Six common mistakes of audit committees

From failing to fully understand complex accounting concepts to failing to interview key sales personnel, a repeating pattern emerges of shortcomings in the work of the audit committee.

By Frederick D. Lipman

Audit committees of public companies are trying their best to adjust to the Sarbanes-Oxley Act of 2002, related SEC rules, and the increased focus by shareholders, corporate governance rating groups, and others on audit committee oversight. This has resulted in longer, more intense and more frequent meetings of audit committees.

Despite their best efforts, I have observed the six common mistakes made by audit committees:

1. Failure to fully understand complex accounting concepts

It is the duty of audit committee members to fully understand the accounting used by the company. Accounting concepts can be very complex. Anyone who has read any of the recent opinions of the Financial Accounting Standards Board is aware of this complexity. The accounting in certain companies is extremely complex even for trained accountants, let alone the average audit committee member. SEC accounting pronouncements (such as SAB 101 and 104) further compound the problem.

It is difficult to ask incisive questions of the auditor or management if the audit committee does not fully understand the accounting used by the company. A number of auditors and CFOs have privately advised me that they do not consider anyone on their audit committees to have the necessary accounting expertise to fully understand the financial statements.

The audit committee should schedule special education sessions with the CFO, the auditor, and possibly a consultant to the audit committee (e.g., an accounting professor) to make certain that they fully understand the company’s accounting policies. It may be necessary to have continuing education sessions over a period of time to enhance the audit committee’s expertise.

2. Failure to interview sales personnel and the tax manager

Many of the revenue recognition problems of public companies have resulted from side deals with customers made by sales personnel that are not correctly reflected in the financial statements. Most audit committees do a good job of interviewing the auditor, company accounting personnel, corporate governance officers (if any), inside and outside counsel, head of the disclosure committee, internal auditor (if any), and top management as part of their oversight function.

Few audit committees consider it necessary to go beyond these groups to sales personnel, particularly the head of sales. This is a mistake, since the accounting for a transaction is no better than the quality of the information provided by the sales department.

Many audit committees also fail to inquire of the company’s tax manager (if any) about any aggressive tax strategies being undertaken by the company that could affect the size of the tax reserves. If the company does not have its own tax manager, such questions should be raised with the firm that performs tax planning.

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3. Permitting members of the audit team to receive compensation for selling non-audit services

The SEC’s auditor independence rules do not prohibit non-partner members of the audit team from receiving compensation for selling non-audit services to the company. However, the SEC has made it clear in the following passage that they expect audit committees to consider this issue in the pre-approval process for non-audit services:

“The rules that we are adopting mitigate the concerns that an audit partner might be viewed as compromising audit judgments in order not to jeopardize the potential for selling non-audit services. These rules do not specifically address the provision of compensation to other audit engagement team members for directly selling non-audit services. We believe that, however, the other audit engagement team members will perform in a fashion that is consistent with the direction and tone set by the audit partners. Nonetheless, as it pre-approves non-audit services an audit committee may wish to consider whether, in the company’s particular circumstances, compensating a senior staff member on the audit engagement team based on his or her success in selling the service to the company compromises that individual’s or the firm’s independence.”

The audit committee ought to prohibit payment of such compensation to audit team members in order to avoid undermining the independence of the audit team and creating potential conflicts of interest. Although some of the large accounting firms currently prohibit any compensation to members of the audit team for selling non-audit services, the audit committee ought to consider prohibiting this practice altogether, since these large accounting firms could change their policies in the future.

4. Failure to require more intensive or extensive audits prior to certain warning events

There are numerous warning events that may suggest to the audit committee that a more intensive or extensive audit should be conducted. These events include the following:

• Management Sale of Stock: The temptation to inflate earnings is greatest prior to the intended sale of stock of the company by management. The HealthSouth scandal amply illustrates this tendency. It was reported in The Wall Street Journal that Richard Scrushy, chief executive officer of HealthSouth, refused to abandon HealthSouth’s earnings manipulation scheme by saying, “Not until I sell my stock.”

Audit committees should carefully consider whether more intensive and extensive audits are required on the eve of insider sales of stock. If this policy is adopted, the audit committee should adopt a policy requiring written notice of insider sales several months before the actual date of such sale so as to arrange the necessary audits.

• Conflict of Interest Situations: The Enron audit committee approved off-balance-sheet special-purpose entities that clearly created a conflict of interest between certain members of management and the company. Yet, based upon the currently available facts, the Enron audit committee did not create oversight mechanisms to verify that the representations made by management to the audit committee, which induced approval of the conflict of interest, were in fact being followed.

Accordingly, in rare situations in which the audit committee elects to approve conflict of interest, an ongoing independent monitoring mechanism must be established by the audit committee. This mechanism may include more intensive or extensive audits by the independent auditor, possibly supplemented by oversight by the internal auditor. The results of both the independent auditor and the internal auditor oversight should be reported directly to the audit committee.

• Other Warning Events: These include a company that never fails to meet an earnings projection and a chief executive officer or chief financial officer who is under personal financial pressure stemming from a divorce, a lavish lifestyle, gambling habits, or other factors.

5. Failure to hire, fire, and fix the compensation of the internal auditor

The internal auditor is the eyes and ears of the audit committee. Some companies, particularly smaller public companies, have no internal audit function. In many companies the internal auditor is hired by the controller, to whom the internal audit reports, and the internal auditor’s compensation is controlled by the chief executive officer or chief financial officer and the controller.

Audit committees should, in consultation with management, hire the head of internal audit, have the head of internal audit report to both the audit
committee and management, and retain the right to fire the head of internal audit. Likewise, compensation for the head of internal audit should be established by the audit committee, in consultation with management. These steps are appropriate to make it clear that the internal auditor has direct responsibility to the audit committee. Serious consideration should be given to structuring his or her compensation to avoid excessive reliance on compensation driven by accounting results.

Some companies would prefer to outsource all or part of the internal audit function. Under these circumstances, the audit committee should consider retaining control over the selection, retention, and compensation of the outside internal auditor.

6. Failure to monitor the law compliance culture within the company

Enron had an extensive and award-winning code of ethics and corporate governance structure. Indeed, there was no scarcity of grandiose ethics policies among most of the companies suffering from corporate scandals. The problem was failure to follow these policies and to develop a law compliance culture within the company.

Management’s primary function is to increase shareholder value and to create incentives for employees to accomplish this goal and disincentives for employees who fail. Management must equally be encouraged to develop an employee culture that emphasizes law compliance.

The audit committee is uniquely situated to help foster the law compliance culture within the company, although there is no legal requirement to do so in Sarbanes-Oxley or otherwise. This may require the audit committee to interact more often with employees below the chief executive officer and chief financial officer position. Occasionally having the chairman of the audit committee present at employee meetings to explain the role of the audit committee helps foster a law compliance culture within the company.