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II. Accountants

The Developing Role of the Independent Auditor in Corporate Governance

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The attention focused on the board of directors' role in corporate governance in the last decade has not shown signs of abating as we settle into the 1980's. Many reforms instituted in the past ten years, of which the audit committee is the most prominent, have been accepted by all parties to the governing process. The challenge in the years ahead is to develop the role of this committee, and of the others which have emerged with it, in such a way that it fosters improved economic and social performance of the corporation without unnecessarily interfering with the prerogative of management. This development will also affect the role of the independent auditor in the corporate governance process.

Corporate governance is a broad concept that encompasses a wide range of decisions made within the modern corporation. These decisions include determining overall policy, specifying operating and employment goals, and implementing those goals through daily managerial decisions. No single participant in this process can be expected to make all of these decisions: Just as delegation of authority is necessary to produce goods and services, so must those responsible for governing the corporation delegate some decisionmaking authority to subordinates.

In this hierarchical scheme, it would seem to be of primary importance that the position of each individual be identified, and that spheres of influence be carefully delineated. However, such discrimination is rare in the modern corporate organization: Managers, directors, and auditors all have overlapping responsibilities, and none may assume a narrowly defined or entirely subordinate role. In addition, the different personalities and abilities of the individuals involved and the diversity of situations encountered make any single prescription of roles untenable.

The manager executes the general policies articulated by the board of directors, yet he (or she) retains considerable latitude for independent decisionmaking in this regard. His paramount duty is to implement policy as outlined by directors; however, he may also influence policy by identifying the issues which will be brought before the board. Managers retain a significant degree of control since many more opportunities confront them than the company's directors can anticipate. Hence, to circumscribe management's ability to function in this manner might damage the long term interests of the corporation.

Nonetheless, the directors must assume responsibility for overseeing all major decisions made by the managers and for monitoring the managers' actions.

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Events of the past decade have forced a public reevaluation of the extent of directors' responsibility and liability for management performance, with the result that the role of directors has dramatically shifted from one of passive approval to one of active participation. This change is reflected in various ways—in the number of journal articles devoted to the "new" director,[1] in the greater time commitments expected of directors, in the liability insurance now available to directors,[2] and in the higher salaries and extended compensation packages now provided many directors.

At the same time that directors' responsibilities have been increasing, inside and outside directors are increasingly being differentiated. It is well known that former Securities and Exchange Commission (SEC) Chairman Harold Williams and others have consistently advocated that the board be comprised entirely of outside directors with the exception of the chief officer.[3] While this position may be extreme, the number of outside directors on a board has nonetheless become a sensitive issue.[4]

The interests of inside directors in most cases do not diverge from those of shareholders. The increased fiduciary liability of all directors constrains their behavior, and their future in the market for managers, an often overlooked factor, also tends to align directors' interests with those of shareholders. The latter incentive is only beginning to be recognized as a theoretically powerful influence on inside directors, but if its effect can be demonstrated empirically, the distinction between inside and outside directors will be of little consequence. However, in the absence of strong evidence to the contrary, the addition of outside directors to the board may be assumed to enhance the board's role as the representative of stockholder interests.

The increase in directors' responsibilities has resulted in an increase in their workload, as they are permitted to leave fewer areas of corporate endeavor unexamined. This development is welcomed by those concerned with the corporation's role in ensuring society's welfare. However, the increased responsibility of the board has also created a greater need for the delegation of authority among board members and to hired agents, such as auditors and counsel.

To satisfy their oversight obligations, directors must rely on the expert opinion of independent investigators of the corporation's activities. One primary source of this expertise is the annual audit, a third party investigation and review of the financial representations of management. The independent auditor acts as a surrogate director by insuring that management's report is not only accurate, but also timely and comprehensive. The auditor's responsibilities have come under increased scrutiny as the visibility of the large accounting firms has grown, as a result both of their own actions in the marketplace and in response to recent

1 *See, e.g.*, Smith, *Boardroom Is Becoming a Different Scene*, 97 FORTUNE 150 (1978); Sethi, *Catch-22 in Reform Proposals for Restructuring Corporate Boards*, 68 MANAGEMENT REV. 27 (1979); *Directors' Duties: New Attitudes and Tougher Laws*, 30 DIRECTOR 73 (1977); Estes, *The Emerging Solution to Corporate Governance*, 55 HARV. BUS. REV. 20 (Nov.-Dec. 1977).

2 *See* MODEL BUS. CORP. ACT § 5(g) (1979); Brockmeier, *Trends in D & O Liability Insurance*, 25 RISK MANAGEMENT 58 (1978); Matter, *Exposure of Corporate Directors: An Overview of Indemnification and Liability Insurance*, 46 J. RISK INS. 411 (1979).

3 *See, e.g.*, Williams, *SEC Chairman Calls for Independent Corporate Boards*, 145 J. ACCOUNTANCY 10 (1978).

4 *See generally* West, *Should Management Sit on the Board?*, 67 MANAGEMENT REV. 29 (1978); Rosenfeld, *Independent or Outside Corporate Directors*, 47 CPA J. 7 (1977).

dramatic legal confrontations.[5]

Auditor independence is the most prominent concern of commentators. The recent initiatives of the SEC[6] and Congress[7] prompted suggestions that the public accounting firms might have to do battle to defend their claims of independence.[8] The issue seems to have receded for the time being, possibly in response to actions taken by the American Institute of Certified Public Accounts to enhance audit quality control.[9] However, the profession will have to examine any future business development in light of the latent concern regarding this issue.

Audit independence is enhanced both in fact and in appearance by the creation of audit committees made up of outside directors. Independent accountants and outside directors are natural allies—both have a responsibility to shareholders from a perspective different from that of management, and both face less potential role conflict than do directors and senior management. The improved and institutionalized communication between policy setters and independent fact-finders with a community of interest enhances the effectiveness of both. The absence of inside directors on audit committees eliminates the possibility that pressure from management will color the auditor's reports to the directors, and makes possible more candid presentation of evolving problems. It is especially important that creation of the audit committee serve to underscore the auditor's ethical obligation to be an active partner in the corporate governance process. This is not to suggest that the auditor engage in decisionmaking, but rather that he not interpret his role in a narrow, legalistic and passive sense.

Public dissatisfaction with the oversight activities of the auditor under direction of the board grew over the past two decades in response to numerous audit failures and corporate scandals. Government initiative increased the scope of the auditor's function over that period in response to the perceived reluctance of all other responsible parties to monitor adequately management's behavior. The most prominent of the government's interventions was the enactment of the Foreign Corrupt Practices Act.[10] This action, in addition to widespread public discussion of directors' social responsibilities and increased stockholder demands for corporate accountability, has made boards and independent auditors increasingly cognizant of their social obligations. The SEC mandated a second major increase in the scope of auditors' activities in 1976 when it increased auditor involvement in interim reporting[11] in response to a concern that adequate controls did not exist in this area.

Now the economic pressures which have been mounting for some time have

5 *See, e.g.*, Touche Ross & Co. v. Redington, 442 U.S. 560 (1979); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

6 *See* Accounting Series Release No. 234, 42 Fed. Reg. 64,304 (1977); Accounting Series Release No. 242, 43 Fed. Reg. 7752 (1978).

7 *See* Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, tit. I, § 102, 91 Stat. 1494 (amending Securities Exchange Act of 1934, § 13(b)(2)) (codified at 15 U.S.C. § 78m(b)(2) (Supp. 1978)).

8 *See, e.g., Williams Urges Independence at Conference on SEC Developments*, 145 J. ACCOUNTANCY 24 (1978); Arthur, *Independence, Yes, but Where do We Draw the Line?*, 89 ACCOUNTANCY 90 (1978).

9 *See, e.g.*, Auditing Statement No. 6: Quality Control—Ensuring and Improving the Quality of Audits, 90 ACCOUNTANCY 109 (1979).

10 Pub. L. No. 95-213, tit. I, 91 Stat. 1494 (1977) (codified at 15 U.S.C. §§ 78m, 78dd-1, 78dd-2, 78ff (Supp. 1978)). The Act added new accounting provisions to the Securities Exchange Act of 1934. 15 U.S.C. § 78m(b)(2) (Supp. 1978).

11 *See* Accounting Series Release No. 177, 40 Fed. Reg. 46,107 (1975).

introduced a new emphasis in corporate governance. Public attention has changed its focus from the corporation's social responsibility to its economic function. Although there is no consensus of opinion as to the causes of the current economic conditions, there is widespread agreement that some relief can be found in improving the efficiency and productivity of corporations.

The reassessment of business priorities requires the supervision of those ultimately responsible for corporate success: the directors. While periods of relative prosperity may free the board to attend to the social governance of the corporation, the demands of stockholders now necessitate greater supervision of the corporation's economic activities. The passivity which characterized much of the board's supervisory activity in the past is being challenged again: this time not by government initiatives requiring more attention to social responsibilities, but by stockholders demanding more attention to their economic interests.

Improved efficiency and productivity are not, therefore, the sole province of management. Directors are obligated to assume an active role—not only as critics of management's performance, but as partners with management in establishing more productive operating systems within the firm.

As the board of directors redirects its attention to the firm's economic potential, several developments will significantly affect both the way it carries out its responsibility and the roles of the other participants in the corporate governance process. These developments are, first, the institutionalization of the audit committee; second, the growing concern of auditing firms with the marketing and development of the audit function; and finally, the remarkable evolution of systems technology which permits substitution of internal controls for much of the customary audit review work and thus frees the external auditors for more sophisticated analytical work.

The emergence of the audit committee has been chronicled by many lawyers and accountants in recent years,[12] and need not be repeated here. At this juncture, the audit committee is in a unique position to expand the board's oversight role through the investigations of the external auditor. Because the duties of audit committees have not been prescribed by any authoritative body,[13] such committees are free to experiment with alternative methods of evaluating management performance, and to assess the extent to which these methods contribute to the overall economic performance of the firm. Most audit committees to date have acted as conduits of information between external auditors and the full board, and have coordinated the functions of internal and external auditors. The independence of audit committee members[14] has assured that the committees have a community of interest with the external auditors in performing the board's oversight function. It is probably fair to say, however, that few audit

12 *See, e.g.*, Greene & Falk, *The Audit Committee—A Measured Contribution to Corporate Governance: A Realistic Appraisal of its Objectives and Functions*, 34 BUS. LAW. 1229 (1979); *Accounting—The Audit Committee—A Progressive Move Toward More Meaningful Financial Reporting*, 3 J. CORP. L. 400 (1978); *Audit Committees*, 179 ACCOUNTANT 706 (1978); Davison, *Role of the Audit Committee*, 179 ACCOUNTANT 290 (1978); Hammond, *Corporate Audit Committee: Its Emerging Roles*, 39 MORTGAGE BANKER 54 (1979).

13 *But see* Baruch, *Audit Committee: A Guide for Directors*, 58 HARV. BUS. REV. 174 (1980); Chait, *Local Government Legislators Should Consider Audit Committees*, 8 GOVERNMENTAL FIN. 29 (1979); *AICPA Holds Public Hearing on Possible Audit Committee Rule*, 146 J. ACCOUNTANCY 12 (1978).

14 All must be outside directors under New York Stock Exchange Rule 2495H.

committees have exploited that community of interest to develop a meaningful dialogue with the corporation's external auditors.

As the audit committee seeks to define and fulfill its obligations to shareholders, it may encounter an opportunity to enhance its usefulness arising from an unlikely source: growing competition among accounting firms. The relative maturity of the market for auditing services is prompting some of the more aggressive auditing firms to examine approaches to marketing their services in an increasingly competitive environment. One possible result may be the expansion of the audit function itself to incorporate a wide range of services to management and the board, services which have long been potential outputs of the auditor's work. Of particular note are those services which would help the board review management's performance—a survey of internal controls, a critique of information systems as decisionmaking supports, and the management audit itself. To date, the profession's response to competition has been markedly less creative than that suggested above; no accounting firm has yet marketed these services. For the most part, the firms have merely stressed the need to sell aggressively their single product—the statutory audit. However, as audit committees add their own weight to the competitive pressures already being felt by the firms, the likelihood increases that they will take a more radical approach to market development.

The third development which will shape the audit committee's increasingly active oversight role is the pace of evolution in auditing technology. External auditors are eliminating more and more of the substantive testing of their clients' systems as the growth in sophisticated internal controls makes such work superfluous. As the role of external auditors becomes more analytical their reliance on internal auditors—and their freedom to extend the scope of the audit—increases. The internal auditor's work and the company's internal control systems not only reduce the overall cost of the audit by minimizing labor-intensive testing, but also enable the external auditor to better understand the client's business. The cooperation between internal and external auditors is particularly useful in this regard, and can be expected to lay the groundwork for a more comprehensive audit function. Additionally, the reliability of the company's internal information systems makes continuous auditing a real possibility in the future. Such continuous auditing would make information available to the board, and to stockholders, much sooner than annual auditing permits.

These developments set the stage for the still-evolving audit committee to assume greater responsibility for overseeing the economic performance of management. Because of the independence shared by the outside directors on the audit committee and the company's auditors, the latter serve as an ideal information resource in the board's supervisory role. Some observers have suggested that the board hire its own staff in addition to the professionals hired by the company's management in order to meet fully the requirement of independence. Except in extreme cases where there is reason to doubt management's integrity and the auditor's independence, separation of "management's staff" from the "board's staff" introduces a superfluous and potentially counterproductive agent into the governance process. Rather than debate the merits of adding another agent to assist the board, it is more instructive to examine the ways in which the audit committee can better use the agent it already has in carrying out its responsibilities.

Creating a closer relationship between audit committee and auditor will facilitate the acquisition of information useful to the board in overseeing management, and may also help create a forum for initiating changes in management information systems. As their role continues to evolve from passive to active supervision, directors will be expected to question not only actions management did take, but also actions it might have taken. This expansion of directors' supervisory role should not take on the aspect of Monday morning quarterbacking, but should focus on assessing management's evaluation procedures and the adequacy of the information on which managers base their decisions. In most cases the board will engage in this evaluation as a confederate rather than an adversary of management, in an effort to encourage more effective decisionmaking procedures. The firm's independent auditors may be among the board's primary resources in this regard. Together with the firm's internal auditors, and under the direction of its audit committee, they may help develop information systems for improved forecasting, more sensitive cost benefit analysis, or more informative social impact reporting.

In addition to seeking information with which to evaluate the performance of management, the audit committee is likely to concern itself with evaluating the performance of the independent auditor. Whereas selection of an auditor was once a relatively simple matter of ratifying management's choice (usually the past year's auditor), the decision will receive more attention from the committee specifically charged with responsibility for making it. In fact, reports of auditor changes suggest that audit committees are already taking a more aggressive stand in proposing changes.[15]

An audit committee has essentially two means of reducing the cost of audits. First, it can insist on substituting internal controls for the labor-intensive work of the independent auditor, and thereafter attempt to curtail the hours the external auditor spends on review. This option obviously entails increasingly high risk for directors and auditors, and both are likely to resist it. The committee's second option is to insist on greater value for its audit dollar through enhancing the output from the audit. Former practicing CPA's serving as audit committee members should be particularly instrumental in this regard. Familiarity with the broad information set obtained in the course of the audit will enable them to make reasonable demands for analytical work based on that information.

A number of spokesmen for the accounting profession have recently pointed to the inadequacy of the auditor's opinion as the sole product of hundreds of hours of investigation into company operations.[16] The management letter, which has traditionally focused on minor improvements in the company's internal controls, is a gesture by auditors towards enhancing their output, but is little more than a step in the right direction.

The preliminary work which must be done in the course of an audit gives the auditor a valuable perspective on both the nature of the client's business and

15 *See* Management Analysis Center, Inc., *Results of Survey of Accounting Firm Changes*, 2 DIRECTORS & BOARDS 52 (1977).

16 *See, e.g.*, Bromage, *Improving the Audit Report*, 148 J. ACCOUNTANCY 88 (1979); Thompson, *Audit Reports that Communicate!*, 37 INTERNAL AUDITOR 83 (1980).

the systems which support it. In large part the high cost of an audit is a result of the cost of obtaining this familiarity with the firm. However, the structure of today's audit prevents the client from obtaining the full benefit of the auditor's knowledge. The traditional orientation of the auditor has been to limit his potential liability by limiting the scope of his review. The accounting profession's reaction to the SEC's recent proposal to require public reports on internal controls[17] is only the most recent example of the profession's opposition to any proposal to increase its responsibilities.

The auditor's potential for serving as a useful resource for directors and management in improving firm efficiency nonetheless exists. Little additional input would be required for the auditor to prepare reports on improving the efficiency of the inventory system, to develop information retrieval systems for tax planning, or to counsel the board on aspects of dealing with the effects of inflation on different firm operations. The auditor also could develop a framework for the independent audit of management, an additional performance review from which the board could benefit. The behavioral complications which might arise in the relationship between managers and auditors if the latter assumed responsibility for a comprehensive performance audit warrant serious attention; however, precedent for the independent review of management performance does exist. A few publicly held firms, and many more government and quasi-government agencies, have begun to require management audits as an additional input into their oversight function. These audits have been performed by both consulting and auditing firms, and reported results suggest that the additional perspective thus provided has been of considerable value in the governance process.[18]

All of the extensions of the audit proposed above are possible for most auditing engagements. Failure to exploit these opportunities has been the shared responsibility of auditors and their clients, neither of whom have demonstrated the imagination or initative to develop these services. It may be expected, however, that as the institution of the audit committee continues to define itself, a closer working relationship between auditor and director will result. This improved communication, together with the growing public demand for director involvement in the corporation's operations, should result in a reexamination of the economic contribution of the firm's auditors. And once the audit itself is subjected to analysis by the corporate directors, it should be only a short step to the development of a truly comprehensive audit.

17 *See, e.g.*, *SEC Commentary; Proposed Rules on Statement of Management on Internal Accounting Control: Implications for Auditors*, 49 CPA J. 65 (1979); Godwin, *Outlook for Public Internal Control Reports*, 48 CPA J. 13 (1978); *New Requirements for Communicating Internal Control Weaknesses*, 11 PRACTICAL ACCOUNTANT 39 (1978).

18 *See generally* Campfield, *Management Auditing: Pathway to Efficient, Economical Operations*, 35 INTERNAL AUDITOR 33 (1978); Ellis, *Auditing the Management Process*, 37 INTERNAL AUDITOR 53 (1980).