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Audit committees : answers to typical questions about their organization and operations

American Institute of Certified Public Accountants (AICPA)

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Answers to Typical Questions about their Organization and Operations

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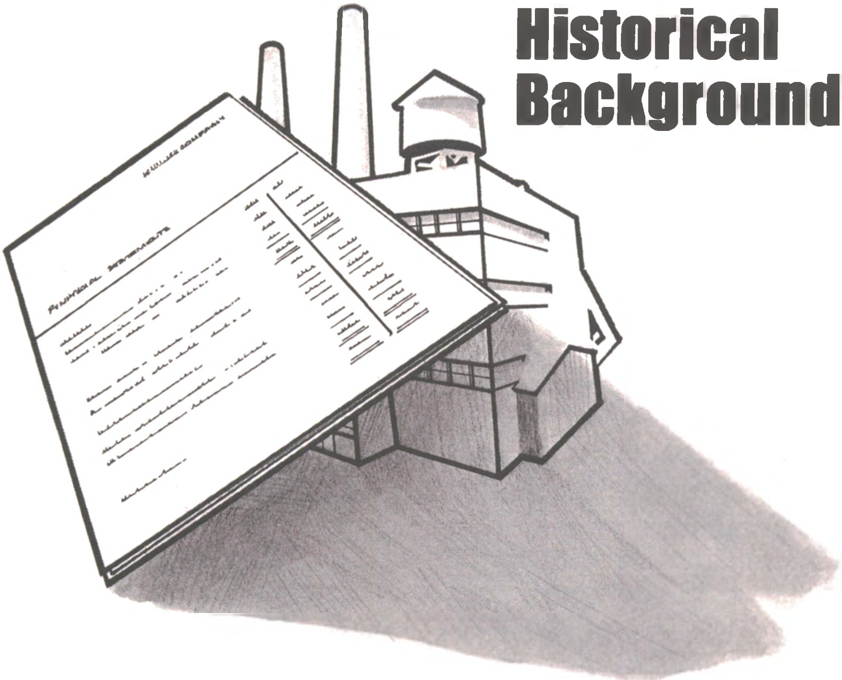
Preface

In recent years, there has been an increasing trend towards the formation of audit committees. The purpose of this booklet is to encourage this trend—in smaller as well as larger public companies—and to provide practical introductory information.

A diligent audit committee can be instrumental in improving a company's financial reporting practices. It can enhance the independence of the company's auditors, both internal and external, and provide assurance that their services are used effectively. It can initiate needed or desirable changes in a company's system of internal accounting control. And it can enable the board of directors to execute its responsibilities to the stockholders in those areas in an effective and efficient manner.

In July, 1977, the board of directors of the American Institute of Certified Public Accountants called for all publicly held corporations to appoint audit committees and urged all AICPA members in public practice to encourage their clients to establish audit committees.

Historical Background



The board of directors is charged with safeguarding and advancing the interests of the stockholders, acting as their representative 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.

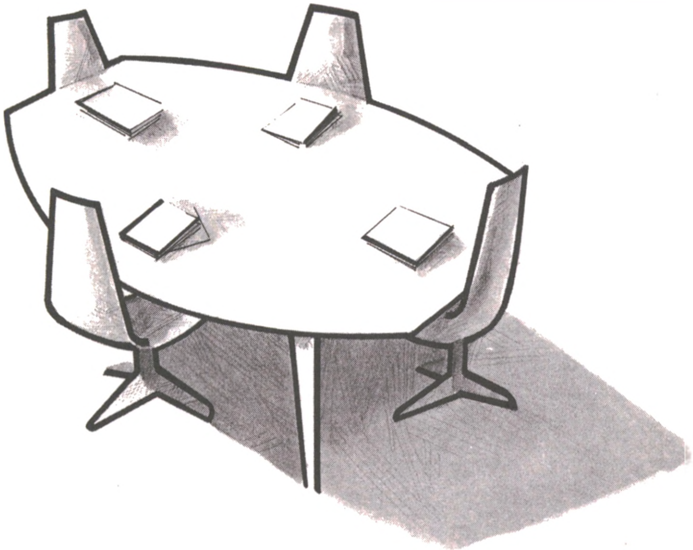
The board generally relies on management to prepare financial statements and on both internal and external auditors to examine those statements. However, the directors have overall responsibility for the financial statements. Many boards have established audit committees to assist them in discharging this responsibility. Nevertheless, the impetus for establishing audit committees has largely been provided by others.

As a result of the McKesson & Robbins scandal of the late 1930s, the New York Stock Exchange issued a report which recommended that the directors of a corporation nominate or select the independent auditors (the "external auditors"), and noted that "where practicable, the selection of the auditors by a special committee of the board composed of directors who are not officers of the company seems desirable." The SEC concurred with this suggestion but also recommended that those committees also assume the duty of arranging the details of the audit.

The need for external auditors to perform their duties in an enhanced independent environment received increased emphasis during the 1960s, and the AICPA issued a statement in 1967 calling for all publicly held corporations to appoint audit committees. Also, various legal decisions during this period, particularly the *BarChris* decision, emphasized both the directors' responsibility to take an active role in overseeing corporate affairs and the directors' liability for misleading or inaccurate financial statements.

Actions came quickly during the 1970s. In 1972, the SEC stated that effective audit committees could afford "the greatest possible protection to investors" and reaffirmed its support of audit committees. In 1973, the New York Stock Exchange stated that an audit committee "no longer represents a corporate luxury, but has become a necessity." In 1974, the SEC adopted rule changes requiring registrants to disclose the names of audit committee members in all proxy statements or to disclose the fact that no audit committee existed. The latest development is that all companies listed on the New York Stock Exchange are required to establish audit committees by June 30, 1978. Such committees are to be "comprised solely of directors that are independent of management and free from any relationship that, in the opinion of its Board of Directors, would interfere with the exercise of independent judgment as a committee member."

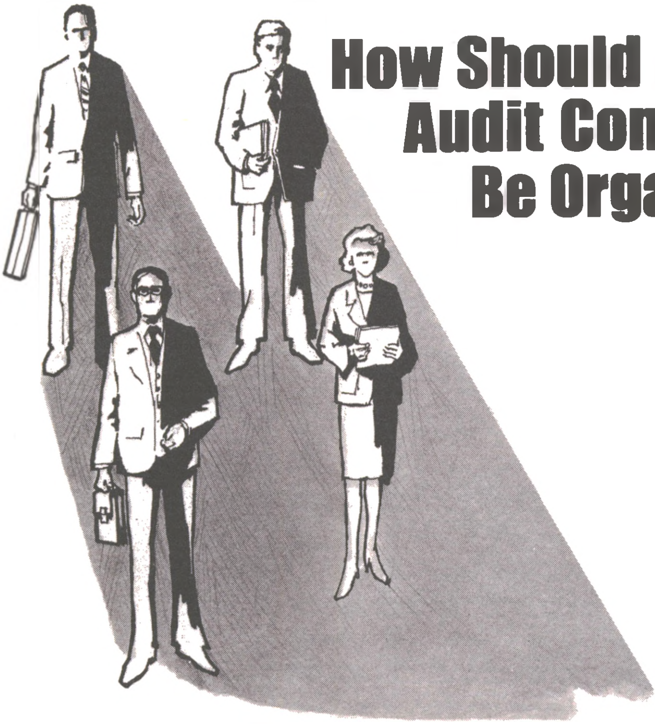
Why Establish an Audit Committee?



Forming an audit committee is in the best interests of the directors, particularly those who are not also officers of the company. Recent litigation has amplified the responsibilities of directors, especially the nonmanagement or "outside" director. Directors increasingly are being subjected to civil and criminal actions for financial statements that are inaccurate or inadequate. Yet, because of its many responsibilities, it may not be practicable for the full board to consider financial reporting matters in depth. An audit committee can do this more effectively because it is smaller than the full board, is typically composed of directors who are independent of management, and is able to concentrate more attention on this aspect of corporate activity. The existence of an effective audit committee demonstrates the board's commitment to the exercise of due care in reviewing financial information to be released to the public.

Another benefit of an audit committee is a betterinformed board more capable of executing its responsibilities to the stockholders. An effectively functioning audit committee, with the help of the company's internal and external auditors, is able to identify and analyze financial reporting problems and to discuss its recommendations with the full board in a comprehensive and effective manner. Thus, although an audit committee cannot relieve the full board of its ultimate responsibility for the financial statements, a vigorous and capable audit committee can help evaluate those financial statements.

An audit committee also enhances the external audit function. An effective external audit must be an independent audit. Relationships do—and should—exist between management and auditor, because an audit should be carried out in an atmosphere of full and open communication. But these relationships must be carefully balanced. Both management and auditor must always be mindful of their ultimate responsibility to the stockholders. An audit committee that carefully monitors the audit function lends assurance that this responsibility is kept in clear view. It also provides the auditor with a forum that is independent of operating management for discussion of matters that he considers significant. Accordingly, an audit committee enhances the independence of the external auditor, increases management's diligence in instituting internal accounting controls and appropriate reporting practices, and increases the participation of directors in the important decisions made as the result of an external audit. Similarly, companies that have an internal audit function should find the effectiveness of that function increased when the internal auditor has a direct line of communication to the board through the audit committee.



How Should an Audit Committee Be Organized?

An audit committee should be organized as a standing committee of the board composed mainly of nonofficer directors. Its major responsibilities should be to deal with the company's financial reports, its external audit, and its system of internal accounting control and internal audit. However, every business is unique, and the audit committee should reflect this.

FORMATION

Audit committees should be formed by a resolution of the board of directors. The audit committee's purpose, responsibilities, and authority should be in writing. The specificity of its charge is a matter to be decided on an individual company basis. The outline of duties and responsibilities should be reasonably specific, but broad enough to allow the committee to pursue matters that it believes have important accounting, reporting, or auditing consequences.

MEMBERSHIP

Members of the audit committee either are appointed directly by the chairman of the board, or the chairman makes nominations and the board approves the choices. Nominations sometimes are submitted to the stockholders for approval.

A 1977 survey of corporations with audit committees revealed that nearly 90 percent had audit committees of three to five members. In general, the audit committee should be large enough to have members with a good mix of business judgment and experience, but not so large as to be unwieldy.

Members should be objective, competent, and aggressive in the execution of their responsibilities. The trend of thinking is that nonofficer directors should represent at least a majority of the audit committee. Many believe that officer-directors should not serve on an audit committee since they are, to some extent, identified with the financial statements under review. Others believe that the inclusion of an officer-director on the audit committee may clear up incipient misunderstandings of management's actions and improve the committee's effectiveness. It should be noted that the New York Stock Exchange requirement for listed companies to establish audit committees bars officer-directors from membership on audit committees.

The term of office for committee members ranges in practice from one year to indefinite terms with termination at the pleasure of the board. Some believe that new committee members bring fresh perspectives to the committee and prevent it from becoming unimaginative. Others argue that the committee will function most efficiently only after it has been together for some time. Many believe that adopting staggered terms of moderate length gives appropriate consideration to both points of view.

MEETINGS

There is no "right" number of meetings. The audit committee itself should determine how many meetings will be sufficient to achieve its goals. Generally, audit committees meet to—

- Recommend the selection, retention, or termination of the company's external auditors.
- Review the overall scope of the audit with the external auditors.

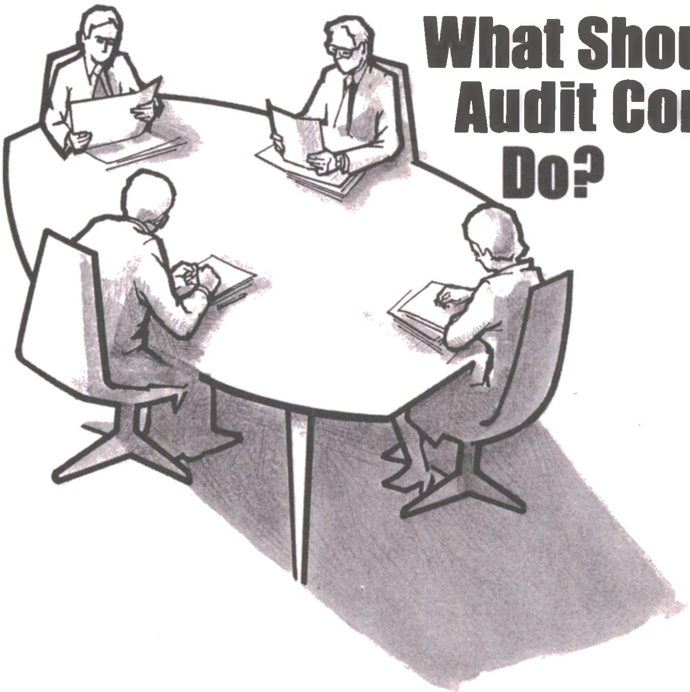
- Review the financial statements and external audit results, including communications of material weaknesses in internal accounting control.
- Prepare the committee's report to the full board.

If the company has an internal audit department, the audit committee will meet to review the results of internal audit activities and may also meet to—

- Approve the department's budget and audit plan for the coming year.
- Approve the selection or termination of the director of internal auditing.

Other meetings with management or internal or external auditors may occasionally be held to deal with unforeseen problems or to provide the auditors with needed access to the board.

Audit committee members should be well prepared for their meetings. They should be supplied with agendas, minutes of the previous meeting, and other related information well in advance of any meeting.



What Should an Audit Committee Do?

As a minimum, an effective audit committee will be involved in the selection of the external auditor, and will review the overall audit plan, the annual financial statements, and the results of the external audit. Each audit committee must decide for itself what else it should do to achieve its goals. Audit committee activities tend to vary because they depend on such factors as the company's size and complexity, the outlooks of the individual directors, the duties of other board committees, and the peculiarities of the industry. In determining the scope of its activities, the audit committee should recognize that it is better to be thorough in a few areas than superficial in many. Some major areas of activity are discussed below.

SELECT AN EXTERNAL AUDITOR

Recommending the external auditor to be selected or retained to examine the financial statements is one of the most important functions of the audit committee. Some of the factors that an audit committee might consider in this process, which should be performed each year, are listed opposite.

■ What has been the company's past experience with the personnel assigned to the audit? Do they convey the impression that they value the company as a client? Do they seem able to work compatibly—but efficiently and independently—with management and the audit committee? Do they demonstrate an understanding of the company's business problems? Do they anticipate problems and advise the company of new accounting, tax, or SEC developments?

■ Can the firm supply the professional services the company needs? For example, does the firm have access to individuals skilled in matters affecting the company (such as industry and SEC specialists or specialists in the problems of smaller companies), and are their skills made available to the company? Does the firm have the capability to serve the company efficiently?[1]

■ What are the firm's quality control policies, including its training policies? What is the firm's policy on rotation of the personnel assigned to the audit? On acceptance of clients? On recruitment of personnel? On growth?

■ Has the firm satisfactorily explained significant variances in actual fees from estimates? Have suggestions been made for management actions that might reduce fees?

REVIEW THE OVERALL PLAN OF THE AUDIT

The external auditor determines the nature, timing, and extent of the tests of the accounting records and other auditing procedures he will perform. These tests and procedures enable him to express an opinion on the financial statements. However, reviewing the overall plan of the audit (not the details of the procedures the auditor intends to apply) serves to provide the audit committee with valuable information, such as the following:

■ A summary of the company's financial reporting requirements and the timetable for meeting those requirements.

■ An understanding of the relationship between the company's system of internal accounting control and the scope of the audit.

■ The effect of accounting and auditing pronouncements and of SEC and other regulatory requirements on the scope of the audit.

■ The extent to which the external auditor uses the work of internal auditors in establishing the scope of his examination.

■ Changes in the company's organization, operations, or controls that have caused the external auditor to change the scope of his examination.

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[1] If the independent auditor plans to have another firm perform part of the audit work, similar inquiries may be appropriate with respect to that firm.

- The degree of audit coverage, such as locations to be visited, the extent of procedures such as inventory observation, receivable confirmation, and so forth.
- The extent to which auditors other than the principal auditor are used.
- Any potential problems that might cause the auditor to qualify his opinion.
- Accounting principles management has selected for new transactions and the auditor's evaluation of those principles.

It is not appropriate for the audit committee to attempt to limit the scope of the audit. However, it is appropriate to query both management and the external auditor about improvements that could be made (for example, in internal accounting controls) that would enable the external auditor to reduce the scope of his work. The audit committee might also ask about additional services that could be of benefit to the company.

The external auditor may summarize his understanding of the services to be rendered in an engagement letter. The audit committee should review that document.

The audit committee should also make itself available for consultation with the external auditor should unexpected circumstances arise that cause major changes in the planned audit scope. The background information obtained from the review of the planned audit scope will help the audit committee consider such problems and evaluate the results of the audit.

REVIEW THE FINANCIAL STATEMENTS AND THE AUDIT RESULTS

The audit committee should meet with management and the external auditor to review the financial statements and the audit results. This is an especially important function of the audit committee.

Some audit committees confine their review of the financial statements to major or critical items, while others examine the statements in considerable detail. The scope of the review is something each audit committee must set forth for itself, bearing in mind that at the conclusion of the meeting the members should have a comprehensive understanding of any major financial reporting problems encountered, how they were resolved, and whether the resolution is satisfactory. Factors affecting the extent of the review include the committee's confidence in management, the system of internal accounting control, and the external auditor; the existence of any unresolved differences between the auditor and management; the extent of adjustments or additional disclosures, if any, proposed by the auditor; and any unusual occurrences during the year. The committee's major concern throughout the review should be whether the financial statements fairly present the company's financial results in conformity with generally accepted accounting principles.

Some questions the committee might ask the external auditor are listed below. (The committee may wish to excuse management representatives from part of the meeting to facilitate candid discussion of some of the questions.)

- Did the auditor receive adequate cooperation from management?
- What unanticipated problems were encountered and how were they resolved?
- What adjustments or additional disclosures, if any, were proposed by the auditor? Were they accepted by management?
- Are there any trends (such as increased bad debt allowances, larger amounts of obsolescent inventory) that the board should be aware of?
- Were any changes in accounting principles made during the year? Is the justification for such changes reasonable?
- How do the company's accounting policies compare with industry practices—for example, are they conservative, aggressive, or middle-of-the-road?
- Which income tax returns have not been examined by the Internal Revenue Service? Are there any significant items that might be disputed by the IRS?
- Are there any material weaknesses in the system of internal accounting control?
- Has management been diligent in identifying and correcting weaknesses in the system of internal accounting control?
- Does the auditor have suggestions for improvements in accounting, reporting, or operating procedures?
- Is the auditor aware of any illegal acts or any errors or irregularities that have not been brought to the attention of the board?

■ How does the auditor evaluate the performance of financial and accounting management?

Upon completion of its considerations, the audit committee should be in a position to make a report to the board of directors on the financial statements and on the execution of the external audit function.[2]

OTHER MATTERS

As an audit committee gains experience, it may wish to become involved in other matters. Two possible areas of interest are mentioned below.

The SEC, in Accounting Series Release no. 177, required that quarterly financial data be filed with Form 10-Q. Accounting Principles Board Opinion no. 28 and, later, Statement on Financial Accounting Standards no. 3 brought interim financial reporting within the scope of generally accepted accounting principles. The need for timely and reliable interim reports creates important potential areas of responsibility for the audit committee.

An audit committee might review company policies concerning political contributions, conflicts of interest, and compliance with federal, state, and local laws and regulations and might investigate compliance with those policies. An audit committee is the logical corporate body to look into such matters. It represents the highest level of the company, and it is composed of individuals who should have no bias with respect to the outcome of the investigation and who should have a good understanding of the company's financial reporting procedures.

[2] The activities of the audit committee with respect to the work of the company's internal auditor are not separately discussed in this booklet. In general, the nature of those activities (especially the inquiries listed in this section) would be similar to those relating to the external auditor.

Conclusion

The purpose of this booklet is to encourage companies to form audit committees. The benefits of an effective audit committee can be realized by both large and small publicly held companies. Similarly, hospitals, universities, trade associations, and other not-for-profit organizations can benefit from audit committees.

This booklet answers some of the typical questions raised about the organization and operations of audit committees. However, a company that is considering establishing such a committee may have additional questions. The best source of answers is the company's external auditor and its outside counsel.