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PERSPECTIVES

# AFTER THE FINANCIAL CRISIS: REVISITING AUDIT COMMITTEE INDEPENDENCE

BY **MICHAEL R. YOUNG**

As the financial crisis recedes into history, it is time to turn renewed attention to the risk of fraudulent financial reporting.

Ironically, a big reason is that times are getting better. Corporate profits are up. Companies are again expanding. The stock market has more than recovered.

But with renewed economic viability comes increased pressure for financial performance. When times are bad, as they were not too long ago, the pressure for spectacular results eases as expectations are low and cash flow and survival are at the top of the agenda. It is as good times return that the pressure for financial performance builds. And with that pressure comes the risk of performance exaggeration.

Some early warning signs are emerging. The US Securities and Exchange Commission has announced a new Financial Reporting and Audit Task Force and the development of enhanced computer searching capabilities to seek out telltale signs of fraudulent financial reporting. The SEC also reports that whistleblower tips are pouring in. Beneath the headlines, some audit committees find themselves needing to commission investigations of the sort that have been a blessed rarity over the last several years.

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One problem, though, is that the investigative machinery has gotten rusty. In particular, some seem to have lost sight of a key feature that is often at the center of a financial reporting system that has gone astray. That is the culture of the company's financial reporting environment.

The centrality of culture to fraudulent financial reporting means that, when credible evidence of accounting irregularities surfaces, the culpability of those with the biggest impact on the financial reporting culture must often be considered. That will vary from company to company, but normally those with the biggest impact on the culture will include members of senior management. Historically, many audit committees have been astonished to learn that members of senior management were themselves complicit in the fraud.

It is rarely an optimum approach to a credible investigation of accounting irregularities, therefore, for management to oversee it. The same goes for those reporting to management, such as the company's regular outside counsel. At the outset, when the information may be limited and the circumstances chaotic, the deployment of a familiar law firm overseen by company executives may seem like the best reaction. Such an approach, however, has the potential to create serious problems – for both the company and its audit committee – down the road.

One problem is that an investigation overseen by management can have a tough time gaining credibility with important constituents. For public companies, foremost among those constituents will be the SEC. A public company faced with potential accounting irregularities quickly learns that credibility with the SEC is crucial. A company's audit committee can often do an investigation of its own accounting faster and more efficiently than can the SEC staff. An audit committee may therefore find itself asking the SEC enforcement staff to hold off to give the audit committee time to itself figure out the problem. Often, the SEC staff will agree.

But the SEC cannot be expected to agree if the company's investigation lacks credibility because it is being overseen or undertaken by those whose objectivity is questionable. Rather, efforts to persuade the SEC staff to defer to the audit committee can be expected to face significant scepticism and challenge.

Another critical constituent for a credible accounting investigation is the company's stock exchange. The discovery of potential accounting irregularities may delay the filing of financial information with the SEC or

compromise the reliability of financial information already on file. One potential result is a violation of exchange listing requirements and delisting. As with the SEC, the company will want to rebuild credibility and buy time. The exchange, in turn, will want to be assured as to the objectivity of the investigation. Like the SEC, the exchange may be sceptical where objectivity is not apparent.

Another constituent that matters is the outside auditor of the company's financial statements. At public companies, auditors subject to US law have a responsibility to consider whether audit committees facing possible accounting irregularities are taking 'timely and appropriate remedial actions'. For non-public companies, auditing standards contain analogous requirements. Experience has taught that accounting investigations undertaken by management, or those who have historically reported to management, may not have the necessary indicia of objectivity to qualify as 'appropriate remedial actions' or to serve as the predicate for issuance of an audit report.

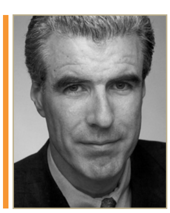
Often lost in all of this, moreover, is a constituent that in many ways has the strongest interest in the objectivity of an investigation: innocent executives themselves. The reason is that an investigation conducted otherwise will often be unable to accomplish a key objective – establishing with credibility those who are guilty and exonerating with credibility those who are innocent. If the investigators are not objective, determinations of innocence are immediately suspect, and the practical consequence is that the investigation is incapable of exonerating anyone. It only has credibility to the extent it finds executives guilty.

A failure to put in place an objective investigative capability at the outset, moreover, can create additional problems as circumstances evolve. For one thing, use of regular outside counsel to investigate may effectively disqualify that counsel from defence of related securities class action litigation since it can be awkward for the same law firm to both objectively investigate, and defend against, contentions of accounting impropriety. The same may be true regarding a parallel SEC or Department of Justice investigation.

Should the complicity of management be discovered, management's oversight of the investigation can place the audit committee in an exceedingly awkward spot. In some cases, audit committees have found it necessary to terminate the investigative team, engage a new one, and start the investigation over.

The inclination to seek the help of familiar faces at the outset of a potential accounting irregularity problem is understandable. However, it can prove to be counterproductive. The consequences can include lack of credibility with the SEC, lack of credibility with the stock exchange, a failure to obtain audited financial statements, unavailability of regular outside counsel to defend against parallel litigation or regulatory proceedings, and, overall, investigative findings that only have credibility to the extent executives are found guilty.

The far better approach is for the audit committee to plan ahead with recognition of the need for investigative objectivity and independence. RC



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