Appendix D

Historical Perspective on Audit Committees

As disclosed in Accounting Series Release No. 19, “In the Matter of McKesson & Robbins, Inc.,” in 1940 the SEC recommended that outside members of the board of directors nominate the outside auditors and, in turn, the shareholders elect the public accounting firm. There was doubt as to whether the external auditors were truly independent of management. Of course, the issue relative to this case involved the reporting of consolidated total assets approximating $90 million, which included nonexistent inventories valued at approximately $10 million and overstated accounts receivable by approximately $9 million.1 Moreover, because of the McKesson & Robbins debacle, the New York Stock Exchange issued a similar recommendation, which 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.”2 Although the term audit committee was not mentioned as such, several companies, for example, General Motors, established audit committees as a result of the McKesson & Robbins scandal.3 This scandal alerted the corporate community and the accounting profession that appointment of an audit committee by the board of directors should be recognized as an important action.

Until 1967, the concept of the audit committee received very little support, and the functions of this committee remained undefined. For example, John L. Carey wrote that a “direct channel of communication between the board and the auditors” is essential in reviewing the financial statements, the “most important representation to the stockholders and the public.”4 In July 1967, the Executive

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3 General Motors, 1979 Proxy Statement, p. 2.
Committee of the American Institute of Certified Public Accountants recommended that publicly held corporations establish audit committees of members outside the board of directors, because “the auditors should communicate with the audit committee whenever any significant question having material bearing on the company’s financial statements has not been satisfactorily resolved at the management level.”

During the 1970s, the role and responsibilities of audit committees in the United States received a great deal of attention because of the post-Watergate discoveries of corporate slush funds, illegal political contributions, and overseas bribes. Thus the investing public demanded greater corporate accountability to increase the confidence in the quality of financial reporting. In view of the separation of ownership and management, shareholders and other constituencies needed more assurance with respect to both the internal and external auditing processes and the financial reporting process.

In response to these demands, in March 1972 the SEC issued Accounting Series Release No. 123, “Standing Audit Committees Composed of Outside Directors,” which stated in part:

... [The SEC] 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 financial statements.

On December 20, 1974, the SEC issued Accounting Series Release No. 165, “Notice of Amendments to Require Increased Disclosure of Relationships Between Registrants and Their Independent Public Accountants,” which stated in part:

Disclosure is required of the existence and composition of the audit committee of the board of directors. The Commission has already expressed its judgment that audit committees made up of outside directors have significant benefits for the company and its shareholders (ASR 123). This disclosure will make stockholders aware of the existence and composition of the committee. If no audit or similar committee exists, the disclosure of that fact is expected to highlight its absence.

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Essentially, this release not only made the disclosure of an audit committee mandatory but also emphasized the importance of selecting a committee of stature and ability.

While the SEC issued the directive in ASR No. 165, the New York Stock Exchange made the first official mandatory recognition of the need for an audit committee. More specifically, the Exchange issued an audit committee policy statement, which stated in part:

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, 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. Directors who are affiliates of the company or its subsidiaries would not be qualified for Audit Committee membership.\(^8\)

Such a mandate for an independent oversight group enhances the reliability of the financial reporting system, which is an essential element of an efficient securities market.

With respect to American Stock Exchange companies and over-the-counter companies, the SEC found in a recent survey that 87 percent of AMEX companies and 79 percent of OTC companies have audit committees.\(^9\) It should be noted that the AMEX did not exact the mandatory listing requirement because a significant number of its members voluntarily establish audit committees.\(^10\) Thus the national stock exchanges have accepted the fact that a watchdog committee helps engender the integrity of a public company’s financial reporting process and audit processes.

In addition to the aforementioned events, there were a series of court actions with respect to the establishment of audit committees. For example, in the Penn Central case, the SEC emphasized the “critical importance” of the director’s responsibility as well as “greater utilization of public and independent directors.”\(^11\)

The Commission was pointing toward the need for an advisory committee of outside directors. The audit committee would fulfill this purpose. In the Mattel case, the SEC sought a consent injunction against the registrant for false financial

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reporting. The Commission charged not only that Mattel’s financial statements for 1971 were overstated by $14 million in sales but also that the pretax income was overstated by $10.5 million because of inadequate accounting provisions. As a result, a court order was issued requiring Mattel to establish and maintain an audit committee.\textsuperscript{12}

Similarly, a U.S. District Court ordered Lum’s, Inc. to establish a standing audit committee because the registrant was charged with proxy fraud in connection with future acquisition of businesses.\textsuperscript{13} Finally, in the Kilearn Properties case, the court ordered the establishment of an audit committee because the registrant failed to provide a prospectus in accordance with the securities laws. In this particular case, the court outlined the specific functions for the committee, which included a review of the independent audit engagement, the internal accounting controls, the internal audit function, the code of conduct, all public releases of financial information, and the activities of the officers and directors.\textsuperscript{14} There is little question that the court actions provided a framework for the functions of audit committees. The question of what constitutes proper standards and practices for these committees was emerging through court settlements.

Although the increase in the establishment of audit committees can be traceable to court actions, the SEC and AICPA recommendations, and the NYSE mandate, it is evident that such committees increase the awareness of boards of directors in discharging their stewardship accountability to their constituencies. Felix Pomeranz asserted that “audit committees have become the guardians of corporate morality within the existing organizational framework.”\textsuperscript{15}

In view of the legal liability of the board of directors and the SEC rule relative to the directors’ signature requirement of Form 10-K, it is obvious that the audit committee must be active. For example, Ernst & Whinney (Ernst & Young) found that in a survey of 419 publicly held clients, about one-half of the companies had all directors sign the Form 10-K; 182 of the companies had a majority of directors sign the form.\textsuperscript{16} The extent of the committee’s activities depends on the complexities of the business and the quality of management. As weaknesses are disclosed, they can be monitored by the audit committee until corrections have been made. Accordingly, the committee can make inquiries of senior management personnel but need not become involved in the day-to-day management. It must be emphasized that the committee has oversight responsibility and serves in an advisory capacity to the board.

\textsuperscript{12}Ibid., par. 94807.
\textsuperscript{13}Ibid., par. 94504.
\textsuperscript{14}Ibid., par. 96256.
\textsuperscript{16}Ernst & Whinney, “Survey of Director’s Involvement with Financial Information” (February 1982), p. 1.
In response to a rash of well-publicized cases of fraudulent financial reporting, the National Commission on Fraudulent Financial Reporting (Treadway Commission) recommended that the boards of directors of all public companies be required by SEC rule to establish audit committees composed solely of independent directors.\textsuperscript{17} In turn, the Auditing Standards Board responded to the Treadway Commission and adopted a Statement on Auditing Standards entitled “Communication with Audit Committees.” The major objective of this standard is to ensure communication of the results of the audit to the audit committee.\textsuperscript{18} In addition, the National Association of Securities Dealers (NASD), for its National Market System (NMS) companies,\textsuperscript{19} and the American Stock Exchange\textsuperscript{20} have adopted requirements for the establishment of audit committees as a condition of listing. More recently, the U.S. Congress adopted banking reform legislation (FDIC Improvement Act of 1991) that included provisions mandating the establishment of independent audit committees.

In Canada, several legislative acts have called for the establishment of audit committees. For example, the Ontario Business Corporation Act (1979) mandates that a corporation is legally required to submit its financial statements to its audit committee before such statements are submitted to the board of directors. Nelson Luscombe notes in an interview with Alan J. Dilworth, former chairman of Touche Ross, Canada, that the MacDonald Commission (1988) in Canada is calling for an expanded scope of the audit committee’s work.\textsuperscript{21} The major objective is to foster a constructive relationship between the audit committee, the internal and external auditors, and management so that all parties fulfill their financial reporting responsibilities.\textsuperscript{22}

Moreover, although such committees are not legally required in the United Kingdom, but are required by law in Australia, the boards of directors of certain publicly held corporations in these countries have, voluntarily or involuntarily, formed audit committees to meet the changing regulatory requirements and financial reporting needs of shareholders and others.\textsuperscript{23} For example, Linda

\textsuperscript{18} Statement on Auditing Standards No. 61, “Communication with Audit Committees” (New York: AICPA), par. 1.
\textsuperscript{19} National Association of Securities Dealers, NASD Manual (Chicago: Commerce Clearing House, 1987), Part III, section (d) of schedule D of the NASD bylaws.
\textsuperscript{21} Nelson Luscombe, “More Power to Audit Committees,” CA Magazine 122, No. 5 (May 1989), p. 27.
\textsuperscript{22} See the Report of the Commission to Study the Public’s Expectations of Audits (The Macdonald Commission), published by the Canadian Institute of Chartered Accountants, for further discussion. Also see the Canadian Securities Administrators Notice on Audit Committees (1990), which is a general mandate to achieve uniformity of the policies of Canada’s provincial securities commissions.
English found that nonexecutive directors of companies in Australia can stand up to forceful CEOs and thereby monitor and discipline management’s actions. Such nonexecutive directors need to implement institutional arrangements that will ensure corporate accountability to the stockholders. English concluded that audit committees are the answer for the nonexecutive directors’ problem.24

Similarly, the Committee on the Financial Aspects of Corporate Governance (Cadbury Committee) in the United Kingdom (1992) has issued a report that includes a Code of Best Practice. The Committee recommended that the boards of all listed companies registered in the United Kingdom establish and maintain audit committees. The code stated, in part:

There should be a minimum of three members. Membership should be confined to the nonexecutive directors of the company and a majority of the nonexecutives serving on the committee should be independent.25

As discussed in the preface, the motivation and rationale for the presence of audit committees in both developed and emerging equity markets has become widespread in the corporate governance arena. Exhibit D.1 summarizes the requirements and/or recommendations for audit committees of publicly held companies by country.26

In sum, over the past two decades, there has been an evolutionary process in the development of the role and responsibilities of audit committees. Their role has evolved into an independent oversight responsibility for the audit processes and the financial reporting process. Although management is responsible for the integrity of the financial statements, the board of directors has overall responsibility for the financial reporting disclosures because of its fiduciary responsibility to the shareholders. Accordingly, the audit committee is responsible for assuring the full board that management fulfills its responsibilities in the preparation of financial statements. For example, a review of the proxy statement of any U.S. corporation that is subject to the periodic reporting requirements of the Securities Act of 1934 reveals many of the normal functions of audit committees. Such functions usually include reviewing the engagement of the external auditors, reviewing the scope of internal and external audit plans, reviewing the internal audit department, and reviewing the adequacy of the corporation’s system of internal

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### Exhibit D.1  Summary of Requirements and/or Recommendations for Audit Committees of Companies Listed on Stock Exchange(s) by Country

<table>
<thead>
<tr>
<th>Country</th>
<th>Reference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hong Kong</td>
<td>Hong Kong Society of CPAs and The Stock Exchange of Hong Kong, Amendments to Appendix 14 of its Listing Rules, May 1998.</td>
</tr>
<tr>
<td>New Zealand</td>
<td>Institute of Directors’ 1992 <em>Draft Code of Practice for Boards of Directors</em>.</td>
</tr>
<tr>
<td>Thailand</td>
<td>Stock Exchange of Thailand 1999.</td>
</tr>
</tbody>
</table>
accounting control. This particular action on the part of the audit committee is important because it enables the committee not only to reinforce the independence of the external auditors from management—and thereby enhance the quality of the company’s financial reporting practices—but also to detect key problem areas that may impair the company’s integrity and securities in the financial community. Thus the audit committee’s review process causes both management and the external auditors to take a more aggressive strategy for corrective action. Clearly, the benefits of such committees outweigh the costs of potential legal liability to the board of directors.

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It is important to review some of the major historical developments of the twentieth century in corporate accountability and their relationship to corporate financial reporting. Such a review is in order since financial reporting is fundamental to the concept of corporate accountability. In short, the corporation must report its accomplishments not only to its principal constituency, the stockholders, but also to other outside constituencies.

**Public Sector Initiatives**

The United States Congress and the Securities and Exchange Commission have imposed several financial reporting requirements and have proposed several requirements to emphasize the fair presentation of financial information and corporate disclosure. The developments of particular importance are summarized in the following paragraphs.

**Foreign Corrupt Practices Act of 1977** In regard to the Foreign Corrupt Practices Act of 1977, Estey and Marston point out:

> One of the more ambitious ventures in the post-Watergate morality, the bill sailed through Congress after more than 300 major U.S. corporations had made gingerly disclosures of millions in “questionable” or “dubious” foreign payments—and after revelation of the payoffs by Lockheed had rocked governments in the Netherlands, Italy, and Japan. In passing the legislation unanimously, Congress labeled corporate bribery “bad business” and “unnecessary.” President Carter pronounced it “ethically repugnant” as he signed the bill into law.  

On December 9, 1977, the United States Congress enacted the Foreign Corrupt Practices Act. The purpose of this legislation is to prohibit U.S. companies, including directors, officers, stockholders, employees, and agents, from bribing foreign governmental officials. In addition, the law provided for the establishment and maintenance of a system of internal accounting control and record-keeping requirements with respect to all publicly held corporations. Accordingly, the law amended the Securities and Exchange Act of 1934.

Specifically, the law states that with the exception of facilitating (grease) payments, which are small payments for customs documents or minor permits, a direct or indirect payment or offer that is intended to promote business interests constitutes foreign bribery. Moreover, the corporation can be fined not more than $1 million, and individuals, such as directors, officers, or stockholders, can be

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30The act is contained in Title I of Public Law No. 95-213, December 19, 1977. See Appendix E on this book’s website.
fined up to $10,000, or imprisoned for up to five years, or both. Furthermore, publicly held companies must do the following: (1) devise and maintain a system of internal control sufficient to provide reasonable assurance that transactions are appropriately authorized and recorded and (2) maintain accounting records that in reasonable detail accurately and fairly reflect the financial activities.\(^3\)

As a case in point, on March 11, 1978, the *New York Times* observed the enforcement provisions of the Foreign Corrupt Practices Act.

Mr. Matusow, Mr. Hyman, and several companies controlled by them have misappropriated and diverted at least $1.24 million of corporate assets. Aminex filed false and misleading annual and quarterly reports with the SEC. Finally, the defendants were charged with disguising the misappropriated funds “by means of false and improper accounting in the books and records of Aminex.”\(^3\)

Although the court granted a temporary restraining order and appointed a receiver to protect the company’s assets, the SEC’s actions indicate that it has the authority to regulate the internal affairs of the company.\(^3\)

Furthermore, in February 1979, the SEC issued release no. 34-15570, which prohibits not only the falsification of corporate records but also false statements by the directors and officers to the corporate accountants, internal auditors, and external auditors. With respect to maintaining records, the SEC stated:

> The concern expressed with respect to inadvertent and inconsequential errors is unwarranted. The statute does not require perfection but only that books, records and accounts “in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer.” In addition, the legislative history reflects that “standards of reasonableness” are to be used in applying this provision.

As a result of the Foreign Corrupt Practices Act, an increasing number of companies are including a management report in the corporate annual report. As D. R. Carmichael, former vice president of auditing, American Institute of Certified Public Accountants, reports:

> The management report is a development in corporate financial reporting that can be implemented now with relative ease. It offers management an opportunity to simultaneously improve corporate communication and demonstrate accountability. Widespread adoption of management reports would also demonstrate the ability of voluntary disclosure to be innovative and responsive to the needs of users of financial information.\(^3\)

\(^3\)See Chapter 8 concerning the role of the audit committee and the internal accounting control aspect of the act.


\(^3\)See Chapters 8 and 12 for some possible implications of this law.

Thus, through the management report, management acknowledges its responsibility for the content of the corporate annual report.

In August 1988, the act was amended as part of an omnibus trade bill. Basically, individuals who knowingly fail to comply with the internal control standard can face criminal penalties on a limited basis. In addition, the amendments to the act clarify the definition of bribery and increase the penalty for bribery. For example, the amendments define what constitutes routine government actions, such as obtaining permits to do business in a foreign country. However, if a foreign official encourages or influences a decision to award or continue new or old business, then such action is not considered routine. Moreover, the corporation can now be fined a maximum of $2 million, and individuals up to $100,000.35

**Federal Deposit Insurance Corporation Improvement Act of 1991**

On December 19, 1991, the United States Congress enacted the Federal Deposit Insurance Corporation Improvement Act. The major objective of this banking reform legislation is to strengthen the internal control environment of financial institutions and improve compliance with laws and regulations. The law provided for the establishment of independent audit committees and internal control reporting by management and the outside auditors. The law is applicable to insured depository institutions that have total assets of $150,000,000 or more. (See Appendix F on this book’s website for further details.)

In response to the banking law, the AICPA issued two Standards for Attestation Engagements that deal with reporting on the internal control structure and compliance attestation. (See Chapter 5 for further discussion.)

As Joseph F. Moraglio and James F. Green conclude:

A quick reading of the new law’s audit and accounting provisions demonstrates it isn’t purely about depository institutions. Congressional faith in the value of the audit function has driven, among other things, a mandate for annual audits and an increase in management reporting, with accompanying attestation about management’s assertions by CPAs.

This trend toward increasing CPAs’ role to attest to management’s representations—in addition to financial statement audits—is likely to continue. The nature and form of the services specified in the new banking law may prove to be the model for future legislation.37

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35The amendments are contained in Title V of Public Law No. 100-418, August 23, 1988. See Appendix E on this book’s website.

36The act is contained in Title 1 of Public Law 102-242, December 19, 1991. See Appendix F on this book’s website.

In addition to the aforementioned legislation related to corporate accountability, the audit committee should be aware of other congressional legislation, such as the Racketeer Influenced and Corrupt Organizations Act (RICO), the Federal Sentencing Guidelines for Organizations, the Insider Trading Sanctions Act, the Insider Trading and Securities Fraud Enforcement Act, and the Private Securities Litigation Reform Act. Such legislation is applicable to officers, directors, and outside auditors because of their legal liability and allegations by plaintiff’s bar that they knew or failed to know what they should have known of material misstatements of financial statements.

Securities and Exchange Commission Corporate Governance Rules

The SEC has been deeply concerned about corporate accountability. The rapid increase in the numerous disclosures of questionable and illegal payments has raised many questions concerning corporate governance. As a result, the SEC embarked on a review and study of the rules regarding corporate governance.

In July 1978, the SEC released a proposal (Number 34-14970) on the corporate conduct of the board of directors. Essentially, the proposal centered on ways to strengthen the independence of the board. For example, the SEC proposed that corporations disclose the identity of each director and nominee in terms of his or her nonmanagement or independent capacity. Accordingly, the SEC is attempting to define the director’s affiliation in order to determine the director’s dealings with the corporation. Thus, a banker who is affiliated with the corporation’s bank should be identified.

Furthermore, the SEC proposed that corporations disclose the standing committees of the board of directors. For example, the SEC wants each corporation not only to disclose the standing committee, such as the nominating committee or audit committee, but also to identify the members of the committees with their affiliations. The objective is to form committees that consist of independent directors.

Moreover, in November 1978, the SEC approved rules with respect to these six disclosure requirements:

1. Relationships that corporate directors have with the company.
2. Whether a corporation has an audit, nominating, or compensation committee.
3. What those committees’ functions are.
4. Names of committee members.
5. Report how often the board of directors and the director committees met. The corporation would have to report when a director failed to attend 75 percent of the aggregate number of board and committee meetings he is obligated to attend.
6. Disclose director resignations due to a disagreement concerning the corporation’s operations, policies, or practices.\(^\text{38}\)

During the 1980s and early 1990s, the SEC adopted a number of key initiatives related to financial reporting.39

- Form 10K signature requirement
- Concept release on Management’s Discussion and Analysis (MD&A)
- Disclosure requirements with respect to changes in accounting firm and opinion shopping
- Disclosure related to environmental liabilities and contingencies
- Executive compensation disclosure40

Therefore, the SEC has enhanced corporate accountability through the issuance of rules that require more disclosure of the board structure and functions.

In reviewing the historical developments in corporate accountability, we have seen that Congress and the SEC endeavor to maintain corporate accountability through legislation and proposals to eliminate unfair corporate financial reporting. Indeed, within the framework of corporate accountability, corporate management must face laws and rules affecting its accountability to its constituencies. Consequently, the board of directors has turned to the audit committee since it is a viable mechanism to monitor corporate accountability.

**Private-Sector Initiatives**

**National Commission on Fraudulent Financial Reporting** One of the major guiding conclusions of the recommendations of the National Commission on Fraudulent Financial Reporting (NCFFR) was corporate accountability. The Commission stated:

> When a company raises funds from the public, that company assumes an obligation of public trust and a commensurate level of accountability to the public. If a company wishes access to the public capital and credit markets, it must accept and fulfill certain obligations necessary to protect the public interest. One of the most fundamental obligations of the public company is the full and fair public disclosure of corporate information, including financial results.

> The independent public accountant who audits the financial statements of a public company also has a public obligation. As the U.S. Supreme Court has recognized, when the independent public accountant opines on a public company’s financial statements, he assumes a public responsibility that transcends the contractual relationship...
with his client. The independent public accountant’s responsibility extends to the corporation’s stockholders, creditors, customers, and the rest of the investing public. The regulations and standards for auditing public companies must be adequate to safeguard that public trust and auditors must adhere to those standards.41

To promote corporate accountability, the NCFFR recommended that officers and directors set the tone at the top and focus on the internal control as well as develop and enforce codes of conduct to establish a proper behavioral and ethical environment. Such initiatives can help to strengthen communication and trust, which are needed to guard against fraudulent financial reporting.42

American Institute of Certified Public Accountants Recognizing the continuing debate over business failure versus audit failure and the general public’s misunderstanding of the independent audit process, in April 1988, the Auditing Standards Board (ASB) of the American Institute of Certified Public Accountants (AICPA) issued nine Statements on Auditing Standards (SAS) that focus on the “expectation gap”:

SAS No. 53  “The Auditor’s Responsibility to Detect and Report Errors and Irregularities” (SAS No. 82, “Consideration of Fraud in Financial Statement Audit,” supersedes SAS No. 53.)
SAS No. 54  “Illegal Acts by Clients”
SAS No. 55  “Consideration of the Internal Control Structure in a Financial Statement Audit”
SAS No. 56  “Analytical Procedures”
SAS No. 57  “Auditing Accounting Estimates”
SAS No. 58  “Reports on Audited Financial Statements”
SAS No. 59  “The Auditor’s Consideration of an Entity’s Ability to Continue as a Going Concern”
SAS No. 60  “Communication of Internal Control Structure Related Matters Noted in an Audit”
SAS No. 61  “Communication with Audit Committees”

The aforementioned auditing pronouncements are discussed in Chapter 5; however, it is clearly evident from their titles that the ASB’s objective was to enhance and strengthen the communication linkages between independent auditors and the board of directors through its audit committee. In turn, such pronouncements enable both independent auditors and boards to discharge their responsibilities for corporate accountability to the investing public.

42 See Appendix I on this book’s website.
The Public Oversight Board  Since 1977, the Public Oversight Board (POB) of the AICPA continues to have oversight responsibility for the Peer Review Program, which is administered by the SEC Practice Section. In addition, since 1979, the POB oversees the activities of the Quality Control Inquiry Committee, which is charged to review alleged audit failures. The chief accountant’s staff of the SEC periodically reviews and annually reports on the POB’s oversight activities related to the SEC Practice Section’s programs.

With respect to corporate governance and accountability, the POB points out:

In most corporations the responsibility for scrutiny of financial statements has been delegated by boards to their audit committees. The experience of the members of the Board indicates that in too many instances the audit committees do not perform their duties adequately and in many cases do not understand their responsibilities.43

In response, the POB recommended the following to audit committees and the SEC:

Recommendation V-9

Audit committees (or the board if there is no audit committee) should assume the following responsibilities relating to an SEC registrant’s preparation of annual financial statements: (a) review the annual financial statements; (b) confer with management and the independent auditor about them; (c) receive from the independent auditor all information that the auditor is required to communicate under auditing standards; (d) assess whether the financial statements are complete and consistent with information known to them; and (e) assess whether the financial statements reflect appropriate accounting principles.

Recommendation V-10

The SEC should require registrants to include in a document containing the annual financial statements a statement by the audit committee (or by the board if there is no audit committee) that describes its responsibilities and tells how they were discharged. This disclosure should state whether the audit committee members (or in the absence of an audit committee, the members of the board) (a) have reviewed the annual financial statements; (b) have conferred with management and the independent auditor about them; (c) have received from the independent auditor all information that the auditor is required to communicate under auditing standards; (d) believe that the financial statements are complete and consistent with information known to them; and (e) believe that the financial statements reflect appropriate accounting principles.44

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43Public Oversight Board, A Special Report by the Public Oversight Board of the SEC Practice Section (Stamford, CT: POB, 1993), p. 50.
44Ibid., pp. 51–52.
The Institute of Internal Auditors recognizes that audit committees and internal auditors have common goals. A good working relationship with internal auditors can assist the audit committee in fulfilling its responsibility to the board of directors, shareholders, and other outside parties. This position statement summarizes The Institute’s views concerning the appropriate relationship between audit committees and internal auditing. The Institute acknowledges that audit committee responsibilities encompass activities which are beyond the scope of this statement, and in no way intends it to be a comprehensive description of audit committee responsibilities.

Purpose

The Institute of Internal Auditors recommends that every public company have an audit committee organized as a standing committee of the board of directors. The Institute also encourages the establishment of audit committees in other organizations, including not-for-profit and governmental bodies. The audit committee should consist solely of outside directors, independent of management.

The primary responsibilities of the audit committee should involve assisting the board of directors in carrying out their responsibilities as they relate to the organization’s accounting policies, internal control and financial reporting practices. The audit committee should establish and maintain lines of communication between the board and the company’s independent auditors, internal auditors, and financial management.

The audit committee should expect internal auditing to examine and evaluate the adequacy and effectiveness of the organization’s system of internal control and the quality of performance in carrying out assigned responsibilities. Internal auditing may be used as a source of information to the audit committee on major frauds or irregularities as well as company compliance with laws and regulations.

To assure that internal auditors carry out their responsibilities, the audit committee should approve and periodically review the internal audit charter, a management-approved document which states internal audit’s purpose, authority, and responsibility. The audit committee should review annually the internal audit department’s objectives and goals, audit schedules, staffing plans, and financial budgets. The director of internal auditing should inform the audit committee of the results of audits, highlighting significant audit findings and recommendations. The audit committee should also determine whether internal audit activities are being carried out in accordance with the Standards for the Professional Practice of Internal Auditing, adopted by The Institute of Internal Auditors.
To help assure independence, the director of internal auditing should have direct communication with the audit committee. The director should attend audit committee meetings and meet privately with the audit committee at least annually. Independence is further enhanced when the audit committee concurs in the appointment or removal of the director of internal auditing.45

**American Law Institute**46 Since 1982, the American Law Institute (ALI) has issued 12 draft statements on the topic of corporate governance. Such draft statements and recommendations are from the proceedings of the ALI’s annual meetings. Over the years, the ALI has strongly supported and endorsed the concept of audit committee. A review of the tentative draft documents and ALI’s recommendations for audit committees clearly indicates that the legal profession echoes the position of the accounting profession. Both professions recognize that audit committees have a major role in corporate governance and accountability and in the financial reporting process.

**Canada**

With respect to public sector initiatives, Canada has mandated the establishment of audit committees for publicly held companies. This direct action was required initially on a provincial basis and, subsequently, on a national basis for federally chartered public companies. For example, the Ontario Business Corporation Act, in Section 182, requires that publicly held companies elect annually an audit committee (see Exhibit D.2.)

In June 1988, the Commission to Study the Public’s Expectation of Audits (the MacDonald Commission) issued its final report. Specifically, the Commission’s mission was to investigate:

> Where a gap exists between what the public expects or needs and what auditors can and should reasonably expect to accomplish, the Commission is charged to develop conclusions and recommendations to determine how the disparity should be resolved.47

Ultimately, the Commission issued 50 recommendations. With respect to corporate accountability, strengthening the audit environment, and audit committees, the Commission made these recommendations:

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The CICA [Canadian Institute of Chartered Accountants] should enlist the support of provincial institutes and other interested bodies in seeking legislative amendments that would require all public companies to have audit committees composed entirely of outside directors.

The CICA Auditing Standards Committee should provide guidance in the CICA Handbook to matters that should be raised by an auditor with an audit committee (or in the absence of an audit committee, with the board of directors) and to actions an auditor should take when not satisfied with the results of such communication. The guidance should stress the need for timeliness in communication.

The CICA and provincial institutes of chartered accountants should press for changes in the law to require that (1) boards of directors draw up and publish to the shareholders a formal statement of responsibilities assigned to the audit committee, (2) audit committees report annually to the shareholders on the manner in which they have fulfilled their mandate, and that (3) audit committees review both interim financial statements and annual financial statements before publication.\(^\text{48}\)

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\(^{48}\)Ibid., p. 139.
In the United Kingdom, there are no mandated requirements for audit committees. However, in May 1991, the Financial Reporting Council, the London Stock Exchange, and the accounting profession established the Committee on the Financial Aspects of Corporate Governance (Cadbury Committee). On December 1, 1992, the Committee issued its final report and a Code of Best Practice. The code contains four key areas: board of directors, nonexecutive directors, executive directors, and reporting and controls. Such areas help to engender a high degree of integrity in the financial reporting process and strengthen corporate accountability. The following are excerpts from the code:

There should be a clearly accepted division of responsibilities at the head of a company, which will ensure a balance of power and authority, such that no one individual has unfettered powers of decision. Where the chairman is also the chief executive, it is essential that there should be a strong and independent element on the board, with a recognized senior member.

Non-executive directors should bring an independent judgment to bear on issues of strategy, performance, resources, including key appointments, and standards of conduct.

Directors’ service contracts should not exceed three years without shareholders’ approval.

The board should establish an audit committee of at least three non-executive directors with written terms of reference which deal clearly with its authority and duties.\(^{49}\)

The Committee’s central recommendation is that the boards of all listed companies registered in the United Kingdom should comply with the code. The Committee encourages as many other companies as possible to aim at meeting its requirements:

The Committee also recommends:

(a) that listed companies reporting in respect of years ending after 30 June 1993 should make a statement in their report and accounts about their compliance with the Code and identify and give reasons for any areas of non-compliance;

(b) that companies’ statements of compliance should be reviewed by the auditors before publication. The review by the auditors should cover only those parts of the compliance statement which relate to provisions of the Code where compliance can be objectively verified.

The publication of a statement of compliance, reviewed by the auditors, is to be made a continuing obligation of listing by the London Stock Exchange.50

OTHER DEVELOPMENTS IN CORPORATE GOVERNANCE

During the latter half of the 1990s, several key organizations in both the private and public sectors have issued reports on how boards of directors can improve corporate accountability, responsibility, and governance. The recommendations and/or conclusions of these reports are briefly presented in order to help the audit committee effectively discharge its oversight responsibilities for the audit processes as well as the financial reporting process.

Public Oversight Board

At a January 1994 AICPA conference in Washington, D.C., Walter Schultze, former chief accountant of the Securities and Exchange Commission, indicated his concern for a growing lack of independence and objectivity of the auditing profession. In response, the POB decided to form an Advisory Panel on Auditor Independence, chaired by Donald J. Kirk, former chair of the Financial Accounting Standards Board. On September 13, 1994, the Advisory Panel issued its report entitled *Strengthening the Professionalism of the Independent Auditor*. With respect to the adoption of a corporate governance approach to improve financial reporting, the panel’s 10 principal conclusions were:

1. There is no need at this time for additional rules, regulations, or legislation dealing with the conflict-of-interest aspect of auditor independence. There are, however, important steps that should be taken in other ways to strengthen the professionalism of independent auditors.

2. Auditing is different from other services accounting firms render. It imposes special and higher responsibilities. Independent auditing firms, regulators, and overseers of the public accounting profession need to focus on how the audit function can be enhanced and not submerged in large multiline public accounting/management consulting firms.

3. The POB, the SEC, and others should support proposals to enhance the independence of boards of directors and their accountability to shareholders. Stronger, more accountable corporate boards of directors will strengthen the professionalism of the outside auditor, enhance the value of the independent audit, and serve the investing public.

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4. To increase the value of the independent audit, corporate boards of directors and their audit committees must hear independent auditors’ views as professional advisors on the appropriateness of the accounting principles used or proposed to be adopted by the company, the clarity of its financial disclosures, and the degree of aggressiveness or conservatism of the company’s accounting principles and underlying estimates.

5. The accounting profession should look to the representatives of the shareholders—the board of directors—as the client, not corporate management. Boards and auditors are, or should be, natural allies in protecting shareholder interests.

6. Auditors must assume the obligation to communicate qualitative judgments about accounting principles, disclosures, and estimates. By doing so, independent auditors can add to the effectiveness of boards of directors in monitoring corporate performance on behalf of shareholders and in assuring that shareholders receive relevant and reliable financial information about company performance and financial condition.

7. By making these suggestions to boards and auditors, the Panel’s objective is not to narrow the range of acceptable accounting practices (that may follow in due course) but to give directors a better basis for influencing corporate practices. These suggestions should also enhance the objectivity and strengthen the professionalism of the auditor.

8. Because they share the objective of providing the public with relevant and reliable financial information, the public accounting profession, the standard setters, and the SEC must have more cooperative, less adversarial relationships. CPA firms should be careful in how they communicate their views to the FASB, the SEC, their clients, and the public at large. The SEC should help identify accounting practice problems and look to the private sector standard setters to solve them. It should only be a standard setter of “last resort” and then only after appropriate due process.

9. It is urgent that the SEC take the lead in helping the profession to reduce exposure to unwarranted litigation. There are dangers, not just to the profession but to the investing public, if the current liability situation continues to drift without SEC leadership.

10. While tort reform is necessary, the other suggestions in this report can be considered separately from, and need not await, legislative action on litigation reform.

For the future, the Panel believes that the SEC and the POB should consider devoting resources to stay informed on a continuing basis about developments in the auditing profession and in the market for audit services. As described in this report, some of those developments could materially affect the viability of the independent audit as a private sector activity. By having the facts, the SEC and the POB will be in a position to anticipate and take appropriate steps to strengthen auditor professionalism.
In the fall of 1995, the POB issued a report entitled *Directors, Management, and Auditors—Allies in Protecting Shareholder Interests*. This report was a follow-up to the report of the Advisory Panel on Auditor Independence. To help boards of directors, audit committees, management, and independent auditors achieve a constructive relationship for both the audit and financial reporting processes, the POB recommended:

- **Responsibilities of Management**  “Financial management should assume an obligation to bring to the attention of both the independent auditor and audit committee the accounting implications of significant new transactions and policies while they are being contemplated, not after the fact or after financial information based on them has been released publicly. This is critical to an effective corporate governance approach to financial reporting.”

- **Responsibilities of the Independent Auditor**  “The auditor should express his or her views about the appropriateness, not just the acceptability, of the accounting principles and financial disclosure practices used or proposed to be adopted by the company and, particularly, about the degree of aggressiveness or conservatism of its accounting principles and underlying estimates and the relevance and reliability of the resulting information for investment, credit, and similar decisions.”

- **Responsibilities of Boards of Directors and Audit Committees**  “Boards of directors have a fiduciary responsibility to shareholders and others for reliable financial reports. To meet that responsibility they should be aware of the implications of alternative accounting principles for reporting significant transactions and events as well as the aggressiveness or conservatism of significant estimates. It is vital, therefore, that audit committees function effectively as the board’s primary contact with both financial management and the independent auditor.”

Additionally, the POB suggested that three steps are needed to further improve the credibility of financial reporting:

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52 Public Oversight Board, *Directors, Management, and Auditors-Allies in Protecting Shareholder Interests* (Stamford, CT: POB, 1995), pp. 3–5. For further discussion, see the recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees as indicated in Chapter 1, Exhibit 1.2.
The board of directors must recognize the primacy of its accountability to shareholders. The auditor must look to the board of directors as the client. The board, and its audit committee, must expect and the auditor must deliver candid communication about the quality of the company’s financial reporting.

With respect to ways for audit committees to implement these suggestions, the POB prescribed the following steps to ensure that their charter or terms of reference are sufficient and adequate:

- An instruction to the independent auditor that the board of directors, as the shareholders’ representative, is the auditor’s client.
- An expectation that financial management and the independent auditor perform a timely analysis of significant financial reporting issues and practices.
- An expectation that financial management and the independent auditor discuss with the audit committee their qualitative judgments about the appropriateness, not just the acceptability, of accounting principles and financial disclosure practices used or proposed to be adopted by the company and, particularly, about the degree of aggressiveness or conservatism of its accounting principles and underlying estimates.
- An opportunity for the independent auditor to be available to the full board of directors at least annually to help provide a basis for the board to recommend to shareholders the appointment of the auditor or ratification of the board’s selection of the auditor.

The audit committee discussion with the independent auditor about the appropriateness of accounting principles and financial disclosure practices should generally include:

- the auditor’s independent qualitative judgments about the appropriateness, not just the acceptability, of the accounting principles and the clarity of the financial disclosure practices used or proposed to be adopted by the company
- the auditor’s views about whether management’s choices of accounting principles are conservative, moderate, or extreme from the perspective of income, asset, and liability recognition, and whether those principles are common practices or are minority practices
- the auditor’s reasoning in determining the appropriateness of changes in accounting principles and disclosure practices
- the auditor’s reasoning in determining the appropriateness of the accounting principles and disclosure practices adopted by management for new transactions or events

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53Ibid., p. 6.
• the auditor’s reasoning in accepting or questioning significant estimates made by management
• the auditor’s views about how the company’s choices of accounting principles and disclosure practices may affect shareholders and public views and attitudes about the company.  

GENERAL ACCOUNTING OFFICE

In September 1996, the General Accounting Office (GAO) issued a report entitled The Accounting Profession—Major Issues: Progress and Concerns. While the GAO found that the accounting profession’s self-regulation program for strengthening the audit process had responded well to the recommendations by the POB, it identified continuing major issues, such as auditor independence, fraud detection, improvement in audit quality, accounting and auditing standard setting, the financial reporting model, and the impact of growing business complexity on the traditional audit function.

With respect to the subject of corporate governance and auditor independence, the GAO’s principal findings are:

The independence of public accountants—both in fact and appearance—is crucial to the credibility of financial reporting and, in turn, the capital formation process. Various study groups over the past 20 years have considered the independence and objectivity of auditors as questions have arisen from (1) significant litigation involving auditors, (2) the auditor’s performance of consulting services for audit clients, (3) “opinion shopping” by clients, and (4) reports of accountants advocating questionable client positions on accounting matters.

The accounting profession recognizes the importance of auditor independence and has taken various steps to strengthen independence. For example, the profession revised its code of ethics to help ensure auditor independence and objectivity and adopted a code of professional conduct to govern the acceptance of consulting services and/or other activities that may be perceived as creating conflicts of interest. In addition, AICPA members are now required to report annually to the client’s audit committee the total fees received for management consulting services during the year under audit and a description of the types of such services rendered. Further, auditing standards require auditors to inform the audit committee of matters such as disagreements with management, consultations with other accountants, and difficulties encountered in performing the audit. The standards also require auditors to report to the audit committee internal control weaknesses that could adversely affect the client’s ability to safeguard assets and to produce reliable financial statements.

Others have also acted to strengthen auditor independence. For example, the SEC requires disclosures when an auditor resigns or is dismissed from an audit in order to discourage the practice of changing auditors to obtain a more favorable accounting

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54Ibid., p. 6.
treatment. In 1991, the Congress enacted the Federal Deposit Insurance Corporation Improvement Act (FDICIA), which includes requirements for independent audit committees in large banks and savings and loans, such as matters they should discuss with the independent auditor, and also sets audit committee membership requirements for the largest of the institutions. In 1995, the Congress enacted the Private Securities Litigation Reform Act of 1995, which codifies the auditor’s responsibility for reporting illegal acts to audit committees and requires, in certain circumstances, auditors to report illegal acts to regulators.

Despite actions taken by the accounting profession and others to strengthen auditor independence, concerns remain. In 1992 and again in 1994, the SEC Chief Accountant questioned the independence of accounting firms in situations in which they condoned or advocated what he questioned as inappropriate interpretations of accounting standards to benefit their clients. In addition, study groups have expressed concern that the growth of consulting services, relative to a static level of auditing and accounting services, could be perceived as lessening the objectivity of the auditor.

Both the accounting profession and the SEC have been active in examining continuing auditor independence concerns. They have found there is no conclusive evidence that providing traditional management consulting services compromises auditor independence. Further, they believe that such services not only benefit the client, but ultimately benefit investors and other interested parties. GAO believes measures that would limit auditor services or mandate changing auditors at set intervals are outweighed by the value of continuity in conducting audits and the value of traditional consulting services. However, GAO also believes that questions of auditor independence will probably continue as long as the existing auditor/client relationship continues. This concern over auditor independence may become larger as accounting firms move to provide new services that go beyond traditional services. The accounting profession needs to be attentive to the concerns over independence in considering the appropriateness of new services to ensure that independence is not impaired and the auditor’s traditional values of being objective and skeptical are not diminished.

GAO supports a recent proposal by the AICPA’s Public Oversight Board to bring the independent auditor into a more direct working relationship with the board of directors. The proposal also emphasizes the role of the independent audit committee as an overseer of the company’s financial reporting process, a buffer between management and the auditor, and a representative of user interests. Such a change is inherently difficult to accomplish. Further, the change may not happen voluntarily since a GAO survey of Fortune Industrial 500 and Fortune Service 500 companies showed that audit committee chairmen appear satisfied with their present relationship with the independent auditor. The fear of litigation by boards of directors and audit committees is another barrier to voluntarily changing auditor/client relationships and the perceived increase in their responsibilities that may result. Although the recently enacted Private Securities Litigation Reform Act of 1995 provides some liability relief and requires reporting on certain matters that could involve directors and auditors, the Act does not fundamentally address existing working relationships between auditors and boards of directors or audit committees.
As an alternative to voluntary action, the SEC, which has the responsibility and authority under securities laws to ensure that accountants who audit companies registered with the SEC are independent, could more clearly define the roles of boards of directors and audit committees as they relate to the independent auditor. The SEC has been reluctant to exercise authority in matters of corporate governance and may want to seek legislation expressly authorizing the SEC to act in this area. For example, the SEC could seek legislation containing audit committee requirements such as those in FDICIA. Although FDICIA-type requirements do not establish a formal relationship between the auditor and the audit committee, they would be an improvement over the current situation. Such requirements could specify certain audit committee qualifications and basic responsibilities regarding reviewing with the auditors the reports on financial statements, internal controls, and compliance with laws and regulations. An independent and knowledgeable audit committee as envisioned by FDICIA would enhance the effectiveness of having the auditor report directly to the audit committee.

As another alternative, the SEC could work through the major stock exchanges to achieve listing requirements that would more specifically define audit committee duties and responsibilities and their relationships with the independent auditor. The listing agreements of the major stock exchanges already require members to have audit committees, so the basic principle has been established. Such an approach by the stock exchanges, backed by the SEC, would not require legislation.

AICPA SEC PRACTICE SECTION

In addition to the previous POB initiatives and the aforementioned GAO report, in 1997 the Best Practices Task Force of the SEC Practice Section Peer Review Committee of the AICPA issued its report entitled *Best Practices—Accounting Consultations, Communications with Board of Director/Audit Committees, Communications with the SEC Staff*. With respect to the best practices in Communications with Board of Directors/Audit Committees in 1996, the task force conducted a survey of the practices of a sample of peer-reviewed firms to address the POB Advisory Panel’s recommendations. As a result of the survey, the SEC Practice Section disseminated to all member firms this recommended guidance:

- Establish policies and procedures within the firm related to communications with boards/audit committees. Discuss such policies and procedures with members of the professional staff to enhance their understanding of the issues and to reemphasize the firm’s commitment to client service. The information that follows may be used as a guide in establishing or evaluating the firm’s policies and procedures in this area. It also may be useful in strengthening the relationships between

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firms and their clients’ boards/audit committees so that the relationships best serve the needs of those clients and their shareholders.

• Establish a framework for the development of relationships that stresses open and candid conversation between the auditor and the boards/audit committees and allows the boards to fulfill their responsibilities to their shareholders. These discussions also may serve to facilitate a board’s/audit committee’s redefinition or determination of their respective roles. Provide a copy of an initiate a discussion with the board/audit committee about the recommendations in the POB Panel’s report. Also, providing a copy of and discussing the POB Panel’s report with members of senior management reemphasize the auditor’s role in facilitating the board’s responsibility to their shareholders and serve to enhance the auditor’s relationship with management. It may also serve to facilitate a working partnership between the board/audit committee, senior management and the auditor. Providing firm literature to boards/audit committees relative to the role of the board/audit committee also may be useful.

• Discuss with boards/audit committees the appropriateness and acceptability of the accounting principles and the clarity of the Company’s financial statement disclosures. Discussions with boards/audit committees would typically include the auditor’s judgments regarding the reasonableness of management’s estimates included in the Company’s financial statements and the auditor’s judgments regarding recently issued accounting principles and/or financial statement disclosures. Hold such discussions with management first to ensure that the auditor has a clear and comprehensive understanding of management’s rationale for determining the appropriateness of the Company’s accounting principles and financial statement disclosures and estimates.

• Consider involving a concurring or second partner and/or a consultation partner in discussions regarding issues relative to the Company before meeting with the audit committee.

• To enhance the efficiency and effectiveness of the audit process, conduct discussions regarding the appropriateness and acceptability of accounting principles, the clarity of financial statement disclosures, and the reasonableness of management’s estimates in advance of the Company’s year end. A timely discussion allows boards to analyze management’s estimates, accounting principles and key financial disclosures along with the auditor’s assessment of the acceptability and appropriateness of those estimates, accounting principles and financial statement disclosures and to make appropriate changes to a Company’s financial statements before they are finalized. Consider incorporating these discussions into the agenda for the annual audit planning meeting with boards/audit committees. Coordinate a final discussion with boards/audit committees at the conclusion of the engagement, in conjunction with communications required under generally accepted auditing standards.

• Establish a regular meeting schedule with boards/audit committees and management to discuss issues relative to a Company, including those noted above. Hold
face-to-face discussions with the boards/audit committees at least once a year. Consider communications with the boards/audit committees on a quarterly basis, especially for clients with quarterly reporting requirements. Regular meetings facilitate communication and understanding regarding the expectations of the boards/audit committees of the auditors and an auditor’s expectation of boards/audit committees.

- During the proposal process with prospective clients, discuss the POB Panel’s report and the firm’s commitment to the establishment of a sound working relationship with the board/audit committee.56

INDEPENDENCE STANDARDS BOARD

In May 1997, the SEC and the AICPA announced the establishment of the Independence Standards Board (ISB) to set independence standards for auditors of public companies. In February 1998, the SEC formally recognized the ISB. The ISB was established in response to the belief that the accounting profession’s AICPA Code of Professional Conduct and the SEC independence regulations were not adequate to deal with auditor independence questions in a rapidly changing business environment along with the independent accounting firms’ new service areas. Thus the major objective of this joint effort is to replace the current case-driven system of adopting independence rules with a principles-based system.

The ISB has eight members (four public and four professional) who serve on a part-time basis. In addition, the ISB has a nine-member Independence Issues Committee (IIC). Either the ISB or the IIC may identify and address inquiries related to emerging independence issues. Also, the ISB or the IIC does not alter or replace the AICPA’s Code of Professional Conduct.

According to the AICPA’s White Paper, which was submitted to the ISB on October 20, 1997, the ISB would adopt this approach:

The proposed new conceptual framework is based on the enforced self-regulation model and reflects the economic and other determinants of auditor independence. For purposes of the new framework, independence would be defined as an absence of interests that create an unacceptable risk of bias with respect to the quality or context of information that is the subject of an audit engagement. Consistent with this definition, the ISB would adopt core principles of independence, promulgate guidelines on how those principles would be applied to situations that raise a threat to independence, identify appropriate types of safeguards and require firms to draft independence codes implementing the system, subject to ISB review. The SEC, the AICPA and state boards of accountancy would retain appropriate oversight and enforcement roles.

Under the new framework, the ISB would adopt the following core principles, which reflect a broad consensus of views within the profession regarding the primary considerations bearing on auditor independence:

• Auditors and firms should not be financially dependent upon an audit client;

• Auditors and firms should not have conflicting interests that would impair their objectivity with regard to matters affecting the financial statements; and,

• Auditors and firms should not have relationships with, or engage in activities for, clients that would entail making managerial decisions or otherwise serve to impair an auditor’s objectivity.57

In May 1998, the ISB had proposed that the AICPA SEC Practice Section adopt a new membership requirement directing auditors to issue an annual independence confirmation under the rules created by the ISB, SEC, and AICPA. Such a report would be issued to the client company’s audits committee (or board of directors).58 In January 1999, ISB issued ISB Standard No. 1, “Independence Discussions with Audit Committees.” The new requirement is effective for audits of public companies with fiscal years ending after July 15, 1999, with earlier adoption permitted. (Visit the ISB web site, www.cpaIndependence.org.)

NATIONAL ASSOCIATION OF CORPORATE DIRECTORS

In September 1996, the National Association of Corporate Directors (NACD) issued the Report of the NACD Blue Ribbon Commission on Director Professionalism. Recognizing that the board of directors is the centerpiece of corporate governance, the Commission described and endorsed key elements of professionalism for board members and for boards. The Commission concluded that:

A professional boardroom culture requires that the governance process be collectively determined by individual board members who:

• are independent of management

• are persons of integrity and diligence who make the necessary commitment of time and energy

• recognize that the board has a function independent of management and explicitly agree on that function, and

• are capable of performing that function as a group, combining diverse skills, perspectives, and experiences.59

58For further discussion, see Invitation to Comment, “Proposed Recommendation to the Executive Committee of the SEC Practice Section of the American Institute of Certified Public Accountants” (New York: ISB, May 29, 1998).
To meet the goals of director professionalism, the Commission set forth these conclusions:

1. **Responsibilities: What Boards Should Do.** Pursuant to the board’s broadly defined powers under state law, each board has the authority to determine its own specific role and responsibilities within the corporation. In consultation with the CEO, the board should clearly define its role, considering both its legal responsibilities to shareholders and the needs of other constituencies, provided shareholders are not disadvantaged.

2. **Processes: How Boards Should Fulfill Their Responsibilities.** The board is responsible for determining its own governance processes. In determining such processes a board should:
   - establish an independent governance committee
   - create independent leadership roles for directors
   - determine the method for the board’s participation in setting board and committee agendas
   - determine the method for selecting and compensating directors and the CEO
   - determine a level and timetable for stock ownership required for each director
   - establish an effective and independent method for periodically evaluating the CEO, the board, and individual directors
   - adopt a policy of holding regular executive sessions without management present, and
   - take a role in selecting advisors to the board, directly retaining those advising the board alone.

3. **Selection: Who Directors Should Be.** Director selection should be based on the personal qualities sought in all directors and the core competencies the board needs as a whole. Each director should exhibit:
   - integrity and accountability
   - informed judgment
   - financial literacy
   - mature confidence, and
   - high performance standards.

Areas of core competence that should be represented on the board as a whole include:

- accounting and finance
- business judgment
- management
- crisis response
- industry knowledge
- international markets
- leadership, and
- strategic vision.

Most importantly, the board should:

- have a substantial majority of independent directors
- develop its own definition of independence, and
• seek disclosure of any relationships that would appear to compromise director independence.

In selecting members, the board must assure itself of their commitment to:

• learn the business of the company and the board
• meet the company’s stock ownership requirements
• offer to resign on change of employment or professional responsibilities, or under other specified conditions, and
• importantly, devote the necessary time and effort.

In this regard, the board should consider guidelines that limit the number of positions on other boards, subject to individual exceptions—for example, for CEOs and senior executives, one or two; for others fully employed, three or four; and for all others, five or six.

With these characteristics, competencies, and commitments in mind, consideration should also include:

• balance of director contributions
• director diversity, and
• company status.

4. Evaluation: How Boards and Directors Should Be Judged. Board effectiveness and credibility depend in part on regular self-evaluation of both the board as a whole and its individual members. The evaluation process should be:

• controlled by the independent directors themselves
• aligned with established evaluation processes and goals
• tailored to meet the needs of the individual company and board
• designed to ensure candor, confidentiality, and trust
• regularly reviewed and improved as necessary, and
• disclosed (process only) to shareholders and the public.

Evaluation of board performance should include consideration of the execution of general board responsibilities as well as:

• delineation of board and management powers
• effective interaction between and among directors, and
• director education and development.

Evaluation of individual director performance should include consideration of the execution of specific board responsibilities as well as:

• personal characteristics, and
• core competencies.

Additional consideration should be given to:

• varying roles for directors, and
• means for removing under-performing directors, if necessary.60

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60Ibid., pp. 21–23.
In September 1997, the Business Roundtable issued a white paper, *Statement on Corporate Governance*. As previously noted, the Business Roundtable described corporate accountability in its statement on *Corporate Governance and American Competitiveness* (1990). The Business Roundtable summarizes its current views as follows:

The Business Roundtable wishes to emphasize that the principal objective of a business enterprise is to generate economic returns to its owners. Although the link between the forms of governance and economic performance is debated, The Business Roundtable believes that good corporate governance practices provide an important framework for a timely response by a corporation’s board of directors to situations that may directly affect stockholder value. The absence of good corporate governance, even in a corporation that is performing well financially, may imply vulnerability for stockholders because the corporation is not optimally positioned to deal with financial or management challenges that may arise.

Many discussions of corporate governance focus on questions of form and abstract principle: Should a corporation have a non-executive chairman of the board? Should the board have a lead director? Should there be a limit on the number of boards on which a director serves? The Business Roundtable considers such questions important. Indeed, much of this Statement is devoted to discussing them. However, The Business Roundtable wishes to emphasize that the substance of good corporate governance is more important than its form; adoption of a set of rules or principles or of any particular practice or policy is not a substitute for, and does not itself assure, good corporate governance.

Examples of this point abound. A corporation with the best formal policies and processes for board involvement may be at risk if the chief executive officer is not genuinely receptive to relevant board input or if knowledgeable directors hesitate to express their views. A corporation can have excellent corporate governance structures and policies on paper, but if the CEO and the directors are not focused on stockholder value, it may be less likely the corporation will realize that value. Directors can satisfy the most demanding tests for independence, but if they do not have the personal stature and self-confidence to stand up to a non-performing CEO, the corporation may not be successful. On the other hand, a corporation that lacks many of the so-called “best practices” for corporate governance, or that does not memorialize its practices in formal documents, may nonetheless perform well if its directors and management are highly able people who are dedicated to advancing the interests of stockholders.

One of the reasons why people focus on the formal, structural aspects of corporate governance is that doing so permits evaluations that appear to be objective and verifiable. Formal attributes of good corporate governance can be tabulated to compare corporate governance practices across the spectrum of companies. Such comparisons do have value, but it would be a mistake to lose sight of their limitations. The “soft,” subjective factors in corporate governance—such as the quality of directors
and the personalities of CEOs and directors—receive less attention from scholars and journalists but are critical in the real world of corporate behavior. Boards and management should not feel that they have discharged their responsibilities in regard to corporate governance just by putting in place a particular set of structures and formal processes. They must also periodically review these structures and processes to insure that they are achieving good corporate governance in substance.

Corporate governance is not an abstract goal, but exists to serve corporate purposes by providing a structure within which stockholders, directors and management can pursue most effectively the objectives of the corporation. There has been much debate in corporate governance literature about the parties to whom directors owe a duty of loyalty and in whose interest the corporation should be managed. Some say corporations should be managed purely in the interests of stockholders or, more precisely, in the interests of its present and future stockholders over the long-term. Others claim that directors should also take into account the interests of other “stakeholders” such as employees, customers, suppliers, creditors and the community.

The Business Roundtable does not view these two positions as being in conflict, but it sees a need for clarification of the relationship between these two perspectives. It is in the long-term interests of stockholders for a corporation to treat its employees well, to serve its customers well, to encourage its suppliers to continue to supply it, to honor its debts, and to have a reputation for civic responsibility. Thus, to manage the corporation in the long-term interests of the stockholders, management and the board of directors must take into account the interests of the corporation’s other stakeholders. Indeed, a number of states have enacted statutes that specifically authorize directors to take into account the interests of constituencies other than stockholders, and a very limited number of state statutes actually require consideration of the interests of other constituencies.

In The Business Roundtable’s view, the paramount duty of management and of boards of directors is to the corporation’s stockholders; the interests of other stakeholders are relevant as a derivative of the duty to stockholders. The notion that the board must somehow balance the interests of stockholders against the interests of other stakeholders fundamentally misconstrues the role of directors. It is, moreover, an unworkable notion because it would leave the board with no criterion for resolving conflicts between interests of stockholders and of other stakeholders or among different groups of stakeholders.

While The Business Roundtable favors certain broad principles as generally contributing to good corporate governance, not all of these broad principles are necessarily right for all corporations at all times. Good corporate governance is not a “one size fits all” proposition, and a wide diversity of approaches to corporate governance should be expected and is entirely appropriate. Moreover, a corporation’s practices will evolve as it adapts to changing situations.\(^61\)

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Sources and Suggested Readings


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