Audit Committee and its Role in Corporate Governance

Authors: Aman Bajaj, Huirem Sonia Chanu, Rupali Kumari, Anisha N, Roopa M, Navneet Gabriel Fullinfaw, Aswathy R, Manjula B, Arun James– Research Scholar's, CHRIST (Deemed to be University)
Guided by : Dr. Kavitha Jayakumar, Associate Professor, CHRIST (Deemed to be University)

Abstract: *In order to improve corporate governance, regulatory bodies and authorities across the world have recommended establishment of Audit Committee. This study focuses on understanding the role of the Audit Committee in improving Corporate Governance as well as the impact of an independent Audit committee on the financial reporting quality, internal audit quality, external audit quality and firm performance through a review of existing literature highlighting the role and importance of Audit Committees. The study indicates that any organization having Audit committee which consist of independent members tends to function better both in internal and external affairs which ultimately increases overall performance along with greater credence by the investors.*

Key words: Corporate Governance, Audit committee, Independent Audit

Introduction: Every business which operates need to be guided & governed under the system called "corporate governance". Corporate governance sets out the rules, regulation, terms, practices to the entities in order to ensure the proper functioning of the whole organization. It ensures the balanced interest between the stakeholder and the management of the company. It is the responsibility of the board of director to put the corporate governance into reality. The board of directors are appointed by shareholder for running and managing the business, so shareholder is also a part of corporate governance. It is the duty of the board of director to set the company in a position to do business, frame objective, monitor and supervise the performance of the company to achieve the defined goal and objective.

Corporate governance has 4 pillars on which it stands: accountability, fairness, transparency and responsibility. It gained its momentum when various high profile company crumbled unexpectedly on these pillars. As a consequences Cadbury published the first of its kind report i.e. Cadbury Report to serve as a code to abide by the company for their governance in the year 1992. Even though it help to recognized issues of corporate governance and instigated to publish various guidelines including that of OECD, It failed to prevent further corporate collapses. It was in the year 2002, after the scam of Enron, Parmalat and WorldCom etc. which give rise to Sarbanes-Oxley Act which is a much stricter rule. India also enacted its own act to govern similar issues through clause 49 which forms a part of the Listing Agreement to keep the investors interest invested in the year 2005. Following the Satyam Scam amendment was brought in the year 2009.With the help of such rules and regulation good corporate governance was executed and business gain trust in the eyes of third parties which is possible only if the business is true in its affairs, following ethical practices, contributing towards the environment, etc.

Companies are not always ethical in their behavior and they involve themselves in unethical practices to defraud the investor for their own personal benefits. This harms the investor and they end up in losing their money. Simultaneously the reputation of the company also declines. Here, an audit committee comes into the picture which has been established to protect the interest of the stakeholders and control the affairs of the company to indulge in any fraudulent or illegal activities.

As per the section 292 of the companies act, 1956 and clause 49 of listing agreement, it became mandatory for the public companies to establish an audit committee which should have minimum 3 member, out of which chairman should be an independent member. Independency of the member differs from country to country. An audit committee should compulsorily organize minimum 2 meetings during a year which has been now raised to 4 meetings during a year. The frequency of the meetings have significant impact on the performance of the organisation as the audit committee are active as well as advisory function will certainly contribute towards the achievement of the objective. It is advisable to the audit committee to invite the regulatory bodies, external and internal auditor, and other relevant bodies to attend the meeting.

The Role of Audit Committee in Corporate Governance

The audit committee in any organisation play a major role in formation of the organisation structure, forming of rules and regulation, compliances of the rules and regulation of the law as well as of the industry in which companies comes under, monitor the compliances of the rules and regulation and measures the deviation, monitor the statutory audit, financial disclosure & reporting, and monitor the performances by applying internal control system. The audit committee oversees the overall financial performances of the organisation.

The audit committee also ensure that the ethical and legal standards of the industry and the various law under which the organisations falls is strictly adhering or not. By ensuring these an audit committee helps in reducing the possibility of the fraudulent act done by the organisation, which makes the corporate governance effective.

Audit committee is not just confined to the organisation but also act in the protection of the interest of the shareholder and other parties which is relating to the company in any matter. It reveals the performance of the organization in the form of statement of balance sheet and profit & loss account to bring the transparency among stakeholders by providing correct, accurate and reliable information about the organisations. By doing this audit committee becomes accountable to the 3rd party of the organisation.

Apart from that the audit committee appoint & regulate the work of internal auditor i.e. it checks the work of the internal auditor whether it is going in the right direction or not. Also the committee sets outs the qualification of the external auditor and the scope of the work of the external auditor. The audit committee also appoint the external auditor in case not appointed by board of director. If appointed by board of directors then audit committee has to approve the appointment of the external auditor. For that an audit committee must ensure the independency of the external & internal auditor working for the organisation.

An audit committee can also terminate the term of the internal auditor in case the internal auditor found guilty or suspicious on the basis of his independency. Audit committee sets out the frequency of the number of meetings of internal auditor with the board of directors in a year. As monitoring the internal audit is the most important role of the audit committee, the committee can inspect, investigate the plan, work arrangement and the resource allocated to the internal auditor.

Audit committee mandatorily make sure that the professional fees paid to the internal & the external auditor or any organization's executive should be paid according to the terms and consist of fairness and professionalism.

An audit committee reviews all the financial report & issues of the organisation and recommend the advises on those issues to the board of directors which is later on submitted to the shareholder of the organisation, in a way audit committee act as the representative of the board of director.

The management of the organisation including external and internal auditor mandatorily provide the report of the internal control's productivity and viability. The audit committee is in a position to question the management over the functioning of the internal control in the organisation.

The committee also monitors the principles, policies, rules & regulation and practices of the organisation. It reviews the organization's size, nature of business, financial statements.

The accounting standards, accounting estimates and the decision made by the management are considered, discussed and reviewed by the audit committee in order to ensure the accuracy, reliability and trustworthiness of the financial performance of the organisation.

This paper focuses on studying the existing literature so as to comprehend the role of audit committee in improving the company's compliance of its corporate governance policies as well as the impact of an independent audit committee on the company's performance and profitability.

Review of Literature

(Waweru, Kamau, & Uliana , 2011) conducted a primary data study in 29 companies listed in the Nairobi Stock Exchange. The study focuses on examining the practices of the audit committee, stakeholder perception of audit committee, major achievements of the audit committees in Kenya and the challenges faced by them. The findings of the study showcase that Audit committees of companies listed in Nairobi Stock Exchange are more independent than the audit committees of other developing countries in Africa. The study concluded that an independent audit committee improves the quality of financial reporting and thereby helps to gain investor confidence which in turn also helps to attract foreign investors.

(Saibaba & Ansari, 2011) explain how audit committee plays a pivotal role in monitoring the internal audit process as prescribed under Clause 49 of Listing Agreement and Section 292A of Companies Act,1956. It

also mentions how Sarbanes Oxley Act 2002, Blue Ribbon Committee's Report and Narayan Murthy Committee's report has emphasized on providing greater independence and strengthen functioning of Audit Committee's so as to ensure proper functioning of Corporate Governance which in turn will help to minimize agency costs. Data for the years 2007 and 2008 was collected, pertaining to firms listed in BSE 100 and BSE 200 indices, for analysis. The study employs multiple regression models to analyse the relation between independence of audit committee, number of independent directors and performance of the firm. The results are congruent to that of the previous studies and states that an independent audit committee results in improved financial reporting and better profitability.

(Bhasin, 2012) and (Bhasin, 2016) explicate that Audit Committee plays a major role in enhancing the reliability and transparency of financial information. In the recent years, the importance of Corporate Governance has grown rapidly and this has boosted the role of Audit committee making it essential for them to play a critical role in Corporate Governance. These papers focus on conducting a content analysis on the Audit Committee reports of top 500 listed companies in India from 2005-2008 and 2010-2013 respectively. The content analysis was performed to analyse compliance with Clause 49 requirements of SEBI as well as trends in Audit committee characteristics which includes composition of the committee, size of committee, activities undertaken and the non-audit services provided by the Auditors.

(Bharadwaj & Rao, 2015) elucidate that due to recent corporate scandals by certain high-profile companies like Enron, Lehman Brothers, AIG Insurance etc. has disturbed the public confidence in the financial reporting process and audit functions. Thus, it becomes imperative to analyse the role of audit committees and also strengthen its functioning so as to ensure that investors are safeguarded. An analytical analysis is undertaken to analyse compliance of companies listed in NIFTY 50 with the Clause 49 of Listing Agreement. The results showcase that there is high level of transparency in role played by audit companies for the selected firms.

Audit committee serves as vital ingredient of the corporate governance providing crucial insights on matters of auditing process and financial reporting (Mohd Fairus A, 2015). The authors say that essence of having audit committee arises due to the need to curb the financial frauds and protecting the interest of the shareholders. Further they state as this body comprises of external independent individuals with expertise in accounting body, they act as a liaison between the management and external parties with invested interest in the organization. Thus, it encourages ethical conduct of business, transparency, accountability and ensuring a blend of sound corporate governance behavioral actions in line with code of ethical conduct (Mohd Fairus A, 2015).

The crisis of Enron and WorldCom created a negative wave among investors and shareholders. The credibility of the financial reports of organization and confidence of the public can be reinstated if the company reinforces an Audit committee (Laura Salloum, 2015). The authors argue that each audit committee of different organizations has uniform aim i.e. prevention of fraudulent behavior towards the stakeholders, however the

decision-making procedures of each committee is distinctive. It has been predominant that higher the independence of committee lesser is audit fees (Laura Salloum, 2015). Nonetheless, equation of audit committee members' level of expertise and audit fees has a positive relationship which is again not same if the size of the committee is large (Laura Salloum, 2015). Furthermore, the authors conclude that CEOs who receives short term compensation tends to agree with greater audit fees. Additionally, when the company indulges in activities beyond one country their willingness to spend more on auditing is higher as they are in need of more expertise (Laura Salloum, 2015).

(Velte, 2017) Audit committee (AC) sets an ambit to bring professionalism and quality in cooperate activities. According to the author better profitability and performances are outcomes of core functions of AC which consist of bringing in lucid as well as constructive financial facts and internal conduct of the company. As a result of it every economic crisis exerts more force for insertion of AC. While in US the incorporation of expert member is emphasized, Europe focuses on having an expert and also a greater number of external members (Velte, 2017). Furthermore, author states that with calculated choice of member AC can also be a pool of experts wherein the body itself can infer economic viability while making critical decisions with achievement of diversity in terms of gender or demographic factors, and expert from various fields. The author argues that having frequent meeting by AC leads to lesser misstatements of various reports. Thus, the author concludes that AC has immense impact on internal audit while work of external auditor effects the AC's nature of monitoring in internal affairs of the company. However, the AC has upper hand in selection of external auditors and its fees (Velte, 2017).

(Ray, 2012) The definition and perception of corporate governance has undergone several changes and it's not merely considered as a compliance of legal requirements rather building a healthy relationship with the stakeholders of the company. As per the author the introduction of principle-agent concept act as a basic element of having independent members and introduction of Audit committee in the organizations. Additionally, the author states that superiority of corporate governance is often measured with the accuracy of financial reports which is vouch by auditors. Thus, Auditors by nature are in positioned which is strategically a point to uphold the credibility and reliability of material facts (Ray, 2012). Additionally, authors bring out a correlation between the reliance of report by public in faith and auditors independence, which is positive in nature. The possible explanation put forth by the author is the several procedures of investigation undergoes by an auditor to prepare a report which scrutinize the soundness of the financial reports (Ray, 2012).

(Andrei Razvan Crisana, 2014) concluded that the subsistence of audit committee is critical to the organization for which he has selected 21 listed companies, 11 of which is from the Bucharest Stock Exchange and 10 listed companies from the London Stock Exchange. The test has been conducted in the form of "true" or "false" statement which is relevant to the corporate governance code and company adaptability to it. The

results show that not all the listed companies used for the study has a separate audit committee. The independency of the director is an issue in the organizations which are listed in BSE in contrast with the organizations listed in LSE. The data towards the expertise and ability of the audit committee of the organizations listed in BSE isn't available in adequate sum. Generally, it can be comprehended that the organizations listed in BSE are unaware about the substantial importance of audit committee.

(Al-Baidhani) highlighted the important functions performed by audit committee in corporate governance. The audit committee subsist the role to be performed towards internal and external audit where the committee monitor and review the report by internal & external auditor, oversees the effectiveness and efficiency of the internal control held by management, recommend management over various issues of financial reporting, ensure regulatory compliance and necessary advises over the management of risk. The paper also analyses the functions performed by the audit committee as well as the power it exercises, responsibilities it accounts for and the relationship it maintains. The author has also not missed to highlight the significance of the audit committee's authority & accountability towards the management, shareholder, stakeholder, and other regulatory bodies.

(Sujatha N, 2017) has majorly focused on the strength and power of the corporate governance which is enhanced by the effective performance of the audit committee. The heart & soul of audit committee lies with the accountability of the management towards the board of directors and board of directors towards the shareholders. Since audit committee plays an important role in monitoring and reviewing the financial procedure and report, the author has laid down two measures to evaluate the performance of any organisation: market based & accounting based. Market based follows the market value of the firm and the accounting-based grounds on the various principle followed while preparing financial statement. Out of both the two-accounting based has been considered as trustworthy. The author has exhibited that there is a positive trend of audit committee and the financial performance of the firm which in turn improve the performance of corporate governance.

(Fülöp, 2013) has opined that the audit committee perform a vital role in developing an effective corporate governance. For developing such the author has specified 2 levels and 7 key elements which has been considered as necessary. These two levels are external level and internal level. The external level consists of 3 key elements out of 7 whereas the internal level consists of the 4 key elements. Transparency, Trust, Auditor's opinion has been covered under external level. As External auditor gives opinion on the financial statement of the organisation induce trust in the eyes of the 3rd party. The trust can be further enhanced by the transparency of the information provided to the stakeholder.

On the other hand, financial reporting, risk management, internal control and board of directors has been covered under the internal level. BOD grants the approval of the internal audit plan which has been approved by the audit committee after reviewing so they are directly related with the financial reporting process. Internal

control & risk management is the central significant element which is assessed for external and internal audit for enhancing the quality of corporate governance.

(ZENGİN, 2013) has stated that independency of the audit is quite necessary to enhance & toughen the strength of the corporate governance. The author has conducted a research in order to find out the association between the strong corporate governance and the selection of the auditor (Big-4 and Non-Big 4). The research has been conducted on the corporate firms listed on the Istanbul stock exchange in Turkey. Turkey has been considered as an ideal environment to conduct this type of research as there is a lack of equity culture, weak protection of investor rights, etc. Secondary data has been collected from the company's website, ISE website, company year book, etc. Also, primary data has been collected through interview and questionnaire to improve the findings. Finally, 805 sample data have been considered for analysis. Data has been analysed through panel regression analysis. The findings of the reports were as such: There is no state of independency in the board of director committee, audit committee consist of only 2 members, large numbers of firms are owned by institutional investor, there is a negative relationship between the independency of the board of director and the auditor to be a Big-4 auditor, firms who have huge board of directors, CEO duality and intense ownership prefers Big 4 auditor. The selection of the auditor by any corporate is determine by the constitution & structure of the ownership, independence of audit and magnitude of board of directors.

(Timothy, Fogarty, Kalbers, & Lawrence, 1993) conducted empirical research on audit committee effectiveness (ACE) and its factors and to test audit committee power functions effectiveness , the study conducted that detailed proposal survey instruments has sent to 90 US audit committee corporation and used linear structural model to check relationship between audit committee corporation mainly focused on three important activities such as through interacting external auditors , internal control and checking financial reports perceive the effectiveness by audit committee and top management authorities help also plays an important role in ACE ,findings of the study shows that through companies survey response these is high transparency in role of audit committee power and function between corporations .

(Louisbraiotta, 2003) these papers focus on conducting exploratory study on the non US commercial bank registrants and US commercial bank registrants with audit committee and study conducted with regression analysis to check the differences the finding of the study shows there is no differences and non US commercial bank increased its market capitalization and increased its transparency with accompanying efforts on charges of foreign equity investment and result of regression analysis shows audit committee presence will not effect on banks "American depository receipts " and suggested for further study can be done on formation of audit committee and securities market place transparency with regard to foreign equity investment.

(F, Danahermansaon, Deboraharchambeault, & Scottreed, 2002) explains how audit committee effectiveness plays an important role and to guide future research thinking on audit committee , the study mainly focused four important component for ACE authority, conscientiousness, audit committee works ,resources,

concentrated on quality audit committee and study concluded that by meeting internal external auditors discussing various financial reports with management and reviewing and controlling issues by considering above factors audit committee becomes more effectiveness but still audit committee has strong composition resource and power finding of the study shows that still audit committee has to expand its efforts for more effectiveness .

(Adam O Emmerich, 2005) says in the united states audit committee for a government company is formed only after the directors meet the standards listed for the membership under the US federal securities law. The committee must contain members with sound financial knowledge that they must be capable of understanding the accounting language and comment on the integrity of the entity's books of accounts. At least one member in the committee must have former employment experience in the field of finance, accounting or is required to have any professional certification in the above said field. On a whole be it a domestic or a foreign issuer must adhere or comply with the specific requirements by the NASDAQ, NYSE and the federal securities law though is different and a tedious task to comply with all of it, but when such standards are it is believed that golden standards of corporate governance is met.

For any economy to flourish, the growth of foreign and domestic companies together is very necessary. Nonetheless, if there is any kind of occurrence of financial fraud in a particular entity, it not only gives a bad image of the entity but also for the entire country as a whole. Such kind of incidents might curb the interests of both foreign and domestic investors, in turn hampering the nation's growth. Taking into account scandals such as WorldCom, Enron, Satyam and many other such scams corporate governance infers the importance of strong corporate governance. Authentic and accurate financial data becomes the basis for the investors to invest in a particular business. But there are organizations that try to manipulate their financial books which might not project the true picture of the financial position of the enterprise. Therefore, an independent body like audit committee is required to keep a check on such unethical activities, when there are independent auditors designated for the said purpose it gains the trust of the investors. In addition, it was also observed that voluntarily adopting corporate governance such as scrutinizing the financial books in order to protect the interests of their stakeholders helped the firms in strengthening their capacity of attracting investors. However, this empirical study found that inclusion of audit committee increased the profitability of the firm due to fewer frauds but it significantly did not have any improvements in the regression model proposed in the study by (Sharma, 2016)

According to (Siti Rochmah Ika, 2012) one of the quantitative attributes of having good financial reporting is timely release of the corporate reports, the timely publication of such reports becomes vital as they become the basis for the investors in the capital market to make their investment. Audit committee generally is said to be a very essential component in the structure of corporate governance particularly in relation to the quality of the audit, but the present study studies the association between corporate governance and timely reporting

of accounts. The study concludes by stating that the entities must ensure as to how to improve their standards of audit committee to further intensify the effectiveness and timeliness of the financial books.

(Al-mudhaki & Joshi, 2004) collected 73 responses in the form of questionnaire to examine the functions, focus and compositions of audit committees and the basis of criteria for selection of member and the effects of meetings of Indian Listed Companies. The results revealed that only 56.2% companies constituted an audit committee, of which 68.3% have three to six members. It further revealed that 14.6% had independent non-executive directors, whereas, 90.2% had dependent non-executive directors, showing lack of independent representation in the audit committee among Indian companies. The author concludes that the functions of the audit committee are not clearly defined and shows a lack on independence in representation and compositions. A positive relationship between the frequency of the meeting and internal control and evaluation for corporate governance was observed.

Conclusion

Audit committee (AC) is pivotal in fostering a sound Cooperate governance for the interest of shareholders. It plays a crucial role in reinstating shareholders relationship with the company specifically after the crisis such as Enron, AIG, and WorldCom etc. Such events led to introduction of stringent legislatures in US and birth of Sarbanes-Oxley Act (SOX) in the year 2002. Similarly Indian legislature has also included a clause in the Listing agreement (then Companies act 1956 in the year 2005) between the stock exchanges and the company which is generally refer to as Clause 49. The amendments were brought in after the Satyam scam in the year 2009. Following the SOX impact worldwide researchers has conducted many empirical study on role of Audit Committee and its trend among the investors and cooperate governance.

This paper focus on structured review of literature to give an account to Audit Committee's contribution in cooperate governance and performance of the organization. It has been observed that authors both from foreign and domestic country are consensus on critical importance of having independent members in the AC as it leads to comprehensive and reliable financial reports of the company. With the existence of stiff regulations both in US and India has seen an upward trend for inclusion of AC which comprises of independent members. Similarly other papers also indicate that level of accuracy of reports of the company like financial statements, Auditor's reports or any other material information has increased exponentially. Additionally, we have found that Big -4 company are popular among the AC which has low independence with greater size. The further findings shows a positive equation in regards to audit fees and expertise level of AC members and CEOs with short term compensations. Overall the Company having an AC is well perceived among investors as they have tendency to link systematic and good cooperate governance with its existence. Further, it can be concluded that AC plays a direct role in the company's adequate governance to protect the interest of shareholders resulting in greater confidence by the investor and performance .Thus,

there is no equivocal with regards to the requirement of AC in a company and its robust role to produce a transparent flow of financial information and established a cohesive environment

References

Al-Baidhani, A. M. (n.d.). *The Role of Audit Committee in Corporate Governance: Descriptive Study.* malaysia.

Andrei Razvan Crisana, M. T. (2014). The role of the audit committee in corporate governance – casestudy for a sample of companies listed on BSE and the London Stock Exchange - FTSE 100. *Procedia Economics and Finance*.

Bharadwaj, N., & Rao, B. R. (2015, April). ROLE OF AUDIT COMMITTEE IN CORPORATE GOVERNANCE. *International Journal of Management and Social Science Research Review, 1*(10).

Bhasin, M. L. (2012, November). Audit Committee Mechanism to Improve Corporate Governance: Evidence from a Developing Country. *Modern Economy, 3*, 856-872.

Bhasin, M. L. (2016, August). Perspectives and Prospects of An Audit Committee in An Asian Economy: An Empirical Study. *International Journal of Management and Social Sciences Research, 5*(8).

F, T., Danahermansaon, Deboraharchambeault, & Scottreed. (2002). Audit Committee Effectiveness: A Synthesis of the empirical audit committee literature. *journal of accounting literature*, 39.

Fülöp, M. T. (2013). AUDIT FUNCTION ROLE IN ACHIEVING AN. *Economics Series*.

Laura Salloum, C. S. (2015). Corporate governance and audit committee . *International Journal of Managerial and Financial Accountin*, 3/4.

Louisbraiotta. (2003). An exploratory study of adopting requirements for audit committee for non US commercial bank registrants : an empirical analysis of foreign equity investment. *managerial auditing*, 9.

Mohd Fairus A, R. R. (2015). Revisited Note on Corporate Governance and Quality of Audit Committee: Malaysian Perspective . *Procedia Economics and Finance* , 213 – 221.

Ray, S. (2012). Auditors' Role in Corporate Governance of India's Business Perspective . *Public Policy and Administration Research* .

Saibaba, M., & Ansari, V. A. (2011, July). Audit Committees and Corporate Governance: A study of select companies listed in the Indian Bourses. *IUP Journal of Accounting Research & Audit Practices , 10*(3), 46-54.

Sujatha N, D. m. (2017). A ROLE OF AUDIT COMMITTEE AND ITS IMPACT ON FIRM PERFORMANCE IN INDIA. *international journal of development research*, 4.

T. J., Fogarty, Kalbers, & Lawrence. (1993). Audit committee effectiveness :an empirical investigation of the contribution of power. *spring*, 16.

Velte, P. (2017). The link between audit committees, corporate governance quality and firm performance: A literature review. *Corporate Ownership & Control*, 15-31.

Waweru, N. M., Kamau, R. G., & Uliana , E. (2011). Audit committees and corporate governance in a developing country. *International Journal of Accounting, Auditing and Performance Evaluation, 7*(4).

ZENGİN, Y. (2013). Is Corporate Governance A Determinant of Auditor. *EGE AKADEMİK BAKIŞ / EGE ACADEMIC REVIEW*, 273-284.