

The Development of Audit Committees - A Review of the Literature on Theoretical and Global Perspective

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Abstract

The audit committee performs a pivotal role in making the right environment for quality auditing. It is the audit committee's obligation to breed an environment that encompasses an open dialogue in a culture of honesty, regard and transparency amongst management and auditors. The prime purpose of an audit committee is to provide oversight of the financial reporting process, the audit process, the system of internal controls and compliance with laws and regulations. Audit committees will consider internal controls and review their effectiveness. Since 1940, the SEC has acknowledged that an audit committee can serve a significant, and eventually essential, role in guaranteeing that a publically listed corporation financial reporting is correct. In the 1970s, the New York Stock Exchange (NYSE) obligated boards of directors of these listed firms to employ an audit committee. Then in the late 1980s, (Nasdaq) the National Association of Securities Dealers and (AMEX) American Stock Exchange afterward employed the audit committees. Today, innumerable practices and rules

command the composition, roles, and duties of audit committees. After the Enron's collapse, audit committee affiliates duties are enhanced and Securities Exchange Commission are investigating the board of directors and management more and more. This article provides a brief overview of audit committee's emergence in UK and Saudi Arabia, Moreover theoretical foundations of the audit committees are also discussed.

Keywords: Audit Committee theories, Corporate Governance, Audit Committee Saudi Arabia, UK audit committee emergence

Introduction

Due to expanding financial misrepresentation bringing about companies breakdown and ineffectual external audit function, corporate administration has gained considerable importance and centered on the foundation of review councils and their obligations for expanding credibility of financial statements (Allegrini & Greco, 2013). In light of this the emergence of many regulations focused on strengthening the audit functions in the corporate governance mechanisms but before discussing the development of audit role in east and west this paper will shed light of some of the theoretical background on the topic.

Agency Theory

The unit of organization from ownership in the current enterprise gives a flawless circumstance for the process of agency theory. Stockholders perform as the key with advantages in creating compelling convenience from the execution of the specialists that is the administration. There is a partition of the ownership from management and that is the reason the fundamental clash emerges, in addition there is one more reason that is the agent are not able to screen the agent's performance (Ho & Wong, 2001). Agreeing to the contradictions of Laffont and Martimort (2009) and Ensminger (2001), there are economic motivation as well as gains for both the agents and principal, hence they fund in numerous data frameworks and checking systems so that the agency cost is minimized which is connected with irregularity of information. These control mechanism might offer high benefits for all individuals involve as the agent will then afford the agency costs which happen when principals rebate the firm's estimation, in view of the probability of hostile selection, moral threat as well as avoidance (Laffont and Martimort, 2009). In order to show the class of information and data administration might utilize numerous methods. Hence, external reviews are insisted to monitor (Sannikov, 2008) directors - who are external - and their utilization (Wright, Mukherji & Kroll, 2001). Governing body uses audit committees in light of the fact that they think that these councils are indispensable element of the choice control framework and to screen internally (Vafeas, 2005). Using an agency theory, previous research which investigated the associations between the creation of audit committees dissimilar cost of agency has made mixed results (e.g., Archambeault & DeZoort, 2001) and has been unsuccessful to systematically evaluate the practices or feasibility of such advisory groups (Sharma, Naiker & Lee, 2009). Subsequently, the surrounding of a review board panel does not significantly interpret into an effective checking body (Baker & Owsen, 2002).

Institutional Theory

Institutional theory suggests that regulatory arrangements in such a domain get to be typical showcases of social obligation and congruity (Abbott & Parker, 2000). Accordingly, internal working methods roughly coupled with the evident structures accomplish the certified work of the firm. In this way, those associations that have appropriate structures set up and maintain a strategic distance of their functionalities by gatherings outsiders (Abbott & Parker, 2000). Keeping in mind the end goal to affirm the legality, organizations are subjected to principals and guidelines of laws, have capital and verify their continuing existence (Al-Twajjry, Brierley & Gwilliam, 2003). Although these principles and guidelines do not

essentially guarantee that the organization will continue (Abbott & Parker, 2000). In the light of developing audit committees within organizations, coercive isomorphism contains powers practiced to make review councils by regulators and SEC. As an outcome, numerous organizations are presently making audit committees. As indicated by Al-Twaijry, Brierley and Gwilliam (2003) the mimetic isomorphism is a technique of adjustment began inside by the company. Mimetic change will happen when organization thinks that a review council will add to the Corporate Governance arrangements inside the company. Normative isomorphism begins from the proficiency of included individuals. Auditors as well as bookkeepers, through their expert entity for instance, the American Institute of Certified Public Accountants (AICPA) and the Institute of Internal Auditors (IIA), have pushed for the development of audit committees and rules for their movements.

Actor-Network Theory

A group of sociologists in France have developed the key conception on which the Actor-Network Theory revolves (Bonner & Chiasson, 2005). This theory is a sort of analysis which is connected sociologically to the process of control Law. According to the theory, organizations, agents and methods are results delivered in arranged system of different things (Arnaboldi & Spiller, 2011). These arranged networks or systems are infrequently obvious in social contact, which prompts representations of the system by sole player (Spira, 2002). This picture of a system by sole player is called translation process (Spira, 2002). The current theory points on the reproduction of power and effect in the middle of arranged frameworks. It was contended by the scholar Spira (2002) that this theory gives a healthier representation as compared to other theories since it distinguishes the instability of systems and helps specialists to check the complex relationship among audit participant's committee. There were few researches that have utilized ANT as a logical foundation to analyze the issues identified with accounting. With the assistance of the contributions of committee of audit tales spira1999 was capable to utilize ANT to clarify the plausible depiction for the repaid raise in the acknowledgement of the audit committee. He examined the adapted execution of the audit committee social affairs and expected that such execution serves as a system asset and at last secures legitimacy of organization through comforting resource provided by the presentation of sensitivity toward restrictive requirements of corporate influence (Dellaportas, 2006).

Power Theory

Power is considered as the ability to do something with achievement even opposite to the argument of others (Bedard, Chtourou & Courteau, 2004). It is referred to as the implied component under firm control (Abbott et al., 2003). It is very important for audit committee as a part of organization to have power so that it can effectively carry out its duties. In 1995, French and Raven gave five sorts of powers. These included reward, coercive, real, and master and referent (Yukl, 2002). While Mintzberg 1983 joint two forces, these forces were reward and coercive powers, and were named sanctionary which means holding resources (Berger, 2007). One more power was added to the list by called information power. However, complete comprehension does not exist, but still there is immense understanding that power

talks to control over resources (prize and coercive), control over information and its substance (information), individual properties (expert and referent) and formal requests and mandates (legal) (Lawrence, 2008). There exist six major types of power as indicated by Webber (2006) and Beattie, Fearnley and Brandt (2004):

1. Legitimate Power: It is the resultant of passing out of responsibility from the board of executives. Yet this board is charged with inevitable obligation of corporate administration.
2. In spite of the certainty that the exertion of the audit committee may be studied by the board, the council is still the authority of decision making. Sanctionary power results from the capacity of the review board of trustees in settling on decisions that can have impacts on prizes and disciplines to diverse groups, for instance, corporate officers, the reviewers both internal and external (Webber, 2006).
3. Most of the members of the audit committee are the executives which are called outsider directors. This implies that they are at the leniency of administration, evaluators internal and external both for the information and data. As a result, the advisory group achievement is on the support of the foundation that it takes from three parties specified (Webber, 2006). Decision of audit committee is consistently affected by the capability of participants to take data and to use it in a structure where it is best to accomplish the goals of audit committee (information power).
4. The audit committee is comprised of individuals, therefore the highlights identifies with the members of it cannot be neglected the possessed by these individuals or members helps significantly in the efficiency and effectiveness of these committees, such as finance, accounting, corporate relations (Beattie, Fearnley & Brandt, 2004). This is called Expert Power.
5. Referent power exhibits that committee for audit members with identities prepared for affecting others are inclined to have any kind of impact and will help ACE. At last, the desire to perform with great level commitment and concern can be a basic component in choosing ACE (will power) (Beattie, Fearnley & Brandt, 2004)..
6. Webber (2006) analyzed the responsibility of the power of audit committee in nearly ninety organizations in the USA. They proposed that ACE (audit committee effectiveness) sufficiency is seen as a limit of the sorts and degree of force practiced by the audit committee. They assembled the six sorts of power into two classes, particularly, institutional (sanctionary, legitimate and information) and individual powers (referent, will and expert). It was likewise been discovered that official and primary assistance from the administration increments the viability of the audit board (institutional forces). Additionally, the results showed that the determination (diligence) has the most astounding effect on the adequacy of committee between all the individual powers.

After reviewing the literature above it is evident that the audit committee plays a significant role in monitoring and holds a pivotal position in corporate governance mechanism. The development of these committees globally has also endorsed its significance and in order to review the literature on the progress of these committees both developed and developing

nations are taken. Moreover while selecting the country one representative of east and one west was chosen. The idea behind this is to analyse if the progress is in congruence with the legislatures.

Development of Audit Committees in the UK

Due to expanding financial misrepresentation bringing about companies breakdown and ineffectual external audit function, corporate administration has gained considerable importance and centered on the foundation of review councils and their obligations for expanding credibility of financial statements (Allegrini & Greco, 2013). Despite the fact that organizations in UK are not legitimately needed to have an audit committee, public organizations still took the activities in 1973. The advantage of having review council was felt by the internal audit in the Civil Service. That included the planning of audit and determination of its roles. Private segment took the most activities in such manner in the most recent two decades. In 1977, the Companies Bill attempted to advocate for legislation for creating review boards. However, the outcomes were a failure (Dafinone 2001). In the year 1982, Bank of England, CBI and other financial institutions set up Pro-Ned, an association for the advancement of non-executive directors (Goobey, 2001). In 1987, the Code of Recommended Best Practice was distributed by Pro-Ned which included the proposal to have non-executive directors for supporting the foundation of review advisory groups in large quoted organizations (Cuervo, 2002).

In 1986, an Institute of Chartered Accountants of England and Wales working party proposed review panels to be in charge of the determination and remuneration of auditors, favoring the audit plans and checking on the administration reports issued by auditors. In 1987, the Bank of England issued of a paper entitled "The Role of Audit Committees in Banks" recommending all banks to make review board (Walker, 2009). Around the same time, the London Stock Exchange has also prescribed all listed organizations to have review councils including non-executive directors. The Committee on the Financial Aspects of Corporate Governance was created by the Financial Reporting Council, the London Stock Exchange and the Accountancy Profession in 1991 to consider the budgetary angles or corporate administration. Suggestions by board of trustees were distributed in a Code of Best Practice the Cadbury Report in 1992 (Dahya, McConnell & Travlos, 2002). As per this report, all public sector organizations are obliged to give an announcement of acknowledgement of Code of Best Practice. Besides, the report additionally suggests the external auditors to review statement of compliance and guarantee the agreeability of the organization with the Code of Best Practice. Passage 4.3 of the Code of Best Practice prescribes foundation of audit committee by board which comprises no less than three non-official chiefs alongside written terms of reference, which deals with the authorities and responsibilities of committee's panel (Dahya, McConnell & Travlos, 2002). The Hampel Report repeated the proposals related to the foundation, structure, obligations and capacities of review councils in UK. Consolidated Code on Corporate Governance included both Cadbury Committee and Hampel Reports (Cohen, Krishnamoorthy & Wright, 2002). The Turnbull Report (1999) considered role of audit committee and underlined that review board can be given a part of auditing the effectiveness of internal control. However, as indicated by this report, internal control

incorporated all controls and not just the financial controls. The allocation of this part to the review council was to conclude that the audit committee is responsible for the total risk of organization (Solomon, 2000). In late July 2002, Financial Reporting Council (FRC) was obliged to give the government body the improvement of the existing Combined Code direction on audit committees. Press Notice reporting the foundation of the FRC-Appointed Group was issued by the FRC. FRC was exhibited a report in December 2002 by this group and it was distributed in January 2003. This report is popular as of the Smith Guidance on Audit Committees (Council, 2010). This direction is prepared to assist the companies so as to make suitable preparations for the audit committees and for the support to the directors who serve the review councils in carrying out their functions. This direction also involves the essential requirements which every audit committee must follow to as it is necessary for the Code's compliance. Listed organizations which do not meet these requirements must provide rationale for it. It is acknowledged that some prerequisites are not suitable for a few organizations. In particular, smaller organizations may have less than three non-official and autonomous directors. Finally, all the UK-recorded organizations are subjected to meet such necessity and should apply in respect of accounting periods beginning on or after 1 January 2003. In April 2002, the Secretary of State, Patricia Hewitt, and the Chancellor, Gordon Brown, selected Derek Higgs for leading brief autonomous audit pertaining the role and adequacy of non-executive directors. Higgs distributed his report in January 2003 (Higgs, 2003). While in US, financial frauds in corporations are the center of most discussion of the administration, in the UK failure of shareholder wealth is more centered than the extortion. The fall in stock exchanges in the period 2000-2002 has given extraordinary examples of loss. The role of committees and board in recent cases of corporate governance in UK was called for debate. Hence, the concerns of accountability as well as increasing the effectiveness of board remain the critical focus of Higgs Report.

In July 2003, most recent report of corporate administration with a title the Combined Code on Corporate Governance was issued by the FRC. The Combined Code issued by the Hampel Committee on Corporate Governance was supplanted by this report (Cohen, Krishnamoorthy & Wright, 2002). It begun from a survey of the adequacy and role of non-official executives (Higgs, 2003) and a audit of review boards. Agreeing to this report, new Code will be applied for reporting years starting on or after 1 November 2003. Essential and optional standards and necessities were included in the code. Agreeing to the current listing rules, listed organizations are obliged to put forth a divulgence expression in two sections in connection to the Code. The principal part is about how the standards in the code are connected. Both essential and auxiliary standards will be obliged later to get covered in it. The reason for this part is just to provide organizations the influence of clarifying the strategies of administration as indicated by the standards and if they do comply with that, they have to get acceptable. The second part of the declaration is the affirmation whether the firm is in agreeability with the provisions of the Code or not, and if not then there must be a reason to be portrayed. This 'Comply or Explain' methodology is broadly acknowledged by both by organization boards and by financial specialists and its being used for more than ten years. Shareholders can utilize it for the assessment of monetary articulations.

In conclusion, despite the fact that foundation of audit committees was not the legitimate prerequisite in UK yet due to the self-regulation approach taken by the legislature through the FRC, every listed organizations are obliged to demonstrate the yearly reports' level of compliance with the Combined Code on Corporate Governance. Self-administrative framework was taken as a more adaptable and versatile contrasted with legitimate framework and requirements (Brown & Tarca, 2005).

Audit Committees in Saudi Arabia

In spite of the fact that corporate breakdown is not confronted by Saudi Arabia, still the overall breakdown (e.g., Enron 2001) and the terrible execution of numerous Saudi organizations in the mid 90s raised the concerns of corporate administration in Saudi Arabia. Royal Consent in 1991 was the activity of creating Certified Public Accountants (SOCPA) in Saudi organizations for overseeing accounts and account functions. As of the significance of audit committees to expand the consistency of financial statements, a declaration was gone by the Minister of Commerce in January 1994, obliging all public organizations to build a review board (Al-Twajjry, Brierley & Gwilliam, 2003).

This specific declaration of review panel in Saudi Arabia centered on the choice of members of committee. These rules include:

- A shareholder having a minimum of twenty shares must be the member and the quantity of the individuals should be odd and at least three.
- The member must have no managerial roles and should be a non-executive director.
- The member should have financial and accountancy skills in addition to the qualification and knowledge of standards and practices in the area of corporate governance.
- The member must not be indirectly or directly interested in the transaction and contracts of the organization.

On the other hand, the part of the selection of members of audit committee must be played by general shareholder's assembly (the yearly general meeting) of the organization. The part of choosing the external auditor for the purpose of external audit as well as receiving reports is played by the review board. Five lawfully permitted firms must be designated by the audit committee for this role in Saudi Arabia. These organizations are then in charge of the accommodation of proposition which will let the review board of trustees prescribes one or more than one firm where suitable. This proposal will be sent by the executives to the general assembly which will choose the external auditor, characterizing the review expense and possession of office. Based on the resolution, in the event of appointment of just single organization, the selection process is not suggested by the committee before three years of beginning. On account of appointment of more than one firm, the selection process is not suggested by the board of trustees before five years (Al-Twajjry, Brierley & Gwilliam, 2003).

After the misconception, the resolution by numerous organizations e.g. accounting and financial skills, capabilities and different roles and privileges of audit committees, the perspective of critics have been distributed in the Saudi print media (Dye, 2009). In Saudi

banks, the case is more troublesome as of the presence of two control practicing administrative bodies, the Ministry of Commerce and the Saudi Arabian Monetary Agency (Alturki, 2014). Rules for establishment of Saudi banks audit committees were exhibited in 1994 by Saudi Arabian Monetary Agency (SAMA) (Ramady, 2010). In the standards of Saudi Arabian Monetary Agency, in regards to audit committees, one of the individuals must be selected by the governing body as a director of chairman of audit committee for at least three years and he must be a non-executive director so as to be efficient. Besides, administrator at last characterizes achievement and adequacy as he coordinates the plan and the method for accomplishment (Ramady, 2010). Due to this significance, below mentioned requirements must be fulfilled for chairman selection:

- He must not be the board's chairman.
- There must be no monetary or any other relationship of chairman with the board members and the senior management of bank.

Three to five individuals must have the participation of review advisory group and every meeting is held compulsory to attend by every board member. Qualified individuals from the board, ex-board individuals and outcasts might be included in an audit committee. However, the committee must include mostly externals who are not the members of the board, senior managers, employees, officers, bank agents or its associates, and major clients. The nature, size as well as the range of functions of committees tends to determine the number of meeting by the audit committee. An advisory group with typical capacities must have a minimum of four meetings every year including a yearly meeting with the board of executives. Based on the prerequisite of the panel and demands from the outside auditors, the quantity of meetings with outside auditors will be arranged and these meetings must not be in the least prerequisites of four meetings in a year (Ramady, 2010). The distinction between the past decides that the necessities for the review boards and its participation and different obligations that are said in the SAMA rules and with those specified in the determination of Ministry of Commerce 1994 is clear as the resolution of Ministry of Commerce 1994 could not clarify the methodology of securing the councils. The point to consider is that the meetings conveyed by Cho and Patten (2007) in 1998 with scholastics and internal and external auditors for contemplating the role of review councils in the Saudi Arabian corporate sector. The terms of reference of audit committee and significance of review councils was demonstrated by the interviewees. The capability of audit committee and freedom was considered. The interviewees exceedingly stressed upon the need of further regulations by the Ministry of Commerce for upgrading the review councils in Saudi organizations. Yet, members of audit committee did not participate in these interviews.

The corporate governance mechanisms are still in infancy in this part of the region since it adopted the corporate governance regulations very late followed by oman, and still many of the rules are not made obligatory to these corporations. In spite of these glitches it can be said that Saudi Arabia is striving to oblige with the current global practices and trends as soon as possible and it has made a recognizable progress so far.

Conclusion

It is evident from the literature mentioned above that UK and Saudi Arabia are out-and-out for constant development in their governance practices. Most of the corporations in the world are now focusing more and more on corporate governance mechanism. Especially after Enron collapse in 2001, many developed and developing nations have incorporated legislatures governing audit committees as a component of corporate governance mechanism. An audit committee is one of the main operating committees of a corporation's board of directors that is in custody of overseeing financial reporting and disclosure. The audit committee is a fundamental pillar of effective corporate governance and is in the superlative position to oversight the corporation's performance therefore every corporation must make sure that the audit committees are working and developing themselves in continuity, they must not leave any stone unturned to maximize their performance for overseeing the governance practices.

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