Perceptions of the Role of Corporate Audit Committees - Now and in the Future.

Brenda Stewart Birkett

Louisiana State University and Agricultural & Mechanical College

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PERCEPTIONS OF THE ROLE OF CORPORATE AUDIT COMMITTEES - NOW AND IN THE FUTURE

A Dissertation

Submitted to the Graduate Faculty of the Louisiana State University and Agricultural and Mechanical College in partial fulfillment of the requirements for the degree of Doctor of Philosophy in The Department of Accounting

by
Brenda Stewart Birkett
B. S., Southern University, 1966
M.B.A., Atlanta University, 1967
August 1980

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Changes in the economy have brought about attempts to improve the structure of the corporate organization and the quality of corporate financial reporting. One such attempt has been to increase the responsibilities of corporate boards of directors, and subcommittees to handle specific duties of the board have been established. The audit committee is one of these subcommittees and is now required for all companies listed on the New York Stock Exchange.

The corporate audit committee should make a significant contribution toward improving the integrity and credibility of financial statements and the overall corporate image in the public sector. To accomplish this goal, the audit committee must aid in preserving external auditor independence in both appearance and in fact. In addition, the committee should add stature and importance to the internal audit function.

Audit committees and their objectives, responsibilities and functions will have an impact on all segments of the business community. To date, however, there has been no clear delineation of these objectives, responsibilities and functions. The SEC, the New York Stock Exchange, the AICPA, Congress and others have consistently supported the establishment of audit committees, but no minimum standards of performance have been instituted.

The purpose of this study was to determine the functions that should be performed by audit committees as perceived by three groups:
audit committee members, CPA firm audit partners and a financial statement user group composed of financial analysts and bankers. Differences in opinions among these groups were identified.

A determination of the effectiveness of current audit committee performance as perceived by audit committee members and CPA firm audit partners was also made. Again, differences in opinions between groups were identified. Also, an attempt was made to determine the characteristics of audit committees that were currently functioning effectively.

Data were collected by mail questionnaires. Appropriate statistical tests were used to evaluate the responses.

According to survey results, the differences in opinions of the three groups were statistically significant for most of the audit committee functions presented for consideration. Most of these differences, however, were caused by the extent of agreement indicated by the respondents. The groups were generally uniform in the belief that current audit committee performance is effective and future performance of some set of minimum duties is desirable. Audit committees can be an integral part of the corporate organization if the effectiveness of their performance is adequate to meet the expectations of the business community and the general public.
CHAPTER I

Introduction

In an ever changing economy, there will be continuing attempts to improve the structure of the corporate organization and the quality of corporate financial reporting. The importance of corporations to the American economy makes it necessary to review constantly and to revise the corporate structure and the standards of financial reporting.

The critics of corporate governance readily identify weaknesses in the corporate system. Antibusiness and anticorporate attitudes are not new in American political history, but perhaps never before have the critics been more strident in their accusations, more zealous in their crusade for reforms. Public confidence has sagged; public regulation has proliferated. Proposals abound for more accountability and more control of corporate activities. And there is the expectation that outside directors will become more involved in monitoring corporate conduct and governance.

A significant effort to improve the corporate image and restore public confidence in the business community has been to increase the corporate boards of directors' responsibilities in financial affairs. As a further step, audit committees have been established and given more responsibility.

One especially positive indicator of the business community's desire to improve its image to the general public has been a change in management's attitude toward audit committees. No longer is the
prevailing attitude one of skepticism about the need for an audit com-
mittee or doubt about its ability to accomplish something constructive.
Rather, those responsible for corporate governance are concerned that
all appropriate areas of the corporate organization are subject to
effective audit committee oversight. Audit committees help assure
that the best use is being made of both the public accountants and the
internal auditors in maintaining the integrity of financial reporting
and compliance with the law and accepted standards of ethical behavior.

Perceived Role of Audit Committees

Audit committees will have an impact on all segments of the
business community. To date, however, there has been no clear delinea-
tion of the objectives, responsibilities and functions of these
committees.

The Metcalf Report. The most authoritative pronouncements con-
cerning audit committees appeared in the "Report of the Subcommittee
on Reports, Accounting and Management" of the United States Senate
Committee on Government Operations (the Metcalf Report), and the SEC
"Report to Congress on the Accounting Profession and the Commission's
Oversight Role." The Metcalf Committee stated:

"The major purpose of a corporate audit com-
mittee should be to handle relations with the
independent auditor, improve internal auditing
controls, and establish appropriate policies
to prohibit unethical, questionable, or illegal
activities by corporate employees. An audit
committee should have sole authority to hire
the independent auditor, set the audit fee, and
dismiss the auditor. In addition, the audit
committee should meet privately with the in-
dependent auditor, receive full reports from
the auditing firm on its findings, and be in-

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formed of all services being provided to the corporation by the auditing firm."  

The SEC Report. The SEC Report to Congress suggested several functions that an effective audit committee should perform:

(1) Engage and discharge outside auditors.

(2) Review the engagement of the auditors, including the fee, scope and timing of the audit and any other services rendered.

(3) Review with the auditors and management a company's policies and procedures with respect to internal auditing, accounting and financial controls.

(4) Review with the independent auditors, upon completion of their audit:

   (a) any report or opinion proposed to be rendered in connection therewith;
   (b) the independent auditor's perceptions of the company's financial and accounting personnel (usually in private session);
   (c) the cooperation which the independent auditor received during the course of their review;
   (d) the extent to which the resources of the company were and should be utilized to minimize time spent by the outside auditors;
   (e) any significant transactions which are not a normal part of the company's business;
   (f) any change in accounting principles and practices and the methods of applying them;
   (g) all significant adjustments proposed by the auditor; any recommendations which the independent auditor may have with respect to improving internal accounting controls, choice of accounting principles, or management systems.

(5) Inquire of the appropriate company personnel and the independent auditors as to any instances of deviations from established codes of conduct of the company and periodically review such policies.
(6) Meet with the company's financial staff periodically to review and discuss with them the scope of internal accounting and auditing procedures then in effect; and the extent to which recommendations made by the internal staff or by the independent auditor have been implemented.

(7) Review significant press releases concerning financial matters.5

The Metcalf and SEC reports both emphasize the importance of audit committee involvement with external and internal audit affairs. The Metcalf Report confines its specific recommendations to audit committee responsibilities and duties relating to the independent auditor. The SEC report also specifically suggests audit committee functions relating to external auditors but in addition makes suggestions for duties relating to internal controls and management activities.

Lack ofAudit Committee Standards. With no required minimum standards of performance, various factions may attempt to dictate to audit committees according to their own purpose. For example, critics of corporate governance and independent auditing have seized upon audit committees as a means to introduce substantive changes in the corporate structure. Some of these critics have prescribed audit committee duties and responsibilities that few audit committee members are qualified to perform.6

The duties of the audit committee should be realistic and consistent with the capabilities of its members. Rarely will any of the committee members have professional training in the field of public accounting.7 Therefore, the committee cannot be expected to take responsibility for the quality of the independent auditor's work or
the completeness of financial statement presentation. Matters of
compliance with professional reporting standards and technical dis­
closure are the responsibilities of corporate management and the
professional experts such as the outside auditor and legal counsel.8

The audit committee cannot be expected to assume direct respon­sibility for the operating effectiveness of internal controls and
accounting systems. The audit committee is concerned with financial
statement disclosure, the adequacy of accounting controls and the scope
of the outside auditors' work. The committee is indeed responsible
for reviewing these matters, but not for assuming responsibility for
any of them.9

If the tendency is to demand more of corporate audit committees
than many of them can provide, this may lead to a decrease in their
effectiveness, further disappointment with and criticism of business
and an unwarranted conclusion that private enterprise cannot set its
own house in order.10

Current Problems in Corporate Reporting

The overall objective of the audit function is to increase the
credibility, integrity and reliability of the financial statements.11
An effective audit committee should contribute significantly to this
objective.

Serious questions have been raised about the integrity of the
entire corporate recordkeeping and auditing system.12 These questions
are partially due to environmental changes. The credibility, integrity
and reliability of financial statements and the corporate reporting
system have been influenced by several changes in the business, investor
and legal environments.

Changes in the Business Environment. In the business environment, the most significant and far-reaching change is in the structure of American business resulting from merger. The current merger trend has lasted longer and is substantially larger than any prior merger movement in American history. In addition, this merger period is unique because conglomerate mergers are now dominant. In prior periods of merger activity vertical and horizontal mergers dominated.13

There are also significant changes in the types of conglomerate mergers. In prior years, most conglomerate mergers involved a market or product extension by the acquiring firm. A market extension merger is one in which two firms selling the same product, but in different geographic markets, merge. In a product extension merger the acquiring firm brings together a number of related products which may be distributed through the same marketing channels. There has also been a substantial increase in conglomerate mergers in which there is little discernible relationship between the activities of the acquiring and the acquired firm. The size of firms acquired has also increased substantially.14

The conglomerate merger movement has focused attention on three immediate questions in financial reporting. How is an acquisition to be treated - as a purchase, or as a pooling of interests? How can we assure that the resultant earnings per share figure is stated as accurately and as consistently as possible? Finally, how do we disclose the financial data which will show the relative contribution to earnings per share of the various lines of business of a conglomerate?15
The common factor running through all of these questions is the impact of a business combination on earnings per share. Investors want to know the effect of an acquisition on earnings per share and to be able to compare earnings through acquisitions with earnings through internal growth. When a company diversifies into unrelated activities, the investor may no longer receive information from the financial statements of the acquired companies. The prospects of the conglomerate are then measured by a figure which reports the total profitability of the enterprise and which tells the investor little about the risk, profitability or growth of each segment.16

Another change in the business environment is the improvement in internal reporting systems of corporations. With the formidable assistance of the computer, systems have been developed for providing timely and reliable internal information. As these internal reporting systems become more sophisticated, demands may increase for more disclosure of material information contained in the resulting internal reports. For example, investors may desire information about such matters as the performance of managers and intra-company transactions. At present, internal reports are considered management tools and publication of these reports could both mislead investors and help competitors.17

Corporate reporting is also complicated by accelerating technological changes in the business environment. Technological changes have created new industries, such as computer leasing, where the accountant must apply accounting principles to novel business transactions and arrangements.18

Changes in the Investor Environment. Changes in the investor
environment have been characterized by an increase in the proportion of institutional investors. Such institutions demand, and can digest, more information than most individual stockholders. Their investment committees are backed up by full-time financial analysts.  

The field of financial analysis, which began early in the twentieth century in the larger insurance companies and trust departments of banks, has emerged over the last thirty years with a public identity. Many universities in the United States have established graduate programs in financial analysis. A growing corps of analysts regularly interview the managements of corporate enterprises in which there is any sizeable degree of public interest. The result is widespread dissemination of description, commentary, and analysis, as well as criticism, of the progress and prospects of these companies.

The emergence of the financial analyst, and the growing importance of the institutions he represents, have the following implications for corporate financial reporting:

(1) Financial analysts are increasingly sophisticated readers of financial reports. Their abilities must be taken into account when the report is prepared. The report cannot be prepared with only the lay reader in mind.

(2) Financial analysts are asking for more information about companies than has been universally disclosed in the past. Many of their institutions do, or have the potential to, influence investments to such an extent that many managements will accede to their requests. Some institutional investors, with such large holdings that liquidation would seriously depress market prices, may feel "locked in" to the point where they have to interest themselves much more directly in corporate affairs and developments than the classical idea of the ephemeral investor would suggest.
(3) Corporate managements who disclose information to a few inquiring analysts will tend to make similar disclosure to all stockholders, so as not to run the risks attached to selective disclosure.21

Changes in the Legal Environment. The growth of the institutional investor, his greater sophistication and access to companies, has raised questions about fairness in the distribution and timing of the release of material corporate information. The near instant liquidity of our securities markets which makes it possible to act upon information quickly, explains regulatory preoccupation with questions of fairness. The SEC and the stock exchanges have been concerned with insuring fair dealing in the market through adequate disclosure of financial information.22

The securities markets are now public markets both in fact and contemplation of law. The markets of the twenties were professional markets which represented themselves as public markets. Now the markets have become truly public markets which must be shared with professionals, including institutions. If the individual investor is to continue to have confidence in the markets, he must be assured that these markets do, in fact, also serve individual investors.23

In addition to the change in the securities market, the legal environment has also been affected by the increase in the legal responsibilities of accountants as a result of case law. Accountants must work under the federal securities laws which impose liability even for non-negligent mistakes. And if, for example, a company goes bankrupt, they inevitably find themselves in the middle of controversies between creditors, stockholders and others.24

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Traditionally, suits against accountants by third parties were unsuccessful. The *Ultramares* case, a landmark decision, seemed until recently to foreclose successful investor actions against accountants for false and misleading financial statements. This has been slowly changing over the years and decisions such as that in *Yale Express* indicate that the courts are not reluctant to extend accountants' liability.25

Independent auditors are increasingly aware of legal responsibility and potential liability. Since the early 1960's, lawsuits against all professionals have increased dramatically and CPAs are no exception to this trend. In the United States, there have been more lawsuits against public accountants in the past decade than in the entire previous history of the profession.26 There are no simple reasons for this trend, but the following are major factors:

1. The greater complexity of auditing and accounting due to such factors as the increasing size of business, the existence of the computer, and the intricacies of business operations.

2. The growing awareness of the responsibilities of public accountants on the part of users of financial statements.

3. An increased consciousness on the part of the SEC regarding its responsibility for protecting investors' interests.

4. Society's increasing acceptance of lawsuits by injured parties against anyone who might be able to provide compensation, regardless of who is at fault.

5. Large civil court judgments against CPA firms in a few cases, which have encouraged attorneys to provide legal services on a contingent fee basis. This arrangement offers the injured party a potential gain when the suit is successful, but minimal loss when it is unsuccessful.
(6) The willingness of CPA firms to settle out of court in an attempt to avoid legal fees and adverse publicity rather than resolve through the judicial process the legal problems facing the profession.

(7) The many alternative accounting principles from which clients can elect to present their financial statements, and the lack of clear-cut criteria for the auditor to evaluate whether the proper alternative was selected.

(8) The increasing number of business failures directly related to the dishonesty of management.

(9) The willingness of some CPAs to succumb to management's pressures to ensure their retention as auditors.27

In an effort to avoid lawsuits and legal liability, CPA firms must consistently exhibit professional conduct and ethical behavior. Professional independence in audit engagements must be maintained in appearance and in fact so as not to provide a basis for a potential lawsuit. The general business community is aware of the requirement and reputation for independence of CPA firms. Therefore, independence is one of the more visible indications of professional conduct. The CPAs' realization of this visibility should cause them to take all reasonable steps necessary to provide assurance to the public of their independence.

At the time of adoption of the federal securities laws, the decision was made that an independent accounting profession rather than government auditors should be the means for assuring the public of full and fair corporate financial reporting. The responsibilities of auditors to shareholders and investors were not precisely delineated. The results of present litigation may bring a better definition of these responsibilities consistent with both the practicalities of accounting
and the policies of the federal securities laws. 28

Changes in the environment will continue to have an impact on corporate financial reporting. However, no matter what changes take place and regardless of their effect, users of financial statements will still require reliable financial information. The role of audit committees must be defined in light of both the changing environment and the needs and demands of users. A delineation of responsibilities of audit committees must include duties that will enable the audit committee to contribute to the reliability of the corporate reporting system and the credibility and integrity of the financial statements.

The Role of the Independent Auditor

Auditors have been attesting to credibility of financial representations at least since the fifteenth century. 29 The exact origin of audits of financial reports is in dispute, but it is known that as early as the fifteenth century auditors were called upon to attest to the absence of fraud in the records kept by stewards of wealthy household estates in England. While the origins of attestations are ancient, development of the attest function has occurred most rapidly in the last century. 30

The independent audit function adds credibility to financial statements. The auditor's endorsement provides some degree of assurance as to (1) the reliability of the financial data incorporated in the financial statements and (2) the propriety of the presentations of such data including disclosure of all pertinent information. Without this added credibility, financial statements could be deemed of questionable reliability which would render them of limited value to
creditors, investors and government regulatory agencies.31

A three-party relationship exists for CPAs who serve as independent auditors of publicly-owned corporations. The three parties in interest are the CPA, the client corporation and the public. Although the independent auditor is retained and paid by the corporate client, the federal securities laws clearly require that the services of the independent auditor be performed for the benefit of the public. The corporation also benefits from the external audit and accounting services designed to produce reliable information on the results of corporate activities, but the federal securities laws were not enacted for the corporation's benefit.32

Auditor Independence. A major responsibility of independent auditors is to perform their services while maintaining strict independence from their clients, both in fact and in appearance. Public confidence in the accuracy and usefulness of corporate financial information depends upon a firm belief that such information has been certified by qualified auditors who are truly independent. Confidence in the independence of auditors requires that they have no direct or indirect interest in the affairs of their clients.33

The Securities and Exchange Commission rule no. 210.2-01 (Regulation S-X) states the position of the SEC on auditor independence as follows:

"The Commission will not recognize any certified public accountant or public accountant as independent who is not in fact independent. For example, an accountant will be considered not independent with respect to any person or any of its parents, its subsidiaries, or other affiliates (1) in which, during the period of his professional engagement to examine the financial statements being reported on or at the date of his report, he
or his firm or a member thereof had, or was committed to acquire, any direct financial interest or any material indirect financial interest; (2) with which, during the period of his professional engagement to examine the financial statements being reported on, at the date of his report or during the period covered by the financial statements, he or his firm or a member thereof was connected as a promoter, underwriter, voting trustee, director, officer, or employee, except that a firm will not be deemed not independent in regard to a particular person if a former officer or employee of such person is employed by the firm and such individual has completely disassociated himself from the person and its affiliates and does not participate in auditing financial statements of the person or its affiliates covering any period of his employment by the person.

In determining whether an accountant may in fact be not independent with respect to a particular person, the Commission will give appropriate consideration to all relevant circumstances, including evidence bearing on all relationships between the accountant and that person or any affiliate thereof, and will not confine itself to the relationships existing in connection with the filing of reports with the Commission."34

Thus, the requirements are clear that a CPA acting as an independent auditor of a publicly-owned corporation must be independent in fact with regard to his total relationship with that corporate client. The standards of conduct followed by independent auditors must preserve their independence.35

The American Institute of Certified Public Accountants' Code of Professional Ethics includes a comprehensive set of rules, interpretations, and rulings which require the Institute's members to avoid situations that would create conflicts of interest or bias, either in appearance or in fact.36 The code recognizes the public's expectation that a CPA will have certain character traits - primarily integrity and objectivity and, in the practice of auditing, independence.37

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Statements of Auditing Standards (SAS) Nos. 1 and 4 emphasize the appearance of independence. The elusive and indefinable nature of independence has caused the accounting profession, led by the SEC, to attempt to spell out detailed prohibitions, not only against those activities or relationships that might actually erode the mental attitude of independence but also against those that might even suggest or imply a possibility of lack of independence.  

The SEC, the AICPA and the entire accounting profession have shown that they are dedicated to preserving auditor independence in appearance and in fact. The importance that is placed on independence is emphasized by the large amount of authoritative literature that has been issued on the subject.

Even with the efforts of the accounting profession, auditor independence has still been subject to criticism and attack. The Metcalf Report sharply criticized auditor independence. The report stated that the large CPA firms have used their designated reputation for independence to market a variety of nonaccounting services. The subcommittee report cites examples of activities undertaken by large accounting firms which contradict their claim to act independently in the public interest. The report states explicitly that "the 'big eight' accounting firms are in fact not independent."  

The report states that the lack of independence of large CPA firms results from the scope of client services they perform for profit and the activities they undertake on their own. Management advisory services is cited as the primary problem area regarding the services offered by the CPA firms because it necessarily involves the CPA in the
business operations of their corporate clients. Management advisory services such as executive recruitment, actuarial services and financial management services reflect, in the committee's opinion, a conflict of interest for the independent auditor. Tax services and representation of client's interests are also mentioned as activities of CPAs which contribute to their loss of independence.40

The accounting profession, the SEC, and responsible leaders of the financial community have recognized that a practical threat to an auditor's professional, independent mental attitude is that he is often selected, retained or replaced at the sole discretion of the management on whose representations he is expected to report. Some steps have been taken to deal with this threat. Some companies require that the selection and retention of auditors be ratified by the stockholders and the SEC requires public notice (Form 8-K) of termination of auditors, disclosure of any accounting disputes between client and former auditor within two years, and a letter from the auditor concurring in such disclosure.41

Audit Committees and Auditor Independence. Corporate executives, nonofficer directors and independent CPAs recognize that a properly constituted audit committee of the board of directors can provide a means of strengthening audit independence without direct interference in corporate affairs.42 Auditors and audit committees are equally concerned with independent judgments of financial decisions, and their mutual interests are strengthened by a formal working relationship.43 External auditors should have direct and regular communication with the audit committee on significant matters. This will enhance the
appearance of their independence from management, and when the com-
mittee demonstrates its effectiveness by active performance, stock-
holders and the financial community will more readily recognize that
such independence actually exists. 44

The Internal Audit Function

Audit committees should also add stature and importance to the
internal audit function. Many companies have internal audit departments.
The function has grown in size and stature and professional societies
of internal auditors have been established which offer specialized
courses, conferences, and publications devoted to the subject. 45 The
internal auditors are involved in policing the effectiveness of internal
control. To the extent they are successful, the internal auditors
strengthen the effectiveness of the system of internal control. 46

The importance of internal control was emphasized further by the
internal control and recordkeeping requirements that may have little,
if anything, to do with corrupt foreign payments. The Act made internal
accounting controls a matter of law for all SEC-reporting companies,
not just those that have foreign operations.

The legislative history indicated that Congress's prime interest
was to prevent corrupt payments to foreign officials and that the
requirements for accurate books and systems of internal accounting
control are intended to help in accomplishing that objective. The
Act's provisions dealing with accurate books and records and internal
accounting control are, however, considerably more far-reaching since

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those requirements cover all transactions, not just those related to foreign payments. Specifically, the Foreign Corrupt Practices Act of 1977, which amended the Securities Exchange Act of 1934, requires that all SEC registered companies devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that:

1. Transactions are executed in accordance with management's general or specific authorization.
2. Transactions are recorded as necessary to (a) permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and (b) maintain accountability for assets.
3. Access to assets is permitted only in accordance with management's general or specific authorization.
4. The recorded accountability for assets is compared with the existing assets at reasonable intervals, and appropriate action is taken with respect to any differences.

By early 1978, the Securities and Exchange Commission had already instituted legal action against two companies for violating the internal control and recordkeeping provisions of the Act. In the case against Aminex Resources Corporation and two of its officers, failure to comply with the law is cited as part of a charge of an alleged misappropriation of corporate assets exceeding one million dollars. The court granted a temporary restraining order and the appointment of a temporary receiver to protect Aminex's remaining assets and correct recordkeeping deficiencies.

Page Airways, Inc., and six of its executives are the subject of
the Commission's second action. Although this still-pending case includes charges of illegal foreign payments, the SEC does not allege foreign bribery violations under the Foreign Corrupt Practices Act - apparently because the payments were made before the Act's effective date of December 19, 1977. However, the Commission is charging violations of the internal control and recordkeeping rules because some of the questionable payments were effected without adequate documentation and controls.\(^50\)

The Securities and Exchange Commission obviously intends to exercise its authority in regulating the internal controls of public companies. The SEC may well take the position that the only appropriate control over certain internal control activities is the establishment of an audit committee of the board of directors. Thus, the failure of a company to institute such a committee, composed of outside directors, would constitute a violation of the Act. The SEC has issued so many pronouncements calling for the establishment of audit committees that any board which fails to do so may have to justify its actions in court.\(^51\)

The audit committee of the board of directors is in a unique position to coordinate and oversee the activities of all parties that contribute to effective financial reporting. The effectiveness of the internal control system can be monitored through a close working relationship with the internal audit staff. The professional conduct of the external audit can also be monitored by the audit committee through direct communication with the independent auditors. The external and internal auditors are provided with a forum for their
grievances and recommendations that does not involve management. The
audit committee, as a subcommittee of the board of directors, has
authority to require that management seriously consider the recommenda-
tions from both the external and internal auditors.

The expectations of the business community for audit committees
are great. To live up to these expectations and meet the challenges
they are sure to encounter, audit committees must have a definite role
within the corporate structure. The responsibilities and duties of these
committees must clearly reflect their intended contribution to improving
corporate accountability.

The general public and financial leaders will be evaluating audit
committee effectiveness on the basis of their impact on external auditor
independence, internal control and internal audit effectiveness, and
finally their contribution toward assuring creditors, investors and
other interested parties of the integrity, reliability and credibility
of financial reporting.

Purpose of the Study

The attention of those segments of the business community interested
in improving the corporate image and the credibility and integrity of
financial statements should now be directed toward defining the audit
committee's responsibilities and enhancing the quality of the committee's
work. Ralph Ferrera, the Securities and Exchange Commission General
Counsel, stated his views on the current status of audit committees in
an address to the Southwestern Legal Foundation:

"When the Commission calls for audit committees,
the call is for effective, responsible audit
committees, and not merely non-functioning, albeit decorative shells. Regrettably, a survey published in the Coopers & Lybrand Audit Committee Guide states that among responding corporations only 60% of the audit committees choose the outside accountant and only 40% review the yearly audit before its release. The most common audit function--reviewing the management letter--was performed only in two-thirds of the corporations. Frankly, I do not know what the other so-called audit committees are doing, but the Coopers & Lybrand study does not suggest that the effort underway in the private sector is anywhere near the quality necessary to insure against preemptive federal action.\textsuperscript{52}

While a large part of the problem is undoubtedly that some audit committees are the decorative shells to which Mr. Ferrara referred, equal danger lies in overloading the committee with responsibilities tangential or unrelated to their primary one. The audit committee should be permitted to concentrate on working with the corporation's internal and external accountants. The importance and uniqueness of that function militates strongly against requiring audit committee members to direct their attention to other duties.\textsuperscript{53}

There is an immediate need to determine the necessary duties and functions of audit committees and to establish minimum standards of performance. While the support of audit committees by various segments of the business community is a definite step toward improving the credibility and integrity of financial statements, more concrete efforts are necessary.

The determination of specific responsibilities and functions that should be required of all audit committees would be beneficial to financial statement users as well as audit committee members themselves. Financial statement users could be confident that the existence of an

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audit committee insured that certain functions designed to improve the credibility and integrity of the financial statements were actually performed. Also, the incidence of misconceptions among users about the role of audit committees within the corporate organization would be minimized.

Audit committee members could be more confident as to what their responsibilities and functions are. Once these responsibilities and functions are defined, the committee members can concentrate on improving their skills to meet these responsibilities. In addition, the audit committee members could be assured that they have satisfied at least the minimum requirements for their committee.

A determination of required minimum functions for audit committees could also influence the composition of the committee. Members of the board of directors could be selected for the audit committee according to whether the skills they possess are compatible with the functions to be performed.

Desirable Audit Committee Functions. The purpose of this study is to determine the functions that should be performed by audit committees as perceived by three groups: audit committee members, CPA firm audit partners and a financial statement user group composed of financial analysts and bankers.

A core set of desirable audit committee functions will be presented to each of the participants. They will be asked to give their perception of the importance of each function. The possible functions will be in two distinct categories - those that relate to external auditor independence and those that relate to internal auditing. The core set
of functions was determined from the current literature.

The three groups of participants in this study were selected because of the difference in their relation to corporations and corporate financial statements. Audit committee members are responsible to stockholders in an oversight capacity for adequate financial reporting and disclosure. A properly active and involved audit committee serves to protect the corporate interest by overseeing the auditor and company management.\textsuperscript{54}

CPA firm audit partners are responsible for rendering an opinion as to the fairness with which the financial statements are presented. The CPA's opinion is relied upon by stockholders, creditors, regulatory agencies and other interested parties.

Financial statement users are the final beneficiaries of any action taken to improve the credibility, integrity and reliability of financial statements. Their perceptions of the importance of audit committee functions may affect any decisions that these users make concerning a company and its financial statements.

Each of the three participating groups sees corporate financial reporting from a different perspective. Any suggestion of required minimum audit committee functions must consider the desires, needs and opinions of these groups.

Audit Committee Effectiveness. A determination of how effectively audit committees are currently performing certain functions as perceived by audit committee members and CPA firm audit partners will also be made. Any differences in opinions of the two groups will be identified. The resulting differences will be used to identify any misconceptions about
the effectiveness of audit committees and the current impact of audit committees on the corporate organization. If the CPAs and audit committee members have differing opinions on current committee effectiveness, this could indicate the need for a closer working relationship and more interaction between these two groups.

Audit Committee Characteristics. Characteristics of audit committees and their related companies will be determined. Implications of characteristics such as size of the company and size, age and composition of the audit committee will be evaluated to identify any correlation between them and the number of effectively performed functions. A high degree of association between the number of effectively performed functions and certain committee characteristics could indicate the relative importance of the audit committee in certain companies. A high correlation could also indicate some steps that companies with ineffective audit committees might take to improve committee performance. For example, more audit committee members with auditing backgrounds might be indicated. The number of effectively performed functions to be used in the correlation analysis will be based on responses of the audit committee members.

Method of Data Collection

Data for this research project will be obtained from questionnaires to be sent to three different groups. Audit committee members will be surveyed to determine what they believe the functions of the audit committee should be and to determine if they are actually carrying out these functions effectively. Each questionnaire will consist of a list of possible duties of audit committees that relate to external auditor
independence and the internal audit function. Each participant will be asked to state whether he believes each function should be performed by audit committees. Possible responses will range from strongly agree to strongly disagree on a scale of one to five. In a separate column, he will be asked to state whether he believes his committee is currently performing the function effectively. Possible responses will be from performed very effectively to not currently performed using an interval scale of one to five. The questionnaires to be sent to the audit committee members will also seek general information about their company and its audit committee. Items such as size of company, size of audit committee, length of time audit committee has been in existence and number of directors on the committee with audit backgrounds will be included.

Questionnaires will also be sent to CPA firm audit partners. Basically, their questionnaire will have the same format as the one sent to audit committee members. The CPAs will be asked to state their extent of agreement with each listed function that should be performed by audit committees. They will also be asked in a separate column if over one-half of the audit committees with which they are familiar do actually perform the functions effectively. Possible responses will be the same as described for the questionnaires to be sent to audit committee members.

The third group to be surveyed will be financial statement users composed of financial analysts and bankers. The questionnaires to the financial statement user group will also list the potential audit committee functions. This group will be asked to state the extent of
their agreement as to whether each function should be performed by the audit committee.

All groups will be asked to give an opinion on each of the following statements:

If the external auditor could verify the effective functioning of the audit committee according to a set of pre-established standards, this would be desirable and useful information.

The existence of an audit committee enhances the credibility and integrity of corporate financial reporting.

Possible responses for each statement will be from strongly agree to strongly disagree using the interval scale of one to five.

Respondents from all groups will be asked to list any additional audit committee functions they think should be performed and make any comments in a designated space on the questionnaire. (Sample copies of the questionnaires are found in Appendix A).

Projected Results and Conclusions

From the results of this research, conclusions will be drawn concerning the importance of audit committees and their future impact. Recommendations will be made as to what the functions of audit committees should be and the implications of any significant differences of opinion among the groups surveyed will be examined. Significant differences could indicate misunderstandings of the purpose of audit committees and their role in the corporate organization.

This research is limited to opinions expressed only by the three groups surveyed. This research is also limited to the audit committee's involvement with internal and external audit activities.
FOOTNOTES - CHAPTER I


3. Ibid., p. 1.


7. Schornack, p. 74.

8. Ibid.

9. Ibid.

10. Mautz and Neary, p. 84.


14. Ibid.

15. Ibid.
16. Ibid., pp. 88-89.

17. Ibid., p. 89.

18. Ibid., p. 90


20. Ibid.


22. Saul, p. 91.

23. Ibid.

24. Ibid., p. 93.

25. Ibid.


27. Ibid.


29. Willingham and Carmichael, p. 3.

30. Ibid.

31. Saul, p. 93.


33. Ibid.


35. Ibid.


40. Ibid.


42. Mautz and Neary, p. 84.

43. Defliese, Johnson and Macleod, p. 21.


45. Defliese, Johnson and Macleod, p. 194.


51. See text accompanying Footnotes 3, 4, 5, 6, and 7 in Chapter 2.

52. Harold M. Williams, quoting Ralph Ferrara in "Corporate Accountability - One Year Later," a paper presented at the sixth annual Securities Regulation Institute, San Diego, California, 18 January 1979. p. 29.

53. Ibid., p. 30.

54. Defliese, Johnson and Macleod, p. 199.
CHAPTER II

The Influence of Certain Historical Events on the Development of Corporate Audit Committees

With the New York Stock Exchange decision to require that all its listed corporations have audit committees as of June 30, 1978, audit committees have become an integral part of the corporate organization structure.

The concept of audit committees is not new. Audit committees first received major attention in the late 1930's when the SEC and the New York Stock Exchange encouraged their establishment as a result of the McKesson-Robbins case. In the last ten years there has been a significant increase in the number of corporations that have formed audit committees.1 A 1970 survey by R. K. Mautz and F. L. Neuman showed that 32 percent of the corporations responding had audit committees, while a repeat of the survey in 1976 showed that 87 percent had audit committees.2 Congress, the SEC, the AICPA and others have also expressed an interest in and support for audit committees. The interest and support of these groups, as well as the increasing responsibilities of corporate boards of directors, have significantly contributed to the increase in the number of audit committees.

Actions of the Securities and Exchange Commission

In 1940, the SEC first recommended the establishment of audit committees in Accounting Series Release No. 19. This was issued in response to the McKesson-Robbins, Inc. investigation. The release

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proposed that, to assure auditor independence, a committee be selected from non-officer board members to nominate auditors and arrange details of the engagement.³

In Accounting Series Release No. 123, issued March 23, 1972, the SEC stated its long interest in corporate audit committees, and concluded with the following statement:

"To this end, the Commission, in the light of the foregoing historical recital, endorses the establishment by all publicly-held companies of audit committees composed of outside directors and urges the business and financial communities and all shareholders of such publicly-held companies to lend their full and continuing support to the effective implementation of the above-cited recommendations in order to assist in affording the greatest possible protection to investors who rely upon such statements."⁴

The stated intention of these recommendations was to impress on the auditor his responsibilities to investors, particularly the need for independence.⁵ The SEC noted in Accounting Series Release No. 126, issued July 5, 1972, that the existence of an audit committee of the board of directors, particularly if composed of outside directors, should also strengthen such independence.⁶

In 1974, the SEC issued Accounting Series Release No. 165 which, among other things, added the following provision to Regulation 14A of the proxy rules:

"If the issuer has an audit or similar committee of the board of directors, state the names of the members of the committee. If the board of directors has no audit or similar committee, so state."⁷

In recent years, the SEC has strongly endorsed or required, as a result of enforcement proceedings, that individual corporations establish

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In the matter of National Telephone Company, the SEC discovered the following facts:

1. The company faced serious cash flow difficulties.
2. The company made public disclosures which did not disclose problems but which reported high earnings and projections of growth.
3. Outside directors were aware of the company's troubled financial condition and were also aware of the optimistic disclosures.
4. The company had an audit committee of three outside directors, but the committee never met.
5. Outside directors did not take meaningful steps to see to it that adequate disclosure be made.

With regard to the audit committee, the SEC concluded:

"Finally, the facts developed during this investigation demonstrate the need for adequate, regularized procedures under the overall supervision of the Board to insure that proper disclosures are being made. Such procedures could include, among other things, a functioning audit committee with authority over disclosure matters, or any other procedure which involves the Board of Directors in a meaningful way in the disclosure process. With such procedures, the corporation's shareholders and the public should be more adequately protected from haphazard or fraudulent disclosure."

The case of SEC v. Killearn resulted in a consent decree in which the company agreed, among other things, to form an audit committee of three outside directors. The SEC specifically stated that duties of the committee would include:

1. Review the arrangements and scope of the audit and the compensation of the auditor.
2. Review with the independent auditor and the company's chief financial officer the company's internal accounting controls.

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(3) Review with the auditor the results of the audit, including -

(a) The auditor's report.

(b) The auditor's perception of the company's financial and accounting personnel.

(c) Cooperation received by the auditor.

(d) Steps to make the audit more efficient.

(e) Significant unusual transactions.

(f) Changes in accounting principles.

(g) Significant adjustments proposed by the auditor.

(h) Recommendations by the auditor with regard to internal accounting controls.

(4) Inquire concerning deviations from the company's code of conduct and periodically review that code.

(5) Meet at least twice a year with the company's financial and accounting staff to review internal accounting and auditing procedures.

(6) Recommend to the board the retention or discharge of the independent auditors.

(7) Review all public releases of financial information.

(8) Review activities of officers and directors in dealing with the company.10

The audit committee would also be authorized to conduct investigations related to carrying out its duties and to approve settlements of certain litigation involving the company's officers.11

The SEC underscored the importance it places on an audit committee in an enforcement action concerning misleading interim reporting. In the case of SEC v. Mattel, Inc.,12 it accepted Mattel's consent to establish an audit committee. As a part of the ensuing settlement, the

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court ordered that the company appoint a majority of unaffiliated directors and that it establish a financial controls and audit committee among whose major functions would be a review of financial controls, accounting procedures, and financial statements disseminated to the public.

In the consent decree arising from SEC v. Lum's, et al., the court, as part of the settlement of the SEC's allegation of manipulations and proxy fraud ordered that a standing audit committee be established. The audit committee was to consist of two or more members of the board of directors who were not officers or employers of the company and whose function would be to review the auditor's evaluation of internal controls and to oversee other required evaluations of casino operations, personnel, and security.

When submitting its report on its inquiry into the reason for the Penn Central collapse to a House subcommittee, the SEC noted that:

"The Commission, taking a look at the future, has paid increasing attention to the role, the qualifications, the responsibilities, and the independence of corporate directors, which appear to be called for. Last month the Commission released a statement endorsing the establishment of audit committees composed of independent directors. The staff report points up the critical importance of the whole subject of the responsibility of directors, the greater utilization of public and independent directors, the professionalization of their function, providing staff support for directors and judging their performance not on the basis of hindsight but on the basis of the reasonableness of their judgment in the circumstances and at the time it was exercised."14

In 1976, the SEC again underscored its interest in audit committees, this time as a means of deterring questionable and illegal corporate payments and other practices. In its report to the Senate on "Ques-

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tionable and Illegal Corporate Payments and Practices," the Commission wrote:

"Actions to further enhance the creation by public corporations of audit committees composed of independent directors to work with outside auditors would serve as a valuable adjunct to these legislative proposals.

The importance of the role of the board of directors, independent audit committees, and independent counsel has been illustrated by the Commission's enforcement actions in the area of questionable or illegal corporate payments. Significantly, in some of these cases no audit committee existed. In others, with a single exception, audit committees either operated only during a portion of the time when the questionable payments were alleged to have been made, or were not wholly independent of management. Accordingly, the resolution of these proceedings typically has involved establishment of a committee comprised of independent members of the board of directors, charged to conduct a full investigation, utilizing independent legal counsel and outside auditors, to conduct the necessary detailed inquiries.

The thoroughness and vigor with which these committees have conducted their investigations demonstrate the importance of enhancing the role of the board of directors, establishing entirely independent audit committees as permanent, rather than extraordinary, corporate organs and encouraging the board to rely on independent counsel."15

Acting to further strengthen the independence of auditors, the SEC in September 1977 proposed a rule to require disclosure in a company's proxy material of audit fees and services and approval thereof by the board of directors or its audit committee.16 The text of the proposal included the following comments:

"It is desirable for all public companies to have audit committees composed of independent directors and ways are being considered by which such committees might be encouraged or required."
The Commission believes that objectivity and independence are enhanced if the auditor deals with an audit committee of independent directors or the board of directors in determining services and fees. In order to provide investors with knowledge of whether the board of directors or audit committee has approved all services provided by the auditors, the Commission proposes to require disclosure of whether such approval has taken place.17

In response to the recommendations of the Moss and Metcalf subcommittees, the SEC urged the AICPA to require audit committees as a condition of an independent audit. Speaking at the AICPA Fifth National Conference on Current SEC Developments on January 4, 1978, Harold M. Williams, Chairman of the SEC, stated:

"The profession must take whatever steps are reasonably available to it--such as insisting that their clients maintain audit committees--to insure and enhance its independence. If the profession is reluctant to take steps of that nature voluntarily and of its own accord, the Commission will need to understand why and how that reluctance can be reconciled with a profession which desires to maintain the initiative for self-regulation and self-discipline.18

Harold M. Williams commented again on the importance of audit committees in a paper presented at Carnegie-Mellon University on October 24, 1979. He stated as follows:

"Audit committees are critical because of the fundamental role which the independent auditor plays in corporate accountability and the special trust which the public places in the auditor's work. With the wide acceptance of the concept of the audit committee, the next question which must be faced is the definition of the committees' responsibilities. At present, many audit committees are, undoubtedly, not yet working fully effectively, and some may serve more to provide windowdressing rather than to add substance to the accountability process. The development of a better consensus as to the minimum responsi-
bilities of audit committees should be an important priority."19

Since the 1940 issuance of Accounting Series Release No. 19, the SEC has consistently shown its support of corporate audit committees. Through several court cases it has required certain individual corporations to establish audit committees and has prescribed definite duties for them. In addition, Accounting Series Releases Nos. 123 and 165 addressed the issue of audit committees and further stated the SEC's endorsement of these committees.

Actions of the New York Stock Exchange

The first major endorsement for the establishment of audit committees came from the New York Stock Exchange in 1939, also as a result of the McKesson and Robbins case. The Exchange's report stated, "...where practicable, the selection of the auditors by a special committee of the board of directors composed of directors who are not officers of the company appears desirable."20

For over twenty years the Exchange has required all newly listed companies to have at least two outside directors. In 1973, the Exchange published a 'white paper' which stated that an audit committee "no longer represents a corporate luxury, but has become a necessity."21

At the urging of the SEC, on January 6, 1977, the NYSE adopted a requirement for all listed companies to maintain an audit committee. It specifically stated:

"Each domestic company with common stock listed on the Exchange, as a condition of listing and continued listing of its securities on the Exchange, shall establish no later than June 30, 1978, and maintain thereafter an audit committee comprised solely of directors independent of

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management and free from any relationship that, in the opinion of its board of directors, would interfere with the exercise of independent judgment as a committee member. Directors who are affiliates of the company or officers or employees of the company or its subsidiaries would not be qualified for audit committee membership."22

Thus, the audit committee became a required part of the corporate organization for all companies listed on the New York Stock Exchange.

Actions of the American Institute of Certified Public Accountants

In July 1967, the AICPA executive committee statement on audit committees of board of directors recommended that publicly owned corporations appoint audit committees. Specifically, the committee stated:

"The executive committee of the American Institute of Certified Public Accountants recommends that publicly owned corporations appoint committees composed of outside directors to nominate the independent auditors and to discuss the auditor's work with them.

Wide adoption of this practice would represent a further step in the continuing improvement of corporate financial reporting to the investing public. Audit committees can be a constructive force in the overall review of internal control and financial structure and give added assurance to stockholders as to the objectivity of corporate financial statements.

Audit committees can assist their full boards of directors in matters involving financial statements and control over financial operations. They can also strengthen the positions of managements by providing assurance that all possible steps have been taken to provide independent review of the management's financial policies and operation. This is good for the company and good for the public."23

In July 1977, the AICPA board of directors again urged the establishment of audit committees and urged AICPA members to encourage corporations to establish audit committees. The board has also asked
the American Stock Exchange and regional exchanges to adopt audit committee requirements similar to the requirement of the New York Stock Exchange. 24

Report of the Commission on Auditors' Responsibilities. In its report issued in January 1978, the Commission on Auditors' Responsibilities (which was established by the AICPA) stated:

"The board of directors, with outside members and an audit committee when appropriate, is the best vehicle for achieving and maintaining balance in the relationship between the independent auditor and management. Therefore, the Commission believes that steps should be taken by boards, auditors, and when necessary, by regulatory authorities to help assure that boards will actively exercise this opportunity. Where appropriate to the size and circumstances of the corporation, board members should include independent outsiders, and an audit committee should be formed." 25

Special Committee on Audit Committees. In early 1978, the AICPA appointed a Special Committee on Audit Committees to study whether the AICPA should require that companies establish audit committees of their boards of directors as a condition of an audit by an independent public accountant. Under consideration by this special committee were such questions as whether audit committees should be required to strengthen auditor independence, and should a requirement for audit committees specify duties to be performed by the committee. 26

As a supplemental issue, the committee was also asked to consider whether the independent auditor should be required to be present and available to answer questions at the annual meeting of stockholders. While this issue is not directly related to audit committees, it does involve similar questions of applicability and implementation. 27

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The special AICPA committee, which was formed in response to congresional and SEC recommendations for requiring corporate audit committees, concluded that it was not possible to sustain the considerable burden of identifying the necessity of an audit committee requirement. The AICPA reported to the Securities and Exchange Commission that while it continues to support the concept of audit committees for publicly owned corporations, it has found no reasonable basis for issuing a technical standard requiring their establishment. The committee pointed out that it does not find audit committees necessary for the maintenance of auditor independence or for performance of an audit in accordance with generally accepted auditing standards. The AICPA committee also stated, however, that it is convinced that audit committees can be helpful to both corporate directors and to independent auditors. In addition, the committee stated that any Institute requirement would be viewed as an intrusion into the area of corporate governance and recommended that the accounting profession urge other bodies such as the stock exchanges and the National Association of Securities Dealers to encourage or require committees for publicly held companies.

While the AICPA is unwilling to make the existence of an audit committee mandatory before an independent audit can be performed, it has consistently shown its support for audit committees. The AICPA's expressed belief in the value of the audit committee has contributed to their significant increase in number and importance.

Actions of Congress

While the accounting profession, the SEC and the NYSE have advocated
the audit committee for many years, Congress has only recently ex-
pressed its interest in the matter. Senate Bill 3379, introduced
May 5, 1976, by Senators Church, Clark and Pearson in response to the
publicity involving questionable corporate payments, had as one of its
requirements that companies establish audit committees made up of
outside directors. The bill also would have required that outside
directors constitute at least one-third of the total board membership. 30
There was, however, no action taken on this bill.

In its 1976 report on an investigation of the Securities and Ex-
change Commission, the Subcommittee on Oversight and Investigations
of the Committee on Interstate and Foreign Commerce, House of Repre-
sentatives (the Moss Committee), was critical of board of directors
performance in general and specifically noted the desirability of audit
committees. The following is an excerpt from that report:

"A director must be willing to devote considerable
time to his important and continuing responsibili-
ties. A director elected because of demonstrated
expertise should be expected to manifest that ex-
pertise in fulfillment of his responsibilities and
should be compensated appropriately. The majority
of the board should be detached from management and
from any other conflict of interest, e.g., associa-
tion with the company's investment banker or
corporate counsel. The board should provide itself
with an independent staff. A board's key audit
committee should be comprised of a majority of
independent directors who adopt rules to govern
the committee's proceedings. The audit committee
should have available to it independent expert
advisors. Likewise, the nominating committee
should be comprised of a majority of independent
directors. Assuring the independence of the
board and its key auditing and nominating com-
mittees as well as holding directors to profes-
sional standards of performance are critical to
building an effective system of corporate ac-
countability to protect public investors as well
as a corporation's customers, suppliers, and
competitors." 31
The Foreign Corrupt Practices Act was passed December 19, 1977. This Act made recordkeeping and an internal control system for all public companies a matter of law. Interpreters of this Act have subsequently suggested that audit committees could provide a vehicle for insuring that the provisions of the Act are met. For example, Leonard M. Savoie, CPA, vice-president and controller of Clark Equipment Company, Buchanan, Michigan, and former executive vice president of the AICPA, spoke on some of the practical problems of monitoring compliance with internal accounting control systems under the Foreign Corrupt Practices Act. Savoie suggested that, to assure compliance, companies institute special procedures including annually distributing corporate policy statements and guidelines to all management personnel and authorizing internal auditors and lawyers to investigate and report to the audit committee on violations of the conduct guidelines.32 Dennis R. Beresford and James D. Bond, in an article in the Financial Executive stated that the immediate effect of the internal control provision of the law will be for management, audit committees, and independent auditors of public companies involved in international trade to challenge more rigorously systems of internal control with a broad question similar to the following:

How does the company's system of internal control provide reasonable assurance that an illegal foreign payment does not occur?33

The Subcommittee on Reports, Accounting and Management of the Senate Committee on Governmental Affairs (the Metcalf subcommittee) stated the following in its November 1977 report:

"The subcommittee strongly believes that the accounting profession or the SEC should
immediately require that publicly owned corporations establish audit committees composed of outside directors as a condition for being accepted as a client by an independent auditor."34

Given this new interest on the part of Congress, a possibility looms that new legislation may require boards of directors of all publicly held companies to establish and maintain such audit committees. The principal concern is that such legislation could conceivably go on to establish specific rules and regulations governing the responsibilities and performance of audit committees and boards of directors in general.35

Increases in Responsibilities of Directors

At least part of the explanation for the suddenly increased enthusiasm for corporate audit committees is the increased awareness of the legal responsibilities of directors. A large number of articles in periodical business publications have emphasized the increasing scope of director responsibility.36 For example, a 1974 editorial in Business Week includes the following:

"The Securities & Exchange Commission's suit against the old management of the bankrupt Penn Central Railroad abruptly extends responsibility for corporate misdeeds to a broad new area. In effect, the SEC is saying that anyone connected with the company who was in a position to know what was going on and to do something about it will be held liable along with those who actually committed the offenses. Applying this philosophy to the Penn Central case, the SEC did not stop with bringing suit against . . . the former president and . . . the former top financial officer. It also included as defendants three outside directors of the company."37
In an article entitled "The SEC Looks Harder at How Directors Act," (Business Week, February 2, 1976), the following comments are included:

"Last week's dismissal of Gulf Oil Corporation Chairman, Bob R. Dorsey, by the company's board suggests that some directors are already worried. Gulf's directors reportedly fear that the SEC would hold them liable for a failure to act in disciplining management implicated in illegal acts.

Even outside directors without knowledge of wrongdoing may be legally obligated to ferret out the facts for themselves. That is the thrust of a consent decree that the SEC negotiated last summer with Theodore Kheel and John Castellucci, the two outside directors of Sterling Homex Corporation when insiders were allegedly practicing fraud in hiding the company's financial deterioration."

A book review in the April 26, 1976 issue of Business Week commences with this statement:

"Corporate scandals have become such everyday occurrences that they hardly evoke surprise anymore, but until a few months ago, at least, one question always popped up in their wake: where were the directors when the price fixing, bribing, or polluting was going on."

Corporate directors, faced with such charges and assertions, can scarcely continue in ignorance of their risks and responsibilities. To the extent that corporate audit committees are perceived as a means of reducing such risks, they are likely to be a welcome addition to corporate practice.

Because of limitations of time and resources, the board's responsibility is particularly heavy and, in recent years, directors have been facing intensifying challenges:

(1) Companies have increased in size, diversity and complexity.
(2) Directors find it virtually impossible to be knowledgeable about and discuss every facet of their directorate companies.

(3) The number of lawsuits against directors has increased, not only because of board actions but also because of actions by management.

(4) The directors' obligation to exercise reasonable care in the fulfillment of their responsibilities to shareholders is underscored by the trend toward litigation.39

Corporate boards of directors must meet the challenges of their changing duties and responsibilities in order to fulfill their role within the corporate organization. The audit committee can be an important aid in this endeavor.

Other Actions Supporting the Establishment of Audit Committees

The Corporate Director's Guidebook, prepared by a subcommittee of the American Bar Association, states that it is desirable that boards of directors establish audit committees. The audit committee is described in this publication as "the communication link between the board of directors as representatives of the stockholders, on the one hand, and the independent auditors on the other hand." 40

Some states have audit committee requirements. For example, a recently enacted statute of Connecticut requires that certain corporations of that state with at least one hundred stockholders must establish audit committees. 41

In Canada, the provisions of the Business Corporations Act include the following:
(1) The directors of a corporation that is offering its securities to the public shall elect annually from among their number a committee to be known as the audit committee to be composed of not fewer than three directors, of whom, a majority shall not be officers or employees of the corporation or an affiliate of the corporation, to hold office until the next annual meeting of the shareholders.

(2) The members of the audit committee shall elect a chairman from among their members.

(3) The corporation shall submit the financial statement to the audit committee for its review and the financial statement shall thereafter be submitted to the board of directors.

(4) The auditor has the right to appear before and be heard at any meeting of the audit committee and shall appear before the audit committee when required to do so by the committee.

(5) Upon the request of the auditor, the chairman of the audit committee shall convene a meeting of the committee to consider any matters the auditor believes should be brought to the attention of the directors or shareholders. 42

Many segments of the business community and the general public have shown interest in and support for corporate audit committees. These segments may differ in the purposes for which they support audit committees and in the objectives they hope will be achieved. However, a historical review of the development of audit committees shows that all interested segments expect the committees to strengthen the corporate image to the general public.

While the composition of audit committees has been addressed by
the SEC, the NYSE, the AICPA and Congress, only the SEC has issued any specific duties to be performed by audit committees, and this has only been done in specific cases for individual companies. Without guidelines to maintain some consistency and standardization of functions and responsibilities for all audit committees, the goals for which these bodies support corporate audit committees may not be achieved.
FOOTNOTES - CHAPTER II

1. AICPA, Special Committee on Audit Committees, An AICPA Require-
ment for Audit Committees: An Analysis of the Issues (New York:

2. R. K. Mautz and F. L. Neuman, Corporate Audit Committees -


5. Ibid.


of Investigation in the Matter of National Telephone Co., Inc., Relating to Activities of the Outside Directors of

9. Ibid.


11. Ibid.


15. U.S., Congress, Senate Subcommittee on Banking, Housing and
Urban Affairs, Report of the Securities and Exchange Commission

Accountants. pp. 4-13.

17. Ibid.


24. AICPA, Special Committee on Audit Committees. p. 5.


26. AICPA, Special Committee on Audit Committees. p. 3.

27. Ibid.


34. U.S., Congress, Senate Subcommittee on Reports, Accounting and Management of the Committee on Governmental Affairs. p. 13.


42. Consolidated Regulations of Canada, Vol. IV, c. 426, p. 3043.
Enthusiasm and support for audit committees are widespread. Since audit committees have shown such tremendous growth in numbers and importance in recent years, a definition of their role within the corporation has been a source of concern. The objectives and functions of audit committees are not clearly identified in many cases. As a result, various segments of the business community may differ in their expectation of the contribution that audit committees should make toward improving corporate accountability. Before the gap in expectations can be narrowed, differences in perceptions must be identified.

CPA firm audit partners, audit committee members and financial statement users have different perceptions about the role of corporate audit committees and their functions. These particular groups were selected for participation in this research because of the difference in their relation to audit committees and to corporations in general.

A random sample of 447 CPA firm audit partners selected from the eight largest public accounting firms in the country, 376 audit committee members selected from the annual reports of U. S. corporations, and 450 financial statement users were included in the survey. The financial statement user group was composed of bankers selected from Polk's World Bank Directory and financial analysts selected...
from the 1979 membership directory of the American Financial Analysts Federation. The sample size for each group was originally 500 participants. However, when those participants with insufficient addresses were eliminated the preceding sample sizes resulted.

Mail questionnaires were pre-tested by surveying twenty additional participants. Nine questionnaires or 45% were returned with no indication of any problems in understanding or completing the questionnaire. Questionnaires were then sent to all survey participants and usable responses were as follows: 159 or 35.6% from CPA firm audit partners; 67 or 18% from audit committee members; and 122 or 27.1% from financial statement users.

**Test for Nonresponse Bias**

Any survey bears an element of risk due to the opinions of nonrespondents. The Hansen-Hurwitz method was followed to test for the effect of nonresponse bias on this questionnaire survey. The following steps were performed:

1. A subsample of possible nonrespondents was selected at random from the sample population of each group surveyed.

2. These possible nonrespondents were contacted as follows: telephone calls to CPAs and financial statement users, and registered letters to audit committee members.

3. Questionnaires from the nonrespondents were compared with an equal number of questionnaires randomly selected from the original respondents.

The El-Badry technique modified the Hansen-Hurwitz method by recommending that successive waves of questionnaires be sent to survey...
participants in order to achieve a high initial mail response before identifying nonrespondents. For this research, two successive waves were mailed. The second request was mailed to all survey participants with the exception of those whose original questionnaires were returned as undeliverable by the post office.

After these two successive mailings, the personal contact procedure was used. This contact procedure produced responses from 11 CPAs, 7 audit committee members, and 9 financial statement users. An equivalent number of original respondents were randomly selected for comparison.

The Kolmogorov-Smirnov test for distributional differences was used to compare questionnaires of the nonrespondents and the respondents. The test was done for each function between pairs of groups. In no case were any statistically significant differences in responses noted. Results of the nonresponse bias test can be found in Appendix B.

Selection of Statistical Test for Survey Data

Parametric and nonparametric statistics were considered in deciding which statistical test was most appropriate to use in determining if there were significant differences in the responses of the groups surveyed.

Parametric statistics were considered first. An assumption of parametric statistics is that the observations are drawn from a normally distributed population. The Kolmogorov-Smirnov D statistic was used to test for normality of responses for each function within each group.
The Kolmogorov-Smirnov D statistic is a test of goodness of fit and is more powerful than the chi-square goodness of fit test.\textsuperscript{3} The results showed that at $P \leq .01$, none of the responses were normally distributed. Therefore, parametric statistics could not be used.

The nonparametric chi-square test was first selected for use to determine the significance of differences among independent groups. However, the data showed a high number of contingency tables where more than 5\% of the cells had expected counts of less than five. Since extensive collapsing of responses would have been necessary,\textsuperscript{4} the chi-square test may not have been valid.

Finally, the Kolmogorov-Smirnov test was selected for use to test for distributional differences. The Kolmogorov-Smirnov two-sample test is a test of whether two independent samples have been drawn from the same population or from populations with the same distribution. The two-tailed test is sensitive to any kind of difference in the distribution from which the two samples were drawn, such as differences in location (central tendency), in dispersion, or in skewness. The test is concerned with the agreement between two sets of sample values.\textsuperscript{5}

If the two samples have in fact been drawn from the same population distribution, then the cumulative distribution of both samples may be expected to be fairly close to each other, inasmuch as they both should show only random deviations from the population distribution. If the two sample cumulative distributions are too far apart at any point, this suggests that the samples come from different populations.\textsuperscript{6}
Pairwise comparisons were made in all cases. Therefore, for each function and the two opinion statements, the following hypothesis was tested:

H: There is no significant difference between the distribution of group responses.

**Questionnaire Data on Performance of Audit Committee Functions**

Questionnaires sent to respondents in each of the three groups contained a list of seven external auditor independence related functions and eight internal audit related functions. The listed functions were limited to these two categories although audit committees can and probably do perform duties in other areas. Auditor independence and internal audit, however, represent the main thrust of their activities as evidenced by the literature. The functions were also limited because if functions related to external auditor independence and internal audit are properly and effectively performed, the need for additional functions may be lessened. The listed functions were determined from a combination of functions suggested by sources such as the SEC, the Metcalf Report and journal articles. The functions included in the questionnaires were:

1. **External Auditor Independence Related**
   - (a) Discuss with independent auditors their experiences and problems in completing the audit
   - (b) Discuss scope and timing of independent audit work
   - (c) Approve or nominate independent auditors
   - (d) Discuss meaning and significance of audited figures and notes thereto
   - (e) Recommend termination of external auditors when necessary
   - (f) Ascertain whether management has taken
proper action on independent auditor recommendations

(g) Consult with the independent auditors (out of the presence of management) with regard to the adequacy of internal controls.

(2) Internal Audit Related

(a) Discuss effectiveness of internal control with the internal auditors
(b) Discuss organization and independence of internal auditors
(c) Evaluate the adequacy of staffing for internal auditing
(d) Discuss internal audit findings and recommendations with internal auditors
(e) Discuss goals and plans, including nature and extent of work, of the internal audit function
(f) Discuss with internal auditors their experiences and problems in completing audits
(g) Ascertain whether management has taken proper action on the internal auditors' recommendations
(h) Consult with internal auditors (out of the presence of management) with regard to the adequacy of internal controls.

CPAs and audit committee members were asked to express their opinion on how well the audit committees, with which they are familiar, perform each function. CPAs, audit committee members and financial statement users were also asked to state their extent of agreement with the desirability of each function that could be performed by audit committees.

Comparison of Responses of CPA Firm Audit Partners and Audit Committee Members Concerning Current Audit Committee Performance of External Auditor Independence Related Functions

The opinions of CPA firm audit partners and audit committee members were significantly different for all seven of the external auditor
independence related functions at P ≤ .05. A summary of responses is shown in Tables 1 and 2.

Discuss With Independent Auditors Their Experiences and Problems in Completing the Audit. CPA firm audit partners thought that the audit committees with which they were familiar adequately discussed experiences and problems in completing the audit with the independent auditor. The responses of the CPAs were about evenly distributed between performed very effectively and performed effectively (31% and 36%, respectively). Audit committee members tended to believe much more strongly that they were effectively performing this function. An overwhelming majority of the audit committee members (87%) indicated a belief that they were very effectively discussing experiences and problems of the audit with the independent auditor. Both groups agreed that effective discussions between independent auditors and audit committees are being held, although the difference in degree of effectiveness is statistically significant.

Discuss Scope and Timing of Independent Audit Work. The majority of audit committee members (72%) indicated that they believe their audit committee is very effectively discussing the scope and timing of the independent audit work. CPAs indicated that they believe effective discussions are being held by audit committees concerning scope and timing of independent audit work although the degree of effectiveness indicated was significantly different from that expressed by audit committee members. The responses of CPAs indicated that only 33% believe this function to be very effectively performed.
<table>
<thead>
<tr>
<th>Function</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Discuss with independent auditors their experiences and problems in completing the audit</td>
<td>31</td>
<td>36</td>
<td>21</td>
<td>7</td>
<td>5</td>
</tr>
<tr>
<td>Discuss scope and timing of independent audit work</td>
<td>33</td>
<td>39</td>
<td>20</td>
<td>5</td>
<td>3</td>
</tr>
<tr>
<td>Approve or nominate independent auditors</td>
<td>55</td>
<td>25</td>
<td>11</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>Discuss meaning and significance of audited figures and notes thereto</td>
<td>22</td>
<td>25</td>
<td>35</td>
<td>14</td>
<td>4</td>
</tr>
<tr>
<td>Recommend termination of external auditors when necessary</td>
<td>24</td>
<td>17</td>
<td>21</td>
<td>15</td>
<td>23</td>
</tr>
<tr>
<td>Ascertain whether management has taken proper action on independent auditor recommendations</td>
<td>29</td>
<td>42</td>
<td>20</td>
<td>6</td>
<td>3</td>
</tr>
<tr>
<td>Consult with the independent auditors (out of the presence of management) with regard to the adequacy of internal controls</td>
<td>41</td>
<td>35</td>
<td>13</td>
<td>6</td>
<td>5</td>
</tr>
</tbody>
</table>

NOTE: The response range is from 1 which indicates very effectively to 5 which indicates not currently performed.
Table 2

Does Your Audit Committee Perform This External Auditor Independence Related Function?
Responses of Audit Committee Members
(Responses in Percentages)

<table>
<thead>
<tr>
<th>Function</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Discuss with independent auditors their experiences and problems in completing the audit</td>
<td>87</td>
<td>9</td>
<td>3</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>Discuss scope and timing of independent audit work</td>
<td>72</td>
<td>13</td>
<td>10</td>
<td>2</td>
<td>3</td>
</tr>
<tr>
<td>Approve or nominate independent auditors</td>
<td>76</td>
<td>7</td>
<td>7</td>
<td>0</td>
<td>10</td>
</tr>
<tr>
<td>Discuss meaning and significance of audited figures and notes thereto</td>
<td>66</td>
<td>18</td>
<td>9</td>
<td>3</td>
<td>4</td>
</tr>
<tr>
<td>Recommend termination of external auditors when necessary</td>
<td>69</td>
<td>8</td>
<td>3</td>
<td>6</td>
<td>14</td>
</tr>
<tr>
<td>Ascertain whether management has taken proper action on independent auditor recommendations</td>
<td>72</td>
<td>15</td>
<td>9</td>
<td>3</td>
<td>1</td>
</tr>
<tr>
<td>Consult with the independent auditors (out of the presence of management) with regard to the adequacy of internal controls</td>
<td>85</td>
<td>9</td>
<td>2</td>
<td>0</td>
<td>4</td>
</tr>
</tbody>
</table>

Note: The response range is from 1 which indicates very effectively to 5 which indicates not currently performed.
and 39% believe it to be effectively performed.

**Approve or Nominate Independent Auditors.** General agreement was indicated between CPAs and audit committee members that audit committees effectively approve and nominate the independent auditors. The degree of effectiveness indicated by the two groups caused a statistically significant difference in responses although the majority of both groups expressed an opinion that this function is very effectively performed (55% of the CPAs and 76% of the audit committee members).

**Discuss Meaning and Significance of Audited Figures and Notes Thereto.** The difference of opinion between CPAs and audit committee members as to whether adequate discussions are held concerning the meaning and significance of audited figures and notes thereto was statistically significant. While 66% of the audit committee members indicated that they believe this function is very effectively performed, a large percentage of the CPAs (35%) indicated average performance. Very few of the audit committee members (3%) thought discussions were ineffective. However, 14% of the CPAs indicated that they believe this function is ineffectively performed by audit committees.

**Recommend Termination of External Auditors When Necessary.** Responses to this function varied significantly between groups. The opinions of CPAs were widely distributed with 24% indicating a belief that audit committees very effectively recommend termination of external auditors when necessary, and 23% indicating average performance of this function. A majority of audit committee members (69%) expressed a belief that their committee very effectively performs this function. A large

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percentage of both groups, however, indicated that the audit committees with which they are familiar do not perform this function (23% of CPAs and 14% of audit committee members). Since the performance of this function would only be necessary in special circumstances, many of the survey respondents may not have encountered an actual situation where the audit committee recommended termination of the auditors. Therefore, responses may be based on planned instead of actual performance and this may partially account for some of the responses.

Ascertain Whether Management Has Taken Proper Action on Independent Auditor Recommendations. CPAs and audit committee members agreed that audit committees effectively ascertained whether management had taken proper action on independent auditor recommendations. The difference in degree of effectiveness indicated was significant between groups, however. A majority of the audit committee members (72%) expressed a belief that their committee was very effectively performing this function. CPAs were clearly less enthusiastic about the degree of effectiveness with only 29% indicating a belief that audit committees were very effective in the performance of this function.

Consult With the Independent Auditors (Out of the Presence of Management) With Regard to the Adequacy of Internal Controls. Both groups indicated a belief that the audit committee effectively consults with the independent auditor with regard to the adequacy of internal controls. A majority of audit committee members (85%) expressed a belief that this function is very effectively performed as compared to 41% of the CPAs. Differences in degree of opinion
caused a statistically significant difference in responses.

Comparison of Responses of CPA Firm Audit Partners and Audit Committee Members Concerning Current Audit Committee Performance of Internal Audit Related Functions

For all of the eight internal audit related functions the distributions of responses were significantly different at \( P = .05 \). Tables 4 and 5 summarize these responses.

Discuss Effectiveness of Internal Control With the Internal Auditors. Responses of the two groups varied significantly with regard to the effectiveness of discussions between audit committees and internal auditors concerning internal control. The majority of CPAs (50%) indicated that they believe this function is effectively performed; however, a substantial percentage (29%) were uncertain, and 21% expressed a belief that this function was ineffectively performed. Audit committee members indicated a belief that the function is performed effectively with 69% indicating very effective performance. Only 6% of the audit committee members indicated a belief that this function is ineffectively performed.

Discuss Organization and Independence of Internal Auditors. The responses of CPAs to the effectiveness with which audit committees discuss the organization and independence of internal auditors varied widely. While most of the CPAs indicated a belief that this function is effectively performed, 15% expressed doubt as to audit committee effectiveness in performing this function. Audit committee members indicated a much stronger belief that audit committees were effectively discussing the organization and independence of internal auditors.
<table>
<thead>
<tr>
<th>Function</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Discuss effectiveness of internal control with the internal auditors</td>
<td>17</td>
<td>33</td>
<td>29</td>
<td>13</td>
<td>3</td>
</tr>
<tr>
<td>Discuss organization and independence of internal auditors</td>
<td>18</td>
<td>27</td>
<td>31</td>
<td>15</td>
<td>9</td>
</tr>
<tr>
<td>Evaluate the adequacy of staffing for internal auditing</td>
<td>10</td>
<td>16</td>
<td>41</td>
<td>18</td>
<td>15</td>
</tr>
<tr>
<td>Discuss internal audit findings and recommendations with internal auditors</td>
<td>16</td>
<td>32</td>
<td>29</td>
<td>16</td>
<td>7</td>
</tr>
<tr>
<td>Discuss goals and plans, including nature and extent of work, of the internal audit function</td>
<td>10</td>
<td>28</td>
<td>41</td>
<td>17</td>
<td>4</td>
</tr>
<tr>
<td>Discuss with internal auditors their experiences and problems in completing audits</td>
<td>6</td>
<td>23</td>
<td>38</td>
<td>20</td>
<td>13</td>
</tr>
<tr>
<td>Ascertain whether management has taken proper action on the internal auditors' recommendations</td>
<td>13</td>
<td>32</td>
<td>33</td>
<td>18</td>
<td>4</td>
</tr>
<tr>
<td>Consult with internal auditors (out of the presence of management) with regard to the adequacy of internal controls</td>
<td>16</td>
<td>19</td>
<td>23</td>
<td>22</td>
<td>20</td>
</tr>
</tbody>
</table>

**NOTE:** The response range is from 1 which indicates very effectively to 5 which indicates not currently performed.
TABLE 4
DOES YOUR AUDIT COMMITTEE PERFORM THIS INTERNAL
AUDIT RELATED FUNCTION?
RESPONSES OF AUDIT COMMITTEE MEMBERS
(Responses in Percentages)

<table>
<thead>
<tr>
<th>Function</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Discuss effectiveness of internal control with the internal auditors</td>
<td>69</td>
<td>18</td>
<td>7</td>
<td>2</td>
<td>4</td>
</tr>
<tr>
<td>Discuss organization and independence of internal auditors</td>
<td>64</td>
<td>12</td>
<td>13</td>
<td>6</td>
<td>5</td>
</tr>
<tr>
<td>Evaluate the adequacy of staffing for internal auditing</td>
<td>52</td>
<td>19</td>
<td>13</td>
<td>10</td>
<td>6</td>
</tr>
<tr>
<td>Discuss internal audit findings and recommendations with internal auditors</td>
<td>69</td>
<td>15</td>
<td>7</td>
<td>3</td>
<td>6</td>
</tr>
<tr>
<td>Discuss goals and plans, including nature and extent of work, of the internal audit function</td>
<td>60</td>
<td>18</td>
<td>12</td>
<td>4</td>
<td>6</td>
</tr>
<tr>
<td>Discuss with internal auditors their experiences and problems in completing audits</td>
<td>58</td>
<td>14</td>
<td>13</td>
<td>7</td>
<td>8</td>
</tr>
<tr>
<td>Ascertain whether management has taken proper action on the internal auditors' recommendations</td>
<td>62</td>
<td>19</td>
<td>6</td>
<td>7</td>
<td>6</td>
</tr>
<tr>
<td>Consult with internal auditors (out of the presence of management) with regard to the adequacy of internal controls</td>
<td>63</td>
<td>12</td>
<td>6</td>
<td>6</td>
<td>13</td>
</tr>
</tbody>
</table>

NOTE: The response range is from 1 which indicates very effectively to 5 which indicates not currently performed.
Of the responding audit committee members, 64% indicated a belief that this function is performed very effectively.

Evaluate the Adequacy of Staffing for Internal Auditing. Disagreement between groups concerning the effectiveness of audit committee evaluation of the adequacy of staffing for internal auditing was substantial. Only 10% of the CPAs expressed a belief that this function is very effectively performed compared to 52% of the audit committee members. In addition, 15% of the CPAs indicated that audit committees with which they are familiar do not currently evaluate the adequacy of internal audit staffing. Only 6% of the audit committee members indicated that their committee does not currently perform this function.

Discuss Internal Audit Findings and Recommendations With Internal Auditors. The responses of both groups tended to indicate that they believe audit committees do effectively discuss internal audit findings with internal auditors. Audit committee members, however, indicated much greater confidence in the effectiveness with which this function is performed. Sixty-nine percent of the audit committee members expressed a belief that this function is very effectively performed compared to only 16% of the CPAs.

Discuss Goals and Plans, Including Nature and Extent of Work, of the Internal Audit Function. Audit committee members expressed a belief that audit committees effectively discuss goals and plans of the internal audit function. CPAs indicated a similar belief but to a significantly less degree. Only 10% of the CPAs indicated a belief that this function is very effectively performed as compared
to 60% of the audit committee members.

**Discuss With Internal Auditors Their Experiences and Problems in Completing Audits.** The degree of effectiveness indicated by CPAs and audit committee members varied significantly. A majority of audit committee members (58%) expressed a belief that audit committees very effectively hold discussions with internal auditors concerning experiences and problems arising from the internal audit process. Only 6% of the CPAs indicated such a strong belief. Responses from both groups indicated that this function is not performed at all in a substantial number of cases. Thirteen percent of the CPAs and 8% of the audit committee members indicated that discussions between audit committees and internal auditors were not held by the committees with which they are associated.

**Ascertain Whether Management Has Taken Proper Action on the Internal Auditors' Recommendations.** Audit committee members indicated much more strongly than CPAs that they believe audit committees effectively ascertain whether management has taken proper action on the recommendations of internal auditors. Thirteen percent and 62% of the CPAs and audit committee members, respectively, indicated a belief that this function is very effectively performed.

**Consult With Internal Auditors (Out of the Presence of Management) With Regard to the Adequacy of Internal Controls.** A majority of audit committee members (63%) indicated a belief that discussions between audit committees and internal auditors with regard to internal controls were very effective. CPAs, however, indicated that they believe the performance of this function is only somewhat effective.
In addition, both CPAs and audit committee members indicated that this function is not performed by audit committees in many cases. Of the respondents, 20% of the CPAs and 13% of the audit committee members indicated that the committees with which they are familiar do not perform this function.

There is an obvious gap in perceived audit committee effectiveness between the responding CPA firm audit partners and audit committee members. Predictably, audit committee members expressed more confidence in the effectiveness of their performance than did CPAs. Assuming the committee is made up of dedicated and conscientious individuals, the expectation is that they will perform their duties to the best of their ability. The difference of opinion expressed by the CPAs, however, suggests that the audit committee members may not fully understand the functions they are attempting to perform.

Another possible reason for the gap in perceived effectiveness between CPAs and audit committee members is that CPAs as a whole may be referring to firms of a smaller size than the audit committee members. All CPAs in the survey are audit partners but they may have been associated with more smaller regional firms than with larger national corporations from which audit committee members were selected. For purposes of this research, however, the assumption is that differences in the size of firms referred to by CPAs and audit committee members are not large enough to affect the survey results.

The survey results also showed that both CPAs and audit committee members are of the opinion that the listed audit committee functions related to external auditor independence are performed much more
effectively than those functions related to internal audit. Audit committees may believe that their most important work is with the external auditor.

Comparison of Responses of CPA Firm Audit Partners, Audit Committee Members and Financial Statement Users Concerning the Desirability of Audit Committee Performance of Certain External Auditor Independence Related Functions

Tables 5, 6, 7, and 8 summarize the responses of the three groups surveyed regarding their opinions of the desirability of audit committee performance of certain external auditor independence related functions. Statistically significant differences were noted in many cases.

Discuss With Independent Auditors Their Experiences and Problems in Completing the Audit. All groups agreed that the audit committee should have discussions with external auditors regarding experiences and problems in completing the audit. A statistically significant difference in responses was noted, however, because CPA firm audit partners and audit committee members expressed a stronger degree of agreement than financial statement users.

Discuss Scope and Timing of Independent Audit Work. All three groups indicated a belief that audit committees should discuss the scope and timing of audit work. Degree of agreement varied substantially, however. Only 46% of the financial statement users expressed strong agreement as compared to 66% and 81% of the CPAs and audit committee members, respectively.

Approve or Nominate Independent Auditors. The approval or nomination of independent auditors was considered to be a desirable

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<table>
<thead>
<tr>
<th>Function</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Discuss with independent auditors their experiences</td>
<td>82</td>
<td>12</td>
<td>3</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>and problems in completing the audit</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Discuss scope and timing of independent audit work</td>
<td>66</td>
<td>26</td>
<td>4</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>Approve or nominate independent auditors</td>
<td>78</td>
<td>14</td>
<td>5</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>Discuss meaning and significance of audited figures and notes thereto</td>
<td>58</td>
<td>29</td>
<td>8</td>
<td>2</td>
<td>3</td>
</tr>
<tr>
<td>Recommend termination of external auditors when necessary</td>
<td>62</td>
<td>17</td>
<td>16</td>
<td>2</td>
<td>3</td>
</tr>
<tr>
<td>Ascertain whether management has taken proper action on independent</td>
<td>78</td>
<td>17</td>
<td>3</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>auditor recommendations</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Consult with the independent auditors (out of the presence of management)</td>
<td>75</td>
<td>17</td>
<td>0</td>
<td>2</td>
<td>6</td>
</tr>
<tr>
<td>with regard to the adequacy of internal controls</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

NOTE: The response range is from 1 which indicates strongly agree to 5 which indicates strongly disagree.
<table>
<thead>
<tr>
<th>Function</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Discuss with independent auditors their experiences and problems in completing the audit</td>
<td>96</td>
<td>2</td>
<td>0</td>
<td>0</td>
<td>2</td>
</tr>
<tr>
<td>Discuss scope and timing of independent audit work</td>
<td>80</td>
<td>9</td>
<td>9</td>
<td>0</td>
<td>2</td>
</tr>
<tr>
<td>Approve or nominate independent auditors</td>
<td>77</td>
<td>11</td>
<td>5</td>
<td>0</td>
<td>7</td>
</tr>
<tr>
<td>Discuss meaning and significance of audited figures and notes thereto</td>
<td>82</td>
<td>9</td>
<td>4</td>
<td>1</td>
<td>4</td>
</tr>
<tr>
<td>Recommend termination of external auditors when necessary</td>
<td>79</td>
<td>11</td>
<td>5</td>
<td>0</td>
<td>5</td>
</tr>
<tr>
<td>Ascertain whether management has taken proper action on independent auditor recommendations</td>
<td>84</td>
<td>13</td>
<td>2</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>Consult with the independent auditors (out of the presence of management) with regard to the adequacy of internal controls</td>
<td>90</td>
<td>4</td>
<td>2</td>
<td>0</td>
<td>4</td>
</tr>
</tbody>
</table>

NOTE: The response range is from 1 which indicates strongly agree to 5 which indicates strongly disagree.
## TABLE 7

DO YOU THINK AUDIT COMMITTEES SHOULD BE PERFORMING THIS EXTERNAL AUDITOR INDEPENDENCE RELATED FUNCTION?

RESPONSES OF FINANCIAL STATEMENT USERS
(Responses in Percentages)

<table>
<thead>
<tr>
<th>Function</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Discuss with independent auditors their experiences and problems in completing the audit</td>
<td>64</td>
<td>23</td>
<td>6</td>
<td>4</td>
<td>3</td>
</tr>
<tr>
<td>Discuss scope and timing of independent audit work</td>
<td>46</td>
<td>25</td>
<td>19</td>
<td>6</td>
<td>4</td>
</tr>
<tr>
<td>Approve or nominate independent auditors</td>
<td>50</td>
<td>17</td>
<td>15</td>
<td>10</td>
<td>8</td>
</tr>
<tr>
<td>Discuss meaning and significance of audited figures and notes thereto</td>
<td>60</td>
<td>24</td>
<td>9</td>
<td>3</td>
<td>4</td>
</tr>
<tr>
<td>Recommend termination of external auditors when necessary</td>
<td>55</td>
<td>21</td>
<td>12</td>
<td>5</td>
<td>7</td>
</tr>
<tr>
<td>Ascertain whether management has taken proper action on independent auditor recommendations</td>
<td>64</td>
<td>25</td>
<td>7</td>
<td>1</td>
<td>3</td>
</tr>
<tr>
<td>Consult with the independent auditors (out of the presence of management) with regard to the adequacy of internal controls</td>
<td>70</td>
<td>16</td>
<td>9</td>
<td>2</td>
<td>3</td>
</tr>
</tbody>
</table>

NOTE: The response range is from 1 which indicates strongly agree to 5 which indicates strongly disagree.
### TABLE 8

**DO YOU THINK AUDIT COMMITTEES SHOULD BE PERFORMING THIS EXTERNAL AUDITOR INDEPENDENCE RELATED FUNCTION?**  
*A COMPARISON OF RESPONSES*

<table>
<thead>
<tr>
<th>Function</th>
<th>CPAs and Committee Members</th>
<th>CPAs and Statement Users</th>
<th>Committee Members and Statement Users</th>
</tr>
</thead>
<tbody>
<tr>
<td>Discuss with independent auditors their experiences and problems in completing the audit</td>
<td>NS**</td>
<td>.05</td>
<td>.05</td>
</tr>
<tr>
<td>Discuss scope and timing of independent audit work</td>
<td>NS</td>
<td>.05</td>
<td>.05</td>
</tr>
<tr>
<td>Approve or nominate independent auditors</td>
<td>NS</td>
<td>.05</td>
<td>.05</td>
</tr>
<tr>
<td>Discuss meaning and significance of audited figures and notes thereto</td>
<td>.05</td>
<td>NS</td>
<td>.05</td>
</tr>
<tr>
<td>Recommend termination of external auditors when necessary</td>
<td>NS</td>
<td>NS</td>
<td>.05</td>
</tr>
<tr>
<td>Ascertain whether management has taken proper action on independent auditor recommendations</td>
<td>NS</td>
<td>NS</td>
<td>NS</td>
</tr>
<tr>
<td>Consult with the independent auditors (out of the presence of management) with regard to the adequacy of internal controls</td>
<td>NS</td>
<td>NS</td>
<td>NS</td>
</tr>
</tbody>
</table>

The hypothesis is that the distribution of group responses is not significantly different.

**NS =** Not Significant.
audit committee function by all groups. Financial statement users indicated lesser agreement than CPAs and audit committee members, however. CPAs and audit committee members strongly agreed with the performance of this function in 78% and 77% of the responses respectively, as compared to 50% of the financial statement users.

**Discuss Meaning and Significance of Audited Figures and Notes Thereto.** All groups supported discussions of the meaning and significance of audited figures and notes thereto as an audit committee function. However, audit committee members, with 82% expressing strong agreement, attached more importance to the performance of this function than CPAs and financial statement users. Strong agreement for performance of this function was indicated by only 58% of the CPAs and 60% of the financial statement users.

**Recommend Termination of External Auditors When Necessary.** Financial statement users indicated a lesser degree of agreement (55% expressed strong agreement) to audit committees recommending termination of external auditors when necessary. CPAs and audit committee members expressed stronger support for audit committee performance of this function, with 62% of the CPAs and 79% of the committee members responding in strong agreement.

**Ascertain Whether Management Has Taken Proper Action on Independent Auditor Recommendations.** The majority of all groups strongly agreed that audit committees should ascertain whether management has taken proper action on independent auditor recommendations. No significant differences in responses were noted.
Consult With the Independent Auditors (Out of the Presence of Management) With Regard to the Adequacy of Internal Controls). A majority of all three groups were strongly in favor of consultations between audit committees and the independent auditor with regard to the adequacy of internal controls. Any differences in the distribution of responses were statistically insignificant.

Comparison of Responses of CPA Firm Audit Partners, Audit Committee Members and Financial Statement Users Concerning the Desirability of Audit Committee Performance of Certain Internal Audit Related Functions

Degree of support for the performance of certain audit committee functions related to internal audit varied significantly among the responding groups. Tables 9, 10, 11, and 12 summarize the survey results.

Discuss Effectiveness of Internal Control With the Internal Auditors. Discussions between audit committees and internal auditors on the effectiveness of internal control were considered important by all three groups. A majority of all groups agreed that this function should be performed by audit committees. A statistically significant difference resulted, however, because a much smaller percentage of financial statement users indicated strong agreement than CPAs and audit committee members. Only 56% of the financial statement users expressed strong agreement compared to 67% and 87% of the CPAs and committee members, respectively.

Discuss Organization and Independence of Internal Auditors. All groups indicated agreement that audit committees should discuss the organization and independence of internal auditors although degree of
<table>
<thead>
<tr>
<th>Function</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Discuss effectiveness of internal control with the internal auditors</td>
<td>67</td>
<td>28</td>
<td>4</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>Discuss organization and independence of internal auditors</td>
<td>68</td>
<td>22</td>
<td>7</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>Evaluate the adequacy of staffing for internal auditing</td>
<td>44</td>
<td>30</td>
<td>17</td>
<td>5</td>
<td>4</td>
</tr>
<tr>
<td>Discuss internal audit findings and recommendations with internal auditors</td>
<td>61</td>
<td>30</td>
<td>6</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>Discuss goals and plans, including nature and extent of work, of the internal audit function</td>
<td>53</td>
<td>29</td>
<td>15</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>Discuss with internal auditors their experiences and problems in completing audits</td>
<td>39</td>
<td>33</td>
<td>17</td>
<td>8</td>
<td>3</td>
</tr>
<tr>
<td>Ascertain whether management has taken proper action on the internal auditors' recommendations</td>
<td>64</td>
<td>28</td>
<td>6</td>
<td>0</td>
<td>2</td>
</tr>
<tr>
<td>Consult with internal auditors (out of presence of management) with regard to the adequacy of internal controls</td>
<td>48</td>
<td>30</td>
<td>11</td>
<td>3</td>
<td>8</td>
</tr>
</tbody>
</table>

NOTE: The response range is from 1 which indicates strongly agree to 5 which indicates strongly disagree.
### TABLE 10

**DO YOU THINK AUDIT COMMITTEES SHOULD BE PERFORMING THIS INTERNAL AUDIT RELATED FUNCTION?**

**RESPONSES OF AUDIT COMMITTEE MEMBERS**

(Responses in Percentages)

<table>
<thead>
<tr>
<th>Function</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Discuss effectiveness of internal control with the internal auditors</td>
<td>85</td>
<td>13</td>
<td>0</td>
<td>0</td>
<td>2</td>
</tr>
<tr>
<td>Discuss organization and independence of internal auditors</td>
<td>71</td>
<td>18</td>
<td>9</td>
<td>0</td>
<td>2</td>
</tr>
<tr>
<td>Evaluate the adequacy of staffing for internal auditing</td>
<td>63</td>
<td>23</td>
<td>8</td>
<td>2</td>
<td>4</td>
</tr>
<tr>
<td>Discuss internal audit findings and recommendations with internal auditors</td>
<td>73</td>
<td>14</td>
<td>9</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>Discuss goals and plans, including nature and extent of work, of the internal audit functions</td>
<td>68</td>
<td>18</td>
<td>5</td>
<td>7</td>
<td>2</td>
</tr>
<tr>
<td>Discuss with internal auditors their experiences and problems in completing audits</td>
<td>64</td>
<td>23</td>
<td>7</td>
<td>4</td>
<td>2</td>
</tr>
<tr>
<td>Ascertain whether management has taken proper action on the internal auditors' recommendations</td>
<td>77</td>
<td>14</td>
<td>2</td>
<td>3</td>
<td>4</td>
</tr>
<tr>
<td>Consult with internal auditors (out of presence of the management) with regard to the adequacy of internal controls</td>
<td>72</td>
<td>7</td>
<td>11</td>
<td>4</td>
<td>6</td>
</tr>
</tbody>
</table>

**NOTE:** The response range is from 1 which indicates strongly agree to 5 which indicates strongly disagree.
<table>
<thead>
<tr>
<th>Function</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Discuss effectiveness of internal control with the internal auditors</td>
<td>56</td>
<td>26</td>
<td>9</td>
<td>5</td>
<td>4</td>
</tr>
<tr>
<td>Discuss organization and independence of internal auditors</td>
<td>38</td>
<td>34</td>
<td>21</td>
<td>5</td>
<td>2</td>
</tr>
<tr>
<td>Evaluate the adequacy of staffing for internal auditing</td>
<td>29</td>
<td>27</td>
<td>26</td>
<td>10</td>
<td>8</td>
</tr>
<tr>
<td>Discuss internal audit findings and recommendations with internal auditors</td>
<td>44</td>
<td>26</td>
<td>22</td>
<td>6</td>
<td>2</td>
</tr>
<tr>
<td>Discuss goals and plans, including nature and extent of work, of the internal audit function</td>
<td>38</td>
<td>27</td>
<td>26</td>
<td>6</td>
<td>3</td>
</tr>
<tr>
<td>Discuss with internal auditors their experiences and problems in completing audits</td>
<td>40</td>
<td>31</td>
<td>20</td>
<td>7</td>
<td>2</td>
</tr>
<tr>
<td>Ascertain whether management has taken proper action on the internal auditors' recommendations</td>
<td>55</td>
<td>28</td>
<td>10</td>
<td>5</td>
<td>2</td>
</tr>
<tr>
<td>Consult with internal auditors (out of presence of management) with regard to adequacy of internal controls</td>
<td>48</td>
<td>26</td>
<td>16</td>
<td>5</td>
<td>5</td>
</tr>
</tbody>
</table>

**NOTE:** The response range is from 1 which indicates strongly agree to 5 which indicates strongly disagree.
TABLE 12

DO YOU THINK AUDIT COMMITTEES SHOULD BE PERFORMING
THIS INTERNAL AUDIT RELATED FUNCTION?
A COMPARISON OF RESPONSES

<table>
<thead>
<tr>
<th>Function</th>
<th>CPAs and Committee Members</th>
<th>CPAs and Statement Users</th>
<th>Committee Members and Statement Users</th>
</tr>
</thead>
<tbody>
<tr>
<td>Discuss effectiveness of internal control with the internal auditors</td>
<td>NS**</td>
<td>NS</td>
<td>.05</td>
</tr>
<tr>
<td>Discuss organization and independence of internal auditors</td>
<td>NS</td>
<td>.05</td>
<td>.05</td>
</tr>
<tr>
<td>Evaluate the adequacy of staffing for internal auditing</td>
<td>NS</td>
<td>.05</td>
<td>.05</td>
</tr>
<tr>
<td>Discuss internal audit findings and recommendations with internal auditors</td>
<td>NS</td>
<td>.05</td>
<td>.05</td>
</tr>
<tr>
<td>Discuss goals and plans, including nature and extent of work, of the internal audit function</td>
<td>NS</td>
<td>.05</td>
<td>.05</td>
</tr>
<tr>
<td>Discuss with internal auditors their experiences and problems in completing audits</td>
<td>.05</td>
<td>NS</td>
<td>.05</td>
</tr>
<tr>
<td>Ascertain whether management has taken proper action on the internal auditors' recommendations</td>
<td>NS</td>
<td>NS</td>
<td>.05</td>
</tr>
<tr>
<td>Consult with internal auditors (out of presence of management) with regard to the adequacy of internal controls</td>
<td>.05</td>
<td>NS</td>
<td>.05</td>
</tr>
</tbody>
</table>

The hypothesis is that the distribution of group responses is not significantly different. **NS = Not Significant."
agreement varied widely. CPAs and audit committee members were in support of this function with 68% of the CPAs and 71% of the committee members indicating strong agreement. The degree of agreement expressed by financial statement users was significantly less. Only 38% of the user group was in strong agreement with audit committee performance of this function. In addition, uncertainty as to whether this function should be performed by audit committees was indicated by 21% of the statement users.

Evaluate the Adequacy of Staffing for Internal Auditing. Uniform agreement was expressed by the three groups surveyed that audit committees should evaluate the adequacy of staffing for internal auditing. Financial statement users, however, indicated a lesser degree of agreement than CPAs and audit committee members. The percentage of statement users indicating strong agreement was 29% compared to 44% of the CPAs and 63% of the audit committee members. Also, 26% of the financial statement users and 17% of the CPAs indicated uncertainty as to whether this function should be performed at all.

Discuss Internal Audit Findings and Recommendations With External Auditors. Financial statement users expressed a lesser degree of agreement than CPAs and audit committee members in regard to discussions of internal audit findings and recommendations between audit committees and internal auditors. All groups did agree that this function should be performed by audit committees, but only 44% of the statement users were in strong agreement, whereas 61% of the CPAs and 73% of the audit committee members expressed strong agreement. Also contributing to a statistically significant difference in the group

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responses was the fact that 22% of the financial statement users indicated that they were uncertain as to the desirability of audit committee performance of this function.

Discuss Goals and Plans, Including Nature and Extent of Work, of the Internal Audit Function. The three groups agreed that audit committees should discuss goals, plans, nature and extent of work of the internal audit function. Financial statement users were less enthusiastic in their support of this function than the other two groups. Also, 26% of the financial statement users and 15% of the CPAs were unsure of whether this should be an audit committee function.

Discuss With Internal Auditors Their Experiences and Problems in Completing Audits. All groups agreed that audit committees should discuss with internal auditors any problems and experiences in completing internal audits. Audit committee members, however, indicated much greater agreement in that 64% of the respondents in this group expressed strong agreement with the performance of this function. Only 39% of the CPAs and 40% of the financial statement users indicated strong agreement. In addition, 20% of the statement users and 17% of the CPAs expressed uncertainty as to whether audit committees should perform this function.

Ascertain Whether Management Has Taken Proper Action on the Internal Auditors' Recommendations. A majority of all groups agreed that audit committees should ascertain whether management has taken proper action on the internal auditors' recommendations. A statistically significant difference in responses was caused by a lesser degree of agreement expressed by financial statement users rather
than any disagreement among groups.

Consult With Internal Auditors (Out of the Presence of Management) With Regard to the Adequacy of Internal Controls. Audit committee members indicated much stronger support for audit committees performance of this function although CPAs and financial statement users agreed that audit committees should consult with internal auditors about internal controls. In 72% of the responses, audit committee members strongly agreed that this function should be performed. Only 48% of the CPAs and 48% of the statement users expressed such strong agreement.

Several pervading perceptions concerning potential audit committee functions were identified by the survey results. First, financial statement users consistently indicated less support for audit committee performance of the functions presented than the other two groups. Alternatively, audit committee members expressed consistently stronger support for the functions presented.

Secondly, survey results indicated that financial statement users are less sure of desirable audit committee functions, particularly those functions related to internal audit. For 5 of the 8 internal audit related functions presented to survey participants for consideration, financial statement users expressed uncertainty in 20% or more of their responses.

Finally, all groups placed less importance on audit committee performance of internal audit related functions. The percentage of respondents strongly agreeing with the desirability of audit committee performance of the external auditor independence related functions was...
Questionnaire Data and Comparison of Group Perceptions of the Role of Audit Committees

Respondents in each of the three groups were asked to give their opinion on the following two statements:

(1) If the external auditor could verify the effective functioning of the audit committee according to a set of pre-established standards, this would be desirable and useful information.

(2) The existence of an audit committee enhances the credibility and integrity of corporate financial reporting.

Responses to these statements give an indication of how the three groups perceive the role of audit committees and its importance to the corporate organization. Opinions were measured on a 1 to 5 scale, with 1 indicating strong agreement and 5 indicating strong disagreement. Actual responses indicate differing opinions among groups to the statements. A summary of these responses is shown in Tables 13 and 14.

External Auditor Verification of Audit Committee Effectiveness. Audit committee members and financial statement users felt that external auditor verification of the effective functioning of audit committees could provide desirable and useful information, even though their support was not very strong. A majority of CPAs (64%), however, disagreed and did not believe in the importance of external auditor verification, with a large percentage (44%) in strong disagreement.

A possibility exists here that CPAs are in disagreement because
TABLE 13
AUDIT COMMITTEE EFFECT ON FINANCIAL REPORTING
RESPONSES OF CPA FIRM AUDIT PARTNERS, AUDIT COMMITTEE MEMBERS AND FINANCIAL STATEMENT USERS
(Responses in Percentages)

<table>
<thead>
<tr>
<th>Statement</th>
<th>CPAs</th>
<th>Committee Members</th>
<th>Statement Users</th>
</tr>
</thead>
<tbody>
<tr>
<td>If the external auditor could verify the effective functioning of the audit committee according to a set of pre-established standards, this would be desirable and useful information</td>
<td>8 14 14 20 44</td>
<td>38 14 14 4 30</td>
<td>20 36 25 8 11</td>
</tr>
<tr>
<td>The existence of an audit committee enhances the credibility and integrity of corporate financial reporting</td>
<td>43 31 22 2 2</td>
<td>67 14 11 6 2</td>
<td>28 35 20 10 6</td>
</tr>
</tbody>
</table>

NOTE: The response range is from 1 which indicates strongly agree to 5 which indicates strongly disagree.
<table>
<thead>
<tr>
<th>Statement</th>
<th>CPAs and Committee Members</th>
<th>CPAs and Statement Users</th>
<th>Committee Members and Statement Users</th>
</tr>
</thead>
<tbody>
<tr>
<td>If the external auditor could verify the effective functioning of the audit committee according to a set of pre-established standards, this would be desirable and useful information.</td>
<td>.05</td>
<td>.05</td>
<td>NS**</td>
</tr>
<tr>
<td>The existence of an audit committee enhances the credibility and integrity of corporate financial reporting.</td>
<td>.05</td>
<td>NS</td>
<td>.05</td>
</tr>
</tbody>
</table>

*The hypothesis is that the distribution of group responses is not significantly different.

**NS = Not Significant.
they do not want the responsibility of evaluating audit committee effectiveness. This may be particularly true at this stage of audit committee development since roles and responsibilities vary between companies. Also, any evaluation of audit committee responsibility may involve subjective judgment by the CPA. Generally, CPAs find objective judgment preferable and therefore may deem additional responsibility of a subjective nature undesirable.

**Audit Committee Effect on Credibility and Integrity of Corporate Financial Reporting.** All groups agreed that the existence of an audit committee enhances the credibility and integrity of corporate financial reporting. Audit committee members felt much more strongly about the impact of the audit committee on financial reporting than did CPAs or financial statement users. Such an opinion on the part of audit committee members could encourage them toward more diligent and effective performance. Additionally, audit committees may currently be assuming more responsibility and becoming more involved in corporate affairs than CPAs or financial statement users are aware of.

**Comments and Additional Audit Committee Functions Suggested by Survey Respondents**

Each survey respondent was asked to list any additional functions that he felt audit committees should perform and make any related comments. This additional information has been grouped under the following general subjects: external audit fees, external auditor performance of non-audit services, company compliance with laws and regulatory agencies, management-related matters, accounting policies and reporting procedures, and other matters.
External Audit Fees. Six percent of the responding CPAs stated that they were in favor of some type of audit committee involvement in external audit fee-related matters. The specific types of involvement suggested were not uniform. Some CPAs said the audit committee should set or approve audit fees, while others felt that the audit committee should only be informed of the fee. Others suggested an evaluation of fees with regard to fairness for company size and complexity of work performed. None of the financial statement users or audit committee members had any comments concerning external audit fees.

External Auditor Performance of Non-Audit Services. Comments from 3 CPAs and 1 financial statement user reflected an opinion that the audit committee should review non-audit services performed by external auditors. Suggestions were made for inquiries to determine the extent of non-audit services, the effect of these services on external auditor independence and the cost of these services.

Compliance With Laws and Regulatory Agencies. Four CPAs and three audit committee members stated that audit committees should investigate and monitor company compliance with appropriate laws and regulatory bodies. Compliance with the Foreign Corrupt Practices Act and agencies such as the Securities and Exchange Commission, Internal Revenue Service, and the Federal Trade Commission were specifically mentioned. One respondent (CPA) also mentioned that the audit committee could become involved with evaluating and monitoring corporate morals and social responsibility and an audit committee member suggested the committee aid in establishing the ethical character of the
Management-Related Matters. Respondents from each surveyed group stated that audit committees should inquire into and evaluate management characteristics and activities. Specifically, 10 CPAs, 2 audit committee members and 2 financial statement users made the following suggestions:

1. Evaluate qualifications of top management and financial personnel.
2. Review the salaries of officers.
3. Review the fringe benefits of officers.
4. Review expenses of top management.
5. Investigate or arrange investigation when the integrity of a senior executive comes under question.
6. Inquire of independent CPA about the cooperation of management.
7. Determine and investigate any scope limitations placed on the independent audit by management.

While supporting an audit committee role in overseeing and monitoring management activities, several respondents warned against excessive committee involvement with management. The audit committee, as a subcommittee of the board of directors, should be a separate unit from management and overlapping of responsibilities should be minimal. Comments from 2 financial statement users, however, expressed a concern that the audit committee could become a rubber stamp for management. This threat is more serious if an audit committee is unsure of its role, responsibilities and functions.

Accounting Policies and Reporting Procedures. Ten CPA firm audit...
partners, three financial statement users, and one audit committee member supported evaluation and/or review of significant accounting policies and reporting practices. Specifically mentioned were a review of an accounting procedure used where alternatives were acceptable, review of the annual report and review of unaudited interim financial data.

Other Matters. Other suggestions from the three groups of respondents included a review of matters pending at the SEC, Financial Accounting Standards Board, the AICPA or elsewhere that may have a significant impact on the company.

Two audit committee members also mentioned that the audit committee should be involved in the investigation of questionable or illegal payments and bribery of political or financial figures.

Most of the additional comments and suggested functions did not deal with external auditor independence or internal auditing. Since the survey conducted did not present functions other than those related to these areas, suggested functions relating to other matters could be expected.

Correlation Analysis of Audit Committee Effectiveness and Certain Corporate and Committee Characteristics

Correlation analysis was used to measure the degree of association between the number of audit committee functions performed effectively as perceived by audit committee members and certain characteristics of the corporation and the corporation's audit committee. Questionnaires sent to audit committee members solicited the following biographical information which was used in the correlation:
total corporate assets, number of audit committee members, number of audit committee members with auditing backgrounds and period of time the audit committee has been in existence.

Size of Audit Committee. The survey results showed that the average size of an audit committee is 4.5 members, although 16% of the respondents indicated that their audit committee membership is 6 or more. Only 1 respondent indicated that his audit committee had 2 members. (See Table 15).

Background of Audit Committee Members. Results showed that little emphasis seems to be placed on an audit background for audit committee membership. The number of audit committee members with auditing backgrounds ranged from 0 - 4, with an average of 1.0 member. The largest percentage of respondents (32%) indicated that none of the members of their audit committee possessed an auditing background. (See Table 15).

Length of Time of Audit Committee Existence. The survey results also indicated that audit committees are relatively recent additions to the corporate organization. The majority of respondents (77%) indicated that their audit committee had been established within the last 10 years. Only 2% of the respondents indicated that their committee had existed for longer than 20 years. These results are summarized in Table 16.

Correlation Results. The Pearson product-moment correlation coefficient was used in this analysis to determine some characteristics of an effective audit committee. This correlation coefficient is a measure of the strength of the relationship between variables.
TABLE 15
SIZE OF AUDIT COMMITTEES AND BACKGROUND
OF MEMBERS

<table>
<thead>
<tr>
<th>Number of Members</th>
<th>Audit Committee Members</th>
<th>Audit Committee Members With Audit Backgrounds</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No.</td>
<td>%</td>
</tr>
<tr>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>1</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>2</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>3</td>
<td>14</td>
<td>21</td>
</tr>
<tr>
<td>4</td>
<td>20</td>
<td>30</td>
</tr>
<tr>
<td>5</td>
<td>21</td>
<td>32</td>
</tr>
<tr>
<td>6 or more</td>
<td>11</td>
<td>16</td>
</tr>
<tr>
<td>No response</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>67</td>
<td>100</td>
</tr>
</tbody>
</table>

TABLE 16
YEARS OF AUDIT COMMITTEE EXISTENCE

<table>
<thead>
<tr>
<th>Years</th>
<th>Audit Committees</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No.</td>
</tr>
<tr>
<td>1 - 5</td>
<td>26</td>
</tr>
<tr>
<td>6 - 10</td>
<td>25</td>
</tr>
<tr>
<td>11 - 15</td>
<td>2</td>
</tr>
<tr>
<td>16 - 20</td>
<td>4</td>
</tr>
<tr>
<td>21 - 25</td>
<td>1</td>
</tr>
<tr>
<td>26 or more</td>
<td>1</td>
</tr>
<tr>
<td>No response</td>
<td>8</td>
</tr>
<tr>
<td>Total</td>
<td>67</td>
</tr>
</tbody>
</table>
Results showed no significant degree of association between effective audit committee performance as perceived by audit committee members and any of the correlated characteristics. (See Table 17).

**TABLE 17**

**RESULTS OF CORRELATION ANALYSIS**

<table>
<thead>
<tr>
<th>Characteristic</th>
<th>Pearson Product-Moment correlation coefficient r</th>
<th>Prob.*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total assets of company</td>
<td>.109</td>
<td>.425</td>
</tr>
<tr>
<td>Number of committee members</td>
<td>.079</td>
<td>.558</td>
</tr>
<tr>
<td>Number of committee members with audit background</td>
<td>-.057</td>
<td>.682</td>
</tr>
<tr>
<td>Years of audit committee existence</td>
<td>.232</td>
<td>.106</td>
</tr>
</tbody>
</table>

* Hypothesis that the degree of association is significant is rejected at $\alpha = .05$.

The results of this survey showed that differences in perception of current and desirable audit committee performance do exist. CPA firm audit partners, audit committee members and financial statement users were selected as research participants because each group is affected by the work of audit committees. Each group has a particular relationship to audit committees and therefore has a perspective that differs from the other groups. An effectively functioning audit committee must serve the interests of all potential benefactors of its' work. The gap in perception indicated by this
research will hamper audit committee effectiveness due to misunderstandings of what audit committees can and should do as well as uncertainty about the role that audit committees should have within the corporate structure.
FOOTNOTES - CHAPTER III


2. Ibid., p. 297.


6. Ibid.
CHAPTER IV

Summary and Conclusions

Public confidence in the corporate organization and the business community, in general, has weakened in recent years. Attempts by various segments have been made to reverse this trend. One of the more significant efforts has come in the form of increased responsibility for corporate boards of directors. Audit committees, as subcommittees of the board of directors, have been established in growing numbers to specifically address certain responsibilities of these boards of directors in financial affairs.

Although the establishment of audit committees is an attempt to solve some of the problems of poor corporate image, their growth has not been without difficulty. To date, there has been no clear delineation of audit committee objectives, functions and responsibilities. Individual committees and the related boards of directors determine their role, responsibilities and functions. This has resulted in varying degrees of audit committee effectiveness. While some audit committees may be contributing significantly to the corporate structure, others may be existing only because of the New York Stock Exchange requirements.

The audit committee is expected to contribute to the overall objective of the audit function which is to increase the credibility, integrity and reliability of the financial reporting system.
Business, investor and legal environmental changes have been significant in recent years and have caused concern about the corporate reporting system. There have been many changes in the business environment. The recent trend toward increased business combinations and expansions is unrivaled in American history. In addition, the internal reporting systems of corporations have become more sophisticated and more reliable and timely information is available. Technological changes have also influenced the business environment as completely new industries have been created.

The investor environment has a new character predominantly because of the growth of financial analysis. Financial analysts are now representing the interests of many investors and are demanding more detailed and sophisticated corporate financial information.

Changes have taken place in the legal environment, increasing accountants' legal liability. The number of suits against accountants has grown steadily since the early 1960s. No reversal of this trend is foreseen.

There is general agreement from the public sector and within the business community that it is the independent audit function that adds credibility to the financial statements. The endorsement of the independent auditor provides a measure of assurance to creditors, investors, government regulatory agencies and others that the financial statements can be relied upon.

One of the most important reasons for the faith placed in the independent auditor's opinion is his independence from the corporation. Independence is also one of the most frequently attacked qualities.
Maintainance of independence in appearance and fact is of great con-
cern to independent auditors and the business community in general.
The Securities and Exchange Commission has consistently shown support
for strengthening auditor independence and the AICPA has strong
requirements in the Code of Ethics regarding independence.

One of the most recent and perhaps most serious attacks on the
existence of auditor independence has come from the Metcalf Report.
This Senate subcommittee report actually charged that the eight
largest CPA firms in the United States are not independent of their
respective corporate clients.

The accounting profession, the SEC and responsible financial
leaders recognize that an auditor's appearance of independence is
threatened where management has the responsibility for auditor selec-
tion, retention and replacement. Audit committees are recognized as
being one vehicle for strengthening auditor independence. The rela-
tionship between the independent auditor and management could be
minimized if audit committees work more closely with the independent
auditor.

Audit committees can also aid in adding stature and importance to
the internal audit function. Internal control and internal audit
staffs have increased significantly and many of them have a vital role
within the corporate organization. This is particularly true since

The Foreign Corrupt Practices Act made internal accounting con-
trols a matter of law for all public companies, not just those having
foreign operations. The SEC has already charged some companies with
violating the accounting provisions of the Act where questionable foreign payments were not an issue.

To be effective, internal control and internal auditing should be evaluated and monitored at the highest organizational level possible. The audit committee can effectively serve this purpose. Through their contact with the audit committee, internal auditors will have access to the board of directors. As a result, internal auditors' recommendations for improving financial reporting will have a greater chance of being accepted and implemented.

Expectations of audit committee benefits are extensive. To effectively fulfill these expectations the audit committee must reassess its role, objectives and functions.

Historically, support for audit committees has come from various segments of the business community. The SEC has consistently encouraged all public corporations to establish audit committees. In Accounting Series Releases Nos. 19, 123, 126, and 165, the support for audit committees has been specifically stated. SEC court actions have resulted in requirements for the establishment of audit committees for certain corporations. In some cases, the SEC has listed detailed duties to be performed by these committees. Although the SEC has refrained from requiring audit committees for all public corporations, it has urged the American Institute of Certified Public Accountants to take this step.

The New York Stock Exchange support for audit committees resulted in the requirement that as of June 30, 1978, all listed members must have audit committees. NYSE support for audit committees was first
evidenced as a result of the McKesson-Robbins case where the exchange report stated that where practicable independent auditors should be selected by a board of directors subcommittee.

The American Institute of Certified Public Accountants first showed its support for audit committees in a 1967 executive committee report. The report recommended that publicly owned corporations appoint committees of outside directors to nominate the independent auditors of a corporation's financial statements and discuss their audit work with them. The report also suggested that the auditor communicate with the audit committee on any significant matters not satisfactorily resolved at the management level. Since that time the AICPA has consistently supported audit committees and urged their establishment.

In 1978 a special committee of the AICPA reported that it found no reason to require audit committees as a prerequisite to conduct of the external audit. However, the committee also stated that it is convinced that audit committees can be helpful to corporate directors and independent auditors.

Congress has recently begun to express interest in the establishment of audit committees. The Moss and Metcalf Committees both reported a belief that audit committees could improve the system of corporate accountability.

The large increase in the number of corporations with audit committees may be partly due to the extended responsibilities of boards of directors. Increasing legal liability on the part of board members has led to many protective actions including the establishment of
audit committees.

With audit committees firmly established as a part of the corporate organization, attention must now be directed toward defining committee objectives and functions. Ill-defined objectives and functions and a nebulous role could render audit committees ineffective and leave many expectations unfulfilled.

The purpose of this study was to reveal the views of three groups with differing perspectives on certain functions of audit committees. A comparison of the views expressed should give an insight into the present importance of audit committees and their expected future impact.

CPA firm audit partners, audit committee members and financial statement users were surveyed by mail questionnaire to determine their perceptions of the role and functions of corporate audit committees. Pairwise comparisons of group responses were made and differences noted. There was general agreement among groups that the functions presented for their consideration are currently effectively performed and should be performed in the future. Differences in degree of perception or agreement, however, were present in the majority of cases.

Summary and Implications of the Perceptions of CPA Firm Audit Partners

CPA firm audit partners were surveyed to determine their opinions on current audit committee performance, desirable audit committee performance, and the role of audit committees within the corporate organization. Generally, the CPAs surveyed indicated a belief that
audit committees are performing the functions presented in the questionnaire with at least adequate effectiveness. However, responses of the CPAs implied that much improvement is needed.

The perceived need for overall improvement in audit committee effectiveness could be the result of unrealistic expectations by CPAs. With no authoritative guide to the responsibilities and functions of audit committees, effectiveness must be perceived by individuals. Therefore, CPAs who possess auditing backgrounds may expect a higher standard of performance from audit committees than is practical or possible. To fulfill all of the functions listed to the satisfaction of CPAs who are educated and experienced in the audit area could be a long and tedious process for audit committees.

Another important perception identified by this research is that CPAs were of the opinion that audit committee functions related to external auditor independence were more effectively performed than those functions related to internal audit. One reason for this opinion may be that internal auditing as compared to external auditing is relatively new to many companies and therefore may receive less emphasis by audit committees. Another reason may be that CPAs are not aware of how effectively internal audit related functions are being performed. Obviously, CPAs have a more intimate knowledge of audit committee performance related to external auditor independence.
Desirable Audit Committee Functions. CPAs were generally enthusiastic in their support of the external auditor independence and internal audit related functions presented in the questionnaire. CPAs, however, attached more importance to audit committee performance of external auditor independence related functions than to those functions related to internal audit. Perhaps understandably, CPAs are more concerned with audit committee functions that affect them directly. Such an implication sharply points out the need for the responsibilities assigned to audit committees to reflect the expectations of all groups that could be affected.

The function considered most important by CPAs was that audit committees discuss with independent auditors their experiences and problems in completing the audit. A significant majority (82%) of the responding CPAs strongly agreed that this should be an audit committee function. The desire for an increased separation from management and therefore an increased appearance of independence is clearly implied. The results of this research support the contention by the AICPA, state and local CPA societies and individual CPAs that the profession is constantly seeking to improve and strengthen auditor independence in appearance and in fact.

The Role of Audit Committees in the Corporation Organization. CPAs indicated a belief that audit committees enhance the credibility and integrity of financial statements. The importance of the audit committee to the corporate organization is specifically related to its
contribution toward improving financial reporting. Survey results indicated that CPAs believe such a contribution is being made.

CPAs did not believe, however, that external auditor verification of audit committee effectiveness constitutes desirable and useful information. Admittedly, verification of audit committee effectiveness would be difficult and would also add to the responsibility of the auditor. CPAs may believe that the resulting verification will not be beneficial enough to warrant the extra time and effort that would be involved. Also, the increased responsibility would give rise to another area for potential legal liability for the external auditor. In a period already plagued with greatly increased litigation against the CPAs, this is clearly not desirable. CPAs are justified in considering very carefully any additional responsibility. The statement presented in the questionnaire for consideration stated that auditor verification would be desirable and useful information. The possibility exists that CPAs, in an attempt to convey an unwillingness to perform such a verification, disagreed with the desirability and usefulness of such information.

Opinions of CPAs and AICPA Support for Audit Committees. The AICPA has shown enthusiastic support for the establishment of audit committees. However, a recent AICPA committee designated to study whether audit committees should be required before an audit could be performed concluded that the AICPA should not have such a requirement. The results of this research indicated that the responding CPAs agreed with the position of the AICPA. If audit committees were required before an external audit could be performed, a judgment would have to
be made by the auditor on the effectiveness of the committee. Clearly, survey results showed that CPAs do not want this responsibility even though survey participants agreed with the importance and desirability of all audit committee functions in the questionnaire.

Summary and Implications of the Perceptions of Audit Committee Members

Audit committee members were surveyed to determine their perceptions of current audit committee performance, desirable audit committee functions and the role of audit committees within the corporate structure. Audit committee members consistently expressed a belief that their committee was functioning very effectively in the performance of the functions presented. Such a strong opinion may have resulted from a lack of understanding of what is expected of an effective audit committee. Audit committee composition may also be influencing the members' perceptions of their effectiveness.

The survey results showed that 32% of the respondents indicated that their audit committee had no members with auditing backgrounds. In addition, the average number of audit committee members with auditing backgrounds indicated by all respondents was less than 1. Even though the correlation analysis showed no significant degree of association between audit committee effectiveness and the number of members with auditing background, the lack of sufficient knowledge of auditing could cause audit committee members to experience extreme difficulty in identifying and performing desirable audit committee functions. This lack of knowledge could also contribute to a mistaken belief by audit committee members that they are performing at maximum...
effectiveness.

Desirable Audit Committee Functions. Audit committee members were in agreement that all external auditor independence and internal audit related functions should be performed by audit committees. Much more emphasis was placed on the performance of external auditor independence related functions, however. Less importance may be attached to internal audit functions because audit committee involvement with internal audit activities may not be stressed by the board of directors or the role of internal audit within the corporation may not be considered important by management.

The audit committee function deemed most desirable by audit committee members is that audit committees should discuss with independent auditors their experiences and problems in completing the audit. An overwhelming majority (96%) of the responding audit committee members indicated they strongly agreed with the desirability of this function. Another function which received substantial support from audit committee members is that the committee should consult with the independent auditors (out of the presence of management) with regard to the adequacy of internal controls. Strong agreement with the desirability of this function was expressed by 91% of the committee members surveyed.

The Role of Audit Committees in the Corporate Structure. Although the majority of audit committee members expressed a belief that external auditor verification of the effective functioning of audit committees would be desirable and useful information, a substantial percentage (30%) disagreed. Many audit committee members are obviously
doubtful about some aspect of this statement. Since no pre-established standards for audit committees exist, some audit committee members may believe external auditor verification is not reasonably possible. Therefore, a belief that verification is impossible may have caused some respondents to disagree with the usefulness of such information. However, the indication by most respondents, that external auditor verification is desirable, implies that audit committee members are confident enough about their ability to perform adequately that they are willing to submit to outside scrutiny.

The majority of audit committee members (81%) also agreed that the existence of an audit committee enhances the credibility and integrity of corporate financial reporting. The results of this survey indicated that audit committee members clearly visualize their committees as an important part of the corporate organization.

Opinions of Audit Committee Members and the Increased Responsibilities of Boards of Directors. Corporate boards of directors are facing increasing responsibilities to meet the challenges of increased company size and complexity, an increased number of lawsuits against directors and an increased obligation to exercise reasonable care in the fulfillment of their duties. The large measure of support given to the desirability of the audit committee functions presented in this survey indicates that audit committee members intend to meet these challenges. The effective performance of the duties deemed desirable will require audit committee members to be diligent in acquiring knowledge of the external and internal audit activities of their companies and devote adequate time to give proper attention to
audit committee responsibilities. The results of this research imply an awareness of and a willingness by audit committee members to meet their growing responsibilities.

Summary and Implications of Perceptions of Financial Statement Users

Of the three groups surveyed, financial statement users attached less importance to the desirability of most of the audit committee functions. Higher percentages of respondents also expressed uncertainty as to whether the listed functions should be performed. However, since the survey results did show that financial statement users believe that audit committees should perform the functions presented (even though their agreement was shown to a lesser degree than that of CPAs or audit committee members) the indication is that financial statement users believe audit committees are desirable. Financial statement users may not be entirely convinced, however, that audit committees represent superior tools for improving corporate accountability. Since financial statement users are the final beneficiaries of any attempt to improve the corporate reporting system, their understanding of the work of audit committees, which represents such an attempt, is essential. Perhaps a problem of communication of information concerning audit committees is indicated here.

The Role of Audit Committees in the Corporate Structure. Financial statement users generally agreed that audit committee existence and external audit verification of effectiveness both have favorable effects on financial reporting. The reason for this opinion may be because financial statement users are required to evaluate the
financial position of companies and may believe that any additional information which does not cause confusion is desirable. Financial statement users also have the option of disregarding any information deemed unnecessary in certain circumstances. Therefore, financial statement users may want information about audit committees whether or not substantial consideration will be given to it.

**Opinions of Financial Statement Users and SEC and Congressional Support for Audit Committees.** The Securities and Exchange Commission has consistently expressed support for the establishment of audit committees through accounting series releases and litigation. Congressional committees have urged the establishment of audit committees to strengthen and improve financial reporting. Both of these bodies are concerned with the adequacy and fairness of corporate reporting to stockholders and the general public. Financial statement users, as representatives of stockholders and members of the general public, are in agreement that audit committees can make a contribution toward better financial reporting. However, the results of this survey indicated that the enthusiasm shown for desirable audit committee functions and the importance attached to the existence and effectiveness of audit committees by financial statement users was mild. The support of the SEC and Congress for audit committees seems to be much greater than that of financial statement users, whose interests they seek to protect.

**Implications of the Differences in Perceived Importance of Audit Committee Performance of External Auditor Independence Related Functions and Internal Audit Related Functions**
Survey results indicated a difference between the perceived desirability of external auditor independence and internal audit related functions. The potential impact of this discrepancy may be far-reaching in that all groups attached less importance to audit committee performance of internal audit related functions. Boards of directors, management and internal auditors must reassess the objectives and responsibilities of internal audit staffs in light of this finding.

Reasons for the lesser degree of importance attached to internal audit functions may be the result of lack of corporate support for internal auditing. The widespread establishment of internal audit departments by corporations is relatively new. Therefore, many of these internal audit departments may still be struggling to convince management of the importance of the contribution that can be made toward improving corporate accountability. Lack of management support leads to ill-defined objectives and goals and lack of authority to require implementation of recommendations made by internal auditors.

Also, the unenthusiastic support for internal audit related functions implies a lack of understanding as well as a lack of faith in the work of internal auditors. Audit committee members and financial statement users particularly may be unsure of the role that internal auditing should play in the overall audit process.

Summary and Implications of Correlation Analysis

The survey results showed no significant degree of association
between the number of effectively performed audit committee functions (as perceived by audit committee members) and the following characteristics: (1) total assets of the company; (2) size of the audit committee; (3) number of audit committee members with auditing backgrounds, and (4) years of audit committee existence. From this research, no implications can be drawn that these characteristics relate in any way to an effective audit committee.

Comparison of Survey Results With the Metcalf Report and the SEC Report to Congress on the Accounting Profession and the Commission's Oversight Role

To date the most authoritative pronouncements concerning audit committee functions have come from the Metcalf Committee and the SEC. The survey results showed that audit committee members, CPA firm audit partners and financial statement users substantially agreed with both of these reports.

There is specific agreement among all parties that the audit committee should engage and dismiss the independent auditor. The Metcalf Report, however, is general in recommending that the audit committee meet privately with the independent auditor and receive full reports from the auditing firm on its findings. The SEC report addresses relations with the independent auditor more specifically by recommending that the committee review with the independent auditor, upon completion of their audit, such items as the proposed audit report or opinion, any unusual and significant transactions, changes in accounting principles and practices, significant adjustments, and recommendations for improving internal control. A comparison of
survey responses to similar functions showed substantial agreement with the reports. For example, respondents in all categories favored audit committee performance of the following functions:

1. discuss with independent auditors their experiences and problems in completing the audit
2. discuss meaning and significance of audited figures and notes thereto
3. review the extent to which recommendations made by the independent auditor have been implemented.

The Metcalf and SEC reports both recommended that the audit committee be concerned with the audit fee. The Metcalf Report suggests the committee actually set the fee while the SEC Report favors a review after the fee is determined. Although no function listed in the survey related to the audit fee, the additional comments from many of the CPA firm audit partners supported some form of audit committee consideration of the audit fee.

Another function not presented in the questionnaire but which received support in additional comments was audit committee review of non-audit services performed by independent auditors. Both the Metcalf and SEC reports agreed that audit committees should be informed of or review any non-audit service.

Many survey respondents suggested in additional comments audit committee functions that relate to management. The SEC Report also recommends several functions that are management-related. Survey respondents and the SEC were in general agreement on audit committee performance of the following specific functions:

1. Review with management a company's policies and procedures with respect to internal auditing, accounting and financial controls.
(2) Inquire of the appropriate company personnel as to any instances of deviations from established codes of conduct of the company.

(3) Meet with the company's financial staff periodically to review and discuss with them the scope of internal accounting and auditing procedures then in effect.

The Metcalf Report does not mention any recommendations of audit committee involvement with management.

The Metcalf and SEC reports and the survey respondents favor audit committee involvement with internal controls and internal auditing. The Metcalf Report states that a major purpose of the corporate audit committee is to improve internal auditing controls. The SEC Report suggests that the committee review a company's policies and procedures with respect to internal auditing, accounting and financial controls, and review and discuss with the company's financial staff the extent to which recommendations made by the internal staff have been implemented. Survey respondents showed support for all functions of the audit committee that relate to internal control and internal auditing.

The results of this research showed substantial agreement among CPA firm audit partners, audit committee members and financial statement users with the audit committee recommendations of the Metcalf Committee and the SEC Report. There is overall support for the audit committee to assume a role in relations with independent auditors and the internal auditing staff. As noted previously, however, the SEC Report and survey respondents indicated an interest in audit committee performance of specific management-related functions. The
Metcalf Report does not mention any specific involvement with management but the report does state that audit committees should establish appropriate policies to prohibit unethical, questionable or illegal activities by corporate employees. The intent of this statement may have been to encourage a closer review of management activities.

**Recommendations**

Survey results showed significant gaps in the perceptions of CPAs, audit committee members and financial statement users concerning the role and functions of audit committees. The identification of these gaps by this research specifically points to problems that could cause audit committees, which may become powerful tools in the quest for improved financial integrity, to be lost in a mass of confusion and misunderstanding. Therefore, the need for an authoritative prescription of minimum audit committee duties and responsibilities is necessary. This authoritative prescription could come from the SEC, a government agency designated to protect stockholders or the AICPA, the leading organization of the auditing profession.

Based on the survey results the following functions are recommended for inclusion in an authoritative guide for audit committees. The functions are listed in order of importance as indicated by the strength of support given by participants in all groups:

1. External auditor independence related functions:
   a. Discuss with independent auditors their experiences and problems in completing the audit.
   b. Consult with the independent auditors (out of the presence of management) with regard to the adequacy of internal controls.

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Ascertain whether management has taken proper action on independent auditor recommendations.

Approve or nominate independent auditors.

Discuss meaning and significance of audited figures and notes thereto.

Recommend termination of external auditors when necessary.

Discuss scope and timing of independent audit work.

(2) Internal audit related functions:

Discuss effectiveness of internal control with the internal auditors.

Ascertain whether management has taken proper action on the internal auditors' recommendations.

Discuss internal audit findings and recommendations with internal auditors.

Discuss organization and independence of internal auditors.

Consult with internal auditors (out of the presence of management) with regard to the adequacy of internal controls.

Discuss goals and plans, including nature and extent of work, of the internal audit function.

Discuss with internal auditors their experiences and problems in completing audits.

Evaluate the adequacy of staffing for internal auditing.

In addition, increased emphasis should be placed on internal auditing by boards of directors and audit committees. This increased emphasis would lead to a greater respect for and understanding of the purpose of internal auditing. Therefore, the perceived desirability
of audit committee performance of internal audit related functions would be enhanced. Audit committee effectiveness as well as the stature of the internal audit department would also be improved.

Areas for Further Research

First, a determination of the proper background for audit committee members is necessary. The composition of audit committees is of paramount importance in insuring effectiveness. The educational and experience background of a member directly affects the contribution he will make to the audit committee. If the background that seems to provide the best foundation for audit committee performance could be determined, then prospective members could be screened for certain characteristics before serving on audit committees. If the quality of members improves, the quality of the work of the audit committee will also improve.

Secondly, audit committees can and probably do perform functions that do not relate to the external auditor or internal control and internal auditing. These functions should be identified. As evidenced by the additional comments, many of the survey respondents think the committee should be performing some non-audit related functions. The possibility exists, however, that if the external auditor independence and internal audit related functions are performed effectively, the need for additional functions may be lessened. Further investigation is needed.

Third, no attempt was made in this research to categorize functions appropriate to certain industries or other specific circum-
stances. Recognition must be given to the fact that some audit committee functions may be specifically necessary for particular companies. There should always be flexibility in audit committee functioning, but the desirability of certain required minimum standards is obvious.

Conclusion

Audit committees can be an integral part of the corporate organization for all companies. The circumstances under which these committees operate, however, will greatly affect their impact. Ill-defined objectives and functions could hamper what is possibly the most important step toward improving corporate accountability in recent years.
I. Books


II. Journals


### III. Letters

New York Stock Exchange, William M. Batten letter to chief executive officers of listed companies, January 6, 1977.

### IV. Public Documents


U.S. SEC. *Accounting Series Release No. 19.* December 5, 1940.


U.S., Congress, Senate Committee on Banking, Housing and Urban Affairs.
Report of the Securities & Exchange Commission on Questionable and

U.S., Congress, Senate. International Contribution, Payments, and Gifts

U.S. Congress, Senate Subcommittee on Governmental Efficiency and the
District, Committee on Governmental Affairs, Securities & Exchange
Commission Report to Congress on the Accounting Profession and the
Commission's Oversight Role. 95th Cong., 2d sess., 1978.

U.S. Congress, Senate. Subcommittee on Reports, Accounting, and
Management of the Committee on Government Operations. The Account-
ing Establishment. 95th Cong., 1st sess., 1977.

U.S. Congress, Senate Subcommittee on Reports, Accounting and Manage-
ment of the Committee on Governmental Affairs. Improving the
Accountability of Publicly Owned Corporations and Their Auditors.

V. Papers

Williams, Harold M., quoting Ralph Ferrara in "Corporate Accountability -
One Year Later." A paper presented at the Sixth Annual Securities
Regulation Institute, San Diego, CA, 18 January 1979.

__________. "Corporate Accountability and Corporate Power," A paper
presented at the Fairless Lecture Series, Carnegie-Mellon Univer-
sity, Pittsburgh, PA, 24 October 1979.

VI. Court Cases


SEC v. Lum's, Inc. (D.C.N.Y.) 365 FSupp 1046.


Dear CPA Firm Audit Partner:

With the New York Stock Exchange decision to require that all its listed corporations must have audit committees as of June 30, 1978, audit committees have become an inescapable part of the corporate organization structure. The establishment of audit committees has also been endorsed by other authoritative bodies such as the Securities and Exchange Commission and the American Institute of Certified Public Accountants. To date, however, there has been no clear delineation of the objectives, responsibilities and functions of audit committees. Each corporation's board of directors or the audit committee itself has to determine its role within the organization.

I am currently conducting a survey to determine the perceptions of CPA Firm audit partners concerning the present role of corporate audit committees and what the committee's role should be in the future. Your participation by filling out the enclosed brief questionnaire would be greatly appreciated.

Please do not sign your name on the questionnaire. All responses will remain anonymous. Your responses will be used in statistical tabulations only.

If you would like a copy of the results of this study, please send this request to me on a card separate from your questionnaire.

Sincerely,

Brenda S. Birkett
QUESTIONNAIRE FOR CPA FIRM AUDIT PARTNERS

For category 1 and category 2, please circle your response to the question stated at the top of the column. The possible responses range from:

Category 1: 1 - performed very effectively to 5 - not currently performed
Category 2: 1 - strongly agree to 5 - strongly disagree

<table>
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<tr>
<td>Do over one-half of the audit committees with which you are familiar perform this function?</td>
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<td>Do you think audit committees should be performing this function?</td>
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Ascertain whether management has taken proper action on independent auditor recommendations

Consult with the independent auditors (out of the presence of management) with regard to the adequacy of internal controls

Internal Audit related

Discuss effectiveness of internal control with the internal auditors

Discuss organization and independence of internal auditors

Evaluate the adequacy of staffing for internal auditing

Discuss internal audit findings and recommendations with internal auditors

Discuss goals and plans, including nature and extent of work, of the internal audit function

Discuss with internal auditors their experiences and problems in completing audits

Ascertain whether management has taken proper action on the internal auditors' recommendations

Consult with internal auditors (out of the presence of management) with regard to the adequacy of internal controls
Please give your opinion on the following questions, using the category 2 responses (strongly agree to strongly disagree).

If the external auditor could verify the effective functioning of the audit committee according to a set of pre-established standards, this would be desirable and useful information.

1 2 3 4 5

The existence of an audit committee enhances the credibility and integrity of corporate financial reporting.

1 2 3 4 5

Please list any functions not previously listed that you think audit committees should perform and make any comments below.
September 15, 1979

Dear Audit Committee Member:

With the New York Stock Exchange decision to require that all its listed corporations must have audit committees as of June 30, 1978, audit committees have become an inescapable part of the corporate organization structure. The establishment of audit committees has also been endorsed by other authoritative bodies such as the Securities and Exchange Commission and the American Institute of Certified Public Accountants. To date, however, there has been no clear delineation of the objectives, responsibilities and functions of audit committees. Each corporation's board of directors or the audit committee itself has to determine its role within the organization.

I am currently conducting a survey to determine the perceptions of audit committee members concerning what their present role is and what it should be. Your participation by filling out the enclosed brief questionnaire would be greatly appreciated.

Please do not sign your name on the questionnaire. All responses will remain anonymous. Your responses will be used in statistical tabulations only.

If you would like a copy of the results of this study, please send this request to me on a card separate from your questionnaire.

Sincerely,

Brenda S. Birkett
QUESTIONNAIRE FOR AUDIT COMMITTEE MEMBERS

For category 1 and category 2, please circle your response to the question stated at the top of the column. The possible responses range from:

Category 1: 1 - performed very effectively to 5 - not currently performed

Category 2: 1 - strongly agree to 5 - strongly disagree

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Please give your opinion on the following questions, using the category 2 responses (strongly agree to strongly disagree).

If the external auditor could verify the effective functioning of the audit committee according to a set of pre-established standards, this would be desirable and useful information.

1 2 3 4 5

The existence of an audit committee enhances the credibility and integrity of corporate financial reporting.

1 2 3 4 5

Please give the following information about your company.

1. What are the total assets of your company as of December 31, 1978 to the nearest million?

________________________

2. How many members does your audit committee have as of December 31, 1978?

________________________

3. How many audit committee members have auditing backgrounds?

________________________

4. How long has your company had an audit committee?

________________________

Please list any functions not listed previously that you think audit committees should perform and make any comments below.

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September 15, 1979

Dear Financial Statement User:

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I am currently conducting a survey to determine the perceptions of financial statement users concerning the present role of corporate audit committees. Your participation by filling out the enclosed brief questionnaire would be greatly appreciated.

Please do not sign your name on the questionnaire. All responses will remain anonymous. Your responses will be used in statistical tabulations only.

If you would like a copy of the results of this study, please send this request to me on a card separate from your questionnaire.

Sincerely,

Brenda S. Birkett
QUESTIONNAIRE FOR FINANCIAL STATEMENT USERS

Please circle your response to the question stated at the top of the column. The possible responses range from:

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**Internal Audit related**

Discuss effectiveness of internal control with the internal auditors

Discuss organization and independence of internal auditors

Evaluate the adequacy of staffing for internal auditing

Discuss internal audit findings and recommendations with internal auditors

Discuss goals and plans, including nature and extent of work, of the internal audit function

Discuss with internal auditors their experiences and problems in completing audits

Ascertain whether management has taken proper action on the internal auditors' recommendations

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The existence of an audit committee enhances the credibility and integrity of corporate financial reporting.

Please list any functions not previously listed that you think audit committees should perform and make any comments below.
October 10, 1979

Dear CPA Firm Audit Partner:

You were recently sent a letter requesting your participation in a questionnaire survey concerning the present role of corporate audit committees and what the committee's role should be in the future. Audit committees and their objectives, responsibilities, and functions will have an impact on all segments of the business community. This research is very important in that there has been no clear delineation of these objectives, responsibilities and functions.

Enclosed is another copy of the brief questionnaire. If you did not respond to the original request, your participation would still be appreciated.

Please do not sign your name on the questionnaire. All responses will remain anonymous. Your responses will be used in statistical tabulations only.

If you would like a copy of the results of this study please send this request to me separate from your questionnaire.

Sincerely,

Brenda S. Birkett

Brenda S. Birkett
October 10, 1979

Dear Audit Committee Member:

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If you would like a copy of the results of this study please send this request to me separate from your questionnaire.

Sincerely,

[Signature]

Brenda S. Birkett
January 28, 1980

Dear CPA Audit Partner:

You were recently sent a questionnaire concerning the objectives, functions and responsibilities of audit committees. The determination of the audit committees' role within the corporate organization is very important and your response to the questionnaire will be very valuable in this research.

If you did not respond to the original request, please answer the enclosed questionnaire and return it immediately.

Please do not sign your name on the questionnaire. All responses will remain anonymous. Your response will be used in statistical tabulations only.

If you would like a copy of the results of this study, please send this request to me on a card separate from your questionnaire.

Sincerely,

Brenda S. Birkett
Dear Audit Committee Member:

You were recently sent a questionnaire concerning the objectives, functions and responsibilities of audit committees. The determination of the audit committees' role within the corporate organization is very important and your response to the questionnaire will be very valuable in this research.

If you did not respond to the original request, please answer the enclosed questionnaire and return it immediately.

Please do not sign your name on the questionnaire. All responses will remain anonymous. Your response will be used in statistical tabulations only.

If you would like a copy of the results of this study, please send this request to me on a card separate from your questionnaire.

Sincerely,

Brenda S. Birkett
Dear Financial Statement User:

You were recently sent a questionnaire concerning the objectives, functions and responsibilities of audit committees. The determination of the audit committees' role within the corporate organization is very important and your response to the questionnaire will be very valuable in this research.

If you did not respond to the original request, please answer the enclosed questionnaire and return it immediately.

Please do not sign your name on the questionnaire. All responses will remain anonymous. Your response will be used in statistical tabulations only.

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Sincerely,

Brenda S. Birkett
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NOTE: The response range is from 1 which indicates very effectively to 5 which indicates not currently performed.
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</tr>
<tr>
<td>Consult with the independent auditors (out of the presence of management) with regard to the adequacy of internal controls</td>
<td>56 22 11 0 11</td>
<td>89 0 0 11 0</td>
</tr>
</tbody>
</table>

**NOTE:** The response range is from 1 which indicates strongly agree to 5 which indicates strongly disagree.
TABLE B 10

DO YOU THINK AUDIT COMMITTEES SHOULD BE PERFORMING THIS INTERNAL AUDIT RELATED FUNCTION? NONRESPONSE BIAS TEST FOR FINANCIAL STATEMENT USERS
(Responses in Percentages)

<table>
<thead>
<tr>
<th>Function</th>
<th>Respondents</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th>Nonrespondents</th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Discuss effectiveness of internal control with the internal auditors</td>
<td>56 0 22 11 11</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>67 11 0 22 0</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Discuss organization and independence of internal auditors</td>
<td>33 33 23 0 11</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>33 33 11 23 0</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Evaluate the adequacy of staffing for internal auditing</td>
<td>33 11 33 23 0</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>22 11 67 0 0</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Discuss internal audit findings and recommendations with internal auditors</td>
<td>45 22 22 11 0</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>45 22 11 22 0</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Discuss goals and plans, including nature and extent of work, of the internal audit function</td>
<td>33 0 45 22 0</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>33 11 45 0 11</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

(Continued)
<table>
<thead>
<tr>
<th>Function</th>
<th>Respondents</th>
<th>Nonrespondents</th>
</tr>
</thead>
<tbody>
<tr>
<td>Discuss with internal auditors their experiences and problems in completing audits</td>
<td>45 22 11 22 0</td>
<td>33 11 33 23 0</td>
</tr>
<tr>
<td>Ascertain whether management has taken proper action on the internal auditors' recommendations</td>
<td>56 11 22 11 0</td>
<td>45 22 22 11 0</td>
</tr>
<tr>
<td>Consult with internal auditors (out of the presence of management) with regard to the adequacy of internal controls</td>
<td>34 22 11 22 11</td>
<td>45 33 11 11 0</td>
</tr>
</tbody>
</table>

NOTE: The response range is from 1 which indicates strongly agree to 5 which indicates strongly disagree.
### TABLE B.11

**AUDIT COMMITTEE EFFECT ON FINANCIAL REPORTING**

**NONRESPONSE BIAS TEST FOR CPA FIRM AUDIT PARTNERS**

(Responses in Percentages)

<table>
<thead>
<tr>
<th>Statement</th>
<th>Respondents</th>
<th>Nonrespondents</th>
</tr>
</thead>
<tbody>
<tr>
<td>If the external auditor could verify the effective functioning of the audit committee according to a set of pre-established standards, this would be desirable and useful information</td>
<td>9 27 9 18 37</td>
<td>0 18 18 46 18</td>
</tr>
<tr>
<td>The existence of an audit committee enhances the credibility and integrity of corporate financial reporting</td>
<td>37 18 36 0 9</td>
<td>55 45 0 0 0</td>
</tr>
</tbody>
</table>

**NOTE:** The response range is from 1 which indicates strongly agree to 5 which indicates strongly disagree.
### TABLE B 12
AUDIT COMMITTEE EFFECT ON FINANCIAL REPORTING
NONRESPONSE BIAS TEST FOR AUDIT COMMITTEE MEMBERS
(Responses in Percentages)

<table>
<thead>
<tr>
<th>Statement</th>
<th>Respondents</th>
<th>Nonrespondents</th>
</tr>
</thead>
<tbody>
<tr>
<td>If the external auditor could verify the effective functioning of the audit committee according to a set of pre-established standards, this would be desirable and useful information</td>
<td>72 14 0 0 14</td>
<td>29 14 14 0 43</td>
</tr>
<tr>
<td>The existence of an audit committee enhances the credibility and integrity of corporate financial reporting</td>
<td>86 14 0 0 0</td>
<td>57 43 0 0 0</td>
</tr>
</tbody>
</table>

**NOTE:** The response range is from 1 which indicates strongly agree to 5 which indicates strongly disagree.
<table>
<thead>
<tr>
<th>Statement</th>
<th>Respondents</th>
<th>Nonrespondents</th>
</tr>
</thead>
<tbody>
<tr>
<td>If the external auditor could verify the effective functioning of the audit committee according to a set of preestablished standards, this would be desirable and useful information</td>
<td>23 33 33 0 11</td>
<td>33 33 34 0 0</td>
</tr>
<tr>
<td>The existence of an audit committee enhances the credibility and integrity of corporate financial reporting</td>
<td>56 33 0 0 11</td>
<td>11 56 22 11 0</td>
</tr>
</tbody>
</table>

NOTE: The response range is from 1 which indicates strongly agree to 5 which indicates strongly disagree.
VITA

The author was born January 18, 1946 in Jacksonville, North Carolina.

Her elementary and secondary education was at Southern University Laboratory School in Baton Rouge, Louisiana. She attended college at Southern University, also in Baton Rouge, and graduated with a B.S. degree in Business in 1966. In 1967 she received a Master of Business Administration degree from Atlanta University, Atlanta, Georgia. Presently she is a candidate for the Ph.D. degree in Accounting, with a minor in Management from Louisiana State University in Baton Rouge.

She is a Certified Public Accountant in Louisiana, and a member of several professional organizations.

Her job plans are to return to Southern University from which she is presently on leave. She will be a member of the faculty in the Department of Accounting.

She lives at Route 2, Box 378-N, Baker, Louisiana with her husband and son.

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EXAMINATION AND THESIS REPORT

Candidate: Brenda Stewart Birkett

Major Field: Accounting

Title of Thesis: Perceptions of the Role of Corporate Audit Committees - Now and in the Future

Approved:

[Signatures]

Major Professor and Chairperson

Dean of the Graduate School

EXAMINING COMMITTEE:

[Signatures]

Date of Examination: July 15, 1980

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