Part One

Getting Acquainted with Your Responsibilities

Chapter 1

Corporate Accountability

Focus on the Audit Committee

Audit committee responsibilities have increased significantly in recent years because of the uncertainties arising from (1) a changing statutory, regulatory, legal, and risk environment for corporations, directors and officers; and (2) the accounting and auditing substance of audit committees' jobs. Certain questions are sure to concern audit committee members and those considering audit committee membership. How can I tell if the company has complied with the spirit and letter of new regulations? Am I going to be second-guessed by someone outside the company for my best efforts? Will that second-guess expose me to legal liability or personal embarrassment? How can I satisfy all these new responsibilities in a few meetings a year? How can the company best comply with myriad regulations while managing costs and maintaining a business focus rather than one of compliance? The purpose of this handbook is to help form responses to such questions.

Sections 205 and 301 of the Sarbanes-Oxley Act of 2002 establish three fundamental roles for audit committees. First, they have oversight responsibility for the accounting and financial reporting processes of the company and for its financial statement audits. Second, they are responsible for appointing, compensating, and overseeing the external auditor. Third, they must establish procedures for "receipt, retention, and treatment of complaints" about accounting, internal control, or auditing matters and for "the confidential, anonymous submission by employees" regarding questionable accounting or auditing issues. In the aftermath of the various regulatory activities that were initiated by Sarbanes-Oxley, audit committees also have responsibility, as part of exchange listing requirements, for ensuring that the company has appropriate systems in place for the effective monitoring and management of risk. Unlike the first three responsibilities, this last one is not necessarily one that must be fulfilled by the audit committee itself. Rather, the intent of the stock exchange listing rules is for the audit committee to ensure that the board has adequately addressed this important issue.

In essence, the audit committee's role is to stand objectively between management, the external auditors, and capital providers—creditors, investors, owners, or donors—to ensure that they receive complete, timely, and accurate financial information that has been subjected to the appropriate, but not excessive, level of scrutiny, both internally and by an external auditor. Audit committees accomplish this goal by focusing on five key areas:

1. Appropriate accounting skills in management
2. Internal control oversight
3. External auditor oversight
4. Adequate resources for the committee's functions
5. Understanding the economics behind every transaction

APPROPRIATE ACCOUNTING SKILLS

The need has never been greater for organizations to hire or engage individuals who have accounting skills that are commensurate with the complexity and scope of their business. Most companies continuously accelerate their business transactions to increase their number and to extend them to new markets, whether domestically or abroad, but increasingly in foreign countries. The flow of business information coming from these innovations continues to grow in quantity and speed. Similarly, the complexity and extent of accounting and financial reporting expands to accommodate increasingly creative business transactions. Because every organization that depends on external capital must exercise diligence in accounting for and reporting its financial information, the right personnel with the right skills and the right authority must be in the right positions.

Management is responsible for making sure the company has the right people with the proper accounting and financial reporting skills, and the commitment to apply them with integrity. The audit committee's job is to make certain that management is doing its job. Audit committees can begin to assess management's job by understanding the accounting complexities and challenges that arise because of their company's industry, geography, or business practices. The next step is to gain assurance about the quality and adequacy of the related knowledge and skills. For example, revenue recognition in the software industry is highly complex. A reasonable question for an audit committee in this industry is whether the company has people with the knowledge, skills, experience, training, and authority to account properly for software revenue.

Internal audit can help audit committees by continuously providing an objective assessment of the state of the necessary accounting skills. External auditors' assessments also may be helpful to an audit committee in fulfilling its oversight responsibilities. Audit committees may find value in listing complex and high-risk financial reporting areas such as revenue recognition, cost capitalization, structured transactions like derivatives and other financial instruments measured at fair value, and accounts based on significant judgments like reserves and asset retirement obligations. Geographic issues may involve the use of international financial reporting standards (IFRS), transfer pricing, and other tax-related issues. Whatever the issues may be, once they are identified it becomes much easier to assess whether the organization has the appropriate expertise to manage them appropriately.

INTERNAL CONTROL OVERSIGHT

Just as an organization cannot produce reliable services or products without good controls over service delivery or manufacturing processes, it cannot produce consistently reliable financial statements without good internal control over financial reporting.

Management should have a basis for knowing whether its financial reporting processes are working properly. Having a general conviction without persuasive evidence is inadequate. ‘‘We have good people and have not had a problem in the past’’ is a phrase repeated by managements and audit committees in almost all accounting restatements, whether the restatements result from errors or fraud.

Well-run organizations establish controls to manage and mitigate risks. They also establish proper oversight and monitoring functions, because systems deteriorate over time. Internal control monitoring, and ways of determining its effectiveness, should be part of the DNA of the organization. While not every risk and control requires equal monitoring, management should do all of the following:

1. Know the financial reporting risks and have methods for prioritizing them and identifying changes over time
2. Know what controls are in place to manage and mitigate those risks that are critical to the organization’s objectives
3. Implement monitoring procedures that provide persuasive and timely assessments of the effectiveness of those controls

The audit committee’s job is to make sure that management performs these three tasks routinely and effectively. Asking the right questions of management and probing their answers for reasonableness is an effective approach to ensuring proper internal control. Here are some questions to consider:

- How does management identify and prioritize financial reporting risks?
- How often is this analysis updated for changes?
- Do the procedures and outcomes reasonably match the organization’s structure and operations?
- Does management involve the appropriate people?
- What controls are focused on the most critical aspects of the financial reporting process?
- How does management determine whether controls are working?
- Does management listen to critical viewpoints?

These are good questions for all organizations’ audit committees—public or private, for-profit or not-for-profit.

Monitoring is such an important part of internal control that the Committee of Sponsoring Organizations (COSO)—a body recognized internationally for its internal control framework—has devoted itself to monitoring an entire series of guidance, applications, and examples.[1] COSO's monitoring guidance draws on two fundamental principles of the COSO Integrated Framework for Internal Control:

1. Ongoing and/or separate evaluations enable management to determine whether the other components of internal control continue to function over time.
2. Internal control deficiencies are identified and communicated in a timely manner to those parties responsible for taking corrective action, and to management and the board as appropriate.

The monitoring guidance develops three broad elements for achieving these principles:

1. Establishing a foundation for monitoring, which includes:
   - A proper tone at the top
   - An effective organizational structure that assigns monitoring roles to people with appropriate capabilities, objectivity, and authority
   - A starting point or "baseline" of known effective internal control from which ongoing monitoring and separate evaluations can be implemented
2. Designing and executing monitoring procedures that:
   - Are focused on persuasive information
   - Are about the operation of key controls
   - Address meaningful risks to organizational objectives
3. Assessing and reporting results, which includes:
   - Evaluating the severity of any identified deficiencies
   - Reporting the monitoring results to the appropriate personnel and the board for timely action and follow-up if needed

See Chapter 8 for further discussion of internal control monitoring and COSO's related guidance.

AUDITOR OVERSIGHT

Two aspects of the audit committee's responsibility for oversight of the external auditor are paramount. First, the audit committee should determine whether the auditors have the capability and commitment to address properly the areas of greatest financial reporting risk. Once the audit committee has established its assessment of financial reporting risk, it needs to make certain that its auditors

[1] See COSO's Guidance on Monitoring Internal Control Systems (2009). Available at www.coso.org/guidance.htm.

have the characteristics that match up well. These characteristics usually come down to whether the auditor has the following capabilities:

- Sufficient technical knowledge of accounting and the company's industry to be able to handle the transactions inherent in the company's business
- The capacity to handle the company's accounting issues on a timely basis
- A service delivery model that matches well with the company's needs
- The geographical presence to handle the company's operations

Audit committees can get a good idea of different auditors' capabilities through interviews and interactions with auditors during the proposal process.

The second aspect is somewhat more intangible, relating to whether the audit committee can count on the auditors to have the integrity and fortitude to be frank and honest about their assessments of organizational processes, skills, and attitudes related to financial reporting. Such strength of character is especially important if management executives have aggressive personalities or management styles. The audit committee should be confident about the auditors' commitment to tell them the truth, the whole truth, and nothing but the truth. This confidence should extend beyond the individuals on the audit engagement to the reputation and support systems internal to the audit firm. One way to obtain specific impressions about the auditors' capabilities and commitment to integrity is to ask them challenging, open-ended questions about the organization, its policies, the management team, internal control, accounting knowledge and skills, and then gauge the frankness of their responses. Such discussions are most effective when conducted privately with the auditors, but every audit committee should know whether their auditors are willing to tell management the hard truth just as they will tell the audit committee.

Reviewing audit plans, monitoring cost effectiveness, and evaluating the auditors' reports are other important aspects of auditor oversight, but all such activities fall appropriately into place only if the auditors have the right people on the engagement team, the right internal support system for those people, and the integrity to stand up for what is right.

AUDIT COMMITTEE RESOURCES

To meet its oversight responsibilities, the audit committee needs adequate resources, which typically come from the knowledge, skills, and time of individual audit committee members, internal audit personnel, external auditors, and other experts engaged independently of management.

Audit committees also depend on the active support and engagement of management in fulfilling their duties. It's not enough to have high-quality people on audit committees devoting time and energy to understanding the organization's operations and financial reporting risk. Audit committees need the raw materials for their work, which consist of financial and other information provided far enough in advance of meetings for members' appropriate review and development of questions or concerns.

Audit committee members may also need to observe certain operations or accounting systems, especially those related to areas of high financial reporting risk. To that end, an appropriately staffed, supervised, and autonomous internal audit function can be of great assistance to audit committees by becoming their eyes, ears, arms, and legs. As organizations grow in size or complexity, the relationship between the audit committee and the internal audit group becomes increasingly important.

Audit committees also can follow up on areas of concern raised by the external auditors. The external auditors' independence requirements prohibit them from becoming a part of the organization's internal control, but their observations can be the springboard for further work by internal audit, management, the audit committee or board, or other experts. Because external auditors operate on a sampling basis, they cannot test every transaction (doing so would not be practical). Accordingly, while professional standards require auditors to report problems that they find, audit committees should be aware that the auditor may not identify every problem.

Audit committees also can hire subject matter experts or other counselors where specialized skills may be required, such as in accounting for acquisitions, asset impairments, fair value measurements, intangibles, derivatives, and complex financial instruments.

TRANSACTIONAL ECONOMICS

The proper accounting for a transaction depends heavily on understanding the transaction's economic consequences to the organization. From both a financial reporting and an economic perspective, high-risk transactions include complex derivatives, sale-leaseback agreements of assets unrelated to the organization's core activities, and contracts or agreements in locations where the organization normally does not do business. Management is responsible for understanding and communicating the business purpose and economic outcomes of every significant transaction. The audit committee must be confident that management and those responsible for recording transactions understand the underlying economics. Management's responses to probing questions about the business purpose, expected cash flows, and anticipated risks associated with transactions can help an audit committee gauge whether management is fulfilling its responsibilities in this area.

THE NATURE AND IMPORTANCE OF CORPORATE ACCOUNTABILITY

The Meaning of Corporate Accountability

The concept of corporate accountability may be stated in this way:

> The board of directors is charged with safeguarding and advancing the interest of the stockholders, acting as their representatives in establishing corporate policies, and

reviewing management's execution of those policies. Accordingly, the directors have a fiduciary responsibility to the stockholders. They have an obligation to inform themselves about the company's affairs and to act diligently and capably in fulfilling their responsibilities.[2]

The Business Roundtable has described corporate accountability as follows:

> The board of directors is ultimately accountable to the shareholders for the long-term successful economic performance of the corporation consistent with its underlying public purpose. Directors are held accountable for their performance in a variety of ways.
>
> First, there is the powerful accountability imposed by markets. The impact of consumer dissatisfaction with products and services is quick and visible. Financial markets also quickly reflect their evaluation of the quality of accountability through the price of equity and debt.
>
> Accountability is also imposed through the numerous statutes and regulations enacted by governmental bodies to limit and control corporate action. Directors are held accountable to regulatory mechanisms.
>
> There is also a body of law—part statutory, part court-made—which defines the duties of directors and the principles and boundaries within which they must keep their decisions. If they overstep, their decisions are subject to reversal by the courts. Directors can also be held personally liable, without limitation, to the extent of their personal assets if they violate their duty of loyalty to the corporation.
>
> A final form of board accountability comes through the election of directors by the shareholders at the corporation's annual meeting. Annual meetings may also include shareholder resolutions which are a form of governance by referendum.
>
> Each of these forms of accountability is dynamic, not static. The developing specifics of each form of accountability must be judged as to its overall potential to contribute to the successful long-term performance of the corporation. Each specific new item of accountability carries with it the potential for harm as well as good.[3]

More recently, the Business Roundtable has restated its guiding principles of corporate governance:

> First, the paramount duty of the board of directors of a public corporation is to select a chief executive officer and to oversee the CEO and other senior management in the competent and ethical operation of the corporation on a day-to-day basis.
>
> Second, it is the responsibility of management to operate the corporation in an effective and ethical manner in order to produce value for stockholders. Senior management is expected to know how the corporation earns its income and what risks the corporation is undertaking in the course of carrying out its business.

[2] American Institute of Certified Public Accountants, *Audit Committees, Answers to Typical Questions about Their Organization and Operations* (New York: AICPA, 1978), 7.
[3] Business Roundtable, *Corporate Governance and American Competitiveness* (New York: Business Roundtable, 1990), 15–16.

> Management should never put personal interests ahead of or in conflict with the interests of the corporation.
>
> Third, it is the responsibility of management, under the oversight of the board and its audit committee, to produce financial statements that fairly present the financial condition and results of operations of the corporation, and to make the timely disclosures investors need to permit them to assess the financial and business soundness and risks of the corporation.
>
> Fourth, it is the responsibility of the board and its audit committee to engage an independent accounting firm to audit the financial statements prepared by management and to issue an opinion on those statements based on Generally Accepted Accounting Principles. The board, its audit committee, and management must be vigilant to ensure that no actions are taken by the corporation or its employees that compromise the independence of the outside auditor.
>
> Fifth, it is the responsibility of the independent accounting firm to ensure that it is in fact independent, is without conflicts of interest, employs highly competent staff, and carries out its work in accordance with Generally Accepted Auditing Standards. It is also the responsibility of the independent accounting firm to inform the board, through the audit committee, of any concerns the auditor may have about the appropriateness or quality of significant accounting treatments, business transactions that affect the fair presentation of the corporation's financial condition and results of operations, and weaknesses in internal control systems. The auditor should do so in a forthright manner and on a timely basis, whether or not management has also communicated with the board or the audit committee on these matters.
>
> Sixth, the corporation has a responsibility to deal with its employees in a fair and equitable manner.
>
> These responsibilities, and others, are critical to the functioning of the modern public corporation and the integrity of the public markets. No law or regulation alone can be a substitute for the voluntary adherence to these principles by corporate directors and management and by the accounting firms retained to serve American corporations.
>
> The Business Roundtable continues to believe that the most effective way to enhance corporate governance is through conscientious and forward-looking action by a business community that focuses on generating long-term stockholder value with the highest degree of integrity.
>
> The principles discussed here are intended to assist corporate management and boards of directors in their individual efforts to implement best practices of corporate governance, and also to serve as guideposts for the public dialogue on evolving governance standards.[4]

In addition to their fiduciary duties of care and loyalty, directors are expected to attend board meetings and their appropriate standing committee meetings. Directors must keep informed on the affairs of the corporation and use reasonable care and diligence in the performance of their duties. It is imperative that the

[4] Business Roundtable, *Principles of Corporate Governance* (Washington, DC: Business Roundtable, May 2002), iv–vi.

directors keep abreast of the corporate developments since they are directly responsible for participating in the decisions that affect the management of the corporation. Directors may be held liable for losses sustained by the corporation as a result of their neglect.

Practically speaking, the concept of corporate accountability extends not only to the stockholders but also to the other constituencies of the board of directors, such as credit grantors and governmental agencies. The extension of corporate accountability to the other constituencies is discussed by the American Assembly. The discussion leaders focused their attention on questions central to running the corporation vis-à-vis its many constituencies. With respect to a framework for corporate accountability, the participants generally agreed that:

> Boards of directors have a primary role in interpreting society's expectations and standards for management.
>
> The five key board functions are:
>
> (a) Appraisal of management performance and provision for management and board succession;
> (b) Determination of significant policies and actions with respect to present and future profitability and strategic direction of the enterprise;
> (c) Determination of policies and actions with a potential for significant financial, economic, and social impact;
> (d) Establishment of policies and procedures designed to obtain compliance with the law; and
> (e) Responsibility for monitoring the totality of corporate performance.
>
> Boards should continue to be the central focus in improving the way corporations are governed.[5]

The subject of corporate accountability is a dynamic concept in the governance of the corporation. It is dynamic because the directors must not only assess the changing needs of their constituencies but also render a stewardship accountability based on legal pressures from their constituencies.

In a 2009 report, ''Rebuilding Corporate Leadership: How Directors Can Link Long-Term Performance with Public Goals,'' the Committee for Economic Development links shareholders' prosperity to the health of society. In its view (page 2), ''Directors have a legal obligation and duty to address the long-term performance of the corporation. Directors' fiduciary duties include broader societal concerns that affirmatively affect the corporation's performance and long-term sustainability.''

The Need for Corporate Accountability

In an effort to address the credibility gap or expectation gap that arose from the corporate accounting scandals involving Enron, WorldCom, Tyco, and others, the

[5] American Assembly, *Corporate Governance in America,* Pamphlet 54 (New York: Columbia University, April 1978), 6.

U.S. Congress passed the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley) on July 25 of that year, and President George W. Bush signed the bill into law on July 30, 2002.[6] Sarbanes-Oxley incorporated many standards of corporate accountability into a federal statute that has changed securities laws and self-regulatory organizations' listing standards. This legislation provides a framework that can be used to measure the performance of audit committee members, independent auditors, chief executive officers, and chief financial officers.[7] As a consequence of the expansion of federal statutes into an area traditionally left more to state common law, directors of publicly held corporations likely will face more sources of lawsuits as well as an increased risk of liability. Although some qualified persons may be reluctant to accept a position on a board of directors because of a perception of heightened risk, others will appreciate that due diligence, care, and loyalty will go a long way in mitigating any possible risks.

DEVELOPMENTS IN CORPORATE ACCOUNTABILITY

During the late 1990s, unprecedented public attention was focused on the role and responsibility of audit committees in promoting corporate accountability and investor confidence in the integrity of the audit and financial reporting. Although audit committees had been recognized and accepted for more than 20 years, unexpected failures of major corporations and disclosures of questionable financial reporting practices dashed investors' confidence in the capital marketplace. Notwithstanding, the common question asked by investors was "Where were the auditors?" Another question was "Where was the audit committee?" As a result, a number of public and private sector initiatives were undertaken in the late 1990s and in the post-Enron, post-WorldCom period in response to high-profile accounting scandals and the demise of a large accounting firm.

This timeline shown in Exhibit 1.1 provides a chronology of the important developments or studies related to audit committees (The timeline presents major developments; the reader may wish to visit the Web sites noted parenthetically for further reading.)

Public and Private Sector Initiatives

Securities and Exchange Commission In September 1998 SEC Chairman Arthur Levitt, in a keynote speech entitled "The Numbers Game," expressed his concerns about "hocus pocus accounting." In addition to his remarks regarding the decline in the quality of financial reporting (e.g., earnings management strategies to meet analyst and market quarterly expectations via creative acquisition accounting, premature revenue recognition, restructuring charges, "cookie

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[6] Sarbanes-Oxley Act of 2002, H.R. Rep. No. 107-610, July 25, 2002, and Title 1 of Public Law No. 107-204, July 30, 2002.

[7] The initial implementation of some aspects of Sarbanes-Oxley—in particular Section 404—was fraught with difficulty and high costs. Chapter 8 addresses some of the causes of and solutions to those problems.

EXHIBIT 1.1 Important Audit Committee Developments Timeline

1998	SEC chairman Arthur Levitt's speech, "The Numbers Game" (remarks at New York University's Center for Law and Business and the SEC's Nine-Point Action Plan).
1999	Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees,
	Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees.
	Securities and Exchange Commission, *Final Rules, Audit Committee Disclosure*, and approval of the New York Stock Exchange, NASDAQ, and American Stock Exchange.
	American Institute of Certified Public Accountants' Auditing Standards Board, *Statement on Auditing Standards No. 90, ''Audit Committee Communication.''* Available at www.aicpa.org.
	National Association of Corporate Directors (NACD), *Report of the NACD Blue Ribbon Commission on Audit Committees.* Available at www.nacdonline.org.
	Committee of Sponsoring Organizations of the Treadway Commission, *Fraudulent Financial Reporting: 1987–1997 An Analysis of U.S. Public Companies*. Available at www.coso.org.
	Independence Standards Board
	No. 1 ''Independence Discussion with Audit Committees.'' Available at ISB-Independence Discussion with Audit Committees.
2000	Public Oversight Board, Panel on Audit Effectiveness (O'Malley Panel), *The Panel on Audit Effectiveness, Report and Recommendations.*
2001	Chairman Arthur Levitt's Letter to Audit Committees, Public Oversight Board, Final Annual Report (May 1, 2002, the POB terminated its existence; visit the POB Web site, www.publicoversightboard.org.
2002	The Business Roundtable*, Principles of Corporate Governance.*
	NYSE Corporate Accountability and Listing Standards Committee, *Report on Proposed Changes to the Corporate Governance Listing Standards.*
	NASDAQ Listing and Hearing Review Council, *Letter of recommendations proposing corporate governance reforms*. Available at www.nasdaq.com/newsroom.
	Sarbanes-Oxley Act of 2002. Available at www.sec.gov.
	Public Company Accounting Oversight Board. Available at www.pcaobus.org.
2003	Implementation of the sections of the Sarbanes-Oxley Act of 2002 through amendments to Sec. 10A of the Securities Exchange of 1934.
2004	PCAOB Standard No. 2, *Integrated Audits of Financial Statements and Internal Control over Financial Reporting*. Available at www.pcaobus.org.
2006	COSO, *Internal Control over Financial Reporting — Guidance for Smaller Public Companies*. Available at www.coso.org/guidance.htm.
	The Committee for Economic Development, *Private Enterprise, Public Trust: The State of Corporate America After Sarbanes-Oxley*. Available at www.ced.org.

(*continued*)

EXHIBIT 1.1 (*Continued*)

2007	PCAOB Standard No. 5 replaces Standard No. 2 on *Integrated Audits of Financial Statements and Internal Control over Financial Reporting*. Available at www.pcaobus.org.
	The Committee for Economic Development, *Built to Last: Focusing Corporations on Long-Term Performance*. Available at www.ced.org.
2008	SEC, *Report of the Advisory Committee on Improvements to Financial Reporting*. Available at www.sec.gov.
	U.S. Treasury, *Report of the Advisory Committee on the Auditing Profession*. Available at www.treas.gov.
2009	PCAOB Staff View, *An Audit of Internal Control over Financial Reporting That Is Integrated with An Audit of Financial Statements: Guidance for Auditors of Smaller Public Companies*. Available at www.pcaobus.org.
	Center for Audit Quality, *Lessons Learned—Performing an Audit of Internal Control in an Integrated Audit*. Available at www.thecaq.org/resources/library.htm.
	COSO, *Internal Control—Integrated Framework: Guidance on Monitoring Internal Control Systems*. Available at www.coso.org/guidance.htm.
	The Committee for Economic Development, *Rebuilding Corporate Leadership: How Directors Can Link Long-Term Performance with Public Goals*. Available at www.ced.org.

jar reserves,'' and materiality judgments) as well as the related decline in market capitalization, Levitt stated that with respect to audit committees:

> [Q]ualified, committed, independent and tough minded audit committees represent the most reliable guardians of the public interest. Sadly, stories abound of audit committees whose members lack expertise in the basic principles of financial reporting as well as the mandate to ask probing questions.[8]

Recognizing the problem with respect to the decline in the integrity and credibility of financial reporting, Levitt set forth the SEC's nine-point action plan (see Exhibit 1.2), which included, in point eight, an action item to strengthen the audit committee process. Subsequently the SEC, the New York Stock Exchange (NYSE), and the National Association of Securities Dealers[9] agreed that both self-regulatory organizations would sponsor a Blue Ribbon Committee (BRC) called Improving the Effectiveness of Corporate Audit Committees. In September 1998, the BRC was formed. It issued its final report and recommendations in February 1999. The BRC's primary goal was to produce a report ''geared toward effecting pragmatic, progressive changes in the functions and expectations placed

[8] See remarks by Chairman Arthur Levitt, Securities and Exchange Commission, ''The Numbers Game,'' NYU Center for Law and Business, New York, September 28, 1998. Available at www.sec.gov/news/speech/speecharchive/1998/spch220.txt.

[9] Now the Financial Industry Regulatory Authority (FINRA).

EXHIBIT 1.2 Summary of the Securities and Exchange's Nine-Point Action Plan

First, I have instructed the SEC staff to require well-detailed disclosures about the impact of changes in accounting assumptions. This should include a supplement to the financial statement showing beginning and ending balances as well as activity in between, including any adjustments. This will, I believe, enable the market to better understand the nature and effects of the restructuring liabilities and other loss accruals.

Second, we are challenging the profession, through the AICPA, to clarify the ground rules for auditing of purchased R&D. We also are requesting that they augment existing guidance on restructurings, large acquisition write-offs, and revenue recognition practices. It's time for the accounting profession to better qualify for auditors what's acceptable and what's not.

Third, I reject the notion that the concept of materiality can be used to excuse deliberate misstatements of performance. I know of one Fortune 500 company who had recorded a significant accounting error, and whose auditors told them so. But they still used a materiality ceiling of six percent earnings to justify the error. I have asked the SEC staff to focus on this problem and publish guidance that emphasizes the need to consider qualitative, not just quantitative factors of earnings. Materiality is not a bright line cutoff of three or five percent. It requires consideration of all relevant factors that could impact an investor's decision.

Fourth, SEC staff will immediately consider interpretive accounting guidance on the do's and don'ts of revenue recognition. The staff will also determine whether recently published standards for the software industry can be applied to other service companies.

Fifth, I am asking private sector standard setters to take action where current standards and guidance are inadequate. I encourage a prompt resolution of the FASB's projects, currently underway, that should bring greater clarity to the definition of a liability.

Sixth, the SEC's review and enforcement teams will reinforce these regulatory initiatives. We will formally target reviews of public companies that announce restructuring liability reserves, major write-offs or other practices that appear to manage earnings. Likewise, our enforcement team will continue to root out and aggressively act on abuses of the financial reporting process.

Improved Outside Auditing in the Financial Reporting Process

Seventh, I don't think it should surprise anyone here that recent headlines of accounting failures have led some people to question the thoroughness of audits. I need not remind auditors they are the public's watchdog in the financial reporting process. We rely on auditors to put something like the good housekeeping seal of approval on the information investors receive. The integrity of that information must take priority over a desire for cost efficiencies or competitive advantage in the audit process. High quality auditing requires well-trained, well-focused and well-supervised auditors.

As I look at some of the failures today, I can't help but wonder if the staff in the trenches of the profession have the training and supervision they need to ensure that audits are being done right. We cannot permit thorough audits to be sacrificed for re-engineered approaches that are efficient, but less effective. I have just proposed that the Public Oversight Board form a group of all the major constituencies to review the way audits are performed and assess the impact of recent trends on the public interest.

Strengthening the Audit Committee Process

And, finally, qualified, committed, independent and tough-minded audit committees represent the most reliable guardians of the public interest. Sadly, stories abound of

(*continued*)

EXHIBIT 1.2 (*Continued*)

audit committees whose members lack expertise in the basic principles of financial reporting as well as the mandate to ask probing questions. In fact, I've heard of one audit committee that convenes only twice a year before the regular board meeting for 15 minutes and whose duties are limited to a perfunctory presentation.

Compare that situation with the audit committee which meets twelve times a year before each board meeting; where every member has a financial background; where there are no personal ties to the chairman or the company; where they have their own advisers; where they ask tough questions of management and outside auditors; and where, ultimately, the investor interest is being served.

The SEC stands ready to take appropriate action if that interest is not protected. But, a private sector response that empowers audit committees and obviates the need for public sector dictates seems the wisest choice. I am pleased to announce that the financial community has agreed to accept this challenge.

As part eight of this comprehensive effort to address earnings management, the New York Stock Exchange and the National Association of Securities Dealers have agreed to sponsor a "blue-ribbon" panel to be headed by John Whitehead, former Deputy Secretary of State and retired senior partner of Goldman, Sachs, and Ira Millstein, a lawyer and noted corporate governance expert. Within the next 90 days, this distinguished group will develop a series of far-ranging recommendations intended to empower audit committees and function as the ultimate guardian of investor interests and corporate accountability. They are going to examine how we can get the right people to do the right things and ask the right questions.

Need for a Cultural Change

Finally, I'm challenging corporate management and Wall Street to re-examine our current environment. I believe we need to embrace nothing less than a cultural change. For corporate managers, remember, the integrity of the numbers in the financial reporting system is directly related to the long-term interests of a corporation. While the temptations are great, and the pressures strong, illusions in numbers are only that—ephemeral, and ultimately self-destructive.

To Wall Street, I say, look beyond the latest quarter. Punish those who rely on deception, rather than the practice of openness and transparency.

Source: See remarks by Chairman Arthur Levitt, Securities and Exchange Commission, "The Numbers Game," New York: NYU Center for Law and Business, September 28, 1998, www.sec.gov/news/speech/speecharchive/1998/spch220.txt.

on corporate boards, audit committees, senior and financial management, the internal audit, and the outside auditors regarding financial reporting and the oversight process."[10] Furthermore, the BRC noted that its final recommendations were based on two essentials: "First, an audit committee, with actual practice and overall performance that reflects the professionalism embodied by the full board of which it is a part, and second, a legal, regulatory, and self-regulating framework that emphasizes disclosure and transparency and accountability."[11] (See Exhibit 1.3 for a summary of the BRC's recommendations.)

[10] The report is available at www.nyse.com and www.finra.org.

[11] Ibid., 8.

EXHIBIT 1.3 Summary of Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees

The first two recommendations are aimed at strengthening the independence of the audit committee:

Recommendation 1

The Committee recommends that both the New York Stock Exchange (NYSE) and the Financial Industry Regulatory Authority (FINRA)* adopt the following definitions of independence for purposes of service on the audit committee for listed companies with a market capitalization above $200 million (or a more appropriate measure for identifying smaller-sized companies as determined jointly by the NYSE and FINRA).

Members of the audit committee shall be considered independent if they have no relationship to the corporation that may interfere with the exercise of their independence from management and the corporation. Examples of such relationships include.

- a director being employed by the corporation or any of its affiliates for the current year or any of the past five years;
- a director accepting any compensation from the corporation or any of its affiliates other than compensation for board service or benefits under a tax-qualified retirement plan;
- a director being a member of the immediate family of an individual who is, or has been in any of the past five years, employed by the corporation or any of its affiliates as an executive officer;
- a director being a partner in, or a controlling shareholder or an executive officer of, any for-profit business organizations to which the corporation made, or from which the corporation received, payments that are or have been significant** to the corporation or business organization in any of the past five years;
- a director being employed as an executive of another company where any of the corporation's executives serve on that company's compensation committee.

A director who has one or more of these relationships may be appointed to the audit committee, if the board, under exceptional and limited circumstances, determines that membership on the committee by the individual is required by the best interests of the corporation and its shareholders, and the board discloses, in the next annual proxy statement subsequent to such determination, the nature of the relationship and the reasons for that determination.

Recommendation 2

The Committee recommends that in addition to adopting and complying with the definition of independence set forth above for purposes of service on the audit committee, the NYSE and FINRA require that listed companies with a market capitalization above $200 million (or a more appropriate measure for identifying smaller-sized companies as determined jointly by the NYSE and FINRA) have an audit committee comprised solely of independent directors.

*Formerly the National Association of Securities Dealers (NASD).

**The committee views the term ‘‘significant’’ in the spirit of Section 1.34(a)(4) of the American Law Institute Principles of Corporate Governance and the accompanying commentary to that section.

(*continued*)

EXHIBIT 1.3 (*Continued*)

The Committee recommends that the NYSE and FINRA maintain their respective current audit committee independence requirements as well as their respective definitions of independence for listed companies with a market capitalization of $200 million or below (or a more appropriate measure for identifying smaller-sized companies as determined jointly by the NYSE and FINRA).

Our second set of recommendations is aimed at making the audit committee more effective:

Recommendation 3

The Committee recommends that the NYSE and FINRA require listed companies with a market capitalization above $200 million (or a more appropriate measure for identifying smaller-sized companies as determined jointly by the NYSE and FINRA) to have an audit committee comprised of a minimum of three directors, each of whom is financially literate (as described in the section of this report entitled ''Financial Literacy'') or becomes financially literate within a reasonable period of time after his or her appointment to the audit committee, and further that at least one member of the audit committee have accounting or related financial management expertise.

The Committee recommends that the NYSE and FINRA maintain their respective current audit committee size and membership requirements for companies with a market capitalization of $200 million or below (or a more appropriate measure for identifying smaller-sized companies as determined jointly by the NYSE and FINRA).

Recommendation 4

The Committee recommends that the NYSE and FINRA require the audit committee of each listed company to (i) adopt a formal written charter that is approved by the full board of directors and that specifies the scope of the committee's responsibilities, and how it carries out those responsibilities, including structure, processes, and membership requirements, and (ii) review and reassess the adequacy of the audit committee charter on an annual basis.

Recommendation 5

The Committee recommends that the Securities and Exchange Commission (SEC) promulgate rules that require the audit committee for each reporting company to disclose in the company's proxy statement for its annual meeting of shareholders whether the audit committee has adopted a formal written charter, and, if so, whether the audit committee satisfied its responsibilities during the prior year in compliance with its charter, which charter shall be disclosed at least triennially in the annual report to shareholders or proxy statement and in the next annual report to shareholders or proxy statement after any significant amendment to that charter.

The Committee further recommends that the SEC adopt a ''safe harbor'' applicable to all disclosure referenced in the Recommendation 5.

Our final group of recommendations addresses mechanisms for accountability among the audit committee, the outside auditors, and management:

Recommendation 6

The Committee recommends that the listing rules for both the NYSE and FINRA require that the audit committee charter for every listed company specify that the outside auditor is ultimately accountable to the board of directors and the audit committee, as representatives of shareholders, and that these shareholder representatives have the ultimate authority and responsibility to select, evaluate, and, where appropriate, replace the outside auditor (or to nominate the outside auditor to be proposed for shareholder approval in any proxy statement).

Recommendation 7

The Committee recommends that the listing rules for both the NYSE and FINRA require that the audit committee charter for every listed company specify that the audit committee is responsible for ensuring its receipt from the outside auditors of a formal written statement delineating all relationships between the auditor and the company, consistent with Independence Standards Board Standard 1, and that the audit committee is also responsible for actively engaging in a dialogue with the auditor with respect to any disclosed relationships or services that may impact the objectivity and independence of the auditor and for taking, or recommending that the full board take, appropriate action to ensure the independence of the outside auditor.

Recommendation 8

The Committee recommends that Generally Accepted Auditing Standards (GAAS) require that a company's outside auditor discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the company's accounting principles as applied in its financial reporting; the discussion should include such issues as the clarity of the company's financial disclosures and degree of aggressiveness or conservatism of the company's accounting principles and underlying estimates and other significant decisions made by management in preparing the financial disclosure and reviewed by the outside auditors. This requirement should be written in a way to encourage open, frank discussion and to avoid boilerplate.

Recommendation 9

The Committee recommends that the SEC require all reporting companies to include a letter from the audit committee in the company's annual report to shareholders and Form 10-K Annual Report disclosing whether or not, with respect to the prior fiscal year: (i) management has reviewed the audited financial statements with the audit committee, including a discussion of the quality of the accounting principles as applied and significant judgments affecting the company's financial statements; (ii) the outside auditors have discussed with the audit committee the outside auditors' judgments of the quality of those principles as applied and judgments referenced in (i) above under the circumstances; (iii) the members of the audit committee have discussed among themselves, without management or the outside auditors present, the information disclosed to the audit committee described in (i) and (ii) above; and (iv) the audit committee, in reliance on the review and discussions conducted with management and the outside auditors pursuant to (i) and (ii) above, believes that the company's financial statements are fairly presented in conformity with Generally Accepted Accounting Principles (GAAP) in all material aspects.

The Committee further recommends that the SEC adopt a ''safe harbor'' applicable to any disclosure referenced in this Recommendation 9.

Recommendation 10

The Committee recommends that the SEC require that a reporting company's outside auditor conduct a SAS 71 Interim Financial Review prior to the company's filing of its Form 10-Q.

(*continued*)

EXHIBIT 1.3 (*Continued*)

The Committee further recommends that SAS 71 be amended to require that a reporting company's outside auditor discuss with the audit committee, or at least its chairman, and a representative of financial management, in person, or by telephone conference call, the matters described in AU Section 380, Communications With the Audit Committee, prior to the filing of the Form 10-Q (and preferably prior to any public announcement of financial results), including significant adjustments, management judgments and accounting estimates, significant new accounting policies, and disagreements with management.

Source: Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees* (New York: The Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, 1999), pp. 10–16.

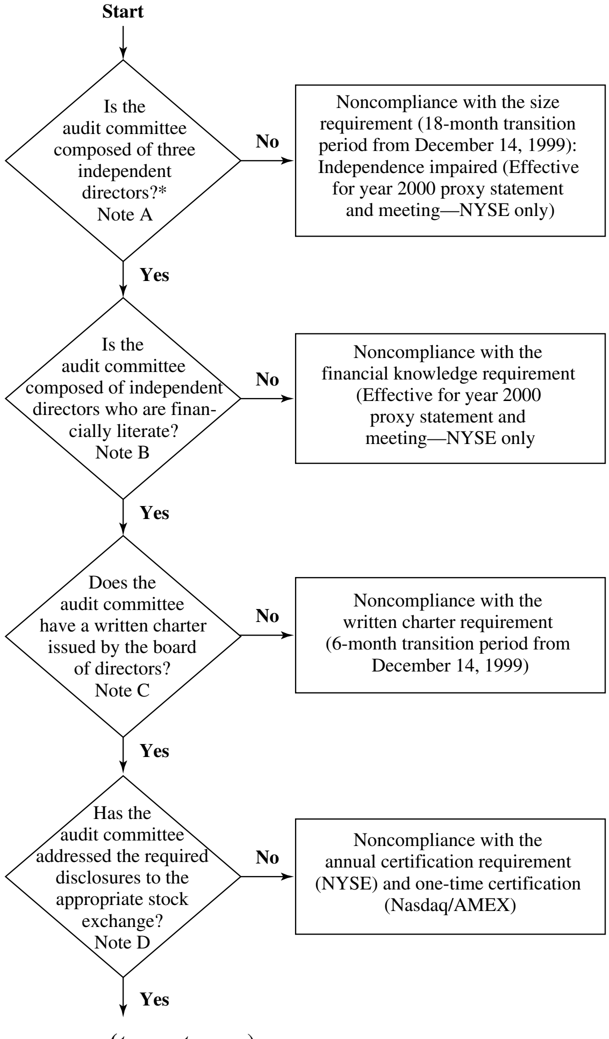
Between February and December 1999, boards of directors and audit committee members studied the BRC's recommendations and reevaluated the responsibilities of their audit committees.[12] Additionally, the SEC and self-regulatory organizations (SROs) issued proposed rules and changes to the SROs' listing standards. Finally, in December 1999, the SEC, the SROs, and the AICPA's Auditing Standards Board adopted new rules, listing standards, and auditing standards for improving the effectiveness of audit committees. Exhibit 1.4 contains a flow chart that delineates the items to meet the new SEC disclosure rules, the SROs' listing standards, and professional auditing standards.

In January 1999, the Public Oversight Board agreed to sponsor the Panel on Audit Effectiveness. The major objective of the panel was to review and evaluate ways to improve independent audits in the financial reporting process and to assess the impact of recent trends on the public interest. In August 2000, the panel issued its report and recommendations. With respect to audit committees, the panel made these recommendations:

> **2.88** The Panel recommends that audit committees increase the time and attention they devote to discussions of internal control with management and both the internal and external auditors. Specifically, audit committees should:
>
> - Obtain a written report from management on the effectiveness of internal control over financial reporting (ordinarily using the criteria in the 1992 report of the Committee of Sponsoring Organizations of the Treadway Commission [COSO]). Annual reporting by management on internal control to the audit committee is necessary for the effective discharge of the audit committee's responsibilities and will serve as a catalyst for its more substantive involvement in the area of internal control and a more meaningful dialogue with the internal and external auditors about controls. It also should provide a basis for discussions about the degree of

[12] See, for example, *Report of the NACD Blue Ribbon Commission on Audit Committees* (Washington, DC: NACD, 1999); see also Financial Executives Institute and Arthur Andersen, *The Audit Symposium: A Balanced Responsibility* (Morristown, NJ: Financial Executives Institute); *Fraudulent Financial Reporting: 1987–1997, An Analysis of U.S. Public Companies* (New York: COSO of the Treadway Commission, 1999).

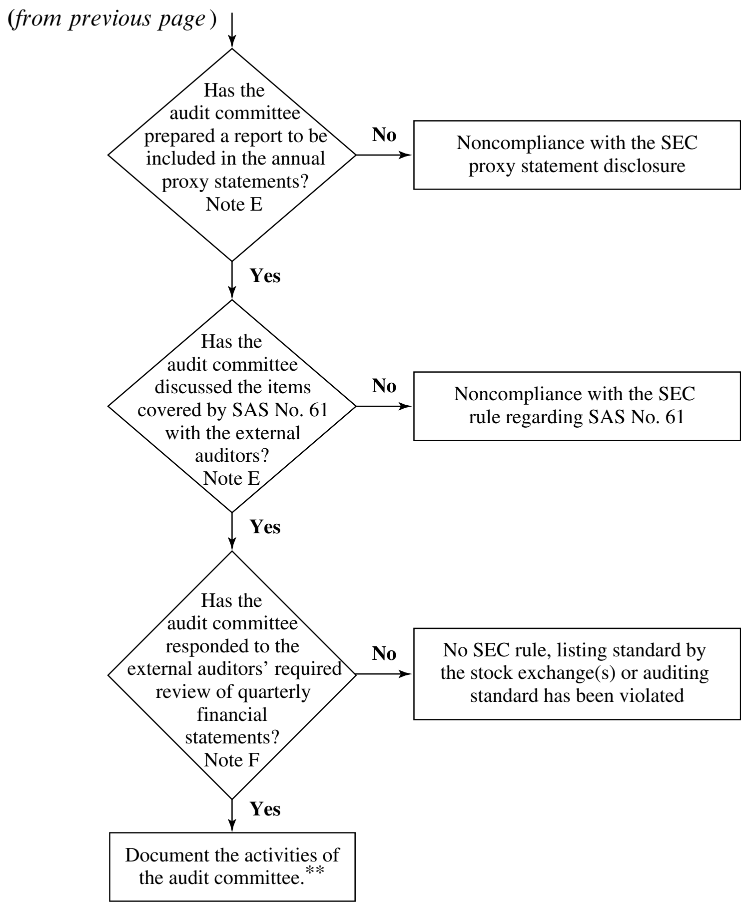
EXHIBIT 1.4 The New Requirements and Disclosure Rules for Audit Committees: A Flow Chart



(*to next page*)

Notes: A. If the board of directors determines in its business judgment that the relationship (e.g., certain business relationships and/or one non-independent member relationship) does not interfere with the director's exercise of independent judgment, then independence is not impaired.
B. The board of directors determines in its business judgment whether each member of the audit committee is financially literate. Based on the board's business judgment, at least one member must have accounting or related financial management expertise.
C. Each listed company must have an audit committee charter that guides its activities.
D. Each listed company (NYSE) is required to furnish a written certification letter, submitted annually, affirming the aforementioned points in A, B, and C. NASDAQ/AMEX listed companies require a one-time certification with respect to A, B, and C above.
E. After December 15, 2000, the SEC requires proxy statement disclosure of a report from the audit committee indicating whether the committee: (1) reviewed and discussed financial statements with management and the

(*continued*)



external auditors; (2) discussed with the external auditors matters required by SAS No. 61; (3) received a written letter from the external auditors required by ISBS No. 1 and discussed independence issues; and (4) based on the aforementioned review and discussions, recommended to the board that the audited financial statements be included in the company's annual SEC 10-K report. Additionally, after December 15, 2000, the SEC requires proxy statement disclosures of whether the audit committee is governed by a written charter, and if it is, each registrant must attach a copy to the proxy statement once every three years. Finally, each SEC registrant is required to disclose in its proxy statements whether audit committee members are independent and provide information about members that are not. (See Note A above).

F. Starting with the fiscal quarter ending on or after March 15, 2000, SEC rules mandate that the external auditors review the quarterly financial statements prior to the filing of Form 10-Q or 10-QSB. In its 1987 report, the National Commission on Fraudulent Financial Reporting (NCFFR) recommended that "the audit committee oversight responsibilities undertaken on behalf of the board of directors extend to the quarterly reporting process. The audit committee should review the controls that management has established to protect the integrity of the quarterly reporting process. This review should be ongoing" (p. 48). In February 1999, the Blue Ribbon Committee reaffirmed the NCFFR's position (p. 16).

*The SEC approved amendments to the NYSE, FINRA, and AMEX listing standards that require all audit committee members to be independent; however, one non-independent member can serve on the committee. See Order Approving Proposed Rule Change SEC Release No. NYSE 34-42233, SEC Release No. NASD 34-42231, and SEC Release No. AMEX 34-42232.

**It may be advisable to have in-house general counsel review the above documentation as well as a review by outside legal counsel.

Source: This flow chart, prepared by Louis Braiotta, Jr., is included and adopted from an article by Robert W. Rouse and Mark R. Borrelli, "Audit Committees in an Era of Increased Scrutiny," *CPA Journal* 70, no. 6 (June 2000): 30–31. Copyright © 2000 by the New York State Society of Certified Public Accountants, 530 Fifth Avenue, New York, NY 10036-5101. All rights reserved.

the external auditor's involvement with internal control during the financial statement audit.

- Establish specific expectations with management and the internal and external auditors about the qualitative information needs of the committee related to internal control. Particular emphasis should be given to understanding management's and the auditors' views on (1) the control environment and (2) the controls (or lack thereof) over financial reporting, with particular attention to controls in higher-risk areas of the company's information systems. In addition, these discussions should include the effects of technology on current and future information systems [pp. 32–33].

2.164 The Panel recommends that audit committees evaluate the nature of entities' reserves and review activity in them with both management and the auditors [p. 55].

2.219 The Panel recommends that audit committees:

- Specify in their charters and reflect in their actions, as recommended by the Blue Ribbon Committee, "that the outside auditor is ultimately accountable to the board of directors and the audit committee, as representatives of the shareholders, and that these shareholder representatives have the ultimate authority and responsibility to select, evaluate, and where appropriate, replace the outside auditors (or to nominate the outside auditors to be proposed for shareholder approval in any proxy statement)."
- Develop a formal calendar of activities related to those areas of responsibility prescribed in the committee charter, including a meeting plan that is reviewed and agreed to by the entire board. The meeting plan should include communications between the committee chair or full committee and the auditor before the release of interim or year-end financial data. In addition, the Panel recommends a minimum of two face-to-face meetings during the year with the external auditor and at least one executive session with the internal and external auditors without management's presence.
- Take charge of their agenda and ensure, in particular, that it focuses on, among other matters, risks directly affecting the financial statements, key controls, interim financial information, policies and practices for management's communications with analysts, and the qualitative aspects of financial reporting.
- Inquire about time pressures on the auditor, including pressures on the timing of audit procedures; the degree of management's cooperation with the auditor; and their potential effects on audit effectiveness.
- Review the internal and external auditors' performance on an annual basis; exercise responsibility, as the external auditor's primary client, to assess the auditor's responsiveness to the committee's and board of directors' expectations; and be satisfied that the auditor is appropriately compensated for performing a thorough audit.
- Require the auditor and management to advise the committee of the entity's plans to hire any of the audit firm's personnel into high-level positions, and the actions, if any, that the auditor and management intend to take to ensure that the auditor maintains independence [pp. 68–69].

3.54 The Panel recommends that audit committees:

- Request management to report on the control environment within the entity and how that environment and the entity's policies and procedures (including management's monitoring activities) serve to prevent and detect financial statement fraud. Such reporting should acknowledge, in explicit terms, that fraud prevention and detection are primarily the responsibility of management. It also should help audit committees assess the strength of management's commitment to a culture of intolerance for improper conduct. Furthermore, audit committees should seek the views of auditors on their assessment of the risks of financial statement fraud and their understanding of the controls designed to mitigate such risks.

- Accept responsibility for ascertaining that the auditors receive the necessary cooperation from management to carry out their duties in accordance with the strengthened auditing standards to be developed by the ASB [Accounting Standards Board] [p. 94].

5.30 The Panel recommends that audit committees pre-approve non-audit services that exceed a threshold determined by the committee. This recommendation is consistent with the recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees regarding auditors' services. The threshold should be at a level that ensures that significant services are pre-approved, but not so low that the committee assumes a management function.

When audit committees determine whether to approve specific non-audit services, the Panel recommends that they consider the same guiding principle and the factors suggested above for use by the ISB. [p. 117][13]

In addition to the panel's recommendations, Arthur Levitt issued a letter to the chairmen of audit committees of the top 5,000 corporations. The letter is shown in Exhibit 1.5.

In May 2002, the Business Roundtable issued a white paper, *Principles of Corporate Governance*, explaining how boards of directors perform their oversight function through the audit committee. The Business Roundtable provides these guidelines:

- Every publicly owned corporation should have an audit committee comprised solely of independent directors.
- Audit committees typically consist of three to five members. The listing standards of the major securities markets require audit committees and require that an audit committee have at least three members and that all members of the audit committee qualify as independent under the applicable listing standards, subject to limited exceptions.
- Audit committee members should meet minimum financial literacy standards, and at least one of the committee members should have accounting or financial management expertise, as required by the listing standards of the major securities markets. However, more important than financial expertise is the ability of audit committee members, as with all directors, to understand the corporation's business and risk profile and to apply their business experience

[13] Panel on Audit Effectiveness, *Panel on Audit Effectiveness Report and Recommendations* (Stamford, CT: POB, 2000).

EXHIBIT 1.5 Chairman Arthur Levitt's Letter to Audit Committees

Washington, DC, January 5, 2001—Securities and Exchange Commission Chairman Arthur Levitt today sent the following letter to the audit committee chairmen of the top 5,000 public companies.

Dear Members of the Audit Committee:

Almost a year ago, the Commission, our major markets and standard setters—building on the work of the Blue Ribbon Committee on Audit Committee Effectiveness—adopted rules that strengthen the audit committee's independence, and give its members the tools and the wherewithal to fulfill their duty to the investing public. In addition, the rules improve communications, through greater disclosure, among the board, outside auditors and management.

When auditors and the board engage in frank and meaningful discussions about the significant, but sometimes gray areas of accounting, both the company's and its shareholders' interests are served. In this way, the board, including the audit committee, management, and outside auditors, form a "three-legged stool" of responsible disclosure and active oversight.

In recent months, the Commission and the accounting profession have been engaged in a discussion on the vital issue of auditor independence. Among other reasons, increased economic pressures on the profession, coupled with greater competition and consolidation, mandated that we modernize and further clarify independence requirements. This discussion has led to a combination of rules and disclosures that establish clear guidelines on the non-audit services an auditor may provide to an audit client, as well as the meaningful involvement of the audit committee in consideration of consulting services that may impair independence. More specifically, the Commission's rules require companies to state in their proxy statement whether the audit committee has considered whether the provision of non-audit services is compatible with maintaining the auditor's independence.

In August, the Panel on Audit Effectiveness issued its final report recommending that, among other things, audit committees obtain annual reports from management assessing the company's internal controls, specify in their charters that the outside auditor is ultimately accountable to the board of directors and audit committee, inquire about time pressures on the auditor, and pre-approve non-audit services provided by the auditor.

The Panel, more specifically, provided guidance an audit committee can use to determine the appropriateness of a service. This guidance includes:

1. Whether the service is being performed principally for the audit committee.
2. The effects of the service, if any, on audit effectiveness or on the quality and timeliness of the entity's financial reporting process.
3. Whether the service would be performed by specialists (e.g., technology specialists) who ordinarily also provide recurring audit support.
4. Whether the service would be performed by audit personnel, and if so, whether it will enhance their knowledge of the entity's business and operations.
5. Whether the role of those performing the service would be inconsistent with the auditors' role (e.g., a role where neutrality, impartiality, and auditor skepticism are likely to be subverted).
6. Whether the audit firm personnel would be assuming a management role or creating a mutual or conflicting interest with management.
7. Whether the auditors, in effect, would be "auditing their own numbers."
8. Whether the project must be started and completed very quickly.
9. Whether the audit firm has unique expertise in the service.
10. The size of the fee(s) for the non-audit service(s).

(*continued*)

EXHIBIT 1.5 (*Continued*)

I encourage your audit committee to discuss the Panel's recommendations as well as these ten factors and consider them in relevant discussions with your auditor. The Panel's report can be found at *www.pobauditpanel.org/*. I also encourage you to read the Commission's rule release at *www.sec.gov.rules/final/33-7919.htm*.

During my almost eight years at the Commission, I have come to believe that one of the most reliable guardians of the public interest is a competent, committed, independent and tough-minded audit committee. The audit committee stands to protect and preserve the integrity of America's financial reporting process. I encourage your committee to take every step possible to ensure that the integrity of the financial statements, and by extension, the interest of shareholders, remains second to none.

Sincerely,

Arthur Levitt

Source: www.sec.gov/news/digest/2001/dig010501.pdf.

and judgment to the issues for which the committee is responsible with an independent and critical eye.

- The audit committee is responsible for oversight of the corporation's financial reporting process. The primary functions of the audit committee are the following:
  - *Risk profile.* The audit committee should understand the corporation's risk profile and oversee the corporation's risk assessment and management practices.
  - *Outside auditor.* The audit committee is responsible for supervising the corporation's relationship with its outside auditor, including recommending to the full board the firm to be engaged as the outside auditor, evaluating the auditor's performance, and considering whether it would be appropriate to rotate senior audit personnel or for the corporation periodically to change its outside auditor. The selection of an outside auditor should involve an annual due diligence process in which the audit committee reviews the qualifications, work product, independence, and reputation of the proposed outside auditor. The audit committee should base its decisions about selecting and possibly changing the outside auditor on its assessment of what is likely to lead to more effective audits. Based on its due diligence, the audit committee should make an annual recommendation to the full board about the selection of the outside auditor.
  - *Auditor independence.* The audit committee should consider the independence of the outside auditor and should develop policies concerning the provision of non-audit services by the outside auditor. The provision of some types of audit-related and consulting services by the outside auditor may not be inconsistent with independence or the attestation function. In considering whether the outside auditor should provide certain types of non-audit services, the audit committee should consider the degree of review and

oversight that may be appropriate for new and existing services. When making independence judgments, the audit committee should consider the nature and dollar amount of all services provided by the outside auditor.

- *Critical accounting policies, judgments, and estimates.* The audit committee should review and discuss with management and the outside auditor the corporation's critical accounting policies and the quality of accounting judgments and estimates made by management.
- *Internal controls.* The audit committee should understand and be familiar with the corporation's system of internal controls and on a periodic basis should review with both internal and outside auditors the adequacy of this system.
- *Compliance.* Unless the full board or another committee does so, the audit committee should review the corporation's procedures addressing compliance with the law and important corporate policies, including the corporation's code of ethics or code of conduct.
- *Financial statements.* The audit committee should review and discuss the corporation's annual financial statements with management and the outside auditor and, based on these discussions, recommend that the board approve the financial statements for publication and filing. Most audit committees also find it advisable to implement processes for the committee or its designee to review the corporation's quarterly financial statements prior to release.
- *Internal audit function.* The audit committee should oversee the corporation's internal audit function, including review of reports submitted by the internal audit staff, and should review the appointment and replacement of the senior internal auditing executive.
- *Communication.* The audit committee should provide a channel of communication to the board for the outside auditor and internal auditors and may also meet with and receive reports from finance officers, compliance officers, and the general counsel.
- *Hiring auditor personnel.* Under audit committee supervision, some corporations have implemented "revolving door" policies covering the hiring of auditor personnel. For example, these policies may impose "cooling off" periods prohibiting the corporation from employing members of the audit engagement team in senior financial management positions for some period of time after their work as auditors for the corporation. The audit committee should consider whether to adopt such a policy. Any policy on the hiring of auditor personnel should be flexible enough to allow exceptions, but only when specifically approved by the audit committee.

- Audit committee meetings should be held frequently enough to allow the committee to appropriately monitor the annual and quarterly financial reports. For many corporations, this means four or more meetings a year. Meetings should be scheduled with enough time to permit and encourage active discussions with management and the internal and outside auditors. The audit committee should meet with the internal and outside auditors, without management present, at every meeting and communicate with them between meetings as necessary. Some audit committees may decide that specific functions, such as quarterly review meetings with the outside auditor or management, can be delegated to the audit committee chairman or other members of the audit committee.[14]

In addition to the Business Roundtable's *Principles of Corporate Governance*, both the NYSE and NASDAQ proposed new changes to their corporate governance listing standards. The NYSE's rule changes are:

> *6. Add to the ''independence'' requirement for audit committee membership the requirements of Rule 10A-3(b)(1) under the Exchange Act, subject to the exemptions provided for in Rule 10A-3(c).*
>
> Commentary Applicable to All Companies: While it is not the audit committee's responsibility to certify the company's financial statements or to guarantee the auditor's report, the committee stands at the crucial intersection of management, independent auditors, internal auditors and the board of directors. The Exchange supports additional directors' fees to compensate audit committee members for the significant time and effort they expend to fulfill their duties as audit committee members, but does not believe that any member of the audit committee should receive any compensation other than such director's fees from the company. If a director satisfies the definition of ''independent director'' set out in Section 303A(2), then his or her receipt of a pension or other form of deferred compensation from the company for prior service (provided such compensation is not contingent in any way on continued service) will not preclude him or her from satisfying the requirement that director's fees are the only form of compensation he or she receives from the company.
>
> An audit committee member may receive his or her fee in cash and/or company stock or options or other in-kind consideration ordinarily available to directors, as well as all of the regular benefits that other directors receive. Because of the significantly greater commitment of audit committee members, they may receive reasonable compensation greater than that paid to the other directors (as may other directors for other committee work). Disallowed compensation for an audit committee member includes fees paid directly or indirectly for services as a consultant or a legal or financial advisor, regardless of the amount. Disallowed compensation also includes compensation paid to such a director's firm for such consulting or advisory services even if the director is not the actual service provider. Disallowed compensation is not intended to include ordinary compensation paid in another customer or supplier or business relationship that the board has already determined to be immaterial for purposes of its basic director independence analysis. To avoid any confusion, note that this requirement pertains only to audit committee qualification and not to the independence determinations that the board must make for other directors.
>
> Commentary Applicable to All Companies Other than Foreign Private Issuers: Each member of the committee must be financially literate, as such qualification is interpreted by the company's board in its business judgment, or must become financially literate within a reasonable period of time after his or her appointment to

[14] Business Roundtable, *Principles of Corporate Governance* (Washington, DC: Business Roundtable, May 2002), 12–16.

the audit committee. In addition, at least one member of the audit committee must have accounting or related financial management expertise, as the company's board interprets such qualification in its business judgment. A board may presume that a person who satisfies the definition of audit committee financial expert set out in Item 401(e) of Regulation S-K has accounting or related financial management expertise.

Because of the audit committee's demanding role and responsibilities, and the time commitment attendant to committee membership, each prospective audit committee member should evaluate carefully the existing demands on his or her time before accepting this important assignment. Additionally, if an audit committee member simultaneously serves on the audit committee of more than three public companies, and the listed company does not limit the number of audit committees on which its audit committee members serve, then in each case, the board must determine that such simultaneous service would not impair the ability of such member to effectively serve on the listed company's audit committee and disclose such determination in the annual proxy statement or, if the company does not file an annual proxy statement, in the company's annual report on Form 10-K filed with the SEC.

7. (a) Each company is required to have a minimum three person audit committee composed entirely of independent directors that meet the requirements of Section 303A(6).

(b) The audit committee must have a written charter that addresses:

(i) the committee's purpose—which, at minimum, must be to:

(A) assist board oversight of (1) the integrity of the company's financial statements, (2) the company's compliance with legal and regulatory requirements, (3) the independent auditor's qualifications and independence, and (4) the performance of the company's internal audit function and independent auditors; and

(B) prepare the report required by the SEC's proxy rules to be included in the company's annual proxy statement, or, if the company does not file a proxy statement, in the company's annual report filed on Form 10-K with the SEC;

(ii) the duties and responsibilities of the audit committee set out in Section 303A (7)(c) and (d); and

(iii) an annual performance evaluation of the audit committee.

(c) As required by Rule 10A-3(b)(2), (3), (4) and (5) of the Securities Exchange Act of 1934, and subject to the exemptions provided for in Rule 10A-3(c), the audit committee must:

(i) directly appoint, retain, compensate, evaluate and terminate the company's independent auditors;

Commentary: In connection with this requirement, the audit committee must have the sole authority to approve all audit engagement fees and terms, as well as all significant non-audit engagements with the independent auditors. In addition, the independent auditor must report directly to the audit committee. This requirement does not preclude the committee from obtaining the input of management, but these responsibilities may not be delegated to management. The audit committee must be directly responsible for oversight of the independent auditors, including resolution of disagreements between management and the independent auditor and pre-approval of all non-audit services.

(*ii*) *establish procedures for the receipt, retention and treatment of complaints from listed company employees on accounting, internal accounting controls or auditing matters, as well as for confidential, anonymous submissions by listed company employees of concerns regarding questionable accounting or auditing matters;*

(*iii*) *obtain advice and assistance from outside legal, accounting or other advisors as the audit committee deems necessary to carry out its duties; and*

Commentary: In the course of fulfilling its duties, the audit committee may wish to consult with independent counsel and other advisors. The audit committee must be empowered to retain and compensate these advisors without seeking board approval.

(*iv*) *receive appropriate funding, as determined by the audit committee, from the listed company for payment of compensation to the outside legal, accounting or other advisors employed by the audit committee.*

(*d*) *In addition to the duties set out in Section 303(A)(7)(c), the duties of the audit committee must be, at a minimum, to:*

(*i*) *at least annually, obtain and review a report by the independent auditor describing: the firm's internal quality-control procedures; any material issues raised by the most recent internal quality-control review, or peer review, of the firm, or by any inquiry or investigation by governmental or professional authorities, within the preceding five years, respecting one or more independent audits carried out by the firm, and any steps taken to deal with any such issues; and (to assess the auditor's independence) all relationships between the independent auditor and the company;*

Commentary: After reviewing the foregoing report and the independent auditor's work throughout the year, the audit committee will be in a position to evaluate the auditor's qualifications, performance and independence. This evaluation should include the review and evaluation of the lead partner of the independent auditor. In making its evaluation, the audit committee should take into account the opinions of management and the company's internal auditors (or other personnel responsible for the internal audit function). In addition to assuring the regular rotation of the lead audit partner as required by law, the audit committee should further consider whether, in order to assure continuing auditor independence, there should be regular rotation of the audit firm itself. The audit committee should present its conclusions with respect to the independent auditor to the full board.

(*ii*) *discuss the annual audited financial statements and quarterly financial statements with management and the independent auditor, including the company's disclosures under ''Management's Discussion and Analysis of Financial Condition and Results of Operations'';*

(*iii*) *discuss earnings press releases, as well as financial information and earnings guidance provided to analysts and rating agencies;*

Commentary: The audit committee's responsibility to discuss earnings releases as well as financial information and earnings guidance may be done generally (i.e., discussion of the types of information to be disclosed and the type of presentation to be made). The audit committee need not discuss in advance each earnings release or each instance in which a company may provide earnings guidance.

(*iv*) *discuss policies with respect to risk assessment and risk management;*

Commentary: While it is the job of the CEO and senior management to assess and manage the company's exposure to risk, the audit committee must discuss guidelines and policies to govern the process by which this is handled. The audit committee should discuss the company's major financial risk exposures and the steps management has taken to monitor and control such exposures. The audit committee is not required to be the sole body responsible for risk assessment and management, but, as stated above, the committee must discuss guidelines and policies to govern the process by which risk assessment and management is undertaken. Many companies, particularly financial companies, manage and assess their risk through mechanisms other than the audit committee. The processes these companies have in place should be reviewed in a general manner by the audit committee, but they need not be replaced by the audit committee.

(*v*) *meet separately, periodically, with management, with internal auditors (or other personnel responsible for the internal audit function) and with independent auditors;*

Commentary: To perform its oversight functions most effectively, the audit committee must have the benefit of separate sessions with management, the independent auditors and those responsible for the internal audit function. As noted herein, all listed companies must have an internal audit function. These separate sessions may be more productive than joint sessions in surfacing issues warranting committee attention.

(*vi*) *review with the independent auditor any audit problems or difficulties and management's response;*

Commentary: The audit committee must regularly review with the independent auditor any difficulties the auditor encountered in the course of the audit work, including any restrictions on the scope of the independent auditor's activities or on access to requested information, and any significant disagreements with management. Among the items the audit committee may want to review with the auditor are: any accounting adjustments that were noted or proposed by the auditor but were "passed" (as immaterial or otherwise); any communications between the audit team and the audit firm's national office respecting auditing or accounting issues presented by the engagement; and any "management" or "internal control" letter issued, or proposed to be issued, by the audit firm to the company. The review should also include discussion of the responsibilities, budget, and staffing of the company's internal audit function.

(*vii*) *set clear hiring policies for employees or former employees of the independent auditors; and*

Commentary: Employees or former employees of the independent auditor are often valuable additions to corporate management. Such individuals' familiarity with the business, and personal rapport with the employees, may be attractive qualities when filling a key opening. However, the audit committee should set hiring policies taking into account the pressures that may exist for auditors consciously or subconsciously seeking a job with the company they audit.

(*viii*) *report regularly to the board of directors.*

Commentary: The audit committee should review with the full board any issues that arise with respect to the quality or integrity of the company's financial statements, the company's compliance with legal or regulatory requirements, the performance and independence of the company's independent auditors, or the performance of the internal audit function.

General Commentary to Section 303A(7)(d): While the fundamental responsibility for the company's financial statements and disclosures rests with management and the independent auditor, the audit committee must review: (A) major issues regarding accounting principles and financial statement presentations, including any significant changes in the company's selection or application of accounting principles, and major issues as to the adequacy of the company's internal controls and any special audit steps adopted in light of material control deficiencies; (B) analyses prepared by management and/or the independent auditor setting forth significant financial reporting issues and judgments made in connection with the preparation of the financial statements, including analyses of the effects of alternative GAAP methods on the financial statements; (C) the effect of regulatory and accounting initiatives, as well as off–balance sheet structures, on the financial statements of the company; and (D) the type and presentation of information to be included in earnings press releases (paying particular attention to any use of "pro forma," or "adjusted" non-GAAP, information), as well as review any financial information and earnings guidance provided to analysts and rating agencies.

General Commentary to Section 303A(7): To avoid any confusion, note that the audit committee functions specified in Section 303A(7) are the sole responsibility of the audit committee and may not be allocated to a different committee.

(*e*) *Each listed company must have an internal audit function.*

Commentary: Listed companies must maintain an internal audit function to provide management and the audit committee with ongoing assessments of the company's risk management processes and system of internal control. A company may choose to outsource this function to a firm other than its independent auditor.[15]

CORPORATE ACCOUNTABILITY AND THE AUDIT COMMITTEE

The Role of the Audit Committee

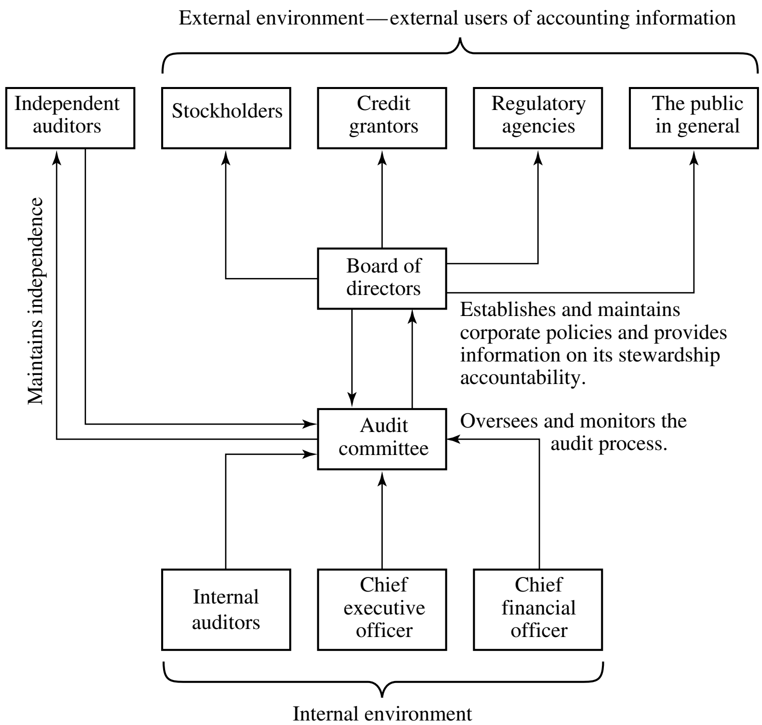
The audit committee has a critical role within the framework of corporate accountability since the jurisdiction of the committee is to oversee and monitor the activities of the corporation's financial reporting system and the internal and external audit processes. The audit committee assists the board of directors with the development and maintenance of the corporate accountability framework and helps create an environment conducive to exemplary financial reporting.

As Harold M. Williams, former chairman of the SEC, asserted:

It should be evident, but perhaps bears repeating, that integrity in reporting financial data is vital both to an efficient and effective securities market and to capital formation. One key to increasing public confidence in that data long advocated by many segments of the financial community, including public accounting firms, is

[15] Securities and Exchange Commission Release No. 34-47672, File No. SR-NYSE-2002-33, *Proposed Rule Change Relating to Corporate Governance* (Washington DC: April 11, 2003). See also SEC Release No. 34-47672, File No. SR-NASD-2002-141, for FINRA, *Proposed Rule Change Relating to Corporate Governance*.

EXHIBIT 1.6 The Audit Committee's Accountability Relationship



> more direct involvement by boards of directors in the auditing process and the integrity of reported financial information. The vehicle which the Securities and Exchange Commission, the New York Stock Exchange and an increasing number of public corporations have turned to has been the independent audit committee.[16]

As a standing committee appointed by the board of directors, the audit committee is directly accountable for its actions to the board. The audit committee operates in an advisory capacity. Thus the audit committee has limited authority because a final decision concerning its recommendations is made by the board. The board seeks guidance from the audit committee in formulating or amending the financial accounting policies to service properly the needs of its various constituencies.

To further illustrate the role of the audit committee, Exhibit 1.6 diagrams the direct relationship between the committee and its constituencies in the internal corporate environment.

[16] Harold M. Williams, "Audit Committees—The Public Sector's View," *Journal of Accountancy* 144, no. 3 (September 1977), 71.

The Audit Committee and the Chief Executive Officer The chief executive officer has an obligation not only to the board but also to the standing committees of the board. The chief CEO is responsible primarily for recommending major policy decisions to the board of directors. Since CEOs participate in the decisions concerning the financial accounting policies, they should have direct communication with the audit committee.

However, it is essential that the audit committee be totally independent from the CEO because he is a ‘‘managing director.’’ As a managing director, the CEO participates in the general administration of the corporation as well as assuming ultimate responsibility for the decisions.

Based on a close examination of the audit committees of 13 corporations listed on the NYSE, Michael L. Lovdal found:

> Effective audit committees permit the chief executive to attend by invitation only . . . After all, he is the best source concerning questions related to the business and he can ensure quick action on committee requests. In achieving the appropriate relationship with the chief executive, a key ingredient is the quality of the audit committee chairman. He must have both the sensitivity to know when to bring the CEO into the group's deliberations and the strength to stand up to him when the committee wants to pursue an inquiry or change policy.[17]

In short, the audit committee should determine its own agenda items, which should not be based on the chief executive officer's prerogatives. As Ivan Bull observed,

> Concern about other environmental factors, such as legal liability, also may have influenced board agendas and operating practices. The board's practice of allowing and listening to dissent and advice from outside members is healthier than the popular belief that CEOs dominate passive boards.[18]

The Audit Committee and the Chief Financial Officer[19] In most corporations, the chief financial officer (CFO) is responsible for the functions of the controller. In turn, the CFO is accountable to the CEO for the conduct of the various administrative functions of the controller. Although the controller is responsible for the general administration and supervision of the accounting operations, the CFO has executive responsibility for the financial accounting policies.

Since the audit committee is responsible for assuring that management fulfills its responsibilities in the preparation of the financial statements, the CFO should consult with the committee in order to coordinate the financial accounting activities. Thus the audit committee should have a dialogue with

[17] Michael L. Lovdal, ‘‘Making the Audit Committee Work,’’ *Harvard Business Review* 55 (March–April 1977): 110.

[18] Bull, ‘‘Board of Director Acceptance,’’ 71. Also see J. Michael Cook, ‘‘The CEO and the Audit Committee,’’ *Chief Executive* no. 76 (April 1993): 44–47.

[19] For further discussion, see Louis Braiotta, Jr., and Jay R. Olson, ‘‘Guiding the Audit Committee: A CFO's Concern,’’ *Financial Executive* 51, no. 9 (September 1983): 52–54. See also Chapter 13 for a discussion of the audit committee's review of the quarterly reporting process.

the CFO to consider any questions concerning the financial reporting practices. For example, if the CFO has certain reservations or exceptions to certain accounting policies and practices, the audit committee would recommend the necessary course of action subsequent to its consultation with the independent auditors.

The Audit Committee and the Internal Audit Group The internal audit executive is essentially responsible for the establishment and maintenance of an effective and efficient system of internal auditing. With respect to the audit committee's involvement with the internal audit group, Lovdal points out:

> The internal audit group can be an avenue for the committee in reaching the source of a variety of problems. One committee I examined uses internal auditors regularly for investigations in such areas as computer security, transfer pricing, and capital budgeting. For these activities, the committee should deal directly with the head of internal audit, rather than solely through other finance or control executives, and should make itself knowledgeable about the organization, staffing, and budgets of the internal audit department.[20]

The reporting responsibility of the internal audit group varies from one organization to the next. For example, the director of internal auditing may report to the controller or CFO and meet with the audit committee on a separate or joint basis. Whatever the reporting arrangement, the director of internal auditing should have access to the audit committee to provide for a forum whereby the internal audit group can resolve questionable matters between the audit staff and corporate management. (See Chapter 9.)

The Audit Committee and the External Auditor One of the major provisions of the Sarbanes-Oxley Act was to create the Public Company Accounting Oversight Board (PCAOB), which now is the regulator of auditors of public companies. Previously, public company auditors were self-regulated through the Public Oversight Board (POB), a private organization that worked in concert with the American Institute of Certified Public Accountants to regulate the quality control aspects of public company audits through a private sector, firm-on-firm, peer review process. While the POB was a distinct body from the AICPA, the AICPA administered peer review and created the quality control standards that formed the basis for a peer review. Another unit of the AICPA, the Auditing Standards Board (ASB), was the source of generally accepted auditing standards (GAAS) for virtually all financial statement audits performed in the country.

For the audits of public companies only, the creation of the PCOAB removed from the private sector at the AICPA the auditing standards, quality control standards, ethics standards, peer review monitoring, and enforcement activities. Audits of other entities remain the subject of standards, monitoring, and enforcement of the AICPA, other private-sector bodies such as state CPA organizations, and state

[20] Lovdal, "Making the Audit Committee Work," 111.

governments. Of course, audit failures in the non-public company sector can be litigated in state courts. Because of this dual system of control that is determined by the status of the auditee as an issuer subject to SEC regulation, an audit firm is subject to PCOAB oversight for its public company audits and to a collection of private sector and state governments for its non-public company audits.

The PCAOB has five board members appointed by the SEC, one of whom serves as the chair. Up to two of the board members can be CPAs from the audit profession, but to chair the board a CPA must not have been associated with a CPA firm for at least five years. Board members serve five-year terms. The PCAOB is organized as a not-for-profit in the District of Columbia. The PCAOB's budget, along with that of the FASB, is approved annually by the SEC. The Sarbanes-Oxley Act authorizes the PCAOB to collect fees from public companies and their auditors to fund the budgets of the PCAOB and FASB. Any of the rules of the PCAOB are approved by the SEC after appropriate exposure and comment periods. If the SEC does not approve a PCAOB rule, then it is returned to the PCAOB for additional work.

The PCAOB is organized into two divisions and a number of offices. The Division of Registration and Inspections registers CPA firms that audit U.S. public companies, or that aspire to audit U.S. public companies. On September 1, 2009, 2,146 audit firms from around the world were registered with the PCAOB. This Division also conducts the annual or triennial inspections of registered firms. Firms that audit 100 or more U.S. public companies are inspected annually. Firms auditing between five and 99 U.S. public companies are inspected every three years. Firms auditing fewer than five U.S. public companies have each of their audits inspected. PCAOB inspections cover the quality control of the firms and selected audit issues for selected clients. The inspections are meant to be risk-based, so inspectors deliberately choose the riskiest companies and riskiest transactions for their examinations. The inspection reports have two parts. Part A is publicly available at the PCAOB Web site (www.pcaobus.org) and focuses on accounting or auditing issues that the PCAOB inspectors consider problematic. Part B, which is not public by statute, is the PCAOB's assessment of a firm's quality control. The Sarbanes-Oxley Act provides that as long as a firm makes satisfactory progress in addressing quality control concerns, Part B of the report remains private between the firm and the PCAOB.

The Division of Enforcement and Investigations is the disciplinary arm of the PCAOB. Its investigations and actions can lead to disciplinary actions against individual auditors or audit firms. Disciplinary actions range from remedial activities to complete bars from audits of U.S. public companies. The authority to subpoena, conduct investigations, and discipline is well beyond the power that previously had been held by the POB. The inspection process at the PCAOB also has much more authority than the peer review process previously conducted by the AICPA.

The office of the PCAOB that likely is of most interest to audit committee members is the Office of the Chief Auditor, which is responsible for the development of professional standards for auditing, quality control, and independence and ethics. The PCAOB adopted interim standards that had been developed previously by various bodies at the AICPA. The PCAOB has extended the standards for independence beyond the interim standards and has developed two standards related to integrated audits of financial statements and internal control over financial reporting. The second standard simplified the original standard in order to focus auditors' attention more clearly on risk issues and to reduce overall costs on implementing the internal control requirements of the Sarbanes-Oxley Act. The debates and disagreements about how to implement Section 404 of the Act consumed enormous time and energy between 2004 and 2007, the time between the first standard on integrated audits, Standard 2, and the new standard, Standard 5.

Auditors of U.S. non-public companies participate in a peer review program that is a cooperative effort between the AICPA, the state CPA societies, and those states that require a quality review of CPA firms registered with them. This private-sector-run program has been in existence since the late 1970s. Firms could be part of several distinct peer review programs, depending on which program they entered and when. Many of the firms will be part of a program with a public file, which is available at www.aicpa.org under the peer review program tab. Some firms will participate in a program that does not have a public file, in which case the results of peer review are available only from the firm itself. The quality control standards for the peer review are the same regardless of the program, and the AICPA's standards have functioned well for the PCAOB as interim standards, so the standards are consistent with those used by PCAOB inspections.

Auditors subject to PCAOB oversight have formed the Center for Audit Quality (CAQ) as a public interest forum for public company auditors. The CAQ's Web site, at www.thecaq.org, frequently has material of interest to audit committee members about public company auditing and current developments. The CAQ also has acted as the organizing body for public company auditors when the federal government forms commissions or blue ribbon committees studying the audit industry. The U.S. Treasury formed such a committee in 2007, the Advisory Committee on the Auditing Profession (ACAP), which issued its report in October 2008. The ACAP report is available at www.treas.gov. Among other things, the report suggests that public company audit firms publish an annual "transparency report" with metrics about audit quality variables and financial information. The PCAOB, CAQ, and audit firms currently are studying how to implement this recommendation.

Such reports already are published by audit firms in the EU.

To see an example of such a transparency report, visit the Grant Thornton International Web site, which can be accessed at www.gt.com, the public Web site for Grant Thornton LLP, the U.S. member firm of Grant Thornton International. This transparency report covers topics such as legal structure and ownership, membership criteria, governance and management, client acceptance and reacceptance, quality control systems, independence practices, people and culture, financial information, partner remuneration, public interest entities audited, and member firms of Grant Thornton International. Other firms have similar reports about their operations.

Public transparency reports, the public section of PCAOB inspections, and public peer review files can provide audit committees with insights into different audit firms and be of assistance in conducting a constructive dialog with incumbent and prospective auditors. Audit committees should discuss such

EXHIBIT 1.7 Summaries of Research Studies

DeZoort, F. Todd, Dana R. Hermanson, and Richard W. Houston, "Audit Committee Support for Auditors: The Effects of Materiality Justification and Accounting Precision." *Journal of Accounting and Public Policy* 22, (2003), pp. 175–199.

Summary: The authors find that, in the context of auditor-management disagreements, independent auditors and audit committees need to discuss the qualitative aspects of materiality with respect to unrecorded adjustments. Additionally, the authors conclude that both accounting and auditing standard setters should consider approaches to enhance accounting estimates in the financial reporting process, including communications with audit committees. Finally, they find that audit committees with CPAs provide greater support for independent auditors.

Klein, April, "Audit Committees, Board of Director Characteristics, and Earnings Management." *Journal of Accounting & Economics* 33 (2002), pp. 375–400.

Summary: Klein concludes that reductions in the independence of boards of directors or audit committees cause large increases in abnormal accruals. The results suggest that boards of directors that are more independent of the CEO are more effective in monitoring earnings management in the financial reporting process.

Beasley, Mark S., and Steven E. Salterio, "The Relationship between Board Characteristics and Voluntary Improvements in Audit Committee Composition and Experience." *Contemporary Accounting Research* 18, No. 4 (Winter 2001), pp. 539–570.

Summary: Beasley and Salterio find that Canadian firms that voluntarily include more outside directors on the audit committee than the minimum mandated by Canadian corporate law have larger boards of directors with more outside directors and thus are more likely to segregate the board chair and CEO/president positions. Likewise, audit committees with financial reporting knowledge and experience and larger boards with outside members are less likely to be chaired by the CEO/president. Thus the researchers conclude that one person serving as both chairman and CEO/president increases the potential for less effective monitoring by the audit committee.

Klein, April, "Economic Determinants of Audit Committee Independence." *Accounting Review* 77, No. 2 (April 2002), pp. 435–452.

Summary: Klein reports that audit committee independence increases with board size and the percentage of outsiders on the board of directors. However, audit committee independence decreases with an increase in a firm's growth opportunities or when a firm reports net losses. Klein confirms the findings of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees that "one size doesn't fill all" when it comes to audit committees. The results suggest that the stock exchanges should allow boards flexibility with respect to audit committee composition.

Carcello, Joseph V., and Terry L. Neal, "Audit Committee Composition and Auditor Reporting." *Accounting Review* 75, No. 4 (October 2000), pp. 453–467.

Summary: Carcello and Neal find that the greater the percentage of affiliated directors on the audit committee, the lower the probability the auditor will issue a going-concern report. Thus their evidence supports the proposition that the audit committee should be composed of independent, outside directors.

Beasley, Mark S., Joseph V. Carcello, Dana R. Hermanson, and Paul D. Lapides, "Fraudulent Financial Reporting: Consideration of Industry Traits and Corporate Governance Mechanisms." *Accounting Horizons* 14, No. 4 (December 2000), pp. 441–454.

Summary: The authors confirm earlier findings that fraudulent firms and no-fraud firms differ to the extent that audit committees exist and such committees are independent, including the board's independence from management. With the identification of no-fraud industry benchmarks (e.g., number of audit committee meetings and internal audit experience), they find that the sample fraud firms have weak governance mechanisms. Moreover, independent auditors should consider the industry context with respect to their fraud risk assessment on client audit engagements.

Abbott, Lawrence J., and Susan Parker, "Auditor Selection and Audit Committee Characteristics." *Auditing: A Journal of Practice and Theory* 19, No. 2 (Fall 2000), pp. 47–66.

Summary: The authors conclude that the requirement for financial experts on audit committees is more likely to change the structure and focus of audit committee discussions about the quality of the financial reporting process. Their results suggest that audit committee members who are financially literate are more likely to focus on reporting treatments that are prominent in the press and nonrecurring, while financial experts are more likely to focus on the relevance of reporting treatments as well as recurring activities.

Abbott, Lawrence J., and Susan Parker, "Auditor Selection and Audit Committee Characteristics." *Auditing: A Journal of Practice and Theory* 19, No. 2 (Fall 2000), pp. 47–66.

Summary: Abbott and Parker find that independent and active audit committee members are more likely to select an industry-specialist auditor because they demand a high level of audit quality. Their results suggest that an industry-specialist auditor helps minimize the client's reputational or monetary losses.

McDaniel, Linda, Roger D. Martin, and Laureen A. Maines, "Evaluating Financial Reporting Quality: The Effects of Financial Expertise vs. Financial Literacy." *Accounting Review* 77 (Supplement 2002), pp. 139–167.

Summary: The authors conclude that the requirement for financial experts on audit committees is more likely to change the structure and focus of audit committee discussions about the quality of the financial reporting process. Their results suggest that audit committee members who are financially literate are more likely to focus on reporting treatments that are prominent in the press and nonrecurring, while financial experts are more likely to focus on the relevance of reporting treatments as well as recurring activities.

Carcello, Joseph V., and Terry L. Neal, "Audit Committee Characteristics and Auditor Dismissals Following 'New' Going-Concern Reports." *Accounting Review* 78, No. 1 (January 2003), pp. 95–117.

Summary: Carcello and Neal find as a follow-on to their 2000 study that the higher the percentage of affiliated directors on the audit committee, the more likely a client will dismiss its independent auditors because of a going-concern audit report. Moreover, they report that the probability of client dismissal of the independent auditors

(*continued*)

EXHIBIT 1.7 (*Continued*)

subsequent to the going-concern report increases as audit committee ownership of client stock increases. In contrast, audit committee members with more governance expertise are less likely to dismiss their independent auditors after receiving a going-concern report. Likewise, the turnover rate of independent audit committee members who retain their independent auditors is less significant compared to audit committee members who dismiss their independent auditors.

Zaman, Mahbub, "The Corporate Governance Effects of Audit Committees." *Journal of Management and Governance,* Vol. 8, No. 3 (2004), pp. 305–332.

Summary: This paper synthesizes previous empirical research on the governance effects of audit committees in several countries. It finds that most of the existing evidence has focused on factors associated with audit committee existence, characteristics, and measures of activities. There is very little evidence about audit committee processes and operations and other ways that they might impact corporate behavior. The evidence suggests that there is no automatic relationship between the existence of an audit committee with certain characteristics and achievement of desirable corporate effects. The author cautions against excessive codification of specific requirements until more is understood about the interactions of audit committees and effective governance.

Yang, Joon S., and Jagan Krishnan, "Audit Committees and Quarterly Earnings Management." *International Journal of Auditing*, Vol. 9, No. 3 (November 2005), pp. 201–219.

Summary: The authors collected a sample of 896 observations for the years 1996-2000, prior to the reforms generated by the Sarbanes-Oxley Act of 2002, to test the association between audit committee characteristics and measures of quarterly earnings management. They found that (1) quarterly earnings management is lower for companies whose audit committee members have greater governance experience, (2) stock ownership by audit committee members is positively associated with measures of quarterly earnings management, and (3) the average tenure of audit committee members is negatively associated with measures of quarterly earnings management.

Baxter, Peter, and Julie Cotter, "Audit Committees and Earnings Quality." *Accounting & Finance*, Vol. 49, Issue 2 (June 2009), pp. 267–290.

Summary: The authors investigate whether audit committees are associated with improvements in earnings quality for a sample of Australian listed companies before the introduction of mandatory audit committees in 2003, while audit committees were still voluntary. The results indicate that audit committee formation reduces intentional earnings management, but does not affect accrual estimation errors. Audit committees with more accounting expertise are associated statistically with higher earnings-quality measures.

Goh, Beng Wee, "Audit Committees, Boards of Directors, and Remediation of Material Weaknesses in Internal Control." *Contemporary Accounting Research*, Vol, 26, No. 2 (Summer 2009).

Summary: This study correlates board and audit committee characteristics with the speed of remediation of material weaknesses in internal control of accelerated filers in

(*continued*)

the U.S. that disclosed at least one material weakness between July 2003 and December 2004 as described in section 302 of the Sarbanes-Oxley Act. Companies with larger audit committees composed of individuals with financial expertise but not accounting expertise, in the context of boards with more independent members, are more likely to remediate material weaknesses rapidly.

Skaife, Hollis Ashbaugh, Daniel W., Collins, William R., Jr., Kinney, and Ryan, LaFond, "The Effect of SOX Internal Control Deficiencies on Firm Risk and Cost of Equity." *Journal of Accounting Research*, Vol. 47, Issue 1 (March 2009), pp. 1–43.

Summary: The authors use unaudited pre-Sarbanes-Oxley disclosures and Sarbanes-Oxley Section 404 audit opinions to assess how changes in internal control quality affect company risk and cost of equity. After controlling for other risk factors, they find that companies with internal control deficiencies have significantly higher idiosyncratic risk (company specific risk), higher systematic risk, and higher cost of equity. Auditor-confirmed improvements in internal control effectiveness, including remediation of previously disclosed control deficiencies, are followed by significant decreases in the cost of equity ranging from 50 to 150 basis points.

EXHIBIT 1.8 Summary of Sections of the Sarbanes-Oxley Act of 2002 Impacting Audit Committees

Sections	Title
2	Definitions
101	Public Company Accounting Oversight Board
201	Services Outside the Scope of Practice of Auditors
202	Preapproval Requirements (audit and non-audit services)
203	Audit Partner Rotation (5-year rotation period)
204	Auditor Reports to Audit Committees
206	Conflicts of Interest (1-year cooling-off period)
207	Study of Mandatory Rotation of Registered Public Accounting Firms
301	Public Company Audit Committees
302	Corporate Responsibility for Financial Reports
303	Improper Influence on Conduct of Audits
307	Rules of Professional Responsibility for Attorneys
401	Disclosure in Periodic Reports
402	Enhanced Conflict of Interest Provisions (Personal Loans to Executives)
403	Disclosures of Transactions Involving Management and Principal Stockholders
404	Management Assessment of Internal Controls
406	Code of Ethics for Senior Financial Officers
407	Disclosure of Audit Committee Financial Expert
409	Real Time Issues Disclosures
906	Corporate Responsibility for Financial Reports (Failure of Corporate Officers to Certify Financial Reports and Criminal Penalties)

Source: The act is contained in Public Law No. 107-204, July 30, 2002.

EXHIBIT 1.9 Corporate Accountability: Self-Assessment Checklist

Services available from:	Management	Internal Auditors	External Auditors	Legal Counsel	Bd of Directors	Sarbanes-Oxley	SEC	SROs	ASB	
Audit Committee Practice Area										**Comments**
Legal liabilities under,										
State statutes										
Fiduciary liability				✓						
Business judgment rule				✓						
Standards of conduct				✓						
Federal Statutes*										
Sarbanes-Oxley Act of 2002				✓		✓	✓			
Private Securities Litigation Reform Act of 1995				✓			✓			
Securities Act of 1933				✓			✓			
Securities Exchange Act of 1934				✓			✓			
Legal Cases				✓						
Corporate Governance Principles and Rules					✓	✓	✓	✓		
Formation†						✓		✓		
Membership										
Number of members (size)						✓		✓		
Appointments						✓				
Term of Service						✓				
Qualifications						✓		✓		
Composition						✓		✓		
Meetings, frequency and type								✓		
Knowledge Areas										
Type of business and industry	✓									
Internal audit process		✓								
External audit process			✓							
Internal control concepts‡		✓	✓							
Management's risk assessment	✓	✓	✓							
Industry accounting practices	✓	✓	✓							
Complex business transactions	✓	✓	✓	✓						
Financial reporting process	✓	✓	✓							
Internal communication process§	✓	✓	✓	✓	✓	✓	✓	✓		
External communication process					✓	✓	✓	✓	✓	

* See Chapter 4 for other acts. † Board resolution or corporate bylaws and a format written charter. ‡ Includes conflicts of interest (e.g., code of conduct, related party transactions). § Related to the above areas.

reports with their auditors and understand how their auditors are trying to manage and improve their delivery of high-quality audits.

CONCLUSION

The purpose of this chapter is to orient audit committee members to their governance responsibilities as directors and committee members. Chapter 1 has drawn some samples from the rich literature that is available about audit committees. In addition, Exhibit 1.7 presents summaries of selected academic research studies concerning audit committees. Summarizing the wisdom distilled from that research, to the extent that the audit committee maintains an independent posture in the corporate environment, the committee will act as a check on corporate management with respect to its corporate power and as a supporter of corporate stewardship accountability. The committee's primary objective is to foster the accountability relationship between the audit committee and the representatives of management and thereby create an environment in which management will be positively responsive in fulfilling its financial reporting responsibilities to its constituencies.

Because the Sarbanes-Oxley Act has had such a seminal impact on corporate governance, especially on the role of the audit committee, Exhibit 1.8 presents a summary of selected sections and titles of the Act. Each section is presented in Chapter 2. Exhibit 1.9 contains a corporate accountability self-assessment checklist.

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