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Do Audit Committees Face New Legal Challenges in the Future? - August 10, 1999
 H. Stephen Grace, Robert S. Roath and John E. Hauptert - Grace & Company Consultancy, Inc.

FMN's June 28 article - "Who's Minding the Store?" advised readers of the heavy emphasis being placed on audit committee oversight by the SEC, the Exchanges and others involved in corporate governance.

The article also made two important recommendations for improving audit committee performance. It was suggested that firms design company specific cash flow controls to supplement existing control structures and that professional, outside assistance be made available to advise audit committees.

Since that article was written, there has been a realization that the potential liability of audit committees and their individual members may be increasing as a result of the strong focus on their oversight role. Recent publications by the big five and other leading accounting firms regarding audit committee structure and responsibilities may well set the tone for evaluating future cases judging the liability of audit committees and these publications make it quite clear that the role of the audit committee is no longer passive review, but rather proactive oversight.

The accounting firms' studies do not stand alone, but are supported by insightful work from a number of creditable sources, including organizations of current and former CEOs.

Clearly there is a growing consensus that the buck stops with the audit committee. That being the case, it is quite likely that parties with real, or perceived, damages may look to take action against audit committees.

This is serious business, a road map for such litigation appears to be in place. The publications prepared by accounting firms make it clear that outside auditors no longer see themselves as primarily responsible for oversight of their clients' financial reporting, risk management or internal controls. Accounting firms have made this point in their written materials and in meetings with clients. They have emphasized that an audit committee's primary purpose is to protect a company's shareholders and directors and that the committee is the ultimate guardian of investor interests.

In light of this new thinking, many are of the view that directors and audit committee members should be more concerned about their exposure to litigation, questioning their performance and taking some preemptive action.

The seriousness of this matter should also be considered in the light of the cover article in the August 2, issue of Fortune "The Crackdown is Here." This article, while not directly applicable to audit committees, may well be an ominous harbinger of things to come. The thrust of this article is that corporate executives maybe subject to criminal penalties for cooking the books. As the article so cleverly puts it: "The nation's top earnings cop (SEC Chair Arthur Levitt) has put corporate America on notice: Quit cooking the books. Cross the line, you may do time."

While this threat of criminal action is directed at corporate management, one can only assume it has serious implications for audit committees, given Chairman Levitt's wishes that audit committees take a more proactive role.

What does this changing environment suggest? The bottom line is that the potential for litigation involving audit committees has clearly increased and therefore, it would be wise for these committees

to take steps to protect themselves.

As is often the case, the best defense may be a good offense. By securing legal counsel and their own independent advisors, as recommended by Chairman Levitt, audit committees can get the objective input they need to make sure they are properly structured and staffed and that defensible processes are in place.

A final thought: Now is the time for audit committees to draw the proper line so that no person in their organization ever has to do time.

H. Stephen Grace, Jr. is president of Grace & Co. Consultancy, Inc. John E. Haupt and Roberts S. Roath are members of the board of advisors of Grace & Co. Prior to their respective retirements, Mr. Haupt was treasurer of The Port Authority of New York and New Jersey; Mr. Roath was CFO of RJR Nabisco Holdings Corp.

Grace & Co. Consultancy,
Inc.

H. Stephen Grace, John
Haupt

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