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THE RECENT HISTORY OF CORPORATE AUDIT COMMITTEES

Abstract: This article explores factors in the financial, legal and social environments that have significantly influenced the development of corporate audit committees. Particular emphasis is given to the actions of the Securities and Exchange Commission and the American Institute of Certified Public Accountants.

The New York Stock Exchange (NYSE) decision requiring that all listed corporations have audit committees as of June 30, 1978, made audit committees an integral part of the corporate organization.

The concept of an audit committee is not new. Audit committees first attracted attention in the late 1930's when the Securities and Exchange Commission (SEC) and New York Stock Exchange encouraged their establishment after the McKesson and Robbins case. In recent years there has been a significant increase in the number of corporations that have formed audit committees [AICPA, 1978]. A 1970 survey by R. K. Mautz and F. L. Neuman 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 [Mautz and Neuman, 1977]. Congress, the SEC, the accounting profession and others have expressed an interest in and support for audit committees.

Actions of the Securities and Exchange Commission

In 1940, the SEC first recommended the establishment of audit committees in Accounting Series Release No. 19. This was issued in response to the McKesson and Robbins, Inc. investigation. The release proposed that, to assure auditor independence, a committee be selected from non-officer board members to nominate auditors and arrange details of the engagement.

In Accounting Series Release No. 123, issued March 23, 1972, the SEC stated its long interest in corporate audit committees, and concluded with the following statement:

> To this end, the Commission, in the light of the foregoing historical recital, endorses the establishment by all publicly-held companies of audit committees composed of outside directors and urges the business and financial communities and all shareholders of such publicly-held companies to lend their full and continuing support to the effective implementation of the above-cited recommendations in order to assist in affording the greatest possible protection to investors who rely upon such statements.

The stated intention of these recommendations was to impress on the auditor his responsibilities to investors, particularly the need for independence. The SEC noted in Accounting Series Release No. 126, issued July 5, 1972, that the existence of an audit committee of the board of directors, particularly if composed of outside directors, should also strengthen such independence.

In 1974, the SEC issued Accounting Series Release No. 165 which, among other things, added the following provision to Regulation 14A of the proxy rules:

> If the issuer has an audit or similar committee of the board of directors, state the names of the members of the committee. If the board of directors has no audit or similar committee, so state.

In recent years, the SEC has strongly endorsed or required, as a result of enforcement proceedings, that individual corporations establish audit committees. In the matter of *National Telephone Company,* the SEC discovered the following facts:

(1) The company faced serious cash flow difficulties.
(2) The company made public disclosures which did not disclose problems but which reported high earnings and projections of growth.
(3) Outside directors were aware of the company's troubled financial condition and were also aware of the optimistic disclosures.
(4) The company had an audit committee of three outside directors, but the committee never met.
(5) Outside directors did not take meaningful steps to see to it that adequate disclosure be made [SEC, January 1978].

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 insure 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 [SEC, January 1978].

The case of *SEC v. Killearn* resulted in a consent decree in which the company agreed, among other things, to form an audit committee of three outside directors. The SEC specifically stated that duties of the 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.

The SEC underscored the importance it places on an audit committee in an enforcement action concerning misleading interim reporting. In the case of *SEC v. Mattel, Inc.,* it accepted Mattel's consent to establish an audit committee. As a part of the ensuing settlement, the court ordered that the company appoint a majority of unaffiliated directors and that it establish a financial controls and audit committee among whose major functions would be a review of financial controls, accounting procedures, and financial statements disseminated to the public.

In the consent decree arising from *SEC v. Lum's, et al.,* the court, as part of the settlement of the SEC's allegation of manipulations and proxy fraud, ordered that a standing audit committee be established. The audit committee was to consist of two or more members of the board of directors who were not officers or employees of the company and whose function would be to review the auditor's evaluation of internal controls and to oversee other required evaluations of casino operations, personnel, and security.

When submitting its report on its inquiry into the reason for the Penn Central collapse to a House subcommittee, the SEC noted that:

> The Commission, taking a look at the future, has paid increasing attention to the role, the qualifications, the responsibilities, and the independence of corporate directors, which appear to be called for. Last month the Commission released a statement endorsing the establishment of audit committees composed of independent directors. The staff report points up the critical importance of the whole subject of the responsibility of directors, the greater utilization of public and independent directors, the professionalization of their function, providing staff support for directors and judging their performance not on the basis of hindsight but on the basis of the reasonableness of their judgment in the circumstances and at the time it was exercised.

In 1976, the SEC again underscored its interest in audit committees, this time as a means of deterring questionable and illegal corporate payments and other practices. In its report to the Senate on "Questionable and Illegal Corporate Payments and Practices," the Commission wrote:

> Actions to further enhance the creation by public corporations of audit committees composed of independent directors to work with outside auditors would serve as a valuable adjunct to these legislative proposals.
>
> The importance of the role of the board of directors, independent audit committees, and independent counsel has been illustrated by the Commission's enforcement actions in the area of questionable or illegal corporate payments. Significantly, in some of these cases no audit committee existed. In others, with a single exception, audit committees either operated only during a portion of the time when the questionable payments were alleged to have been made, or were not wholly independent of management. Accordingly, the resolution of these proceedings typically has involved establishment of a committee comprised of independent members of the board of directors, charged to conduct a full investigation, utilizing independent legal counsel and outside auditors, to conduct the necessary detailed inquiries.
>
> The thoroughness and vigor with which these committees have conducted their investigations demonstrate the importance of enhancing the role of the board of directors, establishing entirely independent audit committees as permanent rather than extraordinary, corporate organs and encouraging the board to rely on independent counsel.

Acting to further strengthen the independence of auditors, the SEC in September 1977 proposed a rule to require disclosure in a company's proxy material of audit fees and services and approval thereof by the board of directors or its audit committee. The text of the proposal included the following comments:

> It is desirable for all public companies to have audit committees composed of independent directors and ways are being considered by which such committees might be encouraged or required.
>
> The Commission believes that objectivity and independence are enhanced if the auditor deals with an audit

> committee of independent directors or the board of directors in determining services and fees. In order to provide investors with knowledge of whether the board of directors or audit committee has approved all services provided by the auditors, the Commission proposes to require disclosure of whether such approval has taken place.

More recently, in response to the recommendations of U.S. congressional subcommittees, the SEC urged the AICPA to require audit committees as a condition of an independent audit. Speaking at the American Institute of Certified Public Accountants (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.

Harold M. Williams commented again on the importance of audit committees in a paper presented at Carnegie-Mellon University on October 24, 1979. He stated that:

> Audit committees are critical because of the fundamental role which the independent auditor plays in corporate accountability and the special trust which the public places in the auditor's work. With the wide acceptance of the concept of the audit committee, the next question which must be faced is the definition of the committees' responsibilities. At present, many audit committees are, undoubtedly, not yet working fully effectively, and some may serve more to provide windowdressing rather than to add substance to the accountability process. The development of a better consensus as to the minimum responsibilities of audit committees should be an important priority.

SEC regulation is assumed to be in the public interest, and the SEC's support for the development of audit committees gained momentum due to the declining corporate image in the public sector. The August 9, 1976 issue of *Business Week*, began a review of a book on the world of business by stating that "American business has seldom been held in such low regard as it is today. A succession of scandals, ranging from the collapse of Penn Central to ITT's misadventures in Chile to the illegal payoffs of Gulf, Lockheed and scores of others, has given business a corrupt and dehumanizing image. . ." Antibusiness and anticorporate attitudes were not new in American political history, but perhaps never before had the critics been more strident in their accusations, more zealous in their crusade for reforms. Public confidence sagged; public regulation proliferated. Proposals abounded for more accountability and more control of corporate activities. And there was the expectation that outside directors would become more involved in monitoring corporate conduct and governance [Schornack, April 1979].

Since the 1940 issuance of Accounting Series Release No. 19, the SEC has consistently shown its support of corporate audit committees. Through several court cases it has required certain individual corporations to establish audit committees and has prescribed definite duties for them. In addition, Accounting Series Releases Nos. 123 and 165 addressed the issue of audit committees and further stated the SEC's endorsement of these committees.

Actions of the New York Stock Exchange

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

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."

At the urging of the SEC, on January 6, 1977, the NYSE adopted a requirement for all listed companies to maintain an audit committee. It specifically stated:

> Each domestic company with common stock listed on the Exchange, as a condition of listing and continued list-

> ing 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.

Thus, the audit committee became a required part of the corporate organization for all companies listed on the New York Stock Exchange.

Actions of the American Institute of Certified Public Accountants

In July 1967, the AICPA executive committee statement on audit committees of board of directors recommended that publicly owned corporations appoint audit committees. Specifically, the committee stated:

> The executive committee of the American Institute of Certified Public Accountants recommends that publicly owned corporations appoint committees composed of outside directors to nominate the independent auditors and to discuss the auditor's work with them.
>
> Wide adoption of this practice would represent a further step in the continuing improvement of corporate financial reporting to the investing public. Audit committees can be a constructive force in the overall review of internal control and financial structure and give added assurance to stockholders as to the objectivity of corporate financial statements.
>
> Audit committees can assist their full boards of directors in matters involving financial statements and control over financial operations. They can also strengthen the positions of managements by providing assurance that all possible steps have been taken to provide independent review of the management's financial policies and operation. This is good for the company and good for the public.

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.

Report of the Commission on Auditors' Responsibilities. In its report issued in January 1978, the Commission an Auditors' Responsibilities (which was established by the AICPA) 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 members should include independent outsiders, and an audit committee should be formed.

Special Committee on Audit Committees. In early 1978, the AICPA appointed a Special Committee on Audit Committees to study whether the AICPA should require that companies establish audit committees of their boards of directors as a condition of an audit by an independent public accountant. Under consideration by this special committee were such questions as whether audit committees should be required to strengthen auditor independence, and should a requirement for audit committees specify duties to be performed by the committee.

As a supplemental issue, the committee was also 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.

The special AICPA committee, which was formed in response to congressional and SEC recommendations for requiring corporate audit committees, concluded that it was not possible to sustain the considerable burden of identifying the necessity of an audit committee requirement. The AICPA reported to the Securities and Exchange Commission that while it continues to support the concept of audit committees for publicly owned corporations, it has found no reasonable basis for issuing a technical standard requiring their establishment. The committee pointed out that it does not find audit committees necessary for the maintenance of auditor independence or for performance of an audit in accordance with generally accepted auditing standards. The AICPA committee also stated, however, that it is convinced that audit committees can be helpful to both corporate directors and to independent auditors. In addition, the committee stated that any Institute requirement would be viewed as an intrusion into the area of corporate governance and recommended that the accounting profession urge other bodies such as the stock exchanges and the National Association of Securities Dealers to encourage or require committees for publicly held companies.

While the AICPA is unwilling to make the existence of an audit committee mandatory before an independent audit can be performed, it has consistently shown its support for audit committees. The AICPA's expressed belief in the value of the audit committee has contributed to their significant increase in number and importance.

Actions of Congress

While the accounting profession, the SEC and the NYSE have advocated the audit committee for many years, Congress has only recently expressed its interest in the matter. 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. There was, however, no action taken on this bill.

In its 1976 report on an investigation of the Securities and Exchange Commission, the Subcommittee on Oversight and Investigations of the Committee on Interstate and Foreign Commerce, House of Representatives (the Moss Committee), was critical of board of directors performance in general and specifically noted the desirability of audit committees. The following is an excerpt from that report:

> A director must be willing to devote considerable time to his important and continuing responsibilities. A director elected because of demonstrated expertise should be expected to manifest that expertise in fulfillment of his

> responsibilities and should be compensated appropriately. The majority of the board should be detached from management and from any other conflict of interest, e.g., association with the company's investment banker or corporate counsel. The board should provide itself with an independent staff. A board's key audit committee should be comprised of a majority of independent directors who adopt rules to govern the committee's proceedings. The audit committee should have available to it independent expert advisors. Likewise, the nominating committee should be comprised of a majority of independent directors. Assuring the independence of the board and its key auditing and nominating committees as well as holding directors to professional standards of performance are critical to building an effective system of corporate accountability to protect public investors as well as a corporation's customers, suppliers, and competitors.

The Foreign Corrupt Practices Act was passed December 19, 1977. This Act made recordkeeping and an internal control system for all public companies a matter of law. Interpreters of this Act have subsequently suggested that audit committees could provide a vehicle for insuring that the provisions of the Act are met. For example, Leonard M. Savoie, CPA, vice-president and controller of Clark Equipment Company, Buchanan, Michigan, and former executive vice president of the AICPA, spoke on some of the practical problems of monitoring compliance with internal accounting control systems under the Foreign Corrupt Practices Act. Savoie suggested that, to assure compliance, companies institute special procedures including annually distributing corporate policy statements and guidelines to all management personnel and authorizing internal auditors and lawyers to investigate and report to the audit committee on violations of the conduct guidelines. Dennis R. Beresford and James D. Bond, in an article in the *Financial Executive* stated that the immediate effect of the internal control provision of the law will be for management, audit committees, and independent auditors of public companies involved in international trade to challenge more rigorously systems of internal control with a broad question similar to the following:

> How does the company's system of internal control provide reasonable assurance that an illegal foreign payment does not occur [August 1978]?

The Subcommittee on Reports, Accounting and Management of the Senate Committee on Governmental Affairs (the Metcalf Committee) stated the following in its November 1977 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.

Given this new interest on the part of Congress, a possibility looms that new legislation may require boards of directors of all publicly held companies to establish and maintain such audit committees. The principal concern is that such legislation could conceivably go on to establish specific rules and regulations governing the responsibilities and performance of audit committees and boards of directors in general [Arthur Andersen & Co., 1978].

Increases in Responsibilities of Directors

At least part of the explanation for the suddenly increased enthusiasm for corporate audit committees is the increased awareness of the legal responsibilities of directors. A large number of articles in periodical business publications have emphasized the increasing scope of director responsibility [Mautz and Neuman, 1977]. For example, a May 11, 1974 editorial in *Business Week* includes the following:

> The Securities & Exchange Commission's suit against the old management of the bankrupt Penn Central Railroad abruptly extends responsibility for corporate misdeeds to a broad new area. In effect, the SEC is saying that anyone connected with the company who was in a position to know what was going on and to do something about it will be held liable along with those who actually committed the offenses. Applying this philosophy to the Penn Central case, the SEC did not stop with bringing suit against . . . the former president and . . . the former top financial officer. It also included as defendants three outside directors of the company.

In an article entitled "The SEC Looks Harder at How Directors Act," [*Business Week*, February 2, 1976], the following comments are included:

> Last week's dismissal of Gulf Oil Corporation Chairman, Bob R. Dorsey, by the company's board suggests that some directors are already worried. Gulf's directors reportedly fear that the SEC would hold them liable for a failure to act in disciplining management implicated in illegal acts.
>
> Even outside directors without knowledge of wrongdoing may be legally obligated to ferret out the facts for themselves. That is the thrust of a consent decree that the SEC negotiated last summer with Theodore Kheel and John Castellucci, the two outside directors of Sterling Homex Corporation when insiders were allegedly practicing fraud in hiding the company's financial deterioration.

A book review in the April 26, 1976 issue of *Business Week* commences with this statement:

> Corporate scandals have become such everyday occurrences that they hardly evoke surprise anymore, but until a few months ago, at least, one question always popped up in their wake: where were the directors when the price fixing, bribing, or polluting was going on.

Corporate directors, faced with such charges and assertions, can scarcely continue in ignorance of their risks and responsibilities. To the extent that corporate audit committees are perceived as a means of reducing such risks, they are likely to be a welcome addition to corporate practice [Mautz and Neuman, 1977].

Because of limitations of time and resources, the board's responsibility is particularly heavy and, in recent years, directors have been facing intensifying challenges:

(1) Companies have increased in size, diversity and complexity.
(2) Directors find it virtually impossible to be knowledgeable about and discuss every facet of their directorate companies.
(3) The number of lawsuits against directors has increased, not only because of board actions but also because of actions by management.
(4) The directors' obligation to exercise reasonable care in the fulfillment of their responsibilities to shareholders is underscored by the trend toward litigation [Coopers & Lybrand, 1976].

Corporate boards of directors must meet the challenges of their changing duties and responsibilities in order to fulfill their role within the corporate organization. The audit committee can be an important aid in this endeavor.

Other Actions Supporting the Establishment of Audit Committees

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. The audit committee is described in this publication 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."

Some states have audit committee requirements. For example, a recently enacted statute of Connecticut requires that certain corpoartions of that state with at least one hundred stockholders must establish audit committees [*Connecticut General Statutes Annotated*, 1980].

In Canada, the provisions of the Business Corporations Act include the following:

(1) The directors of a corporation that is offering its securities to the public shall elect annually from among their number a committee to be known as the audit committee to be composed of not fewer than three directors, of whom a majority shall not be officers or employees of the corporation or an affiliate of the corporation, to hold office until the next annual meeting of the shareholders.

(2) The members of the audit committee shall elect a chairman from among their members

(3) The corporation shall submit the financial statement to the audit committee for its review and the financial statement shall thereafter be submitted to the board of directors.

(4) The auditor has the right to appear before and be heard at any meeting of the audit committee and shall appear before the audit committee when required to do so by the committee.

(5) Upon the request of the auditor, the chairman of the audit committee shall convene a meeting of the committee to consider any matters the auditor believes

should be brought to the attention of the directors or shareholders.

Many segments of the business community and the general public have shown interest in and support for corporate audit committees. These segments may differ in the purposes for which they support audit committees and in the objectives they hope will be achieved. However, a historical review of the development of audit committees shows that all interested segments expect the committees to strengthen the corporate image to the general public.

While the composition of audit committees has been addressed by the SEC, the NYSE, the AICPA and Congress, only the SEC has issued any specific duties to be performed by audit committees, and this has only been done in specific cases for individual companies. Without guidelines to maintain some consistency and standardization of functions and responsibilities for all audit committees, the goals for which these bodies support corporate audit committees may not be achieved.

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