

Journal of Hospitality Financial Management

The Professional Refereed Journal of the International Association of Hospitality Financial Management Educators

Volume 18 | Issue 1

Article 4

Summer 8-4-2010

Enhanced Corporate Governance for Restaurant Companies: The Role of Well Performing Audit Committees

James Damitio
Central Michigan University

Philip Kintzele

Vernon Kwiatkowski

Marilyn Kintzele

Follow this and additional works at: <https://scholarworks.umass.edu/jhfm>

Recommended Citation

Damitio, James; Kintzele, Philip; Kwiatkowski, Vernon; and Kintzele, Marilyn (2010) "Enhanced Corporate Governance for Restaurant Companies: The Role of Well Performing Audit Committees," *Journal of Hospitality Financial Management*. Vol. 18 : Iss. 1 , Article 4.

Available at: <https://scholarworks.umass.edu/jhfm/vol18/iss1/4>

This Refereed Article is brought to you for free and open access by ScholarWorks@UMass Amherst. It has been accepted for inclusion in Journal of Hospitality Financial Management by an authorized editor of ScholarWorks@UMass Amherst. For more information, please contact scholarworks@library.umass.edu.

Enhanced Corporate Governance for Restaurant Companies: The Role of Well Performing Audit Committees

Cover Page Footnote

Bob Evans Farms Inc. (2009). Charter of the Audit Committee of the Board of Directors of Bob Evans Farms, Inc. in proxy statement for Annual Report. Burger King Corporation. (2009). Corporate Responsibility Report. Retrieved from <http://www.bk.com/en/us/company-info/corporate-responsibility/corporate-governance.html> Cheesecake Factory Incorporated. (2009). Audit Committee Charter in proxy statement for Annual Report. Denny's Corporation. (2008). Audit Committee Charter in proxy statement for Annual Report. Kintzele, M.R. (1991). The Use of Audit Committee Reports in Financial Reporting. *Internal Auditing*, 6 (4), 16. Kintzele, P.L., Arndt, T.L., Kintzele, M.R., Kwiatowski, V.E. (2008). Audit Committees and Internal Auditors: Their Roles in Financial Reporting Today. *Internal Auditing*, 23 (3), 30-37. Klein, A., (2002). Economic Determinants of Audit Committee Independence. *The Accounting Review*, 77 (2), 435-542. McDonald's Corporation. (2008). Audit Committee Charter in proxy statement for Annual Report. McDonald's Corporation. (2008). Statement of Corporate Governance. Retrieved from http://www.aboutmcdonalds.com/mcd/investors/corporate_governance.html National Commission of Fraudulent Financial Reporting. (1987). Report of the National Commission on Fraudulent Financial Reporting. 179-192 Panel on Audit Effectiveness. (2000). The Panel of Audit Effectiveness: Report and Recommendations. Ruby Tuesday, Inc. (2009). Corporate Governance Guidelines. Retrieved from <http://www.rubytuesday.com/investors/governance> Securities & Exchange Commission. (2003). Release No. 33-8177. The Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees. (1999). Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees. 10-16. Value Line, Inc. (2009). Retrieved from <http://www.valueline.com/lookup/current.aspx>

Enhanced Corporate Governance for Restaurant Companies: The Role of Well Performing Audit Committees

During the past decade, a multitude of problems regarding accounting and financial reporting issues in the United States have become exposed to broad based scrutiny by regulators and the media. Many large publicly traded companies such as Enron, World Com, Lehman Brothers and others have become bankrupt. In addition, General Motors in the manufacturing area and K-mart in the retailing sector have struggled as a result of poor management. Many financial services companies were forced to merge or be rescued by federal government intervention. Criminal sanctions were brought forth which caused the demise of Arthur Andersen, LLP, which had been one of the world's largest public accounting firms. (Andersen was later cleared of criminal actions about two to three years after it failed.) All of this caused the global business community to become fully aware of the significance of high quality, ethical financial reporting.

During 2002, the Sarbanes-Oxley act was passed by the United States Congress and became law with President Bush's signature. The goal was to usher in an era of improved financial reporting for the United States. A continuing need for effective, high quality financial reporting has been kept in the forefront by issues regarding subprime lending and various types of sophisticated and exotic financial instruments. In order to attain the goal of effective, high quality financial reporting, all of the significant participants in the financial reporting process have to fulfill many responsibilities. For publicly traded corporations, the list of significant participants typically includes the outside auditing firm, the internal auditors, senior management, and the corporation's board of directors.

An indispensable element of an effective financial accounting and reporting system is an effectively operating audit committee of the corporate board interfacing in a suitable fashion with the internal audit function. One of the major responsibilities of the audit committee is to maintain oversight of the activities of management's external and internal auditors.

The Development of Audit Committees

Audit committees have been required since 1978 by the New York Stock Exchange (NYSE) when it mandated that all corporations traded on the NYSE have an audit committee composed of members from their boards of directors. At that point in time, the financial reporting community had recognized the importance of audit committees to the financial reporting process.

The National Commission of Fraudulent Financial Reporting, usually referred to as the Treadway Commission, emphasized the importance of audit committees and strongly recommended the adoption of audit committee reports in annual reports of corporations. The Treadway Commission's recommendation was for the chairman of the audit committee to issue a report that would be

included in the corporate annual financial report. A list of “good practice” guidelines for corporate audit committees was set forth by the Treadway Commission and are discussed in detail below.

Good Practice Guidelines – General Guidelines

The list of “good practice” guidelines was divided into three categories: general guidelines, selection of the independent outside auditor, and post-audit review. The size of the committee was among the items contained in the general guidelines. The good practice general guidelines suggested that a corporate audit committee should have at a minimum three members; yet, it should not be too large as to inhibit each member from being an active participant in the deliberations of the committee. The general guidelines also recommend that each corporate audit committee member should be an outside, independent director of the corporate board, and the terms of service on the audit committee should be staggered. Regular meetings of the audit committee and reporting to the corporate board of directors on a regular basis were also recommended by the Treadway Commission’s good practice general guidelines.

All recommendations in this paragraph are also part of the general guidelines of good practice. According to the National Commission of Fraudulent Financial Reporting (1987), the corporate audit committee should oversee the audits of both the internal and external auditor. It is the corporate audit committee’s responsibility that there is coordination between both groups of auditors. The internal and external auditors should specify to the corporate audit committee how each of their audit scopes could lead to the detection of fraud or identify internal control weaknesses. The head of the internal audit function or other designated internal audit person and the independent public accountant should meet privately with the audit committee. Should there be cases where the independent accountant needs to rely on the work of other independent accountants, the audit committee must require that their independent accountant reviews the work of any other outside auditors. The audit committee must consider the use of any additional outside auditors as an appropriate procedure. The corporate audit committee must review, for compliance with company policy, the expenses of corporate officers and their use of company assets. Both the external and internal auditors need to be cognizant that the corporate audit committee needs to be informed of any specific topical areas they discover that requires the attention of the audit committee.

Good Practice Guidelines – Selection of an Independent Accountant

The process for the selection of the independent public accountant by the corporate audit committee is the second category of guidelines contained in the Treadway Commission good practice guidelines. The audit committee needs to

review the proposed audit fee and the engagement letter of the independent public accountant. The audit committee also should oversee the level of audit partner participation and the level of audit staff participation for the proposed audit engagement. Should the audit committee select a new independent accountant, it needs to review the process to enable a smooth transition from the predecessor to the successor independent accountant. Because the selection of the independent outside auditor must usually be ratified by the shareholders, the review process helps to facilitate the needed shareholder notification and ratification vote.

Good Practice Guidelines – Post-Audit Review

The Treadway Commission also recommended another group of important duties for the audit committees. These duties pertain to the many steps that must be followed in a post audit review. The Treadway Commission specifies that the audit committee be responsible for meetings with the corporation's legal counsel. Legal issues that could have a material impact on the corporation's financial statements should be discussed. These duties pertain to the many steps that must be followed in a post audit review. Management's explanations must be sought by the audit committee for any significant variances in the financial statements regarding all years of comparative financial statements presented. The audit committee should review the consistency of the management's discussion and analysis (M D & A) section of the annual report with the information disclosed in the annual report.

Another task for the audit committee is to question the outside auditors and corporate management regarding any changes in the application of accounting principles and auditing standards that would have an effect on the financial statements. Corporate management needs to be questioned by the audit committee regarding the existence of any items that may materially affect the financial statements. The audit committee should give special attention to any accounting accruals, significant reserves, estimates, and changes in estimates. The post-audit review process needs to have the audit committee meet privately with the outside auditors. This meeting should be a discussion of the quality of the internal audit function and the quality of the corporate accounting and finance staff. The outside auditors should discuss with the audit committee what the outside auditors' greatest concerns are pertaining to the audit and if they would like to discuss any other issues that have not already been discussed.

The management representation letter should be reviewed by the audit committee. The outside auditor needs to be questioned by the audit committee whether any issues surfaced in obtaining the letter or receiving satisfactory coverage of issues set forth in the representation letter. The audit committee also needs to deal with another set of issues that could have come to light during the audit. These other issues concern contingencies, litigation, other claims,

judgments or assessments that were viewed by outside lawyers or in-house company legal staff. The resolution of these legal issues or contingencies and/or their disclosure in the corporation's financial statements must be determined by the audit committee.

The audit committee needs to review the M D & A section of the corporate annual report with corporate management and the outside auditor. The consistency of the other information contained in the corporation's annual report with the financial statements must be determined by the audit committee. Any issues related to this must be discussed with the outside auditor. The audit committee must determine whether the outside auditors need to meet with the corporation's full board of directors regarding answering any questions pertaining to the audit of the outside auditors.

Good Practice Guidelines - Audit Committee Chairman's Letter

The Treadway Commission recommended that the chairman of the audit committee should have a letter in the corporate annual report that would summarize the duties and activities of the audit committee. Because the Treadway Commission's recommendations did not have the force of a Financial Accounting Standards Board (FASB) or Securities and Exchange Commission (SEC) reporting requirement, only a very small number of corporate annual reports have ever included an audit committee chairman's letter. However, the functioning of the company's audit committee has been described by a significant majority of listed companies in the company's report of management (Kintzele, 1991). These companies believed it necessary to discuss their audit committee function in their annual reports, but they did not want to create a separate report in the form of an audit committee chairman's letter. Those concerned about financial reporting on the functioning of the audit committee found the discussion in the report of management lacking much that was suggested to be written in the audit committee chairman's letter.

Independent, outside directors are required by the different stock exchanges to serve as audit committee members. Not being an employee of the corporation was the initial interpretation of an outside director. Soon a class of "grey area" directors was identified. Retired management, relatives of management, consultants hired by the corporation, and individuals serving as interlocking directors on two or more corporations were considered "grey area" directors. The independent functioning of the audit committee could be at risk if "grey area" directors served on the committee. A study (Klein, 2002) on the independence issue of audit committees concluded that audit committee independence increases with board size and board independence and decreases with the firm's growth opportunities and for firms that report consecutive losses. In 1999 both the NYSE and the NASD (National Association of Securities

Dealers) declared requirements that permitted corporations the option of including non-outside directors on their audit committees if they conclude that it is in the best interest of the corporation to do so.

A Blue Ribbon Committee was established by the NYSE and the NASD in 1998. The committee attempted to address concerns of the SEC regarding audit committee accounting and reporting practices. The Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (1999) issued its report and ten major recommendations as follows:

1. Strict definitions of independence of directors serving on audit committees of listed companies should be adopted by the NYSE and NASD.
2. Larger companies should be required by the NYSE and NASD to have audit committees composed entirely of independent directors.
3. Larger companies should be required by the NYSE and NASD to have “financially literate” directors on their audit committees.

4. Each company should be required by the NSYE and NASD to adopt a formal audit committee charter and review its adequacy annually.
5. Each company should be required by the SEC to disclose in its proxy statement whether it has adopted an audit committee charter, as well as other information.
6. Audit committee charters must state that the outside auditor is ultimately accountable to the board of directors and the audit committee for each company listed on the NYSE and NASD.
7. Companies listed on the NYSE and NASD should ensure that their charters mandate that their audit committees communicate with the outside auditor about independence issues, in accordance with Independence Standards Board regulations.
8. Generally accepted auditing standards should require that the outside auditor discuss with the audit committee the quality—not just the acceptability—of accounting principles used.
9. The corporate annual report should include a letter from the audit committee clarifying that it has reviewed the audited financial statements with management and performed other tasks required by the SEC.
10. The outside auditor should be required by the SEC to perform an interim review under SAS No. 71, *Interim Financial Information*, before a company files its Form 10-Q.
- 11.

The Panel on Audit Effectiveness

The Panel on Audit Effectiveness, usually referred to as the O'Malley Panel, was created in 1999 by the Public Oversight Board which was the independent, private-sector body that oversaw the programs of the SEC Practice Section of the American Institute of Certified Public Accountants (AICPA). The SEC had concerns about the deliberate efforts by corporate management to manipulate earnings. This panel was created as a response to those concerns. The Panel on Audit Effectiveness (2000) issued a report with the following recommendations which relate to audit committees:

1. Increase emphasis on internal control. Management should provide a written report on the effectiveness of internal control.
2. Evaluate corporate reserves and review activity in them with the auditors and management.
3. Have a minimum of two face-to-face meetings with the auditors. At least one meeting should be in private. Topics to be discussed include such issues as business risks, pressures on auditors, auditor

performance, and any plans to hire audit firm personnel into high-level positions.

4. Request a report by management on the corporation's control environment and how that environment along with established policies and procedures help to prevent or detect financial statement fraud.
5. Ensure that there is cooperation between management and auditors, so that auditors' efforts relating to the detection of fraudulent financial reporting are successful.
6. The audit committee should determine the threshold amount to pre-approve non-audit services.

Actions by the SEC

Corporations were being persuaded by such bodies as the Treadway Commission, the Blue Ribbon Committee and the O'Malley Panel to adopt their recommendations. These commissions and panels could only make recommendations, but the SEC sets regulations that corporations must follow. On December 15, 2000 the SEC issued a regulation requiring corporations in their proxy statements to provide a report from their audit committee. The report was to disclose whether the audit committee had recommended that the corporation's audited financial statements be filed with the SEC. Another disclosure was to state whether the audit committee had a written charter which stated specific duties of the committee. The SEC required that every three years the charter would need to be submitted to the SEC.

New listing standards for the NYSE, the American Stock Exchange and the NASDAQ were additionally approved by the SEC. These standards require corporation's disclosure whether their audit committee members are independent of management and require that audit committee members have some financial expertise.

The SEC was empowered by the Sarbanes-Oxley Act to establish the Public Company Accounting Oversight Board (PCAOB). By April 2003 the board was functional. The PCAOB sets standards for auditing publicly traded companies and on a test basis reviews these audits performed by certified public accountants for conformance with these standards. The establishment of many regulations was left by the Sarbanes-Oxley Act to the SEC.

Final rules were adopted by the SEC on March 3, 2003 that require a public company to disclose whether its audit committee includes at least one member who is considered a financial expert. The Securities and Exchange Commission (2003) defines an audit committee financial expert as possessing the following attributes:

- an understanding of generally accepted accounting principles and financial statements;
- the ability to assess the general application of such principles in connection with accounting for estimates, accruals, and reserves;
- experience in preparing, auditing, analyzing, or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the issuer's financial statements, or experience actively supervising one or more persons engaged in such activities;
- an understanding of internal controls and procedures for financial reporting; and

- an understanding of audit committee functions.

Comparison of S&P 100 and Large Restaurant Companies

The previous section of this paper provides an extensive review of the role of audit committees in corporate governance in the United States. It was intended to erect the background necessary to determine the extent to which companies in general, and restaurant companies in particular, are complying with audit committee mandates and recommendations. This background provides a basis for comparing certain aspects of the audit committees of S&P100 companies with those of the top 51 restaurant companies.

A prior research project (Kintzele, Arndt, Kintzele & Kwiatowski, 2008) reported on the audit committee disclosures of the S&P 100 companies for 2006. Table 1 presents a summary of the membership of audit committees for both the S&P 100 companies and the top 51 restaurant companies in Value Line, Inc., for 2008. Recall that the Treadway Commission recommended at least three members for an audit committee. This table reveals that for the S&P 100 companies, just over half (51%) had three or four members on the audit committee while most (86%) of the restaurant companies had three or four members on the committee. All but one of the 51 restaurant companies met Treadway's recommendation for the minimum number of audit committee members. Forty nine percent of the S&P 100 companies had over five audit committee members, while only 12% of the restaurant companies had that many members. Companies in the restaurant industry tend to have smaller audit committees than is the case for S&P 100 companies.

Table 1

Membership on Audit Committees

Number of members	S&P 100 2006 %	Restaurant companies 2008/2009 %
Two	0	2
Three or four	51	86
Five or six	44	12
Seven or eight	5	0
Nine or more	0	0

Table 2 provides information on the number of audit committee meetings held in a year. Whereas 75% of the S&P 100 firms held nine or more meetings

per year, only 19% of the restaurant companies met that many times per year. Most (61%) of the restaurant companies met 6 or fewer times per year compared to only 13% of the S&P 100 firms. All of the restaurant companies met the recommendation of having at least three audit committee meetings per year.

Table 2

Number of Audit Committee Meetings in the Year

Number of Meetings	S&P 100 2006 %	Restaurant companies 2008/2009 %
One or two	0	0
Three or four	2	37
Five or six	11	24
Seven or eight	11	20
Nine or ten	33	12
More than ten	42	7

*Percentages do not equal 100% due to rounding.

Other important audit committee disclosures are presented in Table 3. This table reveals that 85% of the S&P 100 companies reported that they had a stated policy, for example, on how to deal with the situation when someone in the company reports irregularities with the accounting function. This is often referred to as a “whistleblower” policy. However, in the case of the restaurant companies, 98% reported having a stated whistleblower policy. For example, in the audit charter of the McDonald’s Corporation (2008), under “Whistle blowing Procedures” it states: “The Committee shall establish and maintain procedures for the receipt, retention and treatment of complaints received by the Company regarding accounting, internal accounting controls or auditing matters and for the confidential, anonymous submission by employees of the Company of concerns regarding questionable accounting or auditing matters.”

When it came to the credentials of members of the audit committees, 86% of the S&P 100 companies surveyed indicated at least one member should be considered a “financial expert.” For the restaurant companies, 98% reported at least one member should be a “financial expert.” Restaurant companies are doing considerably better than the S&P100 companies in regard to this recommendation. In the audit charter of Denny’s Corporation (2008), the policy is stated as follows: “At least one member of the Committee shall be an “audit committee financial expert” as defined by the SEC, and the company will make the disclosure required by the rules and regulations of the SEC with respect to such matters.”

A big difference between the S&P 100 companies and the restaurant companies had to do with restrictions that committee members could not be on other public companies' audit committees. The charter of the Cheesecake Factory (2009) states: "A member of the Committee may not serve on the audit committee of more than two public companies in addition to the Company without the prior determination by a majority of the independent directors of such board that such concurrent service would not impair the member's ability to serve effectively as a member of the committee." In the case of the S&P 100 companies, 60% of those surveyed had such a policy whereas only 33% of the restaurant companies had one. Restaurant companies are considerably behind the S&P 100 companies in this regard.

When discussing whether an audit committee member must be literate in financial matters, only 85% of the S&P 100 companies believed it was important enough to be stated in the charter whereas 100% of the restaurant companies formally stated such a policy. In the charter of Bob Evans (2009), for example, the following policy is stated: "All members of the Audit Committee must be able to read and understand fundamental financial statements including the Company's balance sheet, income statement, and cash flow statement." Clearly, the restaurant companies are taking the financial literacy recommendation seriously.

Table 3

Additional Audit Committee Disclosures in Proxy Statements

	S&P 100 2006	Restaurant companies 2008/2009
Whistleblowers	85	98
Financial Experts	86	98
Other Committee Memberships	60	33
Membership Financial Literacy	85	100

Conclusions and Recommendations

Over the last several years, many industries have been tainted by scandals and poor management. Specific examples include General Motors in the manufacturing area, K-Mart in the retailing sector and Lehman Brothers in the financial services industry. Audit committees can be effective vehicles to assist in corporate governance. Restaurant companies appear to be adhering well to recommendations on the composition and operation audit committees and value their role in enhancing corporate governance. A reasonable conclusion is that good corporate governance, due in part to the strengths of the audit committees, in the restaurant industry has contributed to the lack of serious scandals in this sector of the economy. A greater number of members on the audit committees of the restaurant companies could provide more breadth and experience for those committees. A limitation of this study that some of the higher percentages for the restaurant companies compared to the S&P 100 companies could be explained by the two year time lag between the two studies. Further research in this area could be done to compare restaurant and lodging companies with regard to the audit committee's role in corporate governance. In the future, one would expect to see a closer relationship between the internal auditors and the audit committee. This would result in more value added to the financial reporting process.

References

- Bob Evans Farms Inc. (2009). *Charter of the Audit Committee of the Board of Directors of Bob Evans Farms, Inc. in proxy statement for Annual Report*.
- Burger King Corporation. (2009). *Corporate Responsibility Report*. Retrieved from <http://www.bk.com/en/us/company-info/corporate-responsibility/corporate-governance.html>.
- Cheesecake Factory Incorporated. (2009). *Audit Committee Charter in proxy statement for Annual Report*.
- Denny's Corporation. (2008). *Audit Committee Charter in proxy statement for Annual Report*.
- Kintzele, M.R. (1991). The Use of Audit Committee Reports in Financial Reporting. *Internal Auditing*, 6 (4), 16.
- Kintzele, P.L., Arndt, T.L., Kintzele, M.R., Kwiatowski, V.E. (2008). Audit Committees and Internal Auditors: Their Roles in Financial Reporting Today. *Internal Auditing*, 23 (3), 30-37.
- Klein, A., (2002). Economic Determinants of Audit Committee Independence. *The Accounting Review*, 77 (2), 435-542.
- McDonald's Corporation. (2008). *Audit Committee Charter in proxy statement for Annual Report*.
- McDonald's Corporation. (2008). *Statement of Corporate Governance*. Retrieved from http://www.aboutmcdonalds.com/mcd/investors/corporate_governance.html.
- National Commission of Fraudulent Financial Reporting. (1987). *Report of the National Commission on Fraudulent Financial Reporting*. 179-192.
- Panel on Audit Effectiveness. (2000). *The Panel of Audit Effectiveness: Report and Recommendations*.
- Ruby Tuesday, Inc. (2009). *Corporate Governance Guidelines*. Retrieved from <http://www.rubytuesday.com/investors/governance>.
- Securities & Exchange Commission. (2003). Release No. 33-8177.
- The Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees. (1999). *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees*. 10-16.
- Value Line, Inc. (2009). Retrieved from <http://www.valueline.com/lookup/current.aspx>.