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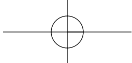
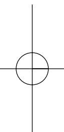
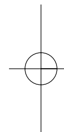
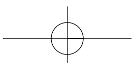


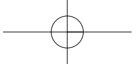
Part One

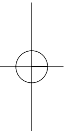
Getting Acquainted with Your Responsibilities

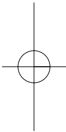


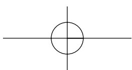












Chapter 1

Corporate Accountability: The New Environment

To properly understand the importance of the corporate director's position on the audit committee, one must understand the nature and importance of the concept of corporate accountability in the new legal and regulatory framework under statutory law. Therefore, the major objectives of this chapter are: first, to revisit the meaning and significance of corporate accountability; second, to explain the significance of major audit committee developments in the context of corporate accountability with special emphasis on those of the past five years; and third, to show the impact of corporate accountability on the audit committee and its corporate relationships.

Although the recent failures of major corporations, such as Enron, WorldCom, and others, have accelerated the need for legal and regulatory reforms, the concept and meaning of corporate accountability in relation to the institution of the audit committee remains the same both before and after accounting scandals. However, with the enactment of the Sarbanes-Oxley Act of 2002, the substantive meaning of corporate accountability has caused many best practices for audit committees to become statutory law. Moreover, the new legislation has caused an institutional restructuring of the accounting profession as well as additional resources for the Securities and Exchange Commission (SEC) to curb abuses of fraudulent financial reporting.

THE NATURE AND IMPORTANCE OF CORPORATE ACCOUNTABILITY

The Meaning of Corporate Accountability

With the recent establishment of the Public Company Accounting Oversight Board (PCAOB) with its oversight and enforcement authority over the independent audit process and the concomitant effect on strengthening the institution of the audit committee, it is reasonable to expect that shareholders and other constituencies of corporations will receive relevant and reliable financial information. Thus, such congressional legislative action will help to ensure an efficient capital market system. As James S. Turley, chairman and chief executive officer of Ernst & Young LLP, points out;

> The biggest problem today is the loss of confidence, in not just our profession, but in financial management, executive management. audit committees and boards.

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> [While] I see no silver bullet to turn that around, I think it is going to be turned around by sustained, outstanding performance, high quality [and] high integrity by all parties—management, audit committees, audit firms.[1]

Strictly speaking, the concept of corporate accountability may be stated in this way:

> The board of directors is charged with safeguarding and advancing the interest of the stockholders, acting as their representatives in establishing corporate policies, and reviewing management's execution of those policies. Accordingly, the directors have a fiduciary responsibility to the stockholders. They have an obligation to inform themselves about the company's affairs and to act diligently and capably in fulfilling their responsibilities.[2]

The board of directors is charged with protecting the interests of the stockholders because the position of the board is determined by state laws. The powers and responsibilities of the board are defined in the corporate charter and the corporate bylaws. Therefore, from a legal point of view, the basic purpose of corporate accountability is to provide a legal framework within which the directors must discharge their stewardship accountability to the stockholders. Furthermore, the board is directly answerable to the stockholders because the stockholders, as the owners of the enterprise, have entrusted their capital resources to the management of the corporation. (See Appendix H on this book's website.)

The Business Roundtable described corporate accountability in this way:

> The board of directors is ultimately accountable to the shareholders for the long-term successful economic performance of the corporation consistent with its underlying public purpose. Directors are held accountable for their performance in a variety of ways.
>
> First, there is the powerful accountability imposed by markets. The impact of consumer dissatisfaction with products and services is quick and visible. Financial markets also quickly reflect their evaluation of the quality of accountability through the price of equity and debt.
>
> Accountability is also imposed through the numerous statutes and regulations enacted by governmental bodies to limit and control corporate action. Directors are held accountable to regulatory mechanisms.
>
> There is also a body of law—part statutory, part court-made—which defines the duties of directors and the principles and boundaries within which they must keep their decisions. If they overstep, their decisions are subject to reversal by the courts. Directors can also be held personally liable, without limitation, to the extent of their personal assets if they violate their duty of loyalty to the corporation.
>
> A final form of board accountability comes through the election of directors by the shareholders at the corporation's annual meeting. Annual meetings may also include shareholder resolutions which are a form of governance by referendum.

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[1]James S. Turley, "The Future of Corporate Reporting: From the Top," *Financial Executive* 70 (December 2002), p. 2.

[2]American Institute of Certified Public Accountants, *Audit Committees, Answers to Typical Questions about Their Organization and Operations* (New York: AICPA, 1978), p. 7.

> Each of these forms of accountability is dynamic, not static. The developing specifics of each form of accountability must be judged as to its overall potential to contribute to the successful long-term performance of the corporation. Each specific new item of accountability carries with it the potential for harm as well as good.[3]

More recently, the Business Roundtable restated its guiding principles of corporate governance:

> First, the paramount duty of the board of directors of a public corporation is to select a chief executive officer and to oversee the CEO and other senior management in the competent and ethical operation of the corporation on a day-to-day basis.
>
> Second, it is the responsibility of management to operate the corporation in an effective and ethical manner in order to produce value for stockholders. Senior management is expected to know how the corporation earns its income and what risks the corporation is undertaking in the course of carrying out its business. Management should never put personal interests ahead of or in conflict with the interests of the corporation.
>
> Third, it is the responsiblity of management, under the oversight of the board and its audit committee, to produce financial statements that fairly present the financial condition and results of operations of the corporation, and to make the timely disclosures investors need to permit them to assess the financial and business soundness and risks of the corporation.
>
> Fourth, it is the responsibility of the board and its audit committee to engage an independent accounting firm to audit the financial statements prepared by management and to issue an opinion on those statements based on Generally Accepted Accounting Principles. The board, its audit committee, and management must be vigilant to ensure that no actions are taken by the corporation or its employees that compromise the independence of the outside auditor.
>
> Fifth, it is the responsibility of the independent accounting firm to ensure that it is in fact independent, is without conflicts of interest, employs highly competent staff, and carries out its work in accordance with Generally Accepted Auditing Standards. It is also the responsibility of the independent accounting firm to inform the board, through the audit committee, of any concerns the auditor may have about the appropriateness or quality of significant accounting treatments, business transactions that affect the fair presentation of the corporation's financial condition and results of operations, and weaknesses in internal control systems. The auditor should do so in a forthright manner and on a timely basis, whether or not management has also communicated with the board or the audit committee on these matters.
>
> Sixth, the corporation has a responsibility to deal with its employees in a fair and equitable manner.
>
> These responsibilities, and others, are critical to the functioning of the modern public corporation and the integrity of the public markets. No law or regulation alone can be a substitute for the voluntary adherence to these principles by corporate directors and management and by the accounting firms retained to serve American corporations.
>
> The Business Roundtable continues to believe that the most effective way to enhance corporate governance is through conscientious and forward-looking action by a

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[3]The Business Roundtable, *Corporate Governance and American Competitiveness* (New York: The Business Roundtable, 1990), pp. 15–16.

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> business community that focuses on generating long-term stockholder value with the highest degree of integrity.
>
> The principles discussed here are intended to assist corporate management and boards of directors in their individual efforts to implement best practices of corporate governance, and also to serve as guideposts for the public dialogue on evolving governance standards.[4]

With respect to establishing and maintaining corporate policies, the board of directors is responsible to the stockholders for ensuring that management fulfills its responsibilities in the execution of the corporate policies. For example, the board can authorize the establishment of an audit committee to assist the board with the development of the financial accounting policies. In addition, the audit committee can be authorized to review the preparation of the financial statements as well as to select the independent auditors. Although the board has the power to delegate authority to the various standing committees, such as the audit committee or the executive committee, the board must render an accountability to the stockholders. In short, the board has a fiduciary relationship with the stockholders and, as a result, must report periodically on the status of the corporation's economic resources.

As John Shandor points out:

> Audit committees have become crucial to the audit process. Also, the audit committee has been considered essential in an organizational approach to making boards of directors more effective in their interaction with financial management and chief executive officers as well as with internal audit staff and independent auditors.[5]

In addition to the directors' fiduciary responsibility, they are expected to attend board meetings and their appropriate standing committee meetings. A director must keep informed on the affairs of the corporation and use reasonable care and diligence in the performance of his or her duties. It is imperative that the director keep abreast of the corporate developments since he or she is directly responsible for participating in the decisions that affect the management of the corporation. Thus the director may be held liable for losses sustained by the corporation as a result of his or her neglect.

Practically speaking, the concept of corporate accountability extends not only to the stockholders but also to the other constituencies of the board of directors, such as credit grantors and governmental agencies. The extension of corporate accountability to the other constituencies is evidenced by a meeting of the American Assembly. The discussion leaders focused their attention on questions central to running the corporation vis-à-vis its many constituencies. With respect to a framework for corporate accountability, the participants generally agreed on this:

> Boards of directors have a primary role in interpreting society's expectations and standards for management.

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[4]The Business Roundtable, *Principles of Corporate Governance* (Washington, DC: The Business Roundtable, May 2002), pp. iv–vi.

[5]John Shandor, "Audit Committees Take a Broader Role in Corporate Policy," *Corporate Controller* 2 (November/December 1989), pp. 46–48.

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The five key board functions are:

(a) Appraisal of management performance and provision for management and board succession;

(b) Determination of significant policies and actions with respect to present and future profitability and strategic direction of the enterprise;

(c) Determination of policies and actions with a potential for significant financial, economic, and social impact;

(d) Establishment of policies and procedures designed to obtain compliance with the law; and

(e) Responsibility for monitoring the totality of corporate performance.

Boards should continue to be the central focus in improving the way corporations are governed.[6]

In addition to the American Assembly's recommendations, to establish and maintain a successful program of corporate accountability, the following three prerequisites are necessary:

1. The board of directors and the officers must assume prime responsibility for corporate accountability as well as define and clarify the objectives and responsibilities concerning the different levels of the organization. Therefore, the individuals who are assigned responsibility at the middle and lower management levels should be held accountable for their activities.
2. The organization chart of the corporation is central to establishing corporate accountability since the jurisdiction for each area within the corporation must be defined. Also, the extent of authority should not only be clearly outlined but also commensurate with the individual's responsibilities.
3. Executive management should create a management environment whereby the middle and lower management levels understand the nature of corporate accountability. Thus management should maintain an effective communications network within the organizational structure.

As a case in point, Bruce W. McCuaig and Paul G. Makosz report that Gulf Canada Resources, Ltd., has developed a new approach to corporate governance through the use of an internal control assessment strategy. Such a strategy was developed based on a clear definition of internal control as a combination of (1) organization controls, (2) systems development and change controls, (3) authorization and reporting controls, (4) accounting systems controls, (5) safeguarding controls, (6) management supervisory controls, and (7) documentation controls. With the implementation of a management-by-objectives framework and related control mechanisms, the authors observed that the board of directors and senior management are far better informed.[7]

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[6]The American Assembly, *Corporate Governance in America,* Pamphlet 54 (New York: Columbia University, April 1978), p. 6.

[7]Bruce W. McCuaig and Paul G. Makosz, "Is Everything Under Control? A New Approach to Corporate Governance," *Financial Executive* 6, No. 1 (January/February 1990), p. 25.

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The subject of corporate accountability is a dynamic concept in the governance of the corporation. It is dynamic because the directors not only must assess the changing needs of their constituencies but also render a stewardship accountability based on legal pressures from their constituencies.

The Need for Corporate Accountability

In view of the size and scope of modern corporations as well as the increasing demands in the legal and regulatory environment, the need for corporate accountability has become very important in the evaluation of the performance of the board of directors. For example, the sales figures of these corporations amount to billions of dollars, which far exceed the gross national product of several countries. In addition, large corporations have control over the major economic resources of society. Furthermore, the board of directors is subject to numerous public laws, such as the Environmental Protection Act, the Occupational Safety and Health Act, federal securities laws, and antitrust laws. Thus many of these corporate enterprises play a significant role in the future of our society, since the decisions of corporate management have a direct impact on the economy.

Unfortunately, corporations are confronted with the problem of a lack of credibility because they often have been subject to corporate self-interest as opposed to the public interest. As one former executive partner of Price Waterhouse International asserts:

> We have all been stunned by the shocking disclosures of alleged improper payments and similar activities, not by funny fly-by-night firms nobody ever heard of, but by some of the finest names on the roster of American enterprise. . . . As one inevitable result, reinforced by uneasy business conditions, public confidence in American business has plunged to its lowest level since the great depression. It is as if these events simply confirmed a gathering suspicion that such transgressions are not exceptional—a suspicion that American business is built on bribery and deceit.[8]

Samuel A. DiPiazza, Jr., CEO, PricewaterhouseCoopers LLP, and Robert G. Eccles, president, Advisory Capital Partners, echo that observation:

> Public trust has shaken in the institutions on which this value creation depends. These institutions share a collective responsibility for producing the information on which people of many levels—investors, lenders, trading partners, customers, employees—depend to make a wide range of economic decisions. The challenge now is to institute the necessary reforms to ensure that public trust does not disappear, and the foundation for those reforms lies in corporate reporting.[9]

In an effort to close the credibility gap or the expectation gap with respect corporate accounting scandals, the U.S. Congress passed the Sarbanes-Oxley Act on

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[8]John C. Biegler, "Rebuilding Public Trust in Business," *Financial Executive* 45 (June 1977), p. 28.

[9]Samuel A. DiPiazza and Robert Eccles, *Building Public Trust: The Future of Coporate Reporting* (New York: John Wiley & Sons, 2002), p. 2. See also John Morrissey, Securities and Exchange Commission, "Corporate Responsibility and the Audit Committee," March 21, 2000, *www.sec.gov/news/speech/spch357.htm*.

July 25, 2002, and President George W. Bush signed the bill into law on July 30, 2002.[10] Now the standards of corporate accountability have been enacted into statutory law, including securities laws and self-regulatory organizations' listing standards. Such legislation will provide a framework that can be used to measure the performance of audit committee members, independent auditors, chief executive officers, and chief financial officers. Consequently, directors of publicly help corporations may be more vulnerable to lawsuits as well as to the increased risk of liability. As a result, many qualified persons may be reluctant to accept a position on a board of directors.

Although the standards of corporate accountability have been addressed recently in the U.S. Congress, the call for higher standards in corporate governance and financial reporting has remained a top priority, as evidenced by these observations.

The need to resolve the credibility gap is evident. Corporate management must adopt standards of corporate accountability. As one proponent points out:

> Every corporation's business is conducted by some standard. If it is not formulated systematically at the top, it will be formulated haphazardly and impulsively in the field. And top management will be called on to defend practices that were unnecessary and unintended.[11]

Consequently, the need for corporate accountability is not only apparent but essential in shaping and projecting a corporate image to the public.

Shaun F. O'Malley, former co-chairman of Price Waterhouse World Firm (now PricewaterhouseCoopers), points out that dramatic changes have occurred in the roles of boards of directors, auditors, and management and in the relationships between these groups. Corporate accountability is a question of balance among the three groups as well as between government and the private sector. Shareholders and other constituencies of the company will continue their demands for protecting the company from fraud along with communicating warning signals of possible business failures.[12]

Daniel J. McCauley and John C. Burton comment on the changing expectations of director responsibility and audit committees:

> The limited responsibility of the directors for financial matters, as it formerly existed, has been significantly changed in recent years. The public's loss of confidence in the business community has been accompanied by a correlative demand for greater director vigilance over company financial integrity. This oversight function of the board has been promoted as one of the means for restoring business's image.[13]

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[10]Sarbanes-Oxley Act of 2002, H.R. Rep. No. 107-610, July 25, 2002, and Title 1 of Public Law No. 107-204, July 30, 2002.

[11]Biegler, "Rebuilding Public Trust in Business," p. 29.

[12]Shaun F. O'Malley, "Auditing, Directors, and Management: Promoting Accountability," *Internal Auditing* 5, No. 3 (Winter 1990), p. 3.

[13]Daniel J. McCauley and John C. Burton, *Audit Committees,* C.P.S. No. 49 (Washington, DC: The Bureau of National Affairs, 1986), p. A–3.

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RECENT DEVELOPMENTS IN CORPORATE ACCOUNTABILITY

As previously discussed, during the late 1990s, unprecedented public attention was focused on the role and responsibility of audit committees in promoting corporate accountability and investor confidence in the integrity of the audit processes and financial reporting process. Although the concept and practices of audit committees were recognized and accepted over the past 20 years, unexpected failures of major corporations and disclosures of questionable financial reporting practices diluted investors' confidence in the capital marketplace. Notwithstanding, the common question asked by investors was "Where were the auditors?" Another question was "Where was the audit committee?" As a result, a number of public and private sector initiatives were undertaken in the late 1990s and the post–Enron, post–WorldCom period in response to high-profile accounting scandals and the demise of a large accounting firm.

This time line provides a chronology of the important developments and/or studies related to audit committees. (The time line presents major developments; the reader may wish to visit the websites noted parenthetically for further reading.)

1998 SEC chairman Arthur Levitt's speech, "The Numbers Game" (Remarks at New York University's Center for Law and Business and the SEC's Nine-Point Action Plan)

1999 Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees,
Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees
Securities and Exchange Commission,
Final Rules, Audit Committee Disclosure, and approval of the New York Stock Exchange, Nasdaq, and American Stock Exchange
American Institute of Certified Public Accountants' Auditing Standards Board
Statement on Auditing Standards No. 90, "Audit Committee Communication"
National Association of Corporate Directors (NACD) *Blue Ribbon Commission on Audit Committees,*
Report of the NACD Blue Ribbon Commission on Audit Committees (visit the NACD website, *www.nacdonline.org*.)
Committee of Sponsoring Organizations of the Treadway Commission,
Fraudulent Financial Reporting: 1987–1997 An Analysis of U.S. Public Companies (visit the AICPA website, *www.aicpa.org*.)
Independence Standards Board
No. 1 "Independence Discussion with Audit Committees" (Visit the ISB website, *www.cpaindependence.org*; see also Appendix D on this book's website.)

2000 Public Oversight Board
Panel on Audit Effectiveness (O'Malley Panel),
The Panel on Audit Effectiveness,
Report and Recommendations

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2001 Chairman Arthur Levitt's Letter to Audit Committees
Public Oversight Board, Final Annual Report
(May 1, 2002 the POB terminated its existence; visit the POB website, *www.POB.org*.)

2002 *The Business Roundtable*
Principles of Corporate Governance
NYSE Corporate Accountability and Listing Standards Committee, *Report on Proposed Changes to the Corporate Governance Listing Standards*
Nasdaq Listing and Hearing Review Council, *Letter of recommendations proposing corporate governance reforms* (Visit the NASD website, *www.nasdaqnewsroom.com*.)
U.S. Congress, *Corporate Responsibility Act and the Public Company Accountability Public Oversight Board*
(Sarbanes-Oxley Act of 2002)
CEO/CFO Certification Statement Day
(Visit the SEC website, *www.sec.gov*.)
Public Company Accounting Oversight Board
(Visit the SEC website, *www.sec.gov*.)

2003 Implementation of the sections of the Sarbanes-Oxley Act of 2002 through amendments to Sec. 10A of the Securities Exchange of 1934

Public and Private Sector Initiatives

Securities and Exchange Commission In September 1998, Arthur Levitt, chairman of the Securities and Exchange Commission and now chairman emeritus, expressed his concerns about "hocus pocus accounting" in a keynote speech entitled "The Numbers Game." In addition to his remarks regarding the decline in the quality of financial reporting (e.g., earnings management strategies to meet analyst and market quarterly expectations via creative acquisition accounting, premature revenue recognition, restructuring charges, "cookie jar reserves," and materiality judgments) as well as the related decline in market capitalization, Levitt stated that with respect to audit committees:

> qualified, committed, independent and toughminded audit committees represent the most reliable guardians of the public interest. Sadly, stories abound of audit committees whose members lack expertise in the basic principles of financial reporting as well as the mandate to ask probing questions.[14]

Recognizing the problem with respect to the decline in the integrity and credibility of financial reporting, Levitt set forth the SEC's nine-point action plan (see Exhibit 1.1). Strengthening the audit committee process was number 8 of the action items. As a result, the SEC, the New York Stock Exchange (NYSE), and the

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[14]See remarks by Chairman Arthur Levitt, Securities and Exchange Commission, "The Numbers Game," NYU Center for Law and Business, New York, September 28, 1998, (*www.sec.gov/news/speeches/spch220.txt*).

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Exhibit 1.1 Summary of the Securities and Exchange's Nine-Point Action Plan

First, I have instructed the SEC staff to require well-detailed disclosures about the impact of changes in accounting assumptions. This should include a supplement to the financial statement showing beginning and ending balances as well as activity in between, including any adjustments. This will, I believe, enable the market to better understand the nature and effects of the restructuring liabilites and other loss accruals.

Second, we are challenging the profession, through the AICPA, to clarify the ground rules for auditing of purchased R&D. We also are requesting that they augment existing guidance on restructurings, large acquisition write-offs, and revenue recognition practices. It's time for the accounting profession to better qualify for auditors what's acceptable and what's not.

Third, I reject the notion that the concept of materiality can be used to excuse deliberate misstatements of performance. I know of one Fortune 500 company who had recorded a significant accounting error, and whose auditors told them so. But they still used a materiality ceiling of six percent earnings to justify the error. I have asked the SEC staff to focus on this problem and publish guidance that emphasizes the need to consider qualitative, not just quantitative factors of earnings. Materiality is not a bright line cutoff of three or five percent. It requires consideration of all relevant factors that could impact an investor's decision.

Fourth, SEC staff will immediately consider interpretive accounting guidance on the do's and don'ts of revenue recognition. The staff will also determine whether recently published standards for the software industry can be applied to other service companies.

Fifth, I am asking private sector standard setters to take action where current standards and guidance are inadequate. I encourage a prompt resolution of the FASB's projects, currently underway, that should bring greater clarity to the definition of a liability.

Sixth, the SEC's review and enforcement teams will reinforce these regulatory initiatives. We will formally target reviews of public companies that announce restructuring liability reserves, major write-offs or other practices that appear to manage earnings. Likewise, our enforcement team will continue to root out and aggressively act on abuses of the financial reporting process.

Improved Outside Auditing in the Financial Reporting Process

Seventh, I don't think it should surprise anyone here that recent headlines of accounting failures have led some people to question the thoroughness of audits. I need not remind auditors they are the public's watchdog in the financial reporting process. We rely on auditors to put something like the good housekeeping seal of approval on the information investors receive. The integrity of that information must take priority over a desire for cost efficiencies or competitive advantage in the audit process. High quality auditing requires well-trained, well-focused and well-supervised auditors.

As I look at some of the failures today, I can't help but wonder if the staff in the trenches of the profession have the training and supervision they need to ensure that audits are being done right. We cannot permit thorough audits to be sacrificed for re-engineered

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approaches that are efficient, but less effective. I have just proposed that the Public Oversight Board form a group of all the major constituencies to review the way audits are performed and assess the impact of recent trends on the public interest.

Strengthening the Audit Committee Process

And, finally, qualified, committed, independent and tough-minded audit committees represent the most reliable guardians of the public interest. Sadly, stories abound of audit committees whose members lack expertise in the basic principles of financial reporting as well as the mandate to ask probing questions. In fact, I've heard of one audit committee that convenes only twice a year before the regular board meeting for 15 minutes and whose duties are limited to a perfunctory presentation.

Compare that situation with the audit committee which meets twelve times a year before each board meeting; where every member has a financial background; where there are no personal ties to the chairman or the company; where they have their own advisers; where they ask tough questions of management and outside auditors; and where, ultimately, the investor interest is being served.

The SEC stands ready to take appropriate action if that interest is not protected. But, a private sector response that empowers audit committtees and obviates the need for public sector dictates seems the wisest choice. I am pleased to announce that the financial community has agreed to accept this challenge.

As part eight of this comprehensive effort to address earnings management, the New York Stock Exchange and the National Association of Securities Dealers have agreed to sponsor a "blue-ribbon" panel to be headed by John Whitehead, former Deputy Secretary of State and retired senior partner of Goldman, Sachs, and Ira Millstein, a lawyer and noted corporate governance expert. Within the next 90 days, this distinguished group will develop a series of far-ranging recommendations intended to empower audit committees and function as the ultimate guardian of investor interests and corporate accountability. They are going to examine how we can get the right people to do the right things and ask the right questions.

Need for a Cultural Change

Finally, I'm challenging corporate management and Wall Street to re-examine our current environment. I believe we need to embrace nothing less than a cultural change. For corporate managers, remember, the integrity of the numbers in the financial reporting system is directly related to the long-term interests of a corporation. While the temptations are great, and the pressures strong, illusions in numbers are only that—ephemeral, and ultimately self-destructive.

To Wall Street, I say, look beyond the latest quarter. Punish those who rely on deception, rather than the practice of openness and transparency.

Source: See remarks by Chairman Arthur Levitt, Securites and Exchange Commission, "The Numbers Game," NYU Center for Law and Business, New York, September 28, 1998, *www.sec.gov/news/speeches/spch220.txt*.

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National Association of Securities Dealers agreed that both self-regulatory organizations sponsor a Blue Ribbon Committee (BRC) called Improving the Effectiveness of Corporate Audit Committees. In September 1998, the BRC was formed. It issued its final report and recommendations in February 1999. The BRC's primary goal was to produce a report "geared toward effecting pragmatic, progressive changes in the functions and expectations placed on corporate boards, audit committees, senior and financial management, the internal audit, and the outside auditors regarding financial reporting and the oversight process."[15] Furthermore, the BRC noted that its final recommendations were based on two essentials: "First, an audit committee, with actual practice and overall performance that reflects the professionalism embodied by the full board of which it is a part, and second, a legal, regulatory, and self-regulating framework that emphasizes disclosure and transparency and accountability."[16] (See Exhibit 1.2 for a summary of the BRC's recommendations.)

During the period between February and December 1999, boards of directors and their audit committees studied the BRC's recommendations and reevaluated the responsibilities of their audit committees.[17] Additionally, the SEC and

Exhibit 1.2 Summary of Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees

The first two recommendations are aimed at strengthing the independence of the audit committee:

Recommendation 1

The Committee recommends that both the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD) adopt the following definitions of independence for purposes of service on the audit committee for listed companies with a market capitalization above $200 million (or a more appropriate measure for identifying smaller-sized companies as determined jointly by the NYSE and the NASD):

Members of the audit committee shall be considered independent if they have no relationship to the corporation that may interfere with the exercise of their independence from management and the corporation. Examples of such relationships include:

- a director being employed by the corporation or any of its affiliates for the current year or any of the past five years;
- a director accepting any compensation from the corporation or any of its affiliates other than compensation for board service or benefits under a tax-qualified retirement plan;
- a director being a member of the immediate family of an individual who is, or has been in any of the past five years, employed by the corporation or any of its affiliates as an executive officer;

(*continued*)

[15]The report is available on the Internet at *www.nyse.com* and *www.nasd.com*.

[16]Ibid., p. 8.

[17]See for example, *Report of the NACD Blue Ribbon Commission on Audit Committees* (Washington, DC: NACD, 1999); see also Financial Executives Institute and Arthur Andersen, "The Audit Symposium: A Balanced Reponsibility" (Morristown, NJ: Financial Executives Institute); *Fraudulent Financial Reporting: 1987–1997, An Analysis of U.S. Public Companies* (New York: COSO of the Treadway Commission, 1999).

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- a director being a partner in, or a controlling shareholder or an executive officer of, any for-profit business organizations to which the corporation made, or from which the corporation received, payments that are or have been significant* to the corporation or business organization in any of the past five years;
- a director being employed as an executive of another company where any of the corporation's executives serves on that company's compensation committee.

A director who has one or more of these relationships may be appointed to the audit committee, if the board, under exceptional and limited circumstances, determines that membership on the committee by the individual is required by the best interests of the corporation and its shareholders, and the board discloses, in the next annual proxy statement subsequent to such determination, the nature of the relationship and the reasons for that determination.

Recommendation 2

The Committee recommends that in addition to adopting and complying with the definition of independence set forth above for purposes of service on the audit committee, the NYSE and the NASD require that listed companies with a market capitalization above $200 million (or a more appropriate measure for identifying smaller-sized companies as determined jointly by the NYSE and the NASD) have an audit committee comprised solely of independent directors.

The Committee recommends that the NYSE and the NASD maintain their respective current audit committee independence requirements as well as their respective definitions of independence for listed companies with a market capitalization of $200 million or below (or a more appropriate measure for identifying smaller-sized companies as determined jointly by the NYSE and the NASD).

Our second set of recommendations is aimed at making the audit committee more effective:

Recommendation 3

The Committee recommends that the NYSE and the NASD require listed companies with a market capitalization above $200 million (or a more appropriate measure for identifying smaller-sized companies as determined jointly by the NYSE and the NASD) to have an audit committee comprised of a minimum of three directors, each of whom is financially literate (as described in the section of this report entitled "Financial Literacy") or becomes financially literate within a reasonable period of time after his or her appointment to the audit committee, and further that at least one member of the audit committee have accounting or related financial management expertise.

The Committee recommends that the NYSE and the NASD maintain their respective current audit committee size and membership requirements for companies with a market capitalization of $200 million or below (or a more appropriate measure for identifying smaller-sized companies as determined jointly by the NYSE and the NASD).

Recommendation 4

The Committee recommends that the NYSE and the NASD require the audit committee of each listed company to (i) adopt a formal written charter that is approved by the full board of directors and that specifies the scope of the committee's responsibilities, and how it

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*The committee views the term "significant" in the spirit of Section 1.34(a)(4) of the American Law Institute Principles of Corporate Governance and the accompanying commentary to that section.

(*continued*)

Exhibit 1.2 (*Continued*)

carries out those responsibilities, including structure, processes, and membership requirements, and (ii) review and reassess the adequacy of the audit committee charter on an annual basis.

Recommendation 5

The Committee recommends that the Securities and Exchange Commission (SEC) promulgate rules that require the audit committee for each reporting company to disclose in the company's proxy statement for its annual meeting of shareholders whether the audit committee has adopted a formal written charter, and, if so, whether the audit committee satisfied its responsibilities during the prior year in compliance with its charter, which charter shall be disclosed at least triennially in the annual report to shareholders or proxy statement and in the next annual report to shareholders or proxy statement after any significant amendment to that charter.

The Committee further recommends that the SEC adopt a "safe harbor" applicable to all disclosure referenced in the Recommendation 5.

Our final group of recommendations addresses mechanisms for accountability among the audit committee, the outside auditors, and management:

Recommendation 6

The Committee recommends that the listing rules for both the NYSE and the NASD require that the audit committee charter for every listed company specifiy that the oustide auditor is ultimately accountable to the board of directors and the audit committee, as representatives of shareholders, and that these shareholder representatives have the ultimate authority and responsibility to select, evaluate, and, where appropriate, replace the outside auditor (or to nominate the outside auditor to be proposed for shareholder approval in any proxy statement).

Recommendation 7

The Committee recommends that the listing rules for both the NYSE and the NASD require that the audit committee charter for every listed company specify that the audit committee is responsible for ensuring its receipt from the outside auditors of a formal written statement delineating all relationships between the auditor and the company, consistent with Independence Standards Board Standard 1, and that the audit committee is also responsible for actively engaging in a dialogue with the auditor with respect to any disclosed relationships or services that may impact the objectivity and independence of the auditor and for taking, or recommending that the full board take, appropriate action to ensure the independence of the outside auditor.

Recommendation 8

The Committee recommends that Generally Accepted Auditing Standards (GAAS) require that a company's outside auditor discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the company's accounting principles as applied in its financial reporting; the discussion should include such issues as the clarity of the company's financial disclosures and degree of aggressiveness or conservatism of the company's accounting principles and underlying estimates and other significant decisions made by management in preparing the financial disclosure and reviewed by

the outside auditors. This requirement should be written in a way to encourage open, frank discussion and to avoid boilerplate.

Recommendation 9

The Committee recommends that the SEC require all reporting companies to include a letter from the audit committee in the company's annual report to shareholders and Form 10-K Annual Report disclosing whether or not, with respect to the prior fiscal year: (i) management has reviewed the audited financial statements with the audit committee, including a discussion of the quality of the accounting principles as applied and significant judgments affecting the company's financial statements; (ii) the outside auditors have discussed with the audit committee the outside auditors' judgments of the quality of those principles as applied and judgments referenced in (i) above under the circumstances; (iii) the members of the audit committee have discussed among themselves, without management or the outside auditors present, the information disclosed to the audit committee described in (i) and (ii) above; and (iv) the audit committee, in reliance on the review and discussions conducted with management and the outside auditors pursuant to (i) and (ii) above, believes that the company's financial statements are fairly presented in conformity with Generally Accepted Accounting Principles (GAAP) in all material aspects.

The Committee further recommends that the SEC adopt a "safe harbor" applicable to any disclosure referenced in this Recommendation 9.

Recommendation 10

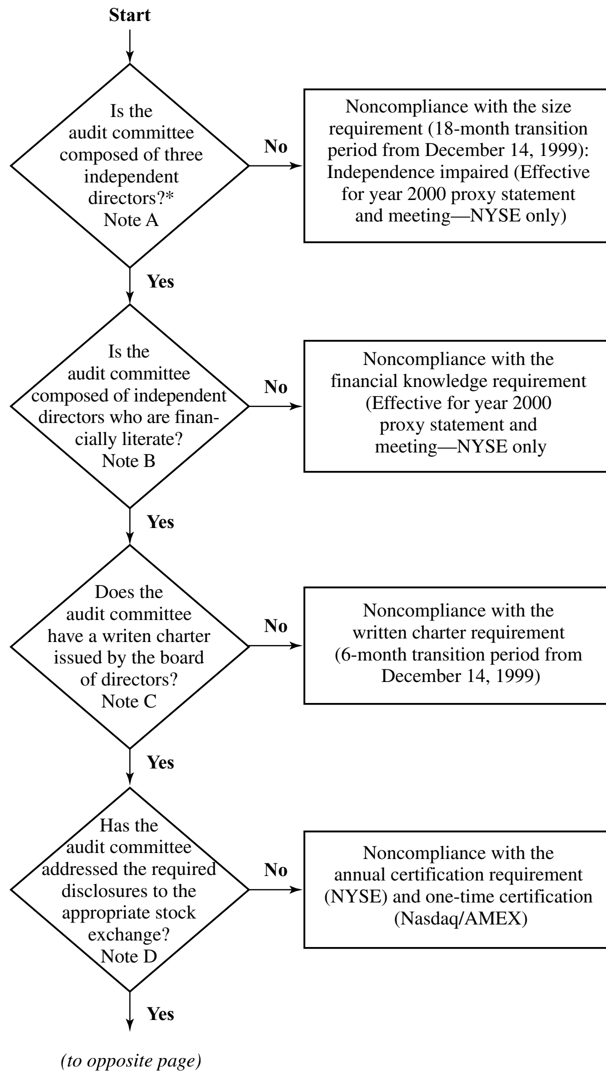
The Committee recommends that the SEC require that a reporting company's outside auditor conduct a SAS 71 Interim Financial Review prior to the company's filing of its Form 10-Q.

The Committee further recommends that SAS 71 be amended to require that a reporting company's outside auditor discuss with the audit committee, or at least its chairman, and a representative of financial management, in person, or by telephone conference call, the matters described in AU Section 380, Communications With the Audit Committee, prior to the filing of the Form 10-Q (and preferably prior to any public announcement of financial results), including significant adjustments, management judgments and accounting estimates, significant new accounting policies, and disagreements with management.

Source: Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees* (New York: The Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, 1999), pp. 10–16.

self-regulatory organizations (SROs) issued proposed rules and changes to the SRO's listing standards. Finally, in December 1999, the SEC, the SRO's, and the AICPA's Auditing Standards Board adopted new rules, listing standards, and auditing standards for improving the effectiveness of audit committees. Exhibit 1.3 contains a flow chart that delineates the items to meet the new SEC disclosure rules, the SRO's listing standards, and professional auditing standards.

Exhibit 1.3 New Requirements and Disclosure Rules for Audit Committees: A Flow Chart



(to opposite page)

Notes: A. If the board of directors determines in its business judgment that the relationship (e.g., certain business relationships and/or one nonindependent member relationship) does not interfere with the director's exercise of independent judgment, then independence is not impaired.
B. The board of directors determines in its business judgment whether each member of the audit committee is financially literate. Based on the board's business judgment, at least one member must have accounting or related financial management expertise.
C. Each listed company must have an audit committee charter that guides its activities.
D. Each listed company (NYSE) is required to furnish a written certification letter, submitted annually, affirming the aforementioned points in A, B, and C. Nasdaq/AMEX listed companies require a one-time certification with respect to A, B, and C above.
E. After December 15, 2000, the SEC requires proxy statement disclosure of a report from the audit committee indicating whether the committee: (1) reviewed and discussed financial statements with management and the external auditors; (2) discussed with the external auditors matters required by SAS No. 61;

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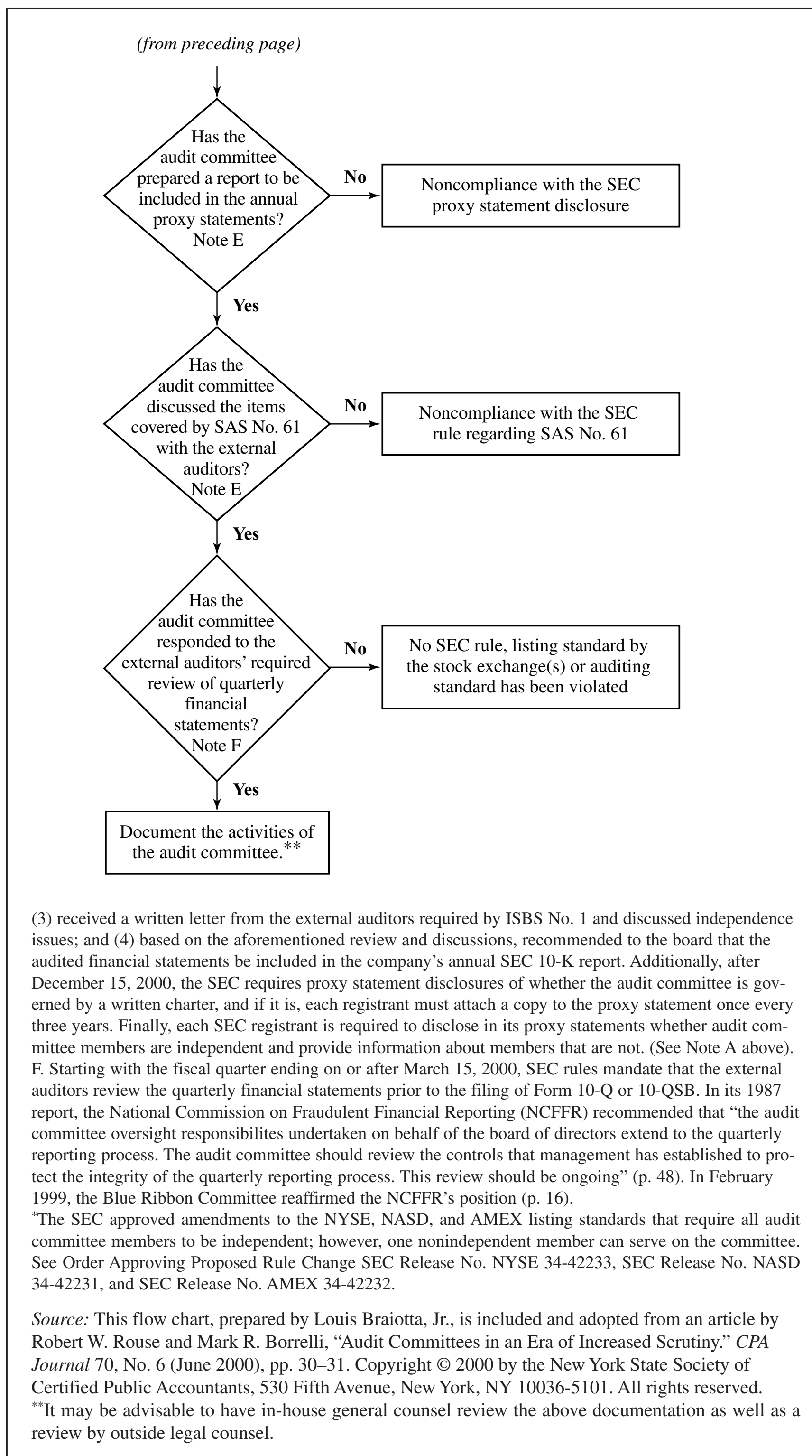

(3) received a written letter from the external auditors required by ISBS No. 1 and discussed independence issues; and (4) based on the aforementioned review and discussions, recommended to the board that the audited financial statements be included in the company's annual SEC 10-K report. Additionally, after December 15, 2000, the SEC requires proxy statement disclosures of whether the audit committee is governed by a written charter, and if it is, each registrant must attach a copy to the proxy statement once every three years. Finally, each SEC registrant is required to disclose in its proxy statements whether audit committee members are independent and provide information about members that are not. (See Note A above).

F. Starting with the fiscal quarter ending on or after March 15, 2000, SEC rules mandate that the external auditors review the quarterly financial statements prior to the filing of Form 10-Q or 10-QSB. In its 1987 report, the National Commission on Fraudulent Financial Reporting (NCFFR) recommended that "the audit committee oversight responsibilites undertaken on behalf of the board of directors extend to the quarterly reporting process. The audit committee should review the controls that management has established to protect the integrity of the quarterly reporting process. This review should be ongoing" (p. 48). In February 1999, the Blue Ribbon Committee reaffirmed the NCFFR's position (p. 16).

*The SEC approved amendments to the NYSE, NASD, and AMEX listing standards that require all audit committee members to be independent; however, one nonindependent member can serve on the committee. See Order Approving Proposed Rule Change SEC Release No. NYSE 34-42233, SEC Release No. NASD 34-42231, and SEC Release No. AMEX 34-42232.

Source: This flow chart, prepared by Louis Braiotta, Jr., is included and adopted from an article by Robert W. Rouse and Mark R. Borrelli, "Audit Committees in an Era of Increased Scrutiny." *CPA Journal* 70, No. 6 (June 2000), pp. 30–31. Copyright © 2000 by the New York State Society of Certified Public Accountants, 530 Fifth Avenue, New York, NY 10036-5101. All rights reserved.

**It may be advisable to have in-house general counsel review the above documentation as well as a review by outside legal counsel.

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In January 1999, the Public Oversight Board agreed to sponsor the Panel on Audit Effectiveness. The major objective of the panel was to review and evaluate ways to improve independent audits in the financial reporting process and to assess the impact of recent trends on the public interest. In August 2000, the panel issued its report and recommendations. With respect to audit committees, the panel made these recommendations:

> **2.88** The Panel recommends that audit committees increase the time and attention they devote to discussions of internal control with management and both the internal and external auditors. Specifically, audit committees should:
>
> - Obtain a written report from management on the effectiveness of internal control over financial reporting (ordinarily using the criteria in the 1992 report of the Committee of Sponsoring Organizations of the Treadway Commission [COSO]). Annual reporting by management on internal control to the audit committee is necessary for the effective discharge of the audit committee's responsibilities and will serve as a catalyst for its more substantive involvement in the area of internal control and a more meaningful dialogue with the internal and external auditors about controls. It also should provide a basis for discussions about the degree of the external auditor's involvement with internal control during the financial statement audit.
> - Establish specific expectations with management and the internal and external auditors about the qualitative information needs of the committee related to internal control. Particular emphasis should be given to understanding management's and the auditors' views on (1) the control environment and (2) the controls (or lack thereof) over financial reporting, with particular attention to controls in higher-risk areas of the company's information systems. In addition, these discussions should include the effects of technology on current and future information systems. [pp. 32–33]
>
> **2.164** The Panel recommends that audit committees evaluate the nature of entities' reserves and review activity in them with both management and the auditors. [p. 55]
>
> **2.219** The Panel recommends that audit committees:
>
> - Specify in their charters and reflect in their actions, as recommended by the Blue Ribbon Committee, "that the outside auditor is ultimately accountable to the board of directors and the audit committee, as representatives of the shareholders, and that these shareholder representatives have the ultimate authority and responsibility to select, evaluate, and where appropriate, replace the outside auditors (or to nominate the outside auditors to be proposed for shareholder approval in any proxy statement)."
> - Develop a formal calendar of activities related to those areas of responsibility prescribed in the committee charter, including a meeting plan that is reviewed and agreed to by the entire board. The meeting plan should include communications between the committee chair or full committee and the auditor before the release of interim or year-end financial data. In addition, the Panel recommends a minimum of two face-to-face meetings during the year with the external auditor and at least one executive session with the internal and external auditors without management's presence.
> - Take charge of their agenda and ensure, in particular, that it focuses on, among other matters, risks directly affecting the financial statements, key controls, interim financial information, policies and practices for management's communications with analysts, and the qualitative aspects of financial reporting.

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- Inquire about time pressures on the auditor, including pressures on the timing of audit procedures; the degree of management's cooperation with the auditor; and their potential effects on audit effectiveness.
- Review the internal and external auditors' performance on an annual basis; exercise responsibility, as the external auditor's primary client, to assess the auditor's responsiveness to the committee's and board of directors' expections; and be satisfied that the auditor is appropriately compensated for performing a thorough audit.
- Require the auditor and management to advise the committee of the entity's plans to hire any of the audit firm's personnel into high-level positions, and the actions, if any, that the auditor and management intend to take to ensure that the auditor maintains independence. [pp. 68–69]

3.54 The Panel recommends that audit committees:

- Request management to report on the control environment within the entity and how that environment and the entity's policies and procedures (including management's monitoring activities) serve to prevent and detect financial statement fraud. Such reporting should acknowledge, in explicit terms, that fraud prevention and detection are primarily the responsibility of management. It also should help audit committees assess the strength of management's commitment to a culture of intolerance for improper conduct. Furthermore, audit committees should seek the views of auditors on their assessment of the risks of financial statement fraud and their understanding of the controls designed to mitigate such risks.
- Accept responsibility for ascertaining that the auditors receive the necessary cooperation from management to carry out their duties in accordance with the strengthened auditing standards to be developed by the ASB [Accouting Standards Board]. [p. 94]

5.30 The Panel recommends that audit committees pre-approve non-audit services that exceed a threshold determined by the committee. This recommendation is consistent with the recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees regarding auditors' services. The threshold should be at a level that ensures that significant services are pre-approved, but not so low that the committee assumes a management function.

When audit committees determine whether to approve specific non-audit services, the Panel recommends that they consider the same guiding principle and the factors suggested above for use by the ISB. [p. 117][18]

In addition to the panel's recommendations, Arthur Levitt issued a letter to the chairmen of audit committees of the top 5,000 corporations. The letter is shown in Exhibit 1.4.

In May 2002, the Business Roundtable issued a white paper, *Principles of Corporate Governance*, with respect to how boards of directors perform their oversight function through the audit committee. The Business Roundtable provides these guidelines:

- Every publicly owned corporation should have an audit committee comprised solely of independent directors.

[18]Panel on Audit Effectiveness, *Panel on Audit Effectiveness Report and Recommendations* (Stanford, CT: POB, 2000).

Exhibit 1.4 Chairman Arthur Levitt's Letter to Audit Committees

Washington, DC, January 5, 2001—Securities and Exchange Commission Chairman Arthur Levitt today sent the following letter to the audit committee chairmen of the top 5,000 public companies.

Dear Members of the Audit Committee:

Almost a year ago, the Commission, our major markets and standard setters—building on the work of the Blue Ribbon Committee on Audit Committee Effectiveness—adopted rules that strengthen the audit committee's independence, and give its members the tools and the wherewithal to fulfill their duty to the investing public. In addition, the rules improve communications, through greater disclosure, among the board, outside auditors and management.

When auditors and the board engage in frank and meaningful discussions about the significant, but sometimes gray areas of accounting, both the company's and its shareholders' interests are served. In this way, the board, including the audit committee, management, and outside auditors, form a "three-legged stool" of responsible disclosure and active oversight.

In recent months, the Commission and the accounting profession have been engaged in a discussion on the vital issue of auditor independence. Among other reasons, increased economic pressures on the profession, coupled with greater competition and consolidation, mandated that we modernize and further clarify independence requirements. This discussion has led to a combination of rules and disclosures that establish clear guidelines on the non-audit services an auditor may provide to an audit client, as well as the meaningful involvement of the audit committee in consideration of consulting services that may impair independence. More specifically, the Commission's rules require companies to state in their proxy statement whether the audit committee has considered whether the provision of non-audit services is compatible with maintaining the auditor's independence.

In August, the Panel on Audit Effectiveness issued its final report recommending that, among other things, audit committees obtain annual reports from mangement assessing the company's internal controls, specify in their charters that the outside auditor is ultimately accountable to the board of directors and audit committee, inquire about time pressures on the auditor, and pre-approve non-audit services provided by the auditor.

The Panel, more specifically, provided guidance an audit committee can use to determine the appropriateness of a service. This guidance includes:

1. Whether the service is being performed principally for the audit committee.
2. The effects of the service, if any, on audit effectiveness or on the quality and timeliness of the entity's financial reporting process.
3. Whether the service would be performed by specialists (e.g., technology specialists) who ordinarily also provide recurring audit support.
4. Whether the service would be performed by audit personnel, and if so, whether it will enhance their knowledge of the entity's business and operations.
5. Whether the role of those performing the service would be inconsistent with the auditors' role (e.g., a role where neutrality, impartiality, and auditor skepticism are likely to be subverted).
6. Whether the audit firm personnel would be assuming a management role or creating a mutual or conflicting interest with management.
7. Whether the auditors, in effect, would be "auditing their own numbers."
8. Whether the project must be started and completed very quickly.
9. Whether the audit firm has unique expertise in the service.
10. The size of the fee(s) for the non-audit service(s).

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I encourage your audit committee to discuss the Panel's recommendations as well as these ten factors and consider them in relevant discussions with your auditor. The Panel's report can be found at *www.pobauditpanel.org/*. I also encourage you to read the Commission's rule release at *www.sec.gov.rules/final/33-7919.htm*.

During my almost eight years at the Commission, I have come to believe that one of the most reliable guardians of the public interest is a competent, committed, independent and tough-minded audit committee. The audit committee stands to protect and preserve the integrity of America's financial reporting process. I encourage your committee to take every step possible to ensure that the integrity of the financial statements, and by extension, the interest of shareholders, remains second to none.

Sincerely,
Arthur Levitt

Source: www.sec.gov/news.htm.

- Audit committees typically consist of three to five members. The listing standards of the major securities markets require audit committees and require that an audit committee have at least three members and that all members of the audit committee qualify as independent under the applicable listing standards, subject to limited exceptions.
- Audit committee members should meet minimum financial literacy standards, and at least one of the committee members should have accounting or financial management expertise, as required by the listing standards of the major securities markets. However, more important than financial expertise is the ability of audit committee members, as with all directors, to understand the corporation's business and risk profile and to apply their business experience and judgment to the issues for which the committee is responsible with an independent and critical eye.
- The audit committee is responsible for oversight of the corporation's financial reporting process. The primary functions of the audit committee are the following:
  - *Risk profile*. The audit committee should understand the corporation's risk profile and oversee the corporation's risk assessment and management practices.
  - *Outside auditor*. The audit committee is responsible for supervising the corporation's relationship with its outside auditor, including recommending to the full board the firm to be engaged as the outside auditor, evaluating the auditor's performance, and considering whether it would be appropriate to rotate senior audit personnel or for the corporation periodically to change its outside auditor. The selection of an outside auditor should involve an annual due diligence process in which the audit committee reviews the qualifications, work product, independence, and reputation of the proposed outside auditor. The audit committee should base its decisions about selecting and possibly changing the outside auditor on its assessment of what is likely to lead to more effective audits. Based on its due diligence, the audit committee should make an annual recommendation to the full board about the selection of the outside auditor.

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- *Auditor independence*. The audit committee should consider the independence of the outside auditor and should develop policies concerning the provision of nonaudit services by the outside auditor. The provision of some types of audit-related and consulting services by the outside auditor may not be inconsistent with independence or the attestation function. In considering whether the outside auditor should provide certain types of nonaudit services, the audit committee should consider the degree of review and oversight that may be appropriate for new and existing services. When making independence judgments, the audit committee should consider the nature and dollar amount of all services provided by the outside auditor.
- *Critical accounting policies, judgments, and estimates*. The audit committee should review and discuss with management and the outside auditor the corporation's critical accounting policies and the quality of accounting judgments and estimates made by management.
- *Internal controls*. The audit committee should understand and be familiar with the corporation's system of internal controls and on a periodic basis should review with both internal and outside auditors the adequacy of this system.
- *Compliance*. Unless the full board or another committee does so, the audit committee should review the corporation's procedures addressing compliance with the law and important corporate policies, including the corporation's code of ethics or code of conduct.
- *Financial statements*. The audit committee should review and discuss the corporation's annual financial statements with management and the outside auditor and, based on these discussions, recommend that the board approve the financial statements for publication and filing. Most audit committees also find it advisable to implement processes for the committee or its designee to review the corporation's quarterly financial statements prior to release.
- *Internal audit function*. The audit committee should oversee the corporation's internal audit function, including review of reports submitted by the internal audit staff, and should review the appointment and replacement of the senior internal auditing executive.
- *Communication*. The audit committee should provide a channel of communication to the board for the outside auditor and internal auditors and may also meet with and receive reports from finance officers, compliance officers, and the general counsel.
- *Hiring auditor personnel*. Under audit committee supervision, some corporations have implemented "revolving door" policies covering the hiring of auditor personnel. For example, these policies may impose "cooling off" periods prohibiting the corporation from employing members of the audit engagement team in senior financial management positions for some period of time after their work as auditors for the corporation. The audit committee should consider whether to adopt such a policy. Any policy on the hiring of auditor personnel should be flexible enough to allow exceptions, but only when specifically approved by the audit committee.

- Audit committee meetings should be held frequently enough to allow the committee to appropriately monitor the annual and quarterly financial reports. For many corporations, this means four or more meetings a year. Meetings should be scheduled with enough time to permit and encourage active discussions with

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> management and the internal and outside auditors. The audit committee should meet with the internal and outside auditors, without management present, at every meeting and communicate with them between meetings as necessary. Some audit committees may decide that specific functions, such as quarterly review meetings with the outside auditor or management, can be delegated to the audit committee chairman or other members of the audit committee.[19]

In addition to the Business Roundtable's *Principles of Corporate Governance*, both the NYSE and Nasdaq proposed new changes to their corporate governance listing standards. The NYSE's proposed rule changes are:

> *6. Add to the "independence" requirement for audit committee membership the requirements of Rule 10A-3(b)(1) under the Exchange Act, subject to the exemptions provided for in Rule 10A-3(c).*
>
> Commentary Applicable to All Companies: While it is not the audit committee's responsibility to certify the company's financial statements or to guarantee the auditor's report, the committee stands at the crucial intersection of management, independent auditors, internal auditors and the board of directors. The Exchange supports additional directors' fees to compensate audit committee members for the significant time and effort they expend to fulfill their duties as audit committee members, but does not believe that any member of the audit committee should receive any compensation other than such director's fees from the company. If a director satisfies the definition of "independent director" set out in Section 303A(2), then his or her receipt of a pension or other form of deferred compensation from the company for prior service (provided such compensation is not contingent in any way on continued service) will not preclude him or her from satisfying the requirement that director's fees are the only form of compensation he or she receives from the company.
>
> An audit committee member may receive his or her fee in cash and/or company stock or options or other in-kind consideration ordinarily available to directors, as well as all of the regular benefits that other directors receive. Because of the significantly greater commitment of audit committee members, they may receive reasonable compensation greater than that paid to the other directors (as may other directors for other committee work). Disallowed compensation for an audit committee member includes fees paid directly or indirectly for services as a consultant or a legal or financial advisor, regardless of the amount. Disallowed compensation also includes compensation paid to such a director's firm for such consulting or advisory services even if the director is not the actual service provider. Disallowed compensation is not intended to include ordinary compensation paid in another customer or supplier or business relationship that the board has already determined to be immaterial for purposes of its basic director independence analysis. To avoid any confusion, note that this requirement pertains only to audit committee qualification and not to the independence determinations that the board must make for other directors.
>
> Commentary Applicable to All Companies Other than Foreign Private Issuers: Each member of the committee must be financially literate, as such qualification is interpreted by the company's board in its business judgment, or must become financially literate within a reasonable period of time after his or her appointment to the audit

[19]The Business Roundtable, *Principles of Corporate Governance* (Washington, DC: The Business Roundtable, May 2002), pp. 12–16.

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committee. In addition, at least one member of the audit committee must have accounting or related financial management expertise, as the company's board interprets such qualification in its business judgment. A board may presume that a person who satisfies the definition of audit committee financial expert set out in Item 401(e) of Regulation S-K has accounting or related financial management expertise.

Because of the audit committee's demanding role and responsibilities, and the time commitment attendant to committee membership, each prospective audit committee member should evaluate carefully the existing demands on his or her time before accepting this important assignment. Additionally, if an audit committee member simultaneously serves on the audit committee of more than three public companies, and the listed company does not limit the number of audit committees on which its audit committee members serve, then in each case, the board must determine that such simultaneous service would not impair the ability of such member to effectively serve on the listed company's audit committee and disclose such determination in the annual proxy statement or, if the company does not file an annual proxy statement, in the company's annual report on Form 10-K filed with the SEC.

7. *(a) Each company is required to have a minimum three person audit committee composed entirely of independent directors that meet the requirements of Section 303A(6).*

(b) The audit committee must have a written charter that addresses:

(i) the committee's purpose—which, at minimum, must be to:

(A) assist board oversight of (1) the integrity of the company's financial statements, (2) the company's compliance with legal and regulatory requirements, (3) the independent auditor's qualifications and independence, and (4) the performance of the company's internal audit function and independent auditors; and

(B) prepare the report required by the SEC's proxy rules to be included in the company's annual proxy statement, or, if the company does not file a proxy statement, in the company's annual report filed on Form 10-K with the SEC;

(ii) the duties and responsibilities of the audit committee set out in Section 303A (7)(c) and (d); and

(iii) an annual performance evaluation of the audit committee.

(c) As required by Rule 10A-3(b)(2), (3), (4) and (5) of the Securities Exchange Act of 1934, and subject to the exemptions provided for in Rule 10A-3(c), the audit committee must:

(i) directly appoint, retain, compensate, evaluate and terminate the company's independent auditors;

Commentary: In connection with this requirement, the audit committee must have the sole authority to approve all audit engagement fees and terms, as well as all significant non-audit engagements with the independent auditors. In addition, the independent auditor must report directly to the audit committee. This requirement does not preclude the committee from obtaining the input of management, but these responsibilities may not be delegated to management. The audit committee must be directly responsible for oversight of the independent auditors, including resolution of disagreements between management and the independent auditor and pre-approval of all non-audit services.

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(ii) establish procedures for the receipt, retention and treatment of complaints from listed company employees on accounting, internal accounting controls or auditing matters, as well as for confidential, anonymous submissions by listed company employees of concerns regarding questionable accounting or auditing matters;

(iii) obtain advice and assistance from outside legal, accounting or other advisors as the audit committee deems necessary to carry out its duties; and

Commentary: In the course of fulfilling its duties, the audit committee may wish to consult with independent counsel and other advisors. The audit committee must be empowered to retain and compensate these advisors without seeking board approval.

(iv) receive appropriate funding, as determined by the audit committee, from the listed company for payment of compensation to the ouside legal, accounting or other advisors employed by the audit committee.

(d) In addition to the duties set out in Section 303(A)(7)(c), the duties of the audit committee must be, at a minimum, to:

(i) at least annually, obtain and review a report by the independent auditor describing: the firm's internal quality-control procedures; any material issues raised by the most recent internal quality-control review, or peer review, of the firm, or by any inquiry or investigation by governmental or professional authorities, within the preceding five years, respecting one or more independent audits carried out by the firm, and any steps taken to deal with any such issues; and (to assess the auditor's independence) all relationships between the independent auditor and the company;

Commentary: After reviewing the foregoing report and the independent auditor's work throughout the year, the audit committee will be in a position to evaluate the auditor's qualifications, performance and independence. This evaluation should include the review and evaluation of the lead partner of the independent auditor. In making its evaluation, the audit committee should take into account the opinions of management and the company's internal auditors (or other personnel responsible for the internal audit function). In addition to assuring the regular rotation of the lead audit partner as required by law, the audit committee should further consider whether, in order to assure continuing auditor independence, there should be regular rotation of the audit firm itself. The audit committee should present its conclusions with respect to the independent auditor to the full board.

(ii) discuss the annual audited financial statements and quarterly financial statements with management and the independent auditor, including the company's disclosures under "Management's Discussion and Analysis of Financial Condition and Results of Operations";

(iii) discuss earnings press releases, as well as financial information and earnings guidance provided to analysts and rating agencies;

Commentary: The audit committee's responsibility to discuss earnings releases as well as financial information and earnings guidance may be done generally (i.e., discussion of the types of information to be disclosed and the type of presentation to be made). The audit committee need not discuss in advance each earnings release or each instance in which a company may provide earnings guidance.

(iv) discuss policies with respect to risk assessment and risk management;

Commentary: While it is the job of the CEO and senior management to assess and manage the company's exposure to risk, the audit committee must discuss guidelines and policies to govern the process by which this is handled. The audit committee should discuss the company's major financial risk exposures and the steps management has taken to monitor and control such exposures. The audit committee is not required to be the sole body responsible for risk assessment and management, but, as stated above, the committee must discuss guidelines and policies to govern the process by which risk assessment and management is undertaken. Many companies, particularly financial companies, manage and assess their risk through mechanisms other than the audit committee. The processes these companies have in place should be reviewed in a general manner by the audit committee, but they need not be replaced by the audit committee.

(v) meet separately, periodically, with management, with internal auditors (or other personnel responsible for the internal audit function) and with independent auditors

Commentary: To perform its oversight functions most effectively, the audit committee must have the benefit of separate sessions with management, the independent auditors and those responsible for the internal audit function. As noted herein, all listed companies must have an internal audit function. These separate sessions may be more productive than joint sessions in surfacing issues warranting committee attention.

(vi) review with the independent auditor any audit problems or difficulties and management's response;

Commentary: The audit committee must regularly review with the independent auditor any difficulties the auditor encountered in the course of the audit work, including any restrictions on the scope of the independent auditor's activities or on access to requested information, and any significant disagreements with management. Among the items the audit committee may want to review with the auditor are: any accounting adjustments that were noted or proposed by the auditor but were "passed" (as immaterial or otherwise); any communications between the audit team and the audit firm's national office respecting auditing or accounting issues presented by the engagement; and any "management" or "internal control" letter issued, or proposed to be issued, by the audit firm to the company. The review should also include discussion of the responsibilities, budget and staffing of the company's internal audit function.

(vii) set clear hiring policies for employees or former employees of the independent auditors; and

Commentary: Employees or former employees of the independent auditor are often valuable additions to corporate management. Such individuals' familiarity with the business, and personal rapport with the employees, may be attractive qualities when filling a key opening. However, the audit committee should set hiring policies taking into account the pressures that may exist for auditors consciously or subconsciously seeking a job with the company they audit.

(viii) report regularly to the board of directors.

Commentary: The audit committee should review with the full board any issues that arise with respect to the quality or integrity of the company's financial statements, the company's compliance with legal or regulatory requirements, the performance and independence of the company's independent auditors, or the performance of the internal audit function.

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General Commentary to Section 303A(7)(d): While the fundamental responsibility for the company's financial statements and disclosures rests with management and the independent auditor, the audit committee must review: (A) major issues regarding accounting principles and financial statement presentations, including any significant changes in the company's selection or application of accounting principles, and major issues as to the adequacy of the company's internal controls and any special audit steps adopted in light of material control deficiencies; (B) analyses prepared by management and/or the independent auditor setting forth significant financial reporting issues and judgments made in connection with the preparation of the financial statements, including analyses of the effects of alternative GAAP methods on the financial statements; (C) the effect of regulatory and accounting initiatives, as well as off-balance sheet structures, on the financial statements of the company; and (D) the type and presentation of information to be included in earnings press releases (paying particular attention to any use of "pro forma," or "adjusted" non-GAAP, information), as well as review any financial information and earnings guidance provided to analysts and rating agencies.

General Commentary to Section 303A(7): To avoid any confusion, note that the audit committee functions specified in Section 303A(7) are the sole responsibility of the audit committee and may not be allocated to a different committee.

(e) Each listed company must have an internal audit function.

Commentary: Listed companies must maintain an internal audit function to provide management and the audit committee with ongoing assessments of the company's risk management processes and system of internal control. A company may choose to outsource this function to a firm other than its independent auditor.[20]

CORPORATE ACCOUNTABILITY AND THE AUDIT COMMITTEE

The Role of the Audit Committee

The audit committee has a critical role within the framework of corporate accountability since the jurisdiction of the committee is to oversee and monitor the activities of the corporation's financial reporting system and the internal and external audit processes. The audit committee assists the board of directors with the development and maintenance of the corporate accountability framework, because the committee compels the board to be accountable for its stewardship accountability. Thus the audit committee helps create an environment in which the activities of corporate management are subject to scrutiny.

As Harold M. Williams, former chairman of the SEC, asserted:

It should be evident, but perhaps bears repeating, that integrity in reporting financial data is vital both to an efficient and effective securities market and to capital formation. One key to increasing public confidence in that data long advocated by many segments of the financial community, including public accounting firms, is more direct involvement by boards of directors in the auditing process and the integrity of reported financial information. The vehicle which the Securities and Exchange

[20]Securities and Exchange Commission Release No. 34-47672, File No. SR-NYSE-2002-33, *Proposed Rule Change Relating to Corporate Governance* (Washington DC: April 11, 2003). See also SEC Release No. 34-47672, File No. SR-NASD-2002-141, for the NASD, *Proposed Rule Change Relating to Corporate Governance*.

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> Commission, the New York Stock Exchange and an increasing number of public corporations have turned to has been the independent audit committee.[21]

As a standing committee appointed by the board of directors, the audit committee is directly accountable for its actions to the board. The audit committee operates in an advisory capacity. Thus the audit committee has limited authority, because a final decision concerning its recommendations is made by the board. The board seeks guidance from the audit committee in formulating or amending the financial accounting policies to service properly the needs of its various constituencies.

With respect to the expectations of the various constituencies, Russell E. Palmer, former managing partner of Touche Ross and Co. (now Deloitte and Touche), stated:

> Every audit committee will be expected to weigh the appropriateness of the corporation's accounting policies as they apply to the corporation and its industry. It seems reasonable that committee members will be expected to assess and be satisfied with the corporation's entire disclosure system—the financial statements, the published stockholders' reports, and even discussions between management and the financial media.[22]

To further illustrate the role of the audit committee, Exhibit 1.5 diagrams the direct relationship between the committee and its constituencies in the internal corporate environment.

Important Surveys

In their survey of audit committees, Joseph F. Castellano, Harper A. Roehm, and Albert A. Vondra found that the corporate community is building a strong case for self-regulation by complying with the recommendation of the Treadway Commission. Such compliance has improved the quality of financial reporting.[23] Their survey results are further supported by Ivan Bull. He found that in a survey of 13 chairpersons of publicly held corporations in Illinois, "most boards were either already following or have since implemented the Treadway Commission recommendations" to prevent fraudulent misstatements in their financial statements. "Audit committee chairpeople generally believe their committees are 'informed, vigilant, and effective overseers' described in the Treadway report."[24]

In another survey of audit partners, directors of internal auditing, and chief financial officers associated with audit committees of 90 U.S. corporations, Lawrence P. Kalbers and Timothy J. Fogarty investigated the relationship between audit committee effectiveness and the types and extent of the committee's power. They concluded:

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[21]Harold M. Williams, "Audit Committees—The Public Sector's View," *Journal of Accountancy* 144, No. 3 (September 1977), p. 71.

[22]Russell E. Palmer, "Audit Committees—Are They Effective? An Auditor's View," *Journal of Accountancy* 144, No. 3 (September 1977), p. 77.

[23]Joseph F. Castellano, Harper A. Roehm, and Albert A. Vondra, "Audit Committee Compliance with the Treadway Commission Report: A Survey," *OHIO CPA Journal* 48, No. 4 (Winter 1989), p. 42.

[24]Ivan Bull, "Board of Director Acceptance of Treadway Responsibilities," *Journal of Accountancy* 171, No. 2 (February 1991), p. 67.

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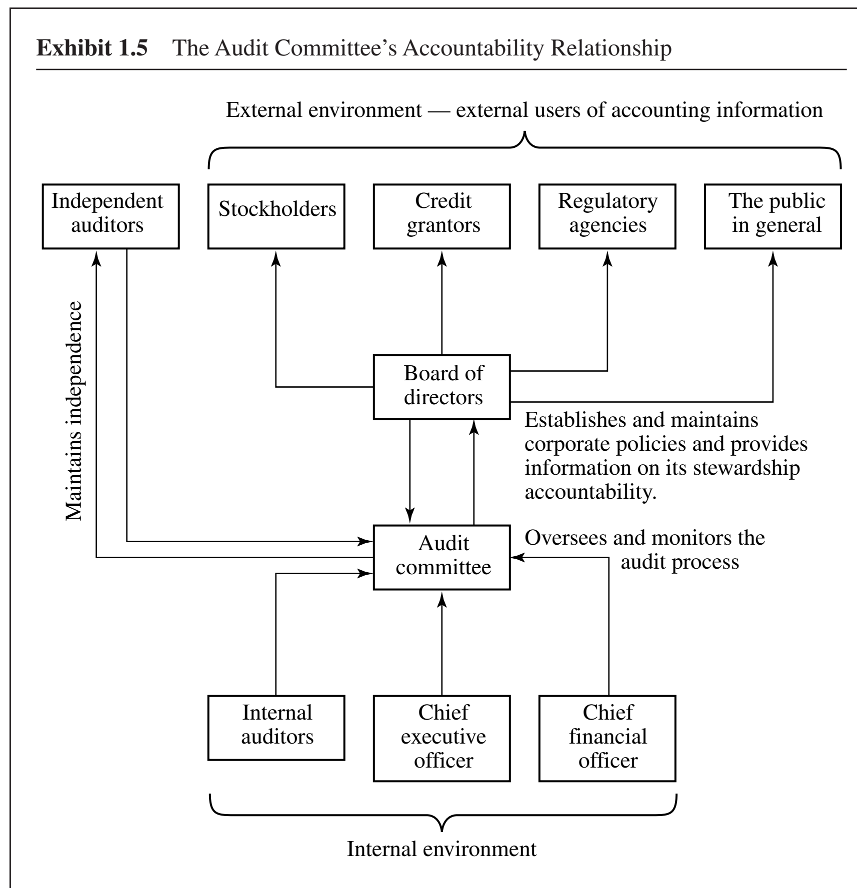
Exhibit 1.5 The Audit Committee's Accountability Relationship



This study suggests that the fundamental types of power needed by audit committees to perform effectively are (1) institutional support, (2) actual authority (written and implied), and (3) diligence. With the possible exception of written mandates (such as audit committee charters), these factors are especially difficult to evaluate with any traditional means of regulation. Perhaps more effective regulation should aim for more substantive reviews of power within the organization.[25]

[25]Lawrence P. Kalbers and Timothy J. Fogarty, "Audit Committee Effectiveness: An Empirical Investigation of the Contribution of Power," *Auditing: A Journal of Practice & Theory* 12, No. 1 (Spring 1993), p. 45. For additional information, consult Dana Wechsler, "Giving the Watchdog Fangs," *Forbes* 144 (November 13, 1989), pp. 130, 132–133; Nelson Luscombe, "More Power to Audit Committees" *CA Magazine* 122, No. 5 (May 1989), pp. 26–37; Dorothy A. McMullen, "Audit Committee Performance: An Investigation of the Consequences Associated with Audit Committees," *Auditing: A Journal of Practice & Theory* 15, No. 1 (Spring 1996), pp. 87–103; Donald J. Kirk and Arthur Siegel, "How Directors and Auditors Can Improve Corporate Governance," *Journal of Accountancy* 181, No. 1 (January 1996), pp. 53–57; Zabihollah Rezaee, "Corporate Governance and Accountability: The Role of Audit Committees," *Internal Auditing* 13, No. 1 (Summer 1997), pp. 27–41; and Michael A. Mackenzie, "The Evolving Board: The Mechanism of Board Oversight," *Canadian Business Law Journal* 26 (1996), pp. 140–144. Also see additional suggested readings.

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The Audit Committee and the Chief Executive Officer The chief executive officer has an obligation not only to the board but also to the standing committees of the board. The chief CEO is responsible primarily for recommending major policy decisions to the board of directors. Since the CEO participates in the decisions concerning the financial accounting policies, he or she should have direct communication with the audit committee.

However, it is essential that the audit committee be totally independent from the CEO because he or she is a "managing director." As a managing director, the CEO participates in the general administration of the corporation as well as assuming ultimate responsibility for the decisions.

Based on a close examination of the audit committees of 13 corporations listed on the NYSE, Michael L. Lovdal found that:

> Effective audit committees permit the chief executive to attend by invitation only. . . . After all, he is the best source concerning questions related to the business and he can ensure quick action on committee requests. In achieving the appropriate relationship with the chief executive, a key ingredient is the quality of the audit committee chairman. He must have both the sensitivity to know when to bring the CEO into the group's deliberations and the strength to stand up to him when the committee wants to pursue an inquiry or change policy.[26]

In short, the audit committee should determine its own agenda items, which should not be based on the chief executive officer's prerogatives. As Ivan Bull observed:

> Concern about other environmental factors, such as legal liability, also may have influenced board agendas and operating practices. The board's practice of allowing and listening to dissent and advice from outside members is healthier than the popular belief that CEOs dominate passive boards.[27]

The Audit Committee and the Chief Financial Officer[28] In most corporations, the chief financial officer (CFO) is responsible for the functions of the controller. In turn, the CFO is accountable to the president for the conduct of the various administrative functions of the controller. Although the controller is responsible for the general administration and supervision of the accounting operations, the CFO has executive responsibility for the financial accounting policies.

Since the audit committee is responsible for assuring that management fulfills its responsibilities in the preparation of the financial statements, the CFO should

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[26]Michael L. Lovdal, "Making the Audit Committee Work," *Harvard Business Review* 55 (March–April 1977), p. 110.

[27]Bull, "Board of Director Acceptance," p. 71. Also see J. Michael Cook, "The CEO and the Audit Committee," *Chief Executive,* No. 76 (April 1993), pp. 44–47.

[28]For further discussion, see Louis Braiotta, Jr., and Jay R. Olson, "Guiding the Audit Committee: A CFO's Concern," *Financial Executive* 51, No. 9 (September 1983), pp. 52–54. See also Chapter 13 for a discussion of the audit committee's review of the quarterly reporting process.

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consult with the committee in order to coordinate the financial accounting activities. Thus the audit committee should have a dialogue with the CFO to consider any questions concerning the financial reporting practices. For example, if the CFO has certain reservations or exceptions to certain accounting policies and practices, the audit committee would recommend the necessary course of action subsequent to its consultation with the independent auditors.

The Audit Committee and the Internal Audit Group The internal audit executive is essentially responsible for the establishment and maintenance of an effective and efficient system of internal auditing. With respect to the audit committee's involvement with the internal audit group, Lovdal points out:

> The internal audit group can be an avenue for the committee in reaching the source of a variety of problems. One committee I examined uses internal auditors regularly for investigations in such areas as computer security, transfer pricing, and capital budgeting. For these activities, the committee should deal directly with the head of internal audit, rather than solely through other finance or control executives, and should make itself knowledgeable about the organization, staffing, and budgets of the internal audit department.[29]

The reporting responsibility of the internal audit group varies from one organization to the next. For example, the director of internal auditing may report to the controller or CFO and meet with the audit committee on a separate or joint basis. However, the director of internal auditing should have access to the audit committee to provide for a forum whereby the internal audit group can resolve questionable matters between the audit staff and corporate management. (See Chapter 9.)

Exhibit 1.6 presents more recent academic research studies. To the extent that the audit committee maintains an independent posture in the corporate environment, the committee will represent a check on the corporate management with respect to its corporate power and stewardship accountability. The primary objective is to foster the accountability relationship between the audit committee and the representatives of management and thereby create an environment in which management will be responsive to its constituencies.

Subsequent to the aforementioned proxy statement seasons, a number of accounting scandals and the demise of a large international accounting firm provided the impetus for the Sarbanes-Oxley Act of 2002 and proposed amendments to the SRO's listing standards. Exhibit 1.7 presents a summary of selected sections and titles of the act. Each section is presented in Chapter 2. Also, Exhibit 1.8 summarizes the SEC releases to implement the sections of the Sarbanes-Oxley Act available at the time of this writing. Exhibit 1.9 contains a corporate accountability self-assessment checklist.

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[29] Lovdal, "Making the Audit Committee Work," p. 111.

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Exhibit 1.6 Summaries of Recent Research Studies

DeZoort, F. Todd, Dana R. Hermanson, and Richard W. Houston, "Audit Committee Support for Auditors: The Effects of Materiality Justification and Accounting Precision." *Journal of Accounting and Public Policy* 22, (2003), pp. 175–199.

Summary: The authors find that, in the context of auditor-management disagreements, independent auditors and audit committees need to discuss the qualitative aspects of materiality with respect to undrecorded adjustments. Additionally, the authors conclude that both accounting and auditing standard setters should consider approaches to enhance accounting estimates in the financial reporting process, including communications with audit committees. Finally, they find that audit committees with CPAs provide greater support for independent auditors.

Klein, April, "Audit Committees, Board of Director Characteristics, and Earnings Management." *Journal of Accounting & Economics* 33 (2002), pp. 375–400.

Summary: Klein concludes that reductions in the independence of boards of directors or audit committees cause large increases in abnormal accruals. The results suggest that boards of directors that are more independent of the CEO are more effective in monitoring earnings management in the financial reporting process.

Beasley, Mark S. and Steven E. Salterio, "The Relationship between Board Characteristics and Voluntary Improvements in Audit Committee Composition and Experience." *Contemporary Accounting Research* 18, No. 4 (Winter 2001), pp. 539–570.

Summary: Beasley and Salterio find that Canadian firms that voluntarily include more outside directors on the audit committee than the minimum mandated by Canadian corporate law have larger boards of directors with more outside directors and thus are more likely to segregate the board chair and CEO/president positions. Likewise, audit committees with financial reporting knowledge and experience and larger boards with outside members are less likely to be chaired by the CEO/president. Thus the researchers conclude that one person serving as both chairman and CEO/president increases the potential for less effective monitoring by the audit committee.

Klein, April, "Economic Determinants of Audit Committee Independence." *Accounting Review* 77, No. 2 (April 2002), pp. 435–452.

Summary: Klein reports that audit committee independence increases with board size and the percentage of outsiders on the board of directors. However, audit committee independence decreases with an increase in a firm's growth opportunities or when a firm reports net losses. Klein confirms the findings of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees that "one size doesn't fill all" when it comes to audit committees. The results suggest that the stock exchanges should allow boards flexibility with respect to audit committee composition.

Carcello, Joseph V. and Terry L. Neal, "Audit Committee Composition and Auditor Reporting." *Accounting Review* 75, No. 4 (October 2000), pp. 453–467.

Summary: Carcello and Neal find that the greater the percentage of affiliated directors on the audit committee, the lower the probability the auditor will issue a going-concern report. Thus their evidence supports the proposition that the audit committee should be composed of independent, outside directors.

Beasley, Mark S., Joseph V. Carcello, Dana R. Hermanson, and Paul D. Lapides, "Fraudulent Financial Reporting: Consideration of Industry Traits and Corporate Governance Mechanisms." *Accounting Horizons* 14, No. 4 (December 2000), pp. 441–454.

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Summary: The authors confirm earlier findings that fraudulent firms and no-fraud firms differ to the extent that audit committees exist and such committees are independent, including the board's independence from management. With the identification of no-fraud industry benchmarks (e.g., number of audit committee meetings and internal audit experience), they find that the sample fraud firms have weak governance mechanisms. Moreover, independent auditors should consider the industry context with respect to their fraud risk assessment on client audit engagements.

Abbott, Lawrence J. and Susan Parker, "Auditor Selection and Audit Committee Characteristics." *Auditing: A Journal of Practice and Theory* 19, No. 2 (Fall 2000), pp. 47–66.

Summary: The authors conclude that the requirement for financial experts on audit committees is more likely to change the structure and focus of audit committee discussions about the quality of the financial reporting process. Their results suggest that audit committee members who are financially literate are more likely to focus on reporting treatments that are prominent in the press and nonrecurring, while financial experts are more likely to focus on the relevance of reporting treatments as well as recurring activities.

Abbott, Lawrence J. and Susan Parker, "Auditor Selection and Audit Committee Characteristics." *Auditing: A Journal of Practice and Theory* 19, No. 2 (Fall 2000), pp. 47–66.

Summary: Abbott and Parker find that independent and active audit committee members are more likely to select an industry-specialist auditor because they demand a high level of audit quality. Their results suggest that an industry-specialist auditor helps minimize the client's reputational or monetary losses.

McDaniel, Linda, Roger D. Martin, and Laureen A. Maines, "Evaluating Financial Reporting Quality: The Effects of Financial Expertise vs. Financial Literacy." *Accounting Review* 77 (Supplement 2002), pp. 139–167.

Summary: The authors conclude that the requirement for financial experts on audit committees is more likely to change the structure and focus of audit committee discussions about the quality of the financial reporting process. Their results suggest that audit committee members who are financially literate are more likely to focus on reporting treatments that are prominent in the press and nonrecurring, while financial experts are more likely to focus on the relevance of reporting treatments as well as recurring activities.

Carcello, Joseph V., and Terry L. Neal, "Audit Committee Characteristics and Auditor Dismissals Following 'New' Going-Concern Reports." *Accounting Review* 78, No. 1 (January 2003), pp. 95–117.

Summary: Carcello and Neal find as a follow-on to their 2000 study that the higher the percentage of affiliated directors on the audit committee, the more likely a client will dismiss its independent auditors because of a going-concern audit report. Moreover, they report that the probability of client dismissal of the independent auditors subsequent to the going-concern report increases as audit committee ownership of client stock increases. In contrast, audit committee members with more governance expertise are less likely to dismiss their independent auditors after receiving a going-concern report. Likewise, the turnover rate of independent audit committee members who retain their independent auditors is less significant compared to audit committee members who dismiss their independent auditors.

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Exhibit 1.7 Summary of Sections of the Sarbanes-Oxley Act of 2002 Impacting Audit Committees

Sections	Title
2	Definitions
101	Public Company Accounting Oversight Board
201	Services Outside the Scope of Practice of Auditors
202	Preapproval Requirements (audit and nonaudit services)
203	Audit Partner Rotation (5-year rotation period)
204	Auditor Reports to Audit Committees
206	Conflicts of Interest (1-year cooling-off period)
207	Study of Mandatory Rotation of Registered Public Accounting Firms
301	Public Company Audit Committees
302	Corporate Responsibility for Financial Reports
303	Improper Influence on Conduct of Audits
307	Rules of Professional Responsibility for Attorneys
401	Disclosure in Periodic Reports
402	Enhanced Conflict of Interest Provisions (Personal Loans to Executives)
403	Disclosures of Transactions Involving Management and Principlal Stockholders
404	Management Assessment of Internal Controls
406	Code of Ethics for Senior Financial Officers
407	Disclosure of Audit Committee Financial Expert
409	Real Time Issues Disclosures
906	Corporate Responsibility for Financial Reports (Failure of Corporate Officers to Certify Financial Reports and Criminal Penalties)

Source: The act is contained in Public Law No. 107-204, July 30, 2002.

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Exhibit 1.8 Summary of SEC Releases Issued to Implement the Provisions of the Sarbanes-Oxley Act of 2002, Relating to Audit Committees (as of June 2003)

Release No.	Date	Title
34-46421	August 27, 2002	Ownership Reports and Trading by Officers, Directors and Principal Security Holders
33-8124	August 28, 2002	Certification of Disclosures in Companies' Quarterly and Annual Reports
33-46685	October 18, 2002	Proposals Regarding Improper Influence on Conduct of Audits
33-8138	October 22, 2002	Proposals Regarding Internal Control Reports
33-8176	January 22, 2003	Conditions for Use on Non-GAAP Financial Information
34-47225	January 22, 2003	Insider Traders During Pension Plan Blackout Periods
33-8177	January 23, 2003	Disclosure Regarding Audit Committee Financial Experts and Company Codes of Ethics
33-8180	January 24, 2003	Retention of Records Relevant to Audits and Reviews
33-8182	January 28, 2003	Disclosure About Off-Balance Sheet Arrangements
33-8183	January 28, 2003	Strengthening the Commission's Requirements Regarding Auditor Independence
33-8185	January 29, 2003	Implementation of Standards of Professional Conduct for Attorneys
33-8212	March 21, 2003	Certification of Disclosure in Certain Exchange Act Reports
33-8177a	March 26, 2003	Disclosure Required by Sections 406 and 407 of Sarbanes-Oxley Act of 2002
33-8220	April 9, 2003	Standards Relating to Listed Company Audit Committees
34-47672	April 11, 2003	Self-Regulating Organizations; Notice of Filing of Proposed Rule Changes and Amendment No. 1 thereto by the NYSE Relating to Corporate Governance
2003-66	May 27, 2003	SEC Implements Internal Control Provisions of Sarbanes-Oxley Act
33-8238	June 5, 2003	Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports

Source: www.sec.gov/rules/final/htm; *www.sec.gov/new/press/htm*; and *www.sec.gov/rules/proposed/htm*.

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Exhibit 1.9 Corporate Accountability: Self-Assessment Checklist

Services available from:	Management	Internal Auditors	External Auditors	Legal counsel	Board of Directors	Sarbanes-Oxley Act	SEC	SROs	ASB	
Audit Committee Practice Area										Comments
Legal liabilities under, State statutes										
Fiduciary liability				✔						
Business judgment rule				✔						
Standards of conduct				✔						
Federal Statutes*										
Sarbanes-Oxley Act of 2002				✔		✔	✔			
Private Securities Litigation Reform Act of 1995				✔			✔			
Securities Act of 1933				✔			✔			
Securities Exchange Act of 1934				✔			✔			
Legal Cases				✔						
Corporate Governance Principles and Rules					✔	✔	✔	✔		
Formation†						✔		✔		
Membership										
Number of members (size)						✔		✔		
Appointments						✔				
Term of Service						✔				
Qualifications						✔		✔		
Composition						✔		✔		
Meetings, frequency and type								✔		
Knowledge Areas										
Type of business and industry	✔									
Internal audit process		✔								
External audit process			✔							
Internal control concepts‡		✔	✔							
Management's risk assessment	✔	✔	✔							
Industry accounting practices	✔	✔	✔							
Complex business transactions	✔	✔	✔	✔						
Financial reporting process	✔	✔	✔							
Internal communication process§	✔	✔	✔	✔	✔	✔	✔	✔		
External communication process					✔	✔	✔	✔	✔	

*See Chapter 4 and Appendix D in this book's website for other acts.
†Board resolution or corporate bylaws and a format written charter.
‡Includes conflicts of interest (e.g., code of conduct, related party transactions).
§Related to the above areas.

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