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HERALDING AUDIT COMMITTEE: A PRECURSOR OF ETHICAL ACCOUNTING AND REPORTING

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ABSTRACT

This study models a manager who privately reports earnings to an independent audit committee that, after its own due diligence, modifies the report for public release to investors. The audit committee is to observe the highest standards of propriety involving impartiality, integrity and objectivity in relation to the stewardship of public funds, the management of the company and the conduct of its business. The audit committee's presence changes the impact of penalties and incentives on reporting, valuation, and due-diligence activities. The audit committee alters the reporting and valuation dynamics by attempting to remove the manager's reporting bias, but then presents the information it has collected with its own bias. For example, increasing penalties can sometimes degrade the reporting process.

KEYWORDS: *Audit Committee, Penalties & Incentives on Reporting, Due-Diligence Activities.*

Introduction

Board of Directors has the power to constitute committees and delegate certain authority and responsibility to these committees. These committees analysis the issue in depth and suggest recommendations to the Board of Directors. Thus, committees help to improve its efficiency and effectiveness. Board committees are divided into two categories i.e. Mandatory committees and Non-mandatory committees. Non-mandatory committees such as finance committee, ethics committee, public relations committee, are voluntary in nature, whereas audit committee, remuneration committee and shareholders' grievance committee are mandatory in nature. As under Clause 49 of the listing Agreement, Board of Directors is required to constitute statutory committees.

Overview of Audit Committee

Audit Committee is one of the most important committee of the Board of Directors. It is a statutory committee responsible for oversight over accounting, internal audit, external audit and reporting systems of the company. It is conceive as an interface between the Board of Directors and the internal and external auditors. It has become a crucial element of oversight of financial reporting thereby reducing the dominance of senior executives in the audit process. The fundamental reason d'être of audit committees is to oversee the integrity of financial statements. Committee needs to review annual and interim financial statements carefully, understanding them, assessing the quality of earnings and being comfortable with management's conclusions. Audit committees function best when they have productive relationships with management and internal audit with open, candid and ongoing lines of communication. Audit committees help in building trusting and professional relationships with the external auditors in addressing responsibilities for selecting, compensating, evaluating and retaining them, as well as overseeing independence.

Evolution of Auditing

Audit committee is an advancement of the auditing practice in a systemized and a regularized manner by all the listed corporations across the world. The evolution of audit committee in the present form

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can be studied in a phase manner starting from origin of the discipline of audit in ancient times, its development in the present form, to the formation of audit committees and their gradual emergence in statutory form.

Audit Committee Concept Formalization

With the growth in the auditor's responsibility and the increased gap between ownership and management coupled with proliferation of the volume of transactions, need was felt to develop a committee of the board entrusted with the auditing procedure in a more systemized and transparent manner. Historically, the concept of audit committee took shape in the following chronology:

- **Introduction of the Concept of Audit Committee (1939):** The New York Stock Exchange (NYSE) first endorsed the audit committee concept composed of independent directors, entrusted with the responsibility of selection of auditors for the company. Early twentieth century statutes placed specific audit requirements on banks, insurance companies and similar financial institutions, consequently, such organizations stood among the first corporations to establish audit committees.[1]
- **Canadian Initiatives for Audit Committee (Late 1960s to 1975):** In late 1960s, the bankruptcy of the Atlantic Acceptance Corporation in Canada led to a Royal Commission Report recommending that all public companies to establish an audit committee (Collier, 1996, Walker, 2004). When the Ontario Select Committee on Company Law and the Canadian Institute of Chartered Accountants, Special Committee on Shareholder Audits made similar recommendations (Collier, 1996), several Canadian provinces passed legislation requiring audit committees in corporations that offered securities to the public. In 1975, Canada amended its Business Corporations Act to require that all federally incorporated public companies establish an audit committee to approve the annual financial statements before submission to the board of directors.[2]
- **Security Exchange Commission Initiative for Audit Committee (1972):** The SEC promoted the audit committee concept after its investigation of the McKesson and Robbins case. In the McKesson and Robbins fraud, a corrupt management claimed the existence of inventory that later turned out to be bogus, a practice that resulted in on-site inventory inspections. At about the same time, the collapse of Penn Central Railroad and Equity Funding in the United States renewed the SEC's interest in audit committees. In 1972, the SEC encouraged the establishment of audit committees composed of independent directors and by 1974, the SEC began to require public disclosure of whether audit committee members were, in fact, independent.
- **Enactment of Sarbanes Oxley Act and its Implementations (2002):** The United States government responded to the corporate scandals by enacting Sarbanes–Oxley in July of 2002, which sought to regulate the accounting profession, improve corporate governance and restore investor confidence in the integrity and transparency of public companies financial statements by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws.
- **Post Sarbanes-Oxley Initiatives (2004 Onwards):** In 2004, when Sarbanes Oxley audit committee requirements became effective, the Australian Stock Exchange amended its listing rules to require that all entities included in the S & P All Ordinaries Index establish an audit committee (Australian Stock Exchange, 2004), consisting of at least three members, a majority of which are independent members and none of the members are an executive director.

The following table presents the list of forty large capital markets and the year- wise enactments of audit committee requirements for listing.

Table 1: Audit Committee Requirements for Companies in Forty Largest Capital Markets

Capital Markets With Mandatory Audit Committee Requirements and Date of Implementation		Capital Markets With No Mandatory Audit Committee Requirements	
1.	Canada (1975)	1.	Brazil
2.	Nigeria (1990)	2.	Iran
3.	Hong Kong (1999)	3.	Ireland
4.	Thailand (1999)	4.	Italy

1 Bryan A. Mc Grane, "The Audit Committee: Director Liability In The Wake Of The Sarbanes-Oxley Act", Cornell Journal Of Law And Public Policy, Vol. 18:575, 2009.

2 Fichtner Jason Royce, "The Recent International Growth of Mandatory Audit Committee Requirements", International Journal of Disclosure and Governance, Macmillan Publishers Ltd. 1741-3591, 2009.

5.	India (2000)	5.	Japan
6.	Indonesia (2000)	6.	Norway
7.	Korea (2000)	7.	Saudi Arabia
8.	Mexico (2001)	8.	Switzerland
9.	Argentina (2001)	9.	Venezuela
10.	United States of America (2002)		
11.	Spain (2002)		
12.	Turkey (2002)		
13.	Australia (2004)		
14.	Columbia (2005)		
15.	Austria (2006)		
16.	Portugal (2006)		
17.	South Africa (2006)		
18.	Russia (2007)		
19.	Finland (2008)		
20.	France (2008)		
21.	The Netherlands (2008)		
22.	Romania (2008)		
23.	Sweden (2008)		
24.	United Kingdom (2008)		
25.	Belgium (2009)		
26.	China (2009)		
27.	Czech Republic (2009)		
28.	Denmark (2009)		
29.	Germany (2009)		
30.	Greece (2009)		
31.	Poland (2009)		

Source: Fichtner[1], 2009.

The Companies Act, 2013 (India) specify a tight framework for Audit & Auditors, which is as follows:

- An Individual auditor can have a maximum term of five years, and Audit firm can have ten years.
- Incoming auditor should not be associated with the outgoing auditor; there should be no common auditor or partner.
- Reappointment takes place only after end of five years, after an auditor completes its first term.
- Company can prescribe rotation of auditing partner and team within the audit firm.
- Companies will have to rotate auditors after every four years. This will prevent promoters and auditors to unite and doctor books of account.
- Auditors can face imprisonment up-to one year for violating relevant provisions and pay damages for incorrect or misleading statements.

Framework of Audit Committee

Audit committee's constitution is a statutory requirement under the laws and codes of most countries. The purpose of the audit committee is to assist the Board of Directors in oversight of the company's accounting, auditing and financial reporting processes. The concept of audit committee in the framework of corporate governance endeavored to deliver correct and accurate financial statements while ensuring smooth flow of the audit function of the organization.

Composition of Audit Committee

Effective functioning of the committee depends upon the right combination of directors on the committee. The nature of the committee is not only contingent on constitution but adequate orientation and training with specific appraisal could be advantageous for long term growth in profitability and higher investor confidence along with enhanced corporate governance.

A qualified and independent audit committee shall be set up, which comprise of the following:

- The audit committee shall have minimum three directors as members. Two-thirds of the members of audit committee shall be independent directors.

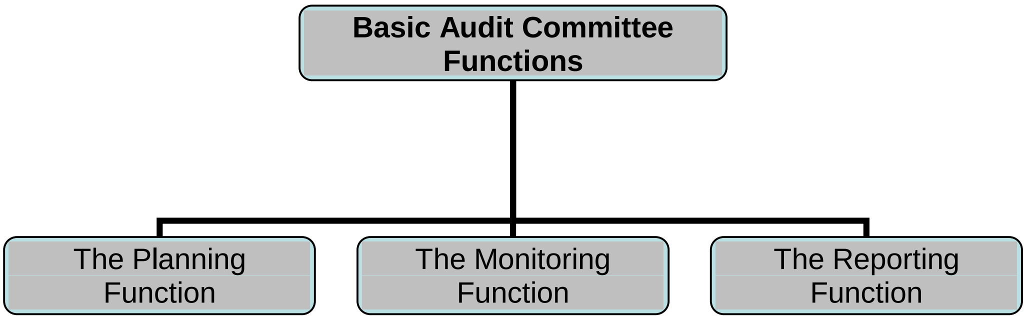
[1] Op Cit. Fichtner., 2009.

- All members of audit committee shall be financially literate and at least one member shall have accounting or related financial management expertise.
- The Chairman of the Audit Committee shall be an independent director;
- Independent Directors must possess the specified qualifications. Listed companies must have at least independent directors to be one third of all directors. An independent director cannot hold more than two consecutive terms of three years. One independent director can represent small shareholders in listed companies.
- The Chairman of the Audit Committee shall be present at Annual general Meeting to answer shareholder queries;
- The audit committee shall meet at least thrice a year. One meeting shall be held before finalization of annual accounts and one every six months.
- The quorum shall be either two members or one third of the members of the audit committee, whichever is higher and minimum of two independent directors.
- The Company Secretary shall act as the secretary to the committee;
- The audit committee may invite such of the executives, as it considers appropriate to be present at the meetings of the committee, but on occasions it may also meet without the presence of any executives of the company. The finance director, head of internal audit and a representative of the statutory auditor may be present as invites for the meetings of the audit committee.

Audit Committee Functions

The Audit Committee is formed to regularly review processes and procedures to ensure the effectiveness of internal control systems so that the accuracy and adequacy of the reporting of financial results is maintained at high level at all times.[1] The committee carries out functions and adopted additional policies and procedures as appropriate in light of changing business, legislative, regulatory, legal or other conditions. The committee also shoulders to carry out any other responsibilities and duties delegated to it by the board of directors from time to time related to the purposes of the committee. Broadly the functions of the audit committee were represented in the following diagram:

Figure 1: Basic Audit Committee Functions



Source : Braiotta. Louis, 2004 [2]

According to the diagram the functions performed by the audit committee could be broadly classified into these three groups.[3]

- **The Planning Function:** In view of the fact that the basic objective of the committee is oversee and monitor, the financial accounting and auditing process, it is needed that the committee adopts its own coordinated plan of administration which is consistent with this objective. The plan includes appraisal of the annual corporate audit plans covering financial, operational, external compliance audit and internal compliance audit segments, consolidation of internal and external auditing groups, to formulate the audit plan in accordance with the committee's charter as well as committee's recommendations of the audit goals and objectives. Additionally, the committee considers in totality an integrated approach for combining initial

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1 Aggarwal, Sanjiv, "Corporate Governance through Audit Committees", the Chartered Accountant, November, 2006.

2 Braiotta. Louis, "The Audit Committee Handbook", Fourth Edition, John Wiley and Sons, U.S.A., 2004,

3 Ibid. Braiotta. Louis, 2004, pp 58-78.

planning segment concerned with review and appraisal of the goals and objective of audit function and the resource availability for the same, pre-audit segment demanding the cooperation of the independent auditors, internal auditors and senior executive in order to have a clear understanding of the realistic condition of the business and post-audit segment dealing with assessments to ensure that the plans for the audit are effective.

- **The Monitoring Function:** In order to accomplish the planning function monitoring and oversight function need to be administered by audit directors on corporation activities based on their jurisdiction. In administering the monitoring function it is advisable for the committee to retain the necessary professional expertise such as the corporations outside legal counsel or external data processing experts. The review function strengthens the corporate structure and enhances staff independence. Monitoring and review is undertaken with respect to the internal auditing function, the internal control system and related business risks, the financial reporting disclosures, conflict of interests, ethics and fraud audit activities, corporate contributions to ensure compliance with corporate giving policy, information technology systems or any other tasks as requested by the board. Additionally oversight of internal auditing policy, scope of internal and external auditing plans and reports, assessing the competence of the auditing personnel and organizing training for them including determination of special assignments are part of the monitoring function of the committee.

- **The Reporting Function:** The audit committee report directly to the board. The report is critically important to the board because it communicates to the board financial, accounting and auditing matters and also contains an independent objective appraisal of the audit functions. The report is substantiated by a summary of findings and recommendations with appropriate figures and narrative remarks. Primarily the report is focused on matters such as, financial accounting policies and related industry accounting practices like depreciation methods, inventory pricing; report of independent auditors and internal auditors on system of internal control, report of legal counsel with respect to significant commitments, contingencies and governmental compliance or any report of special investigation concerning the review of corporations financial affairs. The report is titled as 'the Audit Committee Report', properly dated and addressed to the board of directors. Report contains a statement of scope of committees review, including specific information related to organization financial reporting requirements, annual reports and proxy materials, system of internal control and scope of audit, coordination between internal and external auditors, management justification for adopting specific accounting principles and entity's compliance with applicable laws and regulations and it is necessarily signed and the signing members of the committee are held responsible for the facts stated in the report.

Audit Committee of a Public Sector Undertaking

Public sector undertakings which are listed government companies have to confirm to the provisions of the Companies Act, 1956 and Clause 49 of the Listing agreement. In addition, Department of Public Enterprise (DPE) has issued the guidelines on Corporate Governance (2007) for Central Public Sector Undertakings. The Audit committee should comprised of three or more members of the board, at least two-third being independent and the independence criteria of the members being determined by applicable listing rules or legal requirement of relevant stock exchanges. It is desirable that all members of the committee have a working familiarity with basic finance and accounting practices and at least one member of the committee is required to be an 'audit committee financial expert'.

Role of Audit Committee

The role of Audit committee should include the following:

- Oversight of the Company's financial reporting process and the disclosure of its financial information to ensure that the financial statement is correct, sufficient and credible.
- Recommending to the board the fixation of audit fees.
- Approval of payment to statutory auditors for any other services rendered by the statutory auditors.
- Reviewing, with the management, the annual financial statements before submission to the Board of approval.
- Reviewing, with the management, the quarterly financial statements before submission to the Board of approval.
- Reviewing the adequacy of internal audit function, if any, including the structure of the internal audit department, staffing and seniority of the official heading the department, reporting structure coverage and frequency of internal audit.

- Discussion with internal auditors and/or auditors any significant findings and follows up there on.
- Reviewing the findings of any internal investigations by the internal auditors/auditors/agencies into matters where there is suspected fraud or irregularity or failure of internal control systems of a material nature and reporting the matter to the board.
- Discussion with statutory auditors before the audit commences, about the nature and scope of audit as well as post-audit discussion to ascertain any area of concern.
- To look into the reasons for substantial defaults in the payments to the depositors, debenture holders, shareholders and creditors.
- To review the functioning of the whistleblower mechanism.
- Carrying out any other function as is mentioned in the terms of reference of the Audit Committee.
- To review the follow-up action on the audit observations of the C & AG audit.
- To review the follow-up action taken on the recommendations of Committee on Public Undertaking (COPU) of the Parliament.

The Role of the Comptroller and Auditor General of India (CAG)

- **Public Enterprises are subject to Two Audits**
    - First, commercial audit is conducted by Chartered Accountant as per the Companies Act 1956 and second a supplementary audit by the Comptroller and Auditor General of India (CAG).
    - Public enterprises are financed out of public funds, CAG checks the regularity of commercial audit and also performs propriety audit. CAG carries out a periodical performance audit through the medium of audit board. With the introduction of Audit Committee the relevance of CAG has been reduced. The audit by CAG has become a burden on the company.
- **Recommendation of Irani Panel**

The Irani panel had said the CAG's auditing of PSUs was superfluous. It said statutory audits by chartered accountants would suffice. The CAG should not duplicate efforts of the audit committee. The CAG should not waste resources in reviewing the work of Statutory Auditors. Moreover, with the review of the accounting policy and audit comments by the audit committee the audit quality is likely to improve. However, government decided not to pursue the Irani committee recommendation of dispensing with CAG audit amidst opposition from Parliament. At the same time, CAG audits are also reckoned to be qualitative in nature and a reliable source of information for the parliament about the functioning of the PSUs. Audit by the CAG helps expose fraud, siphoning of funds, mismanagement and violation of law the companies. The CAG should focus on the comprehensive review of PSUs. The comprehensive review should be more a 'management audit' than an 'operation audit'.

Disclosures of Audit Committee

The disclosures in relation to the functioning of the audit committee is two dimensional; the first one relates to the disclosures made by the organization about the audit committee and the other is in the form of reports of the audit committees. The following table presents the disclosing authority and the types of disclosures made by the respective authorities.

Table 2: Disclosures Made by the Company in Relation to Audit committee

General Disclosures made by the Company's Board of Directors	Specific Disclosures made by the Audit Committee
Written Charter of Audit Committee adopted by the Company	Report on Review and Audit of Financial Statements
Presence of Financial Expert in Audit Committee	Report on Review of Auditing Standards and Adoption of Specific Provisions
'Independence' of Audit Committee Members	Report on Statutory Auditor's Independence
Presence of Professional Experts on Audit Committee	Recommendations by the Audit committee to the Board of Directors
Management Assessment of Internal Control	Review of Periodic Disclosures
Code of Ethics for Senior Financial Officers	Report of Legal Compliance
Real Time Issuer Disclosures	Rotation of Audit Partners
Report of Audit Committee in Proxy Statements	Statutory Auditors Report
Off Balance Sheet Disclosure of Material Facts	Report of Special Investigation
Disclosures of Transactions Involving Management and Principal Stockholders	Report of Communications with Internal Audit Department and External Auditors

Source: Recommendations of Blue Ribbon Committee, Sarbanes-Oxley Act and Clause 49 of Listing Agreement.

Role in Corporate Governance

The audit committee assists the board in oversight over accounting, auditing, & financial reporting. Its role can be strengthened in the following ways:

- The Internal Auditors should be required to report to the committee in the defined manner within the prescribed limits.
- The work of checking financial disclosures and oversight over internal audit should be properly divided among the committee's members.
- Regular training needs to be provided to members of the committee so to update their knowledge and skills in finance, information technology and other relevant areas.

Scope for Improvements of Audit Committee

The concept of audit committee is one of the turning stones in the area of good corporate governance. The implementations of the mandatory regulations of the committee ensures conformity with ethical business practice, protection of shareholder's interest and increased transparency reducing the chances of corporate frauds and failures. The audit committee in its formative shape is embedded with several limitations which obstructed in the professional functioning of the committee.[1] Some of these restrictions are discussed below:

- It is mandated that disclosure about the composition of audit committee composition need to be provided in the annual report, but the act failed to stipulate which part of annual report should contain the said disclosure, whether it was to be included in the directors report under section 217 of the Companies Act 1956 or any other segment of the report. This provided freedom to the companies to place the details about the functioning of the audit committee at any part of the annual report and making it difficult for the time constrained stakeholders to locate the details of the committee.
- It is mandated that in case of non-compliance of the provisions of the audit committee by the board of directors, the same need to be communicated to the shareholder along with justified reasons for such act. But nowhere in the act had mentioned the process of communication with the shareholder regarding non-compliance of the recommendations of the audit committee.
- The provisions for the committee were also silent on remedial measures for aspects like if external or internal auditor failed to attend the meetings of the committee due to various reasons beyond his control or if the chairman of the committee fails to attend annual general meeting because of similar reasons.
- The success of audit committee depends on the personal qualities and traits of members.[2] The rules for audit committee are also silent on behavioral aspects effects on member selection and on the provisions for providing orientation and training to members.
- Publication of the charter of the audit committee is not compulsory for the companies only they have to file the corporate compliance report with respective stock exchanges. In such case it becomes difficult for all stakeholders to know the gamut of responsibilities of the committee and evaluate their functions.
- The selection of members to the committee is vested in the hands of executive directors, and if they wished they would select only those independent members to the committee who abide by their vested interests.
- Guidelines for financial literacy for member's qualification as mandated in various codes failed to define what constituted financial literacy in real terms whether understanding of financial statements or formal educational degree in related subjects.
- The mechanism of complaint submission whether by the employee of the company or by anyone else with anonymous or pseudonymous name through intranet or internet web forum or by email regarding a company's 'accounting, internal or accounting controls or auditing matters' and possible course of action on it while maintaining the confidentiality was yet to be accomplished.[3]

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[1] Dhar. Satyajit., "Audit Committees in Corporate India – Certain Issues", SEBI and Corporate Laws, May 2001.

[2] Tuteja. S.K., "Empowering Audit Committee's in India", SEBI and Corporate Laws, August 2004.

[3] Strasser. Mathias and Edgar Wieppl, "Sarbanes_Oxley Act Stategies for Implenting Audit committee Complaints Procedure", CISA, Vol.5 2006.

- With the wide acceptance of audit committee in various markets, it had been a phenomenon that on reporting of material weakness there was decline in price of shares as well negative impact on the careers of the executives responsible. This reality had encouraged an increasing number of organizations to hire consultants independent of the external auditors to assist compliance of section 404 of Sarbanes-Oxley Act. Thus, in the name of efficient management of resources, the cost of managing has increased with the benefits accrued remained static.[1]
- According to the Internal Control Integrated Framework, issued by the Committee of Sponsoring Organizations (COSO) in 1992, internal controls encompass a set of policies, rules and procedures enacted by management to provide reasonable assurance that the financial reporting was reliable, the operations were effective and efficient, and the activities complied with applicable laws and regulations. Thus, internal control dealt with information processes, operation processes and compliance processes. Whereas, an effective system of internal control is needed to be built on the basis of the analysis of enterprise-wide risks by the management and independent auditors and approved by the audit committee but in the present form while the audit committee narrowed down the scope of internal control and deliberated to cover all corporate governance frauds and failures as accounting failures.[2]
- No obligation on the directors to get the audit report printed in the same form as it was provided by the auditor U/s 227(3)e, audit report along with observations or comments , disqualifications of directors U/s 274(1)g.

To conclude, audit committee is an evolutionary concept and formative steps regarding various aspects of the committee are needed in order to have an unbiased, independent and professional audit committee supportive to the structure of corporate governance in the companies.

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[1] Blaskovich. Jennifer and Natalia Mintchik., "Post–Sarbanes-Oxley Audit Planning Perceptions of Internal Control Assessments and Other Institutional Considerations", CPA Journal, October, 2007.

[2] Hsieu. Heng Lin and Frederick H. Wu., "Limitations of Section 404 of Sarbanes-Oxley Act", CPA Journal, March, 2006.