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AUDIT COMMITTEE PERFORMANCE AND RELEVANCE: AN EMPIRICAL INVESTIGATION

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ABSTRACT:

The purpose of the study was to examine the users' perception of the inclusion of audit committee report in the financial statements of the companies. Questionnaires were used to collect the information from the respondents. The Chi-Square statistical tool was employed in the analysis and testing of the various hypotheses that were formulated. The results of the analysis concluded that the audit report does not significantly affect the quality of financial reporting although some users consider it in their decision making process.

KEYWORDS: Audit Committee, Financial Reporting, Financial statements, Observations.

Introduction

The financial statement as prepared by company directors is a statutory report, conveying both qualitative and quantitative information to assist users of accounting information in making informed decisions. As a statement that serves multiplicity of users, the financial statement meets the general needs of users. For them to make quality decisions, the financial statements should be credible. For the financial statements to be credible and relevant for decision-making, Generally Accepted Accounting Principles (GAAP) must be followed in their preparation hence, the appointment of external auditors to ensure compliance. Furthermore, to improve the quality of financial statements, the audit committee is constituted. According to Pitt (2001); Ruder (2002), the incidence that led to the collapse of Enron made the public call out to audit committee members to improve the performance of their functions. Prior to 1967, the whole idea of audit committee received very little accolades, and the expected functions of this committee were uncertain. However, the American Institute of Certified Public Accountants [AICPA] in 1967 made a recommendation that audit committee boards be established so that external auditors can communicate and interact with the audit committee whenever any question having material importance on the company's financial statements has not been satisfactorily resolved with management. To further encourage the establishment of audit committee boards, the Security and Exchange Commission (SEC) issued in 1972, Accounting Series Release No. 123, "Standing Audit Committees Composed of Outside Directors" to give protection to investors who rely upon the financial statements for decision- making. This they do by reporting in the financial statement the oversight functions performed. The clamor for the formation of audit committees around the world shows the relevance of audit committees as a governance mechanism. According to Lindsell (1992), the audit committee is a mechanism of corporate governance to check the quality, credibility, and objectivity of financial reporting; it performs an oversight function in the financial reporting process and communicates to users through a report in the financial statement. This committee has a monitoring responsibility over management and external auditors alike. They are intermediaries or watch dogs. The financial statement users will normally take actions based on the analysis of the various reports contained in financial statements. One of these reports is the report by the audit committee. This report is used to comment and communicate on the report of the external auditors, the objections or queries as well as the response from management; state if proper procedures have been followed by the auditors in the course of performing their audit … just to mention a few.

Statement of the Research Problem

Abbott and Parker, (2000); Krishnan, (2005), assert that audit committees have been in existence for decades. However, there are criticisms of the practices of audit committees and their relevance. This committee according to consists of shareholders and directors who are expected to carry out oversight functions and present their report to shareholders contained in the financial statement. However, these committee members might not be capable to handle the expected responsibilities since the same law is silent as to their professional capacity or qualifications. Furthermore, does the inclusion of the report by this committee in the financial statement have any effect on the decisions users would make? Does it not amount to duplication of efforts or information overload to have both the reports of the audit committee and external auditor in just one financial statement? Undertaking this study is justified from the purview of the decision usefulness of financial statements. It is a known fact that financial statement is a source of information to aid users in decision making however, provision of this information will require an analysis of the benefit and associated cost of providing it. If the associated cost outweigh the benefit, then provision of such for decision-making is not relevant. Therefore, a question worth answering is if the cost of including the audit committee report in the financial statement outweighs the information benefits it provides. Hence, the importance attached to a study as this that seeks to examine users' perception of the inclusion of audit committee report in corporate financial statements. This study will indeed contribute to the existing debate on the importance or otherwise of including the audit committee report in the financial statement. Furthermore, the management team of companies stands to benefit, as this work will reveal if the audit committee report in the financial statement add value to decision making or is just an item of more cost.

For the sake of clarity, the following research questions are raised.

1. Does the audit committee report significantly influence the decisions made by users of financial statements?
2. Can the report from the audit committee be said to add credibility to the financial statement?
3. Can the inclusion of the audit committee report in the financial statement significantly affect the quality of financial reporting?

Review of Literature

The statutory duty of preparing and presenting corporate financial statements rests with management. However, to ensure credibility and confidence in the report, the financial statements be audited by an independent third party having the professional capacity to do so. Over time, the conflicts between this third party (external auditor) and directors led to the establishment of audit committees charged with an oversight function. The audit committee is expected to disclose its responsibilities as a report in the financial statement. Some scholarly publications on the issue of audit committee include: Fearnley and Beattie (2004), Ayinde (2002), Urbancic (1991), Williams (1977).

Historical Background of Audit Committee

The development of audit committees in the corporate environment can be divided basically into two periods: voluntary establishment period and mandatory establishment period. The former was prior to 1970 while the latter is subsequent to 1970. According to the Canadian Institute of Chartered Accountants (1981), Canada was the first country to legally introduce Audit committees after which, the USA followed suits. In 1970, audit committees were constituted in the mentioned countries as a result of several corporate collapses and questionable conduct that severely tarnished the reputation of major organizations (The Canadian Institute of Chartered Accountants 1981). Some of these organizations are the Atlantic Acceptance Corporation Ltd., Penn Central Company... just to mention a few. In 1978, as the pressure from the public as well as Security and Exchange Commission (SEC) mounted for public companies to be mandated to establish audit committees, they became a part of requirements for listing on the New York Stock Exchange (NYSE).

Urbancic (1991) asserts that the need for these committees was further heightened in 1987 when the Treadway Commission recommended that audit committee be established by all public companies in order to enhance financial reporting quality. Today, the recommendations by the Blue Ribbon Committee in 1999, the Auditing Standards Board (SAS 61 as amended), the SOX Act of 2002...just to mention a few are justifications for the continued operations of the audit committee as these recommendations were further proposed because of the corporate failures of Enron, WorldCom, Adelphia Communications, and others. The failure of Enron was a huge upset in corporate financial reporting and auditing. Due to the nature of the global capital markets and ripple effect of the corporate scandals in Europe, the Sarbanes-Oxley style reforms have now been adopted almost throughout the globe. Furthermore, the SEC recently adopted more rules and standards that focus on the composition and operations of audit committees with the expectation of improving financial reporting quality.

In India, the Ministry of Petroleum and Natural Gas has issued guidelines to the entire public sector oil corporation to set up audit committees in August 1997.Oil and Natural Gas Corporation (ONGC) was the first to establish audit committee in pursuance of these guidelines.

Legal Framework of Audit Committee

In India, the constitution of audit committees is now mandatory for listed companies both under the Companies Bill of 2009 as well as under Clause 49. Section 158 of the Companies Bill of 2009 requires all listed companies to have an audit committee with a minimum of three directors, with independent directors forming a majority and at least one director having knowledge of financial management, audit, or accounts. The chairperson of the audit committee has to be an independent director. The company is required to disclose the composition of the audit committee in its Director's Report.

Clause 49 requires the audit committee to meet at least four times a year, with the gap between two successive meetings not exceeding four months. The regulation tries to ensure the quality of audit committees by requiring that all audit committee members should be "financially literate," with at least one member having "accounting or related financial management expertise."

The Companies Bill 2012 retained all the provisions of the Companies Bill 2009 with respect to the size, composition, powers, and functions of the audit committee, except for one striking modification/ alteration—the Companies Bill 2012 does not require the chairperson of the audit committee to be an independent director. There is a view that this provision was made to accommodate the fact that many unlisted but registered companies to which the Bill would apply may have to find independent directors only to chair their audit committees, as these unlisted but registered companies are not bound by the Clause 49 Regulations (which applies only to listed companies) on board independence. However, notwithstanding its merit, this view is not applicable as the provisions of the Companies Bill

2012 as specified in Clause 177 clearly mention that the regulations apply only to listed companies.

Conceptual Framework for Audit Committee

The earliest evidence of the use of audit committees was in the United States in the late 1930s when the New York Stock Exchange advised corporations to set up audit committees (Armitage and Bradley, 1994). By 1978, the establishment of audit committees had become mandatory for all companies listed in the New York Stock Exchange (Williams, 1977).

According to the SOX 2002, an audit committee refers to:

> *A committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer; and if no such committee exists with respect to an issuer, the entire board of directors of the issuer.*

The audit committee is the ultimate body that provides oversight of the workings of both the internal as well as the external auditors, and ensures that all relevant disclosures are made as required by the law, and that the accounts give a full and accurate view of the financial status of the company. The audit committee plays a vital role in ensuring the independence of the audit process. The audit committee has been formed to act as a conduit of the information supplied by the management to the auditors and at the same time to insulate the auditor from the pulls and pressures of the management.

Klein (2002), Krishnan (2001) Carcello and Neal (2000), Dechow, Sloan and Sweeney (1996), McMullen (1996) are example of prior researches that have shown a relationship between weaknesses in governance and poor financial reporting quality, financial statement fraud, and weaker internal controls. Furthermore, the Securities and Exchange Commission (SEC) cites that the key to poor quality of financial statements is regulatory oversight. Consequently, they resolve to improve financial reporting effectiveness by introducing the establishment of audit committees. Thus, they issued and force a rule for public companies (see the Blue Ribbon Committee, (BRC), 1999).

The audit committee boosts an investor confidence in the operations of firm with governance practice (Price Waterhouse, 1997). Its members are expected to have knowledge and experience of business, business risk, oversight performance, financial situation and accounting policy that can help to monitor the activities of a firm. Therefore, corporate boards and audit committees are both valuable and rare resources of any organization. In the long run, firms with higher resources and capability tend to gain reputation or credibility.

Research Hypotheses

Finally, in light of the foregoing discussions and exploration of literature, the following hypotheses stated in their null forms have been formulated.

Ho1: The audit committee report does not significantly influence the decisions made by users of financial statements.

Ho2: The report from the audit committee cannot be said to add credibility to the financial statement.

Ho3: The inclusion of the audit committee report in the financial statement does not significantly affect the quality of financial reporting.

Methodology

Prior researches on the subject matter employed different statistical tools. Muhamad-Sori, Abdul-Hamid, Mohd-Saad, and Evans (2007) used the Mann Whitney test together with postal questionnaires in carrying out their survey research; Urbancic (1991) employed a controlled experiment settings together with questionnaires, Phuangthip and Phaproke (2010) applied the ordinary least square regression analysis (OLS) while carrying out their research... just to mention a few. However, we shall apply the Chi Square statistical tool together with questionnaires, as we intend to relax on the normality of our population and sample, which though, is over 50.

The research design employed in this work is the survey design. The population under consideration consists of the users of financial statements. The simple random sampling method, which is a kind of probability technique, has been used to pick our sample from the population so as to give every member of the population equal chance of being chosen.

The data used for the purpose of this work was primary data. The information elicited from the questionnaire distributed to respondents within the geographic scope forms our primary data, while other documented evidences were also used according to the situation.

Data Presentation and Analysis

Reliability Test

Table 1- Cronbach Reliability Test

Section B	**Cronbach Alpha**	**Number of Items**
Questions 4-10	0.972	7

Source: Researchers' computation

A critical look at the above table reveals the extent of internal consistency of the scales and questions put forward to respondents. On the average, the cronbach's alpha is approximately 98%, which according to the George and Mallery (2003) is accorded the score of excellence as regards reliability of research instrument.

Demographic Factors and Descriptive Statistics

Table 2-Demographic Distribution of Respondents

Users	**Number**	**Percentage (Absolute)**	**Percentage (Relative)**
Managers	12	6.7	0.067
Shareholders	57	31.7	0.317
Investors	36	20.0	0.2

Employees	42	23.3	0.233
Others	33	18.3	0.183
Total	180	100	1.000

Source: Researchers' computation

Table 3- Distribution of Report-Interest in the Financial Statement

Report Interest	**Number**	**Percentage (Absolute)**	**Percentage (Relative)**
Profit and Loss only	60	33.3	0.333
Balance Sheet only	30	16.7	0.167
Audit Committee Report only	6	3.3	0.033
Auditors Report only	6	3.3	0.033
Two or more reports	21	11.7	0.117
The whole financials	39	21.7	0.217
Unanswered	18	10.0	0.1
Total	180	100	1.000

Source: Researchers' computation

From the table 2 above, it is evident that our users cut across different sections so as to at least capture a wider range of perception. This is also in line with literature, as we do not just have one single class of users. Of the two hundred distributed questionnaires, the returned ones totaled one hundred and eighty (180). However, of the one hundred and eighty (180), only one hundred and sixty-two (162) were completely filled and useful, hence giving us a response rate of 81%. Shareholders represent the largest class (31.7%) and managers the smallest (6.7%).

Furthermore, from table 3, majority of our respondents (33.3%) are interested in the profit and loss statement however, the opposite is the case for both the audit committee report and the external auditors report. It must be stated that this does not say much as it is possible that those belonging to the group of two or more reports and the whole financials will be interested also in the audit reports.

Table 4- Questionnaire Response Analysis

Questions	Strongly Agree	Agree	Undecided	Disagree	Strongly Disagree	Total	Mean
4	33(20.4%)	72(44.4%)	9(6%)	30(18.5%)	18(11.1%)	162	3.44
5	21(13%)	81(50%)	3(1.8%)	33(20.4%)	24(14.8%)	162	3.26
6	24(14.8%)	69(42.6%)	12(7.4%)	30(18.5%)	27(16.7%)	162	3.20
7	36(22.2%)	81(50%)	6(3.6%)	18(11.1%)	21(13%)	162	3.57
8	48(29.6%)	60(37%)	27(16.7%)	15(9%)	12(7.4%)	162	3.72
9	27(16.7%)	45(27.8%)	15(9%)	48(29.6%)	27(16.7%)	162	2.99
10	39(24.1%)	78(48.1%)	9(6%)	18(11.1%)	18(11.1%)	162	3.63

Source: Researchers' Computation

From the above table, the analysis of the response to question 4, indicates that 33 (20.4%) respondents ticked strongly agree, 72 and 9 ticked agree and undecided respectively which represented 44.4% and 6% of the total respondents while 30 (18.5%) and 18 (about 11%) ticked disagree and strongly disagree respectively. Furthermore, the mean stood at 3.44. The response to question 5 shows that 21 respondents ticked strongly agree, while 81 and 3 of the respondents chose agree and undecided respectively. Also, about 20.4% and 14.8% of the respondents ticked disagree and strongly disagree while the mean is 3.26. The analysis of the response to question 6 reveals that 24, 69 and 12 of the respondents chose strongly agree, agree and undecided respectively which represents 14.8%, 42.6%, and 7.4% of the sample while 30 and 27 respondents ticked disagree and strongly disagree respectively. The response to question 7 shows that 36 (22.2%), 81(50%), and 6(3.6%) of the respondents ticked strongly agree, agree and undecided respectively, while about 24% had contrary views. The analysis of the response to question 8 reveals that 48, 60, and 27 respondents ticked strongly agree, agree and undecided respectively. The mean of the responses stood at 3.72.

The analysis of the responses to question 9 and 10 indicates that the means stood at 2.99 and 3.63 respectively while the number of respondents that agreed to the questions was 72 and 117 respectively.

Hypotheses Testing and Analysis

This section relates to the testing of hypotheses earlier stated. The decision rule is to reject the null hypothesis and accept the alternative if the X^2 calculated is greater than the critical value of X^2 at 5% significant level with degree of freedom of 4.

Responses	Q4	Q5	Total Observation	Expected Observation	(o-e)	$(o-e)^2$
SA	33	21	54	64.8	-10.8	116.64
A	72	81	153	64.8	88.2	7779.24
UND	9	3	12	64.8	-52.8	2787.84
D	30	33	63	64.8	-1.8	3.24
SD	18	24	42	64.8	-22.8	519.84
TOTAL			324	324		11206.8
X^2 Cal $[(o-e)^2/e]$						**34.5888**
X^2 0.95,4						**9.488**

Source: Researcher's Computation

Hypothesis One: From the above analysis, the null hypothesis is rejected and the alternate is accepted since the calculated X^2 value (34.58) is greater than the table X^2 value of 9.488 at 95% confidence interval.

Responses	Q6	Q7	Total Observations	Expected Observations	(o-e)	$(o-e)^2$
SA	24	36	60	64.8	-4.8	23.04
A	69	81	150	64.8	85.2	7259.04
UND	12	6	18	64.8	-46.8	2190.24
D	30	18	48	64.8	-16.8	282.24
SD	27	21	48	64.8	-16.8	282.24
TOTAL			324	324		10.036.8
X^2 Cal $[(o-e)^2/e]$						**30.9777**
X^2 0.95,4						**9.488**

Source: Researcher's Computation

Hypothesis Two: The analysis above requires that the alternate hypothesis be accepted and the null hypothesis rejected since the calculated X^2 value (30.97) is greater than the table X^2 value of 9.488.

Responses	**Q8**	**Q9**	**Total Observation**	**Expected Observation**	**(o-e)**	**$(o-e)^2$**
SA	48	27	75	64.8	10.2	104.04
A	60	45	105	64.8	40.2	1616.04
UND	27	15	42	64.8	-22.8	519.84
D	15	48	63	64.8	-1.8	3.24
SD	12	27	39	64.8	-25.8	665.64
TOTAL **X^2 Cal $[(o-e)^2/e]$** **X^2 0.95,4**			324	324		2908.8 **8.9777** **9.488**

Source: Researcher's Computation

Hypothesis Three: From the above analysis, the alternate hypothesis is rejected while the null is accepted.

Conclusion

Users significantly agree that the audit committee report influence their decision making process. That is, most users take into consideration what is contained in the audit committee report before making their decision. This finding is in line with the arguments of Muhamad-Sori, Abdul-Hamid, Mohd-Saad, and Evans (2007) but has opposite view when compared with the findings of Urbancic (1991). The audit committee report, which brings to light the responsibilities and duties of the audit committee, according to users' perception, adds to the credibility of the financial statement. Users believe that the inclusion of the audit committee report in the corporate financial statement enhances its relevance hence, may be argued not to be duplication of efforts. This view is also contrary to the view shared by Urbancic (1991). Quite similar to the above is the issue of financial reporting. Users are persuaded that the inclusion of the audit committee report in the financials does not significantly improve the financial reporting quality of an organization. Users' perception of a subject matter is highly subjective, however, from the work done, it is safe to say that the audit committee report in itself is relevant but to include it as a compulsory report may not be quite necessary, as most financial statement users do believe that it does not significantly affect the quality of financial reporting.

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