

# The study of factors affecting the quality of audit committee

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## Abstract

The expansion of private ownership scope, through privatization of state owned enterprises and decentralization has increased the attention towards the capital owners' interests to strengthen accountability culture and to promote the information transparency of companies and other economic units in which all or a part of capital is supplied by the public. This aims to require mechanisms to ensure the proper governance in companies and other economic firms. Corporate governance has particular elements. Audit committee is a key element of corporate governance that strengthens the health of financial reporting. In the current study it is attempted to examine factors affecting the quality of the audit committee. The research sample includes all financial managers or board members of listed companies in the Tehran stock exchange in which the final sample consists of financial managers or board members of 185 listed companies. The research results indicate that the enhancement in independency, expertise and activities of non-executive members of board increases independency, expertise and activities of the audit committee and also there is a meaningful relationship between the size of non-executive members of board and the size of the audit committee.

**Keywords:** Audit committee, Board of directors, Executive members of board of directors and Non-executive members of board of directors.

## Introduction

Given the increasing use of financial intelligence from economic units and also the need to ensure the accuracy of their information, it is required to employ some people whose services including the handling of documents, accounts and accounting documents of firms will result in the discovery of any misuse and possible frauds, and also they provide their unbiased opinions related to the accuracy of this information. These persons are usually selected among non-executive members of board of directors and outside managers (Carcello & Neal, 2000). In recent years, developed countries have witnessed the fast emergence and evolution of the audit committee. Expansion of international operations, increased activities of corporations, increased debt resulting from damage to the environment, the role and impact of management estimates on figures contained in financial statements and reports, absence of a credible basis for evaluation of management's claim regarding the adequacy of internal control structure by independent auditors, expanded the use of computer systems and subsequently more difficult

monitoring and controlling of these systems have intensified formation and implementation of the audit committee (Asabakhsh, 2010).

The audit committee is one of the firm's board committees consisting of 3 to 5 and in some cases, 7 non-executive members of the board whose ultimate responsibility is to oversee all financial activities of the company (Arense & Loebbecke, 2003).

Among the duties of the audit committee, the others are to help choosing the auditor, to manage auditing process, to review audit results, to help board members getting better understanding about audit results and to work with management and independent auditor solving internal control problems or weaknesses identified during the audit process. If the audit committee is organized and employed correctly, it can have significant benefits for all interested groups. Audit committee has the ability to strengthen the stewardship capacity of board of directors with regard to reporting and also is able to improve communication between management and independent auditor and the

auditor's independence serving as a shield between auditor and management. Audit committee helps creditors and beneficiaries to ensure that their maximum interests are obtained through auditing activities (Wilson *et al.*, 2000).

### *Background of audit committee in the world and Iran*

The establishment of the audit committee dates back to 1940. In that time, after the incident of Robbins' fraud, the US Stock exchange organization proposed to all of the listed companies in New York stock exchange to select the independent auditors from non-executive members of board of directors and to seek their advices on audit contracts and the associated fees; it was named as audit committee. Then, in 1971 this proposal was approved by US stock exchange organization. The organization believed that the audit committee can be the most appropriate means of protecting the interests of corporations' investors. In 1972, Securities and Exchange Commission recommended to all public companies to establish their own audit committees (Vera-Munoz, 2005).

Following this, in 1978 the New York stock exchange made it mandatory for listed public companies to establish their audit committees. To comply with this policy of New York stock exchange, the US Stock exchange also recommended the listed companies to have an audit committee but it did not make it mandatory. Over time, the creation and development of the audit committees increased in the U.S. companies. According to the past researches, until 1958 only 14.70 percent of US firms have had audit committees, while the number of audit committees in the US LLPs reached to 18.60 percent in 1961 and to 91.40 percent in 1977 (Deli & Gillan, 2000).

In 1993, the Australian Securities Exchange Act, required all the economic units to have audit committee and asked them to comment in their annual reports about audit committee and explain the reasons for the lack of such a committee. This law was amended in 1996 and required companies

to mention the corporate governance important activities during the reporting period in their annual reports. In March 2003, the Association of Corporate Governance issued a report containing some principles for good corporate governance and the best practical suggestions. The revised version of principles and recommendations was released in 2007. In this Act, all economic units are required to have an audit committee during their fiscal year and they must follow the Society's recommendations regarding the composition, functions and responsibilities of audit committee.

The Society recommends that the audit committee should be structured so that it only contains non-executive directors including several independent directors and it should be run by an independent chairman who is not the chairman of board of directors simultaneously; at least three members should be included in the committee who don't have any financial dependency and at least one member with relevant competencies and experience and some members familiar with the corresponding industry should be present in the committee. Audit committee should have a formal charter that explains the roles and responsibilities, composition, structure and requirements of members and also determines the procedures for inviting non-committee members to meetings, in addition, the audit committee should be most efficiently take on its role (Baxter, 2010).

In Iran, growing trend of firms' public ownership, transfer of public firms to private sector and financing through the public participation, on the one hand, and the incidence of financial scandals on the other hand show major changes in the economic environment. Regarding the growth and expansion of the scope of public companies' activities in the Iranian economy and the need for increasing their accountability toward investors who provide their small and large scale investments in these companies hoping to earn money, the importance of proper management, control and supervision on public companies is increased (Etemadiand & Banisharif, 2009). Given that the establishment of audit committee is one of today's

key strategies to control and monitor the affairs of such companies, it is expected that the committee to have a special place in Iran's firms. But due to a lot of reasons, this issue has been ignored especially in public companies although in Tehran stock exchange, the securities act approved in December 2005 paved the way for listed companies to establish the committee based on corporate governance regulations and in November 2007, the 47<sup>th</sup> session of the Tehran stock exchange board approved a charter called "audit committee charter".

Those referred to in this Charter are as follows:

*Purpose of the audit committee:* to assist the board in carrying out its supervisory responsibilities;

*Number of audit committee members:* It has five members of which at least two members are non-executive members of board of directors and others are outsider and are selected by the board;

*Meetings of the audit committee:* It must meet at least six times a year;

*Characteristics of audit committee members:* financial knowledge and independence.

*Responsibilities of Audit Committee:*

- Evaluation of accounting and financial reporting issues and understanding impacts on the financial statements.
- Reviewing the effectiveness of internal control systems.
- Examining the charter, plans, activities, personnel and organizational structure of internal audit department.
- Holding regular periodic meetings with the internal audit director for discussion. Reviewing the audit scope and approach proposed by independent auditors including harmonization of internal auditing with independent auditors.
- Observing the necessary regulations.
- Reporting responsibilities etc.

### **Literature review**

Lisic *et al.* (2011), examined the relationship between the audit committee characteristics and protection of auditors' independence. They evaluate four aspects of the audit committee composition: real independence, financial expertise, regulatory expertise and beneficial ownership. They believe that although all members of the audit committee should have apparent independence, but true independence of the audit committee is one of the important effectiveness features of the committee. In reality, the audit committee's independence is vital in protection of auditors against dismissal after the issuance of adverse auditing reports. Also, they present evidences that show the financial expertise of audit committee is important for the protection of independent auditors against dismissal after issuing negative reports.

Hrichi, (2010) studies the effectiveness of the audit committee in the increase of financial reporting quality in Tunisia. To evaluate the effectiveness of the audit committee, he evaluates some factors such as independence, activity and number of audit committee meetings. He states that the effective audit committees have to be independent and its decisions should have enough objectivity to successfully implement its functions, audit committee members should be equipped with the necessary expertise to implement the committee's role and also the number of committee meetings is a guarantee for quality decision-making process. He concluded in his study that in Tunisia, audit committees have yet to reach full effectiveness due to several factors including a focus on ownership structure and high number of family firms, low number of audit committee meetings, lack of explicit rules and regulations, lack of continuous and professional training and resistance of executive managers against operationalizing the audit committees in Tunisia.

Baxter (2010), assesses factors associated with the audit committees. His research is about the Australian stock exchange listed companies. He concludes that there is a significant positive relationship between each of the indicators related

to the quality of the audit committee and board characteristics such as board independence and audit committee independence. Board independence and board size also shows a significant positive relationship with the number of audit committee meetings. In addition, a significant positive relationship exist between the firm's size and percent of directors in audit committee, professional legal competence and number of audit committee meetings. He could not justify the effect of auditor power or management stock ownership by non-independent directors on the audit committee's quality indexes.

Zhang *et al.*, (2007), examined the relationship between audit committee quality, auditor independence and disclosure of internal control weaknesses after the approval of Sarbanes-Oxley law. They classify a sample of firms with internal control weaknesses based on industry type, size and performance, and then they compared these companies with a sample of companies with no weaknesses in their internal control systems. Their conditional logit analysis reveals that there is a relationship between the quality of audit committee, auditor independence and internal control weaknesses. Most of the companies classified as firms with internal control weaknesses had the audit committee members with less financial knowledge. If companies have audit committees with low financial and accounting experience or even without any financial experiences, they may be prone to internal control weaknesses. Additionally, companies that have recently been experiencing auditor changes are also prone to internal control weaknesses.

Salehi, (2011) evaluates the reasons for the lack of audit committee in Iran. He examines six hypotheses and enumerated the reasons as unawareness of financial reports users, accounting professionals and law makers from the benefits of the audit committee, culture of individualism, unique focus of managers and lack of legal force. The study used 150 questionnaires and its sample included accountants, auditors, financial managers and financial expert. The questionnaire results

indicated that the hypotheses 1 to 3 (lack of awareness of users of financial reports, accounting professionals and legislators from the benefits of the audit committee) are rejected while hypotheses 4 to 6 (culture of individualism, managers focus and lack of the legal force) are accepted.

The results of Asabakhsh, (2010) shows that the barriers of establishing and maintaining a positive relationship between the firm's board of directors and auditors is caused by some cases which create disagreement between them. Excluding these cases, there is no barrier against establishing and maintaining this relationship.

The presence of audit committee increases auditors independency compared to the firm's board of directors. The regulations of professional conduct for independent auditors and the audit standards declaration have also emphasized on independency of independent auditors.

Regarding the organizational position of audit committee and its defined responsibilities, it is assumed that the audit committee increases the effectiveness and efficiency of accounting and internal audit departments in the Iranian firms.

Audit committee members should have needed financial and accounting knowledge and expertise. Hence, it is expected that the presence and operation of audit committee to improve the quality of financial reporting.

Etemadiand & Banisharif (2009), research results' achieved through the questionnaire instrument. All of the hypotheses presented in the study there were accepted except a hypothesis claiming a meaningful relationship between the decentralization of firms in Iran and the establishment possibility of employers' audit committee. The results indicate that there is a meaningful relationship between the establishment possibility of employers' audit committee, establishment of imperative rules and standards, awareness of owners and stock holders about its necessity, familiarity of professional and legal

bodies with its role and impact and awareness of different user groups about its role and functions.

### *Research hypotheses*

The separation of ownership and control has some costs for modern corporations (Fama & Jensen, 1983). The costs are results of communications between the companies, shareholders and borrowers. One of the control mechanisms provided to reduce organizational costs is in the form of activity restrictions for managers who are responsible for decision making in the company (Jensen & Meckling, 1976). The board of directors is one of the innermost control mechanism which acts as a control system for managerial activities (Fama & Jensen, 1983).

The board of directors has a responsibility to submit the management's financial reports to audit committees. The audit committee is thus a subcommittee of board which its functions and roles are determined by the board. The committee primary operations include regular meetings with internal and independent auditors in order to review the financial statements, accounting procedures and internal controls (Baxter, 2010).

The quality of audit committee is enhanced through the increase of independence, expertise, activity and size. Independent directors on the board of directors have the needed motivation to strengthen audit because in this way, they can reduce the information asymmetry between the internal and external managers. In addition, a larger board of directors should obtain higher control advantages from efficient audit committee compared to smaller boards (Collier & Gregory, 1999). It is thus predicted that boards of directors to play an important role in the composition, size and activity level of audit committees.

Klein, (2002) observes that the higher the level of financial expertise and independence is among the board of directors, the more are the motivations and abilities to increase the ultimate expertise of audit committee, although the larger board of directors increases the accessibility of directors for

attending in the audit committee. So when the board reaches to a threshold size, the ability of company to incorporate more directors in the audit committee will be increased. Accordingly, the audit committees formed by larger boards are more active and independent than that formed by smaller boards.

Based on the above discussion, the following research hypotheses were proposed:

H<sub>1</sub>: Independency of non-executive members of board increases independency of audit committee.

H<sub>2</sub>: Expertise of non-executive members of board increases independency of audit committee.

H<sub>3</sub>: Activities of non-executive members of board increases independency of audit committee.

H<sub>4</sub>: There is a relationship between the size of non-executive members of board and the size of audit committee.

In the developed countries, companies have focused on the necessity of audit committee establishment in the recent years and in this context organization' not only manages at different levels but try to learn the concepts of the committee, and some organizations at national and international levels put their efforts to develop laws and regulations related to the audit committees. But the subject is still strange in the business environment of Iranian companies. It is due to the fact that the country's educational system does not provide such information for managers and also no significant activity has been undertaken in the legislative arena. Therefore, it is expected that the auditing and accounting communities to have little information in this field. However, in order to overcome this disadvantage in the present research, a specific part of the professionals with higher academic and executive levels has been selected as the research sample i.e. the members of board and financial managers of listed companies in Tehran stock exchange.

The sample includes the members of board and financial managers of 342 listed companies; these companies have been accepted in Tehran stock exchange from July 2011. The sample volume chosen for financial managers and boards' members of listed companies includes 181 subjects assuming a limited sample, confidence level of 95% and the maximum acceptable error of 5%.

The needed information for testing the proposed hypotheses was collected in two steps. In the first step, the library-based method was used and in the second step, the survey method was employed. For this purpose, 185 questionnaires were directly distributed to and collected from the sample.

The questionnaire used in this study was designed according to literature review and then was adjusted referring to a panel sample not participated in the main sample. Reliability is confirmed if a test is repeated several times under the same conditions and its score is the same in all cases. Cronbach's alpha is employed to ensure the reliability of the research questionnaire. According to the calculations, the alpha of about 0.82 is determined. Alpha value of 0.77 is considered as desirable and acceptable reliability.

#### Research hypotheses testing

For data analysis, the descriptive statistics method is employed. To test the hypotheses regarding the qualitative data, the non-parametric test, one-way chi square and the parametric test singular t-test are employed and to compare the score averages, the Friedman test is used.

#### Hypothesis testing results

Chi-square test focuses on testing the presence or absence of a direct relationship between the considered variables. The statistical hypothesis to test the relationship between dependent and independent variables is as follows:

$H_0$  = There is no direct relationship between the independent variable and dependent variable.

$H_1$  = There is a direct relationship between the independent variable and dependent variable.

Table 1. The results of hypotheses

Hypothesis	Variable	Sig	Chi-square	Df	Group with the highest ratio
$H_1$	q 1	0.000	89.78	4	Agree
	q 2	0.000	30.11	3	Strongly agree
	q 3	0.000	30.20	3	Agree
	q 4	0.000	40.37	4	No comment
	q 5	0.000	73.35	3	Agree
	q 6	0.000	68.68	3	Agree
	q 7	0.000	37.37	3	Agree
	q 8	0.000	81.29	4	Agree
	q 9	0.000	67.47	4	Agree
$H_2$	q 10	0.000	67.64	3	Agree
	q 11	0.000	122.32	4	Agree
	q 12	0.000	93.45	4	Agree
	q 13	0.000	130.78	3	Strongly agree
	q 14	0.000	79.93	3	Agree
$H_3$	q 15	0.000	225.94	3	Agree
	q 16	0.000	99.51	4	Agree
	q 17	0.000	52.61	2	Agree
	q 18	0.000	124.38	4	Agree
	q 19	0.000	138.65	3	Agree
	q 20	0.000	127.84	3	Agree
	q 21	0.000	26.00	3	Agree
	q 22	0.000	84.12	3	Agree
$H_4$	q 23	0.000	131.865	3	Agree
	q 24	0.000	71.405	4	Agree
	q 25	0.000	18.308	3	Agree
	q 26	0.000	118.114	3	Agree

According to Table.1, the values of meaningfulness level in chi square test equal to 0.000 for all questions. Because the sig = 0.000 is less than 5% alpha in confidence level of 95%,  $H_0$  is rejected and  $H_1$  (relationship between dependent and independent variables) is acceptable. Singular t-test: The test is used to affirm the equality of averages with a fixed value. This test assumes data normality. The considered variable should have a numeric value. If the data show some degree of skewness, it will not limit the test applicability and

Table 2. Singular t-test results

t-statistic value H		95% confidence interval for the differences mean				
		D.f	Sig.	Differences mean	Low limit	High limit
H <sub>1</sub>	-8.19	184	0.000	-0.714	-0.89	-0.54
	-12.32	184	0.000	-0.865	-1.00	-0.73
	-9.73	184	0.000	-0.773	-0.93	-0.62
	-6.41	184	0.000	-0.541	-.71	-0.37
	-14.78	184	0.000	-0.892	-1.01	-0.77
	-12.68	184	0.000	-0.876	-1.01	-0.74
	-11.77	184	0.000	-0.843	-0.98	-0.70
	-7.95	184	0.000	-0.573	-0.71	-0.43
	-15.63	184	0.000	-0.924	-1.04	-0.81
H <sub>2</sub>	-17.62	184	0.000	-1.049	-1.17	-0.93
	-11.89	184	0.000	-0.914	-1.06	-0.76
	-9.09	184	0.000	-0.708	-.86	-0.55
	-27.36	184	0.000	-1.368	-1.47	-1.27
	-14.52	184	0.000	-0.832	-0.95	-0.72
	-12.99	184	0.000	-0.773	-0.89	-0.66
H <sub>3</sub>	-10.13	184	0.000	-0.827	-0.99	-0.67
	-20.26	184	0.000	-0.962	-1.06	-0.87
	-21.08	184	0.000	-1.157	-1.26	-1.05
	-29.53	184	0.000	-1.368	-1.46	-1.28
	-20.60	184	0.000	-1.086	-1.19	-0.98
	-9.51	184	0.000	-0.659	-0.80	-0.52
	-16.43	184	0.000	-0.962	-1.08	-0.85
H <sub>4</sub>	-16.831	184	0.000	-0.876	-0.98	-0.77
	-4.698	184	0.000	-0.335	-0.48	-0.19
	-8.415	184	0.000	-0.605	-0.75	-0.46
	-11.497	184	0.000	-0.622	-0.73	-0.51

so it can detect the existed differences easily. The test's statistical hypothesis is as follows:

$$\begin{cases} H_0 : \mu = 3 \\ H_1 : \mu < 3 \end{cases}$$

According to Table 2, the value of obtained meaningfulness levels equals to zero. According to the analysis,  $H_0 : \mu = 3$  is rejected at  $0.05 = \alpha$ . The average column in the table shows that the variables average is less than 3, so  $H_1 : \mu < 3$  is accepted at  $0.05 = \alpha$ .

The Friedman test is employed to compare the mean scores. Here, when the significance level is less than  $\alpha = 0.05$  (test level), the null hypothesis (assuming equality of mean scores) is rejected at level  $\alpha$ . Thus, according to the items directions in the questionnaire and the assigned group scores, a

Table 3. Results of Friedman test

Hypothesis	Variables	Mean score	Test Statistics	
H <sub>1</sub>	q1	5.04	Number Chi square value D.f Sig.	185 33.12 8 0.000
	q2	4.79		
	q3	5.04		
	q4	5.58		
	q5	4.70		
	q6	4.63		
	q7	4.85		
	q8	5.62		
	q9	4.75		
H <sub>2</sub>	q10	3.29	Number Chi square value D.f Sig.	185 115.46 5 0.000
	q11	3.46		
	q12	3.93		
	q13	2.53		
	q14	3.92		
	q15	3.87		
H <sub>3</sub>	q16	4.04	Number Chi square value D.f Sig.	185 97.25 6 0.000
	q17	4.22		
	q18	3.68		
	q19	3.18		
	q20	3.90		
	q21	4.94		
	q22	4.04		
H <sub>4</sub>	q23	2.17	Number Chi square value D.f Sig.	185 44.28 3 0.000
	q24	2.88		
	q25	2.47		
	q26	2.48		

variable with the lowest average score contains the highest agreement degree. The results of Friedman test for the proposed hypotheses are reported in (Table 3).

## Conclusion

Based on the responses to the questions by the sample, all hypotheses are accepted. Therefore, the statistical results obtained from this study clearly reveal that the enhancement in independency, expertise and activities of non-executive members of board increases independency, expertise and activities of the audit committee and also there is a meaningful relationship between the size of non-executive members of board and the size of the audit committee. It means that the board's non-executive members also serve as members of audit committee; they should have needed independence and financial expertise. They should attend the

meetings and follow-up sessions in order to increase the efficiency, effectiveness and quality of the audit committee.

With respect to the fact that the Tehran stock exchange prepared the Audit Committee Charter in 2007, however, only a handful of companies have established their own audit committees which mostly are among banks and also none of them have issued the audit committee's report. Given the above mentioned reality, the researchers in the present research collected data using the questionnaire.

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