The Role of Audit Committee in Corporate Governance: Descriptive Study

Ahmed Mohsen Al-Baidhani
CPA, MBA, PhD Candidate
Universiti Putra Malaysia (UPM)
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.
Shleifer and Vishny (1997) concentrate on: incentive contracts, legal protection for the investors against the managerial self-dealing, and the ownership by large investors; they point out the costs and benefits of each governance mechanism. Denis and McConnell (2003) use a dual classification of corporate governance mechanisms (They use systems as synonym to mechanisms) as follows: (1) internal governance mechanisms including: boards of directors and ownership structure and (2) external governance mechanisms including: the takeover market and the legal regulatory system. Farinha (2003) surveys two categories of governance (or disciplining) mechanisms, the first category is the external disciplining mechanisms including: takeovers threat, product market competition, managerial labor market and mutual monitoring by managers, security analysts, the legal environment, and the role of reputation. The other category is the internal disciplining mechanisms which include: large and institutional shareholders, board of directors, insider ownership, compensation packages, debt policy, and dividend policy.

Despite the existence of different corporate governance structures, the basic building blocks of the structures are similar. They include the existence of a company, directors, accountability and audit, directors’ remuneration, shareholders, and the annual general meetings. Cadbury (1992) called for greater transparency and accountability in areas such as board structure and operation, directors’ contracts and the establishment of board monitoring committees. In addition, it emphasized the importance of the non-executive directors’ monitoring role.

3. Audit Committee Composition and Meetings

3.1. Composition

Although it is compulsory in many countries that all publicly held companies should have audit committees, many non-public companies have audit committees voluntarily established for better oversight and monitoring of these companies’ financial and accounting performance. Usually the audit committee should be composed of three to six members. The European Union requires that there should be an audit committee for each
publicly held company; however, each member state has the power to decide on the composition of these committees (i.e., members from outside the company, from its supervisory body, and/or members appointed by the company’s shareholders). The Union also requires that at least one member should be independent of the company and competent (have expertise in accounting and/or auditing) to enhance the effectiveness of the audit committee’s oversight and monitoring activities.

On the other side of the Atlantic, the United States requires that the public companies should have audit committees composed of independent members from outside the companies’ managements. Since it is critical for the audit committee to be independent, the NYSE requires that at least three audit committee members should be independent and have no relation with the company. Similarly, the SEC issued rules to exclude any member who is not independent (i.e., who was or still working for the company during the last three years, who receives compensation for participating in other committees which have links with the audit committee, or who is a family member of one of the company’s executives). In this regard, Beasley and Salterio (2001) found that Canadian organizations that voluntarily include more outside directors on the audit committee are more likely to segregate the position of the chairperson from the positions of the CEO/president.

In addition to independence, competency is also taken into consideration as regards the composition of audit committee members. Consequently, the BRC recommended that the audit committee should be composed of members who understand the organizations’ financial statements, and recommended that at least one member should be expert in finance or accounting field. On similar context, the NYSE requires that at least one of the three audit committee members should be a financial/accounting expert in order to have an audit committee capable of performing its oversight and monitoring activities to the fullest extent.
3.2. Meetings

Audit committee meetings have a major impact on the evaluation of the organization’s overall performance and its internal control functions. The three features of such meetings are as follows:

3.2.1. Frequency

European Parliament Resolution of March 10, 2009 on implementation of Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts stresses that recent experience shows the need for frequent and high-quality interaction with and within audit committees. Even though it is very important for the audit committee meetings to be frequent, it is noted that most of the organizations do not meet frequently. Many committees meet on a monthly basis, while others meet on a quarterly basis or even a semi-annual basis. The minimum number of meetings used to be twice a year but this number has been increased to four times a year according to the (BRC, 1999). In Europe, the codes are silent on this issue; however some European States, such as the United Kingdom and the Czech Republic, recommended that these meetings are to be held three to four times per year. The frequency and duration of these meetings have to be according to the size of the organization and the number and size of issues to be discussed during such meetings. Consequently, while four times a year could be too much for some organizations, twelve times a year could be just sufficient for others. However, what is more important than the frequency of the meetings is the content and results of such meetings.

In addition, audit committee chairpersons usually conduct interim calls, between periodic meetings, with key members of management such as CEO, CFO, chief internal auditor, as well as external audit partner. Informal unstructured meetings, such as scheduled dinners, may also take place to allow informal interaction between audit committee and management, and help audit committee obtain feedback of these managers in private.

The importance of the frequency of audit committee meetings are supported by many research studies. For example, Al-Najjar (2011) found that organizations with large audit committees and large boards that meet more frequently are active and demand more audit
committee meetings. Study results of Stewart and Menro (2007) also show that the audit committee, the frequency of its meetings, and the auditor’s attendance at these meetings are significantly correlated with a reduction in audit risk. Meanwhile, Goodwin-Stewart and Kent (2006) found that the audit committee expertise is associated with higher audit fees when meeting frequency and independence are low.

3.2.2. Attendance

In addition to the less-frequent meetings held by many audit committees, it is noticeable that not all of the members attend these meetings. However, the attendees should not be limited to the committee members. The audit committees invite CEOs, CFOs, internal auditors, external auditors, regulatory bodies, finance directors, and relevant others, to attend such meetings, with whom the committee members discuss issues related to the organization.

3.2.3. Content

There should be an agenda for the meeting summarizing the issues that would be discussed including, among other things, the organization’s internal control, current internal and external auditors’ reports, the organization’s accounts (including funds, revenues, and expenses), assessment of the internal audit programs, and review of the management’s responsiveness to the notes made by the external and internal auditors. The organization’s compliance with the laws, regulations and standards, as well as issues related to risk management should also be discussed during these meetings. The minutes of the meetings should be noted by a specified person describing the issues that have been discussed, the results the attendees reached to, and the respective decisions that have been made. The audit committee should feel that the board of directors is allotting sufficient time for it to present its report and that the board is taking appropriate actions accordingly.
4. Roles of Audit Committee in Corporate Governance

4.1. General

Most, if not all, of the audit committee activities and responsibilities are related directly or indirectly to the audit committee roles in corporate governance. The audit committee’s composition, competence, independence, and expertise are strongly correlated with the organization’s corporate governance. The increasing demand on the corporate governance and accountability related to the board of directors, particularly the recent lawsuits and investigations, made the creation of audit committees an extremely necessary step. The audit committee reviews the organization’s annual, quarterly, and monthly reports; it issues its reports and recommendations to the board of directors; and annually issues a report submitted to the shareholders (as part of the organization’s annual report) describing its activities and responsibilities during the year. The audit committee has relationships with almost all of the organization’s stakeholders (e.g., board of directors, management, internal auditors, external auditors, and, to a certain extent, shareholders and financial statement users), as well as the governing and regulatory bodies.

The big four CPA firms, Price Waterhouse Coopers, Deloitte, Ernst & Young, and KPMG, as well as the Committee of Sponsoring Organizations (COSO) recommended certain oversight practices for audit committees to follow, providing guidelines about the audit responsibility in evaluating and strengthening corporate controls. The SEC confirmed its interest in audit committees by: (a) urging registrants to form audit committees comprised of outside directors; (b) requiring all publicly held companies’ proxies to disclose information about the existence and composition of their audit committees; and (c) requiring publicly held companies to state the number of audit committee meetings held annually and to describe their audit committees’ function.

The National Committee on Fraudulent Financial Reporting (Treadway Commission, 1987) was created to identify factors that can lead to fraudulent financial reporting and recommend procedures to reduce fraud incidences. The 1987 Treadway report identified audit committees as effective means for corporate governance and suggested a list of objectives for audit committees to consider. Among the numerous recommendations
detailed in the report, the Commission stated that audit committees should be informed, vigilant, and effective overseers of the financial reporting process and the company’s internal controls.

As part of the corporate governance mechanism, the audit committee oversees the organization’s management, internal and external auditors to protect and preserve the shareholders’ equity and interests; however, the audit committee’s nature and scope of work should be reviewed to make sure that it is capable of playing its role in this regard appropriately, especially after being recently criticized for its shortcomings in achieving the corporate governance objectives.

In 1999, in order to improve the oversight responsibility related to the audit committee, board of directors, management, internal auditors, and external auditors, the BRC referred to the role of the corporate governance, suggesting that 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. 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.

It is very important to determine and understand the audit committee’s oversight and monitoring functions in order to establish and improve the credibility and trustworthiness of the audit committee as a corporate governance mechanism. The Sarbanes-Oxley Act of 2002 which was passed mainly to protect the investors has a big impact on the corporate governance and accountability, as well as on corporate disclosure. In order to be accepted in most of the Stock Exchange Markets, an organization should have good corporate governance. Audit committees should play a broader corporate governance role and should be supported strongly by the main parties in the governance field; meanwhile, this role should be shown in a clear and written statement.

It should be emphasized that the audit committee should include both independent and financial expert members to guarantee at least the minimum level of audit quality and
strong corporate governance. In this regard, there are many research findings that support such a point; for example, Defond et al. (2005) found a positive market reaction to the appointment of accounting financial experts assigned to audit committees and that this positive reaction is concentrated among firms with relatively strong corporate governance. Meanwhile, initial results of the study conducted by Lee and Mande (2005) suggest that effective audit committees seek to increase audit quality by reducing the non-audit services provided by the external auditor. Farber (2005) also found that fraud firms have, among other things, fewer financial experts on the audit committee. In addition, Chan and Li (2008) found that firm value is enhanced when there are expert-independent directors on board and on the audit committee.

4.2. Role in Internal Audit

After the U.S. corporate scandals and the collapse of Enron and WorldCom, as well as Arthur Andersen and others, the internal audit tasks have been changed, especially pursuant to the issuance of the Sarbanes-Oxley Act of 2002 and other similar regulations worldwide. European Union Directive 2006/43/EC states that the audit committee shall monitor the effectiveness of the company's internal audit where applicable. A cooperative relationship between the audit committee and the internal auditors is important for both parties to fulfill their job commitments.

The scope of the internal audit function is determined by the audit committee. One of the main responsibilities of the audit committee is to enhance and maintain the internal auditors’ independence in order to enable them to achieve their duties. The internal auditors provide the committee with the necessary information to which they have direct access, same as the organization’s management, in order to enable the audit committee to accomplish its oversight and monitoring mission. On the other hand, the audit committee supports the position of the internal audit function and submits management’s irregularities and other relevant managerial and financial issues to the board of directors, after discussing such issues with the internal auditors and relevant other parties.
The audit committee is concerned with recruiting and terminating the head of the internal audit, and the frequency and duration of the meetings with the internal auditors, as well as ensuring that the internal auditors, especially their head, can communicate directly with the audit committee anytime. The audit committee’s meetings with the head of the internal audit enhance the independence of the internal audit function, supporting the parties’ discussion about management’s errors, irregularities, violations, and fraud.

Whereas the oversight of financial reporting and the monitoring of the internal audit performance are two of the main activities of the audit committee, it is mandatory that the audit committee members, or at least one of them, should have the financial or accounting expertise in order to understand the technical and control issues related to the internal audit to enable the audit committee to review the activities of the internal auditors and the results they reach to. Consequently, independence and financial expertise are very critical for the audit committee to play its important role and take advantage of the internal auditors’ performance. Internal auditors’ reports are to be reviewed by the committee so that the committee members discuss such reports with the concerned parties, and make sure that the valid notes are taken into consideration and executed by the management.

Whenever there are internal audit problems or obstacles, the audit committee performs the necessary investigations using internal feedback, its expertise, and external consultations if needed. The audit committee evaluates the internal auditors’ effectiveness, their plans and work arrangements, as well as the resources allocated to them. In addition, the audit committee as well as the internal auditors should be involved in issues related to the organization’s joint ventures, environmental matters, and international operations.

The relationship between the audit committee and internal auditors, and the consequent effects, are supported by many research findings. For example, results of the study conducted by Goodwin (2003) show that independence and accounting experience have a complementary effect on the relationship between audit committee and internal audit. Zain et al. (2006) also found that more effective audit committees and well-resourced internal audit units tend to be positively associated with the assessment of the internal auditors’ contribution to the external audit. In addition, Asare et al. (2008) found that internal
auditors in both a self-assessment role and a due diligence role are sensitive to variations in audit committee quality.

4.3. Role in Internal Control

Internal control is defined by COSO (1992) as “process affected by entity’s board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories: a) effectiveness and efficiency of operations; b) reliability of financial reporting; and c) compliance with laws and regulations”. Internal control structure includes policies, procedures, and practices followed by the organization to control its operations, particularly its financial part, and to ensure the organization’s compliance with the valid and relevant laws and regulations, as well as the organization’s own bylaws and resolutions. Even though it is well-known that the internal control structure cannot prevent or detect all errors and irregularities, organizations establish and maintain such structure for the purpose of providing reasonable, not absolute, assurance regarding the integrity of management, as well as the accuracy and reliability of financial reporting.

The audit committee receives reports about the internal control’s effectiveness and efficiency from the organization’s management, internal and external auditors. European Union Directive 2006/43/EC states that the audit committee shall monitor the effectiveness of the company's internal control. The committee has full authority to investigate about any issue which may affect the organization’s internal control and financial reporting. It should have access to all relevant information, and access to resources which may enable it to perform such investigations appropriately. The committee meets with the management, internal and external auditors to discuss issues related to internal control anytime it deems necessary. It also submits reports to the board of directors about the results it reaches to, as well as recommendations regarding the improvement of the internal control process and how to maintain an effective and efficient internal control system. Evaluation of the internal control structure and process is considered one of the most, if not the most,
important oversight responsibility faced by the audit committee. This importance of internal control has also been indicated in (Treadway Commission, 1987; and COSO, 1992).

The audit committee receives enquiries from the board of directors, shareholders, and financial statement users about the effectiveness and efficiency of the organization’s internal controls in order to know whether there are material illegal acts, irregularities, errors, or unethical activities. The committee assists the external and internal auditors in reporting internal control’s major deficiencies to the board of directors or other governing body of the organization; and also improves the communications between these parties. In order to improve the internal control structure and process, the audit committee monitors and oversees the organization’s financial and operational controls, as well as the organization’s compliance with these controls.

The relationship between the audit committee and internal control, and the consequent effects, are supported by many research findings. For example, Krishnan (2005) found that independent audit committees and audit committees with financial expertise are significantly less likely to be associated with the incidence of internal control problems. Study results of Garcia–Sanchez et al. (2012) also indicated that there is a non-linear relationship of substitution among internal control mechanisms and audit committee characteristics. In addition, Pridgen and Wang (2012) found that hospitals that had audit committees and also hired one of the big four audit firms were associated with better internal control quality.

4.4. Role in External Audit

The external audit tasks are directly related to the audit committee activities. The scope of the external audit function is determined by the audit committee. The audit committee plays a major role in selecting the external auditors since it nominates them, asks them to submit their proposals regarding the audit process, then it recommends to the organization’s board of directors whom it sees are the best to perform the external audit.
European Union Directive 2006/43/EC, Articles 41.3 and 41.4 state: “In a public-interest entity, the proposal of the administrative or supervisory body for the appointment of a statutory auditor or audit firm shall be based on a recommendation made by the audit committee. The statutory auditor or audit firm shall report to the audit committee on key matters arising from the statutory audit, and in particular on material weaknesses in internal control in relation to the financial reporting process”.

The audit committee assists in selecting the external auditor (also called certified public accountant “CPA”, chartered accountant “CA”, et al.) to audit and/or review the organization’s accounts and issue his/her opinion about the correctness and accuracy of the organization’s financial statements, and that these statements present fairly the financial position of the organization. Changing the external auditor also requires direct interference by the audit committee. To protect and preserve the shareholders’ interests, the audit committee oversees the nature and scope of work of the external auditors, evaluates their effectiveness, and recommends the proper audit fees that should be paid to them. The audit committee assists in ensuring that the external auditors are independent, and that there is no conflict of interest which may weaken the external auditors’ ability of issuing their opinion about the organization’s financial statements and financial position.

The external auditors submit their reports to the audit committee where both parties discuss important issues, such as management’s errors, irregularities, and fraud; problems or obstacles in the internal control process; and problems related to the preparation of financial statements or financial reporting. The AICPA (1981) requires that external auditors communicate with the audit committee formally as a main part of the audit performance. AICPA’s (SAS 61) requires that the audit committee receives additional information from the external auditors that may help it in the oversight of the financial reporting and disclosure process. The AICPA (1981) also requires that the external auditors communicate with the audit committee regarding errors and irregularities (SAS 53), illegal acts by clients (SAS 54), and internal control structure (SAS 60). Carcello and Neal (2003) found that audit committees with greater governance expertise, greater independence, and lower stockholdings are more effective in shielding external auditors from dismissal following the issuance of unfavorable report.
The audit committee reviews the external auditors’ management letter and submits its relevant notes to the board of directors. The committee also reviews the external auditors’ plans and arrangements of works, and may ask the external auditors to report to it about any differences or disputes between them and the organization’s management. The audit committee also facilitates the communications between the external auditors and the organization’s board of directors and attends their relevant meetings. External auditors’ reports are to be reviewed by the committee so that the committee members discuss such reports with the concerned parties, and make sure that the valid notes are taken into consideration and executed by the management. Additionally for independence purposes, the audit committee may review any non-audit service agreements with the external auditors to understand the nature and magnitude of relevant fees paid. As part of the organization’s corporate governance, the audit committee should examine the non-audit services rendered by the external auditors in order to prevent any conflict of interest or impairment of the external auditors’ independence.

The relationship between the audit committee and external auditors, and the consequent effects, are supported by many research findings. For example, Chen et al. (2005) found that there is a relationship between a higher proportion of non-executive directors on the audit committee and the selection of a specialist audit firm. Meanwhile, study results of Ghafran and O’Sullivan (2013) found that a higher level of external audit coverage and assurance is sought by an organization when its audit committee is larger, more independent, and with financial expertise.

4.5. Role in Accounting and Financial Reporting

One of the main responsibilities of the audit committee is to oversee the financial reporting process in order to enhance the quality of this process. The significance of this governance mechanism is supported by notes from a past SEC Chairman who argues that the audit committee “may well be the most important development in corporate structure and control in decades . . . [and] benefits everyone interested in the quality of financial reporting”
The role of audit committee in exercising an active monitoring of the organization’s financial reporting process is well established and confirmed by many corporate governance codes and professional announcements recently (Song and Windram, 2004).

The audit committee members often discuss with management the accounting standards and principles, as well as accounting estimates and judgments made by management. The audit committee interacts regularly with the organization’s chief financial officer, controller, and finance manager, and report on the capabilities and competence of these managers. Using outside consulting resources as deemed necessary, the audit committee may direct a special investigation when significant problems with accounting practices or personnel is identified or alleged. Among other things, the external auditors are required to report to the committee on their views on management's selection of accounting principles, accounting adjustments made by management or external auditors, any disagreement or difficulties encountered in working with management, and any identified fraud, irregularities, or illegal acts.

The relationship between the audit committee and financial reporting, and the consequent effects, are supported by many research findings. For example, study results of Pucheta–Manriquez and Garcia–Meca (2014) indicate that directors appointed by pressure–sensitive investors to both boards and audit committees have a large effect on the quality of financial reporting as it is probable that the external auditor issues an unqualified audit opinion. According to Bolton (2014), the audit committee is a very important link between the organization’s financial reporting function and its external constituents; consequently, when this link is compromised, it may lead to large corporate governance problems.
4.6. **Role in Regulatory Compliance**

The audit committee is responsible for overseeing the organization’s disclosure process, ensuring that the organization complies with the relevant local and international laws, implementing regulations and ethical standards and principles, and complying with the organization’s bylaws and internal guidelines. The audit committee discusses with the organization’s management, attorney, and general counsel any litigation or regulatory compliance risks. Large corporations may also have a chief compliance officer or ethics officer with whom the audit committee may discuss reported incidents or risks related to the entity's code of conduct.

4.7. **Role in Risk Management**

The audit committee discusses with the organization’s management the policies and practices used to identify, prioritize, and respond to the risks that threaten the achievement of the organization's objectives or opportunities that enhance the achievement of such objectives. This discussion is a requirement for listing on the New York Stock Exchange. Many organizations develop their practices towards a risk-based management approach, called Enterprise Risk Management (ERM). In this regard, Contesrotto and Moroney (2014) found that there is a negative correlation between audit committee effectiveness and audit risk since the audit committee plays a major role in improving financial statement integrity. The audit committee is also involved in non-financial risk topics.

5. **Summary and Conclusion**

This paper focuses on the audit committee’s powers and functions. The importance of the audit committee’s authorities and responsibilities to the organizations’ board of directors, shareholders, and other stakeholders, as well as to governing and regulating bodies, have been increasing, especially after the corporate collapse of Enron, WorldCom, BCCI and
others, and the passage of the U.S. Sarbanes-Oxley Act of 2002 and other similar laws worldwide. Consequently, most publicly held companies all over the world have been asked to establish and maintain audit committees. These companies and other types of organizations do establish and maintain audit committees to oversee and monitor their overall financial and audit performance. The relationship between the audit committee and other relevant parties is important for all parties to fulfill their job commitments. An organization’s board of directors relies on the audit committee’s reports about matters related to managing, directing and controlling the organization. Audit committees should complete an annual self-evaluation to identify improvement opportunities. This involves comparing the committee's performance versus its charter, formal guidelines and rules, and against best practices. Such an evaluation is confidential and may or may not involve evaluations of specific members. However, observers see that there should be a clear and written statements showing the audit committee’s activities, responsibilities, objectives, and composition.

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. At present, the audit committee plays a major role in corporate governance regarding the organization’s direction, control, and accountability; and it is expected that the audit committee will play a broader corporate governance role in the future, and that the main parties in the governance field do and will support the committee strongly.

References

Al-Baidhani, A.M. (2014a). Review of Corporate Governance Bundle. Corporate Ownership & Control, 11(4), p236-241.

Al-Baidhani, A.M. (2014b). The Effects of Corporate Governance on Bank Performance. Corporate Ownership & Control (volume details after issuance). http://ssrn.com/abstract=2284814.

Al-Najjar, B. (2011). The Determinants of Audit Committee Independence and Activity: Evidence from the UK. International Journal of Auditing, 15, p191-203.
American Institute of Certified Public Accountants (AICPA) (1988). Communication with Audit Committees. AICPA, USA.

American Institute of Certified Public Accountants (AICPA) (1981). Communication with External Auditors. AICPA, USA.

Asare, S.K., Davidson, R.A., and Gramling, A.A. (2008). Internal Auditors’ Evaluation of Fraud Factors in Planning an Audit: The Importance of Audit Committee Quality and Management Incentives. International Journal of Auditing, 12, p181–203.

Basel Committee on Banking Supervision (2005). International Convergence of Capital Measurement and Capital Standards: A Revised Framework, Updated November 2005. Bank for International Settlements Publications.

Basuony, M.A., Mohamed E.K.A., and Al-Baidhani, A.M. (2014). The Effect of Corporate Governance on Bank Financial Performance: Evidence from the Arabian Peninsula. Corporate Ownership & Control, 11(2), p178-191.

Beasley, M.S. and Salterio, S.E. (2001). The Relationship between Board Characteristics and Voluntary Improvements in Audit Committee Composition and Experience. Contemporary Accounting Research, 18(4), p539–570.

Bhagat, S. and Black, B. (2002). The Non-Correlation between Board Independence and Long-term Firm Performance. Journal of Corporation Law, 27, p231-273.

Blue Ribbon Committee (BRC) (1999). Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees. New York Stock Exchange, New York.

Bolton, B. (2004). Audit Committee Performance: Ownership vs. Independence – Did SOX get it wrong? Accounting & Finance, 54, p83-112.

Cadbury Committee (1992). Report of the Committee on Financial Aspects of Corporate Governance Including Code of Best Practice. London: Gee and Co., Ltd. (a division of Professional Publishing Ltd.).

Carcello, J.V. and Neal, T.L. (2003). Audit Committee Characteristics and Auditor Dismissals Following "New" Going-Concern Reports. The Accounting Review, 78(1), p95-117.

Chan, K.C. and Li, J. (2008). Audit Committee and Firm Value: Evidence on Outside Top Executives as Expert-Independent Directors. Corporate Governance, 16(1).

Chen, Y.M., Moroney, R., and Houghton, K. (2005). Audit Committee Composition and the Use of an Industry Specialist Audit Firm. Accounting and Finance, 45, p217–239.
Combined Code of Corporate Governance (2003). Principles of Best Practice. London, United Kingdom.

Committee of Sponsoring Organizations (COSO) (1992). Internal Control – Integrated Framework. Washington, DC.

Contessotto C. and Moroney, R. (2014). The Association between Audit Committee Effectiveness and Audit Risk. Accounting and Finance, 54, p393–418.

Defond, M., Hann, R., and Hu, X. (2005). Does the Market Value Financial Expertise on Audit Committees of Boards of Directors? Journal of Accounting Research, 43(2), p153-193.

Denis, D. and McConnell, J. (2003). International Corporate Governance. Journal of Financial and Quantitative Analysis, 38(1), p1-36.

European Parliament Resolution (2009). Implementation of Directive 2006/43/EC on Statutory Audits of Annual Accounts and Consolidated Accounts.

European Union Directives (2006). Guiding Articles issued by the European Commission (EC), applied across Europe through each country’s legislation.

Fama, E. (1980). Agency Problems and the Theory of the Firm. Journal of Political Economy, 88, p288-307.

Farber, D.B. (2005). Restoring Trust after Fraud: Does Corporate Governance Matter? The Accounting Review, 80(2), p539-561.

Farinha, J. (2003). Corporate Governance: A Survey of the Literature. Journal of Business Finance & Accounting, 30(9-10), p1173–1209.

García-Sánchez, I.-M., Frias-Aceituno, J.V., and Garcia-Rubio, R. (2012). Determining Factors of Audit Committee Attributes: Evidence from Spain. International Journal of Auditing, 16, p184-213.

Ghafran, C. and O’Sullivan, N. (2013). The Governance Role of Audit Committees: Reviewing a Decade of Evidence. International Journal of Management Reviews, 15, p381–407.

Goodwin, J. (2003). The Relationship between the Audit Committee and the Internal Audit Function: Evidence from Australia and New Zealand. International Journal of Auditing, 7, p263–278.

Goodwin-Stewart, J. and Kent, P. (2006). Relation between External Audit Fees, Audit Committee Characteristics and Internal Audit. Accounting and Finance, 46, p387–404.
Jensen, M. (1986). Agency Costs of Free Cash-Flow, Corporate Finance and Takeovers. American Economic Review, 76, p323-329.

Jensen, M. and Meckling, W. (1976). Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure. Journal of Financial Economics, 3, p305-360.

Krishnan, J. (2005). Audit Committee Quality and Internal Control: An Empirical Analysis. The Accounting Review, 80(2) p649-675.

Lee, Y.H. and Mande, V. (2005). The Relationship of Audit Committee Characteristics with Endogenously Determined Audit and Non-Audit Fees. Quarterly Journal of Business and Economics, 44(3/4), p93-112.

Pridgen, A. and Wang, K.J. (2012). Audit Committees and Internal Control Quality: Evidence from Nonprofit Hospitals Subject to the Single Audit Act. International Journal of Auditing, 16, p165–183.

Pucheta-Martínez, M.C. and García-Meca, E. (2014). Institutional Investors on Boards and Audit Committees and Their Effects on Financial Reporting Quality. Corporate Governance: An International Review, 22(4), p347–363.

Ramsay, I. (2001). Ramsay Report: Independence of Australian Company Auditors: Review of Current Australian Requirements and Proposals for Reform. Corporate Governance and Accounting Policy Division, Department of the Treasury.

Sarbanes, P. and Oxley, M. (2002). Sarbanes-Oxley Act of 2002. Public Law 107-204. US Congress, 116 STAT., p745-810.

Shleifer, A., and Vishny, R. W. (1997). A Survey of Corporate Governance. The Journal of Finance, LII(2), p737–783.

Song, J. and Windram, B. (2004). Benchmarking Audit Committee Effectiveness in Financial Reporting. International Journal of Auditing, 8, p195-205.

Spangler, W.D. and Braiotta Jr., L. (1990). Leadership and Corporate Audit Committee Effectiveness. Group & Organization Management, 15(2), p134-157.

Stewart, J. and Munro, L. (2007). The Impact of Audit Committee Existence and Audit Committee Meeting Frequency on the External Audit: Perceptions of Australian Auditors. International Journal of Auditing, 11, p51–69.

Treadway Commission (1987). Report of the National Commission on Fraudulent Financial Reporting.

Turnbull, S. (1997). Corporate Governance: Its Scope, Concerns and Theories. Corporate Governance: An International Review, 5(4), p180-205.
Wild, J. (1996). The Audit Committee and Earnings Quality. Journal of Accounting, Auditing & Finance, 11(2), p247.

Zain, M.M., Subramaniam, N., and Stewart, J. (2006). Internal Auditors’ Assessment of their Contribution to Financial Statement Audits: The Relation with Audit Committee and Internal Audit Function Characteristics. International Journal of Auditing, 10, p1–18.