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Corporate Audit Committee : A Survey of Its Need and Present Status

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Abstract: *In recent years an interest in corporate audit committees has been established at a rapid rate. This adoption has been stimulated, in particular, by a requirement for the Chief Executive and Chief Financial Officer of most corporate sector entities to acknowledge, in the financial statements, their responsibility for those statements and for maintaining an effective system of internal control. This study sought to determine the reasons for adoption of audit committees in corporate sector in Bangladesh and their perceived advantages and disadvantages. To accomplish this, a survey was conducted amongst external auditors, internal auditors and financial statement users. The survey found that about 65% of significant corporate sector had audit committees, and that key players in the corporate arena support them strongly.*

Key words*: audit committee; reasons for establishing audit committees; advantages and disadvantages of audit committees, reliability and responsibility of financial reports.*

Introduction

An audit committee is a committee of a board of directors to which the board delegates its responsibility for oversight of the financial reporting process. An audit committee must have responsibility for: (a) overseeing the work of the external auditors engaged for the purpose of preparing or issuing an auditors' report or related work; and (b) recommending to the board of directors the nomination and compensation of the external auditors.

The audit committees are a legal requirement for the listed companies in Bangladesh following the condition no. 3 along with its sub points imposed by the Notification No. SEC/CMRRCD/2006-158/Admin/02-08 dated 20th February 2006 under section 2CC of the Securities and Exchange Ordinance, 1969. The company should have an Audit Committee as a sub-committee of the Board of Directors. According to SEC law the Audit Committee should be composed of at least 3 (three) members. The Board of Directors should appoint members of the Audit Committee who should be directors of the

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company and should include at least one independent director. For this purpose the law as quoted above stated that "independent director" means a director who does not hold any share in the company or who holds less than one percent shares of the total paid-up shares of the company, who is not connected with the company's promoters or directors or shareholder who holds one percent or more than one percent shares of the total paid-up shares of the company on the basis of family relationship; who does not have any other relationship, whether pecuniary or otherwise, with the company or its subsidiary/associated companies, who is not a member, director or officer of any stock exchange, and who is not a shareholder, director or officer of any member of stock exchange or an intermediary of the capital market.

Under corporate sector legislation, the financial statements of all significant entities in Bangladesh must be accompanied by a statement signed by the entity's Chief Executive and Chief Financial Officer. This statement acknowledges the Chief Executive's responsibility for (a) the financial statements and judgments used therein, and (b) establishing and maintaining a system of internal control designed to provide reasonable assurance as to the integrity and reliability of financial reporting. It must also state that, in the opinion of the Chief Executive, the financial statements fairly reflect the financial position and operations of the entity. Faced by these statutory requirements, Chief Executives need to be assured that their obligations have been met. Audit committees seem to provide a means to meet this need.

The immediately following section deals with previous studies relevant for this research. In the next section the research methodology is described. This is followed by a section reporting the research findings subdivided to reflect the major components of the research, namely: the existence of and reasons for establishing (or not establishing) audit committees; and the perceived advantages and disadvantages of audit committees. The final section of the paper presents conclusions drawn from the research.

Need for Audit Committee

The Boards of Directors are held responsible for the overall stewardship of their organizations' affairs, including a true and fair presentation of financial information. Traditionally, the board members have relied to a great extent on management for the preparation of financial statements (and other matters related to the accounting aspects of the business) and on the independent auditors for the examination of the information contained in those statements.

For the more forward looking organizations, they have internal audit units upon which the board may also rely. However, it should be noted that the reliance on management and on internal and external auditors does not relieve the directors of their overall responsibility for the well-being of their organizations. Thus, in countries like the United States and Canada, the corporate sector has highly institutionalized audit committees, as the steering committees of the Boards, to assist the full board members to discharge their responsibility in financial affairs of the companies. Audit Committee is the most important development in corporate governance. With more demand being made for the greater accountability audit committees have a very important role to play. An effective audit committee can increase the integrity and efficiency of the audit process, as well as the system of internal controls and financial reporting. A number of benefits can be derived from having an audit committee in a company.

The First benefit derived from the presence of an audit committee is that it can greatly enhance the communication between the external auditors and the board/management, the internal auditors and the board/management and also between the external auditors and the internal auditors. Leading audit committees foster closer relationships through frequent communication and private meetings resulting in internal audit directors feeling comfortable calling the audit committee chair to provide information and to discuss issues they are concerned about. The development of better communication can arise because unlike before, everyone concerned is now aware that no excuse can be given as to why certain issues cannot be solved since the audit committee opens up channels of communication between the different parties to meet and solve problems together. Audit committees are building trusting and professional relationships with the external auditors while addressing responsibilities for selecting, compensating, evaluating and retaining them, as well as overseeing independence. Related to this point, the presence of the audit committee increases the independence of both the external and internal auditors from management. An audit committee provides the auditors with a forum to air their concerns which will then be taken up by management upon the constant surveillance by the committee. Thus, what actually happens is that the presence of the audit committee induces the management, the internal auditors and the external auditors to conduct themselves in their respective professional credence.

Secondly, having audit committees comprising of independent directors could strengthen the positions of these directors in the companies. It is a fact that while the responsibilities of the executive directors in a particular company are usually delineated, this is not often the case with the nonexecutive directors. Thus, the latter will find it difficult to "direct" the company effectively since because there is no vehicle, other than the board itself, for them to obtain such information. Having outside directors in the audit committee would mean that they now have specific functions in the company. In addition, the audit committee would enable them to gain invaluable knowledge into the company's operations.

Third benefit is that the audit committee helps the company's directors to fulfill their duties and responsibilities required by the law in relation to financial matters of the company. Specifically, the directors are responsible, among other things, to ensure the existence of a proper system of accounting in the company and the issuance of the true and fair financial statements representing the company' financial affairs. For the board to fulfill this responsibility, it needs to understand the elements that constitute the major financial and operating issues. Thus, the board has to be kept up-to-date on the company's financial conditions, and on the system and procedures that management uses to monitor this condition. An effective audit committee could therefore be more successful in ensuring that the requirements of the law are adhered to, as compared to the full board of directors which has much broader responsibilities. In short, the board receives assistance and assurance in fulfilling its financial reporting responsibilities by having the audit committee serve as the board's conduit regarding the company' financial matters.

Finally, without considering directors' responsibility and liability related to the financial well-being of their companies, the board is already having a tough time doing its job effectively since it is responsible for the overall management of the business and affairs of a company. Indeed, the basic responsibility for corporate management rests with the board of directors. In time, as the company increases in size, diversity, and complexity, the directors will find it virtually impossible to be knowledgeable about and discuss every facet of their directed company. Needless to say, having an audit committee would be very helpful to these directors in fulfilling their duties to the company. It must be stressed, however, that the formation of the audit committees does not at any case reduce the responsibilities of the full board of directors. What the audit committee members do is to assist the board members in carrying out their responsibilities by bringing to their attention issues which might not otherwise arise, and by heightening their awareness of the critical area of financial reporting.

Objective of the Study

An opinion survey was conducted to determine the reasons for adoption of corporate audit committees in Bangladesh. The objective of the survey was to establish the extent to which interested parties in Bangladesh agree or disagree with the arguments in favour and disfavour of having audit committees in the corporate entities.

Literature Review

Interest in corporate audit committees appears particularly appropriate at this time. Directors, business executives and business-related professionals are continually being held to higher standards of accountability and responsibility. The corporate audit committee has been suggested as offering significant assistance to a number of groups in meeting their business responsibilities (Mautz and Neumann, 1970, p. 1). These observations are as pertinent today. Indeed, it is surprising to realize that in 1970 audit committees were 'virtually unheard of' (Canadian Institute of Chartered Accountants, 1981, p. 1).

Today, audit committees are a legal requirement for public companies in Canada and Singapore, a listing requirement of the New York and Kuala Lumpur Stock Exchanges, and a requirement of the National Association of Securities Dealers in the US. They are a normal feature of corporate life in the US and, encouraged by reports such as the Cadbury Report (Committee on the Financial Aspects of Corporate Governance, 1992) in the UK and the Bosch Report (Business Council of Australia, 1991) in Australia, which recommended that audit committees be a regulatory requirement for all public companies, they are becoming commonplace in the UK and Australia. In both of these countries public listed companies are now required to disclose in their annual reports whether they have an audit committee.

During the 1970s and 1980s, as professional and regulatory bodies in various parts of the Anglo-American world urged companies to establish audit committees, arguments were advanced in their favour and disfavour (for a summary see Porter, 1993). These, in essence, reflect the perceived advantages and disadvantages of audit committees.

Research Methodology

In order to obtain a range of opinions from the major interested parties, a survey was conducted amongst three broad groups of respondents, namely:

- external auditors—firms of chartered accountants and personnel from Audit Directorate (public sector auditor of Bangladesh);
- internal auditors—from corporate sector entities (both private and public);
- financial statement users—stockbrokers, and bankers.

The members of each survey group were selected by equal interval random sampling from populations identified primarily from lists of names obtained from relevant organizations. As shown in Table 1, 120 questionnaires were used and 108 usable responses were selected (a response rate of 90%). The response rates were 82% for external & internal auditors and 65% for financial statement users.

The questionnaire was designed to seek information about:

- the current and planned existence of audit committees; and
- reasons for establishing or not establishing audit committees.

Three versions of the questionnaire were prepared — one for external auditors, another for internal auditors, and a third for financial statement users. Although differing in detail, the content of the questionnaires was essentially the same.

The external auditors were asked to complete the questionnaire based on their experience of auditing entities (with and without audit committees) in either the private or the public sector; internal auditors were asked to respond to reflect the position as it existed in their organization; and financial statement users were asked to indicate the position they believed should exist in respect of audit committees.

Table 1: Groups included in the survey and their response rates

Survey Group	No. of respondents in Survey	No. of usable responses	% usable responses
External Auditors			
CA Firms	30	22	73
Audit Directorate, Govt. of Bangladesh	20	19	95
Total	50	41	82
Internal Auditors			
Private sector entities	25	21	84
Public sector entities	25	20	80
Total	50	41	82
Financial Statement Users			
Stockbrokers	20	12	60
Bankers	20	15	70
Total	40	26	65
Combined Totals	120	108	90

Findings regarding the existence of audit committees in the private and public sector were derived from the responses of the internal auditors. While this may have resulted in a conservative estimate of the prevalence of audit committees, it is unlikely to have had any effect on comparisons of audit committees in the private and public sectors. External auditors' responses were excluded from this analysis because of the inability to determine the degree of overlap between entities they had audited and those represented by the internal auditors. While this may have resulted in a conservative estimate of the prevalence of audit committees, it is unlikely to have had any effect on comparisons of audit committees in the private and public sectors.

Survey Results

(a) Existence of, and Reasons for Establishing or not Establishing Audit Committees

At the time of the survey (mid-2009), approximately 65% of private companies and significant public sector entities in Bangladesh had audit committees (see Table 2). The proportion was slightly higher in the private than public sector (64% compared to 63%) but the difference was not significant.

Table 2: Existence of, and reasons for establishing or not establishing audit committees

	Board Survey Groups[1]			
		Internal Auditors		
No. of respondents in survey group:	External Auditors (41)	Private Sector Responds (21)	Public Sector Responds (20)	Financial Statement Users (26)
Existence of audit committees	%[2]	%[2]	%[2]	%[2]
Respondents from (or who have audited) entities with an audit committee	67	64	63	N/A
Plan to establish audit committee in next 12 months	70	31	39	N/A
Reasons for establishing audit committees	%[3]	%[3]	%[3]	%[3]
Regarded as good corporate practice	84	91	87	91
To facilitate effective examination of external financial reports	93	82	77	66
To facilitate examination of entity's internal controls	92	94	91	68
To strengthen independence of internal auditors	47	76	72	58
To strengthen role and independence of non-executive directors	59	46	22	65
To monitor compliance with entity's code of conduct	34	57	52	49
To strengthen independence of external auditors	42	46	34	36
To reduce directors' legal liability	21	18	10	N/A
To comply with requirements of overseas Stock Exchange or other regulator	8	15	8	N/A
Reasons for not establishing audit committees	%[3]	%[3]	%[3]	%[3]
Governing body fulfils duties an audit committee would perform	75	48	39	N/A
Audit committee is not needed as entity has no internal audit function	47	21	17	N/A
Costs of an audit committee would outweigh its benefit	64	28	26	N/A
Corporate culture is not ready for an audit committee	52	11	11	N/A
Insufficient suitable non-executive directives available to form an audit committee	31	17	3	N/A

[1] Respondents were asked to complete the questionnaire as follows:
- Internal auditors – based on the existing situation in their organization.
- Financial statement users – based on their opinions as to the position which should exist.

[2] Percentage of respondents in the survey group responding to the question

[3] Percentage of the survey group signifying the reason is important in an entity's decision to establish or not establish an audit committee.

N/A signifies the survey group was not asked this question

Regarding the reasons for establishing audit committees, more than 65% of each of the broad survey groups signified that important reasons were:

- having an audit committee is regarded as good corporate practice;
- audit committees are able to facilitate effective examination of external financial reports and the entity's internal controls.

Although these reasons were supported strongly by all of the groups, their ranking differed, reflecting each group's perspective. While the corporate financial statement users identified 'recognition as good corporate practice' as a particularly important reason, the internal (both private and public) auditors gave greater support to 'facilitating effective examination of internal controls' and, in the case of the external auditors, 'facilitating effective examination of external financial reports'. The internal auditors also recognized as somewhat important the ability of audit committees to strengthen the independence of internal auditors, identified as important by 76% in case of private and 72% in case of public, compared with 58% of financial statement users, and 47% of external auditors. Of greater significance to all of the groups except the internal auditors is the ability of audit committees to strengthen the role and independence of non-executive directors: 59% of external auditors and 65% of financial statement users identified this as an important reason. Somewhat unexpectedly—given the former role of audit committees in strengthening the external audit function—none of the groups identified as a particularly important reason for establishing audit committees, strengthening the independence of external auditors.

The reasons identified by respondents for establishing audit committees in private, compared with public, sector entities are broadly similar. However, some marked differences are evident. For example, a significantly greater proportion of private than public sector respondents identified strengthening the role and independence of non-executive directors as an important reason for establishing audit committees (46% compared to 22%). Given the traditional absence of non-executives on the governing bodies of public sector entities and the youthfulness of these entities' audit committees (which generally include non-executives), the disparity in the sector group responses is not difficult to understand.

Similarly, differences between private and public sector responses regarding the importance of (i) strengthening the independence of external auditors (46% of private sector responses compared with 34% from the public sector), (ii) reducing directors' legal liability (18% compared to 10%), and (iii) complying with requirements of an overseas stock exchange or other regulator (15% compared to 8%), as reasons for establishing audit committees, reflect historical differences between the two sectors.

As far as the reasons for *not* establishing audit committees are concerned, the survey groups whose views were sought identified as important the fact that the full governing body fulfils the functions normally assigned to an audit committee to be established. Notable features of the reasons for not establishing audit committees are the small percentage of internal auditors identifying any of the reasons as important and the disparity in the responses of the survey groups. For example, while 52% of the external auditors recognized as important the corporate culture not being ready for an audit committee, only 11% of the internal (both private and public) auditors did so. Similarly, 64% of the external auditors identified as an important reason the costs of an audit committee outweighing the benefits, but only 28% of private internal auditors and only 26% of public internal auditors concurred with this view.

(*b*) *Perceived Advantages and Disadvantages of Audit Committees*

As part of the survey, respondents were asked to signify (on a five point scale) their agreement or disagreement with a series of statements which enshrined arguments advanced in the literature in support of, and against, audit committees. The means of the survey group responses are presented in Table 3.

The closer the means are to 5.0, the greater the agreement of the group with the relevant statement: the closer they are to 1.0, the more strongly the group disagreed with the statement.

Table 3: Perceived advantages and disadvantages of audit committees

	Board Survey Groups			
		Internal Auditors		
No. of respondents in survey group:	External Auditors (41)	Private Sector Responds (21)	Public Sector Responds (20)	Financial Statement Users (26)
Advantages of audit committees. *They:*	*Mean* [1]	*Mean* [1]	*Mean* [1]	*Mean* [1]
Assist internal and external auditors report to the entity's governing body:				
- serious deficiencies in internal controls	4.1	3.9	3.9	3.8
- serious management weakness	4.1	3.9	3.8	3.7
Assist the governing body discharge:				
- its external financial reporting duties	4.0	3.9	3.7	3.9
- its responsibilities concerning fraud and other illegal acts	3.4	3.6	3.6	3.5
Improve communication between the governing body and				
- external auditors	4.3	4.1	3.8	3.8
- internal auditors	3.9	3.8	3.8	3.8
Strengthen role and effectiveness of non-executive directors	3.9	3.7	3.6	3.6
Increase the confidence of financial statement users concerning the reliability of the financial statements	2.9	3.4	3.3	3.4
Enhance the independence of:				
- internal auditors	3.6	4.0	3.8	3.4
- external auditors	3.2	3.5	3.3	3.0
Disadvantages of audit committees. *They:*				
Are merely an additional layer of bureaucracy	1.8	1.9	2.1	2.3
Create a barrier between the entity's governing body and external auditors	2.4	2.3	2.4	N/A
Can create conflict within an entity	2.4	2.5	2.6	N/A
If financial statement users know an entity having an audit committee:				% agreeing
- It increases their confidence concerning the reliability of the financial statements	N/A	N/A	N/A	81
- It affects their assessment of the entity	N/A	N/A	N/A	47

[1] Means from 1.0 to 2.9 signify some level of disagreement with the statement;
Means from 3.1 to 5.0 signify some level of agreement with the statement.
N/A signifies the survey group was not asked this question

From Table 3 it can be seen that the opinions of the survey groups are very similar and that, in general, the respondents are very supportive of audit committees. Agreement is particularly strong in relation to the statements that audit committees:

- assist internal and external auditors report to the entity's governing body serious deficiencies in internal controls and serious management weaknesses;
- assist the entity's governing body discharge its external financial reporting duties and its responsibilities concerning fraud and other illegal acts;
- improve communication between the entity's governing body and its external and internal auditors;
- strengthen the role and effectiveness of nonexecutive directors.

By contrast, respondents disagreed strongly with the declaration that audit committees:

- are merely an additional layer of bureaucracy;
- create a barrier between the entity's governing body and external auditors.

There were no significant differences of opinion between respondents in the private and public sectors. Respondents' support for audit committees is also reflected in the fact that 81% of the financial statement users reported that if they know an entity has an audit committee, it increases their confidence in the reliability of the entity's financial statements.

Conclusion

Experience in Canada, the US, the UK and Australia suggests that, faced by unexpected corporate failures and instances of corporate malpractice, the attention of regulators, relevant professional bodies, and significant players in the corporate arena focuses on audit committees as a means of reducing corporate ills. Once these committees begin to be established, awareness of their potential for securing reliable financial reports and responsible corporate governance grows quickly and their adoption proceeds rapidly.

Bangladesh experienced a significant increase in unexpected company failures, often accompanied by reports of corporate malpractice. In 2006, Securities and Exchange Commission introduced a requirement for the CEO and CFO of companies listed with any stock exchange in Bangladesh to acknowledge in their entity's external financial statements their responsibility for those statements and for ensuring that their entity has an effective system of internal control. Given this background, it could be expected that audit committees would be established rapidly in significant private and public sector entities in Bangladesh. The results of this study provide evidence to support this expectation.

This study surveyed financial statement users and made it clear that the benefits derived from having the audit committees would ultimately result in the attainment of reliability of annual financial reports. The public would be more confident of the company, knowing that there exists a party in the organization, comprising independent directors to play the much-needed role of providing an additional check on the information provided by management and ensuring that the auditors-both external and internal-are still independent of management to the highest level possible. From this study, it is also clear that audit committee is not truly responsible for any particular statement/figure of a financial report. Rather, a well-developed audit committee serves to ensure that everyone responsible for the financial matters of the company fulfills their duties and responsibilities. The audit committee assists the board of directors with its financial management responsibilities by serving as a liaison among the internal and external auditors, management, and the board. In consultation with management and the external auditors, the audit committee filters out those financial reporting and internal control issues that do not require the full board's attention, and prioritizes those issues that decrease so. This enables the board to deal efficiently with issues that do require its full and urgent attention, and to avoid those that are less important in financial and operating matters.

This study has examined merits and demerits of having corporate audit committees based on some interested groups' opinions. The main advantages of corporate audit committees include improving communication between the entity's governing body and its external and internal auditors, and strengthening the role and effectiveness of nonexecutive directors. By contrast, this paper also provides some evidence in favour of respondents' disagreement with the demerits of corporate audit committees. Given the opinions from different interested groups, a much higher level of attention needs to be given to the corporate audit committees being prioritized.

This paper suggests that the audit committee should have an important function as an area within which displays of independence may take place. The Committee should assist the Board of Directors in ensuring that the financial statements reflect true and fair view of the state of affairs of the company and in ensuring a good monitoring and signalling system within the business before a financial disaster really occurs.

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