Chapter 2
Corporate Governance and Audits

Learning Objectives:

By studying this chapter, students should be able to:

1. Define corporate governance and identify the parties involved in corporate governance and their respective roles.

2. List and analyze principles of effective corporate governance.

3. Describe events of the last decade that have had significant impact on corporate governance, including the corporate governance failures of various parties.

4. Identify recent governance and disclosures-related regulations that were the response to calls for increased governance and describe how various parties are affected by those regulations.

5. Articulate the responsibilities of audit committees.

6. List and analyze principles of effective audit committees.

7. Describe required communications between the audit firm and the audit committee.

8. Analyze the relationship between corporate governance and the audit.

Teaching Suggestions

Poorly governed companies, such as Enron, WorldCom, Bear Stearns, and Lehman Brothers, turned out to be risky investments for investors. The public accounting profession has been widely criticized for not doing enough to protect investors' interests as they relate to these types of companies. Therefore, audit firms view companies with poor governance as riskier audit clients. Corporate failures during the past decade have resulted in important changes in corporate governance. Congress reacted to these failures by enacting the Sarbanes-Oxley Act of 2002. The failures leading up the Act involved individuals in the audit profession and within organizations, including management and individuals charged with corporate governance. For example, questions have been raised about management greed associated with backdating of stock options and about whether

a board of directors has enough power, time, and resources to provide proper oversight of management. The Sarbanes-Oxley Act contains provisions that affect the conduct of the audit and the responsibilities of management and the audit committee.

This chapter describes what is meant by corporate governance and the relationship between a client's corporate governance and the audit. In terms of the audit opinion formulation process, this chapter focuses on the basic notions of the auditing profession, regulation, and corporate governance in general and Phase II of the process, i.e., understanding the client in terms of the quality of its corporate governance.

Begin by summarizing the events that led up to the Sarbanes-Oxley legislation in 2002. The Enron fiasco certainly provides a rich example of the kind of failure in corporate governance and financial reporting that led congress to act, but any of the widely publicized corporate accounting scandals could be used. Explain that the failures of the past decade were primarily failures across all parts of the corporate governance structure. They were not just audit failures, or just management failures. Thus, to understand the changes affecting the audit profession, we have to understand how the audit profession fits into the overall corporate governance structure. Transparency 2-1 provides a broad schematic of the overall governance process. As we look at the governance process through the 1990's and early 2000's, there were failures in virtually every part of the governance process. Boards of Directors hired managers, but provided large amounts of stock options that ceded enormous power to managers, thus providing incentives to continuously report improved earnings. Managers, in turn, assumed greater responsibilities for hiring external auditors and used their power-relationship to encourage auditors to find accounting treatments those managers viewed as 'value enhancing' (read increase or better manage earnings).

The storm hit when Enron failed and declared the then largest bankruptcy in U.S. history. It sunk the ship when WorldCom failed and became the largest bankruptcy in U.S. history. In both of these companies, the operational failures were covered up with clever accounting frauds that were not detected by the public accounting firms. The press, congress, and the general public continued to ask why such failures could have occurred when the public accounting profession was given the sole license to protect the public from financial fraud and misleading financial statements.

Identify and analyze the key components of the Sarbanes-Oxley Act of 2002 and explain the public implications of the Sarbanes-Oxley Act of 2002. Explain management's role as the key communicator of financial and control information to stakeholders. Discuss the components of Sarbanes-Oxley that were intended to highlight management's role in the financial reporting process. Identify the key responsibilities the audit committee has as the primary audit client of public companies.

Students should know (the the oversight responsibilities of the audit committee, its principles for U.S. public companies, and its required communication which are listed in Transparencies 2-3, 2-4, and 2-5, respectively.

Suggested Homework Problems

Learning Objectives	Review Questions	Multiple-Choice Questions	Discussion and Research Questions	Cases
LO 1	2-1, 2-6, 2-12, 2-22	2-25, 2-29, 2-35	2-36, 2-37, 2-38, 2-39, 2-42, 2-43, 2-47, 2-49, 2-51, 2-52, 2-53, 2-54	2-55
LO 2	2-21	2-34	2-36, 2-38, 2-47, 2-49, 2-51, 2-53, 2-54	2-55
LO 3	2-2, 2-4, 2-5, 2-6, 2-7	2-26, 2-28	2-37, 2-39, 2-40	
LO 4	2-7, 2-8, 2-9, 2-10, 2-11	2-27, 2-31	2-40, 2-41, 2-42, 2-43, 2-45, 2-46, 2-48	
LO 5	2-10, 2-13, 2-14, 2-15, 2-16, 2-17, 2-19, 2-24	2-27, 2-31, 2-33, 2-35	2-36, 2-42, 2-43, 2-44, 2-45, 2-47, 2-49, 2-50	2-55
LO 6	2-10, 2-13, 2-15, 2-21, 2-23, 2-24	2-27, 2-33	2-36, 2-38, 2-43, 2-43, 2-44, 2-45, 2-47, 2-49, 2-50	2-55
LO 7	2-18, 2-19	2-30	2-44	
LO 8	2-20	2-32	2-37, 2-38, 2-39, 2-44	2-55

Chapter Outline

I. Corporate Governance and Auditing

A. Corporate governance is a process by which the owners and creditors of an organization exert control and require accountability for the resources entrusted to the organization. The owners (stockholders) elect a board of directors to provide oversight of the organization's activities and accountability to stakeholders.

B. Primary parties involved in corporate governance are:
   1. Stockholders
   2. Board of directors
   3. Audit committee as a subcommittee of the Board
   4. Management (financial and operational)
   5. Internal auditors
   6. Self-regulatory organizations (i.e. AICPA)
   7. Other self-regulatory organizations (i.e. NYSE, AMEX, etc.)
   8. Regulatory agencies (i.e. SEC, Environmental Protection Agency, FDIC etc.)
   9. External auditors

C. Owners want accountability of things like:
   1. Financial performance
   2. Financial transparency
   3. Stewardship
   4. Quality of internal controls
   5. Composition of the board of directors and their activities

II. Principles of Good Corporate Governance

A. The board's fundamental objective should be to build long-term sustainable growth in shareholder value for the corporation.

B. Successful corporate governance depends upon successful management of the company, as management has the primary responsibility for creating a culture of performance with integrity and ethical behavior.

C. Good corporate governance should be integrated with the company's business strategy and not viewed as simply a compliance obligation.

D. Transparency is a critical element of good corporate governance, and companies should make regular efforts to ensure that they have sound disclosure policies and practices.
E. Independence and objectivity are necessary attributes of board members; however, companies must also strike the right balance in the appointment of independent and non-independent directors to ensure an appropriate range and mix of expertise, diversity, and knowledge on the board.

III. **Events of the Last Decade**

A. The first decade of the twenty-first century has seen more changes in corporate governance than at any time since the Great Depression.
B. There was incredible volatility in the financial markets beginning in 2000, leading to the financial crisis and recession hitting the markets in 2008 and 2009, and continuing into the next decade.
C. There were also a number of financial failures—e.g., Enron and WorldCom—which represented fundamental breakdowns in the structure of corporate governance and involved many parties.
D. The corporate governance failures were broad and a number of different parties contributed to those failures.
E. There was much finger pointing at the auditing profession for its failures.
F. "Practicing professionals should place the public interest above the interests of clients, particularly when participating in a process designed to develop standards expected to achieve fair presentation…. Unfortunately, the auditor today is often a participant in aggressively seeking loopholes."

IV. **SEC Concern**

A. The SEC was increasingly concerned with what it viewed as a decline in professionalism and cited numerous instances in which the accounting that had been certified by public accounting firms did not reflect economic reality, although they might be in accordance with GAAP.
    1. "Cookie jar reserves" to manage earnings.
    2. Improper revenue recognition.
    3. Creative accounting for mergers and acquisitions that did not reflect economic reality.
    4. Increased use of stock-based compensation that put increased pressure on meeting earnings targets.

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B. **The Sarbanes/Oxley Act of 2002**

1. Was passed by Congress in response to massive accounting scandals <u>significant provisions include:</u>
   - i) Establishes the Public Companies Accounting Oversight Board (PCAOB) with broad powers, including the power to set auditing standards for audits of public companies
   - ii) Requires the CEO and CFO certify the financial statements
   - iii) Requires companies to provide a comprehensive report on internal controls over financial reporting
   - iv) Requires companies to certify correctness of financial statements quality of its internal controls
   - v) Audit Committees given expanded powers as the 'audit client' and must pre-approve any non-audit services by its external auditors
   - vi) Audit Committees must report their activities to the public
   - vii) Audit Committees must have at least one person who is a financial expert. Other members must be knowledgeable in financial accounting and control
   - viii) Audit engagement partners, as well as other partners and managers with significant roles in the audit, must be rotated off the engagement every five years
   - ix) A "cooling off" period before an audit partner or manager can take a high-level position with an audit client without jeopardizing the independence of the public accounting firm
   - x) Increased disclosure of "off-balance sheet" transactions or agreements that may have a material effect Requires the GAO to study a number of issues including the effect of consolidation on competition with the accounting profession, and an analysis of mandatory audit firm rotation

C. **The PCAOB**

1. The PCAOB will set standards for audits of public companies and will define the profession's responsibilities for detecting fraud and other financial misdeeds. The PCAOB has five members, only two of which can be CPAs. The PCAOB has the ability to make choices including:
   - i. Setting accounting standards. The PCAOB has chosen to let the FASB continue to set accounting standards.

ii. Set standards for the reports on internal control and risk management.
iii. Perform quality reviews and inspections of public accounting firm performance and recommend penalties, including censure, if the firms fail to perform at required levels.
iv. Establish quality control standards for the conduct of audits of public companies.
v. Require all public accounting firms that audit public companies to register with the PCAOB and become licensed to perform such audits.

D. **Stock Exchange Listing Requirements**
1. Boards need to consist of a majority of independent directors.
2. Boards need to hold regular executive sessions of independent directors without management directors present.
3. Certain committees of the board (nominating/governance, compensation, audit) need to publish charters.
4. CEOs need to provide an annual certification of compliance with corporate governance standards
5. Website disclosure of specific corporate governance issues.

E. **Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010**
1. Mandates enhanced stock exchange listing standards on compensation committee independence.
2. Requires additional disclosure of the relationship between executive compensation and financial performance, as well as internal pay equity.
3. Mandates corporate policies on the forfeiture of executive compensation in certain circumstances.

F. **Role of Audit Committees**
1. As indicated in the Sarbanes-Oxley Act, a committee of the board of directors that has important significance to the auditor is the audit committee.
2. The audit committee is a standing committee of the board of directors whose purpose is to oversee the accounting and financial reporting processes of the company and the financial statement audits.
3. That committee is designated as the “audit client” to whom the external auditor should report.

4. For public companies, the audit committee must be composed of outside directors, i.e., directors who are not members of management and do not have other relationships with the firm (e.g., as vendor, consultant, or general counsel).
5. The audit committee should include at least one financial expert who has an understanding of GAAP and has relevant accounting and audit experience.
6. The audit committee has three primary responsibilities related to the financial reporting process:
   i) Provide oversight of the accounting and financial reporting processes and of the financial statement audits.
   ii) Appoint, compensate, and oversee the external auditor, including approving any nonaudit services to be provided by the external auditor.
   iii) Ensure that the board establishes a whistleblower program.
   iv) Additional responsibilities of the audit committee may include:
   (1) The authority to hire and fire the head of the internal audit function.
   (2) Set the budget for the internal audit activity, and review the internal audit plan and discuss all significant internal audit results.
   (3) Performing or supervising special investigations, reviewing policies on sensitive payments, maintaining communication between the board, management, the external auditors, and the internal auditors, and coordinating periodic reviews of compliance with company policies such as corporate governance policies.
7. The audit committee must make informed choices about the quality of work it receives from the auditors:
8. The audit committee must monitor and assess the independence and competence of all audit functions.
9. It should review quality-control reports on both the external audit firm and the internal audit function, and it should evaluate the quality of reports it receives from the auditors and the quality of financial reporting and control discussions.

10. The audit committee will receive feedback from both the internal and external auditors on a number of issues including the quality of internal controls over financial reporting.
11. As part of its oversight responsibility, the audit committee expects the external auditor to report to the audit committee :
    i) All critical accounting policies and practices used by management.
    ii) All material alternative GAAP treatments that have been discussed with management.
    iii) Other material written communications between the auditor and management.
    iv) The audit committee should review all regulatory audit findings, where applicable, to determine if they provide important feedback on the quality of controls, operational problems, or financial issues.
12. One primary role of the Audit Committee is to ensure the independence of the external audit firm.
13. Makes the Audit Committee the auditor's client.
14. Requires the Audit Committee to pre-approve all non-audit services by the audit firm.
15. Requiring the audit committee to pre-approve any nonaudit services provided by the public accounting firm.

G. **Principles of Effective Audit Committees**

1. Committee Purpose.
2. Committee Responsibilities.
3. Interaction.
4. Independence.
5. Expertise and Integrity.
6. Philosophy and Culture.
7. Internal Control.
8. Risk Assessment.
9. Meetings and Information.
10. External Auditor.
11. Internal Audit.
12. Oversight of “Whistleblower” Procedures.
13. Compensation and Stock Ownership.
14. Service and Term Limits.
15. Disclosure.

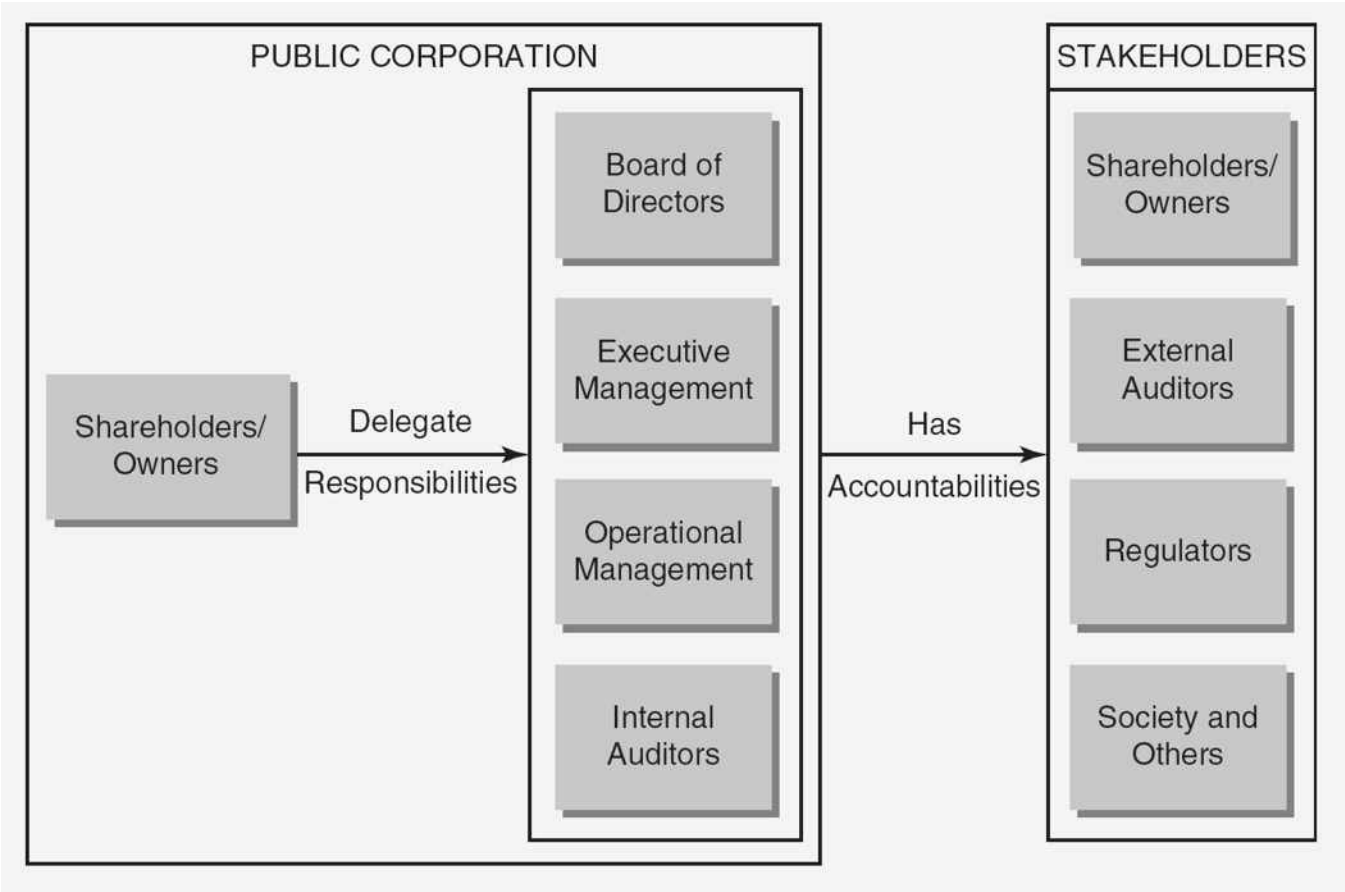
H. **External Auditor Communication to the Audit Committee**

1. Auditor's Responsibility under Generally Accepted Auditing Standards.
2. Significant Accounting Policies.
3. Management Judgments and Accounting Estimates.
4. Significant Audit Adjustments.
5. Judgments about the Quality of the Company's Accounting Principles.
6. Other Information in Annual Reports.
7. Disagreements with Management.
8. Consultation with Other Accountants.
9. Major Issues Discussed with Management Before Retention.
10. Overview and Planned Scope of the Audit.
11. Difficulties in Performing the Audit.
12. Representations Requested from Management.

I. **Corporate Governance and the Audit**

1. Good governance is important to the conduct of an audit for one very simple reason: companies with good corporate governance are less risky to audit.
2. These companies generally have the following characteristics:
3. Are less likely to engage in "financial engineering".
4. Have a code of conduct that is reinforced by actions of top management.
5. Have independent board members who take their jobs seriously and have sufficient time and resources to perform their work.
6. Take the requirements of good internal control over financial reporting seriously.
7. Make a commitment to financial competencies needed.

TRANSPARENCY 2-1
Exhibit 2.1 Overview of Corporate Governance



TRANSPARENCY 2-2
Exhibit 2.2 Corporate Governance Responsibilities and Failures

Party	Overview of Responsibilities	Overview of Corporate Governance Failures
Stockholders	**Broad Role:** Provide effective oversight through election of board members, approval of major initiatives such as buying or selling stock, annual reports on management compensation from the board	• Focused on short-term prices • failed to perform long-term growth analysis • abdicated most responsibilities to management and analysts as long as stock price increased
Board of Directors	**Broad Role:** The major representative of stockholders to ensure that the organization is run according to the organization's charter and that there is proper accountability **Specific activities include:** • Selecting management • Reviewing management performance and determining compensation • Declaring dividends • Approving major changes, e.g., mergers • Approving corporate strategy • Overseeing accountability activities	• Inadequate oversight of management • Approval of management compensation plans, particularly stock options that provided perverse incentives, including incentives to manage earnings • Directors often dominated by management • Did not spend sufficient time or have sufficient expertise to perform duties • Continually re-priced stock options when market price declined
Management	**Broad Role:** Operations and accountability. Manage the organization effectively; provide accurate and timely accountability to shareholders and other stakeholders **Specific activities include:** • Formulating strategy and risk management • Implementing effective internal controls • Developing financial and other reports to meet public, stakeholder, and regulatory requirements • Managing and reviewing operations • Implementing an effective ethical environment	• Earnings management to meet analyst expectations • Fraudulent financial reporting • Using accounting concepts to achieve reporting objectives • Created an environment of greed, rather than one of high ethical conduct
Audit Committees of the Board of Directors	**Broad Role:** Provide oversight of the internal and external audit function and the process of preparing the annual financial statements and public reports on internal control **Specific activities include:** • Selecting the external audit firm • Approving any nonaudit work performed by the audit firm • Selecting and/or approving the appointment of the Chief Audit Executive (Internal Auditor) • Reviewing and approving the scope and budget of the internal audit function • Discussing audit findings with internal auditor and external auditor and advising the board (and management) on specific actions that should be taken	• Similar to board members—did not have expertise or time to provide effective oversight of audit functions • Were not viewed by auditors as the "audit client"; Rather, the power to hire and fire the auditors often rested with management
Self-Regulatory Organizations: AICPA, FASB	**Broad Role:** Set accounting and auditing standards dictating underlying financial reporting and auditing concepts; set the expectations of audit quality and accounting quality **Specific activities include:** • Establishing accounting principles • Establishing auditing standards • Interpreting previously issued standards	• **AICPA:** Peer reviews did not take a public perspective; rather, the reviews looked at standards that were developed and reinforced internally • Inadequate enforcement of existing audit standards • **AICPA:** Did not actively involve third parties in standard setting

TRANSPARENCY 2-2
Exhibit 2.2 Corporate Governance Responsibilities and Failures (cont.)

Party	Overview of Responsibilities	Overview of Corporate Governance Failures
	• Implementing quality control processes to ensure audit quality • Educating members on audit and accounting requirements	• **FASB:** Became more rule-oriented in response to (a) complex economic transactions, and (b) an auditing profession that was more oriented to pushing the rules rather than enforcing concepts • **FASB:** Pressure from Congress to develop rules that enhanced economic growth, e.g., allowing organizations to not expense stock options
Other Self-Regulatory Organizations: NYSE, NASDAQ	**Broad Role:** Ensure the efficiency of the financial markets including oversight of trading and oversight of companies that are allowed to trade on the exchange **Specific activities include:** • Establishing listing requirements—including accounting requirements and governance requirements • Overseeing trading activities	Pushed for improvements for better corporate governance procedures by its members, but failed to implement those same procedures for its governing board, management, and trading specialists
Regulatory Agencies: the SEC	**Broad Role:** Ensure the accuracy, timeliness, and fairness of public reporting of financial and other in formation for public companies **Specific activities include:** • Reviewing filings with the SEC • Interacting with the FASB in setting accounting standards • Specifying independence standards required of auditors that report on public financial statements • Identify corporate frauds, investigate causes, and suggest remedial actions	Identified problems but was not granted sufficient resources by Congress or the Administration to deal with the issues
External Auditors	**Broad Role:** Perform audits of company financial statements to ensure that the statements are free of material misstatements including misstatements that may be due to fraud **Specific activities include:** • Audits of public company financial statements • Audits of nonpublic company financial statements • Other services such as tax or consulting	• Helped companies use accounting concepts to achieve earnings objectives • Promoted personnel based on ability to sell "nonaudit products" • Replaced direct tests of accounting balances with inquiries, risk analysis, and analytics • Failed to uncover basic frauds in cases such as WorldCom and HealthSouth because fundamental audit procedures were not performed
Internal Auditors	**Broad Role:** Perform audits of companies for compliance with company policies and laws, audits to evaluate the efficiency of operations, and periodic evaluation and tests of controls **Specific activities include:** • Reporting results and analyses to management (including operational management) and audit committees • Evaluating internal controls	• Focused efforts on "operational audits" and assumed that financial auditing was addressed by the external audit function • Reported primarily to management with little reporting to the audit committee • In some instances (HealthSouth, WorldCom) did not have access to the corporate financial accounting records

TRANSPARENCY 2-4
Exhibit 2.4 Audit Committee Principles for U.S. Public Companies

1. **Committee Purpose**—The purpose of the audit committee is to oversee all aspects of the financial reporting process, including preparation and filing of financial statements, internal control over financial reporting, and related risks.
2. **Committee Responsibilities**—The audit committee's major areas of responsibility include (1) oversight of the internal control system, (2) oversight of the internal audit function and external auditor, (3) review of financial filings, and (4) establishment and oversight of a "whistleblower" process.
3. **Interaction**—Audit committee effectiveness requires ongoing, timely, and substantive interaction among the board, management, the external auditor, the internal auditor, and legal counsel.
4. **Independence**—The audit committee should be composed of independent directors only, and these directors should be chosen by an independent nominating committee. The CEO's role in selecting new directors, especially those who are targeted for audit committee service, should be limited.
5. **Expertise and Integrity**—The audit committee should have at least one financial expert, and all other members should have a high level of financial literacy. The financial expert should have a background in accounting, and there should be increased proxy disclosure as to the nature and timing of this accounting background. The committee members should reflect a mix of backgrounds and perspectives, and each member should be familiar with the company's risks and controls and capable of inquisitive and independent judgment. All members should receive detailed orientation and continuing education on financial accounting and reporting issues to assure they achieve and maintain the necessary level of expertise.
6. **Philosophy and Culture**—The audit committee should clearly set expectations that financial statements and supporting disclosures reflect economic substance and that they be prepared in a manner that is informative and transparent. A legalistic view of accounting and auditing (e.g., "can we get away with recording it this way?") is not appropriate. Management integrity and a strong control environment are critical to reliable financial reporting.
7. **Internal Control**—The audit committee is responsible for ensuring that management designs and implements sound internal control, which is essential for reliable financial reporting for any organization. Section 404 of the Sarbanes-Oxley Act should apply to all public companies, and the primary focus of reporting on internal control should be effectiveness.
8. **Risk Assessment**—The audit committee should lead the board's assessment of enterprise risk, including the risk of management override of internal control. The board also should discuss the audit committee's fraud risk assessments and the fraud risk assessments developed by internal and external auditors.
9. **Meetings and Information**—The audit committee members should meet frequently for extended periods of time and should have unrestricted access to the information and personnel they need to perform their duties. Face-to-face meetings should occur at least quarterly, and executive sessions should be held at each of these meetings. Additionally, the committee should meet in separate executive sessions with management, the external auditor, the internal auditor, legal counsel, and other advisors.
10. **External Auditor**—The audit committee should hire, evaluate, fire (if appropriate), and determine the fee of the external auditor with only minimal input from senior management. The committee should review the proposed audit scope and approach, as well as the external auditor's independence. Additionally, the committee should seek audit firms whose personnel are selected, evaluated, compensated, and promoted primarily on the basis of technical competence, not on their ability to generate new business.
11. **Internal Audit**—The chief (internal) audit executive should have direct reporting access to the audit committee, and the committee should oversee the activities and budget of the internal audit function.
12. **Oversight of "Whistleblower" Procedures**—Whistleblower allegations should be initially screened by internal audit or an external whistleblower system provider and reported directly to the audit committee. Access to the whistleblower process should be extended to outside parties (customers, suppliers, etc.).
13. **Compensation and Stock Ownership**—The board should consider any risks of audit committee member stock/stock option holdings and should set compensation at a level that is appropriate for the expanded duties and risks these members face.
14. **Service and Term Limits**—The board should limit the number of other audit committees on which its audit committee members can sit to no more than one other public company if the member holds a full-time position (three others for members who are retired). The board should consider limiting the number of years an individual can serve on the audit committee to ensure adequate rotation of its members.
15. **Disclosure**—In addition to disclosure of the audit committee responsibilities in the charter, the annual proxy statement should contain an audit committee report on actual activities performed. The audit committee should disclose the processes it uses in discharging its responsibilities, including (1) the length of its meetings, (2) meeting participants; (3) use of executive sessions; (4) how the committee selects, compensates, and oversees the external auditor; (5) how the committee oversees the internal audit function; (6) the committee's role in overseeing internal control; (7) committee activities performed to assess the risk of fraudulent financial reporting, especially via management override of internal control; and (8) activities performed by the committee to review financial filings before their release to the public.

Source: Lapides, P. D., M. S. Beasley, J. V. Carcello, F. T. DeZoort, D. R. Hermanson, T. L. Neal, and J. G. Tompkins. May 8, 2007. 21st Century Governance and Audit Committee Principles by Corporate Governance Center, Kennesaw State University • Corporate Governance Center, University of Tennessee • Enterprise Risk Management Initiative, North Carolina State University, Culverhouse School of Accountancy, The University of Alabama

TRANSPARENCY 2-5
Exhibit 2.5 Communications to Audit Committees

EXAMPLES OF REQUIRED COMMUNICATIONS TO AUDIT COMMITTEES

Auditor's Responsibility under Generally Accepted Auditing Standards

The auditor must clearly communicate the audit firm's responsibility to perform the audit according to relevant auditing standards and independently assess the fairness of the financial statements, to assess the quality of the entity's internal controls over financial reporting, and to design the audit to detect material misstatements.

Significant Accounting Policies

The auditor should ensure that the audit committee is informed about the initial selection of, and changes in, significant accounting policies or their application, and discuss the quality of accounting principles used.

Management Judgments and Accounting Estimates

Many corporate failures have involved manipulation of accounting estimates such as loan loss reserves. The auditor should ensure that the audit committee is aware of the processes used by management in making sensitive accounting estimates, and the auditor's assessment of those processes and accompanying estimates.

Significant Audit Adjustments

Significant audit adjustments may reflect on the stewardship and accountability of management. The audit committee should be made aware of such adjustments, even if management readily agrees to make them. Significant adjustments, by definition, suggest that there have been internal control failures that must be communicated to management and the audit committee.

Judgments about the Quality of the Company's Accounting Principles

The auditor needs to discuss with the audit committee the quality of the company's financial statements and ensure that they are acceptable under GAAP. Auditors should be prepared to have a frank discussion about differences in assessments of the quality of the financial statements.

Other Information in Annual Reports

The auditor should briefly describe his or her responsibility to review other information contained in an annual report and whether such information is consistent with the audited financial statements.

Disagreements with Management

All major accounting disagreements with management, even if eventually resolved, should be discussed with the audit committee. This requirement is intended to insulate the auditors from management pressure to change or bend accounting treatments to suit management and should remove any subtle hints that the auditing firm may be replaced because it disagrees with management's proposed accounting treatments.

Consultation with Other Accountants

In some instances the auditor may become aware that management has consulted with other accounting firms about an accounting policy or its application. In those instances, the auditor should inform the audit committee of this consultation and possibly provide an assessment of the consultation.

Major Issues Discussed with Management Before Retention

During the proposal and hiring stages of the engagement, management and the auditor likely discussed issues related to accounting principles and audit standards. These issues should be discussed with the audit committee.

Overview and Planned Scope of the Audit

The auditor needs to communicate the planned scope of the audit engagement to the audit committee and have a discussion with it on the adequacy of the planned scope, as well as the materiality chosen for the audit.

Difficulties in Performing the Audit

Auditors may experience various difficulties in performing the audit (e.g., scheduling, cooperation). The auditor should discuss these issues with the audit committee.

Representations Requested from Management

The auditor normally requests representations from management on a number of important issues, such as management's responsibility for the financial statements, the appropriate allowances for accounts that need to be adjusted to market value, and the quality of controls. The nature of these requests, as well as management's responses, should be shared with the audit committee.