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**AN AICPA REQUIREMENT
FOR AUDIT COMMITTEES:
AN ANALYSIS OF THE ISSUES**

By

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

MARCH 31, 1978

NOTICE OF PUBLIC HEARING AND REQUEST FOR COMMENTS

The Special Committee on Audit Committees urges interested parties to consider the issues discussed in this booklet as well as others they consider relevant. The committee will hold a public hearing on May 31, 1978, at the Hyatt Regency O'Hare in Chicago, Illinois. It will begin at 9 A.M. and continue as long as necessary to accommodate all those who request time to be heard.

Those who desire to make oral presentations should observe the following procedural requirements.

- May 10, 1978 Notification in writing of intent to make an oral presentation, including the names of the individuals who will make the presentation, the organization they represent (if any), and the amount of time desired.
- May 17, 1978 Submission of fifteen copies of written comments or summaries of proposed oral presentations.

Those who do not desire to make oral presentations, but who wish to submit written comments, should do so by May 31, 1978.

Requests to appear at the public hearing, written comments, and summaries should be addressed to

D. R. Carmichael
American Institute of CPAs
1211 Avenue of the Americas
New York, New York 10036

Written comments and a transcript of the public hearing will be available for inspection at the AICPA offices in New York, and copies will be available for a reasonable fee.

An AICPA Requirement for Audit Committees: An Analysis of the Issues

SUMMARY

The 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. If audit committees are to be required, the special committee is to propose a plan for the adoption of the requirement. This booklet describes the issues related to the study. The committee urges interested parties to consider these issues as well as others they consider relevant.

Impetus for Audit Committee Requirement

Voluntary establishment of audit committees has been widely advocated. The board of directors of the AICPA has recommended that publicly owned corporations establish audit committees. The *Corporate Director's Guidebook* prepared by a subcommittee of the American Bar Association recommends the establishment of audit committees.

The New York Stock Exchange has long advocated audit committees, and effective June 30, 1978, listed companies of the Exchange must have audit committees of independent directors.

A bill proposed in the Senate in 1976 would have required companies to establish audit committees of outside directors. A recent report of a House subcommittee recommended that the SEC require audit committees, and a report by a Senate subcommittee recommended that the accounting profession or the SEC require audit

committees as a condition for an independent audit.

The report of the Commission on Auditors' Responsibilities states that audit committees should be formed if appropriate to the size and circumstances of the corporation.

In a number of recent enforcement actions by the SEC, companies have been required to establish audit committees. SEC Chairman Harold M. Williams has recently called on the AICPA to require audit committees.

Issues to Be Considered

The following are the issues on which the committee is requesting comments. The considerations underlying these issues are described later in this booklet.

1. Should audit committees be required—
 - 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?
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 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 as necessary for the auditor to fulfill his 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?
- As a supplemental issue, the committee has also been asked to consider whether the independent auditor should be required to be present and available to answer questions at the annual meeting of stockholders. While this issue is not directly related to audit committees, it does involve similar questions of applicability and implementation.

BACKGROUND

The concept of audit committees is not new. Audit committees first received major attention in the late 1930s, and in the last ten years there has been a significant increase in the number of corporations that have formed audit committees. A 1970 survey 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.¹ Many audit committees have been formed at the recommendation of corporate directors or management or at the suggestion of independent auditors. Actions by Congress, the SEC, the New York Stock Exchange, the AICPA, and others have also added to the impetus for forming audit committees.

Congress

Congress has recently expressed interest in audit committees, and several recommendations have been made to require corporations having securities registered with the SEC to establish audit committees.

Senate bill 3379, introduced May 5, 1976, by Senators Church, Clark, and Pearson in response to the publicity involving questionable corporate payments, had as one of its requirements that companies establish audit committees made up of outside directors. The bill also would have required that outside directors constitute at least one third of the total board membership.

In September 1976, the Subcommittee on Oversight and Investigations of the House Committee on Interstate and Foreign Commerce (the Moss subcommittee)² recom-

mended that the SEC promulgate rules concerning corporate boards of directors to assure that—

- A majority of the board is independent of senior management and operating executives and from any other conflicts of interest.
- The board's audit and nominating committees have a majority of independent directors.
- The board's audit committee has available to it independent expert advisors.
- The board has the authority to engage and dismiss the independent auditor.

The Subcommittee on Reports, Accounting and Management of the Senate Committee on Governmental Affairs (the Metcalf subcommittee) stated in its report:

The subcommittee strongly believes that the accounting profession or the SEC should immediately require that publicly owned corporations establish audit committees composed of outside directors as a condition for being accepted as a client by an independent auditor.³

Securities and Exchange Commission

In 1940, as a result of the McKesson & Robbins case, the SEC recommended the "establishment of a committee to be selected from non-officer members of the board of directors which shall make all company or management nominations of auditors and shall be charged with the duty of arranging the details of the engagement." Also included was a recommendation for the current election of auditors at the annual meetings of stockholders.⁴ In 1972, while citing its previ-

ous recommendation and the 1967 recommendation of the AICPA, the SEC endorsed the establishment of audit committees by all publicly held corporations.⁵ The stated intention of these recommendations was to impress on the auditor his responsibilities to investors, particularly the need for independence. The SEC noted, "The existence of an audit committee of the board of directors, particularly if composed of outside directors, should also strengthen such independence."⁶

In 1974, the SEC amended its regulation 14A to require disclosure in proxy statements stating whether the board of directors has an audit committee and, if so, the names of the committee members.⁷

In recent years, the SEC has required, as a result of enforcement proceedings, that individual corporations establish audit committees. In some cases, the SEC has specified the duties to be performed by the audit committees. For example, in *SEC v. Killearn Properties, Inc.* the list of duties imposed on the audit committee was quite explicit. In addition to duties relating to the review of the independent audit, it required the audit committee to review (1) the company's code of conduct and deviations from it, (2) all public releases of financial information, and (3) activities of officers and directors in dealing with the company.⁸

In response to the recommendation of the Moss and Metcalf subcommittees, the SEC has urged the AICPA to require audit committees

¹ R. K. Mautz and F. L. Neumann, *Corporate Audit Committees: Policies and Practices* (Cleveland: Ernst & Ernst, 1977), pp. 8-11.

² U.S., Congress, House of Representatives, Subcommittee on Oversight and Investigation of the Committee on Interstate and Foreign Commerce, *Federal Regulation and Regulatory Reform*, 1976, p. 52.

³ U.S., Congress, Senate, Subcommittee on Reports, Accounting and Management of the Committee on Governmental Affairs, *Improving the Accountability of Publicly Owned Corporations and Their Auditors*, 1977, p. 13.

⁴ SEC, Accounting Series Release No. 19, December 5, 1940.

⁵ SEC, Accounting Series Release No. 123, March 23, 1972.

⁶ SEC, Accounting Series Release No. 126, July 5, 1972.

⁷ SEC, Accounting Series Release No. 165, December 20, 1974.

⁸ Summaries of the SEC's findings in its investigation of National Telephone Co., Inc., and of *SEC v. Killearn Properties, Inc.*, No. TCA-75-67 (N.D.Fla. May 1977), are included in Appendixes C and D. Audit committees were also required by the SEC in settlements of two other lawsuits, *SEC v. Mattel, Inc.*, No. 74 Civ. 1185 (D.D.C. October 1, 1974), and *SEC v. Lum's, Inc.*, No. 71 Civ. 5323 (S.D.N.Y. April 11, 1974).

as a condition of an independent audit. Speaking at the AICPA Fifth National Conference on Current SEC Developments on January 4, 1978, Harold M. Williams, chairman of the SEC, stated—

The profession must take whatever steps are reasonably available to it — such as insisting that their clients maintain audit committees — to insure and enhance its independence. If the profession is reluctant to take steps of that nature voluntarily and of its own accord, the Commission will need to understand why and how that reluctance can be reconciled with a profession which desires to maintain the initiative for self-regulation and self-discipline.

Chairman Williams indicated that this project will be one of the central issues in the SEC's first annual report to Congress on the accounting profession to be submitted by July 1, 1978.

New York Stock Exchange

The first major endorsement for the establishment of audit committees came from the New York Stock Exchange in 1939 as a result of the McKesson & Robbins case. The Exchange's report stated, "Where practicable, the selection of the auditors by a special committee of the board composed of directors who are not officers of the company appears desirable."⁹

For over twenty years, the Exchange has required all newly listed companies to have at least two outside directors. In 1973, the Exchange published a "white paper" which stated that an audit committee "no longer represents a corporate luxury, but has become a necessity."¹⁰ At the urging of the

⁹ New York Stock Exchange, "Independent Audit and Audit Procedures," *Accountant*, April 6, 1940, pp. 383-87.

¹⁰ New York Stock Exchange, "Response

SEC, the Exchange 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 comprised solely of directors 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."¹¹ The Exchange's requirement was approved by the SEC on March 9, 1977.

American Institute of CPAs

In 1967, through a statement of its executive committee, the AICPA recommended that "publicly owned corporations appoint committees composed of outside directors (those who are not officers or employees) to nominate the independent auditors of the corporation's financial statements and to discuss the auditors' work with them."¹²

In July 1977, the AICPA Board of Directors again urged the establishment of audit committees and urged AICPA members to encourage corporations to establish audit committees. The board has also asked the American Stock Exchange and regional exchanges to adopt audit committee requirements similar to the requirement of the New York Stock Exchange.

to the White Paper Questionnaire Concerning Recommendations and Comments on Financial Reporting to Shareholders and Related Matters" (New York: NYSE, 1973), p. 2.

¹¹ New York Stock Exchange, William M. Batten letter to chief executive officers of listed companies, January 6, 1977. The text of the requirement is included in Appendix A.

¹² AICPA Executive Committee Statement on Audit Committees of Boards of Directors, *Journal of Accountancy*, Sept. 1967, p. 10.

Commission on Auditors' Responsibilities

In its report issued in January, 1978, the Commission on Auditors' Responsibilities stated—

The board of directors, with outside members and an audit committee when appropriate, is the best vehicle for achieving and maintaining balance in the relationship between the independent auditor and management. Therefore, the Commission believes that steps should be taken by boards, auditors, and when necessary, by regulatory authorities to help assure that boards will actively exercise this opportunity. Where appropriate to the size and circumstances of the corporation, board membership should include independent outsiders, and an audit committee should be formed.¹³

Others

The *Corporate Director's Guidebook*, prepared by a subcommittee of the American Bar Association, states that it is desirable that boards of directors establish audit committees.¹⁴

A recently enacted statute of Connecticut requires that certain corporations of that state with at least one hundred stockholders must establish audit committees. In Canada, audit committees are mandatory under the statutes of the provinces of Ontario, Manitoba, and British Columbia and for federally chartered companies under the Canada Business Corporations Act of 1975.

¹³ Commission on Auditors' Responsibilities, *Report, Concussions, and Recommendations* (New York: AICPA, 1978), p. 106.

¹⁴ Subcommittee on Functions and Responsibilities of Directors, "Corporate Director's Guidebook," *The Business Lawyer* 32 (November 1976): 35.

DISCUSSION OF ISSUES

The Need for a Requirement

Issue 1: Should audit committees

be required?

Consideration should be given to

the purpose of an audit committee to determine whether a require-

ment for audit committees is needed and, if so, to determine to whom such a requirement should apply and how the requirement should be implemented.

Issue 1a: Is an audit committee necessary to assist independent directors in fulfilling their responsibilities?

A number of advocates of the establishment of audit committees see them as a means of assisting independent directors in fulfilling their responsibilities to investors and other outside interests. For example, the *Corporate Director's Guidebook* describes the audit committee as "the communication link between the board of directors as representatives of the stockholders, on the one hand, and the independent auditors on the other hand."¹⁵

In its findings in the investigation of National Telephone Co. (described in Appendix C) the SEC stated that there was a

need for adequate, regularized procedures under the overall supervision of the Board to ensure that proper disclosures are being made. Such procedures could include, among other things, a functioning Audit Committee with authority over disclosure matters, or any other procedure which involves the Board of Directors in a meaningful way in the disclosure process. With such procedures, the corporation's shareholders and the public should be more adequately protected from haphazard or fraudulent disclosure.

An audit committee gives independent directors a source of information on the operations of the corporation that is independent of management. It also allows the independent directors an opportunity to review information that is reported to investors and the public. It may therefore be in the public interest that corporations be required to establish audit committees.

Issue 1b: Is an audit committee necessary for an auditor to be able

to fulfill his responsibilities under generally accepted auditing standards?

Present generally accepted auditing standards require the auditor to communicate certain matters to the board of directors or its audit committee.

For example, Statement on Auditing Standards No. 17 requires the auditor to report illegal acts detected in the audit to the appropriate persons in the client's organization. SAS No. 17 goes on to state—

In some circumstances, the only persons in the organization of a sufficiently high level of authority to take necessary action may be the audit committee or the board of directors.¹⁶

Other requirements in the Statements on Auditing Standards relate to reporting to the audit committee or board (1) the subsequent discovery of facts relating to previously issued financial statements and the refusal of the client to disclose such facts, (2) material weaknesses in internal accounting controls, (3) nonconformity of interim financial information with generally accepted accounting principles, and (4) detected errors or irregularities in financial information. (See Appendix B for a description of those requirements.)

When reporting such matters to the directors, it may well be that the auditor would be required to provide information that is critical of management. So an audit committee of independent directors may be necessary to permit free and candid communication. A determination that an audit committee is necessary for the auditor to fulfill his responsibilities under generally accepted auditing standards may have implications for the form of an audit committee requirement (see issue 5b) and for the composition of the audit committee (see issue 3a).

Issue 1c: Is an audit committee necessary to strengthen auditor independence?

A number of parties have seen the audit committee as a means of strengthening the independence of the auditor. For example, the SEC stated—

Such a committee would lessen the accountants' direct reliance on management and would put them directly in touch with outside members of the Board whose performance was less specifically being reported on in the financial statements, thus increasing the accountants' independence.¹⁷

The chairman of the SEC has also stated that audit committees serve to strengthen the auditor's independence:

One of the avenues already available for strengthening auditor independence is the formation of audit committees composed of independent corporate directors. In companies where the auditor reports to an independent audit committee, a potentially important buffer is provided to insulate accountants from inordinate management pressures and to strengthen the auditor in his relationship with management—and hence his independence. Stated differently, the absence of an audit committee may diminish or impair the ability of an auditor to be independent.¹⁸

The effect of the formation of an audit committee on the independence of an auditor has also been noted in the statements of the New York Stock Exchange, the AICPA, and others.

While it is generally agreed that audit committees may strengthen the auditor's independence, it may or may not be agreed that audit committees are essential to maintaining the auditor's independence. In the past, it has not generally been thought that the lack of an audit committee impaired the audi-

¹⁵ "Corporate Director's Guidebook," p. 35.

¹⁶ Statement on Auditing Standards No. 17, *Illegal Acts by Clients* (January 1977), paragraph 13.

¹⁷ SEC, Accounting Series Release No. 165, December 20, 1974.

¹⁸ Harold M. Williams, address before AICPA Fifth National Conference on Current SEC Developments, Washington, D.C., January 4, 1978.

tor's independence. The public's view of the auditor's responsibilities has, however, changed in recent years, and the profession has responded with more stringent standards.

A requirement based solely on the auditor's independence, however, may not be appropriate if it is determined that the requirement should not apply to all audit clients. It may be difficult, if not impossible, to justify how an auditor could be considered not independent with respect to certain clients without audit committees but independent with respect to others.

Applicability of a Requirement

Issue 2: If audit committees are to be required, to what entities should the requirement apply?

A requirement for audit committees may not be appropriate for all entities for a variety of reasons. If a requirement is needed, consideration must be given to the applicability of the requirement to various types of entities.

A fundamental purpose of an audit committee might be to protect significant outside interests of an entity (for example, large numbers of equity owners or creditors). Significant outside interests will benefit to the extent that an audit committee improves the ability of the auditor or the directors to fulfill their responsibilities or strengthens the independence of the auditor.

The committee has identified the following types of entities to whom such a requirement may apply:

- a. All public entities
- b. All SEC registrants
- c. Certain SEC registrants

Issue 2a: Should a requirement apply to all public entities?

To some extent, all economic entities have outside interests. Some of those outside interests may have little direct access to information about the operations of the entity, and therefore they must rely on independent auditors and those per-

sons in the entity comparable to directors with responsibilities to the outside interests. Therefore, certain of those entities (for example, nonprofit entities such as municipalities or hospitals) may benefit from forming a group to function as an audit committee.

If a requirement is to apply to such public entities, the definition of those entities should be reasonably specific and unambiguous. Consideration must also be given to both the legal forms of those entities and the resulting responsibilities of those associated with the entities to significant outside interests to determine who may appropriately serve on an audit committee.

In corporations there are identifiable individuals—the directors—with recognized responsibilities to outside interest groups. Therefore, it may be appropriate that an audit committee requirement apply only to corporations.

A requirement that all corporations form an audit committee may, however, be too broad. The overwhelming majority of corporations are closely held and directed by their owners. A requirement to have independent directors for those companies may not yield benefits at least equal to the costs.

Issue 2b: Should a requirement apply to all SEC registrants?

A requirement applying to all SEC registrants has an advantage in that it relates to a readily identifiable group. Moreover, SEC registrants are generally considered to have a fairly large number of shareholders who may be expected to benefit from the establishment of an audit committee. However, some public companies, for example, certain banks and insurance companies, are not required by the securities acts to register with the SEC. Those corporations, too, might benefit from the establishment of an audit committee.

If audit committees are to be required, consideration should be given to the costs of the requirement as well as the expected benefits. If the costs of an audit com-

mittee requirement are too high, companies may be discouraged from entering the public capital markets. The difficulties faced by smaller companies in entering the capital markets has recently been a concern of the SEC and others.

Issue 2c: Should a requirement apply only to certain SEC registrants?

A number of surveys have indicated that a large and growing percentage of corporations already have audit committees. A requirement by the AICPA would therefore not be a burden to those corporations. Unfortunately, most surveys have dealt only with the larger corporations, and little is known about the prevalence of audit committees or outside directors in the smaller SEC registrants. Roughly 11,000 corporations have securities registered with the SEC. Approximately 1,500 of those corporations are listed on the New York Stock Exchange and, as previously noted, are already subject to its audit committee requirement. Consideration should be given to the need for, and the effects of, an audit committee requirement for the many relatively smaller SEC registrants.

If an audit committee requirement is relevant only to certain registered corporations, that class of corporations must be reasonably defined. The definition must relate the characteristics of that class of corporations to the expected benefits of the requirement. A definition may be based on such features as the number of shareholders of the corporation, the size of the corporation based on amount of sales or assets, the extent to which the stock of the corporation is publicly traded, whether the stock is listed on an exchange or sold in some other established market, or other factors. For example, in Accounting Series Release No. 177, the SEC made a distinction among its registrants when it required certain disclosures of interim information only for those registrants whose income or total assets exceed certain limits and whose shares meet several

criteria establishing that they are widely traded. Also, certain disclosure requirements under generally accepted accounting principles apply only to "publicly traded" companies, which are generally defined as those "whose securities trade in a public market on either (1) a stock exchange (domestic or foreign) or (2) in the over-the-counter market (including securities quoted only locally or regionally.)"¹⁹

Membership of Audit Committees

Issue 3: What should be the requirements for the composition of the audit committee and the qualifications for membership?

For an audit committee to fulfill its purpose, the members should be able to operate independently of management. If audit committees are required, consideration should be given to the composition of the committee and the qualifications of audit committee members. Advocates of audit committees have recommended that at least a majority of the audit committee members be "independent," and some have recommended that all members be "independent."

Issue 3a: Should all members of the audit committee be independent of management or is it sufficient that a majority be independent?

A 1974 survey of its listed companies by the New York Stock Exchange showed that in 84 percent of the companies with audit committees, the committees were made up solely of independent directors.²⁰ The Exchange's recent requirement for audit committees mandates that the committees be

composed "solely of directors 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."

On the other hand, some have argued that management directors may have a useful place on an audit committee. Because of their knowledge of the operations of the corporation, management directors can usefully participate in the discussions with the auditors, and management should have an opportunity to respond to the reports of the auditor. It may not, however, be necessary to have management representation on the audit committee in order to allow them access to the committee. It may be that the presence of management directors on the audit committee will inhibit the auditor's communication with the committee.

Issue 3b: Could the full board of directors qualify effectively as an audit committee?

If it is determined that it is sufficient that a majority, rather than all, of the members of an audit committee must be independent directors, it may not always be necessary that a separate committee of the board be formed to achieve the objectives of an audit committee. It may be that if a majority of the members of the board of directors are independent, the entire board could function as an audit committee. A 1973 survey of 855 corporations showed that in 86 percent of the nonmanufacturing companies and 71 percent of the manufacturing companies, "outside directors" were in the majority on the boards of directors.²¹

Issue 3c: How should "independence" of directors be defined?

If audit committees of independent directors are to be required, it

may be desirable to define or provide guidance on the independence of directors. For example, the requirement of the New York Stock Exchange provides guidance on the qualifications of audit committee members that considers such factors as whether a director is a former officer of the company, or whether the director has certain business relationships with the company. (See Appendix B for the text of the requirement.)

Additional bases for determining independence have also been suggested. For example, the survey by Mautz and Neumann indicated that a director who is affiliated with the company's primary underwriter may be unacceptable as an audit committee member.²² The report of the Metcalf subcommittee recommended that directors with significant commercial relationships with the company (for example, commercial or investment bankers) should not serve on audit committees.

Issue 3d: What other qualifications should be required?

Consideration should be given to the desirability of providing guidance on qualifications of audit committee members other than independence. For example, the Mautz and Neumann survey indicated that some expertise in finance or accounting and knowledge of the specific industry were helpful.²³ The effectiveness of an audit committee may, however, depend more on the personal qualities of the directors such as integrity, judgment, intelligence, and a willingness to become actively involved in the committee's affairs.

Duties of Audit Committees

Issue 4: Should a requirement for audit committees specify duties to be performed by the committee?

The operations of an audit committee should be flexible enough to meet the needs of the directors, the

¹⁹ Accounting Principles Board Opinion No. 28, *Interim Financial Reporting* (May 1973). See also Financial Accounting Standards Board exposure draft, *Suspension of the Reporting of Earnings per Share and Segment Information by Nonpublic Enterprises*, February 27, 1978.

²⁰ New York Stock Exchange, "Response to the White Paper Questionnaire," p. 3.

²¹ Jeremy Bacon, *Corporate Directorship Practices: Membership and Committees of the Board* (New York: Conference Board, 1973), p. 2.

²² Mautz and Neumann, pp. 32-33.

²³ Mautz and Neumann, p. 33.

auditor, the company, and the investors. A number of sources, however, have suggested specific duties to be performed by the audit committee. (The duties assigned to the audit committees of Killearn Properties, Inc., and Phillips Petroleum Co. as a result of settlements of litigation are described in Appendixes D and E.) Among the duties commonly ascribed to the audit committee are these:

1. Nominate or select the independent auditor
2. Review the arrangements and scope of the independent auditor's examination
3. Review the compensation of the independent auditor
4. Consider the results of the independent auditor's review of internal accounting control and suggestions for improvements
5. Discuss matters of concern to the independent auditor resulting from the audit
6. Review internal accounting procedures with the company's financial and accounting staff
7. Review the activities and recommendations of the company's internal auditors

Additional duties sometimes suggested for the audit committee include these:

8. Review and approve financial information to be distributed by the company to the public
9. Review changes in accounting principles in the financial statements
10. Review nonauditing services performed for the company by the independent auditor
11. Establish and monitor policies to prohibit unethical, questionable, or illegal activities by company employees
12. Review executive perquisites
13. Hold a prescribed minimum number of meetings each year

14. Report on the committee's activities in the annual report to shareholders

Rather than requiring the audit committee to fulfill some of these duties, it may be more practical to achieve the same objectives by requiring the auditor to communicate certain matters with the committee, for example, by requiring the auditor to consult with the audit committee in planning his engagement.

Implementation of an AICPA Requirement

Issue 5: If the AICPA should require audit committees, in what form should the requirement be implemented?

The committee has identified three possible forms an audit committee requirement of the AICPA might take if it is determined that such a requirement is appropriate:

- An amendment of the AICPA Code of Professional Ethics rule on independence
- A Statement on Auditing Standards
- A membership requirement for the SEC practice section of the AICPA Division for CPA Firms

Issue 5a: Should a requirement for audit committees be implemented as an amendment to the AICPA Code of Professional Ethics rule on independence?

Amendments to the AICPA Code of Professional Ethics must be approved by a vote of the Institute's members.

Rule 101 of the Code of Professional Ethics states—

A member or a firm of which he is a partner or shareholder shall not express an opinion on financial statements of an enterprise unless he and his firm are independent with respect to such enterprise.

For an audit committee requirement to be implemented by an amendment of the independence rule, it must be determined that

the auditor's independence is sufficiently strengthened by the existence of an audit committee to justify such a rule. In its statements encouraging the formation of audit committees, the SEC has described the benefits of audit committees mainly in terms of strengthening the auditor's independence. It should be noted, however, that under the securities acts, the SEC's principal authority with respect to auditors is through its power to define independence.

While it has been noted that audit committees may strengthen the auditor's independence, it has not generally been conceded that audit committees are essential to independence. In the past, auditors have not been considered to lack independence solely because of a lack of an audit committee. The public's view of the responsibilities of the auditor has been changing, however, and the profession has responded with standards that have been more stringent than those of the past.

If it is determined that a requirement for audit committees should not apply to all corporations, then a requirement based solely on the auditor's independence may not be appropriate. It may be difficult to justify how an auditor could be considered not independent with respect to certain clients without audit committees but to be considered independent with respect to others.

If the functions of an audit committee are broader than solely assuring the independence of auditors, an amendment of the AICPA Code of Professional Ethics may not be the appropriate form of requirement. Also, the Code of Professional Ethics may not be the appropriate vehicle to provide guidance on the operations of audit committees if it is determined that such guidance is desirable.

Issue 5b: Should a requirement for audit committees be implemented by a Statement on Auditing Standards?

Statements on Auditing Stan-

dards, which are promulgated by the AICPA Auditing Standards Executive Committee and are enforceable under the AICPA Code of Professional Ethics, now describe several circumstances in which it may be necessary for the auditor to communicate with the client's board of directors or its audit committee. (See Appendix B.) It may be desirable that Statements on Auditing Standards require that clients establish audit committees in part to assure that such communication is effective. The improvements in the auditor's independence and the assistance in satisfying the disclosure responsibilities of independent directors may be additional justification for a Statement on Auditing Standards requiring audit committees.

A requirement as a Statement on Auditing Standards could take one of two forms:

1. It could prohibit the independent auditor from giving an opinion on financial statements of certain specified clients that do not have audit committees.
2. It could require the auditor to modify his report on the financial statements of a client that does not have an audit committee by adding an additional paragraph, either with or without qualification of the auditor's opinion.

As an ethics rule or as a membership requirement of the SEC practice section of the AICPA, an audit committee requirement could only take the form of a prohibition against giving opinions on the financial statements of corporations without audit committees. Only a Statement on Auditing Standards could require the auditor to modify his report on financial statements if the client has no audit committee.

A Statement on Auditing Standards can deal more broadly with the relationships of auditors and audit committees. It is not limited to one aspect of the relationship, such as the auditor's independence. Statements on Auditing Standards

may also be more readily recognized and accessible to clients than might ethics rules or membership requirements of the SEC practice section. A Statement on Auditing Standards may, therefore, be the appropriate vehicle if it is desirable to provide guidance on the operations of audit committees as well as to establish requirements.

A requirement for audit committees might make it necessary for a Statement on Auditing Standards to define its applicability to particular clients. Statements on Auditing Standards do not now make such distinctions. In this regard, the Commission on Auditors' Responsibilities has recommended that all audits be subject to the same standards. The commission recognized, however, that the appropriate auditing procedures will vary with the characteristics of individual clients.

Issue 5c: Should a requirement for audit committees be implemented by a membership requirement of the SEC Practice Section of the AICPA Division for CPA Firms?

In September, 1977, the AICPA Council established the SEC practice section of the AICPA Division for CPA Firms. An objective of the SEC practice section is to "improve the quality of practice by CPA firms before the Securities and Exchange Commission through the establishment of practice requirements for member firms." Those requirements are established by the section's executive committee and are subject to review by its public oversight board.

If it is determined that an audit committee requirement should apply only to SEC registrants, a membership requirement of the SEC practice section might be an appropriate method of implementation. Such a requirement might prohibit member firms from accepting audit engagements for certain companies without audit committees. The present membership requirements of the SEC practice section already require the auditor to report certain matters to the client's audit committee or the

board of directors.

A membership requirement of the SEC practice section may not be appropriate if an audit committee requirement is to apply to a class of entities broader than SEC registrants or only to certain types of SEC registrants.

The membership requirement approach may have several drawbacks. Although the auditing firms of the vast majority of SEC registrants (over 460 CPA firms) have applied, membership is voluntary. A membership requirement would also require the development of suitable sanctions for noncompliance. Member firms may also encounter difficulty in convincing clients to recognize its membership requirement in the SEC practice section.

The executive committee is restricted from setting membership requirements that "unreasonably preclude membership by any CPA firm." If an audit committee requirement is to be established by a membership requirement, it must be determined that no firm is so precluded. (See issue 7.)

Alternatives to an AICPA Requirement

Issue 6: If an audit committee requirement should not be implemented by the AICPA, should the requirement be implemented in some other manner?

As already noted, the SEC and certain members of Congress have recommended that the AICPA should establish a requirement for audit committees. However, if for some reason it may be inappropriate for the AICPA to make such a requirement, consideration should be given to other means of implementing a requirement. Alternative forms of an audit committee requirement may include regulations by the SEC or other federal agencies, federal legislation, or state legislation.

Competitive Effects

Issue 7: Will a requirement for audit committees have an economic

or competitive impact on public accounting firms?

One of the suggested duties of an audit committee is to recommend or select the independent auditors. It has been suggested that in selecting the auditors, independent directors may favor larger, better known public accounting firms. A requirement for audit committees could therefore have an anticompetitive impact on the accounting profession to the detriment of smaller public accounting firms.

The committee therefore solicits comments on whether an audit committee requirement would have an economic or competitive impact on public accounting firms, the nature and extent of the impact, if any, and the features of an audit committee requirement that might create such an impact.

Auditor Attendance at Stockholder Meetings

Issue 8: Should the independent auditor be required to be present and available to answer questions at the annual meeting of stockholders?

While this matter is not directly

related to the issue of audit committees, it does involve similar questions of applicability and implementation, and therefore the AICPA Board of Directors recommended that the possibility of such a requirement should also be considered.

Regarding this issue, the report of the Commission on Auditors' Responsibilities stated—

Fulfilling the reasonable expectations of users for access to the auditor within the limitations imposed on such communication could be accomplished by a requirement that the auditor be present and available to answer questions at the annual meeting of the shareholders. The same requirement should apply to due diligence meetings, which are held before securities are issued. We recommend that companies and their auditors undertake to arrange and announce such auditor attendance.²⁴

Also, SEC regulations now require disclosure in the proxy statement of (1) whether representa-

tives of the principal independent auditors for the current year and for the most recently completed fiscal year are expected to be present at the stockholders' meeting with the opportunity to make a statement and (2) whether they will be available to answer questions.

A requirement that the independent auditor be present at the stockholders' meeting would involve some cost for companies. That cost may fall proportionately more heavily on smaller companies. It may therefore be necessary to define the class of corporations to which such a requirement would apply.

If it is desirable that such a requirement be established, consideration should be given to the means of enforcing the requirement and the action the independent auditor should take if he is not invited to the stockholders' meeting.

It would also be necessary to consider the most appropriate means of implementing such a requirement—as a Statement on Auditing Standards or a membership requirement of the SEC practice section.

²⁴ Commission on Auditors' Responsibilities, *Report, Conclusions, and Recommendations*, p. 84.

APPENDIXES

- A. New York Stock Exchange Audit Committee Policy
- B. References in Statements on Auditing Standards to Audit Committees and Boards of Directors
- C. Summary of SEC Findings in the Matter of National Telephone Co.
- D. Summary of Final Judgment in *SEC v. Killearn Properties, Inc.*
- E. Excerpt from Notice to Stockholders of Phillips Petroleum Company Concerning Hearing on Confirmation of Settlement in *Gilbar v. Keeler*

APPENDIX A

NEW YORK STOCK EXCHANGE AUDIT COMMITTEE POLICY

Each domestic company with common stock listed on the Exchange, as a condition of listing and continued listing of its securities on the Exchange, shall establish no later than June 30, 1978, and maintain thereafter an Audit Committee comprised solely of directors 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. Directors who are affiliates of the company or officers or employees of the company or its subsidiaries would not be qualified for Audit Committee membership.

A director who was formerly an officer of the company or any of its subsidiaries may qualify for membership even though he may be receiving pension or deferred compensation payments from the company if, in the opinion of the Board of Directors, such person will exercise independent judgment and will materially assist the function of the committee. However, a majority of the Audit Committee shall be directors who were not formerly officers of the company or any of its subsidiaries.

Supplementary Material

In order to deal with the complex relationships that arise, the following guidelines are provided to assist Boards of Directors to observe the spirit of the policy in selecting members of the Audit Committee.

A director who has, or is a partner, officer, or director of an organization that has, customary commercial, industrial, banking, or underwriting relationships with the company which are carried on in the ordinary course of business on an arms-length basis may qualify for membership unless, in the opinion of the Board of Directors, such director is not independent of management or the relationship would interfere with the exercise of independent judgment as a committee member.

A director who, in addition to fulfilling the customary director's role, also provides additional services directly for the Board of Directors and is separately compensated therefor, would nonetheless qualify for membership on the Audit Committee. However, a director who, in addition to his director's role, also acts on a regular basis as an individual or representative of an organization serving as a professional advisor, legal counsel or consultant to management, would not qualify if, in the opinion of the Board of Directors, such relationship is material to the company, the organization represented or the director.

A director who represents or is a close relative of a person who would not qualify as a member of the Audit Committee in the light of the policy would likewise not qualify for the committee. However, if the director is a close relative of an employee who is not an executive officer or if there are valid countervailing reasons, the Board of Directors' decision as to eligibility shall govern.

While SEC Rule 405 may be helpful to the Board of Directors in determining whether a particular director is an "affiliate" or a close relative for purposes of this policy, it is not intended to be so technically applied as to go beyond the spirit of this policy.

January 6, 1977

APPENDIX B

**REFERENCES IN STATEMENTS ON AUDITING STANDARDS
TO AUDIT COMMITTEES AND BOARDS OF DIRECTORS**

A review of Statements on Auditing Standards Nos. 1 through 21 indicates several situations in which an independent auditor should communicate information known to him to an appropriate level of his client's management, including the board of directors or the audit committee. These situations generally occur when, in the performance of his work, the auditor becomes aware of an unusual or abnormal condition. References to these situations are found in the following sections:

323.01, .04 (SAS No. 20)
327.14 (SAS No. 16)
328.13, .18 (SAS No. 17)
561.05, .08 (SAS No. 1)
720.06, .15, .18 (SAS No. 10)

The following SASs describe circumstances in which it may be necessary for the auditor to report to management or the board of directors:

1. SAS No. 1, section 561, "Subsequent Discovery of Facts Existing at Date of Report," paragraph 4, states:

When the auditor becomes aware of information which relates to financial statements previously reported on by him, but which was not known to him at the date of his report, and which is of such a nature and from such a source that he would have investigated it had it come to his attention during the course of his examination, he should, as soon as practicable, undertake to determine whether the information is reliable and whether the facts existed at the date of his report. In this connection, the auditor should discuss the matter with his client at whatever management levels he deems appropriate, including the board of directors, and request cooperation in whatever investigation may be necessary.

Paragraph 8 describes what the auditor should do if the client does not adequately disclose the subsequent information:

If the client refuses to make the disclosures specified in paragraph 6, the auditor should notify each member of the board of directors of such refusal and of the fact that, in the absence of disclosure by the client, the auditor will take steps . . . to prevent future reliance upon his report.

2. SAS No.10 (section 720) "Limited Review of Interim Financial Information," paragraph 6, states that the objective of a limited review is a report to the board of directors:

The objective of a limited review of interim financial information is to provide the accountant with a basis for reporting to the board of directors on those matters that he believes should be brought to its attention, based upon applying his objectivity and knowledge of financial reporting practices to significant accounting matters of which he becomes aware through inquiries and analytical procedures.

Paragraph 15 of the statement also describes the auditor's responsibility to report to the board of directors when, in the course of performing a limited review, he becomes aware of weaknesses in internal accounting control:

If the system of internal accounting control appears to contain weaknesses that do not permit preparation of interim financial information in conformity with generally accepted accounting principles, and, as a consequence, it is impracticable for the accountant to effectively apply his knowledge of financial reporting practices to the interim financial information, he should advise the board of directors of the circumstances. The accountant also may wish to submit suggestions for changes in the system to permit the preparation of appropriate interim financial information.

Paragraph 18 describes the auditor's responsibility when he believes that the interim information presented does not conform to generally accepted accounting principles:

If, in performing a limited review, information comes to the accountant's attention that leads him to question whether the interim financial information to be reported conforms with generally accepted accounting principles, he should make additional inquiries or employ other procedures he considers appropriate to permit him to report informatively to the board of directors.

3. SAS No. 16 (section 327), "The Independent Auditor's Responsibility for the Detection of Errors or Irregularities," paragraph 14, describes the auditor's responsibility when he believes that material errors or irregularities may exist (This statement was the first to specify notifying the audit committee as an alternative to notifying the full board.):

If the independent auditor's examination causes him to believe that material errors or irregularities may exist, he should consider their implications and discuss the matter and the extent of any further investigation with an appropriate level of management that is at least one level above those involved. If after such discussions the auditor continues to believe that material errors or irregularities may exist, he should determine that the board of directors or its audit committee is aware of the circumstances. Also, he should attempt to obtain sufficient evidential matter to determine whether in fact material errors or irregularities exist and, if so, their effect.

4. SAS No. 17 (section 328), "Illegal Acts by Clients," paragraph 13, describes the auditor's actions after discovery of an illegal act by his client:

After it has been determined that an illegal act has occurred, the auditor should report the circumstances to personnel within the client's organization at a high enough level of authority so that appropriate action can be taken by the client with respect to—

- a. consideration of remedial actions;
- b. adjustments or disclosures that may be necessary in the financial statements;
- c. disclosures that may be required in other documents (such as a proxy statement).

In some circumstances, the only persons in the organization of a sufficiently high level of authority to take necessary action may be the audit committee or the board of directors. The auditor should also consider the implications of an illegal act in relation to the intended degree of reliance to be placed on internal accounting control and the representations of management.

Paragraph 18 gives the auditor further guidance when he is not satisfied by his client's action with respect to the illegal act:

When an illegal act, including one that does not have a material effect on the financial statements, comes to the auditor's attention, he should consider the nature of the act and management's consideration once the matter is brought to their attention. If the client's board of directors, its audit committee,

or other appropriate levels within the organization do not give appropriate consideration to the illegal act, the auditor should consider withdrawing from the current engagement or dissociating himself from any future relationship with the client.

5. SAS No. 20 (section 323), "Required Communication of Material Weaknesses in Internal Accounting Control," paragraph 4, describes the auditor's reporting responsibility when he discovers material weaknesses:

The independent auditor should communicate to senior management and to the board of directors or its audit committee (or the equivalent level of authority, such as a board of trustees) any material weaknesses that come to his attention during the course of his examination of the financial statements if such weaknesses have not been corrected before they come to his attention.

APPENDIX C

SUMMARY OF SEC FINDINGS IN THE MATTER OF NATIONAL TELEPHONE CO.

In its investigation, the SEC found that during a period in which National Telephone Co. faced serious cash flow difficulties, the company made public disclosures (including press releases and letters to stockholders) which did not disclose the problems but which reported high earnings and "rosy projections of growth." Furthermore, the SEC found that the outside directors were aware of the company's troubled financial condition and were also aware of the optimistic disclosures.

Only one of the company's seven directors, the chairman, was an officer of the corporation. The company had an audit committee of three outside directors, but the committee never met.

Though they were aware of the facts, the outside directors "did not take meaningful steps to see to it that adequate disclosure be made." One director wrote to the chairman of the company threatening resignation unless the management kept the board more adequately informed. Apart from that, the SEC found that the directors "did nothing effective to ensure that they be provided accurate current information."

With regard to the responsibilities of outside directors, the SEC concluded:

In general, outside directors should be expected to maintain a general familiarity with their company's communications with the public. In this way, they can compare such communications with what they know to be the facts, and if the facts as they know them are inconsistent with those communications, they can see to it, as stewards for the company, that appropriate revisions or additions be made.

With regard to the audit committee, the SEC concluded:

Finally, the facts developed during this investigation demonstrate the need for adequate, regularized procedures under the overall supervision of the Board to ensure that proper disclosures are being made. Such procedures could include, among other things, a functioning Audit Committee with authority over disclosure matters, or any other procedure which involves the Board of Directors in a meaningful way in the disclosure process. With such procedures, the corporation's shareholders and the public should be more adequately protected from haphazard or fraudulent disclosure.

Securities and Exchange Commission, Securities Exchange Act Release No. 14380, January 16, 1978, "Report of Investigation in the Matter of National Telephone Co., Inc., Relating to Activities of the Outside Directors of National Telephone Co., Inc."

APPENDIX D

SUMMARY OF THE FINAL JUDGMENT IN SEC. v. KILLEARN PROPERTIES, INC.

SEC v. Killearn Properties, Inc. resulted in a consent decree in which the company agreed, among other things, that a majority of the directors of the company would be outside directors. "Outside directors" were generally defined as those who in the five years prior to their election had not been employed by Killearn or its related parties or who were not direct or indirect owners of more than 2 percent of any class of equity securities of Killearn or its affiliates.

Killearn also consented to a requirement that the board of directors form an audit committee of three outside directors. The duties of the audit committee would include—

1. Review the arrangements and scope of the audit and the compensation of the auditor.

2. Review with the independent auditor and the company's chief financial officer the company's internal accounting controls.
3. Review with the auditor the results of the audit including—
 - a. The auditor's report
 - b. The auditor's perception of the company's financial and accounting personnel
 - c. Cooperation received by the auditor
 - d. Steps to make the audit more efficient
 - e. Significant unusual transactions
 - f. Changes in accounting principles
 - g. Significant adjustments proposed by the auditor
 - h. Recommendations by the auditor with regard to internal accounting controls
4. Inquire concerning deviations from the company's code of conduct and periodically review that code.
5. Meet at least twice a year with the company's financial and accounting staff to review internal accounting and auditing procedures.
6. Recommend to the board the retention or discharge of the independent auditors.
7. Review all public releases of financial information.
8. Review activities of officers and directors in dealing with the company.

The audit committee would also be authorized to conduct investigations related to carrying out its duties and to approve settlements of certain litigation involving the company's officers.

Securities and Exchange Commission v. Killearn Properties, Inc., No. TCA-75-67 (N.D. Fla., May, 1977).

APPENDIX E

EXCERPT FROM NOTICE TO STOCKHOLDERS OF PHILLIPS PETROLEUM COMPANY CONCERNING HEARING ON CONFIRMATION OF SETTLEMENT IN GILBAR v. KEELER

The Board of Directors shall appoint an Audit Committee, composed of at least three members and consisting only of independent outside directors, to recommend independent public accountants to the Board and to review and make recommendations to the Board concerning the audit. Only independent outside directors shall be authorized to vote on the selection or retention of independent public accountants. In addition to nominating independent public accountants to the Board, the Audit Committee shall have the following responsibilities:

1. It shall recommend to the Board an independent public accountant to fill any vacancy until the next stockholders meeting.
2. It shall arrange details of the independent public accountant's engagement, including the compensation to be paid.
3. It shall review with Phillips' independent public accountants, as well as Phillips' Comptroller and other appropriate company personnel, the following matters: (i) Phillips' general policies and procedures with respect to audits and accounting and financial controls; and (ii) the general accounting and reporting principles and practices which should be applied in preparing Phillips' financial statements and conducting financial audits of its affairs.
4. It shall meet with the independent public accountants as required, but at least twice a year, and shall review with them Phillips' interim and year-end financial statements, any certification, report, or opinion which the independent public accountants propose to render in connection with such statements, and any other appropriate matter.
5. It shall meet with Phillips' internal audit staff at least twice a year and review all financial statements and the extent to which Phillips' accounting staff has implemented any reforms proposed by either the Audit Committee or the independent public accountants.
6. It shall have the power to direct an investigation by the independent public accountants and/or Phillips' internal audit staff into any matter related to Phillips' business and affairs.
7. It shall recommend to the Board the policies which the Board should adopt and actions the Board should take to prevent any payments constituting an unlawful or improper use of Phillips' funds, including the payment of finders', promoters', or consultants' commissions or fees.

Gilbar v. Keeler, Civ. No. 75-611 (C.D. Cal., February 18, 1978).

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