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Corporate Audit Committees

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Corporate Audit Committees

- promote independent, critical, creative thought
- raise the level of internal financial control
- improve the quality of reported financial information

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December, 1970

Two facts of corporate life are that

- the public lacks confidence in much of the reported financial information, and
- corporate directors bear responsibility for, and may incur liability as a result of, misleading financial information.

To solve these very real problems, several professional and regulatory groups have proposed that public corporations use audit committees made up of members of their boards of directors.⁽¹⁾

We at Touche Ross have actively supported the position taken by these groups—that corporate audit committees can greatly promote the public and corporate good. Further, we have sponsored extensive research in this field by Professors R. K. Mautz and F. L. Neumann, both of the University of Illinois. Results of their research are now being published.^(2, 3)

We recommend that publicly-owned companies have audit committees and that they consist largely of outside directors. We recommend that each committee be organized in a manner carefully calculated to make it effective in advancing corporate responsibility. Privately-owned companies that issue financial statements to outsiders (e.g. for credit purposes) should also follow this recommendation.

(1) The Executive Committee of the American Institute of Certified Public Accountants issued in July, 1967, a recommendation that audit committees be formed. In November, 1968, a committee of the Canadian Institute of Chartered Accountants made recommendations for legislation that would make such committees mandatory for publicly-owned companies. The New York Stock Exchange, the Securities and Exchange Commission, and other regulatory bodies have given attention to the need for audit committees.

(2) Corporate Audit Committees: A Research Report by R. K. Mautz and F. L. Neumann (to be published; Bureau of Economic and Business Research, University of Illinois).

(3) The effective corporate audit committee, by R. K. Mautz and F. L. Neumann (*Harvard Business Review*, November-December, 1970).

Issues concerning the composition and the objectives of corporate audit committees, and questions concerning the scope and manner of their operation are discussed herein. Part of the material presented here, together with the supporting data, will appear in the report on the Mautz-Neumann research study. However, in certain respects, the emphasis in this monograph differs from that of the research study.

Why Have an Audit Committee?

The recently issued court opinion in the Bar-Chris case⁽⁴⁾ has focused attention on the very real responsibility of directors for public reporting of financial information; from this responsibility, extensive legal liability may be incurred. Outside directors ordinarily are in a relatively poor position to be able to assume this responsibility. Their contact with financial information at full board meetings is ordinarily superficial. Little time is available — on the agenda of a busy board — for a careful review of accounting and financial controls.

If an outside director is to intelligently undertake financial responsibilities, he must have background on the structure and nature of financial controls applied within the company. He must also have knowledge of the alternative generally accepted accounting principles that may be appropriate within the industry.

And his knowledge of accounting principles must be up to date—he must be aware of the rapidly changing environment being brought about by new pronouncements of the Accounting Principles Board of the AICPA.

Many outside directors have expressed the need for personal contact with the independent CPAs of their company. Further, many would extend this personal contact to officers and employees

(4) See Federal Securities Law Reporter, Commerce Clearing House, '67-'69 Decisions, Transfer Binder Supp., ¶92,179.

responsible for financial functions at the corporate and divisional levels as well as to those engaged in the internal audit function.

In recent years, discovery of misleading or erroneous published financial information has made newspaper headlines and has been the subject of articles in magazines widely read in the financial community. In years gone by, probably only the McKesson and Robbins case attracted as much attention as have some recently publicized cases. Between the time of the McKesson case and the next one to reach wide public attention there was a long interval. Now, the financial community is seeing an accelerating number of financial reporting problems, a fact which necessarily affects the credibility of all published financial information.

At annual stockholders' meetings, questions are often directed to the officers of the company, and to its CPAs, indicating the concern of stockholders about the company's financial controls and about the nature of the audit performed by the CPAs. Many stockholders believe that the necessarily extensive relations between the officers of a corporation and the partners of its accounting firm are too close. They then raise questions of independence, and of domination over financial reporting by management.

The question of independence is also affected by the situations where there have been sudden replacements of one auditing firm by another. There is concern whether the independent certified public accountant has an adequate channel within the company to convey his thoughts to non-management directors about important issues.

Stockholders want assurance that the function of financial control over assets is under the surveillance of members of the board. Even though in specific instances there are no facts to support the doubts expressed, the credibility problem does exist—and credibility does influence stockholders, as it should.

The problems of improved reporting and of adequate controls are not shadows in the public mind. Directors have responsibility for these problems, and their potential legal liabilities can not and should not be discounted.

Appropriate attention at the policy level is needed to bring about substantive improvements in both reporting and control. Corporate policies concerning accounting and control are the base upon which rests the quality of these functions. Financial officers often become more effective when members of the board are deeply interested in financial reporting and controls.

Who should generate the impetus to better financial reporting and control? While the profession should be continuously responsive to the needs of the financial community, there are areas of improvement that must come from the companies themselves.

If a board is to support accounting and control policies relating to complex matters, the board must first understand the issues involved. For many directors, even a comprehension of the responsibilities CPAs express in their opinions on financial statements can only come from personal exposure. Such matters as the bases used for valuing assets, setting up reserves, providing for depreciation, the significance of footnotes—all these matters require extensive personal exposure and contact on the part of outside directors. To learn about the application of financial controls, they need information that may be given to them by the company's independent accountants, by the financial officers and employees of the company, and by internal auditors.

The process of intelligent challenge of the company's accounting and control activities by the directors—if a satisfactory means exists—may catalyze important substantive improvements. This, in turn, opens the way for independent CPAs, for the financial officers and employees of the company, and for the internal auditors

to bring their recommendations to the attention of the board of directors.

To summarize, there are compelling and urgent needs:

- To aid directors in undertaking and fulfilling their responsibilities for financial reporting to the public;
- To cope with the corporate image problems stemming from tarnished credibility in financial reporting;
- To support, at the highest level, efforts to substantially improve both the financial controls exercised over management and the quality of public reporting;
- To provide better avenues of communication between the board of directors and the external and internal auditors.

A corporate audit committee of competent non-management directors can be responsive to all of these needs. Some managements believe that dealing with the independent CPAs is solely an operating problem and not the concern of members of the board. But the overall significance of the issues involved, and the fact that management itself must be the subject for internal control, argue that increased board concentration on the audit function is warranted.

Benefits flow from the corporate audit committee to stockholders, directors, management, the independent CPA and the accounting profession. Stockholders are assured that the protection of corporate assets is being given top level attention; stockholders also gain from the impact of improved credibility in financial information. Directors are provided a mechanism for the personal contact necessary to their responsibilities. Management gets the benefit of policy support for improved reporting and control practices and avoids the potential stigma of having operated without independent financial controls. The independent auditor is assured an attentive audience at the policy level.

And the accounting profession benefits because the cumulative effects raise the level of performance.

If a corporate audit committee is to yield its potential benefits, it must be appropriately organized, and it must be much more than a conduit for financial statements from the auditors to the board.

Establishment and Composition of Audit Committees

The audit committee should be established by a resolution of the board of directors. The resolution may be general, or it may set forth in detail the objectives and scope of the committee. The significant factor is that the responsibilities of the committee should be stated in writing. To develop an appropriate foundation for this written statement of scope, the entire board should fully discuss the pros and cons of an audit committee and the alternative roles available to it.

Corporate audit committees are generally small, and in many instances three members seem to be enough. In some cases, perhaps particularly because of the appropriate insistence of non-management directors for personal participation, it may be wiser to establish larger committees. The committee should be appointed by the board and should consist either largely or entirely of non-management directors.

Practice indicates that the best qualifications for an audit committee member are—perhaps to a slightly higher degree than the typical board member—an inquiring mind and breadth of knowledge about corporate matters, including experience in financial and general management functions. Specific knowledge of auditing and accounting is not necessary. The ability of the chairman of the committee is apt to have a determining effect upon the success of its activities, just as the skills of participants always influence performance. The chairman should also have conviction that the function of the committee is

useful. And he should have the inter-personal skills to coordinate with management.

While communication to the committee from officers is essential, this interrelationship may be obtained by providing for the attendance of officers during portions of audit committee meetings. Conversely—to obtain full benefit—if management directors are members of the committee there should be a provision that they withdraw from some part of the audit committee meetings.

Scope of Audit Committee Function

The scope of the committee's activities and the manner in which the scope is determined may have much to do with getting successful interaction between management and a corporate audit committee. Some officers feel that financial reporting and controls are solely an operating problem and should not be interfered with by directors. Clearly, the refutation of this position lies in the broad needs to be served. In practice however, a clear definition of scope will minimize difficulties from this source. Further, to plan effectively, the audit committee must have a clear definition of scope.

We recommend that a written statement covering the scope of audit committee activities be developed. Although this may be done as part of the resolution establishing the committee, we suggest that the scope statement be prepared after exploratory meetings held first by the management and the audit committee, then by the audit committee and the company's CPAs, and finally by the audit committee and management. A complete hearing of objectives and objections can clarify expectations, promote understanding, foster modifications in scope and increase the opportunity for satisfactory performance.

The activities of an audit committee may and should include:

- Nomination or selection of the auditors
- Approval of the overall scope of the audit
- Review of results of the audit
- Review of the overall control mechanisms

The fourth category, control mechanisms, may appear to be independent of the first three. However, the audit committee must, in fact, address itself to control. Otherwise it is impossible to evaluate what the audit by the independent CPAs has done to advance control over the financial affairs of the company. The only real choice is whether the audit committee pursues the nature of control by questioning the external auditors or by questioning the financial officers, internal auditors and employees of the company.

Nomination or selection of the auditors by the audit committee tends to establish that auditors are independent of management. The nomination of auditors ordinarily takes place when stockholders directly vote upon the election of the auditors, or when they ratify the action taken by the board; in some instances the audit committee's nomination will be ratified only by the board.

There appears to be general agreement that the more important accomplishment, when the audit committee nominates or selects auditors, is that the external auditors cannot be replaced without the approval of the audit committee. In this case it is most credible that the auditors can stand up to management in the event of disagreement. Accordingly, any statement of scope should be clear as to the rights of the audit committee in connection with the engagement *and retention* of the external auditors.

The overall scope of the audit. The audit begins to pay off in improved financial reporting when it is made responsive to the needs of the company. There may, of course, be specific problems within the company that some part of management may believe the auditors will examine in the ordinary course of events. Others on the board may never have thought about some of these problems. To establish the existence of such problems, and to set specifications for the external audit, the audit committee must understand the internal control function, including internal audit.

While a corporate audit committee should not develop detailed audit procedures, such things as the degree of audit coverage of subsidiaries or divisions, the coverage of stores or plants, and the coverage of foreign operations are certainly matters for their review. The type of coverage to be given to new acquisitions also falls in this category as do special problems such as inventory obsolescence, credit circumstances, and unusual trends in the industry. None of these will be left to chance if they are brought up with the auditors in a discussion about the scope of work. A written memorandum of the scope agreed upon may serve many useful purposes in the future.

Review of results of the audit by the audit committee is presumably its most important contribution. It is here that the members of the committee can learn in detail the auditors' thoughts about the fairness of the financial presentations. Because the wording of the short-form opinion obviously does not convey the subtleties that would be useful to directors in fulfilling their responsibilities, these subtleties should be communicated during personal contact.

The review of the results of the audit should, of course, cover not only the fairness of presentation of financial data, but also the external auditors' opinion about controls, financial personnel, and general business matters. Some feel that direct contact between directors and auditors on delicate matters may embarrass management and create situations difficult to resolve. But the responsibility of the board is paramount and overriding. Accordingly, following a review with the external auditors, the audit committee must transmit to the full board that information which it considers pertinent. Based upon the report given by its audit committee, the full board then acts to approve the financial statements to be included in the annual report. The board relies upon the audit committee members to discharge their responsibility for adequate reporting. It thus behooves the audit committee

members to transmit all information that bears on the directors' responsibilities.

Review of the system of internal control by the audit committee better serves the purposes of the company. Such a review necessarily includes directing audit activities to control problems. Audit activity for this purpose may be expected to come from both the external and internal auditors. Internal control, of course, is a function of the system used, including checks and balances that come from the structure of the organization and the manner of assignment of authorities and responsibilities.

When the scope of the corporate audit committee includes the internal control function, the audit committee may give its fullest attention to gaining the knowledge needed to optimize the coordination of the external audit function with internal activities. Where there is a significant internal audit function, as there should always be, its effectiveness can be increased by allowing it to make reports directly to the corporate audit committee.

Method of Operation

The development of a mode of operation should begin with exploratory meetings. Each group should frankly state what it visualizes may occur and should provide the facts upon which to develop an agenda.

Number and timing of meetings. Generally, apart from initial and exploratory meetings, there should be at least two audit committee meetings with the external auditors every year. At the year's first meeting, the agenda treats what is to be expected during the coming audit; at the second meeting, the findings of the audit are reviewed and the financial statements are received. There is much merit in holding this second meeting shortly before the audit is completed—in the event questions arise that call for further action by the auditors.

Attendance. At audit committee meetings, the independent CPA should minimally be represented by the partner in charge of the engagement and the staff man in charge of the field work. In addition, particularly for larger clients, it is quite appropriate that a senior partner not directly connected with the engagement should also attend. Such a senior partner may make important contributions — discussing general trends in accounting and auditing, evaluating attitudes within the financial community, and clarifying the economic backdrop against which financial statements are being viewed and evaluated. His insights may also serve to sharpen perception of the nature of any controversial issues that may be encountered.

In the usual case where the membership of the audit committee does not include management's chief executive and financial officers, these men should be invited to attend the discussions that involve the presentation of findings and the implications attached to them. It is necessary, for many reasons, that the audit committee have the opportunity to evaluate the responses by management both to the facts presented and to the judgments made by the external auditors.

Where there is a significant internal audit function, it is appropriate that the chief internal auditor be present at both the meeting directed towards setting specifications of the audit and the one for reviewing the audit findings.

Whether officers serve on or have been invited to an audit committee meeting, the meeting should include some time when all management personnel are excluded and only outside members of the audit committee and the external auditors are present. This gives the opportunity to evaluate personnel, including top management, without restriction. It also permits intimate discussion of the implications of delicate policy matters.

Agendas should be developed much in advance, so that all parties have ample time to prepare. We recommend that the typical audit review agenda be built around the following items:

1. Presentation by auditors of financial statements
 - (a) General explanation of responsibilities assumed by the independent auditors
 - (b) Comments concerning accounting principles used, particularly those affected by change
 - (c) Comments on interpretation of individual balance sheet items, including the potential for variation as to amounts stated
 - (d) Comments on interpretation of financial results, including trends, explanations of trends and changes in character of the business
 - (e) Comments about auditing problems, including scope and results in important or sensitive areas
2. Presentation by auditors of comments and recommendations on internal control
 - (a) Management letter, if preparation is possible in time for the meeting
 - (b) General evaluation of organization
3. Discussion of new APB pronouncements and of APB pending items and general accounting trends
4. Comments about service other than auditing performed during year

The external auditors will benefit from reference to written material used during their oral presentations. At the least, a record of points to be covered should be given to members of the audit committee.

Any attempt to develop in writing *all* the discussion that is contemplated can, at the least, be very uneconomical. More importantly, the written material should tend only to focus discussion, not to limit and restrict a free interchange of thoughts.

Expected APB pronouncements and trends should not be treated in technical detail. Rather, there should be a very brief discussion of such matters that are pertinent to the client's general affairs.

Internal control activities must be explored, but the means must be accommodated to the situation. As previously discussed, the audit committee may choose to learn about internal control from the independent CPAs. On the other hand, the responsibility of the committee may call more directly for personal contact with internal auditors, chief financial officers at the corporate level and financial officers at divisional levels.

Establishing internal control as an item on the agenda contributes to efficient coverage of the function. Depending upon the multiplicity of control areas that exist, and the degree of depth that carrying out the scope of the committee requires, an extensive discussion of internal control may be needed. In some cases, several exploratory meetings should be held simply to resolve the scope of this agenda item.

Because today's information and control systems are so integrated, contacts might also be wanted with functional officers outside the accounting and finance function.

Conclusion

A corporate audit committee—properly staffed and chartered, and acting in a fertile environment—will promote independent, critical and creative thought, will raise the level of internal financial control, and will improve the quality of reported financial information. In addition, all parties—the public, stockholders, management, directors, auditors and governmental bodies—will have justifiably increased confidence in the fairness and adequacy of the company's financial reports. We confidently expect that the corporate audit committee will come to be recognized as one of the essentials of enlightened managements.

QUESTIONS WHICH MIGHT BE ASKED INDEPENDENT CPAs BY AN AUDIT COMMITTEE

These illustrations are based on actual situations⁽⁵⁾ and are not intended to be all inclusive. With every question, the context in which the question is asked—the extent of an audit committee member's background knowledge in the particular area and in financial and audit matters in general, the financial condition of the company and the quality of its finance, accounting and internal auditing personnel—will certainly influence the form of the question and the nature of the response.

Audit scope and results

1. Do the independent public accountants believe that the scope of the examination is appropriate in the circumstances? Did management attempt to, or, in fact, place any restrictions on the scope of the examination and its implementation? Were there any major additions to or deletions from the audit program as compared with last year?
2. Did the independent public accountants audit all of the company's units, whether consolidated or unconsolidated? If not, which were omitted and why?
3. What type of work is performed by the independent public accountants in the case of business acquisitions?
4. Do the independent public accountants regularly rotate the staff on the engagement?
5. Have the independent public accountants noted any indications of a possible change in the character of the business?

(5) In large measure, these questions are taken from two actually-used listings contained in a full account of the Research Study sponsored by the Touche Ross Foundation. See footnote (2) on page 1.

6. Are there any serious internal control weaknesses outstanding? What recommendations have been made by the independent public accountants relating to internal control, organization, operations, and internal reporting, and what action has management taken regarding such recommendations?
7. How cooperative were company personnel?
8. What is the opinion of the independent public accountants as to the quality of the accounting and financial staffs? Is the company's internal audit staff adequate?
9. What is the quality of the long-range planning and budgetary controls employed by the company?
10. Does the company use its electronic data processing equipment effectively?
11. Is the company's policy and procedure manual reasonably formal and maintained on a current basis?
12. What have the independent public accountants done to determine any possible conflict of interest? Are company procedures designed to avoid such conflicts adequate in the circumstances?
13. Has the management ever exceeded its authority in any matters prescribed by the directors, or failed to comply with any resolution passed by the directors?

Financial statements—assets

1. For what periods are the company's time deposits committed? What are the company's compensating balance requirements?
2. Has the quoted market of the company's short-term investments changed significantly since year end? And what is the current thinking about carrying such investments at quoted market?
3. Why is the allowance for doubtful receivables lower than last year despite an increase in receivables? What is the average age of accounts compared to a year ago, and how is the change explained? Is the company following an appropriate credit policy? Are there

any large individual amounts where collectibility is in question? Are any of these receivables for an extended time period? Have any receivables been discounted or pledged? Are there any receivables from officers or other management employees?

4. Are inventory physical controls adequate? Has the LIFO method of valuing inventories been considered?
5. What steps have the independent public accountants taken with respect to inventories at outside locations?
6. Does the company generate internal reports on the condition of inventories, so that timely action can be taken with respect to possible obsolescence? Were any significant write-downs incurred? Generally, what have the outside auditors done to satisfy themselves that the inventory as stated on the balance sheet does not contain obsolete or excess stock?
7. What is the basis of valuation of long-term investments? Is the valuation more or less than quoted market?
8. How does the company's equity in foreign companies compare with cost? How much is really at risk when intercompany receivables and temporary advances are considered? How does the company effectively hedge its exposure?
9. Why does the company use accelerated methods of depreciation for some items but not for others? Why is the same method of depreciation used for book and tax purposes? Is the company's policy regarding the differentiation between capital and expense items still responsive to its needs?
10. Does the company have any significant proposed leases which might require capitalization?
11. Is the company policy regarding amortization of intangible assets realistic? Should the company consider prospective amortization of goodwill arising from acquisitions before November 1, 1970?

*Financial statements—
liabilities and stockholders' equity*

1. What is the status of Federal income taxes, such as open years and items in dispute? Does the accrual for Federal income taxes appear to be adequate to cover possible assessments upon examination by the IRS?
2. Has the company complied with debt indenture obligations, or have waivers been required?
3. Are there any restrictions pertaining to senior stock issues that effectively limit company activities? Are there retained earnings restrictions of any kind? Has the company purchased any treasury stock during the year, and, if so, for what purposes?
4. Has the company made any charges or credits directly to stockholders' equity? Why?
5. What is the company's policy on funding past service liabilities relating to retirement plans? Over what period of time is past service being amortized? What amount of the total past service liability has been funded? Has the company's practice followed a consistent pattern?
6. Are there any contingencies of a legal or other nature as to which the appropriate treatment, provision or mere disclosure, was in doubt?
7. Has the company made any unusual commitments regarding, for example, the purchase of inventories, or the acquisition or construction of property assets? How well does the company's capital budgeting system seem to be working?

Financial statements—general

1. Are other companies in the industry giving more or less information than we are planning to give in the financial statements and elsewhere in our report?
2. Why are general and administrative costs allocated in arriving at segmented operating results? Can there be further refinement in directly identifying costs now allocated?

3. Have there been any significant changes in the company's accounting practices in the year? Do all of the company's accounting practices fall within generally accepted accounting principles? Where "free choice" alternate principles are available, which are being used by the company? What would be the impact of using the other available choices? Are the company's accounting practices appropriate for its specific needs?
4. Were there any unusual items reflected in the operating results for the year? Are any of the operations incurring a loss?
5. Were there any prior-year adjustments? What was the rationale in so treating them?
6. What are the reasons for excluding specified subsidiary companies from full consolidations, and what are the prospects for changes?
7. Were there any transactions with non-subsidiary affiliated or related companies?
8. How are earnings per share computed? Why don't the quarterly figures add up to the cumulative figure?
9. Are there any adopted or proposed Accounting Principle Board opinions or Securities and Exchange Commission requirements that will materially affect the company's accounting methods or financial position in the near future? Has there been full compliance with existing opinions and requirements?