

University of Mississippi

eGrove

---

Association Sections, Divisions, Boards, Teams

American Institute of Certified Public  
Accountants (AICPA) Historical Collection

---

1998

## Remarks Before the Blue Ribbon Committee on Audit Committee Practices

William T. Allen

Independence Standards Board

Follow this and additional works at: [https://egrove.olemiss.edu/aicpa\\_assoc](https://egrove.olemiss.edu/aicpa_assoc)



Part of the [Accounting Commons](#), and the [Taxation Commons](#)

---

## Remarks Before the Blue Ribbon Committee on Audit Committee Practices

December 9, 1998

### **William T. Allen**

Director, NYU Center for Law & Business  
Professor of Business & Professor of Law, New York University.  
Chairman, Independence Standards Board  
Of counsel, Wachtell, Lipton, Rosen & Katz

Thank you for the invitation to address this Blue Ribbon Committee. I hope I can contribute something to your deliberations and to the success of your important mission. I commend Chairman Arthur Levitt and the business leaders who are dedicating their attention to the important corporate governance subject of audit committee standards and practices.

I speak today to you in a number of capacities, each of which converges on today's topic. First, I speak as one with an academic interest in corporate governance. I am a Professor of Business in the Department of Finance and a Professor of Law at New York University and director of the NYU Center for Law & Business. In this capacity I am greatly interested in increasing our understanding and facilitating innovation in forms and practices of efficient management and governance. Such knowledge will permit greater productivity of our economy, which in turn would afford us a greater capacity to relieve human suffering and enhance human welfare.

Second, I speak to you also as the Chairman of the Independence Standards Board, the independent private sector board established jointly by the SEC and the American Institute of Certified Public Accountants to establish independence standards for public auditors. In this capacity I am especially concerned that auditors continue to perform their valuable service to our capital markets without being affected by economic or other interests that would cast a shadow upon their independence and thus the reliability of their attestation.

Finally I speak as a lawyer, counsel to a leading corporate law firm and former Chancellor of the Delaware Court of Chancery. In these roles I am concerned that in establishing corporate governance norms we exercise balanced informed judgment and do not create dysfunctional demands on those experienced men and women who accept an invitation to undertake the weighty responsibility of board and audit committee service.

I see each of these roles and goals as being entirely consistent with respect to the functioning of corporate boards in their audit oversight function. After a few background comments I will limit my remarks to a single aspect of audit committee functioning.

#### I.

Corporate governance is not a term that one very often encountered fifteen years ago. Then for the large publicly traded firm, "governance" was not much of an issue. In the conventional wisdom of the period corporate boards were inevitably and optimally passive advisory bodies. Things have changed remarkably over the last 15 years. Complete passivity on boards is no longer seen as optimal. Today it is more likely to be interpreted as pathological, in a strong form or weak one. The forces at work in this transformation have been powerful and in some cases elemental: technological innovation and political evolution contribute to the creation of global markets that are brutally competitive; technological and demographic changes have led to evolution of powerful investor voices in ever larger aggregations of savings, especially in mutual funds and pension funds. Finally, to a lesser extent, law has contributed to the transformation in corporate governance: courts have threatened directors with liability (while very rarely imposing it) and the SEC has notably reduced the costs associated with communication and coordination among institutional investors.

Today we no longer regard corporate boards as merely ornamental features of the business and economic landscape. Instead they have become an important focus of those investors, scholars, and regulators who seek moderate institutional change to improve productivity. Journalists and thus the public appear too to expect more of corporate directors today than in the past. Board members are increasingly urged to find a productive role as intermediaries between the expert senior management and the diverse and less well informed body of investors. Today boards of public companies --- smaller, comprised of individuals who themselves are committed to fewer boards on average and are more engaged -- appear to be responding to these changed expectations. Increasingly they are functioning more actively in their institutional role as informed intermediaries between senior management and a diverse body of investors.

## II.

I approach the subject of corporate boards with a strongly held view from my years as a corporate law judge. That belief is that when we encounter what, in retrospect, we conclude is poor board performance, it is rarely because the individuals involved understood their duty in the circumstances but chose for reason of gain or social ease to breach that duty. That sort of human weakness is of course present, but it does not account for most cases in which in retrospect we find sub-par board performance. Rather, I suggest that those instances of board under-performance we observe from time to time result principally from *a failure of the various constituencies interested in good corporate governance to agree on what constitutes right conduct for a board member in particular circumstances.* I believe, and I hope your experience leads you also to the conclusion that the vast preponderance of corporate directors *want to do the right thing*, but in moments of crisis and in even moments before a crisis, it is sometimes rather unclear what specific actions duty requires. Thus corporate directors can be assisted in their work by guidance respecting the nature and scope of their duty in various contexts from authoritative institutions: from courts in decided cases, from the SEC in enforcement actions, in no action letters and in rules and regulations; from Self Regulatory Organizations, such as the NYSE and NASDAQ in a variety of ways and from responsible professional organizations such as the Business Roundtable or NACD in establishing principles of good practice. Such guidance need not be couched in mandatory terms and should not deprive those on the firing line of flexibility in their considered actions. Progress generally does not lie in the direction of fixed mandatory business governance structures; there should be no single template for good corporate governance

structures. But such guidance will help to establish common expectations of the role of director or, in this instance, of audit committee member. Thus I see this committee's task as potentially highly beneficial.

Let me then turn specifically to audit committees. While our system has generally wisely avoided mandatory governance features, the notable counterexamples are vitally important. For example, every corporation *must* have a board that is replaceable through investor election either in whole annually or in staggered terms. Fundamental transactions -- merger, dissolution, charter amendment, sale of all assets - must be approved by shareholder vote. For Delaware chartered companies shareholders must retain the power to enact bylaws. Among these few mandatory governance provisions is the requirement, for issuers with publicly traded securities, that the board has an audit committee comprised either or by a majority of independent directors. This requirement was wisely and appropriately imposed first by the New York Stock Exchange and later by the NASDAQ. Many practical questions face a board when first establishing its audit committee or when periodically reviewing its board structure. What is the specific scope of audit committee responsibilities? Do they, for example, extend beyond financial audit to include review of the corporation's risk and legal compliance programs? Should the scope of the audit committee's responsibilities be set forth in a written charter for clarity? What skills are needed for effective service on the committee? What direct access should audit committee members have to firm officers or employees? What professional assistance ought the committee be authorized to retain? How extensive should the audit committee's role be in the auditor retention and at what stage? What sort of communication channel should the committee have with internal and external auditors? And finally, can the financial and risk monitoring function be carried out effectively by the audit committee without creating unreasonable burdens considering the nature of the commitment that a director is expected to make in assuming office? These are some of the questions to which I hope this committee is able to offer guidance.

Let me narrow my subject to the single aspect of the audit committee work: its role in selection of the corporation's outside independent auditor and specifically its role in assuring that in its opinion the auditing firm and its relevant personnel are independent of the company, its affiliates and officers. On this subject, as with others, I speak today for myself only and not for the ISB as an institution. The Independence Standards Board has not met and deliberated with respect to your recent invitation for comment.

### III.

Generally our law and our business practices reflect the embedded belief that the requirement that a judgment be made by an independent person - usually meaning an individual with no material conflicting interest with respect to the subject matter -- adds some element of assurance that the judgment reflects a *bona fide* effort to serve the interests that are supposed to be served by the process of which the judgment is a part. In theory our interest in the independent character of a decision maker is really concerned with his or her true mental state or attitude when the decision is weighed and made; on what we might call *subjective independence* of the decision maker. By mental state or attitude I refer to the characteristics of internal fortitude and independence of view that will lead to an evaluation and judgment unaffected by any irrelevant or inappropriate considerations. An extraordinary person may have this characteristic even when required to decide matters affecting his own important interests. But we cannot directly observe this characteristic of unusual integrity and may easily disagree

whether it is present in a particular case.

We design legal systems not with extraordinary persons in mind, but for people with average moral character and diligence and we try to build them in a way in which observable features of the world are employed rather than unobservable ones. We can do this only partially and imperfectly. Subjective states - intention -- is too important a part of our moral reasoning to be wholly eliminated. But in building a system to govern individuals of average moral character we assume that subjective independence - independence of judgment - will occur more frequently among persons who have no *objective circumstances* that would or might affect the judgment of an ordinary person. Thus in seeing if independence of mind is present we tend to use and I believe should use the objective criterion as the first and most essential criterion of independence.

The statutes of the United States require that every issuer of securities traded over an exchange or on NASDAQ periodically file with the Securities and Exchange Commission financial statements that bear the attestation of an *independent auditor*. Thus each issuer of such securities bears a legal duty to employ an independent auditor. Overseeing that that obligation is met is, I suggest, one of the core functions of the audit committee. Since with respect to its own retention the audit firm itself has a conflicting interest, it should certainly be insufficient for the audit committee, in making a determination of auditor independence to rely only upon the conclusion of the auditor itself that it is independent. The auditor's conclusion respecting its independence should I think be regarded as a necessary but insufficient basis for the conclusion that the auditor is in fact independent.

Conscientious corporate directors need three things to assist them to make such a determination. First they need to understand that good corporate practice strongly recommends that they undertake to make a judgment concerning the independence of the auditors who audit the corporation's books and financial statements. In other words they need to understand the *nature and scope of their duty*. Second the audit committee needs relevant information bearing upon all of the relations that the audit firm and its affiliates have with the corporation and its affiliates and officers. Third the board must have some operating definition of independence. When these three factors are present, and the audit committee takes an active part in evaluating auditor independence we can expect a series of safeguards to link. Investors can be offered the additional assurance that independent directors have closely inspected objective threats to auditor integrity. This is valuable to the capital markets because *directors have fewer incentive based compensation motivations than do corporate officers to approve "aggressive" accounting and they have stronger litigation based disincentives to do so*. Few investors or analysts will have the ability (or the economic incentive) to perform an informed review of the independence of the corporation's auditor and under the current regulatory regime they have little information to do so, even if they wanted to do so. The audit committee can perform an important function here.

Consideration of the first of three prerequisites for the committee to perform this function --- recognition of duty to do so --- falls, I believe, within the charge of this committee. I hope you will give active consideration to including within any statement, model, recommendation or standard you may issue a statement of the audit committee's responsibility to reach a conclusion respecting auditor

independence.

The ISB can and I think will shortly act with respect to the second prerequisite of board action: the furnishing of information to the audit committee bearing on auditor independence. The ISB has recently proposed for public comment a standard which if adopted will require an auditor to furnish to the audit committee information disclosing the nature and scope of all of its activities and those of its affiliates that may reasonably be thought to affect a reasonable person's judgment respecting its independence.

Thirdly, the audit committee must have a concept of independence in mind when it considers whether an auditor satisfies the statutory requirement that it is independent. A serious drawback of the current regulation of auditor independence is that over the decades it has grown into a complex body of prior rulings addressing specific fact patterns. The field has become a highly technical specialty requiring expertise and nevertheless it often eludes certainty. Large accounting firms have developed specialists in this learning. The technicality of this learning has had the perverse effect of disabling informed conscientious businessmen and women from making judgments concerning auditor independence on the same basis and with the confidence they might make such judgments concerning other professionals. Instead auditor independence has for the most part been relegated to auditors themselves to certify to the corporation their own independence. Busy board members no doubt have been quite willing to accept this practice. But recognition of the evident fact that the auditor itself is in a conflict of interest situation with respect to this judgment makes any such complete reliance suspect as a matter of fiduciary duty. Especially now when new threats to auditor independence are thought by some, including the Securities and Exchange Commission, to be evolving in the marketplace, existing practice is too frail a support for continuation of board delegation of independence determinations to others. The board itself must make an informed judgment on this subject.

The Independence Standards Board was formed to try to address the dysfunctional complexity of current independence regulation in auditing. The board will if it succeeds bring some clarity to a presently complex field. In the interim it should be sufficient for conscientious audit committees to rely upon the technical opinion of their audit firm for the limited purpose of assuring the auditor's compliance with technical rules or precedents of independence. This opinion should be regarded as a necessary but insufficient basis for the audit committee's own judgment. This judgment, particularly in the absence of contrary authoritative guidance from the SEC, the ISB or other authoritative body, is of the same type as that which any rational, informed decision maker would make in similar circumstances. That is, the board might ask whether, in light of all of the relevant known facts, the judgment of a reasonable person in the situation of the audit firm or any of its partners or employees with significant responsibility with respect to the audit, might reasonably be thought to be subject to a material risk that its or his or her judgment might be affected by an interest other than interests shared by the users of the firm's audited financial statements.

For the audit committee to ask that question in addition to its questions concerning auditor competence, integrity and service and then pass an informed judgment on it will, in my opinion, contribute positively to the market perception of the integrity of the corporation's accounting and reporting practices and the integrity of its financial statements. This contribution will not benefit the costs of capital of the firm but when generalized will enhance the efficiency of our vital

capital markets.

Thank you for the opportunity to share my thoughts on one aspect of your topic.

No Microsoft Word™ version or web version is currently available.

Return to the [Main Page](#).

Copyright © 1998, 1999, 2000, 2001 [Independence Standards Board](#)  
All Rights Reserved.