

2014

Hotel/Gaming Companies and Corporate Governance

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Recommended Citation

Damitio, James W.; Kintzele, Philip; and Kwiatkowski, Vernon (2014) "Hotel/Gaming Companies and Corporate Governance," *Journal of Hospitality Financial Management*: Vol. 22 : Iss. 1 , Article 3.
Available at: <https://scholarworks.umass.edu/jhfm/vol22/iss1/3>

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Cover Page Footnote

Auditing Standards Board of the American Institute of Certified Public Accountants (1988). Statement on Auditing Standards #61, Communication with audit committees. 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. Damitio, J., Kintzele, P., Kwiatkowski, V., Kintzele, M. (2010). Enhanced corporate governance for restaurant companies: the role of well performing audit committees. *The Journal of Hospitality Financial Management*, 18, (1), 33-43. 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., Kwiatkowski, 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. National Commission on 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. Public Company Accounting Oversight Board. Auditing Standard # 16, Communications with audit committees. PCAOB Release No. 2012-004.

Introduction

Since the start of the twenty-first century, issues pertaining to topics of financial reporting and accounting have plagued large corporations in many different industries. Both the financial regulatory system and the media (business and mass) have investigated and reported shortcomings regarding financial reporting issues. Several large publicly owned corporations have gone bankrupt including Enron, Lehman Brothers, MF Global Holdings, and World Com. The financial services sector experienced numerous forced mergers to rescue several companies from falling into bankruptcy. Even one of the world's largest public accounting firms, Arthur Andersen, LLP, ceased to operate because of allegations of illegal activities. In the Andersen case, the criminal charges were dropped a few years after the firm failed. Because a significant number of these financial reporting issues involved the failures of large corporations, the business community has become very aware of the critical need of ethical, high quality financial reporting.

The Sarbanes-Oxley Act became law in 2002. One of the goals was to improve the quality of financial reporting for United States based corporations. Because of problems in the subprime lending industry as well as business dealings with complex financial instruments and commodities trading, the need for continued high quality financial reporting remains as important as ever. There are many important entities that need to be fully engaged in this process to attain the results of high quality financial reporting. The participants include the company's' board of directors, senior management, and the internal auditors, as well as the outside auditors.

A well-functioning audit committee of a corporation's board of directors that has effective engagement with the corporate internal audit function is needed to have a high quality financial

reporting and accounting system. One of the audit committee's most important responsibilities is to have oversight of the corporation's outside and internal auditors.

The purpose of this study is to describe how a well-functioning audit committee is constituted and the attributes of how it performs its duties. The evolution of audit committees over the past 35 years is discussed. It also provides a comparison of the audit committee's policies and procedures of publicly owned restaurant companies with those of lodging companies. The guidelines for good practice of audit committees are discussed as well as prior research studies. The current state of audit committee functioning in the hotel/gaming industry is then reported on and discussed.

Prior Research Studies

A study (P.L. Kintzele, Arndt, M.R. Kintzele, & Kwiatkowski, 2008) was performed on S&P 100 companies that reported on their audit committee disclosures. The study attempted to shed light on the extent of compliance with recommendations on the composition and operation of audit committees. That study reported on the number of members on audit committees, number of audit meetings per year, and additional audit committee disclosures such as whistleblower policy, financial experts, and membership financial literacy.

What is the current state of corporate governance in the hospitality industry today and how does it compare with S&P 100 companies? A study (Damitio, Kintzele, Kwiatkowski, & Kintzele, 2010,) of the restaurant segment of that industry reported that restaurant companies appear to be following the recommendations on the composition and operation of audit committees. In addition the study reported that audit committees played a valuable role in enhancing corporate governance in the restaurant segment. The study also reported some

differences between the audit committee disclosures of restaurant companies and S&P 100 companies.

A conclusion of that study was that enhanced corporate governance in the restaurant segment may have contributed to the lack of scandals in that segment of the economy. This was partially the result of the strengths of the companies' audit committees. A recommendation of the study was that further research should be done with lodging companies in this area of audit committees and their role in corporate governance.

Evolution of Audit Committees

Although some corporations have had audit committees for more than 50 years, they were first required by the New York Stock Exchange (NYSE) in 1978 for all corporations listed on the NYSE. The audit committee needed to be made up from the corporation's board of directors. It was then that the financial reporting stakeholders recognized the importance of audit committees to the financial reporting process. The Treadway Commission, officially known as the National Commission on Fraudulent Financial Reporting (1987), stressed the need to have audit committee reports in corporate annual reports. A letter from the chair of the audit committee appearing in the corporate annual report was strongly recommended by the Treadway Commission. A list of "good practice" guidelines was issued by the Treadway Commission. These good practice guidelines are discussed in detail below.

Guidelines for Good Practice: General Guidelines

The listing of good practice guidelines was set forth in three topical areas: general guidelines, selection of the independent outside auditor, and post audit review. The audit committee's size was one of the items listed as a general guideline. The audit committee should

be at least three members as recommended by the good practice general guidelines. However, it should not be of such size that each member of the audit committee is inhibited from becoming an active participant in the committee's deliberations. Other general guidelines recommend that each member of the audit committee be an independent director of the corporation's board of directors. The terms of service for members on the audit committee should be staggered. Also recommended by the Commission's general guidelines are regularly scheduled meetings of the audit committee and reporting to the corporate board of directors on a regular basis.

The audits conducted by the external and internal auditors should be overseen by the audit committee of the corporate board. This oversight was recommended by the Treadway Commission. It also indicated that it is the responsibility of the audit committee to make sure there is coordination between the internal and external auditors. Both groups of auditors should explain to the audit committee of the board how the audit scopes of each auditor group are designed to identify internal control systems' weaknesses or to lead to the detection of fraud.

The person in charge of the internal audit function or another selected person from internal audit needs to meet privately with the audit committee and the outside public accountant. If there are instances where the outside public accountant has to rely on the work of other outside public accountants, the audit committee needs to require that its current independent accountants review the work of these other outside accountants. The use of another outside independent auditor may need to be considered by the audit committee as an additional appropriate procedure.

Corporate officers' expenses and use of company property must be reviewed by the audit committee for compliance with company policy. The auditors (both internal and external) need to be informed that the corporate audit committee must be made aware of any specific issues that require audit committee attention or action.

Guidelines for Good Practice: Selection of the Independent Accountant

The Treadway Commission's guidelines for good practice contain a second category of guidelines for describing the process of selecting the independent auditor by the corporate audit committee. The proposed audit fee and the letter of engagement of the outside auditing firm must be reviewed by the audit committee. The audit committee needs to understand the planned level of audit partner participation as well as the intended amount of audit staff utilization regarding the audit engagement proposal. If the audit committee should select a new outside auditor, the audit committee must review the process to ensure a smooth transition from the current outside auditor to the successor outside audit firm. In most cases, the selection of the outside auditing firm must be approved by a vote of the shareholders. This review process allows for the necessary notification to shareholders for the required ratification vote.

Guidelines for Good Practice: Post Audit Review

Also recommended by the Treadway Commission were a group of necessary duties of the audit committee that relate to the processes that need to be followed for a post audit review. The Treadway Commission requires that the audit committee be responsible for meetings with the legal counsel of the corporation. Contingencies of a legal nature that may have a material effect on the financial statements of the corporation need to be discussed. If any significant variances contained in the financial statements pertaining to the years of comparative financial statements disclosed exist, the audit committee needs to get corporate management's explanation. Consistency between the management's discussion and analysis (MD&A) part of the corporate annual report and the information contained in the corporate annual report must be reviewed by the audit committee. The audit committee needs to meet privately with the independent auditors during the post-audit review process. The quality of the internal audit

function and the quality of the corporate finance and accounting personnel should be discussed. The independent auditor's greatest concerns relating to the audit should be discussed with the audit committee. Any other issues or concerns not already discussed with the audit committee should be addressed. An important duty of the corporate audit committee is the questioning of corporate management and the independent auditors relating to any changes in the application of accounting principles and auditing standards that would impact the financial statements. Corporate management must be questioned by the audit committee regarding the existence of any items that might materially impact the financial statements. Special attention by the corporate audit committee should be given to accruals, reserves, estimates, and changes in estimates.

The management representation letter needs to be reviewed by the audit committee. The audit committee must question the independent auditor as to whether any issues arose in securing the representation letter or obtaining satisfactory coverage of issues included in the representation letter. Other issues that could come up during the course of the audit must also be dealt with by the audit committee. Litigation, judgments or assessments and other claims that were seen by outside council or in-house lawyers are contingency concerns of the audit committee. The audit committee must not only consider the resolution of these contingencies but whether disclosure in the corporation's financial statements is appropriate.

The MD&A section of the corporation's annual report must be reviewed by the audit committee with corporate management and the independent auditor. All parties need to agree that there is consistency between the financial statements and the other information contained in the annual report. The audit committee needs to discuss any issues related to this with the independent auditor. The audit committee must decide whether the independent auditors should meet with the full board of the corporation's directors to answer any questions regarding the audit of the independent auditors.

Guidelines for Good Practice: Letter of the Audit Committee Chairman

It was recommended by the Treadway Commission that the chairman of the audit committee insert a letter in the corporate annual report summarizing the role of the audit committee including its duties and activities. Because the Treadway Commission's recommendations were never adopted by the Financial Accounting Standards Board (FASB) or by the Securities and Exchange Commission (SEC) as a reporting requirement, very few corporations have ever included an audit committee chairman's letter in their annual report. The actual functioning of audit committees has been described by the majority of corporations in the reports of management for SEC listed corporations (M.R. Kintzele, 1991).

These corporations thought it necessary to discuss the function of their audit committee in their annual reports, but they didn't believe a separate audit committee chairman's letter was needed. Because the discussion of the audit committee lacked much of what was suggested to be written in the audit committee chairman's letter, those concerned about the reporting of the functioning of the audit committee were disappointed.

The members of the audit committee are required by all U.S. based stock exchanges to be independent outside directors. The initial interpretation of an outside director was not being an employee of the corporation that one was serving on the board of directors. As time passed, a classification of "grey area" directors emerged. Grey area directors were identified as consultants hired by the business, relatives of management, retired management and persons serving as interlocking directors on two or more corporate boards. If grey area directors served on the audit committee, the perception of an independent audit committee would be endangered. (Klein, 2002) conducted a study and concluded that independence of the audit committee increases with board size and corporate board member independence. Klein also concluded that audit committee independence decreases with the firm's growth opportunities and for companies that report consecutive losses. The NYSE and NASD (National Association

of Securities Dealers) in 1999 promulgated requirements that allowed corporations the option of allowing non-outside directors on their audit committees, if corporations decided that it is in their interest to do so.

A Blue Ribbon Committee was formed by the NYSE and the NASD in 1998 that addressed the concerns of the SEC pertaining to audit committee accounting and reporting practices. A report was issued by the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (1999) which included ten major recommendations listed below:

1. The NYSE and NASD should adopt strict definitions of independence of directors serving on audit committees of listed companies.
2. The NYSE and NASD should require larger companies to have audit committees composed entirely of independent directors.
3. The NYSE and NASD should require larger companies to have "financially literate" directors on their audit committees.
4. The NYSE and NASD should require each company to adopt a formal audit committee charter and to review its adequacy annually.
5. The SEC should require each company 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's 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 SEC should require the outside auditor to perform an interim review under SAS No. 71, *Interim Financial Information*, before a company files its Form 10-Q.

The O'Malley Panel on Audit Effectiveness

The O'Malley Panel (officially named the Panel on Audit Effectiveness) was created by the Public Oversight Board in 1999. The Public Oversight Board is the independent private-sector entity that oversees the American Institute of Certified Public Accountants (AICPA) SEC Practice Section's programs. The deliberate efforts of corporate management to manipulate earnings caused concerns by the SEC. As a response to those concerns, the O'Malley Panel was formed. A report of the O'Malley Panel was issued in 2000 that contained the following recommendations relating to audit committees:

1. Internal control would receive increased emphasis. A written report by management needs to be provided regarding the effectiveness of the corporation's internal control.
2. Corporate reserves should be evaluated and changes in their balances need to be discussed with the auditors and management.

3. There should be at least two face-to-face meetings with the auditors. There needs to be at least one private meeting with the auditors. Business risks, auditor performance, and pressures on auditors are topics to be discussed. If there are plans to hire audit firm personnel into high-level corporate positions, they should be discussed.
4. Request that management prepare a report on the control environment of the corporation and how that environment, in conjunction with established policies and procedures, aids in the prevention and detection of financial statement fraud.
5. Facilitate the cooperation of the auditors with management so the auditors' efforts regarding the detection of fraudulent financial reporting are successful.
6. The threshold amount for pre-approval of non-audit services should be determined by the audit committee.

The three entities (the Treadway Commission, the Blue Ribbon Committee, and the O'Malley Panel) were convincing corporations to adopt many of their collective recommendations. While the aforementioned entities could only make recommendations, the SEC has the legal authority to promulgate the regulations that corporations must comply with. Corporations regulated by the SEC are required to include a report of their audit committee in their proxy statement issued with their annual report. The SEC issued the regulation on December 15, 2000. The audit committee report needed to state if the audit committee had recommended that the audited financial statements of the corporation be filed with the SEC. The audit committee also needed to disclose if it had a written charter that specified the duties of the audit committee. The SEC required that the audit committee charter must be filed with the SEC every three years.

All major stock exchanges in the United States must have their listing requirements approved by the SEC. Corporations are required to state whether their audit committee

members are considered independent directors. Audit committee members are also required to have some degree of financial expertise.

The Public Company Accounting Oversight Board (PCAOB) was established by the SEC with the enabling passage of the Sarbanes-Oxley Act. The PCAOB started functioning in April 2003. Since 2003, publicly traded corporations are audited under standards determined by the PCAOB. The PCAOB also reviews, on a test basis, audits performed by independent public accountants for conformance with these standards. The establishment of many regulations pertaining to corporate financial reporting and auditing by the SEC was designated by the Sarbanes-Oxley Act.

On March 3, 2003, the SEC adopted its final rules regarding audit committee composition. Public corporations are required to disclose whether its audit committee contains at least one financial expert. As defined by the SEC (2003), an audit committee financial expert possesses 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.

In 2012 the PCAOB issued Audit Standard No. 16 (AS 16) Communications with Audit Committees, effective for fiscal years beginning on or after December 15, 2012. AS 16 slightly expanded some of the audit committee communication requirements set forth previously. It also required outside auditors to communicate significant changes to planned audit strategy or the significant risks identified and the reasons for such changes.

Companies Examined

This project uses the companies of the hotel/gaming Industry listed in the Value Line Investment Survey. The Value Line Investment Survey groups companies into 2 categories: Large-Cap companies and Small and Mid-Cap (Small/Mid-Cap) companies. The first group covers the 1,700 most actively traded U.S. exchange-listed stocks. The Small and Mid-Cap Survey covers 1,800 companies with market values between less than \$1 billion to \$5 billion. The hotel/gaming industry has 24 companies in the Large-Cap category and 18 companies in the Small and Mid-Cap category. The most currently available proxy statement for each company was examined for disclosures concerning the audit committee. Proxy statements for all 18 of the Small and Mid-Cap companies were examined and 23 of the 24 Large-Cap companies were examined. Relevant information for one company, which is headquartered in Hong Kong, was not available.

Information regarding audit committees is typically found in three places within the proxy statement: the section discussing the various boards of directors committees, the audit committee report, and reference to the charter of the audit committee. The charter of the audit committee is often on the company website.

The results of the proxy examinations are presented next. Board of director members who serve on the audit committee are required to meet the general requirements of independence and the more restrictive guidance set by the NYSE or the NASD stock exchange. All members for both the large companies and small companies met these requirements. Table 1 shows the distribution of the number of members on the audit committee for the Large-Cap companies and the numbers for Small/Mid-Cap companies and the restaurant companies. The three groups have very similar number of members on their audit committees.

Table 1
Membership on Audit Committees

Number of Members	Restaurant	-----Hotel/Gaming-----	
	%	Large-Cap %	Small/Mid-Cap %
Two	2	0	0
Three or four	86	82	83
Five or six	12	18	17
More than 6	0	0	0

At least one member of the committee is required to qualify as a financial expert. All of the companies in the 3 groups did have at least one member identified as a financial expert. The number of members so identified does vary across the three groups. Table 2 presents the percentages for the members identified as financial experts.

Table 2
Financial Experts

Number of Members who Are Financial Experts	Restaurant	-----Hotel/Gaming-----	
	%	Large-Cap %	Small/Mid-Cap %
One	98	41	72
Two	*	18	11
Three	*	27	17
Four or more	*	14	0

*data not available

The number of times the audit committee met during the year was another item determined. The results are presented in table 3.

Table 3
Number of audit committee meetings

Number of Meetings	Restaurant	----Hotel/Gaming-----	
	%	Large-Cap %	Small/Mid-Cap %
Three or four	37	14	39
Five or six	24	9	28
Seven or eight	20	24	11
Nine or ten	12	29	17
More than ten	7	24	5

The number of audit committee meetings shows wide variation in the results. The Large-Cap hotel/gaming companies had over 50% of the companies having 9 or more audit committee meeting during the year. Less than 30% of the Restaurant and Small/Mid-Cap companies had nine or more audit committee meetings in the year. The Large-Cap hotel/gaming companies appear to be more involved in a larger number of significant events such as international operations, expansions, mergers and acquisitions which require more attention from the audit committee.

Finally there are several additional items typically presented in the audit committee report. All of the items were presented by all of the hotel/gaming companies.

- Discussions required by Auditing Standards No. 61 as amended and adopted by the Public Companies Accounting Oversight Board (PCAOB).
- Discussions required relating to the independence of the external auditor.
- Appointment or recommendation for the appointment of the external auditor.
- Recommendation the inclusion of the financial statements in the company's Form 10-K.

- Policy that the committee will approve or pre-approve audit, audit-related, tax, and other services.
- Identification of the availability of the audit committee charter.

Conclusion, Limitations, and Recommendations

Audit committees have a central role in good corporate governance and in assuring quality financial reporting. The requirements for audit committee responsibilities and reporting have developed over the last 20 to 30 years. The development of the audit committee was presented in this article. The results of an examination of proxy statements of publicly traded companies in the hotel/gaming industry were reported and compared to the restaurant industry.

While the Large-Cap and Small/Mid-Cap companies of the Hotel/Gaming industry had similar percentages reporting on most of the attributes of companies examined, the Large-Cap companies tended to have more financial experts on their audit committees. The audit committees of the Large-Cap companies also met more times during the year. There is a high degree of compliance with the expectations for audit committees in both industries.

This study pertains only to publicly traded companies. Because many operators and/or owners of all sizes of businesses in this industry are privately held, many relevant entities are not included in this study as well as other similar studies regarding financial performance and corporate governance. As changes in industry expectations and regulations evolve, future studies need to be performed to compare hospitality industry performance with performance in other industries regarding reporting on audit committees.