Corporate Governance – The Role of the Audit Committee

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ABSTRACT:

The provisions of the Sarbanes-Oxley Act have far-reaching ramifications for insurance companies and the organizations they insure (Stein 2003). A direct cost to many insurance companies due to poor corporate governance practices was that they suffered devastating losses to their investment portfolios, since some of the largest institutional investors are insurers (Larkin & Casscles 2003). Another significant cost to insurance companies as a result of fraudulent activities, insider trading, and other instances of corporate malfeasance is the likely increase in payouts by insurers on Directors & Officers (D & O) and Errors & Omissions (E & O) liability insurance policies (Larkin & Casscles 2003; Zacharias 2002). The Sarbanes-Oxley Act attempts to improve the accountability of corporations and to strengthen the role of "corporate governance." While the Act's new rules govern companies that are publicly traded, non-public companies should also attempt to comply with the provisions of the Sarbanes-Oxley Act to help establish "best practices" for their organizations. The Audit Committee of the Board of Directors provides one very significant aspect of corporate governance, since an Audit Committee can be effective not only in providing objective oversight of the accounting of an organization, but also in helping to set an ethical "tone at the top." This paper summarizes the implications for Audit Committees of key provisions of the Sarbanes-Oxley Act. Further, the paper examines corporate governance concepts that can be discussed with members of an Audit Committee, and provides practical suggestions on how members of the Audit Committee of an organization can effectively meet their newly expanded responsibilities.

Key Words: corporate governance; insurance industry; Audit Committees; Sarbanes-Oxley; Enron.

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Introduction

The United States' Public Company Reform and Investor Act of 2002 – commonly referred to as the Sarbanes-Oxley Act of 2002 (the "Act") – attempts to improve the accountability of corporations and to strengthen the role of "corporate governance." The Act directed the Securities and Exchange Commission (SEC) to adopt rules to accomplish these objectives that must be followed by companies listed with national securities exchanges, such as the NYSE, and with Nasdaq. While the new rules govern companies that are publicly traded, non-public companies should also attempt to comply with the provisions of the Sarbanes-Oxley Act to help establish "best practices" for their organizations.

A direct cost to many insurance companies due to poor corporate governance practices was that they suffered devastating losses to their investment portfolios, since some of the largest institutional investors are insurers (Larkin & Casscles 2003). Another cost to the insurance industry as a result of fraudulent activities, insider trading, and other instances of corporate malfeasance is the likely increase in payouts by insurers on Directors & Officers (D & O) and Errors & Omissions (E & O) liability insurance policies (Larkin & Casscles 2003; Zacharias 2002).

The Audit Committee of the Board of Directors provides one very significant aspect of corporate governance. An Audit Committee can be very effective not only in providing objective oversight of the accounting of an organization, but also in helping to set an ethical "tone at the top" (Locatelli 2002; Stein 2003). This paper examines corporate governance concepts that can be discussed with members of an Audit Committee, and provides practical suggestions on how members of the Audit Committee of an organization can effectively meet their responsibilities.

Background

The collapse of Enron and the bankruptcy of WorldCom, representing stunning *lapses* of corporate governance, were compelling forces behind the passage of the Sarbanes-Oxley Act. By stipulating increased reporting requirements and imposing stiff penalties for non-compliance, the Act attempts to increase the accountability of an entity's Chief Financial Officer, Chief Administrative Officer, its Board of Directors, its Audit Committee, and the external auditors. Exhibit 1 summarizes entities and people who may play a role in corporate governance.

[Insert Exhibit 1 about here]

In effect, the Sarbanes-Oxley Act is yet another attempt to lessen the "expectations gap" – the difference (gap) between auditors' beliefs as to their required standards of performance and public expectations of auditors' performance (ABREMA 2002; Lee 1994). For example, many members of the public believe that auditors in effect "guarantee" the accuracy of financial statements when an unqualified audit opinion is expressed; they contend that auditors should accept prime responsibility for the accuracy of financial statements, and for the disastrous consequences that follow when significant inaccuracies or misstatements go undetected. Some people naively believe that auditors verify 100% of all amounts appearing in financial statements, while others think that the primary purpose of an audit is to detect fraud (ABREMA 2002).

The auditing profession, on the other hand, states that according to its professional standards (see, e.g., ABREMA 2002; Guy et al. 1999):

- A company’s management, as preparers of the financial statements, is primarily responsible for the content of financial statements;
- Auditors express only an *opinion* on the *fairness* of financial statements – they add credibility to the financial reporting process, but not absolute assurance;
- Auditors employ sampling techniques to test selected transactions – verifying all transactions is not economically feasible;
- An audit provides only “reasonable” assurance that unintentional errors and/or irregularities due to fraud are detected.

Regarding the second point – auditors expressing an opinion on the fairness of financial statements – the term “fairness” is used (as opposed to “accuracy”) because of the ***estimates*** involved in financial statements and disclosures. Examples of such estimates include the allowance for uncollectible accounts, estimated warranty expenses, loan loss reserves, and contingent liabilities. Exhibit 2 summarizes issues surrounding the “expectations gap” phenomenon.

[Insert Exhibit 2 about here]

The Sarbanes-Oxley Act attempts to lessen the expectations gap by strengthening the independence of both Audit Committee members and the external auditors, which in turn should lead to improved financial reporting. Further, Audit Committees have increased oversight responsibilities for such issues as the internal controls of the organization and for monitoring the activities of external auditors. These increased responsibilities will be discussed in the following paragraphs.

Role Requirements

The new rules require that members of the Audit Committee be composed entirely of independent members of the Board of Directors. The Act states that to be independent, Audit Committee members may not accept any consulting, advisory, or compensatory fees from the company. In addition, Audit Committee members must not be affiliated with the company.

Financial Expertise

One of the principal roles of the Audit Committee is objective oversight of the accounting of the organization. Accordingly, the SEC has issued a rule requiring disclosure in companies' periodic reports as to whether *at least one* member of the Audit Committee of a publicly traded company is a "financial expert," as defined by the SEC. For this purpose, a financial expert must have an understanding of financial statements and generally accepted accounting principles (GAAP). The financial expert must be able to assess the general application of GAAP in connection with any accounting estimates, accruals, or reserves. This person should also have experience in preparing, auditing, analyzing, or evaluating financial statements. The financial expert should possess an understanding not only of internal controls and procedures for financial reporting, but also a sound comprehension of the functions and responsibilities of the Audit Committee.

Audit Committee Functions

Interactions with Outside Auditors

In an effort to improve the independence of a company's public accountants, the Sarbanes-Oxley Act directed the SEC to adopt several rules regarding the relationship between the outside auditors and the Audit Committee. The Audit Committee is now required to be directly responsible for the appointment, compensation, and oversight of the work of any CPA firm employed by the company. The accounting firm must also report directly to the Audit Committee. Previously, the Chief Financial Officer (CFO) of an organization was often the person who had the ability to hire and fire the auditors. Thus, the CFO had a substantial amount of power over the auditors, potentially weakening the independence of the audit function. The responsibilities of the Committee also entail resolution of any disagreements between management and the auditor regarding financial reporting, for the purpose of preparing or issuing an audit report. In today's environment, management should be the subject of the audit, and not manage the relationship and process, as they did in the past (Sutton 2002).

The Audit Committee or a delegated member of the Committee must approve any non-audit services that are disclosed in the company's periodic reports. Further, any such approved non-audit service is to be carefully examined to determine the nature and scope of the service. This provision is not surprising, given that it was widely reported that in some fiscal periods the amount of consulting fees that Enron paid to Andersen exceeded the audit fees. Many people believed that the large amount of non-audit fees that Andersen received compromised the firm's independence and objectivity when reporting on Enron's financial statements.

The Act requires that the external auditors make timely reports to the Audit Committee regarding: 1) all critical accounting policies and practices to be used, 2) all alternative treatments of financial information that have been discussed with management, ramifications of the use of such alternatives, and the treatment preferred by the accounting firm, and 3) any other material (significant) communications between the accounting firm and management.

Monitor Internal Controls

Internal control is defined by *Statement on Auditing Standards No. 55, Consideration of Internal Control in a Financial Statement Audit*, as amended by *SAS No. 78*, as "a process – effected by an entity's board of directors, management, and other personnel – designed to provide reasonable assurance regarding the achievement of objectives in the following categories: (a) reliability of financial reporting, (b) effectiveness and efficiency of operations, and (c) compliance with applicable laws and regulations." Internal controls can take the form of financial, operational, or administrative controls. Strong internal controls increase the probability that transactions are recorded correctly, fraud does not occur, and financial information is reliable.

Establishing and maintaining internal controls is the responsibility of management (Braiotta 2002). However, if controls are to be effective, an entity's Board of Directors, Audit Committee, and management must set an appropriate "tone at the top" (Locatelli 2002; Stein 2003). In other words, for controls to be operative, management must visibly buy into them and communicate the importance of controls to all levels of the organization. This can be accomplished by establishing and adhering to hiring practices, promotion policies, and a reward system that reflects the ethical values of the organization by rewarding people who play by the rules (adhere to sound policies and do not circumvent controls) to meet organizational goals. A summary of internal controls that could be used for a discussion with the Audit Committee is provided in Exhibit 3. Exhibit 4 presents common control activities and procedures.

[Insert Exhibit 3 about here]

[Insert Exhibit 4 about here]

Oversee Internal Audit Department

The head of the Internal Audit function should report directly to the Audit Committee and only on an administrative basis to the CFO, CEO, or their equivalent. This enhances the independence of the internal auditors. The Director of Internal Audit and his or her staff of internal auditors should be competent professionals (Locatelli 2002).

The Audit Committee should require periodic written reports from the Internal Audit department (Locatelli 2002). These reports should describe the audit work performed, and summarize any significant issues, including internal control weaknesses. More importantly, internal audit reports should make recommendations for improvements in controls or procedures and document management's responses to each recommendation. Audit Committee members should ask questions about these and any other matters until they are satisfied with the answers (Locatelli 2002).

It is evident that the increased responsibilities of the Audit Committee have resulted in longer and more frequent meetings of the Committee (Anonymous 2003; Carcello et al. 2002). Exhibit 5 summarizes some of the principal roles of the Audit Committee, including oversight of the Internal Audit Department. Practical suggestions to improve the effectiveness of the Audit Committee are provided in Exhibit 6.

[Insert Exhibit 5 about here]

[Insert Exhibit 6 about here]

Authority to Hire Advisers

One of the provisions of the Sarbanes-Oxley Act states that the Audit Committee must have the authority to hire an outside auditing firm, independent counsel, and other advisers the Committee determines are necessary to carry out its duties. The company is required to fund any such activities that the Audit Committee deems as necessary to fulfill its duties.

Handling of Complaints

Another stipulation of the Act requires the Committee to establish procedures for the receipt, retention, and treatment of any complaints regarding accounting, internal controls related to accounting, or auditing. More specifically, the Audit Committee must assure that any complaints regarding accounting or auditing matters can be submitted confidentially and anonymously. We can only surmise what might have happened if former Enron executive Sherron Watkins would have initially shared her misgivings about accounting at Enron with its Audit Committee, instead of being stone-walled by Kenneth Lay.

As a practical matter, however, while the Committee may be able to facilitate an anonymous submission policy, if the Committee is to act on any submissions of substance, it may be very difficult to ensure that the submission will be kept confidential. After all, the point of the complaint system is to provide information that the Audit Committee could consider and possibly act on.

Audit Committee Charter

The increased responsibilities of the Audit Committee should be reflected in its charter. The Sarbanes-Oxley Act did not mandate changes to the Audit Committee charter. However, publicly traded companies must disclose their written charter in the entity's annual proxy statement (Braiotta 2002; Carcello 2002). Further, the New York Stock Exchange requires modifications to the charter and requires the company to post the charter of important committees, such as the Audit Committee, on the company's Web site (Deloitte & Touché 2003). Accordingly, the charter should provide a clear description of the oversight role of the Audit Committee, including specific responsibilities (Braiotta 2002).

The organization's current Audit Committee charter, if it has one, should be compared to the requirements of the Sarbanes-Oxley Act. Any modifications necessary to comply with provisions of the Act should be made in consultation with the company's legal counsel ((Braiotta 2002; Deloitte & Touché 2003).

Specific Implications for the Insurance Industry

Losses to Portfolios

A direct cost to many insurance companies due to poor corporate governance practices was that they suffered devastating losses to their investment portfolios, since some of the largest institutional investors are insurers (Larkin & Casscles 2003). Most notably, Enron declare bankruptcy and WorldCom is accused of recording expenses as assets to fraudulently inflate profits. Further, some of the nation's largest companies restated earnings, or were accused of insider trading or other fraudulent acts, causing the market value of their stock to drop dramatically (Larkin & Casscles 2003).

It is essential that an insurer's assets, including its investment portfolio, are adequate and available to cover the claims of the insured. Since an insurer's income is principally based on investment income and premiums collected, if investment returns unexpectedly decrease, premiums charged to consumers and others will increase (Larkin & Casscles 2003).

Liability Insurance Coverage

Another cost to insurance companies as a result of fraudulent activities, insider trading, and other instances of corporate malfeasance is the likely increase in payouts by insurers on Directors & Officers (D & O) and Errors & Omissions (E & O) liability insurance policies (Larkin & Casscles 2003; Zacharias 2002). Audit Committee members and Board members have increased and very specific responsibilities under the Sarbanes-Oxley Act, which also carries the risk of increased litigation against them. Further, the Act includes significant increases in jail time and financial penalties, Directors, officers, attorneys, analysts, and other executives associated with publicly-traded companies may increasingly seek to settle lawsuits out-of-court, as opposed to going forward with litigation (Zacharias 2002). Thus, future underwriting decisions for D & O policies should have an increased focus on whether management of the insured company is proactive in managing its financial and operational risks (Stein 2003).

Glass Houses

Insurance companies, especially stock companies, need to make sure their own house is in order. It is important for the insurance industry to emphasize sound corporate governance practices and transparency in its own financial reporting, since investor's and policyholders' confidence is integral to the industry's success (Gupta 2002). If investors lose confidence in the integrity of management, they can take their investment dollars elsewhere. In a similar vein, customers who lack confidence in the ability of their insurer to pay out on claims will seek another insurer.

Conclusion

The provisions of the Sarbanes-Oxley Act have far-reaching ramifications for insurance companies and the companies they insure (Stein 2003). The Act gives Audit Committees many additional responsibilities in fulfilling their corporate governance role, resulting in more frequent meetings of Audit Committees (see e.g., Carcello et. al. 2002). While many view the principal function of the Audit Committee as providing objective oversight of the accounting of an organization, the Sarbanes-Oxley Act has expanded the role of Audit Committees. Fortunately, the Act also provides Audit Committees with the ability to engage outside advisers to assist them with their corporate governance responsibilities. Nonetheless, members of Audit Committees must be knowledgeable of the requirements of their role in corporate governance, and not delegate their responsibilities to others, especially not to corporate management (Locatelli 2002). It should be noted that as Audit Committee members settle into their newly expanded roles, additional issues are likely to arise and will need to be addressed.

Exhibit 1

Entities & People Who May Play a Role in Corporate Governance

- Corporate Governance is broader than just the Board of Directors and the auditors.
- Corporate Governance may be provided by:
  - ✓ Board of Directors
  - ✓ Audit Committee
  - ✓ External Auditors (Public Accounting Firm)
  - ✓ Internal Auditors
    - may include organizational risk assessment
  - ✓ Management
    - setting the "tone at the top"
    - controllership function
  - ✓ Legal & Regulatory System (SEC, examiners)
  - ✓ Analysts
  - ✓ Shareholders – especially major ones
  - ✓ Whistle-blowers

Exhibit 2

The "Expectations Gap"

❖ The **"Expectations Gap"** is a well-documented phenomenon in auditing, and can be defined as ***the difference (gap) between auditors' beliefs as to their required standards of performance when auditing an organization and the public's expectations of auditors' performance***.

❖ What are the reasons for this Expectations Gap??

Public Perceptions **–** Many members of the public ***incorrectly believe***:

✓ Auditors in effect "guarantee" the accuracy of financial statements when an unqualified ("clean") audit opinion is expressed

✓ Auditors should accept prime responsibility for the accuracy of financial statements

✓ Auditors verify 100% of all amounts appearing in financial statements

✓ The primary purpose of an audit is to detect fraud

Auditor Contentions – The auditing profession, on the other hand, states that according to its professional standards:

✓ A company's management, as preparers of the financial statements, is primarily responsible for the content of financial statements;

✓ Auditors express only an *opinion* on the *fairness** of financial statements, adding credibility to the financial reporting process, but not absolute assurance;

✓ Auditors employ sampling techniques to test selected transactions – verifying all transactions is not economically feasible;

✓ An audit provides only "reasonable" assurance that unintentional errors and/or irregularities due to fraud are detected.

Exhibit 3

INTERNAL CONTROLS

- **Internal controls** are designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

    1) Reliability of financial reporting
    2) Compliance with applicable laws and regulations
    3) Effectiveness and efficiency of operations

- An entity's internal control may consist of five components:

    1) The control environment
    2) Risk assessment
    3) Control activities*
    4) Information processing and communication
    5) Monitoring

* Control activities are often integrated and embedded in the other four components

Exhibit 4

CONTROL ACTIVITIES AND PROCEDURES

- **Typical control procedures,** applicable to virtually every account or situation, include:

  - ✓ **Proper authorization** of transactions

  - ✓ **Segregation (separation) of Duties**
    - there should be separation of the authorization, record-keeping, and custody functions of transactions and the related assets

  - ✓ Design and use of **adequate documents and records**
    - includes pre-numbering of documents

  - ✓ **Physical controls**
    - adequate safeguards over access to and use of assets and records

  - ✓ **Monitoring**
    - independent checks on performance and valuation of accounts

Note: ***Information technology*** can be used to check the authorization, accuracy, and completeness of transactions.

Exhibit 5

An Overview of Responsibilities of the Audit Committee

- ❖ Create an ethical **"tone at the top"**
    - It's much more than a "Code of Conduct."
    - It means **institutionalizing ethical behavior** through**:**
        - ✓ Hiring practices
        - ✓ Promotion policies
        - ✓ Reward systems

- ❖ Assure that the Organization has strong **internal controls** – Management is responsible for establishing and monitoring controls. External Auditors evaluate controls to determine the nature, extent, and timing of their audit procedures.

- ❖ Take an **active role** in interviewing, hiring, and deciding whether to retain external auditors

- ❖ Make sure the external *and* internal auditors **report directly to the audit committee**

Exhibit 6

Audit Committee Effectiveness – Practical Suggestions

- Meet with the External Auditors on a Regular Basis
  - ✓ Take an active role in setting the agenda
  - ✓ Discuss areas of emphasis, based upon an assessment of risk
  - ✓ Follow up on unresolved issues
- Meet with the Internal Auditors on a Regular Basis
  - ✓ Take an active role in setting the agenda
  - ✓ Request special audit reviews for areas of concern
  - ✓ Follow up on unresolved issues
- **Ask Questions** until you are satisfied with the answer or understand the issue(s)
- The mindset of the external auditors (and of the organization) should be that the client is the Audit Committee (of the Board of Directors), *not* management. Management is the subject of the audit.

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