1979

Report of the Special Committee on Audit Committees

American Institute of Certified Public Accountants. Special Committee on Audit Committees

Report of the Special Committee on Audit Committees

AICPA American Institute of Certified Public Accountants

Report of the Special Committee on Audit Committees

American Institute of Certified Public Accountants

Foreword

The AICPA Special Committee on Audit Committees was appointed to study whether the American Institute of Certified Public Accountants should require that companies establish audit committees of their boards of directors as a condition of an audit by an independent public accountant and, if so, to propose a plan for adoption of a requirement. This report presents the results of our study.

Special Committee on Audit Committees

Robert D. Neary, *Chairman*
William J. Badecker
Thomas L. Holton
James J. Leisenring
Robert L. May
Richard D. Thorsen

Brian Zell, *AICPA Staff*

December 1978

Report of the Special Committee on Audit Committees

Background

The AICPA has long advocated the formation of audit committees. In 1967, the AICPA recommended that publicly owned corporations establish audit committees composed of outside directors. In July 1977, the AICPA Board of Directors repeated that recommendation and urged Institute members to encourage corporations to establish audit committees.

Congress has recently expressed interest in audit committees. In September 1976, the Subcommittee on Oversight and Investigations of the House Committee on Interstate and Foreign Commerce recommended that the Securities and Exchange Commission (SEC) promulgate rules concerning corporate boards of directors, including a requirement for audit committees. The report of the Subcommittee on Reports, Accounting and Management of the Senate Committee on Governmental Affairs recommended that either the accounting profession or the SEC require publicly owned corporations to establish audit committees.

In the past, the SEC has urged the voluntary formation of audit committees. Recently, the chairman of the SEC recommended that the AICPA consider establishing a requirement for audit committees. The SEC has also recently adopted requirements for proxy statement disclosure of information about the composition and activities of boards of directors and their committees, including audit committees.

The New York Stock Exchange (NYSE) has adopted a requirement that as of June 30, 1978, each domestic company with common stock listed on the exchange must establish and maintain an audit committee. Both the SEC and the AICPA have urged other stock exchanges to establish requirements for audit committees. The American Stock Exchange has established a special advisory committee to study this issue. The National Association of Securities Dealers (NASD) is also considering whether to require audit committees as a condition for a corporation to have its securities listed on the NASDAQ over-the-counter quotation system.

Exact figures on the number of publicly owned corporations with audit committees are not available, but surveys have shown that a large and increasing percentage of publicly owned corporations have voluntarily formed audit committees.[1] Of course, each of the more than 1,500 corporations coming under the requirement of the NYSE must now have an audit committee. Surveys taken before the requirement was established showed that a large majority of NYSE corporations had already formed audit committees. The NASD recently surveyed the approximately 2,600 corporations listed on NASDAQ, its over-the-counter securities quotation system. The survey showed that about 68 percent of those responding had audit committees.

The Committee's Study of the Issues

Issues Paper

A requirement for audit committees involves issues of corporate governance and has implications for many parties outside the accounting profession. Therefore, the committee sought comments and views from individuals and organizations with an interest in the issue. To aid those wishing to comment, we prepared a paper entitled "An AICPA Requirement for Audit Committees: An Analysis of the Issues." The issues paper described the developments leading up to the study and the issues on which we sought comments. The issues were as follows:[2]

1. Should audit committees be required as necessary—
   a. To assist independent directors in fulfilling their responsibilities?
   b. For an auditor to be able to fulfill his responsibilities under generally accepted auditing standards?
   c. To strengthen auditor independence?
2. If audit committees are to be required, should the requirement apply to—
   a. All public entities?
   b. All SEC registrants?
   c. Certain SEC registrants?

---

1. For example, a 1970 survey by Mautz and Neumann showed that 32 percent of the corporations responding had audit committees, while a repeat of the survey in 1976 showed that 87 percent had audit committees. R. K. Mautz and F. L. Neumann, *Corporate Audit Committees: Policies and Practices* (Cleveland: Ernst & Ernst, 1977), pp. 8–11.

2. As a supplemental issue, we were asked to consider whether the independent auditor should be required to be present and available to answer questions at the annual meeting of shareholders. Under SEC proxy statement regulations, shareholders are notified beforehand whether the auditor will be present and available to answer questions at the annual meeting. Furthermore, respondents to the issues paper indicated that auditors typically do attend the annual meetings of publicly owned corporations. Therefore, we do not believe action is needed on this matter.

3. What should be the requirements for the composition of the audit committee and the qualifications for membership?
   a. Should all members of the audit committee be independent of management, or is it sufficient that a majority be independent?
   b. Could the full board of directors qualify effectively as an audit committee?
   c. How should "independence" of directors be defined?
   d. What other qualifications should be required?
4. Should a requirement for audit committees specify duties to be performed by the audit committee?
5. If the AICPA should require audit committees, should the requirement be implemented in the form of—
   a. An amendment of the AICPA Code of Professional Ethics rule on independence?
   b. A statement on auditing standards establishing the auditor's responsibilities under generally accepted auditing standards?
   c. A membership requirement of the SEC practice section of the AICPA Division for CPA Firms?
6. If an audit committee requirement should not be adopted by the AICPA, should it be implemented in some other manner?
7. Will a requirement for audit committees have an economic or competitive impact on public accounting firms?

Over 60,000 copies of the issues paper were distributed. Copies were sent to the individuals and organizations on the AICPA's exposure draft mailing list for auditing standards, to each of the approximately 30,000 members of the National Association of Corporate Directors, to stock exchanges and other organizations, and to many others who requested copies. The request for comments and the announcement of the public hearing were also widely reported in the national and financial press as well as in many business and accounting journals and newsletters.[3]

Response to the Issues Paper

We received written comments from over ninety individuals and organizations of which about one-third were public accountants or accounting firms. The public hearing was held May 31, 1978, in Chicago. All comments received were considered by the committee. We found the written comments and the discussions at the hearing very useful in forming our conclusions and recommendations.

3. Those reporting the announcement included the *Wall Street Journal* (April 10, 1978), the *Chicago Sun Times* (April 10, 1978), the *Daily Variety* (April 10, 1978), the *Reuters Financial Report* (April 7, 1978), the *American Banker* (April 13 and 14, 1978), and the *Los Angeles Daily Journal* (April 20, 1978).

We found considerable agreement among the comments we received. Generally, corporate officers and directors who commented did not object to the establishment of audit committees. In fact, most approved of the audit committee requirement of the NYSE. However, the overwhelming majority believed that an audit committee requirement by the AICPA is not necessary and questioned whether the AICPA has authority to set such a requirement. Respondents generally did not view AICPA involvement in matters of corporate governance as legitimate or appropriate. Many respondents, including larger corporations that already have audit committees, stated that the costs of complying with an audit committee requirement would be a burden to smaller corporations.

The responses from accountants also showed support for the concept of audit committees. However, the responses from local firms and several regional and national firms showed a widespread concern that a broad requirement for audit committees would have unfortunate competitive effects on smaller firms in the accounting profession without corresponding improvements in audit practice.

Many of the comments we received from corporate directors and officers stated that their corporations have audit committees and that the audit committees are performing effectively. Many independent auditors and others also expressed satisfaction with audit committees. The large percentage of publicly owned corporations with audit committees is evidence that voluntary efforts to foster audit committees have been effective. The apparent widespread satisfaction with the performance of audit committees will encourage many more corporations to voluntarily form audit committees.

Conclusions

Summary

Unlike other professional standards on auditing adopted by the public accounting profession, a requirement for audit committees would impose restrictions directly on corporations rather than impose a requirement on members of the profession. For the AICPA to be able to impose such a requirement, it must be demonstrated that audit committees are necessary either for the maintenance of auditor independence or for the performance of audits in accordance with generally accepted auditing standards.

The special committee is convinced that audit committees can be *helpful* to both corporate directors and independent auditors in fulfilling their respective responsibilities, and the responses we have received from directors and auditors are evidence that many audit committees are functioning effectively. However, based on our study and consideration of the issues, we cannot conclude that audit committees are *necessary* either for the maintenance of auditor independence or for performance of an audit in accordance with generally accepted auditing standards.

The AICPA has long supported the concept of audit committees, and we believe that it should continue to support reasonable efforts by stock exchanges, the NASD, or other appropriate bodies to encourage or require audit committees. We do not believe, however, that there is a reasonable basis for the AICPA to establish a requirement for audit committees.

The overwhelming view of respondents was that the involvement of the AICPA in issues of corporate governance is unnecessary and inappropriate. We are aware that, because of this opposition, it is likely that the imposition of an audit committee requirement by the AICPA and the implementation of such a requirement by AICPA members would face legal challenge. We have been advised by the AICPA's counsel that the imposition of an audit committee requirement in the absence of a reasonable foundation would expose the AICPA and its members to a risk that established antitrust principles would be violated. We do not believe it would be possible for the AICPA to sustain the considerable burden of identifying the necessity of an audit committee requirement.

Possible Bases for a Requirement

The issues paper discussed the possible bases for the establishment of an audit committee requirement by the AICPA. An audit committee requirement may be necessary to strengthen auditor independence, or it may be necessary to permit the auditor to fulfill his responsibilities under generally accepted auditing standards.

Auditor Independence. The traditional, underlying concept of rules on independence has been to prohibit relationships with clients that may conflict, or appear to conflict, with the auditor's duties. An audit committee requirement does not fit this concept.

Many advocates of audit committees have noted that the existence of an audit committee can have a beneficial effect on the auditor's relationship with the client. As the Commission on Auditors' Responsibilities stated, "Although other measures may be needed, active outside directors can go a long way toward balancing the auditor's relationship with management."[4] This commission advocated increased participation by outside directors, but it did not indicate that an audit committee is essential to achieve that participation. We agree that audit committees can *assist* the auditor, but we are convinced that a requirement for audit committees is not *necessary* for auditor independence.

4. Commission on Auditors' Responsibilities, *Report, Conclusions, and Recommendations* (New York: AICPA, 1978), p. 12.

An audit committee facilitates the auditor's communication with the board of directors when there are disagreements with management, but the independence of the auditor in a particular engagement depends on the individual auditor. We do not believe that the public now considers an auditor's independence to be impaired because a client does not have an audit committee. Experience has shown that auditors have been able to maintain independence and fulfill their responsibilities without the presence of an audit committee.

As discussed elsewhere in this report, a requirement for audit committees could not reasonably apply to all audit clients. Therefore, a requirement based on auditor independence could not be applied uniformly to all audit practice. We believe the position that an audit committee is necessary for auditor independence for some clients, but not for others, cannot be justified logically or empirically.

Generally Accepted Auditing Standards. The issues paper asked whether an audit committee requirement is necessary for the auditor to be able to fulfill his responsibilities under generally accepted auditing standards. The respondents believed that an audit committee requirement is not necessary for the auditor to fulfill those responsibilities. We have reached the same conclusion.

Statements on auditing standards now require the auditor to communicate several matters to the client's board of directors or its audit committee. Those matters include illegal acts by management, material errors and irregularities detected by the audit, and material weaknesses in internal accounting control. The existence of an audit committee of independent directors can make it *easier* for the auditor to report those matters to the directors, but an audit committee is not *necessary* for this communication. Auditors are able to bring important matters to the attention of boards of directors that do not have audit committees.

In the past, statements on auditing standards have been adopted that raised requirements, although the new requirements may not previously have been considered necessary for the performance of an audit. Statements on auditing standards have not, however, imposed requirements concerning the corporate governance of audit clients. A statement on auditing standards that would impose such a requirement could, in our opinion, only be justified if it could be demonstrated that it is necessary to the performance of an audit in accordance with generally accepted auditing standards. Otherwise, companies may be denied audits even though their financial statements are susceptible to being audited.

We are aware of unusual situations in which independent auditors have asked specific clients to establish audit committees as a condition for accepting or continuing an audit engagement. Those decisions have not involved a concern for the auditor's independence or compliance with generally accepted auditing standards, but have involved the auditor's judgment of the business risks associated with the circumstances of a particular engagement. We considered whether a statement on auditing standards should be issued to provide guidance to auditors on the circumstances in which an audit committee would be necessary. We concluded that it would not be possible to describe those circumstances in a statement on auditing standards for general applicability so that an auditor could appropriately be called on to justify a departure from the guidance.

A Membership Requirement of the SEC Practice Section. Besides establishing an audit committee requirement as an independence rule or in a statement on auditing standards, the issues paper discussed the possibility of having a requirement in the form of a membership requirement of the SEC practice section of the AICPA Division for CPA Firms. An audit committee requirement in the form of an SEC practice section membership requirement involves considerations similar to those for an independence rule or a statement on auditing standards. We do not believe there is a reasonable basis for imposing such a requirement solely on clients of members of the SEC practice section.

Corporate Governance

The large number of companies that have voluntarily formed audit committees and the comments we received about the operations of many audit committees are evidence that many boards of directors find audit committees to be useful.

The overwhelming majority of respondents, however, stated that an AICPA requirement for audit committees would be an inappropriate interference in corporate governance by the accounting profession. The comments of the Financial Executives Institute are representative:

> FEI does not agree that the public accounting profession is responsible for either the organization or conduct of corporate affairs. We believe, therefore, that the AICPA would overstep its bounds in attempting to establish an audit committee requirement. The promulgation of such a rule involves more than simply assuring that enterprises being audited have audit committees. This rule would impose a structured change on the boards of directors of corporations. We believe there are serious questions as to whether or not the accounting profession has the authority to set regulations regarding the establishment and operations of corporate boards.

In their comments, the members of the American Bar Association Committee on Corporate Law and Accounting stated that audit committees are only a part of a much larger issue:

> In our view, the "audit committee issue" is, in reality, a manifestation of concern with the adequacy of the discharge of their duties by directors of

publicly held corporations. This concern is being addressed, in particular, to the duties and responsibilities of the nonmanagement directors, and attention has become recently focused upon the corporate audit committee. When considered in light of this expanded frame of reference, the mandating of audit committees merely begins the debate.

In deciding to accept or to continue an engagement, the auditor is concerned with the management of the client and its possible effect on his ability to perform the audit. The auditor is properly concerned with his relationship with the client's management and directors, but he can resolve his concern by his decision to accept or reject a client. The structure of a particular company is a matter to be decided by the owners or their representatives in accordance with applicable laws and regulations.

Other bodies, including stock exchanges and the NASD, are considering requirements for audit committees. The relationships of those bodies to publicly owned corporations are quite different from that of the AICPA, and we believe they may be appropriate authorities for establishing requirements for audit committees. We recommend that the Institute support reasonable proposals by those bodies to encourage or require audit committees for publicly owned corporations. However, in developing any requirement for audit committees, consideration should be given to the additional costs involved.

Directors Independent of Management

Since it is generally agreed that an audit committee should have members independent of management, a requirement for audit committees is, in effect, a requirement for independent directors.

A majority of the respondents commenting on the issue believe that all members of an audit committee should be directors who are independent of management. We believe it is preferable that all members of the audit committee, but in any case at least a majority of the audit committee, should be independent of management. In its requirement for audit committees, the NYSE provided guidance about the independence of directors. A number of respondents believed that the Exchange's guidance is reasonable, and we see no reason to propose different guidance at this time.

The Duties of Audit Committees

The majority of those commenting on this subject stated that the specific duties of an audit committee should not be mandated but should be determined by individual boards of directors. Some respondents, however, believed that guidance on the duties of audit committees would be helpful.

The operations of an audit committee should be flexible enough to meet the needs of the directors, the investors, the auditor, and the company. The responsibilities and authority of the audit committee are derived from those of the board of directors, and the specific duties of the audit committee will depend on the bylaws of the company and the operating policies and structure of the board of directors.

To assist boards of directors that have established audit committees, or that are considering establishing audit committees, we offer the following list of general duties:

1. Approve the selection of the independent auditor.
2. Review the arrangements and scope of the audit.
3. Consider the comments from the independent auditor with respect to weaknesses in internal accounting control and the consideration given or corrective action taken by management.
4. Discuss matters of concern to the audit committee, the auditor, or management relating to the company's financial statements or other results of the audit.
5. Review internal accounting procedures and controls with the company's financial and accounting staff.
6. Review the activities and recommendations of the company's internal auditors.

It may also be appropriate for the audit committee to perform additional duties as assigned by the board of directors. Such duties might include review of financial statements and other financial information distributed by the company to the public, review of changes in accounting principles or methods of applying them, review of nonaudit services performed for the company by the independent auditor, establishment and monitoring of policies to prohibit unethical, questionable, or illegal activities by company employees, or review of executive perquisites.

Whether the audit committee should be assigned any of these additional duties will depend on the policies and organization of the board of directors. For example, the board of directors may prefer to assign the duties to other committees, such as a compensation committee or an ethics committee.

Applicability of a Requirement

For companies that already have independent directors, the formation of audit committees imposes no great additional financial burden, and most of those companies have already formed audit committees. However, a number of respondents stated that for many smaller corporations, including many SEC registrants, a requirement for outside directors would impose a significant expense.

Although many studies have examined the structures of corporations, those studies have concentrated primarily on the larger corporations. Very little information is available about the many smaller, publicly owned corporations. As one author notes, "Analysis of corporations has been greatly distorted by assuming that all or most corporations are miniature copies of AT&T and GM."[5]

There are thought to be about 11,000 "publicly owned corporations" coming under the reporting provisions of the securities acts. Generally, those are corporations with more than $1 million in assets and 300 shareholders. Of those, only about 3,400 have securities listed on a stock exchange, and about 2,600 have securities listed on the NASDAQ over-the-counter system. It appears, therefore, that there are about 5,000 publicly owned corporations whose securities are not actively traded. Although no exact figures are available, some idea of the characteristics of publicly owned corporations is provided by a study that estimated that roughly 3,200 corporations in the United States have more than 1,000 shareholders.[6] This indicates that a large proportion of publicly owned corporations have a relatively insignificant effect on the public securities markets. For many of those corporations, the cost of an audit committee requirement would impose an unreasonable burden.

Competitive Effects

A significant number of respondents, in particular, medium and smaller sized public accounting firms, stated that a requirement for audit committees would be anticompetitive. In general, two reasons were given for the anticompetitive effect:

1. Newly appointed, independent directors may tend to give little regard to the past service of the smaller firm.
2. Independent directors may favor the selection of larger, well-known firms in the belief that it will prevent criticism of the selection by other outside parties.

For several reasons, the extent of this problem cannot be determined. Several studies of the causes of auditor changes have been undertaken, but, of course, the studies do not reveal how the personal attitudes of directors affect selection of auditors.[7] Furthermore, the problem of displacement of smaller firms existed before audit committees became popular. It is not possible to tell whether audit committees have added to the problem or whether the present problems are a continuation of an existing

---

5. Alfred F. Conrad, "The Corporate Census: A Preliminary Exploration," *California Law Review* 63 (March 1975): 441.

6. Conrad, "The Corporate Census," p. 458.

7. For example, James P. Bedingfield and Stephen E. Loeb, "Auditor Changes: An Examination," *Journal of Accountancy,* March 1974, pp. 66–68.

tendency. Despite the lack of empirical evidence, the significant number of firms commenting on this issue and the fact that many of those respondents cited their experience as the basis for their claims, leads us to believe that the role of audit committees in displacement of smaller firms should be of concern. We note that the executive committee of the SEC practice section of the division for CPA firms has established a subcommittee to study the relations between auditors and audit committees. The board of directors of the AICPA adopted the following policy on the issue:

> As early as 1967 the Board of Directors of the AICPA expressed its support of the establishment of audit committees by boards of directors of publicly traded companies. On July 21, 1977, the Board also endorsed the concept that boards of directors of such companies or their audit committees should evaluate, select, and appoint the independent auditors. In carrying out this function, it should be recognized that all CPA firms whose partners are members of the AICPA are subject to the same stringent rules of conduct with respect to maintaining their independence and must comply with quality control requirements described in Statement on Auditing Standards No. 4. In addition, many firms participate in quality control reviews, either voluntarily or as members of the AICPA Division for CPA Firms, to enhance the quality of their auditing services. Thus, the capability of auditing publicly held companies is shared by a large number of CPA firms and size alone should not be the determinative factor in selecting and appointing independent auditors.

The displacement of smaller firms is a problem, but we do not believe that it is the inescapable result of audit committees. From the comments we received, it appears that the problem lies not in the concept of audit committees but, to a large extent, in the attitudes of independent directors and others. Efforts should be made to change those attitudes, but as long as those attitudes exist, consideration must be given to the competitive effects before imposing audit committees on smaller corporations.