

# New Role of Audit Committee: A Post-Financial Crisis Analysis

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**Abstract.** This paper will throw the light on the audit committee functioning, which is required by various laws and regulations, in order to get objective disclosure of financial statements. The objectives of the committee are spelled out in the Terms of Reference (TOR) or the Charter along with rights, duties, authorities and responsibility. The author will present comprehensive checklist of best practices for effective audit committee (benchmarks) based on recommendations of various committees and laws. The author will suggest the areas where independence and objectivity of audit committee can be improved along with establishing transparent working relationships with management, the internal auditors, and external auditors.

**Keywords:** Audit Committee, Terms of Reference, Fiduciary Duties

## 1. Introduction

Audit committee plays a critical role in today's corporate governance. In a period of corporate scandals and failures, this committee of the board of directors has been drawing the critical eye of regulators, legislators and investors. Almost in all companies, Boards of Directors and their committees rely on the information supplied by management to give strategic direction to the company. The Board's role is better described as oversight or monitoring, rather than execution.

### 1.1. Roles and Responsibilities include:

- Overseeing the financial reporting and disclosure process;
- Monitoring choice of accounting policies and principles;
- Overseeing selecting, evaluating and replacing the independent auditor subject to approval of board and / or shareholders;
- Oversight of regulatory compliance, ethics, and whistleblower hotlines;
- Ensuring and monitoring the internal control policies, systems, and practices;
- Overseeing the performance of the internal audit function; and
- Discussing risk management policies and practices with management.

In addition to the above, the committee must ensure that

- There is a well-defined, well-written, and well-communicated code of ethical standards and guidelines for acceptable behavior, on which a climate of integrity is built and well established.
- All annual and interim financial statements (including management discussion and analysis, auditor's comments and suggestions, and significant accounting or reporting issues) are reviewed timely and on continued basis.

A key element in the corporate governance process of any organization is its audit committee. The battle for financial statement integrity and reliability depends on balancing the pressures of multiple stakeholders, including management, regulators, investors and the public interest. The Sarbanes-Oxley (SOX) Act of 2002 effectively transferred certain powers from the CEO and the CFO to the audit committee. The enhanced role requires committee members with more expertise to devote substantially more time and effort to their task, especially after Lehman Brothers collapse. Indeed, in many cases, time spent on committee work has increased as much as 100 percent.

## 2. Why and How the Committee Get into Trouble?

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Audit committees may find themselves in trouble with regulators and shareholders for a variety of reasons. These reasons typically relate to the failure of the committee to perform its duties diligently.

Past Researches have shown that there are some situations in which fraud is more apt to occur than others. They include situations where

- A majority of the directors are insiders, less qualified and inexperienced.
- There are weak controls over top management, since it is very difficult to have major fraud without the collusion of either or both the CEO and the CFO.
- There is nexus between the management and the directors.
- The members hold too many board memberships with other companies.
- Committee relies heavily on management reports and information and not capable to cross check the information provided by the management.
- There is no independent communication between committee and internal audit department and committee and external audit.
- There is invisible conflict of interest.
- There is no well-defined Terms of Reference.
- There is no effective audit committee, or the audit committee functions on paper only.

The following benchmarks for audit committee are derived (or influenced) from a variety of publications, rules and regulations, including Blue Ribben Committee Recommendations, Cadbury Report recommendations, SOX, SEC- related rules and KPMG audit committee institute publications and others.

### **3. Backdrop**

The company must establish the committee tailored to their corporate governance structure and unique corporate culture and characteristics - one size does not fit all.

#### **3.1. Independence**

Whether all committee members meet independence criteria?

The board examines relationships of, and compensation paid directly or indirectly to, audit committee members including consulting and advisory fees from the company or its subsidiaries, regardless of the amount.

Committee members are not to be "affiliated persons" of the company or any of its subsidiaries.

Whether the company discloses in their proxy statements, if a director is deemed independent, but falls outside the safe harbour.

The board examine that none of committee members has participated in the preparation of the financial statements of the company or any current subsidiary of the company at any time during the past three years.

#### **3.2. Financial and Other Expertise**

All the committee members are financially literate, if not, disclosed in proxy statement.

The committee has minimum one financial expert<sup>2</sup> if not, disclosed in proxy statement.

The board determines that each member is able to read and understand financial statements at the time he or she joins the committee, rather than within a reasonable time after joining.

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<sup>2</sup> . The SEC's rules define an "audit committee financial expert" as a person who has:

- An understanding of Generally Accounting Accepted Principles (GAAP) and financial statements;
- The ability to assess the general application of GAAP in connection with the accounting for estimates, accruals, and reserves;
- Experience: (1) preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to those that the issuer's financial statements can reasonably be expected to raise; or (2) actively supervising individuals engaged in these activities;
- An understanding of internal controls and procedures for financial reporting; and
- An understanding of the audit committee functions.

The members are knowledgeable, experienced, informed, vigilant and diligent.

The committee undertakes an annual self-evaluation to assess its effectiveness.

The members have general understanding of the company's major economic, business, operating, and financial risk.

The members have broad knowledge of the interrelationship of the company's operations and financial reporting.

The members have a clear understanding of the difference between the company's decision making function delegated to management and its oversight function assumed by the audit committee.

The members have the ability to formulate and ask probing questions about the company's operations, business, internal control, financial reporting process, and audit activities to management.

The members have the courage to challenge management, whenever necessary.

### **3.3. Audit Committee Charter**

The company has a formal audit committee charter.

The board reviews the committee charter to assess whether it incorporates new specific responsibilities mandated by laws and regulations.

Whether the committee is directly responsible for the appointment, retention, compensation, and oversight of the work of the outside auditor.

Whether the committee be directly responsible for the appointment, retention, compensation, and oversight of the work of the internal auditor,

Whether the committee has established procedure for the receipt, retention and treatment of complaints regarding accounting, internal accounting controls or auditing matters, as well as for confidential matters.

## **4. Members' Responsibilities**

Whether the committee obtains and reviews, at least annually, a report by the outside auditor describing:

- The audit firm's internal quality control procedures;
- Any material issues raised by the most recent internal quality control review or peer review of the audit firm, or by any investigation by governmental or professional authorities within the last five years, regarding any independent audit carried out by the firm, and any steps taken to address these issues; and
- All relationships between the auditor and the company.

Whether the committee meets to review and discuss the annual audited financial statements and quarterly financial statements with management and the outside auditor, including reviewing the company's specific MD&A disclosures?

Whether the committee discusses earnings press releases, and financial information and earnings guidance provided to analysts and rating agencies?

Whether the committee has the authority, without seeking board approval, to obtain advice and assistance from outside legal, accounting or other advisors, and receive appropriate funding for the compensation of such advisors?

Whether the committee discusses policies with respect to risk assessment and risk management with management?

Whether the committee meets separately, periodically, with management, the internal auditor and the outside auditor?

Does the committee review with the independent auditor any difficulties the auditor encountered in the course of its audit work (including any restrictions on the scope of the auditor's activities or on access to information, and any significant disagreements with management) and management's response?

Does the committee review non-audit services<sup>3</sup> currently provided by the outside auditor to determine whether any of these services are prohibited under any applicable regulation?

Does the company sets clear hiring policies for employees or former employees of the outside auditor?

Does the committee ensure regular rotation of the lead and concurring audit partners?

## **5. Committee Members Serving Other Companies as Member of Board**

The board determines committee member's simultaneous service to other companies' audit committee, is not impairing his or her ability to effectively serve on the company's audit committee and disclosed in the company's proxy statement.

The company has minimum three members throughout the year.

## **6. CEO and CFO Certifications – Disclosure Controls and Procedures.**

Does the committee review with the CEO and CFO how they are meeting their obligations under the certification requirements of applicable laws and reviewed the CEO's and CFO's evaluations of the company's disclosure controls and procedures?

## **7. Related Party Transactions**

Does the committee conduct an appropriate review, on an ongoing basis, of all related party transactions for potential conflict-of-interest situations?

Does the committee (or another independent body of the board of directors) review and approve all related party transactions?

## **8. Critical Accounting Policies, Significant Accounting Judgments and Estimates, Off-Balance Sheet Transactions and Non-GAAP Financial Measures**

Does the committee receive report from the outside auditor on, among other things, critical accounting policies and alternative treatments of financial information that have been discussed with management?

## **9. Others**

Disclose whether or not the company has adopted a code of ethics for its senior financial officers – principal financial officer, comptroller or principal accounting officer – and if not, why not.

## **10. Conclusion**

In the present global financial crisis which is transforming into economic and social crisis, upgrading the audit committee to achieve good corporate governance in order to regain the confidence of the stakeholders

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<sup>3</sup> Under SEC rules, services that impair an auditor's independence include:

- bookkeeping and other services related to the company's accounting records or financial statements; financial information systems design and implementation;
- appraisal or valuation services, fairness opinions and contribution-in-kind reports;
- actuarial services;
- internal audit outsourcing services;
- management functions;
- human resources;
- broker-dealer, investment adviser or investment banking services; and
- legal services; and

is utmost important and the audit committees could play a very vital role in bringing out a better internal control system, better monitoring and also bringing out better disclosures in the annual reports. There is no doubt that qualified audit committee is the key to improving the stakeholder's confidence and corporate governance. If the above benchmarks are used properly by the corporate, there will be a new beginning of confidence building among investors in particular and society at large.

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