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Audit Committee: A Summary of the Findings of Some Existing Literature

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Abstract: *This paper attempts to provide a summary of findings of the fast-growing theoretical and empirical literature on audit committee mainly basing on several available articles. Particular emphasis was given on the issues like the conflicts arising from the relationship between managers and shareholders, earnings management, formation of audit committee, auditors' independence and quality of financial reporting and their relationship with audit committee. The study also aims at exploring the key success factors in the introduction and implementation of audit committees in the corporate world.*

Keywords: *Audit committee, Agency theory, Earnings management, Independent directors, Auditors' independence, Quality of financial reporting.*

Introduction

The huge accounting scandals by so many renowned companies (like Enron, Global Crossing, WorldCom, Adelphia) in the world have made the issue of corporate governance even more important these days than it was before. According to Pound (1995), "Corporate governance is not, at its core, about power, it is about finding ways to ensure that decisions are made more effectively." Cadbury Report (1992) says, corporate governance is the system by which companies are directed and controlled. Actually it is the system within which directors and managers operate the organization with an objective of enhancing the shareholder's value. Good corporate governance can ensure the optimization of the benefits drawn from the agency relationship between shareholders and corporate managers. Agency theory deals with the contractual relationship between at least two parties of which one is called the principal who engages the other party called agent to perform some services for them. According to Jensen and Meckling (1976) an agency relationship is ".. a contract under which one or more (principals) engage another person (the agent) to perform some service on their behalf delegating some decision making authority to the agent." In corporate world, the shareholders appear as principals who delegate the function of day-to-day decision making to their agents who are called managers and these managers are accountable to the shareholders for the proper utilization of economic resources of the firm. As all human beings try to act for their own interest, managers of the companies also try to do that. As a result of trying to fulfill their own interest, the managers

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may not work for the best interest of the shareholders. The concept of adverse selection and moral hazard are liable for that. That is why the agents should be always monitored by the principals and this monitoring is mainly done through scrutinizing annual accounts of the company. But it is also true that as annual accounts are prepared by the managers themselves, there remains a huge chance of manipulation in the accounts. To remove this difficulty, another party, the independent auditors, are employed. Auditors work as watch dogs and after scrutinizing the annual accounts they give reasonable assurance through their opinion to the stakeholders that the accounts give a true and fair view. Even then, there remains a chance of impairment of auditors' independence. If auditors' independence is impaired, there arises a chance that true and fair annual accounts will not reach to the hands of the shareholders. Thus the shareholders or the principals will not get the total picture whether their economic resources were utilized in the best way by the mangers (or their agents). As a result, proper corporate governance will not be ensured.

It is said that to ensure corporate governance, the effectiveness of the Board of Directors and particularly of the non-executive Directors is to be enhanced by establishment of appropriate board sub-committees. Fama and Jensen (1983) proposed that non-executive directors can act as arbiters in disagreements among internal managers and carry out tasks that involve serious agency problems between internal managers and residual claimants.

Audit committee is one of the sub-committees of the board. An audit committee, which is mainly comprised of non-executive directors, can be said as an effective tool to ensure corporate governance in an organization. An audit committee can be defined as a sub-committee in the Governing Body (Board of Directors) that makes arrangements for the audit and also as a sub-committee of the Board, this committee tries to enhance the ability of the Board to fulfill its legal responsibilities and ensure the credibility and objectivity of the financial reports. Accountants International Study Group (1977) defined audit committee in a detailed way: "A committee of directors of a corporation whose specific responsibility is to review the annual financial statements before submission to the board of directors. The committee generally acts as a liaison between the auditor and the board of directors and its activities may include the review of nomination of auditors, overall scope of the audit, results of the audit, internal financial controls and financial information for publication." Companies establish an audit committee within the Board of Directors to take active role in overseeing the company's accounting and financial reporting policies and practices (Whittington and Pany, 2001). An audit committee must be composed with a majority of independent/ non-executive directors who are neither officers nor employees of the company. This committee should represent the owners and not the management. Actually, most of the directors who are the parts of the audit committee should be *Outside Directors* who have no other relationship that may impair their independence (Whittington and Pany, 2001). The major dealings between the independent auditors and the governing body should be done through the audit committee. That means, this committee acts as a communication link among management, auditors and the governing body. This committee will try to ensure that auditor's independence is not hampered.

Objectives and Methodology

This paper attempts to provide a summary of the findings of the fast-growing theoretical and empirical literature on audit committee. This was done through an extensive search on the published books and articles from academic and professional journals. Some articles were collected through searching in the World Wide Web. The amount of research on audit committees has increased dramatically during the last decade. An innumerable amount of researches were done on this topic. As a result, a survey of recent work is a daunting task – and not the purpose of this article. Rather, the objective of this paper is to present a broad overview of the issues and recent work in the area, and place each of the papers talking about a specific issue under one heading. We have surely omitted reference to a number of noteworthy papers – to those authors, we apologize.

Particular emphasis was given on the issues like the conflicts arising from the relationship between managers and shareholders, earnings management, formation of audit committee, auditors' independence and quality of financial reporting and the relationship of all these issues with audit committee. The study also aims at exploring the key success factors in the introduction and implementation of audit committees in the corporate world. At the end of the article, the scenarios of this issue in Bangladesh and India were discussed.

Historical Background: the USA Scenario

In the western world, the concept of audit committee is not new anymore. In the USA, three prominent bodies the New York Stock Exchange (NYSE), the Securities and Exchange Commission (SEC) and the American Institute of Certified Public Accountants (AICPA) contributed a lot in the introduction and implementation of audit committees.

In 1939, NYSE asked its member firms to use audit committees when practicable. Audit committees were proposed by the SEC in 1940 but it was not until 1960 that any progress was made (Goddard and Masters, 2000). In 1947, AICPA informally endorsed the audit committee in the editorial of Journal of Accountancy (Carey, 1947). On July, 1967, the AICPA Executive Committee's Statement suggested that the publicly-owned corporations can appoint an audit committee which is composed of outside directors and this committee can nominate independent auditors and discuss the auditors' work with them (Vanasco,1994). In 1972, SEC formally endorsed the establishment of audit committees for all publicly traded companies (US Securities and Exchange Commission, 1972). In the same year, the SEC made a requirement that corporations disclose to the shareholders whether they had an audit committee (SEC, 1972). In 1973, the NYSE, in a White Paper stated that they first introduced the concept of audit committee in 1940 and this concept got a subsequent support from SEC and AICPA (New York Stock Exchange (1973). After that in 1974, the NYSE strongly asserted that a vigorous audit committee can stimulate improvements in financial reporting and controls and strengthen the credibility of corporate reports (Vanasco, 1994). In the month of January, 1977, the NYSE adopted an Audit Committee Policy Statement in which they asked all the domestic companies to establish audit committees (Comprised solely of directors independent of management) within 30th June, 1978 as a condition of listing and continued listing of their securities in the NYSE (Vanasco,1994). In April, 1977 (Vanasco,1994), in a case called SEC Vs. Killearn Properties Inc., a US district court judge declared judgment as:

1. The majority of the Board of Directors are not to be employees of Killearn;
2. The Board maintain an audit committee of outside Directors;
3. The audit committee becomes involved in internal control and improvements suggested both by independent auditor and internal staff.

On July, 1978, SEC proposed rules for three standing corporate committees and they are, nominating committee, compensation committee and audit committee with independent members and SEC also set forth eight functions of audit committee (SEC, 1978) and these functions are:

1. Recommend engagement or discharge of the independent auditors;
2. Direct and supervise investigations into matters within the scope of its duties;
3. Review with the independent auditors the plan and results of the audit engagement;
4. Review the scope and results of internal auditing activities;
5. Approve each professional service provided by the independent auditors to its performance;
6. Review the independence of the independent auditors;
7. Consider the range of non-audit fees;
8. Review the adequacy of the system of internal control.

In 1978, the concept of audit committee was endorsed by the American Bar Association (ABA) and they made specific recommendations regarding primary and other responsibilities for potential legal liabilities of the audit committees (Vanasco, 1994).

The Special Committee on Audit Committees of AICPA, in 1979, suggested some general functions of audit committee and encouraged the public companies to establish audit committees (AICPA, 1979). The functions suggested by them were:

1. Approve the selection of individual auditor.
2. Review the arrangement and scope of audit.
3. Consider the comments from independent auditor with respect to weaknesses in internal control and the consideration given or corrective actions taken by management.
4. Discuss matters of concern to the audit committee, the auditor or management relating to the company's financial statement or other results of the audit.
5. Review the internal accounting controls with the company's financial and accounting staffs.
6. Review the activities and recommendations of the company's internal auditor.

The National Commission on Fraudulent Fin ancial Reporting (Chaired by J.C. Treadway Jr. a former SEC Commissioner), in 1987, in the Treadway Report gave some recommendations for enhancing the effectiveness of audit committee (Treadway, 1987):

1. The audit committee should have adequate resources and authority to discharge their responsibilities.
2. Audit committee should be informed, vigilant and effective overseers of 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 audit 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 plans 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 public accountant.
11. Annually, the audit committee should review the program that management establishes to monitor compliance with the company's code of ethics.

Though now it is told that because of Treadway report the issue of audit committee became a keystone of corporate financial governance (Metz, 1993), in 1989, in a study on annual reports of 100 companies, it was found that only 7 of them presented a separate audit committee report (Kinzele, 1991). But in another study (Bull, 1991) on 13 Illinois corporations it was found that most board of directors were either already following or implementing the Treadway Commission's recommendations to establish an audit committee and most of the Audit Committee Chairpersons found the recommendations of Treadway report had positive impact on corporate reporting and internal control. After Treadway report in 1992, the Committee of Sponsoring Organizations (COSO) of Treadway Commission issued a report in which they restated the importance of the internal audit function and its relationship to the audit committee.

In 1992, the American Law Institute (ALI) suggested to mandate large publicly held corporations (those with 2000 or more holders of equity securities and $100 million or more total assets) to establish audit committees which should comprise at least three members who are not employed by the company (ALI, 1992). The Public Oversight Board (POB) of the SEC Practice Section of the AICPA (1993) recommended that audit commit tees should assume responsibilities related to an SEC registrant's preparation of annual financial statements such as:

1. Review the annual financial statement;
2. Confer with management and the independent auditor about them;
3. Receive from the independent auditor all information that the auditor is required to communicate under auditing standards;
4. Assess whether financial statements are complete and consistent with information known to them;
5. Assess whether the financial statements reflect appropriate accounting principles.

In 1993, in a statement called "Meeting the Financial Reporting Needs for the Future," the AICPA recommended that (AICPA, 1993):

1. Audit committees be composed entirely of independent directors, and
2. Audit committees describe their responsibilities, including how they have been carried out.

Now, in the USA, audit committees are required by the New York Stock Exchange, the American Stock Exchange and NASDAQ. The New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD) cosponsored the Blue Ribbon Committee (BRC) to give recommendations for improving the effectiveness of audit committees (Blue Ribbon Committee, 1999). BRC and NASD both recommend that audit committees are likely to be more effective in protecting the credibility of the firm's financial reporting if committee members are independent of management. The BRC mainly put forward ten detailed recommendations for improving the audit committee effectiveness. Some of the important recommendations among all these are: audit committee should have at least three members and the members should be independent of the directors, and at least one of members of the audit committee should be expert in accounting or financial management. The NYSE and NASDAQ adopted these recommendations in late 1999. Later in 2002, The Sarbanes-Oxley Act also supported these points. The Blue Ribbon Committee concluded as follows:

1. Quality financial reporting can only be achieved through open and candid communication and close working relationship among the corporation's board of directors, audit committee, management, internal auditors, and external auditors.
2. Strengthening corporate governance oversight in financial reporting process of publicly traded companies will reduce instances of financial frauds.
3. Integrity, quality and transparency of financial reports improve investors' confidence in capital market while incidents of financial statement fraud diminish such confidence.

The Sarbanes-Oxley Act (2002) was an attempt to regain confidence and trust in corporate America and the accounting profession. This Act addressed the corporate scandals and the disaster in audit profession. Some of the provisions of this Act suggests about the audit committee oversight function over corporate governance, financial reporting, internal control structure, internal audit functions, and external audit services (Rezaee, Olibe and Minmier, 2003).

The UK Scenario

On the issue of the audit committee, in the UK, there is a preference for recommendation rather than regulation (Goddard and Masters, 2000). But audit committee is not a recent phenomenon in the UK. Ticker (1978) identified a copy of the report of the Great Railway's audit committee dated 1872 and it was also found that the activities of that committee is much similar to that of today's audit committees. In 1977, the UK Companies Bill proposed the public companies to have audit committees with non-executive directors and this committee should be consulted on major issues related to internal control (Vanasco, 1994). The adoption of audit committees in the UK did not begin until the late 1980s. At that time the audit committee issue got a tremendous support from several bodies like CBI, Bank of England, ProNed and at the beginning of 1990s, from the Auditing Practices Board. A group named Promotion of Non-Executive Directors (ProNed) was formed in 1987. The main purpose of this group was to form a new code of practices for the directors. This group, in 1987, recommended that the public companies should form audit committees with non-executive directors and these people should be consulted for major auditing issues (Vanasco, 1994). It is the publication of the Cadbury Report (in December, 1992) which gave the issue of audit committee a real boost in the UK. The Cadbury Code states that the board should establish an audit committee of at least three non-executive directors with written terms of reference which deal clearly with its authorities and duties. The Cadbury Committee recommends that the audit committee should meet privately with the external auditors at least annually without the presence of members of management. The report recommended some specific responsibilities for the audit committee:

1. Make recommendations to the board on the appointment of the external auditors, the audit fee and any question of resignation and dismissal.
2. Review annual financial statements;
3. Discuss with the external auditors about the nature and scope of audit;
4. Review the external auditor's management report;
5. Review the company's statement on internal control;
6. Review of any significant findings of internal investigations;
7. Review the internal audit program.

Today Cadbury report is worldwide recognized as a significant work on corporate governance after the Treadway Report.

Audit committee and selection of auditors

Pearson and Ryans (1982) found that since management was apprehensive of participating in selecting the auditors, specifying their fees and determining the audit arrangements, they generally welcomed the committee's involvement with the external auditors. Lynn (1985) found that audit fees often were no longer an important criterion in the auditor selection process. No significant differences were found in regards to fees between audit committee and non-audit committee companies. Lynn also found that respondent from audit committee entities focused more on prestige and size of the audit firm than did non-audit committee companies. Schroeder et al (1986) after surveying audit committee chairs found only a slight relationship between professional fees and perceived audit quality and thus any competitive pricing advantage once enjoyed by smaller firms has eroded. Kunitake (1983) surveyed 607 companies mostly listed in AMEX and found that companies with audit committees do not appear to change auditors any more or less frequently than do companies without audit committees. But, he noted that "audit committees usually include outside directors who may be exposed to the larger, well known CPA firms than to local or regional firms through their involvement as officers and directors of other public corporations which employ largest CPA firms." Again, Eicheneher and Shields (1985) in a study of AMEX companies identified a slightly more significant relationship between companies with audit committees and shifts to big-eight firms. As they found slight real switching, and they stressed such factors as company size, degree of financial leverage and whether company operates in a regulated industry as some other significant factors of auditor switching. Reinstein and Weirich (1996) did a study on 247 NYSE firms and found that significant relationship (at the 0.05 level of significance) was there between CPA firms selected by audit committees and by the CPA firms which audits the audit committee member's own organization. The results of this study indicate that audit committee members exhibit conscious or unconscious biases in their selection or retention of their company auditors.

Audit committee, auditor's independence, quality of audit and auditor's report

In a survey of 731 CPAs done by Dockweiler et al (1986), a moderate support was found from the respondents that audit committees enhanced their auditing independence and improved the effectiveness of their audit. But the respondents were neutral about the question whether audit committees have led to more competitive bidding or increased audit turnover. Knapp (1987), after surveying 179 audit committee members found that in audit disputes the audit committee tries to support the auditors rather than the management. Monroe et al (1994) found a signinficant difference between the proportion of companies with an audit committee receiving a qualified audit report and those without audit committees. Collier and Gregory (1996) found that audit committees are associated with higher size related audit fees but there was only weak evidence that audit committees affect complexity related audit fees and no evidence that audit committees affect risk-related audit fee. DeZoort et al. (2003) find that audit committee always supports the auditor in case of management-auditor disagreement regarding materiality justification and the precision of accounting issue. Abbott and Parker (2000) argue that independent and active audit committee members demand a high level of audit quality because of concerns about monetary or reputational losses that may result from lawsuits or SEC sanction. Audit committee can play a major role in improving interim financial reporting. George (2003) surveyed audit committee members at 50 NYSE companies, and found that most members depend upon management and outside auditors for information. They do not think that financial reporting is poor quality until something goes wrong and is discovered by outsiders, with bad news in the press. If this doesn't occur, the issue of financial reporting quality was not discussed by audit committees. The survey showed that audit committees' main concern is that even with their best efforts, they cannot prevent fraudulent financial reporting if management overrides internal controls and GAAP. Audit committee is supposed to have an impact on the quality of audit. Considering the audit fees as a proxy of audit quality Sullivan (1999) finds that formation of audit committee has a significant positive impact on audit fees. Sometimes CEO duality can reduce the activity of audit committee and hence can affect the quality of the audit. Collier and Gregory (1999), find that audit committee activity is reduced in firms that combine the role of chairman and chief executive. Their presence on an audit committee had a significant negative impact on audit committee activity.

Competence of audit committee members

Because of their responsibility for overseeing internal control and financial reporting, good governance dictates that audit committee members should possess a certain level of competencies. Thus Blue Ribbon Committee (1999, p.25) recommends that each member of the audit committee should be financially literate and that at least one member should have accounting or related financial management expertise, where expertise is defined as "past employment experience in finance or accounting or nay other comparable experience or background which results in the individual's financial sophistication, including being or having been a CEO or other senior officer with financial oversight responsibilities." The study by McMullen and Randghun (1996) supports this recommendation which finds that firms subject to SEC enforcemet actions or restating their quarterly reports are less likely to have CPAs on their audit committee. Using an experimental case, DeZoort and Salterio (2001) find that accounting expertise of audit committee members as well as their knowledge of auditing are positively with the likelihood that they will support the auditor in an auditor-corporate management dispute. So the recommended best practices and research findings suggest that audit committee should be formed with those persons who have financial competence. Pomeranz (1997) argues that the qualifications of committee members should follow logically from their responsibilities. These include assessments of corporate ethical environment, issues of regulatory compliance, and reviews of implementation of information systems. Mangena and Pike (2004) in a study in the context of UK find that quality of interim financial reporting increases due to the existence of audit committee. They also find a positive relationship between financial expertise of the audit committee and the quality of interim financial reporting. However, they did not find any relationship between size of audit committee and quality of the interim report.

Audit Committee independence and Financial Reporting

Independence is considered as an essential quality for an audit committee to fulfill its oversight role. The proportion of independent external directors on the audit committee is positively associated with the probability of the auditor issuing a going concern report for a firm experiencing financial distress (Carcello and Neal, 2000), negatively associated with the probability of litigation against the external auditor (Park, 1999) and negatively associated with the probability of SEC enforcement action (Wright, 1996). According to Blue Ribbon Committee (1999, p.22) "several recent studies have produced a correlation between audit committee independence and two desirable outcomes: a higher degree of active oversight and a lower incidence of financial statement fraud." The National Commission of Fraudulent and

Financial Reporting (1987) suggests that audit committee must be entirely composed of non-executive members to be effective. Sometimes the board of directors may choose non-executive audit committee members who have an affiliation or business ties with client firms and are less likely to be effective monitors. The Blue Ribbon Committee (1999) recommends that the audit committee should be comprised only of directors who have no relationship to the corporation that may interfere with their independence. Some researchers believe that a totally independent board may be best suited to perform the essential functions of corporate governance (Firstenberg and Malkiel, 1994). Beasley (1996) shows that the percentage of outside directors on the audit committee is lower for organizations that committed financial statement fraud. Beasley et al (2000) investigated fraudulent financial reporting in technology, health care and financial services industries and found that in all these industries firms committing fraud have less independent audit committees and boards than do other firms. Abbott, Parker and Peters (2002) identified that financial misstatements are less likely to occur in firms with audit committees that are independent and that have a financial expert.

Audit committee and earnings management

Most of the recent corporate collapses are the outcomes of earnings management. An audit committee that is interested in good quality financial reporting must curtail earnings management. DeFond and Jiambalvo (1991) found overstatement of earnings in financial statements are less likely among firms that have audit committee. Wild (1994) investigated the relationship between companies' earning reports and stock returns before and after the formation of audit committee and identified that earnings are significantly more informative after the formation of audit committee. It is said that the audit committees are expected to monitor managers' tendencies to manipulate earnings numbers (Klein, 2002a). Klein (2002b), by using data from 1991 to 1993, identified a negative relationship between abnormal accruals and both audit committee and board independence. Blue Ribbon Committee recommendation indicates that a lower level of earnings management is associated with greater independent outside representation on the board. Xie et al (2001) found that board and audit committee activity and their members' financial sophistication may be important factors in constraining the propensity of managers to engage in earnings management. An active and financially oriented board and audit committee may influence the level of earnings management, but the level of earnings management may influence the subsequent selection of board and audit committee members. Audit committee plays vital role in the future corporate governance, especially in preventing management fraud and improper revenue / expense recognition. Huang and Liu (2005) find that that a strong audit committee should be able to reduce investors' perception of the risks of company's fraudulent financial reporting, then resulting in a less likelihood of company litigation.

Effectiveness of Audit committee

Pomeranz (1997) states that "Audit committees have been around for many years, and have aroused high expectations. Yet, very little is known about the actual effectiveness of these committees." Kalbers (1992) found that the importance of audit committee in financial reporting process varies among companies. Audit committee members rated themselves as effective but auditors rated them significantly lower. Kalbers and Fogarty (1993) says that researches on audit committee effectiveness have been limited and whether the committees are actually discharging their important responsibilities effectively remains insufficiently understood. Commentators on Cadbury have expressed doubt about the effectiveness of operations (Corrin, 1993) and Cadbury (Cadbury, 1992, appendix 4) itself included caveats relating to possible limitation of its effectiveness. US commentators have observed that the existence of audit committee might not guarantee its effectiveness (Sommer, 1991). The academic literature on audit committees forms a sub set of wider corporate governance literature, which has focused principally on the role of characteristics of the board of directors and shares similar characteristics. Characteristics were identified as contributing to effectiveness include independence (Cobb, 1993), length of tenure (Spangler and Braiotta, 1990), frequency of meeting (Menon and Williams, 1994), employment background (Kalbers and Fogarty, 1993), gender balance (Bilimoria and Piderit, 1994) and member skills (Lee and Stone, 1994). Although these studies focus on key areas that affect performance, the purpose of the audit committee is not clearly defined. Pomeranz (1992) says that an audit committee should make use of an executive information system which could provide access to reports on tests of internal control, and status of information such as the activities of internal audit department, including the resolution of audit findings.

Audit Committee: Indian Context

In order to enhance the corporate governance situation Indian Companies (Amendment) Act, 2000 has introduced a new section 292A with the concept of 'Audit Committee'. Some of the important points highlighted in this section are as follows (Kuchhal, 2001):

1. Every public company having a paid up capital of Rs. 5 crores or more shall constitute a committee of the Board of Directors known as "Audit Committee".
2. The committee shall consist of at least three directors of which at least at least 2/3rds shall be non-executive directors (directors other than managing or whole-time directors).
3. The members of the committee shall elect a chairman for themselves.
4. The composition of the committee shall be disclosed in the 'Annual Report' of the company.
5. The audit committee shall have discussions with auditors periodically about internal control systems, the scope of audit including auditor's observations, and review the half yearly annual financial statements before submission to the Board and also ensure compliance of internal control systems.
6. The recommendations of the committee relating to financial management including the audit report shall be binding on the Board of Directors.

Audit Committee: Bangladeshi Context

As audit committee is a new concept in the corporate world of Bangladesh, much research articles are not written yet in Bangladeshi context. Hossain and Amin (2004) found that though the concept of audit committee is very new in Bangladesh the information on audit committee is disclosed by some of the listed companies of Bangladesh in their annual reports.

Requirements of SEC

In Bangladesh the guidelines to keep an audit committee is given by Securities and Exchange Commission (SEC). SEC Notification No. SEC/CMRRCD/2006-158/Admin/02-08, Dated the 20th February, 2006 discussed several guidelines related to audit committees in several ways. This notification suggested that a company should have an Audit Committee as a sub-committee of the Board of Directors. The Audit 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 system within the business. The Audit Committee shall be responsible to the Board of Directors. The duties of the Audit Committee should be clearly set forth in writing.

Constitution of Audit Committee

According to constitution, the SEC suggested the followings:

(i) The Audit Committee should be composed of at least 3 (three) members.

(ii) The Board of Directors should appoint members of the Audit Committee who should be directors of the company and should include at least one independent director.

(iii) When the term of service of the Committee members expires or there is any circumstance causing any Committee member to be unable to hold office until expiration of the term of service, thus making the number of the Committee members to be lower than the prescribed number of 3 (three) persons, the Board of Directors should appoint the new Committee member(s) to fill up the vacancy(ies) immediately or not later than 1 (one) month from the date of vacancy(ies) in the Committee to ensure continuity of the performance of work of the Audit Committee.

Chairman of the Audit Committee

The SEC suggested the followings in relation to the chairman of the audit committee:

(i) The Board of Directors should select 1 (one) member of the Audit Committee to be Chairman of the Audit Committee.

(ii) The Chairman of the audit committee should have a professional qualification or knowledge, understanding and experience in accounting or finance.

Reporting of the Audit Committee

The reporting on audit committee matters is suggested in the following threefold ways:

A. Reporting to the Board of Directors: The Audit Committee should report on its activities to the Board of Directors. The Audit Committee should immediately report to the Board of Directors on the following findings, if any:

1. Report on conflicts of interests;
2. Suspected or presumed fraud or irregularity or material defect in the internal control system;
3. Suspected infringement of laws, including securities related laws, rules and regulations; and
4. Any other matter which should be disclosed to the Board of Directors immediately.

B. Reporting to the Authorities: If the Audit Committee has reported to the Board of Directors about anything which has material impact on the financial condition and results of operation and has discussed with the Board of Directors and the management that any rectification is necessary and if the Audit Committee finds that such rectification has been unreasonably ignored, the Audit Committee should report such finding to the Commission, upon reporting of such matters to the Board of Directors for three times or completion of a period of 9 (nine) months from the date of first reporting to the Board of Directors, whichever is earlier.

C. Reporting to the Shareholders and General Investors: Report on activities carried out by the Audit Committee, including any report made to the Board of Directors during the year, should be signed by the Chairman of the Audit Committee and disclosed in the annual report of the issuer company.

Requirements for Banking Companies

In Bangladesh, for the banking companies, The BRPD Circular No. 12 Dated December 23, 2002 titled "Constitution of the Audit Committee of Board of Directors" issued by Bangladesh Bank includes the following rules and guidelines for audit committees of banks:

Audit Committee of the Board of a bank can play an effective role in providing a bridge between the board and management, shareholders, depositors and stake-holders and help in ensuring efficient, safe and sound banking practices. Role of the audit committee is also important in evolving an effective procedure for financial reporting disclosure, developing a suitable internal control system and maintaining liaison with internal and external auditors to minimize various business risks. Moreover, new business opportunities and increased competition due to globalization of markets, increased use of electronics and information technology, increased complexity of transactions, accounting standards and regulatory requirements are contributing to essentiality and expansion of the role of audit committee. Under the above circumstances, as part of the best practices, banks are advised to constitute Board's Audit Committee and the following regulations are being issued by Bangladesh Bank for compliance by the banks:

Overall Purpose/Objectives: The audit committee will assist the board in fulfilling its oversight responsibilities including implementation of the objectives, strategies and overall business plans set by the board for effective functioning of the bank. The committee will review the financial reporting process, the system of internal control and management of financial risks, the audit process, and the bank's process for monitoring compliance with laws and regulations and its own code of business conduct. The roles and responsibilities of bank audit committees are suggested as follows:

1. Internal control:

a. Evaluate whether management is setting the appropriate compliance culture by communicating the importance of internal control and the management of risk and ensuring that all employees have understanding of their roles and responsibilities;

b. Review the arrangements made by the management for building a suitable Management Information System (MIS) including computerization system and its applications;

c. Consider whether internal control strategies recommended by internal and external auditors have been implemented by the management;

d. Review the existing risk management procedures for ensuring an effective internal check and control system ;

e. Review the corrective measures taken by the management as regards the reports relating to fraud-forgery, deficiencies in internal control or other similar issues detected by internal and external auditors and inspectors of the regulatory authority and inform the board on a regular basis.

2. Financial Reporting:

a. Review the annual financial statements and determine whether they are complete and consistent with the accounting standards set by the regulatory authority;

b. Meet with management and the external auditors to review the financial statements before their finalization.

3. Internal audit:

a. Review the activities and organizational structure of the internal audit function and ensure that no unjustified restrictions or limitations is made;

b. Review the efficiency and effectiveness of internal audit function;

c. Review that findings and recommendations made by the internal auditors for removing the irregularities detected and also running the affairs of the bank are duly considered by the management.

4. External audit:

a. Review the auditing performance of the external auditors and their audit reports ;

b. Review that findings and recommendations made by the external auditors for removing the irregularities detected and also running the affairs of the bank are duly considered by the management.;

c. Make recommendations to the board regarding the appointment of the external auditors.

5. Compliance with existing laws and Regulations: Review whether the laws and regulations framed by the regulatory authorities (central bank and other bodies) and internal regulations approved by the board have been complied with.

6. Other Responsibilities:

a. Place compliance report before the board on quarterly basis regarding regularization of the errors & omissions, fraud and forgeries and other irregularities as detected by the internal and external auditors and inspectors of regulatory authorities;

b. Perform other oversight functions as requested by the board and evaluate the committee's own performance on a regular basis.

Organization: The bank audit committees should be organized as follows:

a. The audit committee will comprise of 3 (three) members;
b. Members of the committee will be nominated by the board of directors from the directors;
c. Members may be appointed for a 03 (three)-year term of office;
d. Company secretary of the bank will be the secretary of the audit committee.

Qualifications of the Member: The members of the bank audit committee should have the following qualifications:

a. Integrity, dedication, and opportunity to spare time for the committee will have to be considered while giving nomination a director to the committee;
b. Each member should be capable of making valuable and effective contributions in the functioning of the committee;
c. To perform his or her role effectively each committee member should have adequate understanding of the detailed responsibilities of the committee membership as well as the bank's business, operations and its risks.

Meetings: Regarding the meetings, the following rules should be followed:

a. The audit committee should hold at least 3/4 meetings in a year and it can seat any time as it may deem fit;
b. The committee may invite such other persons (e.g. the CEO, head of internal audit) to its meetings, as it deems necessary;
c. The internal and external auditors of the bank should be invited to make presentations to the audit committee as appropriate;
d. To maximize effectiveness, detailed memorandum to be discussed in the meeting should be distributed to committee members well in advance of the meeting to allow proper consideration of enclosed papers;
e. The proceedings of all meetings will be minuted.

Conclusion

Every organization that represents the interest of multiple owners (e.g., corporate stockholders) should have an audit committee or the equivalent. The existence of audit committees may actually lead to division of power, thus weakening the board of directors as the overarching monitor of management. The preparation of financial statements and related communications are the responsibility of the entity's management and the governing board. The independent auditor's role is to report on the fairness of the presentation of the entity's financial statements, to identify potential internal control problems and instances of non-compliance, and to provide advice and counsel to management and the committee. The primary role of the audit committee is to provide assurance to the governing board that the organization has the appropriate culture, personnel, policies, systems, and controls in place to safeguard entity assets and to accurately report financial information to internal and external users. So it can prevent fraudulent financial reporting and can enhance the reliability of the published statement. However, the role to be played by the audit committee depends much on its formation. An audit committee having all the independent directors could be the most effective. The competence of the members also affects the effectiveness. After the chain of recent incidents of accounting scandal, the concept of audit committee has acquired more prominence than ever before. Today, it has been placed onto the centre stage in recent global debate on corporate governance reforms.An effective audit committee undoubtedly can play a significant role to ensure better governance practices through reducing the information asymmetry to the shareholders. ❐

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