CORPORATE AUDIT COMMITTEES IN ONTARIO, CANADA: AN EMPIRICAL STUDY

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ABSTRACT

CORPORATE AUDIT COMMITTEES IN ONTARIO, CANADA:
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By

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The objective of this study is to obtain a better understanding of the role played by the mandatory corporate audit committee and to determine the extent of its contribution to corporate governance.

To accomplish the objective, a questionnaire approach is used to obtain relevant and significant information from corporate chief executive officers, members of corporate audit committees, practicing chartered accountants, and financial analysts.

The conclusions, based on the information obtained through questionnaire responses, are as follows:

1. Attitudes toward the mandatory corporate audit committee range from strong opposition and indifference by a few to wholehearted endorsement by the majority of respondents.

2. The mandatory audit committee is generally considered as useful for a variety of corporations.

3. The committee is considered to be a very flexible and adaptive organizational unit in terms of both its purposes and functions. Most committees serve a variety of purposes and functions, in addition to those required by the Ontario Business Corporations Act of

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1971. The two most important purposes are: to relieve the board of directors, as a whole, of details regarding the review of the results of the independent audit, and to serve as an independent review function of the company's operations and its annual financial statements before their submission to the board of directors for approval. Most committees perform effectively the functions that are considered of primary importance: (1) review with the independent auditors, on completion of the audit, their experience, any restrictions on their work, cooperation received, their findings, and their recommendations; (2) review with the independent auditors their evaluation of the company's internal control systems; and (3) review the corporate annual financial statements before their submission to the board of directors for approval.

4. The committee, in establishing a regular and direct channel of communication between independent auditors and directors, can contribute and indeed has contributed the following benefits: (1) added assurance to users of financial statements as to the objectivity of corporate financial statements; (2) reinforcement of the independence of the corporation's external auditors; (3) increased attention to the audit and control functions at the director's level; (4) added protection for the directors of the corporation, especially for the nonofficer directors, against potential litigation concerning the due care they exercise in the fulfillment of their responsibilities; (5) enhancement of communication and access between external auditors and directors; and (6) provision of discipline value for external auditors, directors, and management.

5. The effectiveness of an audit committee apparently is dependent primarily on such factors as the competence of its members and a set of well-established committee objectives.

6. The committee plays an important role in resolving a great number of the major disagreements between the external auditors and the management of corporations.

7. The committee apparently has a positive effect on the reliability of the company's financial statements. However, an ineffective committee probably would have an adverse effect on the credibility of these statements if such ineffectiveness were known to users of the statements.

8. Management representation on the committee is considered desirable, especially by those who have direct experience with the committee.

9. In general, the committee makes a positive contribution to corporate governance.

The recommendations, whose primary objective is to improve the committee's overall usefulness and effectiveness, are as follows:

1. Corporate directors, management, and auditors, both external and internal, should have a clear and full understanding of the committee's purposes and functions. A careful, frank, and extensive discussion by them on what the individual committee should and can do, in light of the environment in which it operates, will eliminate much of the unnecessary confusion, conflicts, and misunderstanding about the committee that may develop.

2. There should be adequate disclosure both internally and externally regarding the committee's membership and its scope of activity.

3. Since the overriding object for establishing the committee is to provide reliable financial information about the company to the investors and the public, it is important that the committee review all financial information released to investors.

4. Since the committee is both useful and beneficial to a variety of parties, including corporate directors, management, external auditors, and users of financial statements, it is strongly recommended that all corporations consider the establishment of such a committee.

5. Legislation or regulations should be enacted to require the disclosure of compliance with this requirement by filing a report with the appropriate government agency and by disclosure in the corporate annual report or in the auditor's report.

6. Consideration should be given to the mundane matter of compensation for committee members.

7. A more important and probably the most difficult matter that deserves consideration is the determination of a proper balance between the social costs and social benefits resulting from the committee. If the social benefits exceed the social costs, the committee is desirable. Although the full extent of such costs and benefits may be indeterminate due to the inability of quantifying at least some of them, it is certainly desirable that attempts be made to ascertain such a relationship to the greatest extent possible.

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By

Wai P. Lam

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Dedicated to

my wife

and

our parents.

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CHAPTER I

INTRODUCTION

Objectives of the Study

Mandatory audit committees for corporations is a relatively recent innovation. The Ontario Business Corporations Act of 1970, which became effective 1 January 1971, is the first legislation in Canada requiring the public corporations under its jurisdiction to establish audit committees. This study will cover those public corporations subject to this legal requirement.

The primary objective of this study is to obtain a better understanding of the role played by the mandatory corporate audit committee and to determine the extent of its contribution to corporate governance. More specifically, the objectives are:

1. to ascertain the most important purposes and functions of the mandatory corporate audit committee;

2. to discuss the major characteristics and the actual operations of audit committees, including their size, composition, principal occupation of their members, functions performed, and effectiveness with which these functions are performed;

3. to determine, in general, the usefulness and effectiveness of these committees, as well as the factors essential for effectiveness; and

4. to establish whether an effective committee can contribute the following benefits:

a. added assurance to financial statement users as to the objectivity of corporate financial statements;[1]

b. reinforcement of the corporation's external auditors' independence;[2]

c. increased attention to the audit and control functions at the director's level;[3] and

d. added protection for the directors of the corporation, especially for the nonofficer directors, in the event of litigation concerning the care, diligence, and skill they exercise in the fulfillment of their proper responsibilities.

Background

Brief Statement on the Development of the Corporate Audit Committee

The concept of a corporate audit committee is not a new one; for example, in the McKesson and Robbins case in 1940, the U.S. Securities and Exchange Commission recommended the establishment of such a committee.[4] The concept, however, was virtually ignored by the business and professional communities until the late 1960s.

In 1967 there were two significant developments, one in the United States, the other in Canada. The American Institute of Certified Public Accountants (AICPA) and the Ontario Select Committee on Company Law (known as the Lawrence Committee) urged public corporations to form audit committees of their boards of directors. The AICPA recommended that "publicly owned corporations appoint committees composed of outside directors (those who are not officers or employees) to nominate the indpendent auditors of the corporations' financial statements and to discuss the auditors' work with them."[5] Similarly, the Lawrence Committee recommended to the Province of Ontario, Canada, that a company with issued equity shares to the public shall be required by law to establish an audit committee of the board of directors, and such a committee shall review and discuss with the independent auditor the company's financial statements and the auditor's report thereon.[6]

In November 1968 the Canadian Institute of Chartered Accountants (CICA) recommended that the requirement for a corporate audit committee be incorporated into both federal and provincial legislation.[7] A year later, the Report of the Royal Commission on Atlantic Acceptance Corporation Limited (known as the Hughes Report) concurred with the Lawrence Committee's recommendation and suggested that the closer contact between the directors and the independent auditor could only have beneficial results in the future.[8]

In April 1970 the Business Corporations Act, which contained an audit committee requirement similar to that suggested by the Lawrence Committee, was introduced into the Ontario Provincial Legislative Assembly and later became the law for all business corporations incorporated in the province. This mandatory requirement for companies offering securities to the public was the first such legislation in Canada.

In November 1970 R. K. Mautz and F. L. Neumann concluded in their major study on corporate audit committees in the United States that these committees generally were useful; accordingly, they strongly recommended that companies should consider carefully the desirability of establishing them.[9]

In April 1971 a further substantial impetus for incorporating the audit committee requirement into Canadian federal legislation emerged. The Proposals for a New Business Corporations Law for Canada, a background paper on the proposals for a new federal corporations act, recommended, among others, an audit committee requirement similar to that suggested by the CICA.[10] This paper essentially became the proposed new Business Corporations Act of Canada, which currently is under consideration for passage by Parliament.

Interest in corporate audit committees also was growing in the United States. The Securities and Exchange Commission, in March 1972, endorsed the practice of audit committees for publicly held companies.[11] Similarly, the New York Stock Exchange strongly recommended, in April 1973, the formation of such a committee by each of its listed companies.[12]

More recently, the Province of British Columbia, Canada, also incorporated a provision for audit committees in its new Companies Act, effective 1 October 1973.

After more than two decades of neglect since the initial recommendation by the Securities and Exchange Commission, the corporate audit committee concept has generated increasing interest and widespread support from professional groups and from governmental representatives and legislatures, both in the United States and Canada. In fact, if the proposed Business Corporations Act of Canada becomes law, the majority of the federal companies will be required to have audit committees, in addition to those companies already required to do so by the Ontario and British Columbia acts.

Legal Requirements for Corporate Audit Committees in Ontario, Canada

Since this study deals with the corporations governed by the audit committee provision of the Ontario Business Corporations Act of 1970, it is essential to set forth the specifics of this provision. Section 182 of the act stipulates:

> (1) Audit Committee--The directors of a corporation that is offering its securities to the public shall elect annually from among their number a 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) Chairman--The members of the audit committee shall elect a chairman from among their number.
> (3) Review--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) Hearing of auditor--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) Idem--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.[13]

While the act is rather specific about the composition and the maximum functions of the committee, it is silent on its purpose. However, it is reasonable to infer from Section 182 and other related sections that the committee's purpose is to protect the interests of a variety of parties, among them company auditors, directors, and shareholders and the general public. The committee's purposes and functions will be discussed in more detail in chapters II and V.

Related Studies

A search of existing literature has produced relatively little written material on the specific subject of corporate audit committees. Only a few articles and two empirical studies have been written and the following subsections will review these.

Articles

The articles published in the various professional and business journals and financial newspapers generally proceed from the assumption that the audit committee is useful. The discussion then focuses primarily on the committee's possible advantages and functions. One article, however, discusses its author's experiences with three audit committees.[14] An overview of these articles is presented below.

"Audit Committees of Boards of Directors" (Arthur Young Journal, Summer, 1967) discusses the advantages of audit committees, their organization, and their operation. It then suggests that audit committees "can be important factors in the successful management of the corporation."[15]

"Audit Committees: Status and Prospects--Accounting and Auditing Problems" (Journal of Accountancy, May, 1969)[16] deals with the advantages of the audit committee, its functions, and the preparation required by both the independent auditors and committee members for the committee meeting. It covers essentially the same materials as in the previous article.

"A Look at Audit Committees and the Auditor's Independence," by W. P. Wallace (Canadian Chartered Accountants, July, 1969),[17] suggests that one of the audit committee's purposes is the recommendation of the selection of the external auditors, and the fulfillment of this purpose, among others, would strengthen the independence of the external auditors.

"The Effective Corporate Audit Committee," by R. K. Mautz and F. L. Neumann (Harvard Business Review, November-December, 1970),[18] summarizes and highlights the findings of the empirical study conducted by the two authors. Since this study will be discussed in detail in a later subsection, it will not be examined here.

"On An Audit Committee and Worried? Here Is What To Do," by D. L. Sinclair and A. G. Fells (The Financial Post, July 17, 1971),[19] explains briefly the nature of the audit committee requirements of the Ontario Business Corporations Act of 1970. It also discusses the committee's formation, purpose, composition, scope, powers, and meeting arrangements, and the remuneration of committee members.

"The Audit Committee: Its Growing Significance in the Corporate Structure," by Morton B. Solomon (Main LaFrentz & Co., 1972)[20] discusses the value and duties of the audit committee.

"Experiences with Audit Committees," by W. M. E. McLeod (Canadian Chartered Accountants, February, 1972),[21] deals with the author's actual experience with three audit committees and offers suggestions to both the independent auditors and their clients on practical matters concerning committee meetings.

"You and the Corporate Audit Committee," by R. K. Mautz (Ernst and Ernst, Winter, 1972-1973),[22] provides practical suggestions to both independent auditors and audit committee members regarding the handling of committee meetings and activities.

Two Studies

There are two empirical studies on corporate audit committees, one by Mautz and Neumann, the other by Auerbach. The former represents the first major and extensive empirical work, while the latter is a sample survey of selected clients of an accounting firm. Both studies deal with voluntary audit committees in the United States.

The Mautz and Neumann Study.[23]--The Mautz and Neumann study was conducted in the late 1960s and published in 1970. Their purpose was

> to gather together, from such sources as are available, as much information as we could obtain that is relevant to present and potential use of corporate audit committees, to evaluate that information sorting out general tendencies, common practices, exceptional applications, and unusual problems, and to draw such conclusions as are justified by the evidence collected.[24]

Accordingly, they

> sought information through library study; through questionnaires directed to non-officer directors, corporate chief executives, independent certified public accountants, and internal auditors; and through interviews with members of each of these and other interested groups.[25]

Their questionnaires covered primarily the following matters:

1. The ranking of purposes and functions of the audit committee;

2. the performance and effectiveness of these committee functions;

3. the desirable size of the committee;

4. the desirable composition of the committee;

5. the actual composition of the committee;

6. the usefulness of the committee; and

7. the frequency and scheduling of committee meetings.[26]

Their interviews covered essentially the following:

1. The role and function of a corporate audit committee, such as the possible expansion or reduction of its role, the way in which its functions can be improved, and factors which may limit the role of such committees;

2. the technical competence of committee members, such as the kind of background that gives one such competence, and any special effort by companies to obtain such competence in forming a board of directors;

3. the relationship of a committee to the company's internal audit department;

4. the composition of a committee, such as whether corporate executives are represented and the reasons therefor;

5. the effect of a company's size and nature on its need for a committee; and

6. the special legal implications in the use of such a committee, such as whether the committee relieves other members of the board of any responsibility and whether committee members have additional legal responsibility.

Based on the data obtained from 42 interviews and 705 usable questionnaire responses (an overall rate of 18 percent, ranging from 8 percent for nonofficer directors to 67 percent for independent certified public accountants), Mautz and Neumann drew seven conclusions and offered five recommendations.

The conclusions, based primarily on interview data, are:

(1) Corporate audit committees are not employed as widely as many people appear to believe and, when they are utilized, they have attained significantly varying degrees of success. In some companies they serve as little more than a formal device for receiving the annual audit report from independent certified public accountants and for recommending reappointment of the auditors; in other instances, they constitute a strong force for strengthening internal discipline and provide significant shareholders protection.

(2) In practice the corporate audit committee concept becomes a very flexible device both in terms of purpose and function. The most important role of such a committee seems to be that of facilitating direct interchange of ideas, experience, and information between members of the board of directors and the independent auditors. . . . The corporate audit committee may also be used as a basis for interchange of ideas and experience between members of the board of directors and those officers and employees within the company who are responsible for internal auditing, accounting, and other financial functions. . . .

(3) There appears to be consensus that the size of a corporate audit committee should be about three to five directors. The positions of those members is less clear. The general feeling is that nonofficer directors should at least be in the majority but representation of management, sometimes only in ex officio capacity, is not without its supporters. The president is the management member most often mentioned to sit on the committee with personnel from the financial area being usually excluded. The composition, like the duties and the normal number of meetings, is largely a function of the nature of the organization and the operating philosophy of the board and management.

(4) The effectiveness of any corporate audit committee appears to depend more upon the personalities involved than upon any other variables. The chief executive officer's approach to corporate governance is most important, especially as displayed in his use of committees of the board of directors. Only slightly less important is the attitude of the chief financial officer toward a committee whose activities may impinge upon the duties and prerogatives of his own office. Finally, the competence, energy, and enthusiasm of members of the audit committee itself, and their ability to work with officers and employees of the company without appearing to encroach upon operating responsibilities, have much to do with defining the scope and effectiveness of audit committee activities.

(5) An increasing emphasis at the board of directors level on the contribution of auditing, both internal and independent, to the maintenance of internal corporate discipline is apparent and adds to the current interest in corporate audit committees.

(6) Attitudes toward the corporate audit committee idea vary widely, all the way from considerable enthusiasm to what can best be described as indifference. Relatively little direct opposition was experienced although some expressed fears that the audit committee's potential for interference with otherwise satisfactory relationships is considerable.

(7) The potential for usefulness of corporate audit committees, in our judgment, sufficiently exceeds the possibilities for disturbance that we strongly recommend that all companies with significant nonmanagement shareholder interests consider carefully the desirability of establishing an audit committee, but that any company do so only after sufficient discussion among those most likely to be involved in its activities to assure that there is sympathy for the idea and that expectations regarding its role and responsibility are both reasonable and shared by all.[28]

The recommendations which focus on the need for and importance of a full understanding of the concept and adequate planning before the adoption of an audit committee by a company are:

(1) A frank and intensive discussion of the corporate audit committee concept in a full meeting of the board of directors in which all present are urged to express their support for or oppposition to the idea. . . . The attitudes of the chief executive officer and the chief financial officer are particularly important. Some attempt to outline, at least in broad terms, the duties which such a committee will be assigned is important in this discussion so that any possible infringement on the duties of the chief financial officer or others will be understood. Attention should also be given to the matter of competence on the part of available board members to discharge the projected duties of an audit committee. . . . Reasons for a completely nonofficer committee or for management representation should be examined.

(2) If the board is favourable to the establishment of a corporate audit committee, an ad hoc committee to hold a series of preliminary meetings is desirable. The members of the committee (possibly those members of the board most likely to serve on the audit committee) should meet to express their views of the committee's responsibilities and duties and, if possible, to draft statements of these. Having done this, an informal meeting with the company's independent accountants is very desirable. . . . Another meeting to discuss possible audit committee activities involving internal auditing and accounting with appropriate company personnel and with any operating department heads who might be affected should also be held.

(3) Upon completion of these meetings, the ad hoc committee should draft a proposed statement of purpose and duties for the consideration and possible approval of the board of directors, taking into account the results of its several meetings. Adequate time to review this in a full board meeting is desirable.

(4) If the board of directors is still favorably inclined toward the establishment of a corporate audit committee, a resolution to that effect is now in order. The extent to which the resolution should include specification of the committee's duties depends largely on the formality of the particular board's operations. In any case, a clear understanding of these duties on the part of directors, officers, and employees concerned is most important. The more sensitive various officers are to implications of the committee's establishment, the more carefully should the committee's duties be specified.

(5) Upon authorization and appointment, the committee should meet to establish its own operating procedures including the number, timing, and duration of meetings, the nature of its agenda, and the responsibilities of its chairman and other members. No limitation should be placed on the number of meetings with the auditors and either party should be able to initiate them.[29]

<u>The Auerbach Study</u>.[30]--The results of the Auerbach study, published in the <u>Financial Executive</u> in September 1973, were based on the responses from 68 of the 100 sampled clients of a major accounting firm in the United States.[31] The study's major findings are presented below.

1. The number of clients with audit committees has increased from 17 percent in 1967 to 68 percent in 1972. Such committees are nearly twice as common in the largest surveyed clients as in the smallest clients.[32]

2. The suggestion of the independent auditors, management, and outside directors is cited as the most common reason for establishing an audit committee.[33]

3. The size of audit committee ranges from two to more than six members, with three-member committee as the most common.[34]

4. The majority of committee members are nonofficer directors.[35]

5. In addition to the primary function of reviewing the scope and results of the audit, many committees perform functions such as the evaluation of the company's financial officers, internal auditors, and the staffing of the accounting and financial departments.[36]

6. About half of the committees meet with independent auditors to discuss the scope and results of the annual audit, the auditors' "management letter," and recent AICPA, SEC, and other regulatory agency pronouncements and their impact on the company's financial statements.[37]

7. Some committee functions are not performed effectively: "For example, 18 percent found the review of alternative accounting policies in meeting with the financial officers ineffective (54 percent did not respond), and 15 percent found previews of the audit with the CPA ineffective (15 percent did not respond)."[38]

This study recommended that

> every company that has not yet established an audit committee should consider its use. In the short run, it can give the board of directors a stronger grasp of each year's audit and annual report; in the long run, it gives stockholders additional protection and greater confidence in the reliability of financial reporting in general.[39]

This Study

The present study deals with the mandatory corporate audit committees in Ontario, Canada. It employs the questionnaire approach to obtain relevant and significant information on audit committees from corporate executive officers, members of audit committees, practicing chartered accountants, and financial analysts.

In addition to the fact that this study deals with mandatory corporate audit committees, it differs from the previous two studies, particularly the Mautz and Neumann study, in two other major aspects: (1) the respondents and (2) the information solicited.

Since one of the most important objectives of the audit committee is to enhance the objectivity of company's financial statements for the benefit of the financial statement users, this study seeks financial analysts' opinion on the subject. Also, it includes all audit committee members rather than only nonofficer members as in the Mautz and Neumann study.

Certain significant information not available in the previous studies is sought by this study, namely: (1) the effect of an audit committee on the reliability and credibility of the company's financial statements; (2) the major benefits of an effective audit committee and the extent of their realization by companies with such committees; (3) the factors contributing to an effective committee; (4) the desirability of disclosing the names of committee members in the annual report; (5) the role played by the committee in resolving major disagreements between the auditor and management; and (6) the disposition of committee minutes.

Need and Significance

Corporate directors, officers, and business related professionals are being held to increasingly high standards of accountability for the affairs of the corporations with which they are associated. Since the corporate audit committee concept has been suggested as offering significant assistance to a number of groups in meeting their business responsibilities, empirical research into the use of such committees could be of great significance. Interest in these committees has been growing in the past few years, especially in Canada, where such a committee is mandatory for companies in both Ontario and British Columbia. If the proposed new Business Corporations Act of Canada becomes law, the majority of federally incorporated companies also will be required to have an audit committee.

However, despite this interest and the apparent potential usefulness of the concept, little empirical work exists. The study by Mautz and Neumann is the first and only such major effort, and they were concerned with voluntary, not mandatory, audit committees. The present study is the first empirical study on mandatory corporate audit committees in Canada. Consequently, it will provide relevant and significant empirical data on the operations and experiences specifically related to the mandatory application of the concept.

This study will offer useful empirical data for the Canadian federal government and those provinces that are considering the enactment of corporate audit committee requirements or are seeking to improve the requirements already in effect. It also will provide pertinent information for those corporations contemplating the establishment of audit committees either at their discretion or as required by law.

Finally, the study will add to and update the present limited literature in the field.

Scope and Limitations

This study concerns only those corporations covered by the audit committee provision in the Ontario Business Corporations Act of 1970. The provision became effective 1 January 1971, and corporations responding to this survey have had a minimum of two years' experience with audit committees. Although some corporations may have had committees prior to 1 January, and thus could provide more valuable insights, such corporations are more likely the exception rather than the rule.

In particular, this study will deal primarily with the functions of audit committees having a direct relationship to the corporation's external audit. The reason for such a restriction is that the legal requirement for audit committees is intended for the external audit. Any other functions which these committees may deem appropriate to perform will be considered as outside the scope of this research, although they may be discussed.

Research Methodology

This study employed a questionnaire approach to obtain as much relevant and significant information as possible from those who have had direct experience with audit committees and those who, by virtue of their profession, could be expected to have such experience and interest. Using this direct experience or professional interest criterion, four groups of individuals were selected: corporate chief executive officers; members of corporate audit committees; practicing chartered accountants (CAs); and financial analysts. These latter were included because, aside from their professional interest, they are, to a certain degree, representatives of the investors.

A separate questionnaire was designed for each of these four groups. Although many of the same questions appeared on each, there were entries relevant to a specific group. For example, the question on the effectiveness with which certain functions were carried out was directed to the groups having direct experience, such as committee members and practicing CAs, and the questions on the effect of the committee on the credibility of financial statements were directed to a more objective group, the financial analysts.

To ensure that the questions were as free from ambiguity and misinterpretation as possible, the questionnaires were pilot tested by administering them to a sample of each of the four groups. Appropriate changes were made as a result of the pilot test, and the questionnaires then were used for the final survey.

Organization of the Study

Chapter I introduces the objective of this study, provides some background information on corporate audit committees, offers a review of related studies, and presents a brief statement about the study. Justification for and limitations of the study are discussed. Finally, the research methodology is indicated.

Chapter II first discusses the definition of the corporate audit committee and then presents its historical development and present status, both in the United States and Canada. Finally, the advantages and disadvantages of the committee are discussed.

Chapter III first discusses the objective of the mail questionnaires used in this study and the kind of information solicited. Second, it discusses the population in general and the establishment of the populations for corporate chief executive officers, members of audit committees, practicing chartered accountants, and financial analysts. Third, it summarizes the details of the pilot study. Finally, it shows the details of administering the final questionnaires.

Chapter IV presents some characteristics and operating procedures of the audit committees. First, the size of the committees, the number of meetings, and the scheduling and minutes of meetings are discussed. Second, the composition of committees and characteristics of their members are analyzed. Third, the issue of officers serving on the audit committees of their own corporations is discussed. Finally, attention is focused on the desirability of disclosing committee membership information and on the committees established prior to the Ontario requirement.

Chapter V summarizes and analyzes the results of questionnaire responses that have not been covered by Chapter IV. First, it discusses the ranking of purposes and functions of the audit committee and the performance and effectiveness of such committe functions. Second, it focuses on the factors contributing to, and benefits of, an effective committee, on the major disagreements between the external auditor and management, and on the role played by the committee in such disagreements. Finally, it discusses the general effectiveness and usefulness of the committee and the effect of the committee on corporate financial reporting.

Chapter VI first presents a summary of findings, highlighting the research findings discussed in Chapters IV and V. Second, it draws conclusions based on the research data presented throughout the study. Third, it presents recommendations, whose primary objective is to improve the committee's overall usefulness and effectiveness. Finally, it provides suggestions for further research.

FOOTNOTES--CHAPTER I

1. AICPA Executive Committee, "Statement on Audit Committees of Boards of Directors," Journal of Accountancy (September, 1967): 10.

2. R. K. Mautz and F. L. Neumann, Corporate Audit Committees (Urbana: Bureau of Economic and Business Research, University of Illinois, 1970), p. 46.

3. Ibid.

4. U.S. Securities and Exchange Commission, "In the Matter of McKesson and Robbins, Inc.--Summary of findings and conclusions," Accounting Series Release, 1-112 (Washington, D.C.: U.S. Government Printing Office), p. 20.

5. AICPA Executive Committee, "Statement on Audit Committees."

6. Ontario, Legislative Assembly, 1967 Interim Report of the Select Committee on Company Law (Toronto: 1967), p. 92.

7. Canadian Institute of Chartered Accountants, "Special Committee on Shareholders' Audit," Canadian Chartered Accountants (November, 1968): 354.

8. Ontario, Royal Commission, Report of the Royal Commission--Atlantic Acceptance Corporation Limited (Toronto, 1969), III, 1653.

9. Mautz and Neumann, Corporate Audit Committees, p. 96.

10. Robert W. V. Dickerson et al., Proposals for a New Business Corporations Law for Canada (Ottawa: Queen's Printer, 1971), II, 107.

11. U.S. Securities and Exchange Commission, "Accounting Series Release No. 123," Journal of Accountancy (May, 1972): 15-16.

12. Haskins & Sells, The Week in Review (Detroit: 27 April 1973), p. 1. Also see the Wall Street Journal, 15 June 1973.

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27. *Ibid.*, 29-30.

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29. *Ibid.*, 96-97.

30. Norman E. Auerbach, "Audit Committees--New Corporate Institution," *Financial Executive* (September, 1973): 96-104.

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CHAPTER II

CORPORATE AUDIT COMMITTEES: DEVELOPMENT, ADVANTAGES, AND DISADVANTAGES

Introduction

This chapter presents a more detailed discussion of the development of the corporate audit committee and its advantages and disadvantages. First, the definition of the corporate audit committtee is discussed. Second, an historical perspective is presented, with specific focus on the rationale for recommending such a committee, its historical development, and its present status, both in the United States and Canada. Third, the possible advantages and disadvantages of a corporate audit committee are discussed.

Definition of the Corporate Audit Committee

Typically, definitions or descriptions of the corporate audit committee tend to focus on the committee's specific composition and functions. The following are examples.

> [The] committee [is] to be selected from non-officer members of the board of directors which shall make all company or management nominations of auditors and shall be charged with the duty of arranging the details of the engagement.[1]

> Committees [shall be] composed of outside directors (those who are not officers or employees) to nominate the independent auditors of the corporations' financial statements and to discuss the auditors' work with them.[2]

> An audit committee of the board of directors . . . [shall be] composed of not less than three directors, of whom a majority shall not be officers of the company or any affiliate of the

> company . . . [to review and discuss] . . . not only the financial statements and his [the auditor's] report thereon, but relevant matters arising therefrom or from his audit generally.[3]

> The directors of a corporation . . . 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 . . . The corporation shall submit the financial statement to the audit committee for its review. . . .[4]

> The term "corporate audit committee" [includes] any committee established at the general officer or board of directors level which has a specific charge to supervise or review the work of the independent or internal auditors.[5]

Three essential elements emerge from these examples. The committee is (1) drawn from boards of directors who are (2) primarily or entirely outside or nonofficer directors, and (3) it is concerned with audit matters and related financial statements.

In addition, certain important implications are apparent. (1) The committee is chosen from the highest level of the corporate structure. (2) It is independent of management because the majority of members are nonofficer directors. (3) Its chief function is to review audit matters and related financial statements. (4) It represents a direct tie between the independent auditors and the board.

Accordingly, a more complete and descriptive definition of a corporate audit committee would be the following:

> A corporate audit committee is a committee of the board of directors, composed chiefly of nonofficer directors who are independent of management, which has a specific charge to deal with the corporation's audit matters, including its financial reports and especially those related to the external or independent audit.

The main advantage of this definition is that it emphasizes the essential characteristics of the committee without dwelling on the details of its composition and its functions.

Historical Perspective

Rationale for the Recommendation of the Corporate Audit Committee

The most salient rationale for the recommendation of a corporate audit committee is the need to assure the independence of the corporation's external auditor. Proponents of the corporate audit committee believe that such an assurance can best be achieved by providing a direct channel of communication between the auditor and the directors through the audit committee. They also believe that this assurance, in turn, will enhance public confidence in corporate financial reporting. The following discussions will focus on this matter of assuring the auditor's independence.

Independence of the auditor generally is classified into two categories: independence in fact and independence in appearance. The former refers to the auditor's ability to maintain an unbiased and impartial mental attitude in all aspects of his work, regardless of whether or not existing circumstance might have an apparent effect on his independence. The latter refers to the auditor's freedom from conflict of interest, that is, it implies "absence of influence or control in the matter of the auditor's conduct, action, and opinion."[6] It is perhaps "the most important single determinant of the need for the audit function."[7] It is the auditor's independence in appearance that is the subject of discussion here.

The auditor always is assumed to be independent of management, although this assumption is questionable at times. It has been suggested that a corporate audit committee, composed chiefly or entirely of outside directors, can assure this independence. For example, the Securities and Exchange Commission, in recommending audit committees in 1940, stated that such a committee, together with other recommendations, would ensure the required degree of independence of the auditor necessary for the protection of investors.[8] The Lawrence Committee gave a similar reason for its recommendation.

> It is generally agreed that one of the most serious threats to the independence of the auditor is the close relationship which frequently (and naturally) develops between management and the auditor. . . . As a practical matter, whether or not he [the auditor] is re-appointed to his office is a management decision and not that of the shareholders. "Management" in this context sometimes means the president and/or the chief financial officer of the company. In carrying out his role, the auditor not infrequently can feel under pressure to follow the dictates of such officers. To avert this threat to the auditor's independence, the Committee recommends that . . . there shall be an audit committee of the board of directors.[9]

The Report of the Royal Commission on the Atlantic case frequently noted that the auditor would have been more independent of management and the sorry story would have been different had there been an audit committee. W. A. Farlinger, who served eighteen and one-half months as a trustee for Atlantic, drew a similar conclusion.

> It would seem that if Atlantic had had such a committee . . . the committee would have realized that the [senior] auditors upon whom they and the public were depending were clearly working under an impossible situation imposed upon them by the president of the company. . . . any inquiry by the senior auditors or an audit committee as to the independence of the [subsidiaries] auditors would have revealed the conflict of interest in their roles as managers, bookkeepers, auditors, if not their identity as borrowers.[10]

Mautz and Neumann considered that the added indpendence contributed by the audit committee is most useful. "An audit committee which holds CPAs directly accountable to the board of directors strengthens their independence of management. Such a contribution is one of the most useful ones the committee can make."[11] More recently, the New York Stock Exchange, in recommending that each of its listed companies form an audit committee, stated that "all available evidence indicates that properly constituted corporate audit committees composed of outside directors, contribute significantly to the independence of the outside auditor."[12]

In short, the major reason for recommending the establishment of the corporate audit committee is to assure the independence of the auditor.

Historical Development and Present Status

United States.--The concept of having a corporate audit committee is a relatively recent development, and the U.S. Securities and Exchange Commission is probably the first significant organization to suggest it. In 1940, as a result of the McKesson and Robbins case, the commission recommended the establishment of such a committee.[13] The concept, however, received little attention from either the business or professional communities in the more than two decades that followed. An editorial in the *Journal of Accountancy* in 1953 offered two explanations for the seeming lack of interest. "In our opinion, it is simply because the matter has received relatively little publicity recently, and has been overshadowed by other, newer problems."[14] This indifference is borne out by the results of the Mautz and Neumann study. They reported in 1970 that only 121 of the 385 corporations included in the study had audit committees; of these 121 companies, only 39 had had such committees for more than 20 years. However, the concept began to receive a renewed and greater interest in the mid- and late 1960s.

In July 1967 the AICPA Executive Committee issued a statement, "Audit Committees of Boards of Directors." It recommended that publicly owned corporations appoint committees of outside directors (those who are not officers or employees) to nominate the independent auditors of the corporations' financial statements and to discuss the auditors' work with them.[15] Specifically, audit committees should do the following.

1. Discuss with the auditors the scope of their examination, with particular attention to areas where either the committee or the accountants believe special attention should be directed. The audit committee would be authorized to have the auditors perform such supplemental reviews or audits as it deemed desirable.
2. After the audit, review the financial statements and the auditors' report thereon with the auditors and determine that they have received all the information and explanations they requested.
3. Invite the auditors' recommendations regarding internal controls and other matters.[16]

The Executive Committee further suggested that "the auditors should communicate with the audit committee whenever any significant question having a material bearing on the company's financial statements has not been satisfactorily resolved at the management level."[17] Apparently, the AICPA recommendation did influence some companies to establish audit committees. Mautz and Neumann indicated that 47, or about 40 percent, of the 121 companies formed their committees in the late 1960s.

In November 1970 Mautz and Neumann concluded in their study of U.S. corporations that

> the potential for usefulness of corporate audit committees . . . sufficiently exceeds the possibilities for disturbance that we strongly recommend that all companies with significant nonmanagement shareholder interests consider carefully the desirability of establishing an audit committee.[18]

In March 1972 the U.S. Securities and Exchange Commission issued its Accounting Series Release No. 123, "Standing Audit Committees Composed of Outside Directors," and it endorsed "the establishment by all publicly-held companies of audit committees composed of outside directors."[19]

In April 1973 the New York Stock Exchange, in its draft white paper, "Comments on Financial Reporting to Shareholders and Related Matters," stated that it "strongly recommends formation by each listed company of a Corporate Audit Committee."[20]

Canada.--In 1967 the audit committee requirement, along with other recommendations of the Select Committee on Company Law, was incorporated into a bill to amend the Ontario Corporations Act. The committee, chaired by Allan F. Lawrence, was appointed by the Legislative Assembly of Ontario in June 1965 to "inquire into and review The Corporations Act of the Province of Ontario and related acts and regulations."[21] The ensuing two-year inquiry and deliberation included queries to all corporations in Ontario and interested segments of the public, as well as the review of written briefs submitted by various organizations and of company laws in England, California, and New York. Specifically, the committee recommended that

> in the case of a company that has issued equity shares . . . to the public . . . there shall be an audit committee of the board of directors . . . [and] that the financial statements of the company, together with the auditor's report thereon . . . be first submitted to the audit committee for the review and comments of such committee . . . the committee shall be composed of not less than three directors, of whom a majority shall not be officers of the company or any affiliate of the company.[22]

It was hoped that the recommendation would "make available to the auditor a means whereby he may discuss with a committee of the directors not only the financial statements thereon, but relevant matters arising therefrom or from his audit generally."[23]

In November 1968 the Canadian Institute of Chartered Accountants (CICA), through its Special Committee on Shareholders' Audit, recommended the incorporation of the following audit committee requirements into both provincial and federal legislation:

1. Legislation, both federal and provincial, should require that the directors of a company that has distributed securities to the public shall appoint from among their number a committee 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 company or of an affiliate of the company.
2. Legislation, both federal and provincial, should require that the financial statements and draft auditor's report thereon shall be submitted to the audit committee for its review prior to such statements and report being presented to the board of directors for approval.
3. Legislation should:
   (a) require that the shareholders' auditor appear before any meeting of the audit committe of the board of directors if such attendance is requested.
   (b) give the auditor the right on request to appear before any meeting of the audit committee and to be given an opportunity to be heard.
   (c) give the auditor the right to cause a meeting of the audit committee to be called to consider any matters

> discovered in the course of his examination which he believes should be brought to the attention of the board of directors or the shareholders.[24]

In September 1969 the Report of the Royal Commission on the Atlantic Acceptance Corporation Limited recommended, among others, the establishment of audit committees for public corporations. The Royal Commission, with the Honourable Mr. Justice S. H. S. Hughes as commissioner, was appointed in August 1965, under the Public Inquiries Act, to investigate the cause and effect of the Atlantic failure. The investigation took four years to complete, and a four-volume report told the story; it concluded with numerous recommendations for changes in legislation. In relating the significance of this case to the accounting profession, the commission said: "It may be said that the Atlantic failure was as much of a watershed in the history of accounting in Canada, and perhaps abroad as was that of McKesson & Robbins Inc. in the United States."[25] The Commission report, which concurred with the details and rationale of the Lawrence Committee's recommendation on corporate audit committees, noted that the sorry story of Atlantic would have been different had there been an audit committee.

In April 1970 the Business Corporations Act of 1970, which incorporated many of the recommendations of the Lawrence Committee, was introduced into the Ontario Provincial Legislative Assembly. This act received Royal Assent on June 1970 and became effective 1 January 1971. It applies to all business corporations incorporated in the Province of Ontario.

Among the major changes embodied in this act is the requirement that public corporations establish audit committees, the first such legislation in Canada. The recommendations by the Lawrence Committee, the CICA, and the Hughes Royal Commission, and perhaps more important the effects of the Atlantic affair itself, no doubt had contributed significantly to the successful enactment of the audit committee requirement. Section 182 of the act, as stated in Chapter I, contains essentially the same requirements as those recommended by the CICA, with one exception: The present legislation does not specifically require the audit committee to review the auditor's report on the financial statements. However, in practice such a review probably will be done.

In April 1971 a further substantial impetus for incorporating the audit committee requirement into Canadian federal legislation emerged. The Proposals for a New Business Corporations Law for Canada, a background paper on the proposals for a new federal corporations act, recommended, among others, an audit committee requirement similar to that suggested by the CICA.[26] The Proposals is the product of a lengthy research conducted by a group of lawyers under the directorship of Robert W. V. Dickerson, a lawyer and a chartered accountant. It was published in two volumes. Volume 1 is the commentary and Volume 2 is the Draft Canada Business Corporations Act of Canada. The second volume has become essentially the new Business Corporations Act of Canada, currently under consideration for passage by Parliament.

More recently, the new Companies Act of the Province of British Columbia, Canada, effective 1 October 1973, also contains an audit committee requirement.

Concluding remarks.--In summary, the corporate audit committee concept, after a long period of neglect, has aroused, within a few years, increasing interest and support from professional groups, government representatives, and government legislatures, both in the United States and Canada. While audit committees are voluntary in the United States, they have become mandatory for at least two Canadian provinces. If the proposed Business Corporations Act of Canada, with the audit committee provision, becomes law, mandatory audit committees will be required for the majority of federal companies in addition to the majority of companies in the Provinces of Ontario and British Columbia. In fact, the audit committee perhaps has become one of the most significant new corporate developments in Canada.

Advantages and Disadvantages of Corporate Audit Committee

The creation of an audit committee introduces a new organizational unit into the corporation's structure. This new unit has its objectives and functions, and it also gives rise to a new set of relationships among the auditor, directors, and management. As a result, literature on the subject has suggested that it has certain advantages and disadvantages. This study will attempt to provide some empirical data to substantiate these contentions.

Advantages

1. Enhances communication between auditor and directors.[27]

2. Enhances credibility and objectivity of financial reporting.[28]

3. Reinforces auditor's independence.[29]

4. Provides protection for directors.[30]

5. Provides discipline value.

Disadvantages

1. Possible conflicts and misunderstanding.[31]

2. Danger of false appearance or overexpectation from added credibility of financial reporting.

The following subsections will discuss these advantages and disadvantages.

Enhances communication between auditor and directors.--The establishment of an audit committee in the corporation creates a more direct and explicit channel of communication between the external auditor and the members of the committee and through them to the full board. With this committee, both the auditor and members have direct and regular access to each other to discuss matters of mutual concern and interest. Such direct communication can be beneficial to both the auditor and directors, as noted in a Journal of Accountancy editorial:

> Certified public accountants generally agree that the full values of the services they render as independent auditors are derived most often by those companies in which the auditors have direct access to the board. Whether that access is best arranged through an audit committee or by appearance of the auditor at board meetings depends on the size of the board, the size of its agenda, and other circumstances. But there seems to be no doubt that a direct channel of communication between the board and the auditors is very much to the advantage of all concerned.[32]

Presumably, this direct channel of communication between the board and the auditor is used frequently. This is not true. Mautz and Neumann describe what is done in practice.

> Our interviews indicated that any extensive exchange between a company's independent CPAs and its board of directors is far from common. Certainly the independent CPAs always have access to the board of directors if necessary, and most of the CPAs we talked to had ready illustrations of situations in which they felt it necessary to take questions to the board of directors. At the same time, it is clear that such is not a normal occurrence but rather is considered to be extraordinary. [Emphasis added.] The independent CPA would be reluctant to go to the board of directors over the head of operating management. . . . His feeling is that such an action is like appealing to a court of last resort.[33]

An audit committee provides an opportunity for contacts between the auditor and directors on a normal and regular rather than extraordinary basis.[34] Moreover, because of the very nature and purpose of the committee, there is likely to be more time for discussions with the members and certainly less chance for management to discourage discussing issues with these directors. More important, when the committee is composed of mostly outside directors, as it should be, issues brought up by the auditor can be settled with greater objectivity. Consequently, such a committee tends to encourage communication between the auditor and its members.

Accordingly, the real value of an audit committee lies not only in the enhancement of communication between the auditor and the board members, but also in the objectivity that it brings.

Enhances credibility and objectivity of financial reports.--The board of directors is responsible for providing investors with accurate, complete, and reliable financial reports. As directors, they are in a position to make a careful and thorough review to ensure that the reports are indeed accurate, complete, and reliable. Such a review best can be accomplished by discussing with the auditor all significant matters relating to the audit and the financial reports. However, the board tends to devote its time to other more complex and pressing issues than such seemingly routine matters as the annual audit and its financial reports. Moreover, the size of the board is often too large to make such an in-depth discussion with the auditor feasible. It has been suggested that an audit committee of the board would help the board to discharge its responsibilities on the audit and report matters without distracting its attention from more or equally important issues.

Indeed, the audit committee, with its smaller size and specific charge to deal with audit and financial reporting matters, can devote the necessary time and attention to these issues and pursue its review in a more inquisitive and discerning manner.[35] In addition, the committee, which usually is composed primarily of outside directors, is independent of management and thus can be objective in its review of audit and financial matters. Consequently, it is rather fair to state that such an independent and objective review mechanism can indeed enhance the credibility and objectivity of corporate financial reporting. In fact, both the AICPA and the SEC agree that the committee can give such added assurance and thus afford the greatest possible protection to investors.[36]

Reinforces auditor's independence.--The external auditor is the representative of shareholders. He must act in their best interest and must be independent of management. However, it is not uncommon that a close relationship often develops between the auditor and management. This relationship raises the question of the auditor's independence, that is, his effective independence from management, especially in view of the auditor's increasing reliance on management to discuss and resolve issues rather than taking them directly to the board.

To reinforce his independence, it is suggested that the auditor should have a direct channel of communication to the board through an audit committee. Such a committee strengthens the auditor's position in his relationship with management and provides a forum independent of management before which the auditor may discuss matters he considers significant. Management probably will be more objective and less dominating in its dealings with the auditor if the auditor, as a normal and regular procedure, will bring the issues discussed to the attention of the committee and keep its members informed. The possibility that management may pressure the auditor to follow its dictates also is minimized.

More specifically, an audit committee can help to reinforce the auditor's independence in two major areas: (1) appointment and dismissal of the auditor and (2) the auditor's work, such as the scope and results of his audit.

First, let us examine the appointment and dismissal of the auditor. In theory, at least, the auditor is appointed, and can be dismissed, by shareholders. In practice, his appointment and dismissal is often a management decision, and the ratification by shareholders is a formality. This frequently puts the auditor under pressure to follow the dictates of management if he wants to be appointed or reappointed. Thus, it is proposed that to emphasize the auditor's independence his appointment should be made by an audit committee of outside directors and approved by the shareholders. "The best hope of establishing the . . . [auditor] as a completely independent operation probably is to ally his interest with those of outside directors."[37] The Committee on Basic Audit Concepts of the American Accounting Association agrees that this type of appointment arrangement "may strengthen the auditor's position of independence and does provide additional assurance to users that the auditor is not subservient to the preparer [management]."[38]

Also, the audit committee may serve as a deterrent for any unreasonable dismissal of the auditor by management. Mautz and Neumann explain how the committee can help.

> If the corporate audit committee demands of the operating management its reasons for severing relations with its auditor and gives the auditor an opportunity to present his case, it may add a great deal to the effective independence of the outside auditor. The mere existence of such a committee, particularly one that has developed close relationships with the auditor, would in itself provide a useful deterrent to any possible hasty action on the part of management.[39]

Regulatory agencies and legislatures also have sought measures to protect the auditor from unfair dismissal by management. For example, the SEC requires companies to report to it any changes of auditors together with the existence of any disagreements with auditors and the disclosure of disagreements that were resolved. The Ontario Business Corporations Act gives the auditor the right to inform the shareholders, in writing and/or by appearance before the shareholders meeting, at the company's expense, of the reasons for his nonreappointment. Such a measure probably discourages willful dismissal by management.

It is important to note the difference the effect of the audit committee and the regulatory or legislative measure may have on the appointment and especially the dismissal of the auditor. The former provides a forum for settling these issues before they materialize, while the latter is more likely to provide explanations after the fact. However, both, in varying degrees, reinforce the auditor's independence.

Second, let us consider the auditor's work. The audit committee generally has as its function the review, with the auditors, of the scope and results of the audit as well as the kind of cooperation he has received from management in the course of his work. Such a review encourages management to provide full cooperation during the process. The auditor, on the other hand, probably will be less likely to be intimidated by any possible restriction on the scope of his audit imposed by management. Moreover, the existence of the audit committee allows the auditor "to discuss problems raised by the accounts with directors" and frees him from his "previous dependence upon management and the internal accounting officers of the company for discussion of these problems."[40] Thus, the committee can resolve policy differences between management and the auditor and precludes management's temptation to change auditors in the hope that the replacement will accept its policies. Accordingly, such a committee tends to reinforce the auditor's independence.

Provides protection for directors.--An audit committee, smaller in size than the full board and more specific in its functions, can devote sufficient time and attention to its review of financial reporting matters. At the same time, it presents an opportunity that was not previously available for committee members who are outside directors to be more knowledgeable about corporate financial affairs and to be able to make a reasonable investigation of them. If the members take their duties seriously and perform them diligently, the committee can be very effective and thus provide protection for directors, particularly the committee members, against potential litigation concerning the due care they exercise in fulfilling their responsibilities. The directors can show, as evidenced by the committee's activities, that they have exercised the care, diligence, and skill that a reasonably prudent person would exercise in comparable circumstances.

In the Bar Chris case, both outside and officer directors were held liable to the investors because they did not exercise "due diligence" or perform "reasonable investigation" concerning the correctness and completeness of the prospectus.

> The judge felt less certain that the fifth officer-director knew of the errors in the prospectus, however, to escape liability this director was required to prove that he had exercised "due diligence" to make sure that the statement . . . was accurate and complete. He could not prove that, and so he, too, was liable. It was on this question of due diligence that the four-outside directors also floundered. None knew they were signing a flawed statement, but none had made the "reasonable investigation" of its accuracy demanded by the securities laws . . . The judge made it clear that what constituted a reasonable investigation could vary from one director to another . . . The court, in considering the case, saw a "reasonable investigation" as simply one that "a prudent man would employ in the management of his own property."[41]

If there had been an audit committee, one would imagine that the directors, particularly the committee members, would have been able to show evidence of "due diligence" and "reasonable investigation." Perhaps such a committee could have made the occurrence of this unfortunate event more difficult and less likely. However, if such events occur despite the committee's diligence and reasonable investigation, it is uncertain what degree of protection other board members can derive from the committee. Apparently, these board members can argue that they may rely on their colleagues to discharge the assigned duties properly. This argument would not be a very strong one unless the directors demonstrate that they had no reason not to rely upon their colleagues. Presumably the best way to demonstrate this is for them to have scrutinized the committee's activities to ensure its competence and effectiveness. It would seem fair to expect that the board would make such a scrutiny one of its normal functions.

Since it is doubtful that all audit committees are as effective as they should be, there is a question as to the degree of protection, if any, that directors can derive from a committee which merely goes through the motions. It has been suggested that there is some protection.

> Some lawyers believe that directors can still satisfy the requirements of the law without too much effort; all that is required is that directors go through the motion of investigation. One lawyer adds that the quality of the probing doesn't matter too much. It's enough if the directors ask questions. They don't have to be the right questions.[42]

Others believe that if the board simply goes through the motions of investigating it could be more damaging than helpful. In any event, few responsible directors would employ such a tactic as a possible defense against potential litigation concerning the due care with which they have discharged their responsibilities.

Provides discipline value.--An audit committee with top-level and independent organizational status can provide discipline value for the auditor and management. Realizing that financial statements and related subjects are to be reviewed by the committee, both the auditor and management are more likely to be alert. The fact that their activities are subject to the committee's scrutiny and discussion probably will motivate them to try a little harder, to be more organized, and be more objective in resolving issues. By the same token, the committee is required to report its activities to the full board and is subject to the board's scrutiny. Therefore, the discipline factor applies to the committee itself as well. As a result, there is a greater likelihood of a better performance by all.

Possible conflicts and misunderstandings.--The corporate audit committee is a recent development. Consequently, there is no great body of literature or experience, particularly that describing the specific duties of such a committee. Companies with audit committees often find it difficult to determine what the committee's duties should be. It is not uncommon to find that many committees do not have well-defined objectives and functions, or that objectives and functions are too general to be of practical value. Thus, committee members who perceive their duties differently and pursue them more vigorously may encroach upon management duties. As a result, conflicts and misunderstanding frequently develop. The consequences of such problems may range from the presence of a continuing source of irritation and deteriorating morale for those who must deal with the committee to serious undermining of the effective functioning of the committee.

Conflicts between the committee and management may arise from potential or actual infringement by the former upon the operational responsibilities of the latter. The mere establishment of the committee, especially one without fairly specific duties, sometimes may be construed by management as potential infringement. Actual infringement, of course, is caused by the actions of the committee members. It is not unusual for those members who take their duties seriously to intrude. In a few cases, some members even may use the committee for improper purposes. A member, in one instance, used the confidential information obtained through the committee to the detriment of other officers.[43]

Misunderstanding among the committee members, the auditor, and members of management may occur because of the nature of the committee's activities and its composition. In addition to misunderstanding caused by the absence of specificity of the committee's activity, as noted earlier, another source of misunderstanding stems from the auditor's direct communication with the committee. Such communication involves discussions on accounting, internal control, financial reporting, and other related areas which may have some bearing on the quality of management's performance in these areas.

If there is no management representation on the committee, management naturally is concerned, not only about what matters are discussed, but also about how they are discussed. Information relating to management's performance may be erroneous, biased, or contrary to the facts as management perceives them. Management may believe that it is exposed to criticism without an adequate and timely opportunity to present its rebuttal. When such an opportunity is made available, it usually is at a later date.

Biased or distorted views may have preconditioned the minds of the committee members to such a degree that subsequent rebuttals are less effective. As far as management is concerned, the damage is done. On the other hand, management representation may inhibit a direct and frank discussion of these matters. Consequently, the committee will not derive the full value from direct communication with the auditor.

Similarly, the committee faces the same dilemma when it discusses management personnel matters with the auditor. If management representatives and/or the officers are present when they are being evaluated, candid and objective discussion may be inhibited. On the other hand, the absence of representation may create misunderstanding. One possible solution to this dilemma is to provide the opportunity for the party involved to respond immediately. However, this may not be practical and may become very unwieldy when a relatively large number of personnel or subjects are involved.

A more practical solution to minimize possible conflicts would be to make the committee's objectives and duties more specific and to consult the significant parties who are likely to be affected by the committee's activities, namely, senior members of management and financial and accounting officers. Minutes should be maintained for all meetings by the committee, and copies of these should be distributed to members of the board, the chief executive officer, the auditor, and senior members of management if matters discussed fall under their jurisdiction.

Also, the auditor should endeavor to consult and thorougly discuss with management the important matters that will be brought to the committee's attention. This step not only allays management's suspicion about the issues to be discussed but also provides the auditor an opportunity to ensure that he has not misinterpreted the situation and has obtained full information in reaching his conclusions. Thus, management feels it is not being by-passed and has more confidence that matters will not be misrepresented. Finally, the committee should allow members of management a timely opportunity to present their side of the story whenever the situation calls for it.

Danger of false appearance or overexpectation of enhanced credibility of financial reporting.--One advantage of the corporate audit committee is that it enhances the credibility of corporate financial reporting. However, this advantage applies to those corporate financial statements where the audit committees are effective. When the committee is ineffective, the credibility of corporate financial reporting is not enhanced. Since financial statement users do not have practical means for determining which committees are effective, they may be expected to presume, in the absence of contrary evidence, that all committees are effective. Consequently, corporations with ineffective committees give a false appearance of the enhanced credibility of their financial reporting.

Overexpectation occurs if a financial statement user expects that credibility has been enhanced and this actually is not the case. Presently there is little knowledge about the degree of enhancement the user expects. Regulatory agency recommendations and legislative requirements concerning these committees tend to heighten the user's expectation of the value that such a committee can contribute. This can be dangerous, particularly when there is little knowledge of what the committee actually does and how effective it is.

In view of the danger of giving a false appearance and of overexpectation of enhanced credibility of financial reporting, there is a need for full disclosure of the committee's objectives, activities, and achievement to financial statement users. Such a disclosure would enable the user to evaluate the effectiveness of the committee and, in turn, the degree of enhancement it gives to the credibility of financial reporting.

Concluding Remarks

On balance, the advantages of a corporate audit committee appear to outweigh the disadvantages. Moreover, the two disadvantages discussed earlier can be overcome by a careful, frank, and extensive consultation by corporate directors, management, and both internal and external auditors on the specific purposes and functions of the audit commitee as well as by an adequate disclosure of the committee's activities on the part of management to both internal and external parties.

FOOTNOTES--CHAPTER II

1. U.S. Securities and Exchange Commission, "In the Matter of McKesson and Robbins."

2. AICPA Executive Committee, "Statement on Audit Committees of Boards of Directors."

3. Ontario, Legislative Assembly, 1967 Interim Report of the Select Committee on Company Law (Toronto, 1967), p. 92.

4. The Business Corporations Act, 1970, Ontario (Toronto: Richard Deboo, 1970), p. 107.

5. Mautz and Neumann, Corporate Audit Committees, p. 12.

6. American Accounting Association, Committee on Basic Auditing Concept, 1969-1971, The Accounting Review, Supplement to Vol. 47, 1972, p. 31.

7. Ibid.

8. U.S. Securities and Exchange Commission, "In the Matter of McKesson and Robbins."

9. 1967 Interim Report, pp. 91-92.

10. W. A. Farlinger, "Atlantic Acceptance: Calamity or Catalyst," Accountancy (January, 1972): 16. Also see "Atlantic Acceptance, Calamity or Catalyst?" Canadian Chartered Accountant (May, 1971): 343.

11. R. K. Mautz and F. L. Neumann, "The Effective Corporate Audit Committee," Harvard Business Review (November-December, 1970): 61.

12. Haskins and Sells, The Week in Review, 27 April 1973, p. 1.

13. U.S. Securities and Exchange Commission, "In the Matter of McKesson and Robbins."

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15. AICPA, loc. cit.

16. Ibid.

17. Ibid.

18. Mautz and Neumann, Corporate Audit Committees, p. 96.

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23. Ibid.

24. Canadian Institute of Chartered Accountants, Special Committee on Shareholders' Audit, Canadian Chartered Accountant (November, 1968): 354.

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27. Morton B. Solomon, "The Audit Committee: Its Growing Significance in the Corporate Structure," 18.

28. AICPA, loc. cit.

29. Ontario, Legislative Assembly, 1967 Interim Report of the Select Committee on Company Law (Toronto, 1967): 92. Also see Mautz and Neumann, Corporate Audit Committees, 46; Morton B. Solomon, loc. cit., 18; etc.

30. Mautz and Neumann, loc. cit., 46.

31. Ibid., 69-74.

32. "Relations of Auditors and Directors," p. 81.

33. Mautz and Neumann, op. cit., p. 51, emphasis added.

34. Morton B. Solomon, loc. cit., 18; Mautz and Neumann, loc. cit., 51.

35. Ibid.

36. AICPA, loc. cit.; U.S. Securities and Exchange Commission, Accounting Series Release No. 123, loc. cit.

37. Finance Commentary, "Why Accountants Need to Tell a Fuller Story," Business Week, 6 February 1971, p. 87.

38. American Accounting Association, op. cit., p. 32.

39. Mautz and Neumann, op. cit., p. 54.

40. Ontario, Report of the Royal Commission, p. 1652.

41. "What the Bar Chris Directors Did (not enough)," Fortune, 15 May 1969, p. 151.

42. Ibid.

43. Mautz and Neumann, p. 73.

CHAPTER III

RESEARCH METHODOLOGY

Introduction

This study employs the questionnaire approach to solicit as much significant and relevant information on corporate audit committees as possible from those individuals likely to have an intimate knowledge of and direct experience with such committees. This chapter first discusses the objective of the mail questionnaires and the kind of information solicited. Second, it discusses the population in general and the establishment of the populations for corporate chief executive officers, members of audit committees, practicing chartered accountants, and financial analysts. Third, it summarizes the details of the pilot study. Finally, it shows the administering procedures and the breakdown of responses of the final questionnaires.

Objective

The objective of the mail questionnaires was to solicit information on corporate audit committees from the most knowledgeable and experienced persons. Accordingly, four groups were selected: (1) corporate chief executive officers; (2) members of the audit committees; (3) practicing chartered accountants; and (4) financial analysts.

Each group received a separate questionnaire, which contained many common questions as well as questions relevant only to the specific group. The following information (common to all the questionnaires) was sought:

1. What are the purposes of corporate audit committees, and how important are they?

2. What are the functions of the committee, and what is the degree of their importance?

3. How useful are such committees to a corporation?

4. Generally how effectively do the committees fulfill their responsibilities?

5. How desirable is management representation on them?

6. What factors make an effective committee, and how should such factors be ranked?

7. What are the major benefits of an effective committee?

8. How desirable is it to disclose the names of committee members in the annual report?

9. What other information, not included in the questionnaire, is significant?

Additional information was solicited from the three groups likely to have direct and intimate involvement with audit committees --chief executive officers, practicing chartered accountants, and audit committee members. These groups were asked: (1) What are the actual functions performed by the committees, and how effectively are they performed? (2) Have there been any major disagreements between the external auditors and management? If so, were these disagreements resolved by the committee? (3) What is the average number of meetings per year? Finally, both chief executive officers and audit committee members were asked whether committee meetings were scheduled regularly.

Other information relating to the specific characteristics of each individual group and its particular interest in the committee was solicited. Essentially, the chief executive officers were asked whether there was a committee established prior to the legal requirement. If so, they were asked whether there had been significant changes since committees became mandatory. They were also asked whether they were members of their own or other companies' committees.

Committee members were questioned about such matters as the number of years they had served, number of memberships on other audit committees, their position with the company or their principal occupation, and whether minutes for committee meetings were kept.

The practicing chartered accountants were asked how many of their clients had audit committees and how many of these benefited from them.

Three questions were directed to the financial analysts, two of which were related to the effect of the audit committee on corporate financial statements and one of which related to their membership on such committees. Since one of the objectives of the audit committee was to enhance the objectivity of corporate financial statements for the protection of investors, it appeared appropriate to obtain financial analysts' opinions on that subject.

The final questionnaires are provided in Appendix A.

The Population

At its inception, this study attempted to cover all companies subject to the audit committee provision of the Ontario Business Corporations Act, that is, all business companies incorporated in Ontario that were offering securities to the public either through a listing on an Ontario stock exchange or by filing a prospectus with the Ontario Securities Commission. Accordingly, officials of the Toronto Stock Exchange and the Ontario Securities Commission were contacted to explore the feasibility of identifying such a population. Even though the commission was empowered to enforce the audit committee requirement, neither it nor the exchange maintained a separate record for the companies governed by this requirement.

The commission did not require companies to disclose the existence of such a committee in the reports submitted to it. Since the commission had a record of each individual company incorporated in Ontario, one alternative was to conduct a very extensive and time-consuming search through individual corporate records. After locating all companies incorporated in Ontario, it would have to be determined whether their securities were listed in the exchange or whether their prospectuses had been filed with the commission. However, the cost of such a search was prohibitive due to the fee levied on the examination of each record and the large number of companies involved.

A more feasible alternative, which would yield a smaller but nevertheless satisfactory population for the study, was to identify companies through the "Survey of Industries--1972" published by the Financial Post. To ensure that the companies selected were subject to the audit committee requirement, only those incorporated in Ontario and with securities listed on the Toronto Stock Exchange were included in the population; 178 companies thus were selected. They covered more than 18 industries and their sizes in terms of total sales and total assets ranged from very small ($36,000 and $1,244,000) to very large ($2,558,752,000 and $1,022,479,000). Tables 3-1 and 3-2 show the details of these characteristics.

In view of the relatively small number of companies selected for this study, it was decided to send questionnaires to the chief executive officers and audit committee members of all 178 companies. The following subsections will discuss the process of identifying the four populations included in the study, namely, the chief executive officers, the members of the committees, the practicing chartered accountants, and the financial analysts.

Chief Executive Officers

The task of identifying chief exeutive officers of the 178 companies was relatively simple since many companies provided this information in the "Survey of Industries--1972." For those which did not, presidents were deemed to be the chief executive officers. The justification was that the president generally was the operating head of the company and that most of the chief executive officers specified in the "Survey of Industries" were presidents. The validity of this justification subsequently was confirmed by the responses to the questionnaires.

Audit Committee Members

The Ontario Business Corporations Act requires that audit committee members must be company directors. While the "Survey of Industries--1972" provided a listing of all directors and company officers, it did not show which were committe members. Examination

TABLE 3-1

SELECTED ONTARIO COMPANIES BY INDUSTRY[a]

Industry	Number of Companies
1. Textile	4
2. Beverage	3
3. Foodstuff and allied products	10
4. Iron and steel	16
5. Nonferrous metals	3
6. Electrical equipment	8
7. Merchandising	25
8. Construction	8
9. Pulp, paper, and lumber	5
10. Printing, publishing, and broadcasting	11
11. Transportation and storage	3
12. Oils and pipelines	1
13. Chemicals	9
14. Property development	33
15. Management and holding	18
16. General manufacturing	15
17. Recreation and entertainment	3
18. Miscellaneous	3
Total	178

[a]Based on the "Survey of Industries--1972," The Financial Post.

TABLE 3-2

SIZE OF COMPANY BASED ON SALES AND TOTAL ASSETS

($ millions)	Number of Companies	
	Sales	Assets
Under 10	58	62
10 - 19	44	41
20 - 29	17	19
30 - 39	12	11
40 - 69	19	14
70 - 99	6	8
110 - 169	6	8
180 - 299	6	6
340 and over	5	7
Subtotal	173	176
Companies not reporting sales or assets	5	2
Total	178	178

of corporate reports filed with both the Ontario Securities Commission and the Toronto Stock Exchange failed to furnish the needed information. Consequently, the only alternative was to obtain this data directly from the companies.

Accordingly, a letter explaining the nature of the research and the reasons for requesting membership information was sent to each of the 178 companies. Three consecutive requests yielded 156 responses (87.6 percent), of which 140 (78.7 percent) were usable. Table 3-3 shows the breakdown of the responses concerning membership information, and Table 3-4 shows the responses by industry.

TABLE 3-3

BREAKDOWN OF THE RESPONSES CONCERNING MEMBERSHIP INFORMATION

Category	Number	Percentage
Usable	140	78.7
Would not participate because of the confidentiality of membership information	5	2.8
No audit committee because no longer offering securities to the public	4	2.2
No current membership information[a]	5	2.8
Ceased operation	2	1.1
Subtotal	156	87.6
No response	22	12.4
Total	178	100.0

[a]Reasons included reorganization of company, substantial change in directorship due to change in controlling interest of the company and amalgamation.

TABLE 3-4

BREAKDOWN OF THE RESPONSES BY INDUSTRY

Industry	Usable	Not Participating	No Audit Committee	No Membership Information	Ceased Operation	No Response	Total
1. Textile	4						4
2. Beverage	3						3
3. Foodstuff and allied products	8		1			1	10
4. Iron and steel	14	1				1	16
5. Nonferrous metals	2					1	3
6. Electrical equipment	6					2	8
7. Merchandising	21	1	1		1	1	25
8. Construction	7					1	5
9. Pulp, paper, and lumber	4					1	5
10. Printing, publishing, and broadcasting	8	1		1		1	11
11. Transportation and storage	3						3
12. Oils and pipelines	1						1
13. Chemicals	6	1	1			1	9
14. Property development	22	1		3		7	33
15. Management and holding	13		1	1	1	2	18
16. General manufacturing	13					2	15
17. Recreation and entertainment	3						3
18. Miscellaneous	2						
Total	140	5	4	5	2	22	178

The size of audit committees ranged from the statutory minimum of three up to eight members, with an average of 3.3 members per committee. The size of the boards of directors was substantially larger, ranging from five to eighteen, with the average size being eight. There was no direct relationship between committee and board size; in fact, the majority of the larger boards had audit committees of only three members.

The usable responses from the 140 companies provided a total of 463 audit committee members. This total included 65 members who were also chief executive officers of their companies and 37 members who served on two or more committees. Since these 65 would be covered in a separate population as chief executive officers, they were excluded from the population of committee members. The 37 who held multimemberships were included only once in order to avoid double counting; only one questionnaire would be sent to each of these members, with their various memberships indicated in the covering letter. Thus, 46 names were eliminated for the administering of questionnaires. Table 3-5 provides information about multimembership.

TABLE 3-5

BREAKDOWN OF MULTIMEMBERSHIPS

Number of Members	Number of Memberships	Overlapping Memberships
32	2	32
3	3	6
2	5	8
37		46

An additional 51 members who resided outside Canada were excluded because of the difficulties in obtaining their mailing addresses and in the follow-up of nonresponses. These exclusions reduced the population from 463 to 301, the final population for questionnaire administration.

Practicing Chartered Accountants

The method used in establishing the population of practicing chartered accountants was somewhat different from that used to select chief executive officers, members of audit committees, and financial analysts. In an effort to ensure that the potential respondents had had direct experience with audit committees, letters were sent to nine major national accounting firms in Ontario requesting them to submit the names of the partners who were likely to have had such experience. These letters were sent to the senior or managing partners with whom the researcher already had established contact. All nine firms responded; seven provided the relevant names, and two did not but requested a certain number of questionnaires be sent to them directly. The strong desire to secure a cross section of opinion from the partners of major national and provincial firms prompted another selection of nine firms which had ten or more partners in their Toronto offices. A total of twenty questionnaires were sent to these firms. In addition, two partners of the national firm's Windsor offices were included, primarily for the pilot test. The population thus arrived at totalled 77. The details are shown in Table 3-6. The majority of these 77 partners were from Toronto offices, while the rest were from offices in London, Hamilton, and Windsor.

TABLE 3-6

ANALYSIS OF THE POPULATION OF PRACTICING CHARTERED ACCOUNTANTS

	Number of Accounting Firms	Number of Partners
National	9	57
Provincial	9	20
	18	77

Financial Analysts

A sample of 276 financial analysts was selected from the 600 listed in the 1973 membership directory of "the Toronto Society of Financial Analysts." This large sample was considered necessary because of possible nonresponses due to lack of knowledge or of experience with audit committees. Moreover, a larger sample would be more likely to generate a larger number of usable responses and thus would provide more information on audit committees. Table 3-7 shows the classification of the functional specialty of these analysts.

The Pilot Study

The initial questionnaires were tested and improved by subjecting them to a pilot study. This test run was designed to eliminate ambiguous or unclear wording, unnecessary or undesirable questions, and other deficiencies as well as to improve the overall research

TABLE 3-7

FINANCIAL ANALYSTS CLASSIFIED BY
THEIR FUNCTIONAL SPECIALTY

Functional Specialty	Number	Percentage
Bonds	15	5.43
Director of research	17	6.16
Economist	18	6.52
Generalist	9	3.26
Investment counselor	33	12.00
Portfolio manager	12	4.30
Special situations	1	.36
Technician (stock market)	2	.72
Subtotal	107	38.75
Not classified[a]	169	61.25
Total	276	100.00

[a]The majority of this group were involved in stocks and were classified by their industry specialty. Some were associated with investment banking firms and the investment department of industrial companies.

methodology. The following paragraphs discuss the details of the pilot study for corporate chief executive officers, members of audit committees, practicing chartered accountants, and financial analysts.

Eighteeen chief executive officers were selected randomly from the total population of 178. Questionnaires were sent to these officers with an introductory letter explaining the nature of the research. Nonresponses were followed up with a second request two weeks after the first. A total of 14 (80 percent) responses were received, of which 12 (68 percent) were usable.

Similarly, 28 audit committee members were randomly selected from a population of 301. Questionnaires were sent to these members, with second requests to those who failed to respond to the first request. The responses totalled 16 (57 percent), of which 11 (40 percent) were usable.

The approach for the practicing chartered accountants was somewhat different because of the way in which the population was established. Ten partners were selected from offices in Toronto, Hamilton, London, and Windsor. Questionnaires with a covering letter explaining the nature of the research and how their names were selected were sent to these partners (the questionnaires for the two partners in the Windsor offices were delivered to them in person). Only four partners responded. Since the six partners not responding to the pilot study questionnaire were included in the final questionnaire, no further follow-up was considered necessary at this time.

Forty-one financial analysts were selected randomly from a population of 600. Two requests yielded 24 responses (58 percent), of which 14 (34 percent) were usable.

Table 3-8 shows the details of the responses from the four groups.

After a careful analysis of the answers to the four groups of questionnaires, it was concluded that they contained no deficiencies. However, two minor instructions were added to two questions to ensure a clearer direction in the answering of those two questions. These changes would not affect the content or the interpretation of the questions involved. Consequently, the initial questionnaires, after these two instructional changes were made, became the final ones used. Since both questionnaires, for all practical purposes, are identical, the results of the responses to the pilot questionnaires are incorporated as part of the overall results of this survey.

The Final Questionnaires

The administering of the final questionnaires was essentially the same as that of the pilot study. However, as a means of encouraging a higher response rate, a letter from the Canadian Insitute of Chartered Accountants requesting participation in this research was included with the final questionnaires. Also, three follow-up attempts were made, whereas only two had been made for the pilot study.

A total of 733 questionnaires were sent out in the first mailing, 149 to chief executive officers,[1] 273 to members of audit committees, 73 to practicing chartered accountants, and 236 to financial analysts. Two weeks following this first mailing, a

TABLE 3-8

BREAKDOWN OF THE RESPONSES TO THE INITIAL QUESTIONNAIRES

Category	Group									
	Chief Executive Officer		Member of Audit Committee		Practicing Chartered Accountants		Financial Analysts		Total	
	Number	Percentage	Number	Percentage	Number	Percentage	Number	Percentage	Number	Percentage
Usable	12	68	11	39.2	4	40	14	34.0	41	42.2
Not participating			3	10.8			1	2.5	4	4.1
Insufficient knowledge							7	17.0	7	7.2
Left employment, moved, or on vacation	2	12	2	7.0	—	—	2	5.0	6	6.2
Subtotal	14	80	16	57.0	4	40	24	58.5	58	59.7
No response	4	20	12	43.0	6	60	17	41.5	39	40.3
Total	18	100	28	100.0	10	100	41	100.0	97	100.0

second request was made to those who had not responded. The third request was made three weeks after the second request.

These three requests yielded responses of 109 (74 percent) for executive officers, 225 (81.2 percent) for audit committee members, 60 (80 percent) for practicing chartered accountants, and 184 (77.9 percent) for financial analysts. The overall responses were 573 (79.1 percent), and those usable numbered 439 (60 percent). The difference between the response rate and the usable rate is due primarily to the large number of respondents who had insufficient or no knowledge about audit committees. Table 3-9 itemizes the responses to the final questionnaires.

TABLE 3-9

BREAKDOWN OF RESPONSES TO THE FINAL QUESTIONNAIRE

Category	Group									
	Chief Executive Officer		Member of Audit Committee		Practicing Chartered Accountants		Financial Analysts		Total	
	Number	Percentage	Number	Percentage	Number	Percentage	Number	Percentage	Number	Percentage
Usable	89	59.7	183	66.0	56	74.7	111	47.0	439	60.0
Not participating	16	11.0	25	9.1			17	7.2	58	7.9
Insufficient knowledge			4[b]	1.5	4[c]	5.3	45	19.0	53	7.2
Other[a]	4	3.3	13	4.7	—	—	11	4.7	28	4.0
Subtotal	109	74.0	225	81.2	60	80.0	184	77.9	578	79.1
No response	39	26.0	52	18.8	15	20.0	52	22.1	155	20.9
Total	148	100.0	277	100.0	75	100.0	236	100.0	733	100.0

[a]This category included those who were no longer member of audit committee, were retired, had left employment, had moved without leaving a forward address, and deceased.

[b]Members recently appointed to the audit committee.

[c]No client with audit committee.

FOOTNOTE--CHAPTER III

1. The 160 officers left after the pilot study were further reduced because five held the chief executive position in two companies, four companies had no audit committees, and two companies ceased operation.

CHAPTER IV

SOME CHARACTERISTICS AND OPERATING PROCEDURES OF CORPORATE AUDIT COMMITTEES

Introduction

This chapter presents some characteristics and operating procedures of the corporate audit committees. First, the size of the corporate audit committees, the number of meetings, and the scheduling and minutes of meetings are discussed. Second, the composition of audit committees and characteristics of their members are analyzed. Third, the issue of officers serving on the audit committees of their own companies is discussed. Finally, attention is focused on the desirability of disclosing committee membership information in the corporate annual report and on the committees established prior to the Ontario requirement.

Size of Corporate Audit Committees

The size of the corporate audit committee is typically small, ranging from the statutory minimum of three up to eight members, with an average of 3.3 members per committee. Three-member committees are the most common, probably reflecting the tendency of companies to conform to the statutory minimum and perhaps the desire to keep membership small in order to make in-depth discussions more effective and efficient. Table 4-1 shows that of the 140 companies responding to the request for committee membership information, 105 (75 percent)

TABLE 4-1

SIZE OF CORPORATE AUDIT COMMITTEES

	Number of Audit Committee Members 3	4	5	6	7	8	Total
By Company							
Number of companies	105	20	9	3*	2*	1*	140
Percentage of companies	75.0	14.3	6.4	2.2	1.4	0.7	100
By Industry							
Textile	3			1			4
Beverage	3						3
Foodstuff and allied products	6	1	1				8
Iron and steel	13	1					14
Nonferrous metals	1	1					2
Electrical equipment	5	1					6
Merchandising	11	3	4	1	1	1	21
Construction	4	1	2				7
Pulp, paper, and lumber	3			1			4
Printing, publishing and broadcasting	7	1					8
Transportation and storage	2		1				3
Oils and pipelines		1					1
Chemicals	6						6
Property development	17	5					22
Management holding	10	2	1		1		14
General manufacturing	12						12
Recreation and entertainment	1	2					3
Miscellaneous	1	1					2
Total	105	20	9	3	2	1	140

*One of the committees is composed of all board members.

have committees with 3 members and only 35 (25 percent) have committees of more than 3 members. Of these 35 companies, 20 (14.3 percent) have 4 members, 9 (6.4 percent) have 5, 3 (2.2 percent) have 6, 2 (1.4 percent) have 7, and only 1 (.7 percent) has 8. Three of the 6 committees with 6 to 8 members are composed of all the directors on the board. Table 4-1 also shows that all 18 industries have both small and large committees and that there is no discernible size pattern unique to a particular industry.

As indicated briefly in chapter III, there is no apparent relationship between the size of the committee and the size of the board of directors. Many boards with 9 or more directors have audit committees with only 3 members. For example, the size of the 8 boards in the foodstuff and allied products industry ranges from 7 to 18 directors, while the size of the 8 committees ranges from 3 to 5 members, with 6 having only 3 members. Of course, a large committee must be taken from a large board. Table 4-2 shows that the size of the 140 boards of directors ranges from 5 to 18, with the average being 8. Since nearly 85 percent of these boards have 5 to 10 directors, it seems that this is the most favored range. However, there is no observable size pattern unique to any particular industry.

It is interesting to note that the size of voluntary audit committees in the United States is also generally small. The Mautz and Neumann study in 1970 shows that 52 (50 percent) of the 104 companies examined have committees with 3 members, 8 (7.7 percent) with less than 3, and 44 (42.3 percent) with more than 4. Similarly, the Auerbach study in 1973 reveals that of the 68 clients with audit

TABLE 4-2

THE SIZE OF BOARDS OF DIRECTORS

By Company	Number of Directors													
	5	6	7	8	9	10	11	12	13	14	16	17	18	Total
Number of companies	10	22	32	18	21	11	5	9	4	5	1	1	1	140
Percentage of companies	7.14	15.70	23.00	12.90	15.00	7.85	3.54	6.43	2.80	3.54	.70	.70	.70	100
By industry														
Textile	1	1	1		1									4
Beverage			1					1		1				3
Foodstuff and allied products			1	1	1	1		2	1				1	8
Iron and steel		3	5	1	3	1	1							14
Nonferrous metals	1							1						2
Electrical equipment	1		3	1	1									6
Merchandising	3	2	5	2	3	2	2	2						21
Construction		1	1	2	1			1		1				7
Pulp, paper, and lumber					1	3								4
Printing, publishing, and broadcasting		1	3		1		1			2				8
Transportation and storage			3											3
Oils and pipelines								1						1
Chemicals	1	2	1	1	1									6
Property development	2	5		6	4	1			3	1				22
Management holding		2	3	1	2	2	1	1			1	1		14
General manufacturing	1	3	4	2	1	1								12
Recreation and entertainment		1		1	1									3
Miscellaneous		1	1											2
Total	10	22	32	18	21	11	5	9	4	5	1	1	1	140

committees,[1] 45 (66 percent) have 3 members, 2 (3 percent) have less than 3 members, and 21 (31 percent) have more than 4 members.

Number of Meetings

The number of meetings held by audit committees depends largely on three major factors. The first two are the size and the type of company in which the committee operates, and the third, which is influenced to some degree by the first two, is the scope of the committees activities. The audit committee of a holding or a small company where assets are few and operations are not complex may meet once a year. On the other hand, the audit committee of a moderately large merchandising or manufacturing company may require more than one meeting. A chief executive officer of a holding company points out that "one meeting is all that is really necessary" for his company. However, he suggests that "a manufacturing concern with plants in various provinces would, of necessity, require several meetings" of the audit committee.

Similarly, an audit committee member who holds eighteen directorships notes that "in a holding company there is really very little for the audit committee to do beyond a review with the external auditors and examination of the accounts before publication." He cites the example of a holding company of which he is an audit committee member: "There are no inventories, no accounts receivable, no accounts payable [and] the only assets are the shares of the companies in which the company holds an investment."

A retired chief executive officer who is the chairman of the audit committee of three companies (including a U.S. corporation operating internationally) and a member of two other audit committees feels that the number of meetings "will depend of course on the scope of [the committee's] terms of reference." Generally, he believes that "an audit committee in any event needs to meet two or three times a year, and at the most four or five times a year usually should be sufficient." He further suggests that "sufficient time always should be allowed for each meeting to permit full coverage of all the matters to be discussed without the pressure of time running out."

Both chief executive officers and members of audit committees were asked about the number of times their committees generally meet within a year. The practicing chartered accountants were asked about the average number of times they meet with the individual audit committees of their clients during the year. Table 4-3 summarizes the responses to this question from 101 chief executive officers, 194 audit committee members, and 60 practicing chartered accountants. It shows that the committee meets from zero to six times a year. The most common practice is to meet once or twice, as reported by 245 (69 percent) of the 355 respondents. The generally smaller number of meetings reported by the practicing chartered accountants probably is due to the fact that some committees hold some of their meetings without the external auditor in attendance.

Those committees which meet only once a year usually do so prior to the annual meeting of the board of directors and before the publication of the annual financial statement. Of those committees which meet twice a year, the first meeting generally occurs prior to or during the annual audit, and the second at the completion of the

TABLE 4-3

NUMBER OF CORPORATE AUDIT COMMITTEE MEETINGS PER YEAR

Number of Meetings	Responses							
	Corporate Chief Executive Officer		Member of Audit Committee		Practicing Chartered Accountant		Total	
	Number	Percentage	Number	Percentage	Number	Percentage	Number	Percentage
0	1	1.00			2	3.34	3	.84
1	42	41.57	68	35.05	24	40.00	134	37.77
2	33	32.67	61	31.44	17	28.33	111	31.27
3	7	6.93	26	13.40	6	10.00	39	11.00
4	13	12.87	30	15.46	5	8.33	48	13.50
5	2	1.98	5	2.59			7	1.97
6	2	1.98	2	1.03	1	1.67	5	1.40
No response	1	1.00	2	1.03	5	8.33	8	2.25
Total	101	100.00	194	100.00	60	100.00	355	100.00

audit and before the final approval of the annual financial statements by the board of directors. As one chief executive officer reports, "we meet twice a year, once after the interim audit and the other immediately prior to the board of directors meeting to approve the annual financial statements." Some audit committees indicated that their meetings are on a quarterly basis unless special events render this scheduling impossible.

Mautz and Neumann and Auerbach report similar findings on the number of audit committee meetings. Of the 121 companies reported on by Mautz and Neumann, 85 (70 percent) meet once or twice a year. Auerbach finds that 47 (69 percent) of the 68 clients' audit committees hold one to two meetings a year.

Scheduling of Meetings

The manner in which the audit committee meetings are scheduled probably reflects the degree of planning of its activities and the seriousness with which the members perceive them. One respondent who holds fifteen directorships and is a member of five audit committees (chairman of three) advocates the setting up of meeting schedules for the whole year at the beginning of the year.

> In respect to audit committee meetings, the dates to be set will have to be related to the company's year-end date, to the scheduled dates of board meetings, to the dates by which the auditors will undertake to have the annual financial report ready for review and by which their annual "management letter" will be ready, etc., etc. However, it is always advisable to get everybody involved pinned down on the dates as far in advance as possible.

Both chief executive officers and audit committee members were asked whether committee meetings were held on a regularly scheduled basis. Table 4-4 shows that 50 (49.5 percent) of the 101 chief executive officers and 97 (50 percent) of the 194 committee members reported that their meetings were held on a regularly scheduled basis; this is slightly lower than the 57 percent reported by Mautz and Neumann.

Minutes of Meetings

The minutes of meetings represent the formal written evidence of the audit committee's activities as well as an indication of the due care and diligence with which the committee discharges its responsibilities; as such, they should be as specific and detailed as possible. Since it is a committee of the board of directors, the audit committee should communicate to the board the scope and results of its activities. The best way to accomplish this is to provide the board with a copy of the minutes. On the other hand, the board of directors, in order to discharge its duties properly, should review the committee's activities. The minutes of the committee's meetings probably make such a review more effective and efficient.

Accordingly, audit committee members were asked the following questions:

(a) Are minutes kept for each of the audit committee meetings?

(b) Are the minutes forward to (1) the board of directors, (2) the corporate chief executive officer, and (3) other?

Table 4-5 summarizes the responses of 194 members, of whom 145 (approximately 75 percent) indicated that they kept minutes of their meetings, while 48 (nearly 25 percent) did not. However, some of

TABLE 4-4

SCHEDULING OF CORPORATE AUDIT COMMITTEE MEETINGS

Scheduling	Responses: Corporate Chief Executive Officer Number	Responses: Corporate Chief Executive Officer Percentage	Responses: Member of Audit Committee Number	Responses: Member of Audit Committee Percentage	Responses: Total Number	Responses: Total Percentage
Regularly scheduled	50	49.50	97	50.00	147	49.80
Not regularly scheduled	46	45.54	91	47.00	137	46.44
No response	5	4.96	6	3.00	11	3.76
Total	101	100.00	194	100.00	295	100.00

TABLE 4-5

MINUTES OF CORPORATE AUDIT COMMITTEE MEETINGS

Minutes	Responses	
	Number	Percentage
Yes	145	74.74
No	48[a]	24.74
No response	1	.52
Total	194	100.00

[a]Five responses indicated that verbal reports on the committee's activities were made in a full board meeting.

those who did not keep minutes made verbal reports to the board of directors during its meetings, and some only reported major problems to the board. In view of the fact that many committee meetings are scheduled in conjunction with the board meetings, these verbal reports may be adequate since they usually are incorporated into the minutes of the board meetings. Where there is a time lag between committee and board meetings, such a procedure may not be totally satisfactory because the verbal reports are likely to be less detailed and more susceptible to omissions or even errors.

Table 4-6 shows how the minutes are distributed. Of the 145 respondents, 122 (84 percent) forwarded a copy of their minutes to the board of directors. Of these 122, 52 (35.86 percent) sent a copy to the board of directors only; 51 (35.17 percent) to both the board

TABLE 4-6

MINUTES OF CORPORATE AUDIT COMMITTEE MEETINGS

Minutes Forwarded to		Responses	
		Number	Percentage
Board of directors only		52	35.86
The board and chief executive officer		51	35.17
The board and external auditor		2	1.40
The board, chief executive officer, and external auditor		9	6.20
The board, chief executive officer, and chief financial officer		4	2.80
The board, chief executive officer, and corporate secretary		1	.70
Chief executive officer only		16	11.03
External auditor only		1	.70
Other			
Retained by the audit committee	4		
Those officers affected by the minutes	2		
The board and corporate secretary	2		
The chairman of the board of directors	1	9	6.14
Total		145	100.00

and the chief executive officer; 2 (1.40 percent) to the board and the external auditor; 9 (6.20 percent) to the board, chief executive officer, and external auditor; 4 (2.80 percent) to the board, chief executive officer, and the financial officer; and 4 (2.80 percent) to the board, or the chairman of the board, chief executive officer, and corporate secretary.

Of the remaining 23 (16 percent) respondents, 16 (11.03 percent) forwarded the minutes to the chief executive officer, 1 (.70 percent) to the external auditor, 4 (2.80 percent) retained the minutes in the committee itself, and 2 (1.4 percent) sent copies to those officers affected by the minutes. It appears that boards of directors are the most common recipients of the minutes, chief executive officers are second most common, and auditors and chief financial officers are third.

It is perhaps worth noting the way in which one committee chairman approaches the minutes.

> In those cases where I am the committee chairman, [I keep] notes of the meeting myself, drafting them up in minutes form immediately after the meeting and then having copies of these draft minutes distributed as soon as possible to other members of the committee for their approval or correction.
>
> In my opinion and in my experience, approved minutes of each audit committee meeting should be distributed to the chief executive officer, the chief financial officer, and for filing to the corporate secretary. The audit committee chairman should report on each audit committee meeting at the next ensuing meeting of the board and, of course, the minutes will form the basis for his report.

Composition of Audit Committees and Characteristics of Committee Members

The results from the request for membership information and the responses to the questionnaires yielded valuable information on the composition of audit committees and on the characteristics of committee members. The following will be discussed: (1) the proportion of company officers on their own audit committees; (2) the position of the company officers and the proportion of the chief executive officers who serve on their own audit committees; (3) the principal occupations of nonofficer committee members; (4) the number of committee memberships held by the individual members; and (5) the number of years of committee experience of the members.

The Proportion of Company Officers on Their Own Audit Committees

The Ontario Business Corporations Act stipulates that the audit committee be composed of not fewer than three directors, of whom a majority shall not be officers or employees of the corporation or affiliates of the corporation. The evidence gathered through the request of membership information in the early stage of this research and the responses from questionnaires to audit committee members, as presented in Table 4-7, indicates that this legal requirement is followed by the companies. Of the 463 committee members studied, only 128 (27.65 percent) are company officers. Of the 194 members responding to the questionnaires, only 38 (19.59 percent) are company officers. Mautz and Neumann show a similar proportion in their study of voluntary audit committees, 22 (23.1 percent) of the 95 being company officers, while 73 (76.9 percent) are nonofficer directors.

TABLE 4-7

PROPORTION OF COMPANY OFFICERS ON THEIR OWN AUDIT COMMITTEES

	Member of Audit Committee: Company Officer		Non-Company Officer		Total	
	Number	Percentage	Number	Percentage	Number	Percentage
From requests for membership information[a]	128	27.65	335	72.35	463	100.00
From questionnaire responses	38	19.59	156	80.41	194	100.00

[a]The information on members' major occupations was obtained from the Directory of Directors published by the Financial Post.

The Position of Company Officers and the Proportion of the Chief Executive Officers Who Are on Their Own Audit Committees

While the officer committee members hold a variety of positions in their companies, the most prominent ones are chairman of the board of directors, president, vice-president (finance or other), and secretary-treasurer. These four positions account for 121 (95.52 percent) of the 128 officer members included in the original population of committe members; 34 (89.48 percent) of the 38 officers who responded to the questionnaires as members of the audit committees held one of these four positions (see Table 4-8). It should be noted that the positions of chairman and president account for 87 (68 percent) of the 128 officers, which is substantially larger than the proportion of questionnaire respondents (6 [15.8 percent] of 38). The reason is that most chairmen and presidents are also chief executive officers and thus were excluded from the questionnaires sent to committee members, but were included in the questionnaires to chief executive officers. Table 4-9 shows that 44 (43.60 percent) of the 101 chief executive officers responding to the questionnaires serve on their own audit committees. Accordingly, it seems that the data gathered through the request for membership information may be a more realistic reflection of the positions held by officer committee members.

The effect of this rather substantial representation of chief executive officers on audit committees is difficult to determine. Much depends on the attitude of the chief executive officer toward the committee. If his participation reflects his genuine

TABLE 4-8

PRESENT POSITION OF COMPANY OFFICERS WHO SERVE ON THEIR OWN AUDIT COMMITTEES

Position	From Requests for Membership Information		From Questionnaire Responses	
	Number	Percentage	Number	Percentage
Chairman of the board[a]	22	17.19	3	7.90
Vice-chairman of the board	1	.80	1	2.63
President[a]	65	50.78	3	7.90
Vice-president (finance)	8[b]	6.25	14	36.84
Vice-President (other)	13	10.15	11	28.94
Secretary	3	2.34	2	5.26
Secretary-treasurer	13	10.15	3	7.90
Treasurer or controller	3	2.34	1	2.63
Total	128	100.00	38	100.00

[a]The number of chairmen and presidents in the questionnaire responses category is substantially less than in the membership information category because many chief executive officers automatically were excluded from the members' questionnaires.

[b]This number is smaller than the one from questionnaire responses, probably because the information obtained from the Directory of Directors was either not updated or because it just indicated one of the official positions held.

TABLE 4-9

CHIEF EXECUTIVE OFFICERS WHO SERVE ON THEIR OWN AUDIT COMMITTEES

	Responses	
	Number	Percentage
Yes	44	43.60
No	56	55.40
No response	1	1.00
Total	101	100.00

interest in this new organizational unit and his desire to make it successful, the committee may be more effective with his presence than without it. Also, his participation may afford him the opportunity to be convinced that the committee is useful, both to management and to other parties. For example, a president of a medium-sized company who at first was apprehensive about the effectiveness of the audit committee was later convinced, after he participated in committee activities, that the committee is indeed useful:

> However, after a couple of years, I have changed my views to the point where I think audit committees serve a very useful and constructive function in the operations of a company and I consider they have some effect in ensuring that directors take their responsibilities even more seriously.

On the other hand, if the chief executive officer is a committee member he may tend to dominate the committee and to direct its activities for his best interests and thus possibly render the committee less independent of management.

The Principal Occupations of Nonofficer Committee Members

Each of the audit committee members was asked the following question: If you are not an officer of this corporation, please indicate your principal occupation. Table 4-10 summarizes both the responses to this question and the data obtained from the Directory of Directors based on the initial membership information. Even though the former has a smaller number of committee members than the latter, the distribution of the members' principal occupation in terms of percentages is essentially the same in both cases. Consequently, only the responses from the members are analyzed in detail.

As exhibited in Table 4-10, the principal occupations of the 156 nonofficer members include business executives (36.36 percent), lawyers (23.7 percent), investment bankers and dealers (11.54 percent), financial and business consultants (5.77 percent), retired executives (3.2 percent), directors and professional directors (6.4 percent), university professors (1.9 percent), and others such as chartered accountants, senators, and a medical doctor. However, lawyers (23.7 percent) lead all other occupations, with presidents (23.10 percent) running a close second, and investment bankers and dealers (11.54 percent) a distant third. Fourth place goes to chairmen of boards of directors (7.05 percent) and the fifth to financial and business consultants (5.77 percent). It is interesting to point out that four (2.56 percent) of the 156 members call themselves "professional directors."

TABLE 4-10

PRINCIPAL OCCUPATIONS OF NONOFFICER AUDIT COMMITTEE MEMBERS

Position	From Request for Membership Information[a]		From Questionnaire Responses	
	Number	Percentage	Number	Percentage
Attorney, barrister, and solicitor	72	21.50	37	23.70
President	94	28.06	36	23.10
Investment banker and dealer	21	6.26	18	11.54
Chairman of the board	31	9.25	11	7.05
Financial and business consultant	10	3.00	9	5.77
Directors	36	10.74	6	3.84
Retired executives	-		5	3.20
Vice-president (other)	34	10.15	4	2.56
Professional directors	-		4	2.56
Vice-president (finance)	11	3.28	3	1.90
University professor	4	1.16	3	1.90
Secretary	2	.60	2	1.28
Vice-chairman of the board	1	.30	1	.60
Treasurer or controller	2	.60	-	--
Other	17[b]	5.10	17[c]	11.00
Total	335	100.00	156	100.00

[a]The data concerning the members' principal occupation were obtained from the Directory of Directors published by the Financial Post.

[b]Including one university chancellor, one general manager, one medical doctor, three chartered accountants, two senators, and nine retired persons.

[c]Including one real estate investor, one public servant, one mortgage banker, one entrepreneur, one medical doctor, one chartered accountant, one trust officer, three general managers, three engineers, and four retired persons.

The Number of Committee Memberships Held by the Individual Members

Each audit committee member was asked to indicate the number of other corporate audit committees of which he was also a member. Tsble 4-11 shows the responses of 194 members. The number of memberships held by individual members ranges from one to six, with the average number being slightly less than two. Specifically, 102 (52.6 percent) of the 194 members hold one membership, 45 (23.2 percent) hold 2, 28 (14.4 percent) hold 3, 5 (2.6 percent) hold 4, 7 (3.6 percent) hold 5, and 4 (2 percent) hold 6.

TABLE 4-11

NUMBER OF CORPORATION AUDIT COMMITTEE MEMBERSHIPS HELD

Number of Committee Membership	Responses	
	Number	Percentage
1	102	52.60
2	45	23.20
3	28	14.40
4	5	2.60
5	7	3.60
6	4	2.00
No response	3	1.60
Total	194	100.00

The Number of Years of Committee Experience of the Members

Table 4-12 summarizes the responses of the audit committee members to the question of the number of years they have served on such committees. Of the 194 respondents, 177 (91.2 percent) have served for three years or less, while 14 (7.2 percent) have served for more than three years. These latter probably are on those committees established prior to the 1971 legal requirements as discussed later in this chapter.

Since 151 (77.8 percent) of the members have been with the same committees for two to three years and 14 (7.2 percent) over three years, it appears that there have been relatively few membership changes over the years.

TABLE 4-12

NUMBER OF YEARS ON CORPORATE AUDIT COMMITTEE

Number of Years	Responses	
	Number	Percentage
1 or less	26	13.40
2	88	45.30
3	63	32.50
4	7	3.60
5	5	2.60
6	2	1.00
No response	3	1.60
Total	194	100.00

Desirability of Officers Serving on the Audit Committees of Their Companies

One of the advantages of an audit committee is to enhance communication between the directors and the external auditor. As pointed out in chapter II, such communication necessarily involves discussions on accounting policies, internal control, financial reporting, and related areas which may have some bearing on the quality of management's performance. In addition, sensitive matters such as management personnel evaluation may be discussed. Unless management is afforded an opportunity to learn in detail not only the matters discussed by the committee but also how they are discussed, there is a potential for misunderstanding and suspicion between management, on the one hand, and committee members and external auditors on the other. Should this potential materialize, it could seriously impair the effective functioning of the committee and, perhaps, the external auditors. However, management representation may inhibit a direct and frank discussion of these matters, and hence the committee will not derive the full value from direct communication with the auditors. Also, management representatives may dominate the direction and activities of the committee to such a degree that its independent status is undermined.

Accordingly, the central question arises as to the desirability of management representation on the committee in order to participate in and voice its opinion on these matters. Table 4-13 reveals the attitudes of the chief executive officers, audit committe members, practicing chartered accountants, and financial analysts on this

TABLE 4-13

DESIRABILITY OF COMPANY OFFICERS SERVING ON THEIR OWN AUDIT COMMITTEES

Desirable	Responses: Chief Executive Officer		Member of Audit Committee		Practicing Chartered Accountant		Financial Analyst		Total	
	No.	Percentage	No.	Percentage	No.	Percentage	No.	Percentage	No.	Percentage
Yes	70	69.30	132	68.00	39	65.00	67	53.60	308	64.10
No	28	27.70	59	30.40	19	31.70	57	45.60	163	34.00
No response	3[a]	3.00	3[b]	1.60	2	3.30	1	.80	9	1.90
Total	101	100.00	194	100.00	60	100.00	125	100.00	480	100.00

[a]One respondent answered no but noted that "it is preferable but not totally undesirable."

[b]One respondent indicated that it was impossible for a small company to have 100 percent nonofficers on the audit committee.

issue. The majority of the respondents feel that management representation is desirable. Those who have direct experience with the committees favor it more than those who do not have such experience. Specifically, 70 (69.3 percent) of 101 chief executive officers, 132 (68.0 percent) of 194 audit committee members, and 39 (65 percent) of 60 practicing chartered accountants support such an idea compared to 67 (53.6 percent) of 125 financial analysts. This strong support perhaps reflects the deisre of these respondents to conform with the provision in the Ontario Act, which only requires the majority of the committee members be nonofficer directors. It is interesting to note, however, that 35 of the 38 officer members favor management representation, while only 97 of the 156 nonofficer members favor it.

The following are some of the typical comments given by those respondents favoring management representation.

Chief executive officers:

> [It] brings problems into proper perspective and facilitates a solution.
>
> [It] gives balance and perhaps internal policy information to nonofficer directors.
>
> [It] acts as liaison between internal accounting staff, external audit committee members, and external auditors.

Audit committee members:

> To enable him [president] to express his opinion on contentious matters and satisfy himself that the audit committee has a full grasp of all material facts. This puts the president in a better position to sell ideas to the board, better support and understanding of situation by outside directors.
>
> [It is] necessary for committees to have presented in depth all sides of any question.

> In order to achieve best results it is essential to have responsible officers familiar with the financial side of the company.
>
> Such officers should pass on the comments of the audit committee to the pertinent parties.
>
> The external [nonofficer] members of the audit committee should be in a position to question the external auditor before a knowledgeable internal officer to more fully explore weaknesses in reporting, etc.

Practicing chartered accountants:

> Officers may be suspicious of activities of the audit committee. Auditors need the cooperation and support of both groups to be effective.
>
> To avoid misunderstanding.
>
> Prevents situations where external auditors can be thought to be going behind the back of company management.
>
> Eliminates any differences developing between audit committee, auditors, and management. Also gives the officer [chief executive] an independent review of the overall financial position.
>
> An auditor should never have to report in private what he would not report to management, and management should have an opportunity for explaining practices being discussed.

Financial analysts:

> . . . need for a bridge of communication between officers and nonofficers; the former shall be kept aware of any investigative activities on a formal basis; otherwise suspicion and ill-feeling could sink an audit committee.
>
> A knowledgeable insider can save considerable time for the audit committee.

Essentially, these comments focus on two main issues: (1) the need to avoid and prevent possible misunderstanding and suspicion among management, committee members, and auditors, and (2) the need to provide management with an opportunity to present its opinions on the matters discussed and to facilitate in-depth discussions.

The following are some of the common reasons cited by those who feel management representation is undesirable.

Chief executive officers:

It would conflict with the desired independence of the audit committee.

To allow for absolute objectivity.

Officers of the corporation may be requested to attend audit committee meetings, but some independence of the audit committee is lost if officers are members of this committee.

It is difficult for them [officers] to be completely objective [which] the audit committee needs in order to be properly effective.

The committee should be fully independent to produce the best results.

The audit committee is a check on management. Management should not influence the proceedings of audit committees.

It impairs free exchange of views between the external auditor and outside directors.

There is an opportunity [for the officers] to exercise undue influence.

Audit committee members:

To preserve the "independent" aspect of the audit.

It is most important that the audit committee should review financial statements with auditors without the influence of management. Officers can be invited to attend if required.

The opinions of the committee should be independently arrived at without interference from in-house officers.

The auditors should be under no constraints, real or supposed, in stating how they find the company officers.

[Outside] directors can retain objectivity; officers cannot do so because they are always defending existing procedures.

Permit auditors to be completely frank in discussions with the audit committee.

Greater opportunity for frankness from auditors. Disputes with management can be identified and resolved.

What the officers can contribute is available to the committee on request.

Practicing chartered accountants:

Audit includes independent review of management. Inclusion of officer on audit committee would tend to reduce the effectiveness of such review. Also a degree of independence would be lost.

I believe the independence factor is of utmost importance in this area and therefore audit committee members should be drawn from outside corporate management.

The purpose of audit committees is to provide objectivity, some of which could be lost particularly if the officer is a forceful individual. If the attendance of the officer is necessary for clarification of a matter, etc., he always can be requested to attend.

The audit committee is an excellent court of appeal in the event of a disagreement between auditors and management. The presence of an officer of the company would inhibit this feature.

I have had experience with two audit committees. The one with no officer member was much more effective. The officer member tends to be on the defensive.

Financial analysts:

The purpose of the committee is to reassert the independence of auditors and their responsibility to the directors as representatives of the shareholders.

The objective of the audit committee is to get an outside check of the presentation of financial results.

[Management representation] negates the purpose [of the audit committee] which is to enable auditors to speak very freely to directors about officers and the way they manage [the company].

Both objectivity and effectiveness [of the committee] will be downgraded by the presence of company officers on the committee.

Their [officers'] presence would inhibit free discussion with independent auditors. Officers should be invited to attend meetings only when necessary.

Basically, the objection to management representation centers on the issues of the independence and objectivity of the committee and the auditors. Perhaps in anticipation of the argument that management representation is needed to avoid potential misunderstanding and suspicion about the committee's activities, many respondents suggest that officers may be invited to attend meetings when necessary. A few respondents feel very strongly about the undesirability of such representation. For example, one audit committee member who is the chairman of the board of another company states: "Company officers are not on any of my three audit committees and I would not serve if they were."

Perhaps the issue of management representation on the audit committee may be resolved by having a more detailed specification of the committee's functions, providing details of its activities through minutes of the meetings, and inviting members of management to attend meetings whenever considered necessary by the committee. In addition, the format of the meetings may eliminate many of the objections voiced by both sides. For example, a respondent who is a chairman of three audit committees and a member of two others suggests the following format for each meeting:

1. The committee meets alone.
2. The committee meets with the auditor's representatives.
3. The committee meets with the chief executive officer, the chief financial officer, perhaps the controller and possibly the head of the internal audit department (the order of 2 and 3 will depend on the main topic of the meeting).

4. The committee meets alone.

5. If it seems required, the committee meets again with the auditor's representatives and the company management people, either separately or with everyone together, or both, as seems indicated.

6. The committee meets alone.

He further states:

> Sometimes, of course, there may be some telescoping of this procedure, but if in essence it is followed each time, then no one will become disturbed by an audit committee suddenly deciding that it needs to meet alone with the company management or alone with the auditor's representatives.

Officers holding the following positions are recommended by those who favor management representation on the committee: (1) president or chief executive officer, (2) chief financial officer or vice-president of finance, and (3) treasurer or controller. This recommendation probably reflects the respondent's desire to seek those officers who are intimately knowledgeable about the company's operations and financial matters. As one respondent expresses it, "it is desirable, if possible, to have financial executives on the committee since a considerable amount of the audit interrogation is technical in nature."

Disclosing the Names of Audit Committee Members in Corporate Annual Report

Since the audit committee represents an important independent organizational unit within the corporation's structure, membership information about it may be of some significance to users of financial statements. Accordingly, a question as to the desirability of disclosing the names of the audit committee members in the corporate annual report was directed to the chief executive officers, audit committee members, chartered accountants, and financial analysts. Table 4-14 summarizes the responses of these four groups. Both the chief executive officers and audit committee members feel that this is not desirable, although the latter feel less strongly about it. The chartered accountants and the financial analysts, on the other hand, believe that such a disclosure is desirable, and the latter appear to feel more strongly about it than the former.

One of the respondents who opposes the disclosure believes that such a practice "would de-emphasize the responsibility of the whole board." Of course, the nature of this disclosure is to identify individuals' specific responsibilities rather than to foster a shifting of responsibility from the board as a whole to audit committee members. For example, some respondents note that "the audit committees do not relieve board members of their responsibilities. They only help them discharge them better." Similarly, Wilbur J. Blair states:

> There is no question, however, that even without specific statutory sanction, the board of directors may entrust certain functions to committees provided the delegation of authority does not constitute a surrender by the board of its own ultimate power to control the business and is not a subterfuge whereby the board seeks to evade its responsibilities.[2]

The Number of Audit Committees Established Prior to the Legal Requirement and Subsequent Changes

In order to obtain some idea concerning the use of corporate audit committees prior to the 1971 legal requirement, chief executive officers were asked whether their companies had had such committees.

TABLE 4-14

DISCLOSING THE NAMES OF THE CORPORATE AUDIT COMMITTEE MEMBERS IN THE CORPORATE ANNUAL REPORT

	Yes		No		No Opinion		No Response		Total	
	No.	%	No.	%	No.	%	No.	%	No.	%
Chief executive officers	26	25.7	66	65.3	6	6.0	3	3.0	101	100.0
Members of audit committees	81	41.7	104*	53.6	6	3.1	3	1.6	194	100.0
Practicing chartered accountants	31	51.7	26	43.3	1	1.7	2	3.3	60	100.0
Financial analysts	79	63.2	40	32.0	2	1.6	4	3.2	125	100.0
Total	217	45.2	236	49.1	15	3.1	12	2.6	480	100.0

*One respondent believed that to disclose the names of the committee members "would de-emphasize the responsibility of the whole board."

Only six companies reported that they had audit committees before 1971; one of them was established as early as 1950, one in 1966, one in 1968, and three in 1969.

Five of these six executives indicated the following reasons for the establishment of the committee:

> It was felt desirable to inject a "third party" into the normal auditor-management relationship.
>
> Recommended by the external auditor.
>
> To give outside directors a chance to talk together and with the [external] auditor.
>
> Additional assurance to shareholders. An incentive to operating personnel for best performance.
>
> In order for our control group to have first-hand analyzed advice at our disposal.

Only one of these six companies experienced any significant alteration as a result of the legal requirement. This company changed its all-officer committee members to a majority of nonofficer members to conform to the requirement of the Ontario Act.

FOOTNOTES--CHAPTER IV

1. Norman E. Auerbach, "Audit Committees--New Corporate Institution," _loc. cit._, 98.

2. Wilbur J. Blair, "Appraising the Board of Directors," _Harvard Business Review_ (January, 1950): 110.

CHAPTER V

SUMMARY AND ANALYSIS OF RESULTS OF THE STUDY

Introduction

This chapter summarizes and analyzes the results of questionnaire responses that have not been covered by chapter IV. It can be divided into three major parts. First, it discusses the ranking of purposes and functions of the audit committee and the performance and effectiveness of these functions. Second, it focuses on the factors contributing to, and benefits of, an effective committee, on the major disagreements between the external auditor and management, and on the role played by the committee in such disagreements. Finally, it discusses the general effectiveness and usefulness of the committee and the effect of the committee on corporate financial reporting.

Purposes of the Corporate Audit Committee

Introduction

The word *purpose* is used to describe the reason for the establishment of the corporate audit committee, as distinguished from the word *function*, which refers to the committee's specific duty. The Ontario Business Corporations Act of 1971 is silent on the committee's specific purposes, as was pointed out in a previous chapter. Similarly, most literature on the subject contains little explicit discussion of this point. Therefore, determining the purposes of audit committees necessarily must be based on inferences from relevant sections of the Ontario Act and on available empirical findings concerning voluntary audit committees in the United States.

Eight purposes of the mandatory audit committee were posited. These purposes were arranged in what was believed to be a natural sequence, and the respondents were asked to evaluate the degree of importance of each of them, that is, to assign only one of the four categories--very important, important, not important, and not important at all--in each of their evaluations. Since each purpose was to be judged separately, the sequence should not have had any influence on the respondents' evaluations. The respondents also were asked to add any purposes that they considered important.

The following subsections will discuss the responses of corporate chief executive officers, members of audit committees, practicing chartered accountants, and financial analysts. The details of responses of these four groups are reported in Tables G-1 through G-5 in Appendix G. In order to facilitate discussion of the findings, the purposes are numbered from one through eight, and they will be referred to as such. The eight purposes are:

To relieve the board of directors, as a whole, of details regarding

1. The nomination of the independent auditors;
2. The arrangements for the independent audit;
3. The review of the results of the indpendent audit; and
4. The review of the annual financial statements;
5. To provide nonofficer directors with direct and more personal contact with the independent auditors;

6. To give additional attention to the audit function performed by the independent auditors;

7. To give attention to the internal control functions of the company; and

8. To serve as an independent review function of the company's operations and its annual financial statements before their submission to the board of directors for approval.

Corporate Chief Executive Officers

The majority of the 101 chief executive officers considered purposes 8 (62.4 percent), 3 (59.4 percent), and 4 (58.4 percent) as very important. Only slightly more than one-fourth of them considered purposes 7 (32.6 percent), 6 (27.7 percent), and 5 (27.7 percent) as very important, while 1 and 2, with 2 percent and 3.9 percent respectively, were far behind in ranking. Table 5-1 provides the details of the ranking by percentage of responses.

When the very important and important categories are combined, purposes 3 through 8 still ranked ahead of 1 and 2 by a very substantial margin. Purposes 3 and 4, with 93 percent, were first in ranking, 8 (87.1 percent) and 7 (84.1 percent) were third and fourth, and 6 (75.2 percent) and 5 (73.2 percent) were fifth and sixth. Purposes 1 and 2, with 26.7 percent and 30.6 percent, were at the bottom of the ranking.

Members of Audit Committees

Table 5-2 shows that the majority of the 194 members of audit committees considered purposes 3 (68.5 percent), 4 (63.4 percent), and 8 (60.7 percent) as very important, and over 30 percent rated 5 (39.1 percent), 7 (35.6 percent), and 6 (32 percent) as

TABLE 5-1

RANKING OF PURPOSES OF CORPORATE AUDIT COMMITTEES - CORPORATE CHIEF EXECUTIVE OFFICERS

Purposes	Very Important %	Very Important Rank	Important %	Important Rank	Combined %	Combined Rank
	Ranking by Percentage of Responses					
To relieve the board of directors, as a whole, of details regarding						
1. The nomination of the independent auditors	2.0	8	24.7	7.5	26.7	8
2. The arrangements for the independent audit	3.9	7	26.7	6	30.6	7
3. The review of the results of the independent audit	59.4	2	33.6	5	93.0	1.5
4. The review of the annual financial statements	58.4	3	34.6	4	93.0	1.5
5. To provide nonofficer directors with direct and more personal contact with the independent auditors	27.7	5.5	45.5	3	73.2	6
6. To give additional attention to the audit function performed by the independent auditors	27.7	5.5	47.5	2	75.2	5
7. To give attention to the internal control functions of the company	32.6	4	51.5	1	84.1	4
8. To serve as an independent review function of the company's operations and its annual financial statements before their submission to the board of directors for approval	62.4	1	24.7	7.5	87.1	3

TABLE 5-2

RANKING OF PURPOSES OF CORPORATE AUDIT COMMITTEES - MEMBERS OF AUDIT COMMITTEES

Purposes	Ranking by Percentage of Responses					
	Very Important		Important		Combined	
	%	Rank	%	Rank	%	Rank
To relieve the board of directors, as a whole, of details regarding						
1. The nomination of the independent auditors	6.6	8	24.2	8	30.8	8
2. The arrangements for the independent audit	12.8	7	30.9	4.5	43.7	7
3. The review of the results of the independent audit	68.5	1	25.2	7	93.7	1
4. The review of the annual financial statements	63.4	2	26.8	6	90.2	3
5. To provide nonofficer directors with direct and more personal contact with the independent auditors	39.1	4	33.0	3	72.1	6
6. To give additional attention to the audit function performed by the independent auditors	32.0	6	52.6	1	84.6	5
7. To give attention to the internal control functions of the company	35.6	5	51.0	2	86.6	4
8. To serve as an independent review function of the company's operations and its annual financial statements before their submission to the board of directors for approval	60.7	3	30.9	4.5	91.6	2

very important. Purposes 1 (6.6 percent) and 2 (12.8 percent) were rated substantially behind the others.

When the very important and important categories are combined, purposes 3 though 8 still ranked significantly ahead of 1 and 2. Purposes 3 (93.7 percent), 8 (91.6 percent), and 4 (90.2 percent) were ranked as the top three, while 7 (86.6 percent), 6 (84.6 percent), and 5 (72.1 percent) were rated as fourth, fifth, and sixth. Purposes 1 (30.8 percent) and 2 (43.7 percent) remained the lowest in ranking.

Practicing Chartered Accountants

Table 5-3 shows that the majority of the 60 practicing chartered accountants rated purposes 4 (71.7 percent), 3 (68.4 percent), 8 (65 percent), and 5 (63.4 percent) as very important. In addition, a substantial number of them considered purposes 6 (48.3 percent) and 7 (33.3 percent) as very important, while only a small number classified purposes 1 (11.7 percent) and 2 (20 percent) in this category.

When the very important and important categories are combined, purposes 3 through 8 still ranked substantially ahead of 1 and 2. However, purpose 2 (53.5 percent) is now rated by the majority as important. Purposes 5 (96.7 percent), 6 (93.3 percent), 3 (91.7 percent), and 8 (91.6 percent) were ranked as the top four, while 4 (88.4 percent) and 7 (83.3 percent) were rated as fifth and sixth respectively. Purposes 1 (31.7 percent) and 2 (53.3 percent) remained the last two in ranking.

TABLE 5-3

RANKING OF PURPOSES OF CORPORATE AUDIT COMMITTEES - PRACTICING CHARTERED ACCOUNTANTS

Purposes	Ranking by Percentage of Responses					
	Very Important		Important		Combined	
	%	Rank	%	Rank	%	Rank
To relieve the board of directors, as a whole, of details regarding						
1. The nomination of the independent auditors	11.7	8	20.0	7	31.7	8
2. The arrangements for the independent audit	20.0	7	33.3	3.5	53.3	7
3. The review of the results of the independent audit	68.4	2	23.3	6	91.7	3
4. The review of the annual financial statements	71.7	1	16.7	8	88.4	5
5. To provide nonofficer directors with direct and more personal contact with the independent auditors	63.4	4	33.3	3.5	96.7	1
6. To give additional attention to the audit function performed by the independent auditors	48.3	5	45.0	2	93.3	2
7. To give attention to the internal control functions of the company	33.3	6	50.0	1	83.3	6
8. To serve as an independent review function of the company's operations and its annual financial statements before their submission to the board of directors for approval	65.0	3	26.6	5	91.6	4

Financial Analysts

Table 5-4 shows that only purpose 8 (59.2 percent) was rated as very important by the majority of the 125 financial analysts. A significant number of them also classified purposes 7 (48.8 percent), 3 (45.6 percent), 4 (40 percent), 6 (35.2 percent), and 5 (25.6 percent) in this category, while only a small number did so for purposes 1 (11.2 percent) and 2 (12.8 percent).

When the very important and important categories are combined, all purposes except 1 and 2 had a substantial majority. Purposes 7 (91.2 percent), 8 (88.8 percent), 6 (87.2 percent), and 3 (82.4 percent) were among the four highest rankings, while 4 (71.2 percent) and 5 (62.4 percent) ranked fifth and sixth respectively. Purposes 1 (40 percent) and 2 (47.2 percent) remained last in ranking.

Combined Ranking by the Four Groups

Table 5-5 summarizes the responses of corporate chief executive officers, members of audit committees, practicing chartered accountants, and financial analysts. It reveals that the majority of the 480 respondents rated purposes 8 (62 percent), 3 (61.2 percent), and 4 (58.1 percent) as very important. Over 30 percent rated purposes 7 (38.7 percent), 5 (37.2 percent), and 6 (34.7 percent) as very important, while less than 13 percent classified 1 (7.8 percent) and 2 (12.1 percent) in this category.

Combining the very important and important categories shows that over 90 percent of the respondents believed purposes 3 (91.3 percent) and 8 (91.1 percent) were important; over 80 percent so rated purposes 7 (88.1 percent), 4 (87 percent), and 6 (86.2 percent);

TABLE 5-4

RANKING OF PURPOSES OF CORPORATE AUDIT COMMITTEES - FINANCIAL ANALYSTS

Purposes	Ranking by Percentage of Responses					
	Very Important		Important		Combined	
	%	Rank	%	Rank	%	Rank
To relieve the board of directors, as a whole, of details regarding						
1. The nomination of the independent auditors	11.2	8	28.8	8	40.0	8
2. The arrangements for the independent audit	12.8	7	34.4	5	47.2	7
3. The review of the results of the independent audit	45.6	3	36.8	3.5	82.4	4
4. The review of the annual financial statements	40.0	4	31.2	6	71.2	5
5. To provide nonofficer directors with direct and more personal contact with the independent auditors	25.6	6	36.8	3.5	62.4	6
6. To give additional attention to the audit function performed by the independent auditors	35.2	5	52.0	1	87.2	3
7. To give attention to the internal control functions of the company	48.8	2	42.4	2	91.2	1
8. To serve as an independent review function of the company's operations and its annual financial statements before their submission to the board of directors for approval	59.2	1	29.6	7	88.8	2

TABLE 5-5

RANKING OF PURPOSES OF CORPORATE AUDIT COMMITTEES - ALL GROUPS COMBINED

Purposes	Ranking by Percentage of Responses					
	Very Important		Important		Combined	
	%	Rank	%	Rank	%	Rank
To relieve the board of directors, as a whole, of details regarding						
1. The nomination of the independent auditors	7.8	8	25.3	8	33.1	8
2. The arrangements for the independent audit	12.1	7	32.0	4	44.0	7
3. The review of the results of the independent audit	61.2	2	30.1	5	91.3	1
4. The review of the annual financial statements	58.1	3	28.9	7	87.0	4
5. To provide nonofficer directors with direct and more personal contact with the independent auditors	37.2	5	37.6	3	74.8	6
6. To give additional attention to the audit function performed by the independent auditors	34.7	6	51.5	1	86.2	5
7. To give attention to the internal control functions of the company	38.7	4	49.4	2	88.1	3
8. To serve as an independent review function of the company's operations and its annual financial statements before their submission to the board of directors for approval	62.0	1	29.1	6	91.1	2

74.8 percent so rated 5; and over 30 percent believed 1 (33.1 percent) and 2 (44 percent) were important.

Summary

It seems reasonable to conclude from earlier discussions and from the data exhibited in Table 5-6 that, while there is a divergence of opinion on the exact order of importance concerning some purposes of the corporate audit committee among the four groups of respondents, there is unanimous agreement about purposes 1 and 2. To relieve the board of directors, as a whole, of details regarding (1) the nomination of the independent auditors and (2) the arrangement for the independent audit was not considered important. Also, Table 5-6 shows the overall ranking for all eight purposes. The following purposes are considered to be the two most important:

> To relieve the board of directors, as a whole, of details regarding the review of the results of the independent audit, and
>
> To serve as an independent review function of the company's operations and its annual financial statements before their submission to the board of directors for approval.

It is worthy of note that the rating of purposes by chief executive officers and audit committee members is almost identical. This is perhaps to be expected because many of these members are business executives, and they probably share similar views on many matters. However, the rating by practicing chartered accountants and financial analysts not only differs somewhat from each other, but also from that of chief executive officers and audit committee members. Such a difference in rating probably stems from the difference in their respective vested interests in the committee.

TABLE 5-6

SUMMARY OF INDIVIDUAL GROUP RANKING ON IMPORTANCE OF PURPOSES OF CORPORATE AUDIT COMMITTEES

Purposes	Ranking by Combined Percentage of Responses to Very Important and Important Categories				
	CEO	MAC	CA	FA	Overall[a]
To relieve the board of directors, as a whole, of details regarding the review of the results of the independent audit	1.5	1	3	4	1
To serve as an independent review function of the company's operations and its annual financial statements before their submission to the board of directors for approval	3	2	4	2	2
To relieve the board of directors, as a whole, of details regarding the review of the annual financial statements	1.5	3	5	5	3
To give attention to the internal control functions of the company	4	4	6	1	4
To give additional attention to the audit function performed by the independent auditors	5	5	2	3	5
To provide nonofficer directors with direct and more personal contact with the independent auditors	6	6	1	6	6
To relieve the board of directors, as a whole, of details regarding					
The arrangements for the independent audit	7	7	7	7	7
The nomination of the independent auditors	8	8	8	8	8

Note: CEO = Corporate chief executive officer;
MAC = Member of audit committee, Mautz and Neumann included only nonofficer members;
CA = Practicing chartered accountant;
FA = Financial analysts;
CPA = Certified public accountant; and
IA = Internal auditor.

[a]Based on a weighted average.

Essentially, the purposes of the committee may be classified in two distinct but interrelated categories; one is the end product of the audit and the other is the audit process. The former category includes the review of the results of the independent audit and the annual financial statements. The latter encompasses all the important steps and procedures essential for an effective and independent audit, namely, to provide a more direct and personal channel of communication between the auditors and the directors and to give added attention to the independent audit function.

Chief executive officers and members of audit committees apparently were more interested in the end product of the audit than the audit process. Accordingly, they considered the review of the results of the independent audit and of the annual financial statements as the most important purposes. Practicing chartered accountants, on the other hand, placed more emphasis on the audit process itself and thus considered the direct and more personal contact with the directors and their additional attention to the audit functions as most important. Financial analysts, as outsiders, appeared to be interested in both the audit process and its end product. Consequently, they considered the committee's attention to the internal control functions of the company, the independent review of annual financial statements, and the additional attention to the independent audit function as the most important purposes.

Thus, it is probably reasonable to infer that the difference in emphasis of the four groups regarding the two essential and interrelated aspects of the committee, the audit process and its end product, gives rise to the difference in the rating of certain of the committee's purposes.

Table 5-7 presents a comparison of the results of this study with that of the Mautz and Neumann study. It is interesting to note that Mautz and Neumann found the two most important purposes to be the following: (1) to provide nonofficer directors with direct and more personal contact with the independnt auditors, and (2) the review of the results of the independent audit. Moreover, the nomination of the independent auditors and the arrangements for the independent audit also were considered as quite important.[1] Basically, the difference in the ranking of the committee's purposes between the two studies centers around three areas: (1) review of annual financial statements; (2) nomination of the independent auditors; and (3) channel of communication between the directors and the auditors.

The first area is considered very important in this study, but it was relatively unimportant in the Mautz and Neumann study. Conversely, the second area was considered as very important in the latter but unimportant in the former. Such a difference in research findings probably stems from the difference in the laws governing Ontario and U.S. corporations. Since the Ontario Business Corporations Act specifically requires the committee to review corporate financial statements, the first area was considered to be very important. Similarly, the act stipulates that the independent auditors are appointed by, and must report to, the shareholders. Therefore, the second area was considered unimportant. On the other hand, in the United States the independent auditors, in many cases, are

TABLE 5-7

SUMMARY OF INDIVIDUAL GROUP RANKING ON IMPORTANCE OF PURPOSES OF CORPORATE AUDIT COMMITTEES AND COMPARISON WITH MAUTZ AND NEUMANN STUDY

Purposes	Ranking by Combined Percentage of Responses to Very Important and Important Categories				Median Ranking by Mautz and Neumann[a]			
	CEO	MAC	CA	FA	CEO	MAC	CPA	IA
To relieve the board of directors, as a whole, of details regarding the review of the results of the independent audit	1.5	1	3	4	2	4	3	2
To serve as an independent review function of the company's operations and its annual financial statements before their submission to the board of directors for approval	3	2	4	2	7	5	7	6
To relieve the board of directors, as a whole, of details regarding the review of the annual financial statements	1.5	3	5	5	-	-	-	-
To give attention to the internal control functions of the company	4	4	6	1	-	-	-	-
To give additional attention to the audit function performed by the independent auditors	5	5	2	3	3	2	2	5
To provide nonofficer directors with direct and more personal contact with the independent auditors	6	6	1	6	1	1	1	4
To relieve the board of directors, as a whole, of details regarding								
The arrangements for the independent audit	7	7	7	7	6	9	5	8
The nomination of the independent auditors	8	8	8	8	5	8	4	3

Note: CEO = Corporate chief executive officer;
MAC = Member of audit committee, Mautz and Neumann included only nonofficer members;
CA = Practicing chartered accountant;
FA = Financial analysts;
CPA = Certified public accountant; and
IA = Internal auditor.

[a]Only the purposes similar to the nine purposes included in the Mautz and Neuman study are compared.

appointed by the board of directors and report to the board. Consequently, it would be more important to involve the audit committee in the nomination of the independent auditors.

The third area of difference presents a very interesting picture. Whereas both the chief executive officers and members of audit committees in this study considered this area as not very important, but as the most important in the Mautz and Neumann study, the rating between the two groups is identical in both studies. Similarly, the rating by the public accountants is also identical. However, it is rather difficult, and perhaps unwise, to speculate why such a difference in rating by both the chief executive officers and members of audit committees exists between the two studies. Also, it is difficult to comment on the rating difference between the financial analysts and the internal auditors because they are hardly comparable groups.

In general, the difference in research findings between this and the Mautz and Neumann studies may be explained by the difference in the perception by respondents on mandatory and voluntary audit committees, the difference in opinion between Canadian and American respondents, or by the method used in ranking, or a combination of the three.

The purposes added by respondents, as requested in the questionnaires, seem to fall into five categories: (1) to enhance communication and access between external auditors and nonmanagement directors; (2) to enhance the independence of external auditors; (3) to provide added protection for shareholders and directors;

(4) to increase the awareness of directors' responsibilities; and

(5) other. The following are typical examples:

To provide ready access to board of directors for the independent auditors;

To provide a direct line of communication between nonmanagement directors and external auditors;

To provide an independent channel of access to the board for the independent auditors;

To prevent auditors from being dominated by management and to reinforce in the minds of the auditors just who they are responsible to;

To increase the independence of the auditor;

To assure the independence of external auditors from management;

To provide assurance to outside directors that auditors were given all information required and that management gave full cooperation in conducting the audit;

To help resolve problems between auditors and management;

To provide a formal means for receiving and evaluating the pros and cons of important disagreement between management and auditors on financial matters;

To review the auditor-management relationship;

To provide added protection for shareholders and directors;

To minimize directors' liability in cases of inadequate or misrepresentative management information;

To increase awareness of the directors as to their responsibilities;

To remind the directors of their responsibility with respect to the company's financial statements;

To review management capability;

To appraise the quality of the audit service;

To scrutinize major purchases, mergers, or changes of direction;

To review presidents' and directors' expense accounts;

To provide a critique of accounting department personnel;

To review areas of potential conflict of interest of management;

To ensure that the auditor's recommendations are acted upon and reviewed; and

To serve as a place for auditors to complain and cleanse their souls by doing so.

Apparently, many respondents considered the audit committee as a very versatile and adaptive device that can serve a wide variety of purposes. No doubt this is true, but the committee could not serve all these purposes equally effectively, and thus the tendency to use it in such a manner could be detrimental.

Functions of the Corporate Audit Committee

Introduction

The word function is used to describe the specific duty of the corporate audit committee. The Ontario Business Corporations Act of 1971 stipulates only the minimum functions, namely: (1) the committee is to review the company's annual financial statements before submission to the board of directors; (2) the auditor must appear before the committee if requested; and (3) the committee must hear the auditor upon his request. Since committees may perform a wide range of other related functions, it is essential for the well-being of the committee to establish the specific functions that fall within its domain. The absence of a set of clearly defined and well-established functions frequently may lead to unnecessary conflicts and misunderstanding among management, the external auditors, and committee members which may seriously undermine the effective functioning of the committee. This problem was discussed in Chapter II.

Accordingly, this research attempts to ascertain these functions and their importance. Respondents were asked to evaluate the degree of importance of each of the eight suggested functions and to add any they thought important. In addition, corporate chief executive officers, audit committee members, and practicing chartered accountants were asked to indicate the functions actually performed by the committee and to assess the effectiveness with which the committee performed such functions.

The following subsections will discuss the responses of corporate chief executive officers, members of audit committees, practicing chartered accountants, and financial analysts. The details of responses of these four groups are reported in Tables H-1 through H-9 in Appendix H. To facilitate discussion of the findings, the functions are numbered from one through eight, and they will be referred to as such. The eight functions are:

1. nominate the independent auditors;
2. discuss with the independent auditors, before the audit is completed, its scope, purpose, and the procedures to be included;
3. review with the independent auditors, on completion of their audit, their experience, any restrictions on their work, cooperation received, their findings, and their recommendations;
4. review with the independent auditors their evaluation of the company's internal control systems;
5. review interim financial reports to shareholders before these reports are approved by the board of directors;

6. review the corporate annual financial statements before their submission to the board of directors for approval;

7. review the scope of internal audit procedures with the chief internal auditor; and

8. review the reports of the internal audit staff.

Corporate Chief Executive Officers

Table 5-8 shows that the majority of the 101 chief executive officers rated functions 3 (65.3 percent), 6 (57.4 percent), and 4 (54.4 percent) as very important. About one-fourth felt that function 5 (24.7 percent) was very important, and less than one-fifth classified the other five functions in the same category.

A more discernible pattern emerges when the very important and important categories are combined. Functions 3 (94 percent), 4 (91.1 percent), and 6 (81.1 percent) are clearly the first three most important. Functions 7 (51.5 percent) and 5 (50.5 percent) are fourth and fifth respectively. The other three functions are at the bottom of the ranking with less than 50 percent.

Members of Audit Committees

As exhibited in Table 5-9, the majority of the 194 members of audit committees considered functions 3 (72.2 percent), 6 (57.7 percent), and 4 (56.7 percent) very important, while only slightly over 20 percent considered 2 (26.8 percent), 7 (23.2 percent), and 5 (21.6 percent) in the same way. The remaining two functions, 8 (10.3 percent) and 1 (7.2 percent), trailed the others by a wide margin.

TABLE 5-8

RANKING OF FUNCTIONS OF CORPORATE AUDIT COMMITTEES - CORPORATE CHIEF EXECUTIVE OFFICERS

Functions	Ranking by Percentage of Responses					
	Very Important		Important		Combined	
	%	Rank	%	Rank	%	Rank
1. Nominate the independent auditors	2.0	8	24.7	7	26.7	8
2. Discuss with the independent auditors, before the audit is completed, its scope, purpose, and the procedures to be included	12.9	6	32.6	2	45.5	6
3. Review with the independent auditors, on completion of the audit, their experience, any restrictions on their work, cooperation received, their findings, and their recommendations	65.3	1	28.7	5	94.0	1
4. Review with the independent auditors their evaluation of the company's internal control systems	54.4	3	36.7	1	91.1	2
5. Review interim financial reports to shareholders before these reports are approved by the board of directors	24.7	4	25.8	6	50.5	5
6. Review the corporate annual financial statements before their submission to the board of directors for approval	57.4	2	31.7	3.5	81.1	3
7. Review the scope of internal audit procedures with the chief internal auditor	19.8	5	31.7	3.5	51.5	4
8. Review the reports of the internal audit staff	8.9	7	22.8	8	31.7	7

TABLE 5-9

RANKING OF FUNCTIONS OF CORPORATE AUDIT COMMITTEES - MEMBERS OF AUDIT COMMITTEES

Functions	Ranking by Percentage of Responses					
	Very Important		Important		Combined	
	%	Rank	%	Rank	%	Rank
1. Nominate the independent auditors	7.2	8	23.7	7.5	30.9	8
2. Discuss with the independent auditors, before the audit is completed, its scope, purpose, and the procedures to be included	26.8	4	42.6	1	69.4	4
3. Review with the independent auditors, on completion of the audit, their experience, any restrictions on their work, cooperation received, their findings, and their recommendations	72.2	1	23.7	7.5	95.9	1
4. Review with the independent auditors their evaluation of the company's internal control systems	56.7	3	36.6	3	93.3	2
5. Review interim financial reports to shareholders before these reports are approved by the board of directors	21.6	6	34.0	4.5	55.6	6
6. Review the corporate annual financial statements before their submission to the board of directors for approval	57.7	2	34.0	4.5	91.7	3
7. Review the scope of internal audit procedures with the chief internal auditor	23.2	5	38.2	2	61.4	5
8. Review the reports of the internal audit staff	10.3	7	30.0	6	40.3	7

When the very important and important categories are combined, over 90 percent rated functions 3 (95.9 percent), 4 (93.3 percent), and 6 (91.7 percent) as the three most important. The next three most important, with over 50 percent, are functions 2 (69.4 percent), 7 (61.4 percent), and 5 (55.6 percent). The last two functions, 8 and 1, received only 40.3 percent and 30.9 percent respectively.

Practicing Chartered Accountants

The majority of the 60 practicing chartered accountants, as shown in Table 5-10, considered functions 3 (91.7 percent), 6 (85 percent), and 4 (55 percent) to be very important, while only about one-third so considered functions 2 (38.3 percent) and 5 (30 percent). About one-fifth rated functions 7 (23.3 percent), 8 (21.7 percent), and 1 (20 percent) as very important.

It is revealing to note that, when the very important and important categories are combined, the majority of chartered accountants indicated that all eight functions were important. Functions 3 and 6, with 100 percent, ranked significantly ahead of all others. Functions 4 (88.3 percent), 5 (81.7 percent), and 2 (80 percent) were the next three most important. The last three were functions 7 (71.6 percent), 8 (68.4 percent), and 1 (53.3 percent).

Financial Analysts

Table 5-11 shows that the majority of the 125 financial analysts considered functions 3 (66.4 percent) and 4 (60.8 percent) to be very important, while only about one-third did so for functions 7 (38.4 percent), 6 (37.6 percent), 2 (31.2 percent), and 8 (30.4

TABLE 5-10

RANKING OF FUNCTIONS OF CORPORATE AUDIT COMMITTEES - PRACTICING CHARTERED ACCOUNTANTS

Functions	Ranking by Percentage of Responses					
	Very Important		Important		Combined	
	%	Rank	%	Rank	%	Rank
1. Nominate the independent auditors	20.0	8	33.3	5.5	53.3	8
2. Discuss with the independent auditors, before the audit is completed, its scope, purpose, and the procedures to be included	38.3	4	41.7	4	80.0	5
3. Review with the independent auditors, on completion of the audit, their experience, any restrictions on their work, cooperation received, their findings, and their recommendations	91.7	1	8.3	7	100.0	1.5
4. Review with the independent auditors their evaluation of the company's internal control systems	55.0	3	33.3	5.5	88.3	3
5. Review interim financial reports to shareholders before these reports are approved by the board of directors	30.0	5	51.7	1	81.7	4
6. Review the corporate annual financial statements before their submission to the board of directors for approval	85.0	2	15.0	6	100.0	1.5
7. Review the scope of internal audit procedures with the chief internal auditor	23.3	6	48.3	2	71.6	6
8. Review the reports of the internal audit staff	21.7	7	46.7	3	68.4	7

TABLE 5-11

RANKING OF FUNCTIONS OF CORPORATE AUDIT COMMITTEES - FINANCIAL ANALYSTS

Functions	Ranking by Percentage of Responses					
	Very Important		Important		Combined	
	%	Rank	%	Rank	%	Rank
1. Nominate the independent auditors	12.0	8	34.4	6	46.4	8
2. Discuss with the independent auditors, before the audit is completed, its scope, purpose, and the procedures to be included	31.2	5	47.2	4	78.4	5
3. Review with the independent auditors, on completion of the audit, their experience, any restrictions on their work, cooperation received, their findings, and their recommendations	66.4	1	28.8	8	95.2	1
4. Review with the independent auditors their evaluation of the company's internal control systems	60.8	2	33.6	7	94.4	2
5. Review interim financial reports to shareholders before these reports are approved by the board of directors	22.4	7	53.6	1	76.0	6
6. Review the corporate annual financial statements before their submission to the board of directors for approval	37.6	4	51.2	2	88.8	3
7. Review the scope of internal audit procedures with the chief internal auditor	38.4	3	49.6	3	88.0	4
8. Review the reports of the internal audit staff	30.4	6	44.8	5	75.2	7

percent). Less than one-fourth classified functions 5 (22.4 percent) and 1 (12 percent) in this category.

When the very important and important categories are combined, a great majority of financial analysts considered all functions except function 1 to be important. Over 90 percent rated functions 3 (95.2 percent) and 4 (94.4 percent) as the two most important, followed by functions 6 (88.8 percent) and 7 (88 percent) as the next most important. Functions 2 (78.4 percent), 5 (76 percent), and 8 (75.2 percent) were fifth, sixth, and seventh. The last was function 1 (46.4 percent).

Combined Rankings by the Four Groups

Table 5-12 summarizes the responses of corporate chief executive officers, members of audit committees, practicing chartered accountants, and financial analysts. It discloses that the majority of the 480 respondents considered functions 3 (73 percent), 4 (58.4 percent), and 6 (57.3 percent) to be very important. Over 25 percent also considered 7 (29.9 percent), 2 (28.2 percent), and 5 (25.3 percent) to be very important, while less than 20 percent classified 8 (19.7 percent) and 1 (10 percent) in this category.

Combining the very important and important categories reveals that over 90 percent of the respondents considered functions 3 (97.6 percent), 4 (94.7 percent), and 6 (93.8 percent) as the top three most important, followed by functions 7 (76.2 percent), and 2 (72.7 percent). Over 60 percent rated functions 5 (67.9 percent) and 8 (60.3 percent) as important, while function 1, in the last position, received only 40.1 percent.

TABLE 5-12

RANKING OF FUNCTIONS OF CORPORATE AUDIT COMMITTEES - ALL GROUPS COMBINED

Functions	Ranking by Percentage of Responses					
	Very Important		Important		Combined	
	%	Rank	%	Rank	%	Rank
1. Nominate the independent auditors	10.0	8	30.1	7	40.1	8
2. Discuss with the independent auditors, before the audit is completed, its scope, purpose, and the procedures to be included	28.2	5	44.5	2	72.7	5
3. Review with the independent auditors, on completion of the audit, their experience, any restrictions on their work, cooperation received, their findings, and their recommendations	73.0	1	24.6	8	97.6	1
4. Review with the independent auditors their evaluation of the company's internal control systems	58.4	2	36.3	6	94.7	2
5. Review interim financial reports to shareholders before these reports are approved by the board of directors	25.3	6	42.6	3	67.9	6
6. Review the corporate annual financial statements before their submission to the board of directors for approval	57.3	3	36.5	5	93.8	3
7. Review the scope of internal audit procedures with the chief internal auditor	29.9	4	46.3	1	76.2	4
8. Review the reports of the internal audit staff	19.7	7	40.6	4	60.3	7

Summary

There appears to be less disparity of opinion among the four groups of respondents regarding the rating of functions than the rating of purposes of the audit committee. As exhibited in Table 5-13 and in earlier discussions, there is unanimous agreement that the most important item is the following:

> Review with the independent auditors, on completion of the audit, their experience, any restrictions on their work, cooperation received, their findings, and their recommendations.

The exact order of the next two most important functions is less than unanimous. Review with the independent auditors their evaluation of the company's internal control systems is rated by three of the four groups as the second most important. Review the corporate annual financial statements before their submission to the board of directors for approval is rated by three of the four groups as the third most important. It is worth noting that this function is the statutory function required by the Ontario Act. Nomination of the independent auditors is unanimously agreed upon as the least important because many respondents believe that it is the responsibility of the whole board rather than of the audit committee.

Table 5-14 shows a comparison between this and the Mautz and Neumann studies. Both studies find "the review with the independent auditors, on completion of their audit, their experience, any restrictions on their work, cooperation recieved, their findings, and their recommendations" as the most important function of the audit committee. However, there are also areas of difference.

TABLE 5-13

SUMMARY OF INDIVIDUAL GROUP RANKING ON IMPORTANCE OF FUNCTIONS OF CORPORATE AUDIT COMMITTEES

Functions	Ranking by Combined Percentage of Responses to Very Important and Important Categories				
	CEO	MAC	CA	FA	Overall[a]
Review with the independent auditors, on completion of the audit, their experience, any restrictions on their work, cooperation received, their findings, and their recommendations	1	1	1.5	1	1
Review with the independent auditors their evaluation of the company's internal control systems	2	2	3	2	2
Review the corporate annual financial statements before their submission to the board of directors for approval	3	3	1.5	3	3
Review the scope of internal audit procedures with the chief internal auditor	4	5	6	4	4
Discuss with the independent auditors, before the audit is completed, its scope, purpose, and the procedures to be included	6	4	5	5	5
Review interim financial reports to shareholders before these reports are approved by the board of directors	5	6	4	6	6
Review the reports of the internal audit staff	7	7	7	7	7
Nominate the independent auditors	8	8	8	8	8

Note: CEO = Corporate chief executive officer;
MAC = Member of audit committee, Mautz and Neuman included only nonofficer members;
CA = Practicing chartered accountants; and
FA = Financial analysts.

[a] Based on a weighted average.

TABLE 5-14

SUMMARY OF INDIVIDUAL GROUP RANKING ON IMPORTANCE OF FUNCTIONS OF CORPORATE AUDIT COMMITTEES AND COMPARISON WITH MAUTZ AND NEUMANN STUDY

Functions	Ranking by Combined Percentage of Responses to Very Important and Important Categories				Median Ranking by Mautz and Neumann[a]	
	CEO	MAC	CA	FA	MAC	CPA
Review with the independent auditors, on completion of the audit, their experience, any restrictions on their work, cooperation received, their findings, and their recommendations	1	1	1.5	1	1	1
Review with the independent auditors their evaluation of the company's internal control systems	2	2	3	2	2	3
Review the corporate annual financial statements before their submission to the board of directors for approval	3	3	1.5	3	7	7
Review the scope of internal audit procedures with the chief internal auditor	4	5	6	4	5	5
Discuss with the independent auditors, before the audit is completed, its scope, purpose, and the procedures to be included	6	4	5	5	3	2
Review interim financial reports to shareholders before these reports are approved by the board of directors	5	6	4	6	8	8
Review the reports of the internal audit staff	7	7	7	7	6	6
Nominate the independent auditors	8	8	8	8	4	4

Note: CEO = Corporate chief executive officer;
MAC = Member of audit committee, Mautz and Neumann included only nonofficer members;
CA = Practicing chartered accountants;
FA = Financial analysts; and
CPA = Certified public accountant.

[a] Only the functions similar to the ten functions included in the Mautz and Neumann study are compared. Also, Mautz and Neumann excluded the CEO and internal auditor in the comparison of ranking with MAC and CPA because they considered the former two were asked to evaluate the importance of functions differently from the latter two. Therefore, only the evaluation of MAC and CPA are comparable to the results of this study.

The functions considered as important by the respondents in this study but relatively unimportant in the Mautz and Neumann study are: (1) the review of the annual corporate financial statement and (2) the review of the interim financial reports to shareholders. Since the Ontario Business Corporations Act specifically requires the audit committee to review the annual corporate financial statements while this is not the case for the corporations covered by the Mautz and Neumann study, such a difference in findings should be expected. Similarly, the importance placed by the respondents in this study on the review of interim financial reports is in accord with the spirit of the audit committee provision, that is, to provide shareholders with added assurance regarding the objectivity of the company's financial information.

The functions considered as important in the Mautz and Neumann study but relatively unimportant in this study are: (1) the nomination of the independent auditors and (2) the discussion with the independent auditors, before the audit is completed, of its scope and purpose, and the procedures to be followed. The primary reason for the ranking difference concerning the first function is the fact that independent auditors of Ontario corporations must be appointed by shareholders, while this may not be the case for many U.S. corporations. Moreover, since the audit committee is established voluntarily by the board of directors in the United States to deal with audit matters, it would appear reasonable for the committee to be involved in the nomination of the independent auditor. The reason for the ranking difference of the second function is less obvious. Many respondents in this study felt that this function was not so important because the purpose, the scope, and the audit procedures employed normally did not change significantly from year to year. Therefore, there was no need to review them with the independent auditors except in unusual situations, such as first audits, or when some other significant changes occurred in the company which might require the auditors' special attention. Some respondents indicated that these matters generally should be left to the professional judgment of the auditors and that the auditors would bring to the committee's attention any significant changes. Since the Mautz and Neumann study contains little discussion on the ranking of committee functions and offers no explanation of their relative ranking, it is not feasible to comment on the rather high ranking of the preaudit discussion of scope and purposes. In general, the dissimilarities in the findings of the two studies are due perhaps to the dissimilarities in the laws governing the companies in the two countries and also in the manner in which the audit committee is created.

The respondents, as requested in the questionnaire, added several functions which they felt important. Typical examples were:

> To ensure that the recommendations of the auditors (external and internal) have been implemented;
>
> To report to the board that they have met with the auditors and that they concur with the handling of all matters brought to their attention;
>
> To increase cooperation between internal and external auditors;
>
> To review the accounting policies with the external auditors;

To review with the independent auditors new or pending requirements of the accounting profession and the Ontario Business Corporations Act as they pertain to the company's financial reporting;

To review or approve the audit fee;

To review in detail the independent auditor's annual "management letter" written after completion of the annual audit, and the responses thereto by the company's management--to resolve any differences there may be--and to see that decisions for change that are agreed upon are in fact implemented;

To evaluate the competence of financial and accounting staff;

To assess the competence of external auditors;

To review relationships between auditors and management;

To review quarterly unaudited financial statements;

To review the prospectus; and

To recommend research and studies in finance, accounting, tax, and financial statement presentation matters which the committee considers to be of concern to the welfare of the company.

All of the above functions are actually performed by the audit committees as indicated by the respondents, and many reported that they have been effectively performed.

Functions Performed by the Corporate Audit Committee

Practicing chartered accountants were asked the proportion of their clients' audit committees that performed each of the eight functions. Of the 60 respondents, 4 had no clients with audit committees, 2 failed to answer this question, and some had clients that issued no interim financial statements to shareholders or had an internal audit department. Consequently, only 54 chartered accountants responded to the question on functions 1, 2, 3, 4, and 6, 52 to function 5, and 45 to functions 7 and 8. These 54 respondents had a total of 170 clients, ranging from 1 to 10 clients, and with an average of 3.1 clients per respondent.

Table 5-15 summarizes the results of responses. All 54 respondents (100 percent) indicated that 50 percent or more of their clients' committees performed function 6, the review of the corporate annual financial statements before their submission to the board of directors for approval. Since this is required by law, it is expected that all committees would perform at least this function. Concerning item 3, 49 (90.7 percent) answered that 50 percent or more of their clients' committees performed this function, and 4 (7.4 percent) also answered that less than 50 percent performed it. Only 1 (1.9 percent) respondent indicated that neither of his two clients' committees performed this function. Regarding item 4, 30 (55.5 percent) indicated that 50 percent or more of their clients' committees performed this function, 11 (20.4 percent) reported less than 50 percent, and 13 (24.1 percent) replied with none. Also, it appears that the majority of these committees also performed function 2. The remaining four functions were performed by only some of these committees.

Corporate chief executive officers and members of audit committees also were asked, in connection with the effectiveness with which the committee performed the functions, which functions were not performed by their committees. The responses from both groups, as summarized in Tables H-6 and H-7 of Appendix H, reveal a pattern almost identical to that of the chartered accountants. Of the 101

TABLE 5-15

FUNCTIONS PERFORMED BY CORPORATE AUDIT COMMITTEES - PRACTICING CHARTERED ACCOUNTANTS

Functions	Function is Performed by						Total	
	50% or More		Less than 50%		None			
	No.	%	No.	%	No.	%	No.	%
1. Nominate the independent auditors	11	20.4	4	7.4	39	72.2	54	100.0
2. Discuss with the independent auditors, before the audit is completed, its scope, purpose, and the procedures to be included	23	42.6	12	22.2	19	35.2	54	100.0
3. Review with the independent auditors, on completion of the audit, their experience, any restrictions on their work, cooperation received, their findings, and their recommendations	49	90.7	4	7.4	1	1.9	54	100.0
4. Review with the independent auditors their evaluation of the company's internal control systems	30	55.5	11	20.4	13	24.1	54	100.0
5. Review interim financial reports to shareholders before these reports are approved by the board of directors	11	21.2	14	26.8	27	52.0	52	100.0
6. Review the corporate annual financial statements before their submission to the board of directors for approval	54	100.0	-		-		54	100.0
7. Review the scope of internal audit procedures with the chief internal auditor	3	6.7	8	17.7	34	75.6	45[a]	100.0
8. Review the reports of the internal audit staff	3	6.7	11	24.4	31	68.9	45[a]	100.0

(a) Seven respondents indicated that their clients did not have an internal audit department.

executive officers, 4 (4 percent) indicated that function 6 was not performed, 3 (2.9 percent) for function 3, and 6 (6 percent) for function 4. Similarly, of the 194 committee members, 3 (1.5 percent) indicated function 6 was not performed, 1 (.5 percent) for function 3, and 7 (3.7 percent) for function 4. The remaining functions were performed by at least some committees.

As might be expected, the three functions that are performed by most of the committees (as indicated in Tables H-6 and H-7 of Appendix H), are also the three most important functions, as discussed in the earlier subsections of this chapter. Also, most committees appear to perform at least three functions, and some probably perform all eight. Judging from the functions added by the respondents, as shown earlier, perhaps a few committees even perform more than the eight functions included in the questionnaire. Accordingly, it may seem reasonable to infer that audit committees perform a variety of duties.

The number of duties that an audit committee can take on and still be expected to discharge properly depends on many factors. The more important factors are the size of the committee, the competence of its members, and the amount of time devoted to its activities by the members. Therefore, the most desirable number of duties a committee should assume hinges on the circumstances in which it operates. However, in view of the fact that the size of the committee is usually small and that it meets only a few times a year, it is important to avoid burdening the committee with too many duties which may divert its full attention from more important matters and thereby may reduce its overall effectiveness.

Effectiveness of Functions Performed by the Corporate Audit Committee

Corporate chief executive officers, members of audit committees, and practicing chartered accountants were asked to evaluate the effectiveness (in terms of care and effort exercised) with which each of the eight functions was performed by the audit committee. They were to indicate "effective" or "ineffective." Also, they were asked to add any function they may wish. Tables 5-16, 5-17, and 5-18 summarize the responses of the three individual groups, Table 5-19 shows the summary of the individual groups, and Table 5-20 combines all the responses. The total number of respondents reported in these tables represent only those who responded whether the functions were effectively or ineffectively performed. Many respondents, ranging from 1 to 39 for chief executive officers, 1 to 53 for committee members, and 1 to 43 for practicing chartered accountants, indicated that the audit committees did not perform many of the functions, and therefore they were not in a position to express an opinion on the matter.

The majority of both chief executive officers and committee members found that all the eight functions were effectively performed. More than 90 percent of them felt that functions 3 and 6 were effective, and more than 80 percent believed this was true for function 4. Function 2 was considered effective by 75.7 percent of committee members compared with only 57.8 percent of chief executive officers.

TABLE 5-16

EFFECTIVENESS OF CORPORATE AUDIT COMMITTEE FUNCTIONS - CORPORATE CHIEF EXECUTIVE OFFICERS

Functions	Responses					
	Effective		Ineffective		Total[a]	
	No.	%	No.	%	No.	%
1. Nominate the independent auditors	33	63.5	19	36.5	52	100.0
2. Discuss with the independent auditors, before the audit is completed, its scope, purpose, and the procedures to be included	37	57.8	27	42.2	64	100.0
3. Review with the independent auditors, on completion of the audit, their experience, any restrictions on their work, cooperation received, their findings, and their recommendations	77	93.9	5	6.1	82	100.0
4. Review with the independent auditors their evaluation of the company's internal control systems	69	88.5	9	11.5	78	100.0
5. Review interim financial reports to shareholders before these reports are approved by the board of directors	38	67.9	18	32.1	56	100.0
6. Review the corporate annual financial statements before their submission to the board of directors for approval	75	92.6	6	7.4	81	100.0
7. Review the scope of internal audit procedures with the chief internal auditor	35	64.8	19	35.2	54	100.0
8. Review the reports of the internal audit staff	26	59.0	18	41.0	44	100.0

[a] This total accounts for those who responded either effective or ineffective. There is a large number of respondents, ranging from 3 to 39, who indicated that their committees did not perform any of these functions and therefore were not in a position to express an opinion. Appendix H, Table H-6 contains more details on this matter.

TABLE 5-17

EFFECTIVENESS OF CORPORATE AUDIT COMMITTEE FUNCTIONS - MEMBERS OF AUDIT COMMITTEES

Functions	Responses					
	Effective		Ineffective		Total[a]	
	No.	%	No.	%	No.	%
1. Nominate the independent auditors	64	66.0	33	34.0	97	100.0
2. Discuss with the independent auditors, before the audit is completed, its scope, purpose, and the procedures to be included	100	75.7	32	24.3	132	100.0
3. Review with the independent auditors, on completion of the audit, their experience, any restrictions on their work, cooperation received, their findings, and their recommendations	150	93.2	11	6.8	161	100.0
4. Review with the independent auditors their evaluation of the company's internal control systems	137	88.4	18	11.6	155	100.0
5. Review interim financial reports to shareholders before these reports are approved by the board of directors	80	69.0	36	31.0	116	100.0
6. Review the corporate annual financial statements before their submission to the board of directors for approval	149	95.5	7	4.5	156	100.0
7. Review the scope of internal audit procedures with the chief internal auditor	72	65.5	38	34.5	110	100.0
8. Review the reports of the internal audit staff	49	53.8	42	46.2	91	100.0

[a] This total accounts for those who responded either effective or ineffective. There is a large number of respondents, ranging from 1 to 53, who indicated that their committee did not perform many of these functions and therefore were not in a position to express an opinion. Appendix H, Table H-7, contains more details on this matter.

TABLE 5-18

EFFECTIVENESS OF CORPORATE AUDIT COMMITTEE FUNCTIONS - PRACTICING CHARTERED ACCOUNTANTS

Functions	Responses					
	Effective		Ineffective		Total[a]	
	No.	%	No.	%	No.	%
1. Nominate the independent auditors	13	81.3	3	18.7	16	100.0
2. Discuss with the independent auditors, before the audit is completed, its scope, purpose, and the procedures to be included	26	74.3	9	25.7	35	100.0
3. Review with the independent auditors, on completion of the audit, their experience, any restrictions on their work, cooperation received, their findings, and their recommendations	46	88.5	6	11.5	52	100.0
4. Review with the independent auditors their evaluation of the company's internal control systems	29	72.5	11	27.5	40	100.0
5. Review interim financial reports to shareholders before these reports are approved by the board of directors	16	64.0	9	36.0	25	100.0
6. Review the corporate annual financial statements before their submission to the board of directors for approval	48	90.6	5	9.4	53	100.0
7. Review the scope of internal audit procedures with the chief internal auditor	4	40.0	6	60.0	10	100.0
8. Review the reports of the internal audit staff	5	41.7	7	58.3	12	100.0

[a] This total accounts for those who responded either effective or ineffective. There is a large number of respondents, ranging from 1 to 43, who indicated that their clients' committees did not perform many of these functions and therefore were not in a position to express an opinion. Appendix H, Tables H-8 and H-9, contain more details on this matter.

The remaining functions were generally considered effective, the percentage for both chief executive officers and committee members ranging from 53.8 percent for function 8 to 69 percent for function 5.

The responses from chartered accountants present a very similar picture. The majority of them felt that all functions except 7 and 8 were effectively performed. More than 90 percent found that function 6 was effective, 88.5 percent for function 3, and 72.5 percent for function 4, which is consistent with the results of both chief executive officers and committee members. Interestingly, 81.3 percent considered function 1 and 74.3 percent considered function 2 as effective, even though these two functions were not performed by many and were relatively low in the importance ranking. Only slightly over 40 percent believed functions 7 and 8 were effectively performed.

Table 5-19 presents a summary of the responses of the three individual groups relating to the effective performance of committee functions. As noted in earlier discussions, there appears to be no significant difference in the results from these groups. In fact, there are more similarities than dissimilarities reported by the individual groups.

When the results of the three groups are combined, as presented in Table 5-20, the three functions considered to be performed more effectively are functions 6 (94 percent), 3 (92.5 percent), and 4 (86 percent). The others effectively performed ranged from 54.4 for function 8 to 70.6 percent for function 2. It appears that function 6, as required by law, is the most effective. Moreover, as might be expected, the three most important functions, namely, 3, 4,

TABLE 5-19

EFFECTIVENESS OF CORPORATE AUDIT COMMITTEE FUNCTIONS--
SUMMARY OF INDIVIDUAL GROUPS

Functions	Responses for Functions Effectively Performed					
	CEO		MAC		CA	
	No.	%	No.	%	No.	%
1. Nominate the independent auditors	33	63.5	64	66.0	13	81.3
2. Discuss with the independent auditors, before the audit is completed, its scope, purpose, and the procedures to be included	37	57.8	100	75.7	26	74.3
3. Review with the indepdendent auditors, on completion of the audit, their experience, any restrictions on their work, cooperation received, their findings, and their recommendations	77	93.9	150	93.2	46	88.5
4. Review with the independent auditors their evaluation of the company's internal control systems	69	88.5	137	88.4	29	72.5
5. Review interim financial reports to shareholders before these reports are approved by the board of directors	38	67.9	80	69.0	16	64.0
6. Review the corporate annual financial statements before their submission to the board of directors for approval	75	92.6	149	95.5	48	90.6
7. Review the scope of internal audit procedures with the chief internal auditor	35	64.8	72	65.5	4	40.0
8. Review the reports of the internal audit staff	26	59.0	49	53.8	5	41.7

Note: CEO = Chief executive officer;
MAC = Member of audit committee; and
CA = Practicing chartered accountant.

TABLE 5-20

EFFECTIVENESS OF CORPORATE AUDIT COMMITTEE FUNCTIONS - ALL THREE GROUPS COMBINED

Functions	Responses: Effective No.	Effective %	Ineffective No.	Ineffective %	Total[a] No.	Total[a] %
1. Nominate the independent auditors	110	66.7	55	33.3	165	100.0
2. Discuss with the independent auditors, before the audit is completed, its scope, purpose, and the procedures to be included	163	70.6	68	29.4	231	100.0
3. Review with the independent auditors, on completion of the audit, their experience, any restrictions on their work, cooperation received, their findings, and their recommendations	273	92.5	22	7.5	295	100.0
4. Review with the independent auditors their evaluation of the company's internal control systems	235	86.0	38	14.0	273	100.0
5. Review interim financial reports to shareholders before these reports are approved by the board of directors	134	68.0	63	32.0	197	100.0
6. Review the corporate annual financial statements before their submission to the board of directors for approval	272	94.0	18	6.0	290	100.0
7. Review the scope of internal audit procedures with the chief internal auditor	111	63.7	63	36.3	174	100.0
8. Review the reports of the internal audit staff	80	54.4	67	45.6	147	100.0

[a] This total accounts for those who responded either effective or ineffective.

and 6, are also the most effective. These findings are somewhat similar to the Mautz and Neumann study, in which they conclude: "In general, those functions that are considered of primary importance are performed with some degree of effectiveness although the overall rating of audit committees for effective performance is not high"[2] (emphasis added). However, it must be noted that most respondents in this study considered effective performance to be rather high.

Factors for an Effective Corporate Audit Committee

Corporate chief executive officers, members of audit committees, practicing chartered accountants, and financial analyts were asked to rank five factors for an effective corporate audit committee on the basis of what they thought the relative importance should be. The details of responses for each individual group are presented in Tables I-1, I-2, I-3, and I-4 in Appendix I. The results of ranking for each of the four groups are summarized in Table 5-21.

It seems that the opinion concerning the relative importance of these five factors is quite consistent among the four groups. Competence of the audit committee members unanimously was regarded as the most important. A set of well-established objectives of the audit committee is the second most important, full cooperation and support of the corporate chief executive officer is third. A set of well-established functions of the audit committee is fourth, and full cooperation and support of the board of directors is last.

Since the success of human endeavors must necessarily depend on the ability of the people involved, it is perhaps not overly surprising that the competence of committee members is considered to be

TABLE 5-21

RANKING OF THE FACTORS FOR AN EFFECTIVE CORPORATE AUDIT COMMITTEE - ALL FOUR GROUPS

Factors	Ranking by				Overall	
	CEO	MAC	CA	FA	Total points	Rank[a]
Competence of the audit committee members	1	1	1	1	931.0	1
Full cooperation and support of the board of directors	5	5	4	3	1,705.5	5
Full cooperation and support of the corporate chief executive officer	2	3	5	4	1,557.5	3
A set of well-established objectives of the audit committee	3	2	2	2	1,271.0	2
A set of well-established functions of the audit committee	4	4	3	5	1,607.5	4

Note: CEO = Chief executive officer;
MAC = Member of audit committee;
CA = Practicing chartered accountant; and
FA = Financial analyst.

[a] The ranking is based on the total points computed for each factor. The total points are computed by multiplying the number of the rank indicated by the respondent by the number of responses in that rank. Therefore the factor with the lowest total points is the most important. For further details, see tables in Appendix I.

the most important. Also, a set of well-established objectives or purposes of the committee tends to minimize potential conflicts and misunderstanding among management, committee members, and external auditors, as discussed in chapter II, and therefore should be very important. Full cooperation and support of the chief executive officer is rather important because the committee seldom can function effectively in an indifferent or unfriendly environment. Similar to the discussion on purposes, a set of well-established functions is important. The audit committee is a subcommittee of the board of directors, and thus it must have the board's cooperation and support.

These findings differ significantly from the conclusions reached in the Mautz and Neumann study. It states:

> The effectiveness of any corporate audit committee appears to depend more upon the personalities involved than upon any other variables. The chief executive officer's approach to corporate governance is most important, especially as displayed in his use of committees of the board of directors. Only slightly less important is the attitude of the chief financial officer toward a committee whose activities may impinge upon the duties and prerogatives of his own office. Finally, the competence, energy, and enthusiasm of members of the committee itself, and their ability to work with officers and employees of the company without appearing to encroach upon operating responsibilities, have much to do with defining the scope and effectiveness of audit committee activities.[3]

According to Mautz and Neumann, the cooperation and support of the chief executive officer is the most important factor for an effective audit committee, and the competence of committee members is the third most important. Perhaps the difference between this study and that of Mautz and Neumann is due to the difference in the data upon which the conclusions were drawn. The data for this study are based on the questionnaire responses, while Mautz and Neumann apparently derived their conclusions from interview data. Another reason is that the findings of this study are based on what the relative importance of the factors should be, and the Mautz and Neumann study probably is based on what the respondents believe the factors actually are.

Benefits of an Effective Corporate Audit Committee

The value of the corporate audit committee depends upon the benefits that it provides. Unless it can contribute tangible benefits to the parties associated with it, the committee's existence lacks substance. The following have been suggested as principal benefits: (1) an added assurance to financial statement users as to the objectivity of corporate financial statements;[4] (2) a reinforcement of the corporation's external auditor's independence;[5] (3) an increased attention to the audit and control functions at the director's level;[6] and (4) an added protection for the directors of the corporation, especially for the nonofficer directors, against potential litigation concerning the due care they exercise in the fulfillment of their responsibilities.

Corporate chief executive officers, members of audit committees, practicing chartered accountants, and financial analysts were asked to indicate whether an effective audit committee can contribute these and any other benefits which they might wish to add. In addition, chartered accountants were asked the proportion of their clients which they believe has realized these benefits.

Table 5-22 summarizes the responses of the four individual groups. It shows that over 80 percent of the respondents in each

TABLE 5-22

BENEFITS OF AN EFFECTIVE CORPORATE AUDIT COMMITTEE--
SUMMARY OF INDIVIDUAL GROUPS

Benefits	Percentage of Yes Responses			
	CEO	MAC	CA	FA
1. Gives added assurance to users of financial statements as to the objectivity of corporate financial statements	73.0	72.0	61.0	67.0
2. Reinforces the independence of the corporation's external auditors	67.0	80.0	90.0	64.0
3. Results in increased attention to the audit and control functions at the director's level	87.0	84.0	97.0	89.0
4. Provides added protection for the directors of the corporation, especially for the nonofficer directors, against potential litigation concerning the due care they exercise in the fulfillment of their responsibilities	77.0	80.0	70.0	80.0

Note: CEO = Chief executive officer;
MAC = Member of audit committee;
CA = Practicing chartered accountant; and
FA = Financial analyst.

group indicated that an effective audit committee would increase attention paid to the audit and control functions at the director's level. About 80 percent of the respondents in each group also believed that it would provide added protection for directors against potential litigation concerning the due care they exercise in the fulfillment of their responsibilities. However, even though the majority in each group felt that it would reinforce the independence of the auditors, the chief executive officers (67 percent) did not appear to be as certain as the members of audit committees (80 percent) and the practicing chartered accountants (90 percent). On the other hand, while the majority in each group indicated that the committee gave added assurance to users of financial statements as to the objectivity of corporate financial statements, the chartered accountants (61 percent) appeared to be less sure than both the chief executive officers (73 percent) and members of audit committees (72 percent).

Table 5-23 shows that the majority of respondents felt that an effective audit committee can, indeed, contribute these benefits. Moreover, the majority of respondents in each of the four groups believed that this was so, as exhibited in Table J-1 of Appendix J. Of the 480 respondents, 422 (88 percent) felt that an effective committee can result in increased attention to the audit and control functions at the director's level. Such a contribution is significant, as noted by the Honourable S. H. S. Hughes in the Atlantic Acceptance report: "A thorough understanding of accounting problems and audit procedures has not hitherto been considered one of the required accomplishments of company directors, and it is more than ever

TABLE 5-23

BENEFITS OF AN EFFECTIVE CORPORATE AUDIT COMMITTEE - ALL FOUR GROUPS COMBINED

Benefits	Responses							
	Yes		No		No Responses		Total	
	No.	%	No.	%	No.	%	No.	%
Gives added assurance to users of financial statements as to the objectivity of corporate financial statements	334	69.6	132	27.5	14	2.9	480	100.0
Reinforces the independence of the corporation's external auditors	356	74.0	112	23.3	12	2.7	480	100.0
Results in increased attention to the audit and control functions at the director's level	422	88.0	52	10.8	6	1.2	480	100.0
Provides added protection for the directors of the corporation, especially for the nonofficer directors, against potential litigation concerning the due care they exercise in the fulfillment of their responsibilities	375	78.1	92	19.1	13	2.8	480	100.0

necessary that it should be so."[7] In another area, 375 (78.1 percent), including 27 of the 37 lawyers who are committee members, believed that the committee can provide added protection for the directors of the corporation, especially for the nonofficer directors, against potential litigation concerning the due care they exercise in the fulfillment of their responsibilities. It also was believed by 356 (74 percent), including 53 of the 60 chartered accountants, that it reinforces the independence of the corporation's external auditors. On the matter of added assurance to users of financial statements as to the objectivity of corporate financial statements, 334 (69.6 percent) believed this to be so.

One major conclusion that can be drawn from these results is that an effective audit committee can, in the opinion of the respondents, contribute tangible benefits to a variety of parties, among them the directors, external auditors, users of financial statements, and management.

However, a more pertinent and important question is whether these benefits are actually realized. Table 5-24 shows that 34 (56.7 percent) of the 60 chartered accountants found most of their clients' committees did realize the benefits, 9 (15 percent) for some clients, and 7 (11.7 percent) for a few clients. Only 4 (6.7 percent) found that no clients realized such benefits. When the results are analyzed in terms of number of clients, it is revealed that most of the 104 (61.2 percent) of the 170 clients realized the benefits, 30 (17.6 percent) for some clients, and 25 (14.7 percent) for a few clients. Only 8 (4.7 percent) clients did not realize such benefits.

TABLE 5-24

BENEFITS REALIZED BY AN EFFECTIVE CORPORATE AUDIT COMMITTEE - PRACTICING CHARTERED ACCOUNTANTS

Benefits realized by	Responses		Clients[b]	
	No.	%	No.	%
Most clients	34	56.7	104	61.2
Some clients	9	15.0	30	17.6
Few clients	7	11.7	25	14.7
No clients	4	6.7	8	4.7
Not answered	2	3.3	3	1.8
Not applicable[a]	4	6.6	0	0
	60	100.0	170	100.0

[a] These four respondents had no clients with an audit committee and therefore did not answer this part of the questionnaire.

[b] The respondents were asked to indicate the number of clients they served.

Accordingly, it appears that the majority of the clients' committees, in the opinion of the practicing chartered accountants, have realized at least some if not all four principal benefits. Furthermore, one respondent reported that some of his clients' voluntary audit committees (that is, not required by law) also realized these benefits.

The following are typical examples of the benefits added by respondents to the questionnaire. They can be classified into six categories:

1. Enhances communication and access between external auditors and directors:

   Provides a more effective vehicle for a dialogue between external auditors and directors;

   Results in a closer liaison between directors and external auditors;

   Provides a ready access to directors for the [external] auditors and vice versa; and

   Allows an open and frank disclosure by the [external] auditors directly to the board.

2. Enhances credibility and objectivity of financial reporting:

   Provides better financial reporting, more effective control systems, and better financial planning;

   Provides additional objective judgment on questions of accounting policy and financial statement presentation;

   Provides additional approval of management action through emphasizing financial matters;

   Prevents the "window dressing" of financial results by operating management;

   Ensures exposure of any suppression of information or procedures by management; and

Provides the vehicle for an objective assessment of management's performance by directors.

3. Reinforces auditor's independence:

Gives auditor greater sense of independence;

Ensures that the auditors can have access to all pertinent data they require;

"There is a tendency for external auditors to get chummy with internal finance departments, and at times avoid seeing the obvious, thus leaving the chief executive officer unprotected. The audit committee fills a badly needed gap here. I have seen this in other companies."

4. Provides protection for directors and stresses their responsibilities:

Provides an opportunity for the outside or nonofficer directors to become more involved with the reviewing of the company's affairs;

Provides a useful forum for outside directors to discuss the affairs of the company among themselves;

Provides outside directors a better "feel" for the problems and prospects of the company;

Enables directors to be more competent to set remuneration and to shape appropriate incentive programs;

Gives added assurance as to the competence of the chief executive officer;

Compels directors to scrutinize accounting principles and procedures as well as results of operation;

Lets directors know who is responsible for the review of the audit; and

Provides additional information to directors regarding the results of the audit.

5. Provide discipline value:

Greater in-depth study by the audit committee keeps management more alert and more responsive;

Keeps everyone involved "honest";

Keeps independent auditors and internal auditors from being sloppy or taking anything for granted; and

Encourages the adoption of suggestions made in the "Post Audit Letter" by the external auditor.

6. Other:

Gives added assurance to the board and the chief executive officer as to the competence and integrity of the treasurer/comptroller function;

Safeguards the interest of shareholders in management-control corporations;

Provides an excellent educational experience for directors; and

"I feel that these functions [of the compensation committee] are performed better now and were the evolution of the audit committe formation."

Apparently, some respondents felt that an effective audit committee can provide a wide range of beneficial effects, as evidenced by the above examples. However, some respondents appeared to be concerned about the tendency to expect too much from the committee and about the responsibility of the board members as a whole relative to those of the committee members. For example, the following are comments from three committee members:

> Too much reliance should not be put on the audit committee by other directors. The latter should quiz audit committee members thoroughly and should get the minutes.
>
> The formation of an audit committee can in no way absolve the board of directors from taking reasonable care in the management of the company. In my opinion one of the most important functions of a board of directors is to ensure that the officers of the company have the ability, integrity, and a sense of what is morally correct in the light of present-day business conditions.
>
> Audit committees do not relieve board members of their responsibilities. They only help them discharge them better.

It seems that other board members must scrutinize the activities of the audit committee if they are to discharge their proper responsibilities. To some extent, the audit committee perhaps may have provided some discipline value here.

Similarly, the discipline value for the practicing chartered accountants is very real. The partners of two major accounting firms indicated that they spent a significant amount of time preparing for the meetings with audit committees. Furthermore, they usually required two partners, one of them not in charge of the audit, to attend these meetings in addition to the senior field audit staff. The reason was that these two partners probably could be able to resolve major issues arising from the meeting which required immediate resolution and to provide a more objective opinion in the discussions by the partner who was not involved in the audit of this client. Perhaps another reason was to give other partners more exposure and experience in dealing with such committees.

In summary, it seems reasonable to conclude not only that the audit committee can provide tangible benefits or advantages as discussed here and in chapter II, but also that the majority of committees have realized them. Therefore, the audit committee is, indeed, performing a useful function in the corporation.

Mautz and Neumann, based primarily on information obtained through interviews, conclude that corporate audit committees can provide the following possible benefits:

> Increased attention to the audit function;
> Reinforcement of the independence of the company's certified public accountants;
> An added protection for shareholders and especially for the directors of the company;

Added leverage for the financial management of the company in effecting necessary improvements; and

More effective accomplishment of specific assignments.[8]

The Role Played by the Corporate Audit Committee in Resolving Major Disagreements between the External Auditor and Management

To determine the extent to which the audit committee is instrumental in settling major disputes between the external auditor and management, corporate chief executive officers, members of audit committees, and practicing chartered accountants were asked whether there had been major disagreements. If so, they were asked if these were resolved by the audit committee. In addition, respondents were asked to describe the specific issues involved.

Table 5-25 shows that major disagreements between the external auditor and management were relatively few and that the majority of them were resolved by the audit committee. Some were handled by the audit committees and management together, and others were handled by the board of directors. Specifically, of the 13 major disagreements reported by chief executive officers, 9 were resolved by audit committees. Of the 23 reported by committee members, 18 were handled by audit committees, 2 by committees and management together, and 3 by boards of directors. Of the 14 reported by chartered accountants, 11 were dealt with by committees, 2 by management, and 1 was unresolved.

Interestingly, the same disagreements were reported by the three groups. Apparently, these respondents were reporting disagreements from the same company. The following summarizes the major issues identified by the respondents:

TABLE 5-25

MAJOR DISAGREEMENTS BETWEEN THE EXTERNAL AUDITOR AND THE MANAGEMENT

	Responses		
	Yes		
	CEO	MAC	CA
a. Number of major disagreements between the external auditor and the management of the corporation in the past two years.	13	23	14
b. Number of these disagreements resolved by the corporate audit committee?	9	23*	11

*Two of these disagreements were resolved by the audit committees and managements. Three were resolved by the board of directors. There is probably some double counting here because they are accounted for by member and not by committee.

Consolidation of a subsidiary company;

Provision for income tax liability in dispute;

Method of disclosure of effect of foreign currency valuation;

Consolidation of a foreign subsidiary and effect on parent company's financial statements;

Basis of accounting for investment in a joint venture;

Method of accounting for capital expenditure for land development;

Method of inventory valuation;

Reporting and treatment of outstanding litigation;

Accounting for depreciation, deferred expenses, and presentation of extraordinary items;

Auditors' recommendation to upgrade the financial staff (implemented only after strong support from the committee); and

Change in accounting principles and procedures and audit matters (resulting in a recommendation by the audit committee to change auditors).

General Effectiveness of the Corporate Audit Committee

Corporate chief executive officers, members of audit committees, chartered accountants, and financial analysts were asked whether they would agree or disagree with the following statement:

"In general, corporate audit committees are effective in fulfilling their responsibilities."

Table 5-26 summarizes the responses from the four groups. It shows that the majority, 331 (69 percent) of the 480 respondents, agreed to the above statement, only 52 (10.8 percent) disagreed, and 97 (20.8 percent) did not respond. Specifically, 82 (81.2 percent) of the 101 chief executive officers, 146 (75.3 percent) of the 194 members of audit committees, and 47 (78.3 percent) of the 60 chartered accountants felt that, in general, corporate audit committees are effective in fulfilling their responsibilities. Since 53 (42.4 percent) of the 125 financial analysts did not express an opinion due to lack of evidence upon which to base their opinions, only 56 (44.8 percent) agreed to the above statement, and 16 (12.8 percent) disagreed. Even though the majority of those who expressed an opinion felt that audit committees were generally effective, the results of this group are less conclusive and should be read with caution because of the large number of respondents who had no opinion on the matter.

TABLE 5-26

GENERAL EFFECTIVENESS OF CORPORATE AUDIT COMMITTEES - ALL GROUPS

	Responses							
	Agree		Disagree		No Response		Total	
	No.	%	No.	%	No.	%	No.	%
Chief executive officers	82	81.2	8	7.9	11	10.9	101	100.0
Members of audit committees	146	75.3	20	10.3	28[a]	14.4	194	100.0
Practicing chartered accountants	47	78.3	8	13.3	5[b]	8.4	60	100.0
Financial analysts	56	44.8	16	12.8	53[c]	42.4	125	100.0
	331	69.0	52	10.8	97	20.8	480	100.0

[a]The majority in this group indicated the lack of sufficient information or experience to express a firm opinion.

[b]Four had no clients with audit committees and therefore did not respond.

[c]The majority in this group indicated the lack of evidence upon which to base their opinions.

It seems evident that the great majority of the respondents who have had direct or intimate involvement with audit committees, namely, chief executive officers, committee members, and chartered accountants, agreed that audit committees were generally effective. Some respondents believed that audit committees would become more effective as the members become more experienced. For example, a chartered accountant, who is a national director of auditing standards of his firm and thus has considerable contact with audit committees, comments: "Our general conclusion is that audit committees are turning out to be more useful and more effective than we had imagined and, as you can well imagine, we were fairly strong advocates [of such committees]." Similarly, some respondents indicated that their committees, while not particularly effective at the time, were making progress and would eventually become effective. On the other hand, a number of respondents suggested that because the committees were so recent their effectiveness in discharging responsibilities should be considered tentative and could only be proven over a longer period of time.

Usefulness of the Corporate Audit Committee

All respondents were asked whether they considered corporate audit committees to be useful to them as corporate chief executive officers, members of audit committees, practicing chartered accountants, and financial analysts. Table 5-27 shows that 450 (94 percent) of the 480 respondents considered such committees useful; specifically, 223 (47 percent) respondents felt that the committees were useful for all corporations, and 204 (43 percent) for only those corporations

TABLE 5-27

USEFULNESS OF CORPORATE AUDIT COMMITTEES
TO THE FOUR GROUPS

Corporate Audit Committee Useful for	Responses								Total	
	CEO		MAC		CA		FA			
	No.	%	No.	%	No.	%	No.	%	No.	%
All corporations	46	45	98	50	14	23	65	52	223	47
Only those corporations offering securities to the public	40	40	85	45	36	60	43	34	204	43
No corporations	8	8	4	2			7	5	19	4
Other										
For large corporations and large boards of directors	3	3	2	1	7	11	2	2	14	3
For all corporations except family held corporations	1	1	-		1	0			2	0
For all corporations where there is substantial nonmanagement shareholder interest	1	1	2	1	1	0	1	1	5	1
For corporations with outside directors			1	0			1	1	2	0
No response	2	2	2	1	1	0	6	5	11	2
	101	100	194	100	60	100	125	100	480	100

Note: CEO = Chief executive officer;
MAC = Member of audit committee;
CA = Practicing chartered accountant; and
FA = Financial analyst.

offering securities to the public. Only 19 (4 percent) of the 480 respondents thought the committees were useful for no corporation.

Some respondents pointed out that audit committees were both new and evolving and that "they have been getting more useful and competent each year." In fact, a few of them were surprised that the committees had turned out to be more useful than they had expected. However, those respondents who indicated that audit committees were useful for no corporations usually based their opinion on unfavorable experience with ineffective committees, as reflected by the following statements:

> My response is based on one client required to have an audit committee under the [Ontario] Business Corporations Act. This audit committee performs its function in a very perfunctory manner.
>
> In my experience audit committees in Canada have been established primarily to satisfy compliance with the law. They are not generally viewed as a beneficial functioning body in the corporation management. In most instances, the committees have tended to provide an after-the-fact review function with no follow up recommendations for corrective action.

However, it seems fair to conclude that an overwhelming majority of the respondents considered audit committees to be useful for a variety of corporations.

Effect of the Corporate Audit Committee on Financial Reporting

It has been suggested that the corporate audit committee can give added assurance to financial statement users concerning the objectivity of corporate financial statements, as discussed in chapter II. Accordingly, this issue was raised with the financial analysts. They not only are frequent users of financial statements but also are proxies for shareholders, and as disclosed in chapter III, a number of them are directly involved in securities investment for their companies. Specifically, they were asked the following questions:

> Do you feel that the annual financial statements are more reliable for those corporations which have audit committees?
>
> Do you feel that an <u>ineffective</u> corporate audit committee has an adverse effect on the credibility of the corporation's financial statements?

Table 5-28 reveals that the majority, or 71 (56.8 percent), of the 125 financial analysts felt that the statements were more reliable for those corporations with audit committees. Only 40 (32 percent) felt that the statements were not more reliable, and 14 (11.2 percent) expressed no opinion or did not respond.

Those who felt that the statements were more reliable supported their position with the following comments:

> With another group of individuals paying closer attention, the financial statements should be more reliable.
>
> Nonofficer directors [who are committee members] will be less willing to condone ultra-liberal or shady accounting policies.
>
> Auditors have greater freedom of objectivity than when they report only to operating officers. Also, operating officers are less likely to attempt to bury adverse items.
>
> It provides a greater effort to achieve objectivity and to properly explain and/or resolve questions of accounting and other important matters.
>
> It is another independent check on the company's own procedures and controls and on the auditors' access to all matters he deems important.
>
> Because major accounting policies and financial statement presentation and disclosure will have been reviewed at the director's level with the external auditors in attendance.

TABLE 5-28

EFFECT OF THE CORPORATE AUDIT COMMITTEE ON CORPORATE FINANCIAL STATEMENTS - FINANCIAL ANALYSTS

	Responses									
	Yes		No		No Basis for an Opinion		No Response		Total	
	No.	%	No.	%	No.	%	No.	%	No.	%
a. The annual financial statements are more reliable for those corporations which have audit committees	71	56.8	40	32.0	10	8.0	4	3.2	125	100.0
B. An ineffective corporate audit committee has an adverse effect on the credibility of the corporation's financial statements.	41	32.8	74[a][b]	59.2	5	4.0	5	4.0	125	100.0

[a]Six respondents answered that there would be an adverse effect if the ineffectiveness were known.

[b]Twenty respondents answered no because there was no reasonable means to ascertain whether an audit committee is ineffective.

> I feel this is an important link and watchdog between three distinct groups--the auditors, directors, and management--for the benefit of the shareholders and investors.

> My experience has been that statements which have passed through audit committees are more detailed and items are better explained.

Those who felt that the statements were not more reliable generally stated that they relied on the external auditors.

> With independent and competent auditors, the financial statements should be reliable as they are. Audit committees, however, will enable the directors to understand better the financial position of the corporation.

> Because accounting firms are generally quite reliable.

> Competent auditors should provide reliable reports.

> I believe that the audit committee relies on the independent auditors. Consequently, all it achieves is to enable the independent auditor to have access to nonmanagement directors with whom to discuss serious difficulties.

However, a number of respondents pointed out that the lack of information concerning audit committees in the annual report made it practically impossible to assess the situation intelligently. Moreover, they suggested that reliability of statements depends much on the effectiveness of the committees.

> As an outside shareholder, I have no idea how strong the audit committee is or of its activities and so I couldn't judge [the added reliability of the statements].

> Outsiders have no knowledge as to whether the audit committee is effective or not.

> It depends on the make-up and functions, etc., of the committee. It is difficult to generalize [whether the statements are more reliable].

> Outsiders seldom know what the audit committees actually do or have done.

> Financial statements do not always reveal if audit committees operate.

In general, then, the majority of financial analysts believed that annual financial statements were more reliable for those corporations with audit committees, despite the absence of information on the committees' activities and the lack of a practical basis for ascertaining their effectiveness.

Table 5-28 reveals that 74 (59.2 percent) of the 125 financial analysts felt that an ineffective audit committee had no adverse effect on the credibility of the corporation's financial statements, and only 41 (32.8 percent) felt it had an adverse effect. However, 20 of the respondents in the former group explained that since there was no practical means for them to ascertain whether the committee was ineffective, there could not be any adverse effect:

> The outsider has no way of knowing whether an audit committee is effective or ineffective.
>
> It is highly unlikely that external readers of the corporation's financial statements will be aware that the audit committee of a particular company is ineffective.
>
> It is impossible for anyone outside of the corporation to determine whether the audit committee is effective or ineffective. It is unlikely that analysts or shareholders would know who is on the committee.
>
> I don't know how one tells the audit committee is ineffective. Speaking from the outside, I don't really even know what it actually does.

In addition, 6 respondents indicated that there would be an adverse effect if the ineffectiveness of the committee were known. For example:

> If recognized as ineffective, this amplifies the feeling of a possible cover-up, indicating management's reluctance to report in a straight-forward manner to its shareholders.
>
> It makes one assume that the company has something to hide.

The image of such a committee will be affected, and, when generally realized, a credibility gap [between users of financial statements and management] will emerge.

Some of those who felt that there was no adverse effect on financial statements explained their position this way:

There is no way for an outsider to judge; also, the fact that a watchdog has no teeth doesn't mean that "something" is taking place.

We rely on the independence and competence of the [external] auditors.

On the other hand, those who felt that the committee's ineffectiveness had an adverse effect on the credibility of corporate financial statements argued that it would create an atmosphere of suspicion and misleading expectations on the part of investors toward corporate management:

An ineffective committee is worse than no committee at all. It is likely to arouse more adverse suspicions regarding the credibility of financial statements since it could appear as a deliberate smoke screen thrown up by management.

This situation may create a false sense of security.

To an analyst or outside shareholder, the impression developed would be a white wash job and would reflect the ineffectiveness of nonofficer directors.

If this part of the corporation is ineffective, why might this not be the case for the whole organization?

Apparently, the lack of information on the activities of the audit committee and particularly on the absence of a practical means by which external financial statement users can intelligently assess its effectiveness probably has contributed to a rather mixed and tenuous reactions from financial analysts as to the effect of the committee on corporate financial reporting. For example, if the ineffectiveness of an audit committee were known, many of those who believed that there would be no adverse effect might well take a different position, as discussed earlier. Consequently, generalizations from these data should be read with caution, and a careful examination of the data is recommended. In general, however, it can be said that the annual financial statements, in the opinion of the financial analysts, are more reliable for those corporations with audit committees than for those without. Also, it is uncertain whether an ineffective audit committee has an adverse effect on the credibility of the company's financial statements, especially in the absence of evidence to support it. Yet it seems reasonable to infer that if the ineffectiveness of the committee is known, there would be some adverse effect on the credibility of financial reporting of the corporation as a whole.

FOOTNOTES--CHAPTER V

1. Mautz and Neumann, Corporate Audit Committees, p. 27.

2. _Ibid._, p. 24.

3. _Ibid._, p. 95.

4. AICPA Executive Committee, "Statement on Audit Committees of Boards of Directors," _Journal of Accountancy_ (September, 1967): 10.

5. Mautz and Neumann, _op. cit._, p. 46.

6. _Ibid._, p. 46.

7. Ontario, Royal Commission, _Report of the Royal Commission--Atlantic Acceptance Corporation Limited_ (Toronto, 1969), III, 1512.

8. Mautz and Neumann, _op. cit._, p. 46.

9. AICPA Executive Committee, "Statement on Audit Committees of Boards of Directors," _op. cit._

CHAPTER VI

SUMMARY OF FINDINGS, CONCLUSIONS, AND RECOMMENDATIONS

Introduction

This chapter focuses on the following areas: (1) summary of findings, highlighting the research findings discussed in chapters IV and V; (2) conclusions, based on the research data presented throughout this study and particularly in chapters IV and V; (3) recommendations, whose primary objective is to improve the committees' overall usefulness and effectiveness; and (4) suggestions for further research, pointing out the reasons and need for similar research in the future.

Summary of Findings

The following summary highlights the research findings discussed in chapters IV and V.

1. The size of the corporate audit committee is typically small, ranging from the statutory minimum of 3 to 8 members, with an average of less than 4 members per committee. Three-member committees are the most common, probably reflecting the tendency of companies to conform to the statutory minimum and perhaps the desire to keep membership small in order to make in-depth discussions more effective and efficient. Likewise, the size of the board of directors is also generally small, ranging from 5 to 18 members, with the average being

8. Nearly 85 percent of the boards have 5 to 10 members. There is no apparent relationship between the size of the committee and the size of the board, and there is also no observable committee or board size pattern unique to any particular industry.

2. The number of meetings held annually by an audit committee depends not only on the size and nature of business of the company in which the committee operates, but also on the scope of the committee's activities. Although the number of committee meetings held ranges from zero to six, the committee generally meets once or twice a year. Except in two cases, it meets with the external auditors at least once, and sometimes as many as six times. Committees which meet only once usually hold their meeting prior to the annual board of directors meeting and before the publication of the annual financial statements. Committees which meet more than once generally hold their meetings prior to or during the annual audit, upon completion of the audit, prior to the publication of quarterly or interim financial statements, and before the board's final approval of the annual financial statements. Most of these meetings are held on a regularly scheduled basis.

3. A great majority of the committees keep minutes of their meetings and forward them to the board of directors and/or the chief executive officers. In some cases, the minutes also are forwarded to the external auditors and chief financial officers of the company. Some committees make a verbal report to the board of directors, and still others report only their major problems to the board.

4. The proportion of company officers on their own audit committees is less than 30 percent, reflecting the general compliance of companies with the statutory requirement to have a majority of nonofficer directors on their committees. About one-half of these officers are chief executives who hold the position of chairman of the board of directors or president, the remaining half are vice-chairmen of the boards, vice-presidents (financial and other), secretary-treasurers, and treasurers or controllers.

5. The principal occupations of nonofficer members of the committees include business executives, lawyers, investment bankers and dealers, and financial and business consultants. One-half of these members are represented equally by lawyers and presidents of other companies. The other half are represented primarily by investment bankers and dealers, chairmen and vice-chairmen of boards of directors, financial and business consultants, directors and professional directors, and retired business executives.

6. Many individual members serve on more than one audit committee, and some serve on as many as six. A great majority of committee members have served for at least two years, and a few have served for five or six years.

7. The majority of corporate chief executive officers, members of audit committees, practicing chartered accountants, and financial analysts feel that management representation on audit committees is desirable. Those who have direct experience with the committees, namely, chief executive officers, committee members, and chartered accountants, favor it more than those who do not have such

experience. The desire to have management representation probably stems from (1) the need to avoid and prevent possible misunderstanding and suspicion among management, committee members, and auditors, and (2) the need to provide management with an opportunity to present its opinions on the matters discussed and to facilitate in-depth discussions because of its familiarity with the details of these matters.

8. Both the corporate chief executive officers and audit committee members feel that it is not desirable to disclose the names of committee members in the corporate annual report, although the latter feel less strongly about it. The chartered accountants and financial analysts, on the other hand, believe that such disclosure is desirable, and the latter appear to feel more strongly about it than the former.

9. Only 6 of the 101 chief executive officers reported that their companies had an audit committee prior to 1971, the year in which the legal requirement came into force, and one company changed its committee membership from all officers to a majority of nonofficers to conform to the requirement of the Ontario act. The reason for establishing such a committee was primarily to inject a third party into the normal auditor-management relationship.

10. The audit committee is considered to be a flexible and adaptive organizational unit that can serve a variety of purposes. As such, there is a divergence of opinion on the exact order of importance concerning its purposes. The two most important of the eight purposes are: (1) to relieve the board of directors, as a whole, of details regarding the review of the results of the

independent audit; and (2) to serve as an independent review function of the company's operations and its annual financial statements before their submission to the board of directors for approval. In addition, the following purposes, listed in order of importance, are considered important:

a. To give attention to the internal control functions of the company;

b. To relieve the board of directors, as a whole, of details regarding the review of the annual financial statements;

c. To give additional attention to the audit function performed by the independent auditors; and

d. To provide nonofficer directors with direct and more personal contact with the independent auditors.

However, there is unanimous agreement that the following purposes are not important:

To relieve the board of directors, as a whole, of details regarding (1) the nomination of the independent auditors, and (2) the arrangements for the independent audit.

11. There is less disparity of opinion regarding the ranking of functions than the ranking of purposes of the audit committee. The three most important functions are:

a. Review with the independent auditors, on completion of the audit, their experience, any restrictions on their work, cooperation received, their findings, and their recommendations;

b. Review with the independent auditors their evaluation of the company's internal control systems; and

c. Review the corporate annual financial statements before their submission to the board of directors for approval.

In addition, the following functions, listed in order of importance, are considered significant:

a. Review the scope of internal audit procedures with the chief internal auditor;

b. Discuss with the independent auditors, before the audit is completed, its scope, purpose, and the procedures to be included;

c. Review interim financial reports to shareholders before these reports are approved by the board of directors; and

d. Review the reports of the internal audit staff.

However, nomination of the independent auditors is not considered to be an important function of the committee.

12. The three functions that are ranked as the most important are performed by most of the audit committees. Also, some committees probably perform all eight suggested functions, and a few committees may even perform more than eight.

The most desirable number of duties a committee should take on and still be expected to discharge properly depends on the circumstances in which it operates. In view of the fact that the size of the committee is usually small and it meets only a few times a year, it is important to avoid burdening the committee with too many duties which may divert its full attention from more important matters and thereby may reduce its overall effectiveness.

13. The three functions that are ranked as the most important are performed effectively by most of the audit committees. It appears that the statutory function--the review of annual financial statements--is the most effective. Also, other functions are performed with some degree of effectiveness. In general, the effective performance of these functions is rather high.

14. The five contributing factors for an effective audit committee, in the order of their relative importance, are: (1) competence of the audit committee members; (2) a set of well-established committee objectives; (3) full cooperation and support of the corporate chief executive officer; (4) a set of well-established functions of the committee; and (5) full cooperation and support of the board of directors.

15. An effective audit committee not only can contribute tangible benefits or advantages to directors, external auditors, users of financial statements, and management, but also the majority of committees have realized at least some of such benefits. The four principal benefits are: (1) gives added assurance to users of financial statements as to the objectivity of corporate financial statements; (2) reinforces the independence of the corporation's external auditors; (3) results in increased attention to the audit and control functions at the director's level; and (4) provides added protection for the directors of the corporation, especially for the nonofficer directors, against potential litigation concerning the due care they exercise in the fulfillment of their responsibilities. In addition, an effective committe can (1) enhance communication and access between external auditors and directors and (2) provide discipline value for external auditors, directors, and management.

16. In general, the audit committee plays an important role in resolving a large number of the major disagreements between the external auditors and the management of the corporation. Examples of these disagreements are:

Consolidation of subsidiaries, both domestic and foreign;

Provision of income tax liability in dispute;

Method of disclosure of effect of foreign currency valuation;

Method of accounting for capital expenditure for land development; and

Accounting for depreciation, deferred expenses, and presentation of extraordinary items.

17. Audit committees are considered generally effective in fulfilling their responsibilities, especially by those who have direct experience with the committees. There is also an expectation that an audit committee will become more effective as the members become more knowledgeable and experienced with the committees' purposes and functions.

18. Audit committees are considered useful for a variety of corporations in addition to those offering securities to the public.

19. In general, annual financial statements are more reliable for those corporations with audit committees than for those without them, despite the absence of information on the committee's activities and the lack of a practical means of ascertaining their effectiveness. However, the impact of an ineffective committee on the credibility of the company's financial statements apparently depends on the financial statement users' knowledge of such ineffectiveness. A reasonable inference is that if the ineffectiveness of the committee is known, there would be some adverse effect.

Conclusions

Conclusions of a research study necessarily involve a distillation from a mass of data to a few precise and salient statements. They are deceptively simple and very often susceptible to misinterpretation unless the underlying research methodology, supporting data, and, more important, the detailed discussions throughout the research study are fully understood and kept in proper perspective. Therefore, the following conclusions should be read with this caveat in mind.

1. Attitudes toward the mandatory corporate audit committee range from strong opposition and indifference by a few to wholehearted endorsement by the majority of corporate chief executive officers, members of audit committees, practicing chartered accountants, and financial analysts.

2. The mandatory audit committee is generally considered useful for a variety of corporations. It is effective in fulfilling its responsibilities as an independent body within the corporate structure in reviewing annual financial statements and discussing the related accounting, auditing, and financial matters with the external auditors.

3. The committee is considered to be a very flexible and adaptive organizational unit in terms of both its purposes and functions. Most committees are used to serve a variety of purposes and functions, in addition to those required by the Ontario Business Corporations Act of 1971. The two most important purposes are: to relieve the board of directors, as a whole, of details regarding the review of the results of the independent audit, and to serve as an

independent review function of the company's operations and its annual financial statements before their submission to the board of directors for approval. Most committees perform effectively the functions that are considered of primary importance: (1) review with the independent auditors, on completion of the audit, their experience, any restrictions on their work, cooperation received, their findings, and their recommendations; (2) review with the independent auditors their evaluation of the company's internal control systems; and (3) review the corporate annual financial statements before their submission to the board of directors for approval. Many committees also perform effectively other important functions: (1) review the scope of internal audit procedures with the chief internal auditor; (2) discuss with the independent auditors, before the audit is completed, its scope, purposes, and the procedures to be followed; (3) review interim financial reports to shareholders before these reports are approved by the board of directors; and (4) review the reports of the internal audit staff.

4. The committee, in establishing a regular and direct channel of communication between independent auditors and directors, can contribute and indeed has contributed the following benefits or advantages to a diversity of parties such as corporate directors, management, external auditors, and financial statement users:

a. gives added assurance to users of financial statements as to the objectivity of corporate financial statements;

b. reinforces the independence of the corporation's external auditors;

c. results in increased attention to the audit and control functions at the director's level;

d. provides added protection for the directors of the corporation, especially for the nonofficer directors, against potential litigation concerning the due care they exercise in the fulfillment of their responsibilities;

e. enhances communication and access between external auditors and directors; and

f. provides discipline value for external auditors, directors, and management.

5. The effectiveness of an audit committee apparently is dependent primarily on such factors as the competence of its members and a set of well-established committee objectives. Other important factors are (1) full cooperation and support of the chief executive officer, (2) a set of well-established committee functions, and (3) full cooperation and support of the board of directors.

6. The committee plays an important role in resolving a large number of the major disagreements between the external auditors and the management of corporations.

7. The committee apparently has a positive effect on the reliability of the company's financial statements. On the other hand, an ineffective committee probably would have an adverse effect on the credibility of the company's financial statements if such ineffectiveness were known to users of the statements.

8. Management representation on the committee is considered desirable, especially by those who have direct experience with the committee. The desire for such representation probably stems from the need to (1) avoid and prevent possible misunderstanding and conflicts among management, committee members, and auditors, and (2) provide management with a timely opportunity to present its opinion on the

matters discussed and to facilitate in-depth discussions because of its familiarity with the details of and its expertise on these matters. For those committees without management representation, necessary steps should be taken to minimize or avoid unnecessary conflicts and misunderstanding among management, committee members, and external auditors that may be attributable to the lack of management representation.

9. In general, the committee makes a positive contribution to corporate governance.

Recommendations

In view of the highly positive reaction toward the mandatory corporate audit committee and the new and evolving nature of the committee, the following recommendations aim primarily at improving the committee's overall usefulness and effectiveness.

1. Corporate directors, management, and auditors, both external and internal, should have a clear and full understanding of the committee's purposes and functions. A careful, frank, and extensive discussion by them on what the individual committee should and can do, in light of the environment in which it operates, will eliminate much of the unnecessary confusion, conflicts, and misunderstanding about the committee that may develop. It probably will foster a more cooperative atmosphere, which would assure the effective functioning of the committee. Furthermore, it also will avoid the likelihood of burdening the committee with too many duties that may divert its full attention from more important matters and thereby impair its overall effectiveness.

2. There should be adequate disclosure both internally and externally regarding the committee. Presently, little is known to outsiders of the company about the committee, let alone the activities or effectiveness of a particular committee. Therefore, it is strongly recommended that companies provide, in the annual reports, relevant information about their committees, such as the names of members, their principal occupation or affiliation, and the committee's scope of activities. Such disclosure will supply users of financial statements with pertinent information on the nature and scope of the committee's responsibilities; this is essential in enhancing user's understanding, and perhaps their evaluation, of the duties and performance of the committee. Similarly, adequate and timely information concerning the committee also should be disclosed internally to members of management to keep them informed. To avoid unnecessary conflicts and misunderstanding by management regarding the nature and scope of the committee's operations, especially in those situations where there is no management representation on the committee, key members of management should be provided with the agenda for and minutes of meetings and should be afforded a timely opportunity to discuss matters either with the committee alone, with the external auditors, or both.

3. Since the overriding object for establishing the committee is to provide reliable financial information about the company to the investors and the public, it is important that the committee review all financial information released to investors. Therefore, it is strongly recommended that quarterly or interim financial

statements and prospectus statements also be under the scrutiny of the committee, in addition to the annual financial statements which presently are reviewed.

4. Since the committee is both useful and beneficial to a variety of parties, including corporate directors, management, external auditors, and users of financial statements, it is strongly recommended that all corporations consider the establishment of such a committee. Naturally, this action should be taken only after sufficient discussion to understand the capability and limitations of the committee by those who will most likely be involved in its activities, as discussed in 1 above.

5. At present, there appears to be little or no enforcement by government agencies to ensure compliance with the audit committee requirement by companies. Therefore, it is recommended that legislation or regulations be enacted to require the disclosure of compliance with this requirement by filing a report with the appropriate government agency and by disclosure in the corporate annual report or in the auditor's report. This disclosure ideally should include the relevant information discussed in 2 above. The additional requirement probably will minimize management's temptation to exercise undue influence on the proper functioning of the committee.[1] Furthermore, the Ontario business Corporations Act of 1971 should require the committee to review the auditor's report on the annual financial statements to ensure that all important matters have received the attention of the committee. The fact that such a review is done in practice does not make it unnecessary to incorporate this requirement into the act.

6. Consideration should be given to the mundane matter of compensation for committee members. While monetary reward is perhaps not a deciding factor in whether a director will serve on a committee, it is nonetheless important that a member be compensated as much as possible for the time he devotes to committee activities.

7. A more important and probably the most difficult matter that deserves consideration is the determination of a proper balance between the social costs and social benefits resulting from the committee. If the social benefits exceed the social costs, the committee is desirable. Although the full extent of such costs and benefits may be indeterminate due to the inability of quantifying at least some of them, it is certainly desirable that attempts be made to ascertain such a relationship to the greatest extent possible.

Suggestions for Further Research

Since this study is limited to those Ontario corporations that are subject to the audit committee requirement and with two years' experience, and since the committee concept is new and evolving, it is pertinent to suggest at this juncture that a similar study be made in the near future, either in the same province or in other provinces, and at the federal government level.

FOOTNOTE--CHAPTER VI

1. Haskins and Sells, <u>The Week in Review</u>, 28 September 1973, pp. 4-5. The main issues reported are the change of auditors and the functioning of the corporate audit committee of Cerro Corporation in the United States. The company claims that the auditors have gone beyond accounting disputes:

   "One of the things Lybrand [the external auditor] talked about was its claim that the audit committee of Cerro's board of directors had not met with Coopers and Lybrand, nor with any of the four accounting firms management was considering as replacements. <u>Lybrand's request to meet with the audit committee has been denied</u>. A Lybrand letter addressed to the Cerro audit committee had never been seen by the chairman of that committee [emphasis added]."

   Since the Ontario Business Corporations Act of 1971 grants the auditor the right to meet with the committee "to consider any matters the auditor believes should be brought to the attention of the directors or shareholders," it seems unlikely that management would deny it as in the case discussed above. However, unless such compliance is enforced by the Act or its regulations, management may be tempted to exert pressure on the committee and auditor to follow its demand.

APPENDICES

APPENDIX A

THE FINAL QUESTIONNAIRES

QUESTIONNAIRE ON CORPORATE AUDIT COMMITTEES
TO CORPORATE CHIEF EXECUTIVE OFFICERS

1. Please indicate whether your corporation had an audit committee prior to the requirement by the Ontario Business Corporations Act, 1970.

   Yes [ ] If yes, please indicate the year in which the audit committee was established ________ and the primary reasons for its establishment.

   ____

   ____

   ____

   No [ ] If no, please proceed to question 3.

2. Have there been any significant changes in the size, composition, responsibilities, or other characteristics of your audit committee as a result of the Ontario Business Corporations Act, 1970, requirement?

   Yes [ ] If yes, please list the changes.

   ____

   ____

   ____

   No [ ]

3. Please indicate whether you are presently a member of the audit committee of another corporation?

   Yes [ ] If yes, please indicate the number of audit committees of which you are a member. Number of audit committees ________.

   No [ ]

4. Please indicate whether you are presently a member of the audit committee of your company.

   Yes [ ]   No [ ]

5. This question seeks your frank evaluation of the usefulness of corporate audit committees to corporate chief executive officers. Corporate audit committees, in your opinion, are useful - (please check one of the following).

   for all corporations [ ]

   for only those corporations offering securities to the public [ ]

   for no corporations [ ]

   Other (please specify)

   ____

   ____

   ____

6. Please evaluate the following suggested purposes of a corporate audit committee, and any you may wish to add, on the basis of what you think their importance should be, by checking the appropriate space on the accompanying 4-point scale.

Purposes of the Audit Committee:	Importance Scale: Very important	Important	Not important	Not Important at all
To relieve the board of directors, as a whole, of details regarding -				
The nomination of the independent auditors	[ ]	[ ]	[ ]	[ ]
The arrangements for the independent audit	[ ]	[ ]	[ ]	[ ]
The review of the results of the independent audit	[ ]	[ ]	[ ]	[ ]
The review of the annual financial statements	[ ]	[ ]	[ ]	[ ]
To provide non-officer directors with direct and more personal contact with the independent auditors	[ ]	[ ]	[ ]	[ ]
To give additional attention to the audit function performed by the independent auditors	[ ]	[ ]	[ ]	[ ]
To give additional attention to the internal control functions of the company	[ ]	[ ]	[ ]	[ ]
To serve as an independent review function of the company's operations and its annual financial statements before their submission to the board of directors for approval	[ ]	[ ]	[ ]	[ ]
Other (please specify)				
______________________	[ ]	[ ]	[ ]	[ ]
______________________	[ ]	[ ]	[ ]	[ ]
______________________	[ ]	[ ]	[ ]	[ ]
______________________	[ ]	[ ]	[ ]	[ ]
______________________	[ ]	[ ]	[ ]	[ ]

7. For the following suggested functions of a corporate audit committee, and any you may wish to add, please:

   (a) evaluate them on the basis of what you think their importance should be, by checking the appropriate space on the accompanying 4-point scale

   (b) evaluate the effectiveness (i.e. in terms of care and effort exercised) with which each function is performed by your audit committee, by checking the category "effective" or "ineffective". Please indicate the functions not performed with a "N/A" in column b.

	(a) Importance Scale				(b) Is Performance of the function generally effective or ineffective	
Functions of the Audit Committee:	Very impor- tant	Impor- tant	Not impor- tant	Not important at all	Effective	Ineffective
Nominate the independent auditors	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Discuss with the independent auditors, before the audit is completed, its scope, purpose, and procedures to be included	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Review with the independent auditors, on completion of the audit, their experience, any restrictions on their work, cooperation received, their findings and their recommendations	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Review with the independent auditors their evaluation of the company's internal control systems	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Review interim financial reports to shareholders before these reports are approved by the board of directors	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Review the corporate annual financial statements before their submission to the board of directors for approval	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Review the scope of internal audit procedures with the chief internal auditor	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Review the reports of the internal audit staff	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Other (please specify)						
________________	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
________________	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
________________	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
________________	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
________________	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]

8. In general, corporate audit committees are effective in fulfilling their responsibilities.

Agree [ ] Disagree [ ]

9. Please rank the following suggested factors for an effective corporate audit committee, on the basis of what you think their relative importance should be (1 - being the most important, 2 - being the second most important, and so on, with 5 being the least important.)

	Rank
Competence of the audit committee members	[ ]
Full cooperation and support of the board of directors	[ ]
Full cooperation and support of the corporate chief executive officer	[ ]
A set of well established objectives of the audit committee	[ ]
A set of well established functions of the audit committee	[ ]

10. Do you feel that an effective audit committee can contribute the following suggested benefits?

	Yes	No
Gives added assurance to users of financial statements as to the objectivity of corporate financial statements	[ ]	[ ]
Reinforces the independence of the corporation's external auditors	[ ]	[ ]
Results in increased attention to the audit and control functions at the director's level	[ ]	[ ]
Provides added protection for the directors of the corporation, especially for the non-officer directors, against potential litigation concerning the due care they exercise in the fulfillment of their responsibilities.	[ ]	[ ]
Other (please specify)		
______________________	[ ]	[ ]
______________________	[ ]	[ ]
______________________	[ ]	[ ]
______________________	[ ]	[ ]
______________________	[ ]	[ ]

11. (a) Please indicate whether there have been major disagreements between the external auditor and the management of the corporation in the past two years.

Yes [ ] (If yes, please also answer part (b) of this question)

No [ ] (If no, please proceed to question #12)

(b) Were these disagreements resolved by the corporate audit committee?

No [ ]

Yes [ ] (If yes, please indicate the areas involved.)

________ Financial statement disclosure and reporting

________ Changes in accounting principles and practices

________ Audit matters (e.g., the scope of audit, audit report, etc.)

________ Other (please specify)

Please comment briefly on the specific disagreement(s) involved.

____

____

____

____

____

12. Do you feel that it is desirable to have officers of the company on the audit committee of their company?

Yes [ ] Please indicate the positions of one or more officers you believe should be on the audit committee.

Position of Officer: ______________________

____

No [ ] Please state your reasons as explicitly as possible.

____

____

____

13. In general, how many times does the audit committee meet? It meets __________ times a year.

14. Are the meetings held on a regularly scheduled basis? Yes [ ] No [ ]

15. **Do you feel that it is desirable to disclose the names of the corporate audit committee members in the corporate annual report?**

Yes [ ]   No [ ]

16. If this questionnaire has omitted any matters relating to corporate audit committees which you feel warrant attention, please comment on them below.

Thank you very much

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QUESTIONNAIRE ON CORPORATE AUDIT COMMITTEES
TO MEMBERS OF AUDIT COMMITTEES

1. Please indicate the number of years you have been on this corporation's audit committee.

_________ years

2. Please indicate the number of other corporate audit committees of which you are presently a member.

____

3. If you are an officer of this corporation, please indicate your present position with the corporation (i.e., "President," "Vice-President of finance," "Secretary," etc.)

Present position _______________________________

4. If you are not an officer of this corporation, please indicate your principal occupation, i.e., "Chairman of the board of directors," "President," "Investment banker," "Attorney," "University President," etc.

Principal occupation _____________________________

5. Please evaluate the following suggested purposes of a corporate audit committee, and any you may wish to add, on the basis of what you think their importance should be, by checking the appropriate space on the accompanying 4-point scale.

	Importance Scale			
Purposes of the Audit Committee:	Very important	Important	Not important	Not important at all
To relieve the board of directors, as a whole, of details regarding -				
The nomination of the independent auditors	[ ]	[ ]	[ ]	[ ]
The arrangements for the independent audit	[ ]	[ ]	[ ]	[ ]
The review of the results of the independent audit	[ ]	[ ]	[ ]	[ ]
The review of the annual financial statements	[ ]	[ ]	[ ]	[ ]
To provide non-officer directors with direct and more personal contact with the independent auditors	[ ]	[ ]	[ ]	[ ]
To give additional attention to the audit function performed by the independent auditors	[ ]	[ ]	[ ]	[ ]
To give additional attention to the internal control functions of the company	[ ]	[ ]	[ ]	[ ]
To serve as an independent review function of the company's operations and its annual financial statements before their submission to the board of directors for approval	[ ]	[ ]	[ ]	[ ]
Other (please specify)				
_______________	[ ]	[ ]	[ ]	[ ]
_______________	[ ]	[ ]	[ ]	[ ]
_______________	[ ]	[ ]	[ ]	[ ]

6. For the following suggested functions of a corporate audit committee, and any you may wish to add, please:

   (a) evaluate them on the basis of what you think their importance should be, by checking the appropriate space on the accompanying 4-point scale

   (b) evaluate the effectiveness (i.e. in terms of care and effort exercised) with which each function is performed by your audit committee, by checking the category "effective" or "ineffective". Please indicate the functions not performed with a "N/A" in column b.

	(a) Importance Scale				(b) Is performance of the function generally effective or ineffective?	
Functions of the Audit Committee:	Very impor-tant	Impor-tant	Not impor-tant	Not important at all	Effective	Ineffective
Nominate the independent auditors	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Discuss with the independent auditors, before the audit is completed, its scope, purpose, and procedures to be included	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Review with the independent auditors, on completion of the audit, their experience, any restrictions on their work, cooperation received, their findings and their recommendations	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Review with the independent auditors their evaluation of the company's internal control systems	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Review interim financial reports to shareholders before these reports are approved by the board of directors	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Review the corporate annual financial statements before their submission to the board of directors for approval	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Review the scope of internal audit procedures with the chief internal auditor	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Review the reports of the internal audit staff	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Other (please specify)						
____________________	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
____________________	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
____________________	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
____________________	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
____________________	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]

7. This question seeks your frank evaluation of the usefulness of corporate audit committees to corporate directors. Corporate audit committees, in your opinion, are useful - (please check one of the following).

for all corporations	[ ]
for only those corporations offering securities to the public	[ ]
for no corporations	[ ]

Other (please specify)

____

____

____

8. In general, corporate audit committees are effective in fulfilling their responsibilities.

Agree [ ] Disagree [ ]

9. Please rank the following suggested factors for an effective corporate audit committee, on the basis of what you think their relative importance should be (1 - being the most important, 2 - being the second most important, and so on, with 5 being the least important.)

	Rank
Competence of the audit committee members	[ ]
Full cooperation and support of the board of directors	[ ]
Full cooperation and support of the corporate chief executive officer	[ ]
A set of well established objectives of the audit committee	[ ]
A set of well established functions of the audit committee	[ ]

10. Do you feel an effective audit committee can contribute the following suggested benefits?

	Yes	No
Gives added assurance to users of financial statements as to the objectivity of corporate financial statements	[ ]	[ ]
Reinforces the independence of the corporation's external auditors	[ ]	[ ]
Results in increased attention to the audit and control functions at the director's level	[ ]	[ ]
Provides added protection for the directors of the corporation, especially for the non-officer directors, against potential litigation concerning the due care they exercise in the fulfillment of their responsibilities.	[ ]	[ ]
Other (please specify)		
____________________	[ ]	[ ]
____________________	[ ]	[ ]
____________________	[ ]	[ ]

11. (a) Please indicate whether there have been major disagreements between the external auditor and the management of the corporation in the past two years.

Yes [ ] (If yes, please also answer part (b) of this question.)

No [ ] (If no, please proceed to question #12.)

(b) Were these disagreements resolved by the corporate audit committee?

No [ ]

Yes [ ] (If yes, please indicate the areas involved.)

__________ Financial statement disclosure and reporting

__________ Changes in accounting principle and practices

__________ Audit matters (e.g., the scope of audit, audit reports, etc.)

__________ Other (please specify)

Please comment briefly on the specific disagreement(s) involved.

____

____

____

____

____

12. Do you feel that it is desirable to have officers of the company on the audit committee of their company?

Yes [ ] Please indicate the positions of one or more officers you believe should be on the audit committee

Position of officer: ____________________

____

No [ ] Please state your reasons as explicitly as possible.

____

____

____

13. In general, how many times does the audit committee meet? It meets ________ times a year.

14. Are the meetings held on a regularly scheduled basis?

Yes [ ] No [ ]

15. (a) **Are minutes kept for each of the audit committee meetings?**

Yes [ ]   No [ ]

(b) Are the minutes forwarded to the

	Yes	No
Board of directors	[ ]	[ ]
Corporate chief executive officer	[ ]	[ ]
Other (specify) ____________	[ ]	[ ]

____

____

____

16. Do you feel that it is desirable to disclose the names of the corporate audit committee members in the corporate annual report?

Yes [ ]   No [ ]

17. If this questionnaire has omitted any matters relating to corporate audit committees which you feel warrant attention, please comment on them below.

Thank you very much

Professor Wai P. Lam, B. Comm., M.B.A., C.A.
Study on Corporate Audit Committees
University of Windsor
Windsor, Ontario N9B 3P4

QUESTIONNAIRE ON CORPORATE AUDIT COMMITTEES
TO PRACTICING CHARTERED ACCOUNTANTS

1. Please indicate the number of corporate clients for which you now personally serve as a partner which are required by the Ontario Business Corporations Act, 1970, to have audit committees.

____________ number of clients

2. For the clients you have indicated in Question 1, please:

   (a) Check the proportion of their audit committees which perform any of the following suggested functions, and any you may wish to add.

   (b) Evaluate the effectiveness (i.e., in terms of care and effort exercised) with which their audit committees generally perform the functions designated in (a) above by checking the category "effective" or "ineffective".

	(a) Function is performed by			(b) Is performance of the function generally effective or ineffective?	
Functions of the Audit Committee:	50% or more	less than 50%	none	Effective	Ineffective
Nominate the independent auditors	[ ]	[ ]	[ ]	[ ]	[ ]
Discuss with the independent auditors, before the audit is completed, its scope, purpose, and procedures to be included.	[ ]	[ ]	[ ]	[ ]	[ ]
Review with the independent auditors, on completion of the audit, their experience, any restrictions on their work, cooperation received, their findings and their recommendations	[ ]	[ ]	[ ]	[ ]	[ ]
Review with the independent auditors their evaluation of the company's internal control systems	[ ]	[ ]	[ ]	[ ]	[ ]
Review interim financial reports to shareholders before these reports are approved by the board of directors	[ ]	[ ]	[ ]	[ ]	[ ]
Review the corporate annual financial statements before their submission to the board of directors for approval	[ ]	[ ]	[ ]	[ ]	[ ]
Review the scope of internal audit procedures with the chief internal auditor	[ ]	[ ]	[ ]	[ ]	[ ]
Review the reports of the internal audit staff	[ ]	[ ]	[ ]	[ ]	[ ]
Other (please specify)					
____________________	[ ]	[ ]	[ ]	[ ]	[ ]
____________________	[ ]	[ ]	[ ]	[ ]	[ ]
____________________	[ ]	[ ]	[ ]	[ ]	[ ]
____________________	[ ]	[ ]	[ ]	[ ]	[ ]
____________________	[ ]	[ ]	[ ]	[ ]	[ ]

3. Please evaluate the following suggested functions of a corporate audit committee, and any you may wish to add, on the basis of what you think their importance should be, by checking the appropriate space on the accompanying 4-point scale.

	Importance Scale			
Functions of the Audit Committee:	Very important	Important	Not important	Not important at all
Nominate the independent auditors	[ ]	[ ]	[ ]	[ ]
Discuss with the independent auditors, before the audit is completed, its scope, purpose, and procedures to be included	[ ]	[ ]	[ ]	[ ]
Review with the independent auditors, on completion of the audit, their experience, any restrictions on their work, cooperation received, their findings and their recommendations	[ ]	[ ]	[ ]	[ ]
Review with the independent auditors their evaluation of the company's internal control systems	[ ]	[ ]	[ ]	[ ]
Review interim financial reports to shareholders before these reports are approved by the board of directors	[ ]	[ ]	[ ]	[ ]
Review the corporate annual financial statements before their submission to the board of directors for approval	[ ]	[ ]	[ ]	[ ]
Review the scope of internal audit procedures with the chief internal auditor	[ ]	[ ]	[ ]	[ ]
Review the reports of the internal audit staff	[ ]	[ ]	[ ]	[ ]
Other (please specify)				
______________________________	[ ]	[ ]	[ ]	[ ]
______________________________	[ ]	[ ]	[ ]	[ ]
______________________________	[ ]	[ ]	[ ]	[ ]
______________________________	[ ]	[ ]	[ ]	[ ]
______________________________	[ ]	[ ]	[ ]	[ ]
______________________________	[ ]	[ ]	[ ]	[ ]

4. **Please evaluate the following suggested purposes of a corporate audit committee, and any you may wish to add, on the basis of what you think their importance should be, by checking the appropriate space on the accompanying 4-point scale.**

Purposes of the Audit Committee:	Importance Scale Very important	Important	Not important	Not important at all
To relieve the board of directors, as a whole, of details regarding -				
The nomination of the independent auditors	[ ]	[ ]	[ ]	[ ]
The arrangements for the independent audit	[ ]	[ ]	[ ]	[ ]
The review of the results of the independent audit	[ ]	[ ]	[ ]	[ ]
The review of the annual financial statements	[ ]	[ ]	[ ]	[ ]
To provide non-officer directors with direct and more personal contact with the independent auditors	[ ]	[ ]	[ ]	[ ]
To give additional attention to the audit function performed by the independent auditors	[ ]	[ ]	[ ]	[ ]
To give attention to the internal control functions of the company	[ ]	[ ]	[ ]	[ ]
To serve as an independent review function of the company's operations and its annual financial statements before their submission to the board of directors for approval.	[ ]	[ ]	[ ]	[ ]
Other (please specify)				
______________________	[ ]	[ ]	[ ]	[ ]
______________________	[ ]	[ ]	[ ]	[ ]
______________________	[ ]	[ ]	[ ]	[ ]
______________________	[ ]	[ ]	[ ]	[ ]
______________________	[ ]	[ ]	[ ]	[ ]
______________________	[ ]	[ ]	[ ]	[ ]

5. This question seeks your frank evaluation of the usefulness of corporate audit committees to you as an independent auditor. Corporate audit committees, in your opinion, are useful - (please check one of the following).

for all corporate clients	[ ]
for only those corporate clients offering securities to the public	[ ]
for no corporate clients	[ ]

Other (please specify) ______________________

____

____

6. In general, corporate audit committees are effective in fulfilling their responsibilities.

Agree [ ]   Disagree [ ]

7. Please rank the following suggested <u>factors</u> for an effective corporate audit committee, on the basis of what you think their relative importance should be (1 - being the most important, 2 - being the second most important, and so on, with 5 being the least important).

	Rank
Competence of the audit committee members	[ ]
Full cooperation and support of the board of directors	[ ]
Full cooperation and support of the corporate chief executive officers	[ ]
A set of well established objectives of the audit committee	[ ]
A set of well established functions of the audit committee	[ ]

8. (a) Do you feel that an effective audit committee can contribute the following suggested <u>benefits</u>?

	Yes	No
Gives added assurance to users of financial statements as to the objectivity of corporate financial statements	[ ]	[ ]
Reinforces the independence of the corporation's external auditors	[ ]	[ ]
Results in increased attention to the audit and control functions at the director's level	[ ]	[ ]
Provides added protection for the directors of the corporation, especially for the non-officer directors, against potential litigation concerning the due care they exercise in the fulfillment of their responsibilities	[ ]	[ ]

Other (please specify)

____

____

____

____

____

(b) Of the clients you now personally serve as a partner which do have audit committees as required by the Ontario Business Corporations Act, how many of these clients have realized the benefits described in 8(a)?

Most clients [ ]

Some clients [ ]

Few clients [ ]

No clients [ ]

9. (a) Please indicate whether there have been major disagreements between the external auditor and the management of the corporation in the past two years.

Yes ________ (If yes, please also answer part (b) of this question.)

No ________ (If no, please proceed to question #10.)

(b) Were these disagreements resolved by the corporate audit committee?

No ________

Yes ________ (If answer yes, please indicate the areas involved.)

__________ Financial statement disclosure and reporting

__________ Changes in accounting principles and practices

__________ Audit matters (e.g., the scope of audit, audit reports, etc.)

__________ Other (please specify)

Please comment briefly on the specific disagreement(s) involved.

____

____

____

____

____

____

10. Do you feel that it is desirable to have officers of the company on the audit committee of their company?

Yes [ ] Please indicate the positions of one or more officers you believe should be on the audit committee.

Position of officer: ______________________

____

No [ ] Please state your reasons as explicitly as possible.

____

____

____

____

____

11. On the average, how many times do you meet with the individual audit committees of your clients during the year?

__________ times

12. Do you feel that it is desirable to disclose the names of the corporate audit committee members in the corporate annual report.

Yes [ ] No [ ]

13. If this questionnaire has omitted any matters relating to corporate audit committees which you feel warrant attention, please comment on them below.

Thank you very much.

Professor Wai P. Lam, B. Comm., M.B.A., C.A.
Study on Corporate Audit Committees
University of Windsor
Windsor, Ontario N9B3P4

QUESTIONNAIRE ON CORPORATE AUDIT COMMITTEES
TO FINANCIAL ANALYSTS

1. Please indicate whether you are presently a member of a corporate audit committee?

   Yes [ ] Please indicate the number of audit committees of which you are a member. __________

   No [ ]

2. Please evaluate the following suggested purposes of a corporate audit committee, and any you may wish to add, on the basis of what you think their importance should be, by checking the appropriate space on the accompanying 4-point scale.

	Importance Scale			
Purposes of the Audit Committee:	Very important	Important	Not important	Not important at all
To relieve the board of directors, as a whole, of details regarding -				
The nomination of the independent auditors	[ ]	[ ]	[ ]	[ ]
The arrangements for the independent audit	[ ]	[ ]	[ ]	[ ]
The review of the results of the independent audit	[ ]	[ ]	[ ]	[ ]
The review of the annual financial statements	[ ]	[ ]	[ ]	[ ]
To provide non-officer directors with direct and more personal contact with the independent auditors	[ ]	[ ]	[ ]	[ ]
To give additional attention to the audit function performed by the independent auditors	[ ]	[ ]	[ ]	[ ]
To give additional attention to the internal control functions of the company	[ ]	[ ]	[ ]	[ ]
To serve as an independent review function of the company's operations and its annual financial statements before their submission to the board of directors for approval	[ ]	[ ]	[ ]	[ ]
Other (please specify)				
__________	[ ]	[ ]	[ ]	[ ]
__________	[ ]	[ ]	[ ]	[ ]
__________	[ ]	[ ]	[ ]	[ ]
__________	[ ]	[ ]	[ ]	[ ]
__________	[ ]	[ ]	[ ]	[ ]

3. **This question seeks your frank evaluation of the usefulness of corporate audit committees to financial analysts. Corporate audit committees, in your opinion, are useful - (please check <u>one</u> of the following).**

for all corporations	[ ]
for only those corporations offering securities to the public	[ ]
for no corporations	[ ]

Other (please specify)

____

____

____

4. **Please evaluate the following suggested <u>functions</u> of a corporate audit committee, and any you may wish to add, on the basis of what you think their importance should be, by checking the appropriate space on the accompanying 4-point scale.**

	Importance Scale			
Functions of the Audit Committee:	Very important	Important	Not important	Not important at all
Nominate the independent auditors	[ ]	[ ]	[ ]	[ ]
Discuss with the independent auditors, before the audit is completed, its scope, purpose, and procedures to be included	[ ]	[ ]	[ ]	[ ]
Review with the independent auditors, on completion of the audit, their experience, any restrictions on their work, cooperation received, their findings and their recommendations	[ ]	[ ]	[ ]	[ ]
Review with the independent auditors their evaluation of the company's internal control systems	[ ]	[ ]	[ ]	[ ]
Review interim financial reports to shareholders before these reports are approved by the board of directors	[ ]	[ ]	[ ]	[ ]
Review the corporate annual financial statements before their submission to the board of directors for approval	[ ]	[ ]	[ ]	[ ]
Review the scope of internal audit procedures with the chief internal auditor	[ ]	[ ]	[ ]	[ ]
Review the reports of the internal audit staff	[ ]	[ ]	[ ]	[ ]
Other (please specify)	[ ]	[ ]	[ ]	[ ]
____________________	[ ]	[ ]	[ ]	[ ]
____________________	[ ]	[ ]	[ ]	[ ]
____________________	[ ]	[ ]	[ ]	[ ]
____________________	[ ]	[ ]	[ ]	[ ]
____________________	[ ]	[ ]	[ ]	[ ]

5. In general, corporate audit committees are effective in fulfilling their responsibilities.

Agree [ ]   Disagree [ ]

6. Do you feel that an effective audit committee can contribute the following suggested benefits?

	Yes	No
Gives added assurance to users of financial statements as to the objectivity of corporate financial statements	[ ]	[ ]
Reinforces the independence of the corporation's external auditors	[ ]	[ ]
Results in increased attention to the audit and control functions at the director's level	[ ]	[ ]
Provides added protection for the directors of the corporation, especially for the non-officer directors, against potential litigation concerning the due care they exercised in the fulfillment of their responsibilities	[ ]	[ ]
Other (please specify)		
________________________	[ ]	[ ]
________________________	[ ]	[ ]
________________________	[ ]	[ ]

7. Please rank the following suggested <u>factors</u> for an effective corporate audit committee, on the basis of what you think their relative importance should be (1 - being the most important, 2 - being the second most important, and so on, with 5 being the least important.)

	Rank
Competence of the audit committee members	[ ]
Full cooperation and support of the board of directors	[ ]
Full cooperation and support of the corporate chief executive officer	[ ]
A set of well established objectives of the audit committee	[ ]
A set of well established functions of the audit committee	[ ]

8. Do you feel that the annual financial statements are more reliable for those corporations which have audit committees?

Yes [ ]   No [ ]

Please briefly state the reasons for your opinion.

____

____

____

____

9. **Do you feel that it is desirable to have officers of the company on the audit committee of their company?**

Yes [ ] Please indicate the positions of one or more officers you believe should be on the audit committee.

Position of Officer: ____________________

____

No [ ] Please state your reasons as explicitly as possible.

____

____

____

10. Do you feel that an <u>ineffective</u> corporate audit committee has an adverse effect on the credibility of the corporation's financial statements?

Yes [ ] No [ ]

Please briefly comment on your answer.

____

____

____

11. Do you feel that it is desirable to disclose the names of the corporate audit committee members in the corporate annual report?

Yes [ ] No [ ]

12. If this question has omitted any matters relating to corporate audit committees which you feel warrant attention, please comment on them below.

Thank you very much

Professor Wai P. Lam, B. Comm., M.B.A., C.A.
Study on Corporate Audit Committees
University of Windsor
Windsor, Ontario N9B 3P4

APPENDIX B

LETTERS SENT WITH

FIRST MAILING

Study on Corporate Audit Committees
University of Windsor
Windsor, Ontario N9B 3P4

I am currently conducting dissertation research on audit committees of the business corporations incorporated in the Province of Ontario. This research is part of the requirements for my doctoral degree in accounting at Michigan State University. I am enclosing a letter from the Canadian Institute of Chartered Accountants concerning this research.

I would like you to participate in this research by answering the enclosed questionnaire. Since only a small number of financial analysts were selected from the Toronto Society of Financial Analysts for this study, your participation is essential to the success of my research.

This research seeks a better understanding of the role played by the corporate audit committees and the extent of their contribution to corporate governance, by gathering relevant information on audit committees from corporate chief executive officers, audit committee members, chartered accountants, and financial analysts.

Corporate directors, officers, and other business-related professionals are being held to increasingly high standards of accountability for the affairs of the corporations with which they are associated. Since the corporate audit committee concept has been suggested as a possible aid to a number of groups in meeting their business responsibilities, I believe that empirical research into the use of such audit committees is of great significance.

I assure you that any information you provide will be held strictly confidential and that complete anonymity will be maintained in the discussion of the results of this research.

Please return the completed questionnaire in the pre-stamped, self-addressed envelope provided. The questionnaire is coded solely for the purpose of non-response follow-up. To ensure anonymity, any identifying codes will be discarded once the follow-up process is completed.

Thank you very much for your cooperation in this research.

Yours sincerely,

Wai P. Lam, B. Comm., M.B.A., C.A.
Associate Professor of Accounting

Study on Corporate Audit Committees
University of Windsor
Windsor, Ontario N9B 3P4

I am currently conducting dissertation research on audit committees of the business corporations incorporated in the Province of Ontario. This research is part of the requirements for my doctoral degree in accounting at Michigan State University.

I would like you to participate in this research by answering the enclosed questionnaire. Since only a small number of audit committee members were included in this study, based upon the membership information provided by the corporations, your participation is essential to the success of my research.

This research seeks a better understanding of the role played by the corporate audit committees and the extent of their contribution to corporate governance, by gathering relevant information on audit committees from corporate chief executive officers, audit committee members, chartered accountants, and financial analysts.

Corporate directors, officers, and other business-related professionals are being held to increasingly high standards of accountability for the affairs of the corporations with which they are associated. Since the corporate audit committee concept has been suggested as a possible aid to a number of groups in meeting their business responsibilities, I believe that empirical research into the use of such audit committees is of great significance.

I assure you that any information you provide will be held strictly confidential and that complete anonymity will be maintained in the discussion of the results of this research.

Please return the completed questionnaire in the pre-stamped, self-addressed envelope provided. The questionnaire is coded solely for the purpose of non-response follow-up. To ensure anonymity, any identifying codes will be discarded once the follow-up process is completed.

Thank you very much for your cooperation in this research.

Yours sincerely,

Wai P. Lam, C.A., M.B.A.

Study on Corporate Audit Committees
University of Windsor
Windsor, Ontario N9B 3P4
June 22, 1973

I am currently conducting dissertation research on audit committees of the business corporations incorporated in the Province of Ontario. This research is part of the requirements for my doctoral degree in accounting at Michigan State University. I am enclosing a letter from the Canadian Institute of Chartered Accountants concerning this research.

I would like to request the partners of your firm who have had audit committee experience to participate in this research by answering the enclosed questionnaires. Since only a very small number of major accounting firms in Ontario were selected for this study, your firm's participation is essential to its success.

This research seeks a better understanding of the role played by corporate audit committees and the extent of their contribution to corporate governance, by gathering relevant information on audit committees from corporate chief executive officers, practicing chartered accountants, audit committee members, and financial analysts.

Corporate directors, officers, practicing chartered accountants, and other business-related professionals are being held to increasingly high standards of accountability for the affairs of the corporations with which they are associated. Since the corporate audit committee concept has been suggested as a possible aid to a number of groups in meeting their business responsibilities, I believe that empirical research into the use of such audit committees is of great significance.

I assure you that any information you provide will be held strictly confidential and that complete anonymity will be maintained in the discussion of the results of this research.

Please return the completed questionnaires in the pre-stamped, self-addressed envelopes provided. The questionnaires are coded solely for the purpose of non-response follow-up. To ensure anonymity, any identifying codes will be discarded once the follow-up process is completed.

Thank you very much for your kind cooperation in this research.

Yours sincerely,

Wai P. Lam, B. Comm., M.B.A., C.A.
Associate Professor of Accounting

Study on Corporate Audit Committees
University of Windsor
Windsor, Ontario N9B 3P4

I am currently conducting dissertation research on audit committees of the business corporations incorporated in the Province of Ontario. This research is part of the requirements for my doctoral degree in accounting at Michigan State University. I am enclosing a letter from the Canadian Institute of Chartered Accountants concerning this research.

I would like you to participate in this research by answering the enclosed questionnaire. Since only a small number of corporate chief executive officers in Ontario were selected from the Financial Post's "Survey of Industries - 1972" for this study, your participation is essential to the success of my research.

This research seeks a better understanding of the role played by the corporate audit committees and the extent of their contribution to corporate governance, by gathering relevant information on audit committees from corporate chief executive officers, audit committee members, chartered accountants, and financial analysts.

Corporate directors, officers, and other business-related professionals are being held to increasingly high standards of accountability for the affairs of the corporations with which they are associated. Since the corporate audit committee concept has been suggested as a possible aid to a number of groups in meeting their business responsibilities, I believe that empirical research into the use of such audit committees is of great significance.

I assure you that any information you provide will be held strictly confidential and that complete anonymity will be maintained in the discussion of the results of this research.

Please return the completed questionnaire in the pre-stamped, self-addressed envelope provided. The questionnaire is coded solely for the purpose of non-response follow-up. To ensure anonymity, any identifying codes will be discarded once the follow-up process is completed.

Thank you very much for your cooperation is this research.

Yours sincerely,

Wai P. Lam, B. Comm., M.B.A., C.A.
Associate Professor of Accounting

APPENDIX C

LETTER SENT WITH

SECOND MAILING

Study on Corporate Audit Committees
University of Windsor
Windsor, Ontario N9B 3P4

A few weeks ago I requested your participation in a study on corporate audit committees in Ontario by responding to my questionnaire. Unfortunately, I have not received a response from you.

Since your participation is essential to the success of this study, I again ask for your kind cooperation in answering the enclosed questionnaire. I would be very grateful if you would complete the questionnaire and return it in the stamped return envelope provided.

To the best of my knowledge, this is the first major empirical study on corporate audit committees in Canada. Consequently, your participation will be especially needed in the search for a better understanding of the use of the corporate audit committee concept. I am enclosing a letter from the Canadian Institute of Chartered Accountants concerning this research.

Again, I assure you that any information you provide will be held <u>strictly confidential</u> and that <u>complete anonymity</u> will be maintained in the discussion of the results of this study.

Thank you very much for your cooperation in this research.

Yours sincerely,

Wai P. Lam, B.Comm., M.B.A., C.A.
Associate Professor of Accounting

APPENDIX D

LETTER SENT WITH

THIRD MAILING

Study on Corporate Audit Committees
University of Windsor
Windsor, Ontario N9B 3P4
July 23, 1973

In the previous two occasions I requested your cooperation concerning my doctoral dissertation research on corporate audit committees in Ontario by responding to my questionnaire. Unfortunately, I have not received a response from you. Consequently I again ask for your help.

Your participation is still very much needed in order for this study to show a reasonably representative and valid finding. I would be most grateful if you would complete the enclosed questionnaire and return it in the stamped envelope provided. I am enclosing a letter from the Canadian Institute of Chartered Accountants concerning this research.

Again, I assure you that any information you provide will be held strictly confidential and that complete anonymity will be maintained in the discussion of the results of this study. The questionnaire is coded solely for the purpose of nonresponse follow-up. To ensure anonymity, any identifying codes will be discarded once the follow-up process is completed.

May I take this opportunity to express my sincere appreciation for your kind cooperation in my research.

Yours sincerely,

Wai P. Lam, B. Comm., M.B.A., C.A.
Associate Professor of Accounting

APPENDIX E

LETTERS OF THE CANADIAN INSTITUTE

OF CHARTERED ACCOUNTANTS

CICA The Canadian Institute of Chartered Accountants
L'Institut Canadien des Comptables Agréés
250 Bloor St. E
Toronto 285, Canada
Telephone (416) 962-1242
Cables Canchart

June 19, 1973

To Corporate Chief Executive Officers:

Professor Wai P. Lam, C.A., of the University of Windsor, is currently conducting research regarding corporate audit committees, and their role in Ontario corporations, in connection with his doctoral dissertation. A major part of this research is to gather the most significant and relevant information on corporate audit committees from corporate chief executive officers.

Professor Lam's research should provide valuable insights into the theoretical and practical merits of the audit committee concept, especially as little empirical research on this topic has yet been conducted. Accordingly, I commend to your attention Professor Lam's request for your participation in this project.

Yours sincerely,

A.K.Mason,
Research Studies Director.

AKM/ads

CICA
The Canadian Institute of Chartered Accountants
L'Institut Canadien des Comptables Agréés
250 Bloor St. E.
Toronto 285 Canada
Telephone (416) 962-1242
Cables: Canchart

June 19, 1973

To Members of Corporate Audit Committees:

Professor Wai P. Lam, C.A., of the University of Windsor, is currently conducting research regarding corporate audit committees, and their role in Ontario corporations, in connection with his doctoral dissertation. A major part of this research is to gather the most significant and relevant information on corporate audit committees from members of corporate audit committees.

Professor Lam's research should provide valuable insights into the theoretical and practical merits of the audit committee concept, especially as little empirical research on this topic has yet been conducted. Accordingly, I commend to your attention Professor Lam's request for your participation in this project.

Yours sincerely,

A. K. Mason,
Research Studies Director.

AKM/ads

CICA The Canadian Institute of Chartered Accountants
L'Institut Canadien des Comptables Agréés
250 Bloor St. E.
Toronto 285, Canada
Telephone (416) 962-1242
Cables Canchart

June 19, 1973

To Members of the Canadian Institute of Chartered Accountants:

Professor Wai P. Lam, C.A., of the University of Windsor, is currently conducting research regarding corporate audit committees, and their role in Ontario corporations, in connection with his doctoral dissertation. A major part of this research is to gather the most significant and relevant information on corporate audit committees from practising chartered accountants.

Professor Lam's research should provide valuable insights into the theoretical and practical merits of the audit committee concept, especially as little empirical research on this topic has yet been conducted. Accordingly, I commend to your attention Professor Lam's request for your participation in this project.

Yours sincerely,

A. K. Mason
Research Studies Director.

AKM/ads

CICA The Canadian Institute of Chartered Accountants
L'Institut Canadien des Comptables Agréés
250 Bloor St. E
Toronto 285, Canada
Telephone (416) 962-1242
Cables Canchart

June 19, 1973

To Members of the Toronto Society of Financial Analysts:

Professor Wai P. Lam, C.A., of the University of Windsor, is currently conducting research regarding corporate audit committees, and their role in Ontario corporations, in connection with his doctoral dissertation. A major part of this research is to gather the most significant and relevant information on corporate audit committees from members of the Toronto Society of Financial Analysts.

Professor Lam's research should provide valuable insights into the theoretical and practical merits of the audit committee concept, especially as little empirical research on this topic has yet been conducted. Accordingly, I commend to your attention Professor Lam's request for your participation in this project.

Yours sincerely,

A. K. Mason
Research Studies Director.

AKM/ads

APPENDIX F

LETTERS REQUESTING AUDIT COMMITTEE

MEMBERSHIP INFORMATION

Study On Corporate Audit Committees
University of Windsor
Windsor, Ontario N9B3P4

Dear

I am a member of the Canadian Institute of Chartered Accountants. Presently, I am completing my doctoral studies at Michigan State University.

I am writing to ask for your cooperation in connection with a research project on corporate audit committees of the companies incorporated in the Province of Ontario. The primary objective of this research is to seek a better understanding of the role played by the corporate audit committees and the extent of their contribution to corporate governance.

A major part of my research is to gather relevant information from the members of the corporate audit committees. My specific request, therefore, is to seek your assistance in identifying the directors of your company who are currently serving on the audit committee. I have enclosed a listing of the directors of your company, as listed in the Financial Post's "Survey of Industries - 1972." Please identify the audit committee members by placing a check mark after the directors' names, and return the listing in the pre-stamped, self-addressed envelope provided.

I assure you that the information you provide will be held strictly confidential and that it will be used solely for this research.

Yours sincerely,

Wai Ping Lam, C.A., M.B.A.

APPENDIX G

PURPOSES OF THE AUDIT COMMITTEE

TABLE G-1

PURPOSES OF A CORPORATE AUDIT COMMITTEE - CORPORATE CHIEF EXECUTIVE OFFICERS

Purposes	Responses: Very Important		Important		Not Important		Not Important at All		No Response		Total	
	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%
1. To relieve the board of directors, as a whole, of details regarding -												
The nomination of the independent auditors	2	2.0	25	24.7	39	38.7	29	28.7	6	5.9	101	100.0
The arrangements for the independent audit	4	3.9	27	26.7	38	37.6	30	29.8	2	2.0	101	100.0
The review of the results of the independent audit	60	59.4	34	33.6	5	5.0	1	1.0	1	1.0	101	100.0
The review of the annual financial statements	59	58.4	35	34.6	4	4.0	1	1.0	2	2.0	101	100.0
2. To provide non-officer directors with direct and more personal contact with the independent auditors	28	27.7	46	45.5	18	17.8	6	6.0	3	3.0	101	100.0
3. To give additional attention to the audit function performed by the independent auditors	28	27.7	48	47.5	20	19.8	4	4.0	1	1.0	101	100.0
4. To give additional attention to the internal control functions of the company	33	32.6	52	51.5	11	10.9	4	4.0	1	1.0	101	100.0
5. To serve as an independent review function of the company's operations and its annual financial statements before their submission to the board of directors for approval	63	62.4	25	24.7	10	9.9	2	2.0	1	1.0	101	100.0
	277		292		145		77		17		808	

TABLE G-2

PURPOSES OF A CORPORATE AUDIT COMMITTEE - MEMBERS OF AUDIT COMMITTEES

Purposes	Responses											
	Very Important		Important		Not Important		Not Important at All		No Response		Total	
	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%
1. To relieve the board of directors, as a whole, of details regarding -												
The nomination of the independent auditor	13	6.6	47	24.2	62[a]	32.0	64[b]	33.0	8[c]	4.2	194	100.0
The arrangements for the independent audit	25	12.8	60	30.9	56	28.8	47	24.4	6	3.1	194	100.0
The review of the results of the independent audit	133	68.5	49	25.2	6	3.1	3	1.6	3	1.6	194	100.0
The review of the annual financial statements	123	63.4	52	26.8	11	5.6	5	2.6	3	1.6	194	100.0
2. To provide non-officer directors with direct and more personal contact with the independent auditors.	76	39.1	64	33.0	32	16.5	15	7.7	7	3.7	194	100.0
3. To give additional attention to the audit function performed by the independent auditors.	62	32.0	102	52.6	19	9.7	5	2.6	6	3.1	194	100.0
4. To give additional attention to the internal control functions of the company.	69	35.6	99	51.0	17	8.7	6	3.1	3	1.6	194	100.0
5. To serve as an independent review function of the company's operations and its annual financial statements before their submission to the board of directors for approval	118	60.7	60	30.9	8	4.2	4	2.1	4	2.1	194	100.0
	619		533		211		149		40		1552	

[a]One respondent indicated that this was not important unless the auditor appointment was done unsatisfactorily.

[b]One indicated that the nomination "should be done by the complete board," another indicated this was "not important if the company has a competent firm of auditors."

[c]One respondent disagreed with the question indicating that he "believes directors should elect auditors."

TABLE G-3

PURPOSES OF A CORPORATE AUDIT COMMITTEE - PRACTICING CHARTERED ACCOUNTANTS

Purposes	Responses										Total	
	Very Important		Important		Not Important		Not Important at All		No Response			
	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%
1. To relieve the board of directors, as a whole, of details regarding -												
The nomination of the independent auditors	7	11.7	12	20.0	24	40.0	17	28.3	-	-	60	100.0
The arrangements for the independent audit	12	20.0	20	33.3	17	28.3	11	18.4	-	-	60	100.0
The review of the results of the independent audit	41	68.4	14	23.3	3	5.0	2	3.3	-	-	60	100.0
The review of the annual financial statements	43	71.7	10	16.7	5	8.3	2	3.3	-	-	60	100.0
2. To provide non-officer directors with direct and more personal contact with the independent auditors.	38	63.4	20	33.3	2	3.3	-	-	-	-	60	100.0
3. To give additional attention to the audit function performed by the independent auditors	29	48.3	27	45.0	3	5.0	-	-	1	1.7	60	100.0
4. To give additional attention to the internal control functions of the company	20	33.3	30	50.0	10	16.7	-	-	-	-	60	100.0
5. To serve as an independent review function of the company's operations and its annual financial statements before their submission to the board of directors for approval.	39	65.0	16	26.6	3	5.0	1	1.7	1	1.7	60	100.0
	229		149		67		33		2		480	

TABLE G-4

PURPOSES OF A CORPORATE AUDIT COMMITTEE - FINANCIAL ANALYSTS

Purposes	Responses: Very Important		Important		Not Important		Not Important at All		No Response		Total	
	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%
1. To relieve the board of directors, as a whole, of details regarding -												
The nomination of the independent auditors	14	11.2	36	28.8	43	34.4	29	23.2	3	2.4	125	100.0
The arrangements for the independent audit	16	12.8	43	34.4	41	32.8	22	17.6	3	2.4	125	100.0
The review of the results of the indepent audit	57	45.6	46	36.8	13	10.4	7	5.6	2	1.6	125	100.0
The review of the annual financial statements	50	40.0	39	31.2	20	16.0	14	11.2	2	1.6	125	100.0
2. To provide non-officer directors with direct and more personal contact with the independent auditors	32	25.6	46	36.8	37	29.6	8	6.4	2	1.6	125	100.0
3. To give additional attention to the audit function performed by the independent auditors	44	35.2	65	52.0	11	8.8	3	2.4	2	1.6	125	100.0
4. To give additional attention to the internal control functions of the company	61	48.8	53	42.4	4	3.2	4	3.2	3	2.4	125	100.0
5. To serve as an independent review function of the company's operations and its annual financial statements before their submission to the board of directors for approval	74	59.2	37	29.6	11	8.8	3	2.4	-	-	125	100.0
	348		365		180		90		17		1000	

TABLE G-5

IMPORTANCE OF THE PURPOSES OF A CORPORATE AUDIT COMMITTEE - ALL GROUPS

Purposes	Responses													
	Very Important		Important		Total		Not Important		Not Important at all		Total		Grand Total	
	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%
1. To relieve the board of directors, as a whole, of details regarding -														
The nomination of the independent auditors	36	7.8	116	25.3	152	33.1	168	36.6	139	30.3	307	69.9	459	100.0
The arrangements for the independent audit	57	12.1	150	32.0	207	44.1	152	32.4	110	23.5	262	55.9	469	100.0
The review of the results of the independent audit	291	61.2	143	30.1	434	91.3	27	5.7	13	3.0	40	8.7	474	100.0
The review of the annual financial statements	275	58.1	136	28.9	411	87.0	40	8.4	22	4.6	62	13.0	473	100.0
2. To provide nonofficer directors with direct and more personal contact with the independent auditors	174	37.2	176	37.6	350	74.8	89	19.0	29	6.2	118	25.2	468	100.0
3. To give additional attention to the audit function performed by the independent auditors	163	34.7	242	51.5	405	86.2	53	11.3	12	2.5	65	13.8	470	100.0
4. To give additional attention to the internal control functions of the company	183	38.7	234	49.4	417	88.1	42	8.9	14	3.0	56	11.9	473	100.0
5. To serve as an independent review function of the company's operations and its annual financial statements before their submission to the board of directors for approval.	294	62.0	138	29.1	432	91.1	32	6.8	10	2.1	42	8.9	474	100.0
	1,473		1,335		2,808		603		349		952		3,760	

*Maximum total should be 480, the smaller totals are due to the number of no response for each individual item.

APPENDIX H

FUNCTIONS OF THE AUDIT COMMITTEE

TABLE H-1

IMPORTANCE OF FUNCTIONS OF A CORPORATE AUDIT COMMITTEE - CORPORATE CHIEF EXECUTIVE OFFICERS

Functions	Responses											
	Very Important		Important		Not Important		Not Important at All		No Response		Total	
	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%
1. Nominate the independent auditors	2	2.0	25	24.7	31	30.8	27	26.7	16	15.8	101	100.0
2. Discuss with the independent auditors, before the audit is completed, its scope, purpose, and procedures to be included	13	12.9	33	32.6	31	30.8	14	13.8	10	9.9	101	100.0
3. Review with the independent auditors, on completion of the audit, their experience, any restrictions on their work, cooperation received, their findings and their recommendations	66	65.3	29	28.7	2	2.0	2	2.0	2	2.0	101	100.0
4. Review with the independent auditors their evaluation of the company's internal control systems	55	54.4	37	36.7	4	4.0	-		5	4.9	101	100.0
5. Review interim financial reports to shareholders before these reports are approved by the board of directors	25	24.7	26	25.8	19	18.8	17	16.8	14	13.9	101	100.0
6. Review the corporate annual financial statements before their submission to the board of directors for approval	58	57.4	32	31.7	5	4.9	2	2.0	4	4.0	101	100.0
7. Review the scope of internal audit procedures with the chief internal auditor	20	19.8	32	31.7	19	18.8	9	8.9	21	20.8	101	100.0
8. Review the reports of the internal audit staff	9	8.9	23	22.8	30	29.8	15	14.8	24	23.7	101	100.0

TABLE H-2

IMPORTANCE OF FUNCTIONS OF A CORPORATE AUDIT COMMITTEE - MEMBERS OF AUDIT COMMITTEES

Functions	Responses													
	Very Important		Important		Not Important		Not Important at All		No Response		Not Applicable*		Total	
	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%
1. Nominate the independent auditors	14	7.2	46	23.7	53	27.3	61	31.4	13	6.7	7[a]	3.7	194	100.0
2. Discuss with the independent auditors, before the audit is completed, its scope, purpose, and procedures to be included	52	26.8	83	42.6	32	16.5	10	5.2	10	5.2	7[b]	3.7	194	100.0
3. Review with the independent auditors, on completion of the audit, their experience, any restrictions on their work, cooperation received, their findings and their recommendations	140	72.2	46	23.7	3	1.5	1	.5	4	2.1	-		194	100.0
4. Review with the independent auditors their evaluation of the company's internal control systems	110	56.7	71	36.6	5	2.5	4	2.1	4	2.1	-		194	100.0
5. Review interim financial reports to shareholders before these reports are approved by the board of directors	42	21.6	66	34.0	45	23.2	24	12.4	9	4.6	8	4.2	194	100.0
6. Review the corporate annual financial statements before their submission to the board of directors for approval	112	57.7	66	34.0	7	3.7	3	1.5	6	3.1	-		194	100.0
7. Review the scope of internal audit procedures with the chief internal auditor	45	23.2	74	38.2	29	14.9	15	7.7	8	4.2	23	11.8	194	100.0
8. Review the reports of the internal audit staff	20	10.3	58	30.0	50	25.8	20	10.3	19	9.8	27	13.8	194	100.0

*This is for those respondents who indicated that the function should not be done by the committee or there was no such function in their company, e.g. no internal audit department.

[a]Many respondents believed "this is not the function of the committee."

[b]One respondent indicated that "auditors plan their own program, except as specifically required by the board or management."

TABLE H-3

IMPORTANCE OF FUNCTIONS OF A CORPORATE AUDIT COMMITTEE - PRACTICING CHARTERED ACCOUNTANTS

Functions	Responses: Very Important		Important		Not Important		Not Important At All		No Response		Total	
	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%
1. Nominate the independent auditors	12	20.0	20	33.3	17	28.3	10[a]	16.7	1	1.7	60	100.0
2. Discuss with the independent auditors, before the audit is completed, its scope, purpose, and procedures to be included	23	38.3	25	41.7	11	18.3	1	1.7	-		60	100.0
3. Review with the independent auditors, on completion of the audit, their experience, any restrictions on their work, coopration received, their findings and their recommendations	55	91.7	5	8.3	-		-		-		60	100.0
4. Review with the independent auditors their evaluation of the company's internal control systems	33	55.0	20	33.3	7	11.7	-		-		60	100.0
5. Review interim financial reports to shareholders before these reports are approved by the board of directors	18	30.0	31	51.7	11	18.3	-		-		60	100.0
6. Review the corporate annual financial statements before their submission to the board of directors for approval	51	85.0	9	15.0	-		-		-		60	100.0
7. Review the scope of internal audit procedures with the chief internal auditor	14	23.3	29	48.3	16	26.7	1	1.7	-		60	100.0
8. Review the reports of the internal audit staff	13	21.7	28	46.7	17	28.3	2	3.3	-		60	100.0

[a]One respondent explained that this "should be the function of the full board" and therefore classified as not important at all.

TABLE H-4

IMPORTANCE OF FUNCTIONS OF A CORPORATE AUDIT COMMITTEE - FINANCIAL ANALYSTS

Functions	Responses										Total	
	Very Important		Important		Not Important		Not Important at All		No Response			
	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%
1. Nominate the independent auditors	15	12.0	43	34.4	44	35.2	20	16.0	3	2.4	125	100.0
2. Discuss with the independent auditors, before the audit is completed, its scope, purpose, and procedures to be included	39	31.2	59	47.2	17	13.6	7	5.6	3	2.4	125	100.0
3. Review with the independent auditors, on completion of the audit, their experience, any restrictions on their work, cooperation received, their findings and their recommendations	83	66.4	36	28.8	3	2.4	-		3	2.4	125	100.0
4. Review with the independent auditors their evaluation of the company's internal control systems	76	60.8	42	33.6	5	4.0	-		2	1.6	125	100.0
5. Review interim financial reports to shareholders before these reports are approved by the board of directors	28	22.4	67	53.6	22	17.6	5	4.0	3	2.4	125	100.0
6. Review the corporate annual financial statements before their submission to the board of directors for approval	47	37.6	64	51.2	8	6.4	4	3.2	2	1.6	125	100.0
7. Review the scope of internal audit procedures with the chief internal auditor	48	38.4	62	49.6	10	8.0	2	1.6	3	2.4	125	100.0
8. Review the reports of the internal audit staff	38	30.4	56	44.8	23	18.4	4	3.2	4	3.2	125	100.0

TABLE H-5

IMPORTANCE OF FUNCTIONS OF A CORPORATE AUDIT COMMITTEE - ALL GROUPS

Functions	Responses													
	Very Important		Important		Total		Not Important		Not Important at All		Total		Grand Total	
	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%
1. Nominate the independent auditors	44	10.0	133	30.1	177	40.1	145	33.0	118	26.9	263	59.9	440	100.0
2. Discuss with the independent auditors, before the audit is completed, its scope, purpose, and procedures to be included.	127	28.2	200	44.5	327	72.7	91	20.2	32	7.1	123	27.3	450	100.0
3. Review with the independent auditors, on completion of the audit, their experience, any restrictions on their work, cooperation received, their findings and their recommendations	344	73.0	116	24.6	460	97.6	8	1.7	3	.7	11	2.4	471	100.0
4. Review with the independent auditors their evaluation of the company's internal control systems	274	58.4	170	36.3	444	94.7	21	4.4	4	.9	25	5.3	469	100.0
5. Review interim financial reports to shareholders before these reports are approved by the board of directors	113	25.3	190	42.6	303	67.9	97	21.7	46	10.4	143	32.1	446	100.0
6. Review the corporate annual financial statements before their submission to the board of directors for approval	268	57.3	171	36.5	439	93.8	20	4.2	9	2.0	29	6.2	468	100.0
7. Review the scope of internal audit procedures with the chief internal auditor	127	29.9	197	46.3	324	76.2	74	17.4	27	6.4	101	23.8	425	100.0
8. Review the reports of the internal audit staff	80	19.7	165	40.6	245	60.3	120	29.5	41	10.2	161	39.7	406	100.0

TABLE H-6

EFFECTIVENESS OF CORPORATE AUDIT COMMITTEE FUNCTIONS - CORPORATE CHIEF EXECUTIVE OFFICERS

Functions	Responses									
	Effectiveness of Performance									
	Effective		Ineffective		No Response		Not Applicable*		Total	
	No.	%	No.	%	No.	%	No.	%	No.	%
1. Nominate the independent auditors	33	32.6	19	18.8	19	18.8	30	29.8	101	100.0
2. Discuss with the independent auditors, before the audit is completed, its scope, purpose, and procedures to be included	37	36.7	27	26.7	17	16.8	20	19.8	101	100.0
3. Review with the independent auditors, on completion of the audit, their experience, any restrictions on their work, cooperation received, their findings and their recommendations	77	76.3	5	5.0	16	15.8	3	2.9	101	100.0
4. Review with the independent auditors their evaluation of the company's internal control systems	69	68.3	9	8.9	17	16.8	6	6.0	101	100.0
5. Review interim financial reports to shareholders before these reports are approved by the board of directors	38	37.6	18	17.8	17	16.8	28	27.8	101	100.0
6. Review the corporate annual financial statements before their submission to the board of directors for approval	75	74.2	6	6.0	16	15.8	4	4.0	101	100.0
7. Review the scope of internal audit procedures with the chief internal auditor	35	34.6	19	18.8	16	15.8	31	30.8	101	100.0
8. Review the reports of the internal audit staff	26	25.7	18	17.8	18	17.8	39	38.7	101	100.0

*This column indicates that the functions are not performed by the committee.

TABLE H-7

EFFECTIVENESS OF CORPORATE AUDIT COMMITTEE FUNCTIONS - MEMBERS OF AUDIT COMMITTEES

Functions	Responses									
	Effectiveness of Performance									
	Effective		Ineffective		No Response		Not Applicable*		Total	
	No.	%	No.	%	No.	%	No.	%	No.	%
1. Nominate the independent auditors	64	33.0	33	17.0	48	24.7	49	25.3	194	100.0
2. Discuss with the independent auditors, before the audit is completed, its scope, purpose, and procedures to be included	100	51.5	32	16.5	38	19.6	24	12.4	194	100.0
3. Review with the independent auditors, on completion of the audit, their experience, any restrictions on their work, cooperation received, their findings and their recommendations	150	77.3	11	5.7	32	16.5	1	.5	194	100.0
4. Review with the independent auditors their evaluation of the company's internal control systems	137	70.6	18	9.2	32	16.5	7	3.7	194	100.0
5. Review interim financial reports to shareholders before these reports are approved by the board of directors	80	41.3	36	18.5	44	22.7	34	17.5	194	100.0
6. Review the corporate annual financial statements before their submission to the board of directors for approval	149	76.8	7	3.7	35	18.0	3	1.5	194	100.0
7. Review the scope of internal audit procedures with the chief internal auditor	72	37.1	38	19.6	38	19.6	46	23.7	194	100.0
8. Review the reports of the internal audit staff	49	25.3	42	21.6	50	25.8	53	27.3	194	100.0

*This column indicates that the functions are not performed by the committee.

TABLE H-8

PERFORMANCE OF CORPORATE AUDIT COMMITTEE FUNCTIONS - PRACTICING CHARTERED ACCOUNTANTS

Functions	Function is Performed By											
	50% or More		Less than 50%		None		No Response		Not Applicable[a]		Total	
	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%
1. Nominate the independent auditors	11	18.3	4	6.7	39	65.0	6	10.0	-		60	100.0
2. Discuss with the independent auditors, before the audit is completed, its scope, purpose, and procedures to be included.	23	38.3	12	20.0	19	31.7	6	10.0	-		60	100.0
3. Review with the independent auditors, on completion of the audit, their experience, any restrictions on their work, cooperation received, their findings and their recommendations	49	81.7	4	6.6	1	1.7	6	10.0	-		60	100.0
4. Review with the independent auditors their evaluation of the company's internal control systems	30	50.0	11	18.3	13	21.7	6	10.0	-		60	100.0
5. Review interim financial reports to shareholders before these reports are approved by the board of directors	11	18.3	14	23.3	27	45.0	8	13.4	-		60	100.0
6. Review the corporate annual financial statements before their submission to the board of directors for approval	54	90.0	-		-		6	10.0	-		60	100.0
7. Review the scope of internal audit procedures with the chief internal auditor	3	5.0	8	13.4	34	56.7	8	13.3	7	11.6	60	100.0
8. Review the reports of the internal audit staff	3	5.0	11	18.3	31	51.8	8	13.3	7	11.6	60	100.0

[a]They are not applicable because the clients did not have an internal audit department.

TABLE H-9

EFFECTIVENESS OF CORPORATE AUDIT COMMITTEE FUNCTIONS - PRACTICING CHARTERED ACCOUNTANTS

Functions	Effective Performance of Function									
	Effective		Ineffective		No Response		No Applicable[a]		Total	
	No.	%	No.	%	No.	%	No.	%	No.	%
1. Nominate the independent auditors	13	21.7	3	5.0	6	10.0	38	63.3	60	100.0
2. Discuss with the independent auditors, before the audit is completed, its scope, purpose, and procedures to be included	26	43.3	9	15.0	6	10.0	19	31.7	60	100.0
3. Review with the independent auditors, on completion of the audit, their experience, any restrictions on their work, cooperation received, their findings and their recommendations	46	76.7	6	10.0	7	11.6	1	1.7	60	100.0
4. Review with the independent auditors their evaluation of the company's internal control systems	29	48.4	11	18.3	7	11.6	13	21.7	60	100.0
5. Review interim financial reports to shareholders before these reports are approved by the board of directors	16	26.7	9	15.0	8	13.3	27	45.0	60	100.0
6. Review the corporate annual financial statements before their submission to the board of directors for approval	48	80.0	5	8.4	7	11.6	-		60	100.0
7. Review the scope of internal audit procedures with the chief internal auditor	4	6.7	6	10.0	7	11.6	43	71.7	60	100.0
8. Review the reports of the internal audit staff	5	8.4	7	11.5	8	13.4	40	66.7	60	100.0

[a]They are not applicable because the clients did not perform these functions.

APPENDIX I

FACTORS FOR AN EFFECTIVE CORPORATE AUDIT COMMITTEE

TABLE I-1

RANKING OF THE FACTORS FOR AN EFFECTIVE CORPORATE AUDIT COMMITTEE - CORPORATE CHIEF EXECUTIVE OFFICERS

Factors	Ranking										Total		
	1	1.5	2	2.5	3	3.5	4	4.5	5	No Response	Responses	Points*	Rank
Competence of the audit committee members	53	1	16	1	21	-	7	1	-	1	101	184.5	1
Full cooperation and support of the board of directors	8	3	11	-	18	1	22	2	35	1	101	364.0	5
Full cooperation and support of the corporate chief executive officer	7	4	35	2	16	1	17	1	17	1	101	297.0	2
A set of well established objectives of the audit committee	18	1	16	1	23	2	22	4	13	1	101	301.0	3
A set of well established functions of the audit committee	2	1	16	2	25	2	27	2	23	1	101	354.5	4

*Total points are computed by multiplying the number of the rank and the number of responses in that rank. For example, if all respondents ranked the first factor as the most important, its total point would be 101. Therefore, the factor with the lowest total points is the most important.

TABLE I-2

RANKING OF THE FACTORS FOR AN EFFECTIVE CORPORATE AUDIT COMMITTEE - MEMBERS OF AUDIT COMMITTEES

Factors	Ranking										Total		
	1	1.5	2	2.5	3	3.5	4	4.5	5	No Response	Responses	Points*	Rank
Competence of the audit committee members	87	7	29	7	31	2	15	-	13	3	194	378.0	1
Full cooperation and support of the board of directors	11	-	23	5	30	4	43	5	70	3	194	718.0	5
Full cooperation and support of the corporate chief executive officer	22	2	37	10	30	5	45	2	38	3	194	610.5	3
A set of well established objectives of the audit committee	26	7	55	10	41	5	25	9	13	3	194	517.5	2
A set of well established functions of the audit committee	13	4	34	10	46	6	32	10	36	3	194	624.0	4

*Total points are computed by multiplying the number of the rank and the number of responses in that rank. For example, if all respondents ranked the first factor as the most important, its total points would be 194. Therefore, the factor with the lowest total point is the most important.

TABLE I-3

RANKING OF THE FACTORS FOR AN EFFECTIVE CORPORATE AUDIT COMMITTEE - PRACTICING CHARTERED ACCOUNTANTS

Factors	Ranking							Total		
	1	2	2.5	3	4	5	No Response	Responses	Points*	Rank
Competence of the audit committee members	33	7	3	9	4	2	2	60	107.5	1
Full cooperation and support of the board of directors	3	10	1	9	20	15	2	60	207.5	4
Full cooperation and support of the corporate chief executive officer	2	5	2	6	17	26	2	60	233.0	5
A set of well established objectives of the audit committee	15	22	3	11	6	1	2	60	128.5	2
A set of well established functions of the audit committee	2	10	3	23	7	13	2	60	191.5	3

*Total points are computed by multiplying the number of the rank and the number of responses in that rank. For example, if all respondents ranked the first factor as the most important, its total points would be 60. Therefore, the factor with the lowest total points is the most important.

TABLE I-4

RANKING OF THE FACTORS FOR AN EFFECTIVE CORPORATE AUDIT COMMITTEE
FINANCIAL ANALYSTS

Factors	Ranking										Total		
	1	1.5	2	2.5	3	3.5	4	4.5	5	No Response	Responses	Points*	Rank
Competence of the audit committee members	57	-	20	3	28	1	9	4	3	-	125	261.0	1
Full cooperation and support of the board of directors	16	1	19	1	21	2	30	4	30	1	125	416.0	3
Full cooperation and support of the corporate chief executive officer	15	1	23	2	20	2	19	6	36	1	125	417.0	4
A set of well established objectives of the audit committee	20	1	40	3	27	2	28	-	3	1	125	324.0	2
A set of well established functions of the audit committee	5	1	22	3	27	3	26	2	35	1	125	437.5	5

*Total points are computed by multiplying the number of the rank and the number of responses in that rank. For example, if all respondents ranked the first factor as the most important, its total points would be 125. Therefore, the factor with the lowest total points is the most important.

APPENDIX J

BENEFITS OF AN EFFECTIVE CORPORATE AUDIT COMMITTEE

TABLE J-1

BENEFITS OF AN EFFECTIVE CORPORATE AUDIT COMMITTEE - ALL GROUPS

Benefits	Responses															
	Yes						No						No Response		Overall Total	
	CEO*	MAC	CA	FA	Total No.	Total %	CEO	MAC	CA	FA	Total No.	Total %	No.	%	No.	%
Gives added assurance to users of financial statements as to the objectivity of corporate financial statements	73	140	37	84	334	69.6	25	48	21	38	132	27.5	14	2.9	480	100.0
Reinforces the independence of the corporation's external auditors	67	156	53	80	356	74.0	29	34	5	44	112	23.3	12	2.7	480	100.0
Results in increased attention to the audit and control functions at the director's level	88	164	58	112	422	88.0	11	29	-	12	52	10.8	6	1.2	480	100.0
Provides added protection for the directors of the corporation, especially for the non-officer directors, against potential litigation concerning the due care they exercise in the fulfillment of their responsibilities	78	155	42	100	375	78.1	19	36	14	23	92	19.1	13	2.8	480	100.0

*CEO = Corporate chief executive officer

MAC = Member of audit committee

CA = Practicing chartered accountant

FA = Financial analysts.

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