Investigation of Effective Factors on Audit Committee Effectiveness from Perspective of Independent Auditors and Board Members

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Abstract: The mere presence of the audit committee does not necessarily translate into an effective monitoring body. As a result, the search for mechanisms to enhance corporate governance and increase the quality of financial reports has mostly focused on the structure of audit committees. The purpose of this research is an investigation of effective factors on audit committee effectiveness from perspective of independent auditors and board members. The statistical survey of two groups of independent auditors and board members of companies listed on the stock exchange. Data was collected using a questionnaire. 269 questionnaires from the independent auditors and board members of 347 questionnaires were analyzed. Results of this study showed that independence, activity, financial expertise, size, chart, support of board of director and experience caused the audit committee effectiveness.
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1. Introduction

During recent years, developed countries have been observed of appearance and evolution of audit committee.

This committee has been responsible for various needs of accounting and financial users, especially stockholders.

Expansion of international operations, intensification of stock companies activities for achieving competitive advantages, increase of liabilities resulted from damaging environment, the role and effect of management estimations in figures inserted into financial statement and its effect on it, lack of a base for investigation of management claims about efficiency of internal control structure by independent auditors, development of using computer systems followed by becoming more difficult monitoring this system controls have resulted in intensification of audit committee creation and application process.

The role of audit committee as an effective factor on increasing financial reports presentation desirability will be continued in the same manner as before and effective audit committee, will play key role in filling accrediting vacancy which today exist in financial reports.

Effective audit committees, cause increasing annual audited financial statements credit, committee effectiveness is in fact its ability to achieve its goals. (Zhang, 2006) in order that audit committee can operate effectively, must be independent of economic unit. To maintain independence, audit committee members should be elected from non-duty managers. They have such relation to economic unit that don't undermine their independence.

Furthermore, audit committee members must have sufficient and necessary financial and accounting expertise and knowledge. Without professional expertise and knowledge, members won't be able to understand economic unit financial reports and accounting information. Thus, can't operate effectively.

If audit committee including expert and independent members is inactive or low-active and inexperienced, certainly won't be effective. Moreover board of directors' support for audit committee increases its effectiveness. The purpose of this research is to investigate factors effective on audit committee effectiveness from viewpoint of independent auditors and board of board of directors' members.

2. Problem Expression

Nowadays with respect to growth and development of common stock companies, monitoring economic units operations and process has been more important than before. Providing reliable financial reports and accounting information is one of the essential needs of current evolving world. Audit committee is one of the mechanisms which it's expected that can operate effectively in direction of keeping different groups' interests which use accounting information.

With respect to current evolving world, safeguarding investors' interests as capital suppliers and also the most important user groups of accounting information and financial reports have become more necessary than before. Nowadays, in some developed countries, they have established audit committee so that undertakes the role of monitoring procedures and the manner of economic units accounting and financial reports.

Created evolutions during recent years, in advanced countries have caused increasing auditors' independence of management when auditing. One of these changes is using audit committee in companies. This committee can operate as supervisory agent.

The member of this committee, are elected from non-duty managers and in the best situation, include managers out of company. Some duties of this committee include electing and deposing independent auditors, auditing services restrictions, auditors' findings investigation and resolving disagreements between management and auditors (Neal & Carcello, 2000). Aligning the interests of auditor and board of directors' non-duty members (auditing committee) is the best way to achieve an independent relationship between auditor and organization management.

Purposes of audit committee are:

- Assisting board of directors' members in order to perform their responsibilities.
- Providing better communication lines
- Improving auditors' internal and external independence
- Increasing credit and reliability of financial reports
- Improving and strengthening the role of non-duty managers.

In advanced countries, audit committee has become an important tool to control financial reporting procedure reliability.

Audit committee operates as a determinant factor in financial reporting process (Rainsbury et al. , 2009). Furthermore, the committee controls economic unit senior management and by preventing management from violating internal controls, such as preventing management deception, plays effective role. Thus, effective audit committees, cause increasing annual audited financial statements credit. Committee effectiveness is in fact its ability to achieve its goals (Yan Zhang et al, 2006). Moreover, the role of audit committee in risk management is also very important. Risk management is often done by audit committee through focus on goals, activities and work framework of organization (Livingston, 2005).

In this research we have tried to investigate factors which cause audit committee effectiveness. In other words, audit committee must have characteristics so that it can achieve short-term and long-term goals in best manner.

3. Necessity of Research

In order to make suitable decisions, financial reports should present information to assist investors, creditors and other users. But important matter is that in most cases, financial information suppliers and users of this information don't have the same goal and it's because of interest confliction between interested parties in companies.

With respect to performed researches, audit committee, as a supervising tool, plays important role in company. Since stockholders aren't able to monitor company continuously, so company board of directors takes this responsibility through entrusting audit committee with monitoring financial reporting process. Performed studies, have described the role of audit committee in improving internal controls and financial reporting very important.

Now, in order that audit committee can perform its supervising responsibilities in best manner, must be effective and it's the reason of performing this investigation that what properties should have audit committee so that can be effective.

4. History

Knapp (1987) conducted a study to identify the factors that could influence the likelihood that audit committees will support auditors in their disputes with management. The results of this study indicate that firms with an audit committee were more likely to support the auditor in auditor-management disputes compared with those with a non-Big 8 auditor.

Kalbers and Fogarty (1993) used the power theory to conduct a survey using audit committee members from 90 corporations to investigate the relationships between audit committee characteristics and ACE. The results of their analysis indicated that effectiveness included oversight of financial reporting, external auditors and internal control. Audit committee power within the organization came from a combination of written authority and the clear support of top management.

Cohen and Hanno (2000) found that external auditors made less favorable audit planning judgments in cases where the corporate governance structure included an audit committee that lacked technical experience and regular access to internal and external auditors without top management present.

Beasley et al. (2000) examined the association between the number of audit committee meetings and the likelihood of having fraud financial reports in the technology and health-care industries. The results of their study indicate that there was a negative relationship between the number of meetings and the likelihood of fraud. Their study indicated that while fraud companies generally held one meeting per year, non-fraud companies met two or three times each year. However, the number of audit committee meetings in both groups of companies is still less than the four meetings per year that was recommended by the Blue Robin Committee (BRC, 1999).

Song and Windram (2000) found that UK companies with an audit committee with a higher level of financial literacy are less likely to have financial reporting problems.

Abbott and Parker (2000) found that firms with independent audit committees were more likely to select industry-specialist external auditors. This may reflect the desire of such audit committees to reduce their members' reputational losses, which, in turn, will enhance audit quality; and indicated that firms with audit committees that met at least twice per year were less likely to be sanctioned by the SEC for financial reporting problems.

Vafeas (2001) examined audit committee composition in terms of independence and experience (expertise) and tried to identify the determinants of audit committee appointments. The results of this study indicate that while the likelihood of audit committee appointment increases with the degree of outside directors' independence, such likelihood decreases with compensation committee membership, other committee membership and the length of board tenure. However, audit committee appointments were not related to equity holdings and the number of other directorships; and highlighted the need to examine the influence of audit committee composition not only in terms of independence and expertise, but also in terms of financial literacy, on audit committee performance and the quality of the financial reports.

Archambeault and DeZoort (2001) examined the association between audit committee independence and suspicious auditor switches1. They found that companies with a suspicious audit change had a smaller percentage of independent directors on the audit committee compared to these with a non-suspicious auditor change; and found that companies with suspicious auditor switches had fewer experts on their audit committees compared to these with non-suspicious audit switches; and investigated the impact of audit committee size on suspicious auditor switching. They found a negative association between audit committee size and suspicious auditor switching; and concluded that companies with an audit committee that met more frequently were less likely to commit a suspicious auditor switch compared to companies with an audit committee that met less frequently.

Raghunandan et al. (2001) surveyed chief internal auditors and found that audit committees with at least one member possessing an accounting or finance background were more likely to have longer meetings with their chief internal auditor, to provide private access to him or her and to review internal audit proposals and results.

Abbott et al. (2002) found that companies with independent audit committees were less likely to be sanctioned by the SEC for fraudulent or misleading financial reporting.

Carcello et al. (2002) examined voluntary audit committee disclosures under the new disclosure requirements implemented in 2001 by the SEC and the securities exchanges such as NYSE. They found voluntary disclosure of audit committee activities to be more common for depository institutions, larger companies, NYSE listed companies, and companies with more independent audit committees.

Felo et al (2003) found a positive association between audit committee size and financial reporting quality. These studies provided support for the use of audit committee size as a proxy for the available audit committee resources.

Bedard et al. (2004) investigated the association between different audit committee characteristics and earnings management. They found that aggressive earnings management is negatively associated with the presence of an independent audit committee; and found that aggressive earnings management is negatively associated with the financial and governance expertise of audit committee members; and concluded that aggressive earnings management is negatively associated with the presence of a clear mandate defining the responsibilities of the audit committee

Chen et al. (2005) examined the relationship between independent audit committees and audit quality using the ASX Top 500 (at the time of testing the list contained 510 firms) in 2000. They found that the ASX Top 500 companies with high percentages of non-executive directors on their audit committees were more likely to hire a specialist (high quality) auditor compared to these with low percentages of non-executive directors on their audit committees

DeFond et al. (2005) investigated the market reaction to the appointment of directors with financial expertise to the audit committee. They found a positive market reaction to the appointment of directors with financial expertise to the audit committee.

The Treadway Commission's Report offered 11 specific recommendations designed to enhance the effectiveness of audit committees:

1. Audit committees should have adequate resources and authority to discharge their responsibilities.
2. Audit committees should be informed, vigilant, and effective overseers of the company's financial reporting process and its internal control system.
3. Audit committees should review management's evaluation of the independence of the company's public accountants.
4. Audit committees should oversee the quarterly as well as the annual reporting process.
5. The SEC should mandate the establishment of an audit committee composed solely of independent directors in all public companies.
6. The SEC should require committees to issue a report describing their responsibilities and activities during the year in the company's annual report to shareholders.
7. A written charter for the committee should be developed. The full board should approve, review, and revise it when necessary.
8. Before the beginning of each year, audit committees should review management's plan to engage the company's independent public accountant to perform management advisory services.
9. Management should inform audit committees of any second opinions sought on significant accounting issues.
10. Together with top management, the audit committee should ensure that the internal auditing involvement in the entire financial reporting process is appropriate and properly coordinated with the independent auditor.
11. Annually, audit committees should review the program that management establishes to monitor compliance with the company's code of ethics.

This report further recommended that all public companies be required by the SEC to establish audit committees composed solely of non-executive directors. However, the SEC did not respond to such recommendation (Solomon 1978).

The *Sarbanes-Oxley Act 2002* is the single most important piece of legislation affecting corporate governance, financial disclosure and the practice of public accounting since the US securities laws; in this Act, special attention was given to the audit committee as one of the most important corporate mechanisms to enhance the integrity of financial reports. In

Section 301, the following requirements are recommended:

• Each member of the audit committee shall be a member of the board of directors, and shall otherwise be independent.
• The audit committee shall be directly responsible for the appointment, compensation, and oversight of the work of the external auditor.
• The audit committee shall establish procedures for the "receipt, retention, and treatment of complaints" received by the firm regarding accounting, internal controls, and auditing.
• Each audit committee shall have the authority to engage independent counsel or other advisors, as it determines necessary to carry out its duties.
• Each firm shall provide appropriate funding to the audit committee.

5. Assumptions

In order to investigate research subject, there were propounded 7 theories each of which is in direction to research main goal assessment.

Theories are derived from theoretical structure, so have necessary credit in order to be tested. To test theories, before propounding theories, technical literature such as books, reliable and foreign scientific researches and publications concerning research subject were studied and through obtained information, subject related ideas were discussed as 7 theories:

1. There is meaningful relation between audit committee members' independence and audit committee effectiveness.
2. There is meaningful relation between audit committee members being active and audit committee effectiveness.
3. There is meaningful relation between existence of at least one accounting or financial management specialist and audit committee effectiveness.
4. There is meaningful relation between existence of audit committee charter and audit committee effectiveness.
5. There is meaningful relation between board of directors support for audit committee and audit committee effectiveness.
6. There is meaningful relation between audit committee members' experience and audit committee effectiveness.
7. There is meaningful relation between audit committee size and audit committee effectiveness.

6. Method of Research

The method used in this research is survey method. Date has been obtained through distributing a questionnaire which justifiability and durability have been confirmed. The questionnaire has been set based on 7-section Likret spectrum. Stages of this research are so that firstly variables were specified based on research literature. Then there were considered 2 statistical communities for research, the first community include board of directors' members of accepted firms in Tehran Stock Exchange and second community includes independent auditors.

After extracting desired data through questionnaire distribution, research theories were analyzed by using of SPSS software.

7. Statistical Community and sample

First group statistical community includes board of directors' members and second group statistical community includes independent auditors. On the basis of the list released by Tehran Stock Exchange in 1390, 453 companies were accepted in Stock and with regard to 10 managers for each companies, it was considered that each statistical community in this research includes 4530 persons. Based on number of independent auditors which has been declared by audit organization, it was considered that second group statistical community includes 1750 persons.

Regarding research method and theories, Cochran formula was used to determine sample volume. Sample number for first group was obtained 355 and for second group was obtained 272.

8. Data Analysis

The main purpose of this research is to investigate effective factors on audit committee effectiveness between 2 groups of independent auditors and board of directors' members of accepted companies in Stock Exchange. In order to investigate research theories, one-sample T-test was applied. Theories were tested at 95% of confidence level. Furthermore, with regard to designed questionnaire format which was 7-item, average has been considered 4. Variance analysis test was used to determine the relation between two respondent groups and research theories.

For independent auditors:

H_0: $\mu_a <= 4$ Contradictory claim

H_1: $\mu_a > 4$ Claim

For board of directors' members:

H_0: $\mu_m <= 4$ Contradictory claim

H_1: $\mu_m > 4$ Claim

Variance analysis test is used to compare influence of a grouping independent variable over a dependent quantity variable. In this research, independent variables are board of directors' members and independent auditors and dependent variables are research theories. The purpose of performing this research is to determine is there any difference between independent auditors and board of directors' members' responses to questionnaire technical questions? **H_0: $\mu_a = \mu_m$ H_1: $\mu_a \neq \mu_m$**

Chart 1: Theories test results

Theory	Group	Average	T-Statistics	Df	Sig	Confirmed/Rejected
1	Auditors	5/9950	5/9950	268	0/000	Confirmed
	Board of directors	5/7474	5/7474	346	0/000	Confirmed
2	Auditors	5/9229	5/9229	268	0/000	Confirmed
	Board of directors	6/2186	6/2186	346	0/000	Confirmed
3	Auditors	6/2416	6/2416	268	0/000	Confirmed
	Board of directors	6/2891	6/2891	346	0/000	Confirmed
4	Auditors	5/8501	5/8501	268	0/000	Confirmed
	Board of directors	5/6590	5/6590	346	0/000	Confirmed
5	Auditors	5/9164	5/9164	268	0/000	Confirmed
	Board of directors	5/9063	5/9063	346	0/000	Confirmed
6	Auditors	5/8297	5/8297	268	0/000	Confirmed
	Board of directors	5/8622	5/8622	346	0/000	Confirmed
7	Auditors	5/2416	5/2416	268	0/000	Confirmed
	Board of directors	5/3516	5/3516	346	0/000	Confirmed

9. Research Findings

By performing this research and testing its theories, following results have been obtained.

In order to have effective audit committee, it's necessary:

- Audit committee members include company non-duty managers
- Board of directors doesn't be a member of audit committee
- To organize regular meetings of audit committee during the year
- Members regular participation in meetings
- To spend enough time to understand company and preparing oneself for meetings
- Timely distribution of agenda and background information
- To have impartial and reasonable questioning attitude towards issues
- To invite non-member (independent auditor, internal auditor and so on) to

meetings, without chairman attendance, if necessary.

- Key persons attendance (managing director, financial manager and so on) in meetings
- To record clearly decisions made in meetings
- Presence of at least one accounting or financial management specialist member
- Members must be able to read, comprehend and understand financial statements
- Training related to financial reports for people who have studied in fields other than accounting or financial management
- To have formal written authority
- Confirming audit committee chart by board of directors
- Reviewing audit committee chart annually and recommendation of necessary changes to board of directors
- Not to fear consequences of decisions made by audit committee
- Considering enough fees by board of directors for audit committee
- Considering organization power for audit committee
- Inviting audit committee to formal meetings, seminars and briefings of foreign auditors and company attorneys
- Having enough resources for utilization of legal consultants' services, if necessary
- Not to limit audit committee members election to one period
- Trainings related to economic unit regulations for audit committee
- Presence of experienced and aware persons in meetings

10. Recommendations for Future Researches

- Investigating the effect of audit committee existence on attracting foreign investors for investment in Iran economic units
- Investigating the effect of number and expertise of audit committee members on audit committee performance
- Determining possible and economical ways, for removing obstacles of audit committee establishment in Iran economic units
- Investigating the effect of audit committee on operational audit committee effectiveness and efficiency
- Investigating effects of audit committee existence on internal audit unit impartiality
- Investigating benefits of establishing effective audit committee in companies
- Investigating factors other than investigated ones in this research, which cause effectiveness of audit committee.

Chart 2: Variance Analysis Test Results

Theory	Situation	Sum of square	df	Mean square	F	Sig	Meaningful difference
1	Between groups	9/296	1	9/296	7/659	0/006	Has
	Intergroup	745/290	614	1/214			
	Total	745/589	615				
2	Between groups	13/258	1	13/258	28/860	0/000	Has
	Intergroup	282/074	614	0/459			
	Total	295/333	615				
3	Between groups	0/342	1	0/342	0/604	0/438	Doesn't have
	Intergroup	347/949	614	0/567			
	Total	348/291	615				
4	Between groups	5/533	1	5/533	6/483	0/011	Has
	Intergroup	524/045	614	0/853			
	Total	529/578	615				
5	Between groups	0/015	1	0/015	0/027	0/870	Doesn't have
	Intergroup	348/907	614	0/568			
	Total	348/923	615				
6	Between groups	0/160	1	0/160	0/278	0/598	Doesn't have
	Intergroup	353/218	614	0/575			
	Total	353/378	615				
7	Between groups	1/832	1	1/832	0/953	0/329	Doesn't have
	Intergroup	1180/400	614	1/922			
	Total	1182/232	615				

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