The IUP Journal of Accounting Research & Audit Practices

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The Icfai University Press
www.iupindia.in
Factors Affecting the Quality of Audit Committee: A Study

Mahdi Salehi*, Majid Zanjirdar** and Fatemeh Zarei***

The expansion of the scope of private ownership through privatization of state-owned enterprises and decentralization has brought into focus the capital owners' interests in strengthening the culture of accountability and in promoting information transparency of companies and other economic units in which all or a part of the capital is supplied by the public. This aim requires mechanisms to ensure proper governance in companies and other economic firms. Among the elements of corporate governance, audit committee is the key element that strengthens the health of financial reporting. The present study attempts to examine the factors affecting the quality of the audit committee. The sample for the study includes financial managers or board members of 185 listed companies in the Tehran Stock Exchange. Research results indicate that enhancement in independency, expertise and activities of non-executive members of the board increases the independency, expertise and activities of the audit committee, and also, there is a meaningful relationship between the size of the board of non-executive members and the size of the audit committee.

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 fraud; and also, they provide their unbiased opinions related to the accuracy of this information. These persons are usually selected from the non-executive members of the board of directors and outside managers (Carcello and 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 the management's claim regarding the adequacy of internal control structure

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by independent auditors, expanded use of computer systems and subsequently more difficult monitoring and controlling of these systems have intensified the formation and implementation of the audit committee (Asabakhsh, 2010).

The audit committee is one of the firm’s board committees consisting of three to five and in some cases seven non-executive members of the board whose ultimate responsibility is to oversee all financial activities of the company (Arensen and Loebbecke, 2003). The duties of the audit committee are:

- To help in choosing the auditor;
- To manage the auditing process;
- To review audit results;
- To help board members get a 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 the board of directors with regard to reporting and also is able to improve the communication between the management and the independent auditor, with the auditor’s independence serving as a shield between the auditor and the management. The audit committee helps creditors and beneficiaries to ensure that their maximum interests are obtained through auditing activities (Wilson et al., 2000).

Audit Committee in the World and Iran

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

Following this, in 1978, the NYSE made it mandatory for the listed public companies to establish their audit committees. To comply with this policy of NYSE, 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 audit committees increased in the US companies. According to the past researches, until 1958, only 14.70% of US firms had audit committees, while the number of audit committees in the US LLPs reached 8.60% in 1961 and 91.40% in 1977 (Deli and Gillan, 2000).

In 1993, the Australian Securities Exchange Act required all economic units to have audit committee and asked them to comment in their annual reports about the audit committee and
explain the reasons for the absence of such a committee. This law was amended in 1996 and required companies to mention the important corporate governance 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 best practical suggestions. The revised version of the 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: (1) non-executive directors, including several independent directors; (2) should be run by an independent chairman who is not the chairman of the board of directors simultaneously; (3) at least three members should be included in the committee who do not have any financial dependency; (4) at least one member with relevant competencies and experience; and (5) some members familiar with the corresponding industry. The 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 play the most-efficient role (Baxter, 2010).

In Iran, a 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. Keeping in view 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 make their small and large-scale investments in these companies hoping to earn money, much importance is given to the proper management, control and supervision on public companies (Etemadi and Banisharif, 2009). Given that the establishment of audit committee is one of the key strategies today to control and monitor the affairs of such companies, it is expected that the committee should have a special place in Iran’s firms. But due to many reasons, this issue has been ignored, especially in the public companies, although in the 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 47th 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 the board of directors, and others are outsiders and are selected by the board;

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

- Characteristics of the audit committee members: Financial knowledge and independence; and
• Responsibilities of the Audit Committee:

- Evaluation of accounting and financial reporting issues and understanding their impact on the financial statements.
- Reviewing the effectiveness of internal control systems.
- Examining the charter, plans, activities, personnel and organizational structure of the internal audit department.
- Holding regular and 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) examine the relationship between the audit committee characteristics and protection of auditors’ independence. They evaluate four aspects of the audit committee composition: (1) real independence; (2) financial expertise; (3) regulatory expertise; and (4) beneficial ownership. They believe that although all members of the audit committee should have apparent independence, 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 protecting auditors against dismissal after the issuance of adverse auditing reports. Also, they present evidences that show the financial expertise of the 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 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, the audit committees are 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 the 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 show a significant positive relationship with the number of audit committee meetings. In addition, a significant positive relationship exists between the firm's size and the percentage of directors in audit committee, professional legal competence and number of audit committee meetings. The study could not justify the effect of auditor power or management stock ownership by non-independent directors on the audit committee's quality indexes.

Zhang and Zhou (2007) examine 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 the industry type, size and performance, and then they compare 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 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 absence of audit committee in Iran. He examines six hypotheses and enumerates the reasons as lack of awareness of financial reports users, accounting professionals and law makers about the benefits of the audit committee, culture of individualism, unique focus of managers and lack of legal force. The study used 150 questionnaires and the sample included accountants, auditors, financial managers and financial experts. The questionnaire results indicate that Hypotheses 1-3 (lack of awareness of users of financial reports, accounting professionals and legislators about the benefits of the audit committee) are rejected, while Hypotheses 4-6 (culture of individualism, managers' focus and lack of legal force) are accepted.

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

The presence of audit committee increases auditors' independence compared to the firm's board of directors. The regulations of professional conduct for independent auditors and the Audit Standards Declaration have also emphasized the independence of independent auditors.

Regarding the organizational position of the 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 financial and accounting knowledge and expertise. Hence, it is expected that the presence and operation of audit committee improves the quality of financial reporting.
The results of the study by Etemadi and Banisharif (2009) show that all the hypotheses stated in the study were accepted, except the one claiming a meaningful relationship between the decentralization of firms in Iran and the possibility of establishment employers' audit committee. The results indicate that there is a meaningful relationship between the establishment of a possible employers' audit committee, establishment of imperative rules and standards, awareness of owners and stockholders 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 and Jensen, 1983) and the costs are the results of communications between 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 and Meckling, 1976). The board of directors is one of the innermost control mechanisms which acts as a control system for managerial activities (Fama and 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 the board whose functions and roles are determined by the board. The primary operations of the committee 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 with an 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 committees compared to smaller boards (Collier and Gregory, 1999). It is thus predicted that the board of directors plays an important role in the composition, size and activity level of the audit committees.

Klein (2002) observes that the higher the level of financial expertise and independence 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 the audit committee. So when the board reaches a threshold size, the ability of the 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 those formed by smaller boards.

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

\( H_1: \) Independency of non-executive members of the board increases the independency of the audit committee.

\( H_2: \) Expertise of the non-executive members of board increases the independency of the audit committee.
$H_2$: Activities of the non-executive members of the board increases the independency of the audit committee.

$H_3$: There is a relationship between the size of the board of non-executive members and the size of the audit committee.

In the developed countries, companies have focused on the necessity of establishing an audit committee in recent years. And in this context, managers at different levels not only try to learn the concepts of the committee, but also study some of the organizations at the national and international levels, and put their efforts in developing laws and regulations related to the audit committees. This subject is still strange in the business environment of the Iranian companies. It is due to the fact that the country’s educational system does not provide such information to managers and also no significant activity has been undertaken in the legislative arena. Therefore, it is expected that the Iranian auditing and accounting communities have little information in this field. However, in order to overcome this disadvantage in the present research, a specific number of professionals with higher academic and executive levels have been selected as the research sample, i.e., the members of the board and financial managers of 342 listed companies in the Tehran Stock Exchange since July 2011.

The sample volume chosen for the financial managers and board members of the listed companies includes 181 subjects assuming a limited sample, with a confidence level of 95% and the maximum acceptable error of 5%. The needed information for testing the proposed hypotheses was collected in two steps: (1) the library-based method was used; and (2) 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 with reference to a panel sample that did not participate in the main sample. The reliability was confirmed if a test was repeated several times under the same conditions and the score remained the same in all cases. Cronbach’s alpha was employed to ensure the reliability of the research questionnaire. According to the calculations, the Cronbach’s alpha of about 0.82 was determined. A Cronbach’s alpha of 0.77 was considered as desirable and acceptable reliability.

**Hypotheses Testing**

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

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

$H_0$: There is no direct relationship between the independent variable and the dependent variable.
H₄: There is a direct relationship between the independent variable and the dependent variable.

According to Table 1, the values of meaningfulness level in Chi-square test was equal to 0.000 for all questions. Because the significance 0.000 is less than 5% alpha in confidence level of 95%, the H₀ is rejected and H₄ (relationship between dependent and independent variables) is accepted.

**Table 1: The Results of Hypotheses**

<table>
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<tr>
<th>Hypothesis</th>
<th>Variable</th>
<th>Sig.</th>
<th>Chi-Square</th>
<th>Df</th>
<th>Group with the Highest Ratio</th>
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**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. Though the data shows some degree of skewness, it does not limit the test applicability. Therefore, it can detect the existing differences easily (Table 2). The test’s statistical hypothesis is as follows:

Factors Affecting the Quality of Audit Committee: A Study
\[ H_0 : \mu = 3 \]
\[ H_a : \mu < 3 \]

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Table 2: Singular t-Test Results
According to Table 2, the value of obtained meaningfulness levels equals to zero. According to the results of the analysis, research hypothesis is accepted and the null hypothesis is rejected.

**The Friedman Test:** This test is employed to compare the mean scores. The results of the test are shown in Table 3. When the significance level is less than $\alpha = 0.05$ (test level), the null hypothesis (assuming equality of mean scores) is rejected at $\alpha$ level. Thus, according to the

<table>
<thead>
<tr>
<th>Hypothesis</th>
<th>Variables</th>
<th>Mean Score</th>
<th>Test Statistics</th>
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</table>

Factors Affecting the Quality of Audit Committee: A Study 43
items in the questionnaire and the assigned group scores, a variable with the lowest average score contains the highest agreement degree.

**Conclusion**

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

In spite of the fact that the Tehran Stock Exchange prepared the Audit Committee Charter in 2007, only a handful of companies have established their own audit committees which mostly are among banks, and also none of them has issued the audit committee’s report. Given the above-mentioned reality, the researchers of this study had to collect data using a questionnaire.

**References**


### Appendix

#### Research Questionnaire

<table>
<thead>
<tr>
<th>S. No.</th>
<th>Items</th>
<th>Strongly Agree</th>
<th>Agree</th>
<th>No Comment</th>
<th>Disagree</th>
<th>Strongly Disagree</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Election of the audit committee members by the board of directors increases the independence of both the board of directors and the audit committee.</td>
<td></td>
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<tr>
<td>2.</td>
<td>Independence of the non-executive members of the board of directors is compromised by financial assistance from the company in the form of loans or unusual payments, and also undermines the independence of the audit committee.</td>
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<tr>
<td>3.</td>
<td>Non-executive members of the board of directors express their opinions more freely and openly compared to the executive members.</td>
<td></td>
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<tr>
<td>4.</td>
<td>Financial and career openness of the non-executive members of the board of directors in the company makes them financially independent.</td>
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<tr>
<td>5.</td>
<td>Separation of chairman and CEO roles, i.e., decentralization of power in the hands of one person (CEO) increases the independence of the audit committee.</td>
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<tr>
<td>6.</td>
<td>A non-executive member of the board of directors should be a person other than directors or employees so that his/her ties do not prevent him/her from independent judgment.</td>
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<td>7.</td>
<td>Firing and hiring of the internal audits by the board of directors increases the independence of the audit committee.</td>
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<td>8.</td>
<td>Election of the non-executive members by executive directors decreases the independence of non-executive members and the audit committee.</td>
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<tr>
<td>9.</td>
<td>The non-executive members of the board of directors with an appropriate level of independence will enhance the independence of the audit committee.</td>
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<tr>
<td>S. No.</td>
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<td>No Comment</td>
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<tr>
<td>10.</td>
<td>Having accounting knowledge and other relevant financial expertise is required for at least one of the non-executive members of the board of directors and it increases the audit committee's expertise.</td>
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<tr>
<td>11.</td>
<td>Ability of the non-executive members of the board of directors to read and understand financial statements increases the audit committee's expertise.</td>
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<tr>
<td>12.</td>
<td>Familiarity of the non-executive members of the board of directors with finance affairs increases the audit committee's expertise.</td>
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<td>13.</td>
<td>The non-executive members of the board of directors should have the skills and experience in consistence with the company's field of activity.</td>
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<td>14.</td>
<td>The non-executive members' good understanding about the areas with the greatest financial risk and their management increases the audit committee's expertise.</td>
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<tr>
<td>15.</td>
<td>Evaluation of important accounting issues (including official professional statements along with recent codes) and their impact on financial reporting by the board of directors increases the audit committee's expertise.</td>
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<tr>
<td>16.</td>
<td>The non-executive members of the board of directors should evaluate quarterly financial statements, annual financial statements and the declaration before they are being issued.</td>
<td></td>
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<tr>
<td>17.</td>
<td>The non-executive members' control over cyclical financial reporting provided by management will increase the audit committee's activity.</td>
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<td>18.</td>
<td>Higher number of meetings of the board of directors and accountants will increase the audit committee's activity.</td>
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<td>S. No.</td>
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<tr>
<td>19.</td>
<td>Open and honest meeting of the board of directors and the audit committee will increase the audit committee’s activity.</td>
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<td>20.</td>
<td>Timely and regular submitting of the audit committee meetings’ records to the board of directors will increase the audit committee’s activity.</td>
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<td>21.</td>
<td>Regular review of the performance of every member of the audit committee (the time spent to get ready for meetings) by the board of directors will increase the audit committee’s activity.</td>
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<td>22.</td>
<td>Holding meetings by the board of directors to review the financial statements, procedures and basic accounting judgments increases the audit committee’s activity.</td>
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<tr>
<td>23.</td>
<td>Presence of at least one non-executive member of the board of directors in the committee meetings is considered to increase the audit committee’s quality.</td>
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<td>24.</td>
<td>An ideal audit committee includes three to six members of the non-executive members of the board of directors.</td>
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<td>25.</td>
<td>With the increase of the non-executives of the audit committee to more than six members, the operational effectiveness of the members shall be expected to be reduced.</td>
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<tr>
<td>26.</td>
<td>An audit committee with its non-executive members of the board of directors should be small enough to perform effectively.</td>
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