

NEWS

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

(202) 755-4846



AUDIT COMMITTEES - THE AMERICAN EXPERIENCE

BY

Philip A. Loomis, Jr.
Commissioner

Securities and Exchange Commission
Washington, D. C.

The Institute of Chartered
Accountants in England
and Wales
Royal Lancaster Hotel
London, England

November 3, 1978

Evolution of the Board of Directors

While the evolution of the board of directors was, of course, closely related to the evolution of the business corporation itself, I will not try to trace the latter except for the basic outline in my synopsis. One major difference between the American experience and the British should, however, be kept in mind. While corporation law in Great Britain has been laid down in a series of Companies Acts of nationwide scope, corporation law in the United States is primarily state law and the various states originally went in rather different ways. Some viewed corporations with some suspicion and sought to restrict them and to guard against abuse, while others were more liberal, or one might say, permissive. The evolution has been towards the latter approach. This resulted, in large measure, from the fact that, under the federal constitution, a corporation established in one state can do business in all the others, subject only to limited restrictions. Thus businessmen chose to incorporate in a state whose corporation laws were to their liking and certain states,

The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication or speech by any of its members or employees. The views expressed here are my own and do not necessarily reflect the views of the Commission or of my fellow Commissioners.

originally New Jersey and later Delaware and Nevada, systematically sought to attract corporations from all over the country in order to collect the fees payable to the state of incorporation. The courts held that, generally speaking, questions of corporation law were to be governed by the law of the state of incorporation.

This development also resulted in a separation of securities law from corporation law to a far greater extent than exists in England. Our major securities markets are national in scope and, for that and other reasons, much securities law is Federal not state and, even in the states, securities laws, unlike corporation laws, were designed largely to protect investors from dubious ventures, rather than to facilitate the development of business.

Turning now to the board of directors. State law requires that they be elected by the shareholders, but provides wide latitude with respect to the size, composition and term of office of the board and its members. The statutes traditionally have said that the business of the corporation "shall be managed by the board of directors" and most still do, although there is a recent tendency to say that the corporation shall be managed "under the direction" or the supervision of the board.

The traditional formula has, I think, meant different things at different times. In earlier periods, up to the beginning of this century or somewhat later, the board was largely composed of the principal officers and shareholders of the corporation and, in that sense, the board did manage the company, or at least board members did. In the case of small companies, this is still true. Later, with the development of very large corporations whose shares were widely distributed among a great many small investors, although the formal structure of the board did not change, the underlying balance of forces was substantially different.

In large corporations, the numerous and unorganized shareholders were neither able to exercise control nor much interested in doing so. They signed and returned the proxies sent to them by management. This meant that management selected the board members and, aside from formal responsibilities required by law, largely determined the role of the board. The primary function of the board, as such, came to be to advise and consult with management on significant matters and board members were frequently selected on the basis of the perceived value of their advice.

This was not a bad system; it facilitated decision making and was conducive to efficiency. Much depended, however, on the competence and character of management,

and the fact that the board was primarily advisory clearly diverged from the concept that the board "manage" the company.

This structure of control with respect to large corporations has come under increasing criticism. Initially, this focused on the diminished role of shareholders as owners of the company and upon the possibility that the interests of shareholders would be subordinated to the interests of management. One principal purpose of the federal securities laws was to provide safeguards for shareholders in terms primarily of full disclosure, and regulation of the proxy solicitation process. While this concern for stockholder protection and, beyond that, for what is sometimes called "corporate democracy" is still very lively, a somewhat broader concern has become manifest in recent years. It is suggested that management is not effectively accountable to anyone and that the system of corporate governance should be re-examined. Some have suggested federal legislation, either requiring federal chartering of large corporations or, at least, the establishment of federal minimum standards for corporate conduct. Naturally the corporate community does not favor additional regulation or governmental involvement and the Commission, the corporate community and

others are exploring alternatives. In that connection, the functioning of the board of directors is receiving considerable attention. While it seems to be generally agreed that the board of directors cannot realistically be expected to "manage" a large corporation, it is believed that measures could be taken to make management more accountable to the board and to emphasize the function of the board in monitoring the activities of the management.

The reasons I have discussed the evolution of the board of directors at some length is because I believe that the creation and development of audit committees in United States corporations can only be understood in terms of the changing nature and function of the board itself.

History and Reasons for the Development of Audit Committees

The origin of audit committees in the United States appears to be somewhat obscure. Some financial corporations, such as banks and insurance companies, have had audit committees for a long time. This seems to have resulted from statutes which required the board of directors of such companies to themselves conduct an audit.

Aside from such special situations, audit committees are a relatively recent development. General Motors Corporation, which has been something of a pioneer in the use of committees and in other aspects of board structure, has had an audit committee since 1939. The McKesson-Robbins scandal exposed in 1938, and the resulting investigation by the Commission, resulted in a number of initiatives in the area of auditing. As some of you may recall, the audited financial statements of McKesson-Robbins for 1937 reported total assets of \$87 million, of which some \$20 million of inventories and accounts receivable proved to be entirely fictitious, as were \$18 million in sales and \$2 million in gross profits. Top management conceived and executed this fraud over a period of some ten years. Among the recommendations in the Commission's 1940 report of its investigation was the establishment of an audit committee of non-officer directors in order to further the independence of auditors. The New York Stock Exchange made a similar suggestion at about the same time and the American Institute of Certified Public Accountants did so somewhat later. Nevertheless the response was initially quite modest. A careful study made in 1970 concluded that "interest in audit committees

was not widespread and their use was not general." 1/
The 1970's, however, have seen a rapid growth of
interest in audit committees and in their establish-
ment by the larger companies. A 1976 successor
to the 1970 study 2/ reported that 87% of the
companies surveyed had audit committees, 10% did
not, and 3% did not reply. More than half of the
companies with audit committees had established
them in the last five years, that is, in the 1970's.
In a memorandum recently filed with the Commission
by the Business Roundtable, it is stated that, of
nearly 900 companies reporting to the Conference
Board, a leading business organization, the
percentage having audit committees had risen to 90%
in 1977, as compared to 24% in 1967 and 45% in 1972.

An important cause of the increased creation of
audit committees has been the action of the New York
Stock Exchange and the Commission. In 1973 the
Exchange issued a so-called "White Paper" with respect
to financial reporting to shareholders, including a
section on audit committees, which said, among other
things, "The Exchange believes that the idea no longer

1/ R. K. Mautz and F. L. Neumann, "Corporate Audit
Committees" (University of Illinois, 1970).

2/ R. K. Mautz and F. L. Neumann, "Corporate Audit
Committees, Policies and Practices" (Cleveland,
Ernst & Ernst, 1977).

represents a corporate luxury but has become a necessity, and we strongly recommend that each listed company form an Audit Committee." In 1972, the Commission issued a statement reciting some of the developments with respect to audit committees and endorsed the establishment of audit committees composed of non-management directors by all publicly-held companies.

The initial reason for the establishment of audit committees appears to have been a desire to strengthen the independence of auditors from management. The Commission's 1940 proposal was based almost entirely on this objective. The independence of auditors is a fundamental concept, and independence is the principal reason why outside auditors are brought in at all, rather than simply using company accounting personnel. If the auditor is selected by a committee of independent directors, which also approves the audit program, and if the auditors can have recourse to such a committee in case of a serious disagreement with management, then their ability to function independently is clearly increased. The usefulness of an audit committee for these purposes depends in large part on the committee being composed wholly or primarily of non-management directors, and that has been a part of the concept almost from the beginning. Consequently,

the establishment of audit committees has gone hand-in-hand with the movement towards having a significant proportion of non-management directors on the board.

Another reason for the development of audit committees has been the change in the function of the board of directors which I outlined earlier. As the board moved from the function of actively managing the company to the function of setting broad policy and examining how that policy is working and whether it is being effectively carried out, the review and analysis aspect of the board's work assumed increasing importance. The function of the audit committee is precisely to engage in such review and examination. Further, the audit committee, through its contacts with the auditors and otherwise, gathers information with respect to the financial condition and operations of the company and thus provides another channel by which information may come to the board. A frequent complaint of non-management directors is that they may not get all the information they would like to have from the reports made to the board by management, so a separate channel can be useful.

The recent experience of the Commission and the business community in the United States with what was called "improper or questionable payments," which often meant bribes to government officials in foreign countries, provides a striking example of this independent information gathering function. Thus, while I do not wish to dwell here on this controversial and unsavory matter, it does relate, to some extent, to audit committees. Management, understandably, did not include such payments in their routine reports to the board. They did not tell the auditor either, but, in some instances, auditors discovered suspicious circumstances. If the auditors were able to bring their suspicions to an audit committee, the problem was more likely to be discovered and dealt with than if such a channel did not exist. When such problems were uncovered, the audit committee was often assigned the task of making at least the initial inquiry. Where no audit committee existed, one was quite often created and given such an assignment. In settling enforcement cases in this area, the Commission has required the creation of audit committees as one of the means of preventing a recurrence of the improper practices. Generally this episode has been a stimulus to the creation of audit committees and that is one of the few favorable things one can say about it.

I think another reason for audit committees is the increasing emphasis on what is called internal controls. As corporations not only become larger but also become more diversified, engaging in a variety of different businesses and doing so in many different countries, it becomes more difficult for responsible management to keep track of what is going on in all the various units and to make sure that management policies and directions are being followed. To accomplish this, corporations have established systems of internal accounting and other controls which are designed to require that transactions are executed in accordance with prescribed procedures and that the acquisition and disposition of assets is properly authorized and duly accounted for. In December 1977, as part of the Foreign Corrupt Practices Act of 1977, Congress required all companies registered with the Commission, which includes almost all publicly-owned companies in the United States, to have such a system of internal controls.

As an additional internal control, many companies have created an internal auditing unit whose principal responsibility is to see to it that the internal control system is functioning properly. Generally, the internal auditors report to management and there is some

uncertainty as to their relationship with the audit committee. Since, however, internal controls and internal auditing relate to the accounting and auditing function, the audit committee is necessarily involved and I believe that as audit committees develop, this will become increasingly so.

In describing the history of audit committees and the reasons why they have developed so rapidly in recent years, I have referred to their function as a check on management control, in such areas as increasing the independence of the auditors, providing a separate channel of information to the board of directors, and improving internal control, including the prevention and detection of improper practices. In so doing, I do not wish to leave the impression that the relationship between management and audit committees is, or should be, an adversary one. Obviously it should not, and the fact that a great many corporate managements have initiated or supported the creation of audit committees demonstrates that it is not so regarded. In the 1976 study I mentioned, only one out of some 250 chief executives questioned regarded the relationship as an adversary one.

Present Requirements and Recommendations Relating
to Audit Committees

At the present time there are few, if any, legal requirements with respect to audit committees. One reason for this is the fact that such committees have come into general use only recently. Beyond that, as I mentioned, the law in the United States with respect to the organization and structure of corporations is primarily state law. I know of only one state, Connecticut, which has adopted any legislation with respect to audit committees. Congress could, of course, adopt legislation in this area but it has not done so.

A subcommittee of the Senate Committee on Government Affairs in a report issued in November of 1977, expressed the view that publicly-owned corporations should be required to have audit committees composed of outside directors but relied on the accounting profession and the Commission to accomplish this. Some Congressional committees will probably revisit this subject in next year's session.

Consequently, the principal requirement now in effect is the Policy Statement of the New York Stock Exchange, adopted in 1977, that each domestic company whose common stock is listed on the Exchange

"shall establish no later than June 30, 1978 and maintain thereafter an Audit Committee composed solely of directors independent of management and free from any relationship that, in the opinion of its Board of Directors, would interfere with the exercise of independent judgment as a committee member."

The Exchange has provided guidelines to assist the companies' boards of directors in applying the policy that members of the audit committee be independent. Officers and employees of the company or its subsidiaries are not eligible. Former officers may be, if the board determines that they are independent. A connection of a director with an organization which does business with the company is not necessarily disqualifying, but service as a professional advisor, consultant, or legal counsel would be, if the board determines that the relationship is material to any of the parties.

In 1974, the Commission amended its disclosure requirements to call for a statement by reporting companies as to whether or not they had an audit committee. In July 1978, the Commission published for public comment proposed rules which would require considerably more disclosure concerning committees of the board of directors. In doing so, we encountered the same problem that appears to have troubled the New York Stock Exchange, which is that, although it is agreed that an audit committee should be composed of "independent" directors, there is no agreed upon definition of "independence." Directors of a corporation may have a great variety of other relationships. They may be connected in one way or another with other companies which are customers, suppliers, or bankers to the corporation, and these relationships may be

important or they may not. Directors may be partners of firms which provide professional services of one kind or another to the company or may be relatives in some degree of officers of the company. The Exchange in large measure leaves these questions to the full board of directors of the company. We can hardly do that in a disclosure requirement, but I am not satisfied that we have yet come up with an adequate answer and I suspect that our proposed rules will be modified before they are adopted.

Early this year, the American Institute of Certified Public Accountants appointed a committee to examine the question of whether the Institute should require that companies establish audit committees as a condition of an audit by an independent public accountant, and if so, how this might be done. They considered such questions as to what companies such a requirement would apply, whether to all public companies, or to only those registered with the Commission, of which there are about 11,000, or only to the larger ones. They also considered the composition of the committee and its functions. If the Institute were to require audit committees, it was suggested that this could be done by requiring, either as an ethical rule or an auditing standard, that a certified public accountant refuse to give an opinion if the client did not have

an audit committee or that he would have to so qualify his opinion. A public hearing was held by the Institute in Chicago early in June. I understand that at the hearing the proposal was received rather coldly, there being a good many objections. The Institute has made no announcement as to its decisions, but I am told that it is unlikely to adopt the proposal, at least at this time.

The Relationship of Audit Committees to the Board of Directors, Management, Auditors and Stockholders

The final item of my agenda, the relationship of the audit committee to the board of directors, management, auditors and stockholders is difficult to deal with because the general use of audit committees is quite recent. There are no definitive standards or rules governing such committees and the companies involved vary greatly, not only in size, but also in their management structure and operating style, as well as in the reasons which have led them to create an audit committee in the first place. At least prior to the recent Exchange requirement, the decision whether to have an audit committee or not rested with each individual company and the company, consequently, has considerable freedom to determine the functions and relationships of the committee.

The 1976 survey which I mentioned earlier found, not surprisingly, that the functions of audit committees tend to evolve with experience. When the committee is first established, its assignment is relatively modest. It would nominate or approve independent auditors, receive and review their reports and perhaps have some other functions. As the committee evolves, it develops a closer relationship with the auditors, meets with them more often, and considers such things as the scope of the audit and any problems encountered, and moves beyond the annual audit to become increasingly involved with such matters as the existence and functioning of the system of internal controls and internal auditing.

Thus in discussing the relationship of the audit committee to other organs of the corporation, such as the board, the management, and the shareholders, I am addressing a moving target since this depends upon the evolution of the audit committee itself, which in turn, is at different stages in different companies. Few generalizations are valid under these circumstances.

The relationship of the audit committee to the board is fairly simple. It is one of the board's committees, assigned to a particular area. It will examine the matters entrusted to it and make recommendations to the board. It also serves as a

separate channel by which information is communicated to the board. As the committee develops, increased responsibilities may be delegated to it, particularly with respect to relations with the auditors. There is an increasing tendency for the audit committee to be composed entirely of non-management directors since this facilitates its function of strengthening the independence of the auditors in relation to management.

Membership on the audit committee affords to non-management directors an opportunity to consult together and to gather information. Some believe that these characteristics of an audit committee will assist the board and particularly the non-management directors in becoming better informed and in taking necessary actions and thus, hopefully, will reduce the possibility that board members will be subject to liability based on charges that they failed to discharge their responsibilities to be aware of the corporation's condition and activities. If problems develop, as illustrated by the improper payments situations, the audit committee may be designated by the board to make an investigation and to report to the full board. This has been done not only in the questionable payments area but in other situations when improper conduct on the part of management is suspected.

The relationship of the audit committee to management is somewhat ambivalent. According to the 1976 survey, the audit committee was viewed as primarily an advisor to management, which is consistent with the advisory function of the board itself which I referred to earlier. But the survey indicated that the committee was also thought of as a critic of management whenever it felt that criticism was called for. This is consistent with the concept of the board as having a responsibility to monitor the activities of management and the belief that the accountability of management to the board should be strengthened.

This theme of the need for accountability has run through a great deal of the recent discussion of corporate structure and corporate governance in the United States, as I understand it has in Great Britain, although with a somewhat different focus. I have the impression that the British concern has been somewhat broader in scope, embracing the relationship of the corporation to society as a whole and to employees in particular. That has not developed to any significant extent in the United States, partially because American labor unions seem reluctant to become involved in questions of corporate governance, for fear that this would compromise their position in arms-length bargaining. There is also more resistance in the United States to the idea of

involving the government in issues of corporate governance and accountability. Nevertheless, there is a growing belief in the United States that management must be accountable to someone. Legally management is accountable to shareholders but, in large public corporations, this is attenuated in practice because the shareholders are a large and amorphous body many of whom regard their holdings as merely an investment. They follow what has been referred to as the "Wall Street Rule," -- if you are dissatisfied with management, sell the stock. Of course, if enough shareholders feel that way, the stock goes down and management may be in trouble. Furthermore, shareholders do have the right to go to court and they do so far more frequently than I understand to be the practice in Great Britain, particularly by the use of "class actions" brought by one or more shareholders on behalf of the whole shareholder body. This, however, is a remedy which can usefully be employed only when illegal or clearly improper conduct can be proven, and thus does not provide for continuing accountability. Consequently, if one does not choose to bring the Government into corporate accountability beyond that already provided for in the federal securities laws, and if the shareholders are not sufficiently involved, then one must look to the board and this is what I think is happening.

The audit committee is well situated to play an important role in providing this accountability because it is composed of non-management directors, has a special relationship with the outside auditors, and necessarily concerns itself with the functioning of the corporation's accounting system and its system of internal controls. The new statutory requirement that corporations reporting to the Commission must have a system of internal accounting controls meeting specified standards as well as adequate books, records and accounts may be expected to emphasize this concern, since the audit committee is the logical body to make sure on behalf of the board that this new legal obligation is complied with.

The relationship between the audit committee and management will, of course, vary from company to company, but the concept appears to be that while the relation should be one of cooperation in the interest of the company, there is a certain tension by reason of the committee's monitoring functions and its participation in the process of furthering management accountability.

The relation between the auditor and the audit committee is necessarily a close one if the audit committee has developed to the extent that it has a significant function in the company. As I mentioned, one of the principal reasons for creating audit committees was to enhance the independence of the

auditor from management. Management, rather than the board as such, has the responsibility to keep books of account and to prepare financial statements. If these statements are to be examined by an "independent" auditor as the federal securities laws require, that auditor must be independent of the management whose statements it audits.

I understand that in England the auditors are regarded as responsible to the shareholders not to management. This has not been so clear in the United States. The corporation statutes are usually silent on the point. Management has traditionally selected the auditor, although his appointment might require formal approval by the board. The auditor's contacts in the course of their work were with representatives of management. The concept of auditors being responsible to shareholders has, however, been recently gaining ground. The Commission suggested in 1940 that the appointment of auditors be submitted to stockholders at the annual meeting and this is now quite generally done. Its significance is more symbolic than anything else since shareholders of large public corporations do not participate in the selection process, but it may influence the auditor's conception of his responsibility. So also the auditors may be subject to suit by stockholders for breach of duty. The existence, however,

of some uncertainty as to who the auditor is responsible to may have contributed to the need for audit committees and other measures to strengthen the independence of the auditors.

The characteristics of the audit committee which are designed to further the independence of the auditor, which I outlined earlier, also enable the auditor and the audit committee to work together to the advantage of both and that is one reason why the accounting profession in the United States has rather consistently over the years advocated and supported the creation of audit committees.

The relation between the audit committee and the internal auditor is less clear and more difficult.

Internal auditors are also a rather recent development. They have been thought of as responsible to, or even as a part of, management, their function being to see that management instructions are complied with. Yet it seems to be recognized that internal auditors should, at least, be independent of the operating personnel whose activities they audit. Outside auditors place some, perhaps considerable, reliance on their work, and audit committees may well do the same. The recent legislation with respect to internal controls seems likely to increase the significance of the internal auditors function,

particularly when this legislation is fully implemented. Internal auditors themselves seem to feel a need for more independence, if not from top management, at least from lower level management. It seems to me that the internal audit function will necessarily be a matter of interest and concern to a fully functioning audit committee and this concern may bring about more corporate stature for that activity. But the internal auditors will probably continue to be responsible to management but increasingly that will be top management and the audit committee will be involved.

In these remarks I have endeavored to describe the American experience with audit committees, since that was my assignment. While I have ventured on some forecasts as to how I think the audit committee will evolve, I have not expressed any conclusions as to whether all this is worthwhile and desirable. In a word, I think it is. I have a few other closing observations.

1. Not every corporation or even every corporation reporting to the Commission needs an audit committee. There is no place for an audit committee unless the company has non-management directors to serve on it. Even where there are such directors, it may well be possible in small corporations for the

full board to perform this function. An audit committee should not be created unless the board and the management are willing to give it a job to do. Otherwise you have a facade which may be misleading.

2. Because of the differences among companies, it is not, at least at this time, feasible to have a standardized and universal model for audit committees. They will be different, although certain principles, such as the composition of the audit committee, are basic. Further, there is still a good deal of defining to do. For example, what relations with management disqualify a director from service on the audit committee? What are its relationships with the internal auditor?

3. Audit committees have developed, at least in part, in response to a felt need to strengthen the accountability of large corporations and their management to their various constituencies. Large corporations perform an essential economic function and they must be free to perform it effectively. At the same time they have considerable power, and power in a free society must be

accompanied by accountability. The fact that most large corporations have voluntarily created audit committees is evidence of a willingness on their part to make necessary changes. To the extent that they make changes voluntarily, the need for more drastic governmental intervention is avoided. We have a great deal of government intervention in business in the United States now, quite possibly too much, and I certainly hope that we will not have to have more of it.