisory relationship with the company, and (iii) any relationship with management including family, business or interlocking board relationships.

With respect to the qualifications of the committee members, the board and the committee will want to ensure that all committee members have the expertise to understand the complex matters under their purview. They will also want to consider if it might be desirable to appoint an "expert" to serve on the committee. In making these determinations, the board and the committee members should bear in mind that the new standards require a high level of proxy statement disclosure regarding the background and experience of the committee members.

After the audit committee's composition has been considered, the committee should meet with management to undertake a comprehensive review of the company's critical accounting policies, public disclosure controls, internal audit procedures, and related party transactions. During its public disclosure review, the committee should question executive managers—in detail—regarding the company's material transactions and any material trends and risks in its operations and financial position. Finally, the committee should solicit management's thoughts regarding the company's independent auditors.

Next the committee should meet with the company's independent auditors to discuss their qualifications and terms of engagement. In particular, the audit committee should inform the independent auditing firm that under no circumstances may it perform any services for the company without the committee's express written approval. The committee should then discuss with the independent auditors the company's critical accounting policies, operations and financial position, its public reporting practices and disclosure controls, its internal controls, its related party transactions and any material information they may have regarding the company's operations.

The committee should next meet with the company's internal auditor to discuss the company's internal controls. In particular, the committee should seek to assess the strength of such controls as well as to identify any undisclosed material or related party transactions.

When its initial review is complete, the committee must then turn its attention to its core function—assuring the accuracy and integrity of the company's financial statements and public reporting. Given the sensitivity of these matters in today's environment, I expect many committees to make substantive changes and recommendations regarding the content of the company's financial statements and public reports. Perhaps more importantly, I expect virtually every audit committee of a public company, whether in conjunction with the board and management or otherwise, to make substantive changes in the procedures the company uses in selecting its critical accounting policies, preparing (and identifying material information for) its public reports, and testing the accuracy of its financial records.

Throughout this process, an audit committee should regularly consult with outside experts including accountants and counsel to ensure that it has as complete an understanding as possible of the company, its reporting practices and the ways in which these practices might be improved. In some cases, the committee may deem it prudent to seek advice from accountants and legal counsel other than the company's outside auditing firm and regular securities counsel.

The emergence of the audit committee as a new source of authority and responsibility within public companies represents a profound change in the structure of U.S. corporations. While the requirements discussed in this article apply primarily to publicly held financial institutions, if they are successful in enhancing financial statement integrity, they will almost certainly be required in some form for all depository institutions by the federal banking regulators.

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