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The Role of Audit Committee in Corporate Governance: Descriptive Study

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Abstract

Corporate governance is very important in our business world today, especially after the frequent non-stop worldwide financial crises. Strong corporate governance is now considered a basic condition to accept and register an organization in most of the Stock Exchange Markets all over the world. The audit committee plays a major role in corporate governance regarding the organization's direction, control, and accountability. As a representative of the board of directors and main part of the corporate governance mechanism, the audit committee is involved in the organization's both internal and external audits, internal control, accounting and financial reporting, regulatory compliance, and risk management. This paper focuses on the audit committee's powers, functions, responsibilities, and relationships within the framework of corporate governance.

Keywords: audit committee, corporate governance, external audit, internal audit, internal control

1. Introduction

Corporate governance is a system used to direct and control an organization. It includes relationships between, and accountability of, the organization's stakeholders, as well as the laws, policies, procedures, practices, standards, and principles which may affect the organization's direction and control (Cadbury, 1992). It also includes reviewing the organization's practices and policies in regard to the ethical standards and principles, as well as the organization's compliance with its own code of conduct.

Corporate governance has become one of the most topical issues in the modern business world today. Spectacular corporate failures, such as those of Enron, WorldCom, the Bank of Credit and Commerce International (BCCI), Polly Peck International, and Baring Bank, have made it a central issue, with various governments and regulatory authorities making efforts to install stringent governance regimes to ensure the smooth running of corporate organizations, and prevent such failures (Al-Baidhani, 2014a) . A corporate governance system is defined as a more-or-less country specific framework of legal, institutional and cultural factors shaping the patterns of influence that shareholders (or stakeholders) exert on managerial decision-making. Corporate governance mechanisms are the methods employed, at the firm level, to solve corporate governance problems (Basuony et al., 2014).

Since it is viewed as a necessary element of market discipline, strong corporate governance is highly demanded by investors and other financial market participants (Ramsay, 2001). Regulators have enacted corporate governance reforms into law in many countries, such as the USA through the Sarbanes-Oxley Act of 2002 which states that in order to safeguard their long-term successes, organizations implement corporate governance to ensure that they are directed and controlled in a professional, responsible, and transparent manner. In other countries, such as the UK, the corporate governance codes, known as the Combined Code of Corporate Governance of 2003, are principles of best practice with some indirect element of legislature operating through the respective stock exchange listing rules. For the banking sector, Basel I, II, and recently III are widely adopted by developed, developing,

emerging, and underdeveloped market economies to enhance their corporate governance codes.

Often the respective organization has “terms of reference” which shows clearly the activities and responsibilities of the audit committee. The board of directors and its committees (including the audit committee) rely on the organization’s management to run the daily operations. The audit committee activities and responsibilities are to oversee and monitor the organization’s overall financial performance, especially the preparation of its financial statements (balance sheet, income statement, statement of stockholders equity, etc.), managerial financial reports such as cost and budgeting reports, the effectiveness and efficiency of the organization’s internal control, and the performance of both internal and external auditors. European Union Directive 2006/43/EC states: “the audit committee shall (a) Monitor the financial reporting process; (b) Monitor the effectiveness of the company's internal control, internal audit where applicable, and risk management systems; (c) Monitor the statutory audit of the annual and consolidated accounts; (d) Review and monitor the independence of the statutory auditor or audit firm, and in particular the provision of additional services to the audited entity”.

The audit committee operates as a representative of the board of directors from whom it receives its powers to perform its corporate governance responsibilities which include overseeing and monitoring the organization’s financial reporting, disclosure, internal and external audit, internal control, regulatory compliance, and risk management activities; this applies to public, private, and mix sectors, as well as some non-governmental and not-for-profit organizations. The audit committee provides the board of directors with necessary advices and recommendations which include ensuring: that the respective organization complies with relevant regulations and ethical principles and standards; that the internal auditors are independent and competent; that the financial statements have been prepared correctly and accurately; and that the compensations paid to the organization’s executives were according to fairness and professionalism (Al-Baidhani, 2014b). As part of improving the integrity of the organization’s financial information, a regulatory body may require a public company to create an independent audit committee (Bhagat and Black, 2002). Audit

committees may seek the consulting resources and expertise needed to perform their responsibilities.

This paper focuses on the role that audit committees play in corporate governance. In addition to this first section, the paper is organized as follows: the second section provides a respective background; the audit committee composition and meetings are provided in the third section; followed by the audit committee's various roles in the fourth section; and finally summary and conclusion provided in the last section.

2. Background

The concept of audit committee was first endorsed in 1939 by the New York Stock Exchange (NYSE). During the 1970s, the audit committee's role was very welcome due to the great demands for corporate governance and corporate accountability (Spangler and Braiotta, 1990). In 1972, the U.S. Securities and Exchange Commission (SEC) was the first to recommend that public companies should create audit committees comprised of directors from outside the relevant companies' managements. In 1977, the NYSE required that all audit committee members should be independent directors. In its Statements on Auditing Standards (SAS 61), the American Institute of Certified Public Accountants (AICPA, 1988) issued "Communication with Audit Committees" regarding the relationship between the audit committee, external auditors, and management of public companies. In 1999, The Blue Ribbon Committee (BRC, 1999) recommended major rule changes, related to improving the effectiveness of the corporate audit committee. And later, after the corporate collapse of Enron, WorldCom, and others, the Sarbanes-Oxley Act was passed by the U.S. Congress in 2002 giving more power to audit committees, especially in regard to whistleblower and disclosure requirements. The Sarbanes-Oxley Act of 2002 increased audit committees' responsibilities and authority. It raised membership requirements and committee composition to include more independent directors. Companies were required to disclose whether or not a financial expert is on the

Committee. In addition, the SEC and the stock exchanges proposed new regulations and rules to further strengthen audit committees.

Audit committees are identified as effective means for corporate governance that reduce the potential for fraudulent financial reporting. Audit committees oversee the organization's management, internal and external auditors to protect and preserve the shareholders' equity and interests. To ensure effective corporate governance, the audit committee report should be included annually in the organization's proxy statement, stating whether the audit committee has reviewed and discussed the financial statements with the management and the internal auditors (Al-Baidhani, 2014b). As a corporate governance monitor, the audit committee should provide the public with correct, accurate, complete, and reliable information, and it should not leave a gap for predictions or uninformed expectations (BRC, 1999). The BRC report provides recommendations and guiding principles for improving the performance of audit committees that should ultimately result in better corporate governance. The importance of the audit function in terms of the audit committee and audit firm is further strengthened by the Sarbanes-Oxley Act of 2002. Corporate governance standards and principles are extracted from local and international laws, regulations, and rules, as well as from the organization's bylaws, codes of conduct, and resolutions. Corporate governance focuses on the control systems and structures by which managers are held accountable to the organization's legitimate stakeholders.

Traditional finance literature has indicated several mechanisms that help solve corporate governance problems (Jensen and Meckling, 1976; Fama, 1980; Jensen, 1986; Turnbull, 1997). There is a consensus on the classification of corporate governance mechanisms to two categories: internal and external mechanisms. However, there is a dissension on the contents of each category and the effectiveness of each mechanism. In addition, the topic of corporate governance mechanisms is too vast and rich research area to the extent that no single paper can survey all the corporate governance mechanisms developed in the literature and instead the papers try to focus on some particular governance mechanisms.