

Evolution of Audit Committees

Audit committees have had an important role in the governance of corporations since their inception in the early 1940s, and their visibility and contributions have greatly increased in the past few years. Audit committees have been described as organizations' guardians of financial integrity. From a regulatory perspective, the governmental agency empowered to regulate the issuance and trading of securities of public corporations, the Securities and Exchange Commission (SEC), has been involved with the establishment and oversight of audit committees in public companies since their beginning years.

Interestingly, however, the stock exchanges, as self-regulatory agencies, have been directly involved in putting into place many of the detailed requirements that the SEC mandated that audit committees of public companies follow. A body of best practices beyond legal and regulatory requirements has also grown up as a result of the work of thought leaders from the legal, investment, and auditing professions.

The public accounting profession through the American Institute of Certified Public Accountants (AICPA) has also long actively supported the need for an important role for audit committees. Because of the increased emphasis placed on the governance of corporations in the postmillennium years, particularly those that are publicly held, audit committees in many not-for-profit organizations have become more prevalent and have received greater attention and visibility. Their influence in organizations has matched this trend.

EARLY EVENTS

The New York Stock Exchange (NYSE) suggested, and the SEC endorsed, the concept of audit committees composed of nonexecutive directors as early as 1940. At that time, the responsibilities envisioned for audit committees were quite narrow, basically being limited to the nomination of the external auditor and arranging some of the parameters of its engagement. The AICPA was also active in the discussion of the need for audit committees and in 1967 issued a policy statement recommending that public corporations establish audit committees composed of outside directors.

In 1974, the SEC required proxy statement disclosure of the existence and composition of audit committees in all public corporations where they were in place.

The NYSE issued a white paper at approximately the same time that strongly recommended the formation of an audit committee by each company listed on that exchange.

Several important developments took place in the late 1970s. The AICPA Special Committee on Audit Committees renewed its earlier support for establishment of an audit committee composed entirely of independent directors. In early 1977, the NYSE enacted a listing requirement that all companies listed on that exchange appoint an audit committee of nonemployee or independent directors as a condition of continued listing on the exchange. The SEC was instrumental in bringing this initiative to fruition.

The NYSE clarified in 1978 its independence requirements for audit committee members. Audit committees had to consist solely of directors “independent of management and free from any relationship that would interfere with the exercise of independent judgment as a committee member.”¹ At about the same time, the American Stock Exchange (ASE) also made a nonbinding recommendation that all of its listed companies should form independent audit committees. As noted later in this chapter, the National Association of Securities Dealers Automated Quotation System (Nasdaq) stock market established an audit committee requirement in 1989.

It should be borne in mind that in the 1970s, the influence of nonexecutive directors was substantially less than it has become in recent years. The idea that the major function of a board of directors is to represent the interests of shareowners was not prevalent. Thus, audit committee members were likely to be the only independent members of the board. In many cases, even total independence of the audit committee from management was more of a goal than an actuality.

An early endorsement by the legal profession of the concept of audit committees in public corporations appeared in the 1978 edition of the *Corporate Director's Guidebook* published by the American Bar Association (ABA). Two years later, the ABA Committee on Corporate Laws published specific recommendations for the membership, responsibilities, and potential liabilities of audit committees and their director-members. Later chapters discuss the contents of subsequent versions of the *Corporate Director's Guidebook* published by the ABA.

SEC REGULATORY, LEGAL, AND PRIVATE SECTOR INITIATIVES

The SEC continued its support for independent audit committees throughout the 1970s and sponsored public hearings related to corporate accountability and the adequacy of internal controls in U.S. corporations. The SEC stressed the “vital importance of an independent audit committee to the proper functioning of the corporation.”

¹ NYSE Listed Company Manual §303.00. See www.nyse.com.

According to the securities laws, the current definition of an audit committee is:

- a) A committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer: and
- b) If no such committee exists with respect to an issuer, the entire board of directors of the issuer.²

Several attempts in the late 1970s to require greater disclosure of internal control adequacy and audit committee performance failed to receive support from the business community and were withdrawn. The last and most sweeping attempt would have required management to assess and report publicly on the effectiveness of internal control systems and also management's responses to internal control recommendations made by either internal or external auditors.

The formation in 1985 of the National Commission on Fraudulent Financial Reporting, also known as the Treadway Commission, after its chairman, resulted in renewed interest in audit committees on the part of financial statement users, preparers, auditors, legislators, regulators, and the general public. The Treadway report showed how audit committees could prevent or detect fraudulent financial reporting and contained 11 specific recommendations as to how this could be accomplished, including the recommendation concerning a management assessment of internal controls.

Appendix I to the Treadway report sets forth good practice guidelines for audit committees. These recommendations include the issues that audit committees should (1) be informed and vigilant, (2) have their duties and responsibilities set forth in a written charter, and (3) be given the resources and authority adequate to discharge their responsibilities. Additional guidance elsewhere in the Treadway report involves these recommendations that the audit committee should:

- Not consist of fewer than three members
- Include private meetings with the internal auditor and the external auditor
- Report to full board
- Require expanded knowledge of company operations
- Include corporate and/or outside counsel in meetings
- Possess knowledge of audit plans—of both external and internal auditor
- Require knowledge of electronic data processing and review of security practices
- Approve controls for use of other auditors in addition to principal auditor

² Securities Exchange Act of 1934, §3(a)(58).

- Provide oversight of sensitive areas such as officers' expenses and perquisites
- Oversee any areas requiring special attention³

Pursuant to Treadway recommendations, in 1989, the Nasdaq stock market required its listed companies to establish and maintain an audit committee of which the majority of members are independent directors.

After several years of deliberations, the American Law Institute, an organization consisting of judges, attorneys, and legal academics, adopted in 1992 but published in 1994 its *Principles of Corporate Governance: Analysis and Recommendations*.⁴ This two-volume work includes recommendations of the appropriate duties that should be undertaken by boards of directors and audit committees. The recommendations for duties of the board of directors as a whole are contained in Chapter 2 and those for audit committees are discussed in Chapter 4. Some of these recommendations became the basis of changes put into practice in later pronouncements of other statutes or recommended by other groups.

A Delaware Chancery Court decision, the *in re Caremark International* case in 1996, established the principle that

a director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists, and that failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance with applicable legal standards.⁵

This decision is most important to audit committees as usually they oversee the organization's information-gathering and dissemination functions, including relationships with internal and external auditors.

In 2003, the Delaware Supreme Court upheld the lower court's articulation of a new duty of corporate directors in the *in re The Walt Disney Company* case.⁶ In this case, which involved whether the directors adequately considered the amount of compensation awarded to Michael Ovitz upon his discharge, was called the duty of good faith. The court held that directors who take an "ostrich-like approach" to corporate governance and "consciously and intentionally disregard their responsibilities, adopting a 'we don't care about the risks' attitude" may be held liable for breaching their duty to act in good faith. The court specifically noted the importance of the duty of good faith, in addition to the duties of due care and of loyalty, as primary guidelines for legally evaluating the conduct of directors.

³ National Commission on Fraudulent Financial Reporting, Report of the National Commission on Fraudulent Financial Reporting (Treadway Report), October 1987, p. 179.

⁴ American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations* (St. Paul, MN: American Law Institute Publishers, 1994).

⁵ *In re Caremark Int'l Inc.*, 698A.2d 959 (Del. Ch. 1996).

⁶ *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693 (2005 Del. Ch.).

REGULATION ARISING FROM BANKING SCANDALS

A significant force in the development of audit committees resulted from the banking scandals of the late 1980s. A study of bank failures by the U.S. General Accounting Office (GAO) (now called the U.S. Government Accountability Office) showed that audit committees of even the largest banks were not sufficiently independent, lacked the expertise to accomplish their responsibilities, and did not receive assessments of key bank operations. The GAO recommended a strengthened role for audit committees in insured banks and savings institutions.

Many of the GAO's recommendations were enacted in December 1991 in the Federal Deposit Insurance Corporation Improvement Act (FDICIA). Under the act, the management of insured institutions are required to increase their activities that are designed to maintain effective internal controls over financial reporting, safeguarding assets, and compliance with relevant laws and regulations. Each year, the management of insured financial institutions must assess and issue a public report on the effectiveness of internal controls over financial reporting. The institution's external auditor must provide an attestation opinion on management's report. This requirement is the forerunner of a similar requirement contained in Sarbanes-Oxley. As a result of this increased emphasis, audit committees of insured institutions are also tasked to higher levels of oversight of the financial reporting, internal controls, and internal and external auditing of insured financial institutions.

STOCK EXCHANGE INITIATIVES

In late 1998, another landmark development affected audit committees. The SEC believed that the quality and related oversight of corporate financial reporting required a significant overall review and upgrade. Consequently, a Blue Ribbon Committee was formed by the New York Stock Exchange and the Nasdaq stock market. Using fast-track methods, the committee issued its report of 10 major recommendations in February 1999.⁷

The *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (Blue Ribbon Committee Report)* focused on the need for total independence and for financial literacy of all audit committee members and the benefits of a formal written charter for the audit committee. The report also included several best practices for audit committee relationships with the external audit firm and recommended specific interactions between the audit firm and the committee. The recommendations in the report were largely put into place as mandatory requirements by means of a series of SEC releases and

⁷ Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, *Blue Ribbon Committee Report*, New York Stock Exchange and the National Association of Securities Dealers, 1999.

stock exchange rules and through AICPA auditing standards that were issued later in 1999 and early 2000.

In the regulatory releases by the SEC and AICPA implementing the *Blue Ribbon Committee Report*, external auditors were directed to be primarily accountable to audit committees and provide them with information that would allow a candid discussion of the accounting judgments that were made by management and reflected in the financial statements. Also, management is required to provide more information to the audit committee regarding its evaluation of the company's risk and control structure, together with supporting information concerning the contents of periodic financial statements.

Additional initiatives from the report led to four more requirements for public companies:

1. Proxy statements must include an annual report of audit committee activities.
2. Proxy statements must include the audit committee's charter at least once every three years and more often if changes are made.
3. External auditors must be engaged to perform a formal current review of interim financial statements each quarter.
4. Proxy statements must include a breakdown of the total fees paid to external auditors for auditing, tax services, and other services.

The fee disclosure requirement exposed many examples (prior to 2002) where external auditors received fees for providing consulting services that some times approached or even exceeded what they received for auditing the corporation's financial statements. Since the firms were well aware that providing consulting services to clients was much more profitable than the "commodity" of auditing financial statements, the large fees for nonaudit services tended to threaten the independence or at least the appearance of independence of external audit firms. The SEC felt very strongly that large consulting fees impaired the independence of external auditors. Public hearings were held, but at the time, the external audit firms successfully resisted any regulatory limits on the amount of consulting that could be provided to their audit clients.

SARBANES-OXLEY ACT OF 2002

The early years of the twenty-first century saw a number of accounting and auditing-related scandals, including Waste Management, Enron, HealthSouth, and WorldCom. These led to the passage of the Sarbanes-Oxley Act of 2002, portions of which are discussed at greater length in subsequent chapters. This legislation has been called the most significant change in the governance of publicly held corporations since passage of the securities laws of the mid-1930s. The major thrust of the legislation was to establish the Public Company Accounting Oversight Board (PCAOB) to regulate and monitor the practice of public accounting as it relates to publicly held

companies. A major function of the PCAOB is to inspect the auditing and quality control practices of firms that audit publicly held companies.

Sarbanes-Oxley also took away from the AICPA, the trade or membership association of certified public accountants, the self-governance functions of public accountants, such as setting ethical, quality, and auditing standards and inspecting firms' performance to assure their proper use. These functions are now provided by the PCAOB, an independent government agency under the oversight of the SEC. Sarbanes-Oxley Section 201(g) prohibits external auditors from performing certain services for their audit clients, including all internal auditing and almost all consulting. Sarbanes-Oxley Section 201(h) requires audit committee to approve in advance any taxation and other nonauditing services that external auditors provide to their audit clients.

Sarbanes-Oxley also contains provisions requiring public corporations to improve their governance practices. The stock exchanges have set forth rules detailing many of the specific actions legislated by this statute. These rules mandate independence and financial competency requirements for audit committees, including financial literacy for all members and financial expertise for one or more members. The act also clarifies the role of all independent directors. Sarbanes-Oxley Sections 302 and 404 require management to certify the completeness and accuracy of periodic financial statements and assess the effectiveness of the corporation's disclosure and internal controls.

Other provisions of Sarbanes-Oxley require companies to establish confidential mechanisms to allow employees to communicate suspected wrongdoing to audit committees (whistleblowing) and to develop and implement a code of ethics for senior financial officers. (The stock exchanges have extended this rule to directors and all employees.) Sarbanes-Oxley also establishes greater criminal penalties for securities fraud, requires attorneys to inform authorities when unlawful conduct takes place, and provides employment protection for employee whistleblowers. More detailed coverage of the provisions contained in Sarbanes-Oxley that affect audit committees is contained in later chapters of this volume.

One important indication of the effect of Sarbanes-Oxley on the work of audit committees is the significant increase in the annual average number of audit committee meetings that take place. Survey research by executive search consulting firm Korn/Ferry shows that the annual average number of audit committee meetings for Fortune 1000 corporations has more than doubled since 2000, before the enactment of Sarbanes-Oxley. In 2000, the average number of meetings held was 4 per year; by 2006, that number had increased to 9 per year.⁸ A later survey by consulting firm Huron Consulting Group notes that from 2002 to 2006, the average annual number of audit committee meetings doubled from about 5 to 10 meetings. In 2006, 60% of public companies held 9 or more meetings of their audit committee, up from 7% in 2002. The number of audit committees in public companies

⁸ Korn/Ferry International, 33rd Annual Board of Directors Study, 2007, p. 16, and 2001, p. 13.

holding 4 or fewer meetings in 2006 dropped to only 3%, down from 44% in 2002.⁹

The substantial cost of implementing some Sarbanes-Oxley requirements has also drawn widespread criticism, particularly Section 404 of the act. This provision requires an annual assessment by management of internal controls over financial reporting and an attestation opinion by the external audit firm. The earlier calls for repeal of portions of Sarbanes-Oxley, particularly Section 404, have subsided. SEC and PCAOB efforts to reduce costs of compliance resulted in two postponements of the effective date for smaller companies to comply with this section. The latest postponement occurred in December 2006, when the deadline for smaller companies to file a management assertion concerning internal control over financial reporting was delayed until fiscal years ending after December 31, 2007. The requirement for an external auditor opinion for such companies was delayed until fiscal years ending after December 31, 2008.

In 2007, the subject of the cost of compliance with Sarbanes-Oxley Section 404 has received attention at both the SEC and the PCAOB. The SEC has published interpretive guidance for management to use in its assessment of internal control over financial reporting. Concurrently, the PCAOB has developed and issued guidance to external auditors in the form of Audit Standard No. 5, which replaces Audit Standard No. 2. Each of these pronouncements describes the need for both management and external auditors to take a top-down and risk-based approach to their tasks and avoid unnecessary work. If entity-wide internal controls are adequate to address a particular risk, no further testing need be done. Chapter 11 presents additional discussion of audit committee involvement with compliance with the provisions of Sarbanes-Oxley Section 404.

DIRECTORS' LIABILITY

Directors may incur personal liability for failure to follow their duties of due care or loyalty or for failure to satisfy regulatory legal requirements, such as those set forth in securities laws. These requirements are discussed in later chapters. Most corporations provide indemnification rights to directors and officers for acts performed in the course of their responsibilities. Directors' and officers' insurance is also commonly provided, although some areas of activity often are excluded under a typical policy.

Most litigation against directors has been brought alleging a breach of loyalty rather than a duty of care. Diligent pursuit of the guidance set forth in this volume is likely to be sufficient to avoid liability. As noted elsewhere, if directors avoid conflicts of interest and act in good faith, discharge their responsibilities with informed judgment, with the measure of care that a person in a similar position

⁹ Huron Consulting Group, *2007 Audit Committee Research Report*, Huron Consulting Group, 2007, p. 4. At www.huronconsulting.com/library/ accessed January 2008.

would use, and in a manner they believe to be in the best interests of the corporation, they should avoid personal liability.

Federal law provides some protection against liability for unpaid directors of not-for-profit organizations. The Volunteer Protection Act of 1997 shields volunteer directors from liability that could otherwise arise from a simple act of negligence. In some states, state laws also prohibit unpaid directors that serve a not-for-profit charitable organization from being sued for malpractice. This subject is further discussed in Chapter 14.

PRIVATE COMPANY AND NOT-FOR-PROFIT GOVERNANCE INITIATIVES

Although the headlines detailing governance scandals have involved events at large publicly held corporations, the pressure for improved disclosure and greater transparency has been felt by not-for-profit organizations as well. Charitable organizations realize that their continued existence and ability to attract donations depends on the trust that givers have that their funds will be utilized in an appropriate manner for the purpose for which they were contributed. The fact that many such organizations consist of locally managed chapters having limited interface with a national headquarters makes good governance an especially high priority.

Although Sarbanes-Oxley applies directly only to publicly held for-profit corporations, because of the reasons just set forth, many private and not-for-profit corporations have chosen to adopt some or all of its provisions as best business practices. Adopters include some large health care providers and some large 501(c)3 organizations. More than three-quarters (78%) of private company respondents to a 2005 survey by attorneys Foley & Lardner have instituted governance reforms, compared with 60% in a similar 2004 survey.¹⁰

In the main, the Sarbanes-Oxley provisions that have been adopted by a number of private and nonprofit corporations are those that are relatively inexpensive to put into place. For example, a number of nonprofit organizations have instituted one or more of these policies:

- The chief financial/chief executive officer makes certifications concerning financial statements and internal and disclosure controls.
- All members of audit committees are independent directors and manage all relationships with the external auditor.
- A financial expert is designated on the audit committee.
- A code of ethics is implemented for the organization or at least for the senior management and finance officers.

¹⁰ Foley & Lardner LLP presentation attended in person by the author, "The Impact of Sarbanes-Oxley on Private and Non-Profit Companies," 2005 National Directors Institute, March 10, 2005, Chicago.

- Mechanisms are established for confidential employee whistleblowing.
- Audit committee approval is required for nonaudit services provided by the external auditors.

California has enacted a Nonprofit Integrity Act of 2004, which raises compliance issues for charities that are required to register with the California Attorney General. Even out-of-state charities that solicit donations, conduct charitable activities, have employees, maintain an office, hold funds or other property, or hold board meetings in California are likely to be subject to this act. This legislation requires charities with revenue of at least \$2 million to have an audit committee that makes recommendations regarding the retention or termination of the external auditor. A provision also requires review of the external audit and conferring with the external auditor to ensure that the organization's financial affairs are in order.

Some observers have called this phenomenon the adoption of Sarbanes-Oxley—Lite. Additionally, several state legislatures including New York have considered bills that would make some Sarbanes-Oxley provisions mandatory for nonprofit organizations headquartered in their state. The U.S. Senate has also held hearings on the subject of improving the governance of not-for-profit organizations. Chapter 14 further discusses issues for audit committees of not-for-profit entities.

FUTURE OUTLOOK

In view of the many calls by investors and the general public for better governance on the part of publicly held corporations, increased oversight burdens have been placed on their boards of directors. Although not legally required to, the boards of directors or trustees of many privately held and not-for-profit corporations have also adopted a number of these practices as a measure of best corporate practice.

As a consequence, audit committees must assume primary responsibility for some of the most important duties of the boards of directors and report regularly to the full board. Additionally, legislative and regulatory initiatives have assigned audit committees specific responsibilities to oversee many of the most critical of the newly recommended or required responsibilities on behalf of the full board.

Another factor motivating improved governance is that corporations perceived to have inadequate corporate governance are being penalized in the marketplace. In fact, several financial service organizations now evaluate and publish the quality of the governance structure of public corporations to guide investors and creditors. The financial rating agencies also utilize governance as one of the measures of financial quality and strength. Thus, corporations with inadequate governance are likely to bear the burden of a higher cost of capital.¹¹ For example, Moody's framework for U.S. and Canadian corporate governance assessment states that:

¹¹ For example, see Moody's series of Special Comments on issues of corporate governance on www.moody's.com accessed January 2008.

Corporate governance can be seen as an important analytic element of management quality. To the extent that shareholders as well as creditors and others have confidence that proper systems of management accountability and incentives are in place, they can have greater confidence in the present management of the company. In theory, they also can be more confident that, should management fail to meet emerging challenges, managers will be held accountable, either through early action by the board of directors, or through pressures, up to and including hostile takeover, in the marketplace for corporate control.¹²

Audit committees are also becoming more involved with processes involving the management of risks the organization chooses to accept. Oversight of risk management—for example, the avoidance of the chance of costly litigation to defend against accusations of bias based on gender, age, and other categories of employees—is gaining importance for audit committees.

In view of the continuing existence of negative public attitudes toward business in general and toward the top levels of management of corporations in particular, the actions of audit committees and boards of directors concerning the governance of their organizations are likely to remain in the public spotlight for years to come. The audit committee should schedule meetings that are free from unreasonable time constraints. The days of board standing committee meetings occurring just “a few hours before the regular board meeting” are long gone. With the prominence audit committees have gained comes a responsibility for members to be sure that they maintain their knowledge of important topics and current developments through continuing education and development. Audit committees should also avail themselves of consulting advice and legal counsel when appropriate.

KEY POINTS IN CHAPTER 1

1. The audit committee is one of the key standing committees of the full board of directors. A primary responsibility is the oversight of a company’s financial integrity.
2. The subject of organizational governance has vastly increased in importance since the business scandals of the early 2000s.
3. Audit committees have been in existence only since the early 1940s.
4. Together with responsibilities of boards of directors as a whole, audit committee responsibilities have increased substantially, particularly in recent years. Board member responsibilities are discussed more fully in Chapter 2; audit committee member responsibilities, in Chapter 4.
5. Although the concept of independence from management is important for all members of boards of directors, it is critically important for audit committee members.

¹² Moody’s, *Rating Methodology, U.S. and Canadian Corporate Governance Assessment*, August 2003. On www.moody’s.com accessed January 2008.

6. Rules and regulations implementing the recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees has increased the transparency of the activities of public company audit committees and set forth new responsibilities. New auditing standards recommended by the committee require external auditors to present information about the use of accounting that may be new and not well covered by existing accounting rules, use of accounting estimates that may not be well supported, and use of accounting principles that may not be the most desirable in the circumstances.
7. The Sarbanes-Oxley Act of 2002 has dramatically changed the landscape of the corporate governance of publicly held corporations. Management responsibilities have been expanded, and the resulting SEC and stock exchange listing standards have greatly increased the responsibilities of audit committees.
8. The breadth of audit committee responsibilities in many companies has expanded from oversight of financial statement preparation to include monitoring of processes relating to governance, risk management, ethics and compliance, internal controls, financial disclosures, and information technology.
9. The governance of not-for-profit organizations has also come under greater public scrutiny. Many have appointed audit committees and adopted some of the Sarbanes-Oxley and similar requirements applicable to public corporations. This trend is particularly true in industries that deal with the federal government, such as those providing health care services.
10. Future demands on audit committees are likely to increase as revelations of new accounting-related scandals emerge, such as the backdating of stock option grants.
11. The trend toward increased breadth in the responsibilities of audit committees beyond merely accounting, auditing, and financial reporting is likely to continue and include areas of compliance, ethics, risk management, and information technology.