THE AUDIT COMMITTEE HANDBOOK

Fourth Edition

LOUIS BRAIOTTA, JR., C.P.A.

School of Management
State University of New York at Binghamton
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To the Adopters of the third edition
and dedicated to my mother,
Frances Braiotta.
From the Forewords of the First Two Editions . . .

Excerpt from the foreword to the second edition:

Members of audit committees will find this second edition an invaluable resource in meeting their oversight responsibilities and give them an increasing awareness of their current duties as well as an insight into future developments.

—Richard S. Hickok, CPA
Chairman, Hickok Associates, Inc.,
and Chairman Emeritus of KMG/Main Hurdman
(now KPMG Peat Marwick)

Excerpt from the foreword of the first edition:

Audit committee members will find this book a useful reference in performing their oversight responsibilities. It should also help them develop a constructive relationship between their function and the activities of the full corporate board, management, and internal and external auditors.

—John C. Biegler, CPA
Chairman Emeritus, Price Waterhouse International
(now PricewaterhouseCoopers)
As a purchaser of *Audit Committee Handbook, Fourth Edition*, you have access to the companion website. The website contains a Glossary and other Appendices that provide valuable perspective and key legislation to interested readers. To access the website, go to www.wiley.com/go/auditcommittee.

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Preface

Since the publication of the third edition of The Audit Committee Handbook in 1999, a number of major accounting scandals (e.g., Enron, WorldCom, and others) as well as the demise of the international accounting firm of Anderson LLP have shaken the global capital markets. As a result, the U.S. Congress enacted the Sarbanes-Oxley Act of 2002 and the Securities and Exchange Commission adopted final rules amending the securities laws. Likewise, the Self-Regulatory Organizations set forth a number of amendments to their listing standards with respect to corporate governance and accountability. The major thrust of these reforms is to create a new regulatory and legal environment and corporate accountability framework, which, in turn, provides an effective financial reporting system with relevant and reliable financial information. The primary goal is to restore investor confidence through an efficient securities market system.

Historically, the role and responsibilities of the audit committee as a key institution in corporate governance has been accepted as an important oversight mechanism to help the board of directors discharge its fiduciary financial responsibility and stewardship accountability to the shareholders. However, the aforementioned events have caused a reexamination of the audit committee’s role in the context of corporate governance. In fact, these events have caused a number of best practices for the audit committee to become federal statute. Given these mandates, members of audit committees must adhere to higher standards in corporate accountability to ensure the quality of financial information and investor protection against accounting scandals. Audit committees in a global securities marketplace continue to respond to the investing public’s demand for oversight protection. (See Appendix D on this book’s website.) As noted, such committees not only help engender a high degree of integrity in both the internal and external audit processes and financial reporting process, but they also help provide for an efficient and transparent securities market. For example, many countries with developed equity markets or emerging markets have adopted audit committees through public and/or private sector initiatives to ensure price protection of their securities to investors. Moreover, the recent initiatives to develop and adopt harmonized international accounting and auditing standards accentuate the need to achieve uniformity in oversight protection to investors. It should be noted that companies will use the endorsement of these standards by the International Organization of Securities Commissions in their stock offering documents to raise capital in a global securities marketplace.
Although many countries have recognized that the establishment and benefits of audit committees help to ensure integrity in the corporate accountability process, it is imperative that such committees conduct their activities in an efficient and effective manner to help their boards of directors discharge their financial and fiduciary responsibilities to stockholders. As noted in the text, the recent enactment of the Sarbanes-Oxley Act of 2002 will influence significantly how boards of directors through their audit committees can meet their oversight responsibilities in both the auditing and financial reporting areas. This fourth edition provides comprehensive guidance to all functions, duties, and responsibilities of audit committees as well as their direction in the corporate governance context. It retains the thrust of the third edition, focusing on current trends and developments that maximize the effectiveness of audit committees. Numerous references are made to the pronouncements of leading organizations in both the public and private sectors to bring an element of authority to the handbook.

Recognizing that audit committees interact with the internal auditor, independent auditor, chief financial officer, internal legal counsel, and independent legal counsel, the fourth edition continues to offer practical guidance in developing a constructive relationship between the committees’ jurisdictional responsibilities and the activities of these executives. This revised professional reference work enables the aforementioned parties to help audit committees plan their agendas and achieve their mission in corporate governance. It provides a perspective that will help the members of the audit committee develop the appropriate requisite knowledge with respect to such matters as:

- Understanding the role and responsibilities of the audit committee with a general update and reality check on auditing cycle activities.
- Identifying the developments that impact audit committee practices and the latest techniques and strategies for committee meetings.
- Understanding the latest authoritative sources that enable audit committee members to develop a repertoire of effective strategies to help the board of directors discharge its fiduciary responsibility to the stockholders.
- Developing a comprehensive professional development program that enables committee members to prepare a periodic assessment of their activities and an informed review of both audit processes and financial reporting process.
- Understanding the legal aspects of the audit committee and role of legal counsel as well as fraudulent financial reporting.

The book is divided into four parts. Part 1 includes a discussion on corporate accountability, the audit committee’s basic roles and responsibilities, the external users of accounting information, and the legal position of the audit committee. In addition, the broad framework of generally accepted auditing standards and their integration with generally accepted accounting principles are dealt with in one chapter to show their interrelationship.

Part 2 covers the planning function of the audit committee. An initial overview of the concept of audit planning is presented and followed with a discussion of the
Preface

audit director’s role in planning the audit. This part includes a discussion of the selection or reappointment of the public accounting firm.

Part 3 describes the monitoring and reviewing functions of the audit committee. Here the book focuses on the system of internal control, the internal audit function, accounting policy disclosures, fraud and the auditor, and sensitive business practices.

Part 4 covers the reporting function of the audit committee. Special attention initially is given to an overview of the independent auditor’s opinions and reports. The final chapter explains the purpose of the audit committee’s report and discusses the guidelines for preparing it.

This book seeks to provide useful information and guidance for the audit committee and to point out opportunities for auditors and management to better serve the audit committee.

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I want to express my appreciation to Dr. Upinder Dhillon, dean of the School of Management of Binghamton University (State University of New York), for his encouragement in the preparation of the manuscript. Also, I want to thank my faculty colleagues, accounting practitioners, and students for their encouragement and support.

I am grateful to the American Institute of Certified Public Accountants, the Institute of Internal Auditors, the American Bar Association, and the Association of Certified Fraud Examiners for their permission to use certain materials subject to their copyrights.

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Part One

Getting Acquainted with Your Responsibilities
Chapter 1

Corporate Accountability:
The New Environment

To properly understand the importance of the corporate director’s position on the audit committee, one must understand the nature and importance of the concept of corporate accountability in the new legal and regulatory framework under statutory law. Therefore, the major objectives of this chapter are: first, to revisit the meaning and significance of corporate accountability; second, to explain the significance of major audit committee developments in the context of corporate accountability with special emphasis on those of the past five years; and third, to show the impact of corporate accountability on the audit committee and its corporate relationships.

Although the recent failures of major corporations, such as Enron, WorldCom, and others, have accelerated the need for legal and regulatory reforms, the concept and meaning of corporate accountability in relation to the institution of the audit committee remains the same both before and after accounting scandals. However, with the enactment of the Sarbanes-Oxley Act of 2002, the substantive meaning of corporate accountability has caused many best practices for audit committees to become statutory law. Moreover, the new legislation has caused an institutional restructuring of the accounting profession as well as additional resources for the Securities and Exchange Commission (SEC) to curb abuses of fraudulent financial reporting.

THE NATURE AND IMPORTANCE OF CORPORATE ACCOUNTABILITY

The Meaning of Corporate Accountability

With the recent establishment of the Public Company Accounting Oversight Board (PCAOB) with its oversight and enforcement authority over the independent audit process and the concomitant effect on strengthening the institution of the audit committee, it is reasonable to expect that shareholders and other constituencies of corporations will receive relevant and reliable financial information. Thus, such congressional legislative action will help to ensure an efficient capital market system. As James S. Turley, chairman and chief executive officer of Ernst & Young LLP, points out;

The biggest problem today is the loss of confidence, in not just our profession, but in financial management, executive management, audit committees and boards.
While I see no silver bullet to turn that around, I think it is going to be turned around by sustained, outstanding performance, high quality [and] high integrity by all parties—management, audit committees, audit firms.¹

Strictly speaking, the concept of corporate accountability may be stated in this way:

The board of directors is charged with safeguarding and advancing the interest of the stockholders, acting as their representatives in establishing corporate policies, and reviewing management’s execution of those policies. Accordingly, the directors have a fiduciary responsibility to the stockholders. They have an obligation to inform themselves about the company’s affairs and to act diligently and capably in fulfilling their responsibilities.²

The board of directors is charged with protecting the interests of the stockholders because the position of the board is determined by state laws. The powers and responsibilities of the board are defined in the corporate charter and the corporate bylaws. Therefore, from a legal point of view, the basic purpose of corporate accountability is to provide a legal framework within which the directors must discharge their stewardship accountability to the stockholders. Furthermore, the board is directly answerable to the stockholders because the stockholders, as the owners of the enterprise, have entrusted their capital resources to the management of the corporation. (See Appendix H on this book’s website.)

The Business Roundtable described corporate accountability in this way:

The board of directors is ultimately accountable to the shareholders for the long-term successful economic performance of the corporation consistent with its underlying public purpose. Directors are held accountable for their performance in a variety of ways.

First, there is the powerful accountability imposed by markets. The impact of consumer dissatisfaction with products and services is quick and visible. Financial markets also quickly reflect their evaluation of the quality of accountability through the price of equity and debt.

Accountability is also imposed through the numerous statutes and regulations enacted by governmental bodies to limit and control corporate action. Directors are held accountable to regulatory mechanisms.

There is also a body of law—part statutory, part court-made—which defines the duties of directors and the principles and boundaries within which they must keep their decisions. If they overstep, their decisions are subject to reversal by the courts. Directors can also be held personally liable, without limitation, to the extent of their personal assets if they violate their duty of loyalty to the corporation.

A final form of board accountability comes through the election of directors by the shareholders at the corporation’s annual meeting. Annual meetings may also include shareholder resolutions which are a form of governance by referendum.

The Nature and Importance of Corporate Accountability

Each of these forms of accountability is dynamic, not static. The developing specifics of each form of accountability must be judged as to its overall potential to contribute to the successful long-term performance of the corporation. Each specific new item of accountability carries with it the potential for harm as well as good.3

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

First, the paramount duty of the board of directors of a public corporation is to select a chief executive officer and to oversee the CEO and other senior management in the competent and ethical operation of the corporation on a day-to-day basis.

Second, it is the responsibility of management to operate the corporation in an effective and ethical manner in order to produce value for stockholders. Senior management is expected to know how the corporation earns its income and what risks the corporation is undertaking in the course of carrying out its business. Management should never put personal interests ahead of or in conflict with the interests of the corporation.

Third, it is the responsibility of management, under the oversight of the board and its audit committee, to produce financial statements that fairly present the financial condition and results of operations of the corporation, and to make the timely disclosures investors need to permit them to assess the financial and business soundness and risks of the corporation.

Fourth, it is the responsibility of the board and its audit committee to engage an independent accounting firm to audit the financial statements prepared by management and to issue an opinion on those statements based on Generally Accepted Accounting Principles. The board, its audit committee, and management must be vigilant to ensure that no actions are taken by the corporation or its employees that compromise the independence of the outside auditor.

Fifth, it is the responsibility of the independent accounting firm to ensure that it is in fact independent, is without conflicts of interest, employs highly competent staff, and carries out its work in accordance with Generally Accepted Auditing Standards. It is also the responsibility of the independent accounting firm to inform the board, through the audit committee, of any concerns the auditor may have about the appropriateness or quality of significant accounting treatments, business transactions that affect the fair presentation of the corporation’s financial condition and results of operations, and weaknesses in internal control systems. The auditor should do so in a forthright manner and on a timely basis, whether or not management has also communicated with the board or the audit committee on these matters.

Sixth, the corporation has a responsibility to deal with its employees in a fair and equitable manner.

These responsibilities, and others, are critical to the functioning of the modern public corporation and the integrity of the public markets. No law or regulation alone can be a substitute for the voluntary adherence to these principles by corporate directors and management and by the accounting firms retained to serve American corporations.

The Business Roundtable continues to believe that the most effective way to enhance corporate governance is through conscientious and forward-looking action by a

business community that focuses on generating long-term stockholder value with the highest degree of integrity.

The principles discussed here are intended to assist corporate management and boards of directors in their individual efforts to implement best practices of corporate governance, and also to serve as guideposts for the public dialogue on evolving governance standards.4

With respect to establishing and maintaining corporate policies, the board of directors is responsible to the stockholders for ensuring that management fulfills its responsibilities in the execution of the corporate policies. For example, the board can authorize the establishment of an audit committee to assist the board with the development of the financial accounting policies. In addition, the audit committee can be authorized to review the preparation of the financial statements as well as to select the independent auditors. Although the board has the power to delegate authority to the various standing committees, such as the audit committee or the executive committee, the board must render an accountability to the stockholders. In short, the board has a fiduciary relationship with the stockholders and, as a result, must report periodically on the status of the corporation’s economic resources.

As John Shandor points out:

Audit committees have become crucial to the audit process. Also, the audit committee has been considered essential in an organizational approach to making boards of directors more effective in their interaction with financial management and chief executive officers as well as with internal audit staff and independent auditors.5

In addition to the directors’ fiduciary responsibility, they are expected to attend board meetings and their appropriate standing committee meetings. A director must keep informed on the affairs of the corporation and use reasonable care and diligence in the performance of his or her duties. It is imperative that the director keep abreast of the corporate developments since he or she is directly responsible for participating in the decisions that affect the management of the corporation. Thus the director may be held liable for losses sustained by the corporation as a result of his or her neglect.

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

Boards of directors have a primary role in interpreting society’s expectations and standards for management.

The Nature and Importance of Corporate Accountability

The five key board functions are:

(a) Appraisal of management performance and provision for management and board succession;
(b) Determination of significant policies and actions with respect to present and future profitability and strategic direction of the enterprise;
(c) Determination of policies and actions with a potential for significant financial, economic, and social impact;
(d) Establishment of policies and procedures designed to obtain compliance with the law; and
(e) Responsibility for monitoring the totality of corporate performance.

Boards should continue to be the central focus in improving the way corporations are governed.6

In addition to the American Assembly’s recommendations, to establish and maintain a successful program of corporate accountability, the following three prerequisites are necessary:

1. The board of directors and the officers must assume prime responsibility for corporate accountability as well as define and clarify the objectives and responsibilities concerning the different levels of the organization. Therefore, the individuals who are assigned responsibility at the middle and lower management levels should be held accountable for their activities.

2. The organization chart of the corporation is central to establishing corporate accountability since the jurisdiction for each area within the corporation must be defined. Also, the extent of authority should not only be clearly outlined but also commensurate with the individual’s responsibilities.

3. Executive management should create a management environment whereby the middle and lower management levels understand the nature of corporate accountability. Thus management should maintain an effective communications network within the organizational structure.

As a case in point, Bruce W. McCuaig and Paul G. Makosz report that Gulf Canada Resources, Ltd., has developed a new approach to corporate governance through the use of an internal control assessment strategy. Such a strategy was developed based on a clear definition of internal control as a combination of (1) organization controls, (2) systems development and change controls, (3) authorization and reporting controls, (4) accounting systems controls, (5) safeguarding controls, (6) management supervisory controls, and (7) documentation controls. With the implementation of a management-by-objectives framework and related control mechanisms, the authors observed that the board of directors and senior management are far better informed.7

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

The Need for Corporate Accountability

In view of the size and scope of modern corporations as well as the increasing demands in the legal and regulatory environment, the need for corporate accountability has become very important in the evaluation of the performance of the board of directors. For example, the sales figures of these corporations amount to billions of dollars, which far exceed the gross national product of several countries. In addition, large corporations have control over the major economic resources of society. Furthermore, the board of directors is subject to numerous public laws, such as the Environmental Protection Act, the Occupational Safety and Health Act, federal securities laws, and antitrust laws. Thus many of these corporate enterprises play a significant role in the future of our society, since the decisions of corporate management have a direct impact on the economy.

Unfortunately, corporations are confronted with the problem of a lack of credibility because they often have been subject to corporate self-interest as opposed to the public interest. As one former executive partner of Price Waterhouse International asserts:

We have all been stunned by the shocking disclosures of alleged improper payments and similar activities, not by funny fly-by-night firms nobody ever heard of, but by some of the finest names on the roster of American enterprise. . . . As one inevitable result, reinforced by uneasy business conditions, public confidence in American business has plunged to its lowest level since the great depression. It is as if these events simply confirmed a gathering suspicion that such transgressions are not exceptional—a suspicion that American business is built on bribery and deceit.8

Samuel A. DiPiazza, Jr., CEO, PricewaterhouseCoopers LLP, and Robert G. Eccles, president, Advisory Capital Partners, echo that observation:

Public trust has shaken in the institutions on which this value creation depends. These institutions share a collective responsibility for producing the information on which people of many levels—investors, lenders, trading partners, customers, employees—depend to make a wide range of economic decisions. The challenge now is to institute the necessary reforms to ensure that public trust does not disappear, and the foundation for those reforms lies in corporate reporting.9

In an effort to close the credibility gap or the expectation gap with respect corporate accounting scandals, the U.S. Congress passed the Sarbanes-Oxley Act on...

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