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AUDIT COMMITTEE OVERSIGHT: INCREASING REGULATORY REQUIREMENTS

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ABSTRACT

Audit committees are required by law for all publicly traded companies in the United States to work with external auditors to improve the integrity of financial reporting. Members of the audit committee have a fiduciary duty to the public and must maintain independence from the company in which they serve. Requirements for audit committees were made more stringent following the collapse of major public companies such as Enron and WorldCom in the early 2000s. The question remains whether audit committees maintain their independence and provide effective control on financial reporting. This paper determines if there should exist statutory regulatory powers to raise the standard of accountability for a company's audit committee. It also will look at how increasing the accountability past what the Sarbanes-Oxley Act of 2002 required, could improve the fairness of financial reporting.

Keywords: audit committee, audit quality, SOX, audit regulation,

INTRODUCTION

Throughout the last century, audit committees have served as an important check on an organization's financial reporting process. During this time, recommendations and regulations have changed to increase the quality of a company's financial statements and the third party's external audit. Audit committees play an essential role in overseeing the external auditor and providing valuable assistance by supervising and communicating with an organization's management. As a result of these responsibilities, audit committees are in a key position to influence both audit quality and financial statement quality. This position within the firm has led many to ponder the effects of specifically increasing regulatory oversight into the functions of the audit committee. While research backs up suggestions on how to improve an audit committee's functionality, the benefits of increased regulation must be weighed against the positive aspect of a self-regulating industry and accounting profession.

AUDIT COMMITTEE HISTORY

Audit committees are not a new development to enhance the credibility of the financial reporting process. Audit committees can trace their history back to the 1930s. In what was described as the SEC case which had the greatest impact on the public accounting profession, a fraud scheme that occurred involving McKesson & Robbins, Inc. caused a tremendous loss of credibility. In a case that was covered exhaustively in the news, McKesson & Robbins had included on their financial statements $19 million of nonexistent assets and a gross profit of $1.8 million that was fueled by fake sales of $18 million (Barr and Galpeer, 1987). Questions were raised about why the public accountants had failed to discover a fraud scheme of such massive proportions. After conducting business with relative anonymity, the accounting profession was being scrutinized by the public.

Brenda S. Birkett (1986) credits the McKesson & Robbins fraud case with a burgeoning interest in the efficacy of audit committees. In the late 1930s, the Securities and Exchange Commission and the New York Stock Exchange (NYSE) encouraged the creation of audit committees. Audit committees also surged in popularity in the 1970s when R.K. Mautz and F.L. Neuman issued a survey in which 32 percent of responding corporations had audit committees. When the survey was repeated in 1976, Mautz and Neuman found that 87 percent of respondents had audit committees (Birkett, 1986). This number continued to grow after the NYSE, with the prodding of the Securities and Exchange Commission, required that all listed companies on the exchange maintain an audit committee on January 6, 1977.

During the 1970s, regulations that governed audit committees began to change. In 1974 the Securities and Exchange Commission changed rules and began requiring that public companies include disclosures about the independence of the members of the audit committees. In addition to the requirement of audit committees by the NYSE in 1977, the audit committee needed to be made up of independent directors. While the American Institution of Certified Public Accountants (AICPA) was slow to adopt a requirement that public companies must have an audit committee, the institution issued SAS 61 entitled Communication with Audit Committees in 1988 (Mo, Shi and Wang, 2013). SAS 61 required that the external auditor communicates with the audit committee any additional information which would help the audit committee in its role of overseeing the financial reporting process.

Research by the Blue-Ribbon Committee (BRC) also helped to increase the requirements of audit committees. In the late 1980s, the BRC began a research project to discover how to increase the effectiveness of audit committees. The final BRC report recommended that audit committees should be composed of at least three financially literate members and one member with financial expertise. Before the turn of the millennium, the NYSE, the National Association of Securities Dealers (NASD), the AICPA, and the Securities and Exchange Commission adopted regulatory changes regarding the composition of audit committees based on the findings of the Blue-Ribbon Committee (Mo et al., 2013).

SARBANES -OXLEY ACT AUDIT CHANGES

Regulations and recommendations throughout the 20th century were not enough to prevent the massive accounting scandals and financial collapse of major corporations such as Enron and WorldCom in the early 21st century. In response to the immensely publicized fraud cases, the federal government stepped in with the Sarbanes-Oxley Act of 2002 (SOX). The objective of SOX was to restore public confidence in the financial reporting process after headline after headline undermined the credibility of the auditing profession. SOX greatly expanded the responsibility of audit committees concerning the oversight of the financial reporting process and checking management's decisions regarding reporting and disclosures (Mo et al., 2013).

The changes to audit committee regulation are derived from four areas of SOX: (1) the definition of an audit committee, (2) a clearer list of responsibilities, (3) the composition of the committee, and (4) qualification requirements for members.

In Section 205 of the Sarbanes Oxley Act of 2002, the definition of audit committees is written as "(A) 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" (GovTrack, 2020). SOX indicates that if there exists no audit committee, the entire board of directors must serve as the committee to oversee the external auditors and financial reporting process of the organization.

SOX also clarifies the responsibilities of the audit committees. It notes that audit committees are directly responsible for the appointment, compensation, and work of the external auditing firm (GovTrack.us, 2020). It also indicates that the audit committee provides oversight into the accounting practices adopted by the organization and discusses risk management procedures with the management of the organization (Mo et al., 2013).

SOX required that audit committee members should be independent of the organization which they serve. The Sarbanes-Oxley Act specifies that in order to remain independent, the members of the audit committee should not accept any consulting, advisory, or compensatory fee from the organization. Also, they should not be an affiliated person of the organization (GovTrack.us, 2020).

The final change to audit committee regulation provided by SOX dealt with the qualification of members on the committee. Audit committees are now required to have at least one financial expert that helps to clarify accounting procedures when the committee reviews the financial statements of the organization (Mo et al., 2013). SOX indicates that the Securities and Exchange Commission has the ability to consider, whether through education and experience, a financial expert has an understanding of generally accepted accounting principles, experience in preparing financial statements, experience in the application of accounting principles, experience with internal accounting controls, and an understanding of what the responsibilities of the audit committee include (GovTrack, 2020).

AUDIT COMMITTEE ROLES AND RESPONSIBILITIES

Audit committees are an integral component of the financial reporting system. The responsibilities of the committees include (1) providing oversight of financial reporting and internal controls, (2) reviewing filings and earnings releases, (3) engaging in risk surveillance, (4) providing oversight of the independent auditor, (5) evaluating ethics and compliance of the organization, (6) overseeing the internal audit, and (7) communicating their findings with management (Bujno, Hitchcock, Parsons, and Lamm, 2018).

Regarding its first responsibility, providing oversight of financial reporting and internal controls, the audit committee should be familiar with the processes and controls that are involved in conducting the business of the organization. This includes being aware of how certain controls encourage compliance and accuracy while deterring misappropriation of assets and fraudulent financial reporting. As a result of this responsibility, many audit committee members have extensive knowledge of the organization's industry.

In addition to the first responsibility, audit committees also provide valuable control by reviewing the filings and earnings releases of the organization. These include reports filed with the Securities and Exchange Commission as well as well as other financial information provided to analysts and third parties. In order to execute an effective review, the audit committees must judge the reports and releases for consistency and transparency.

In the world of business, risk is always present. This explains the audit committee's responsibility for risk oversight. While playing this role, the audit committee will assist and evaluate management's policy and procedures to detect and deter fraud within the organization. According to an article detailing the roles and responsibilities of the audit committee by Deloitte, it is noted that the SEC considers risk oversight a primary responsibility of the board, and for this reason it requires certain disclosures relating to which members of the board provide oversight and whether employees responsible for risk management report to the board (Bujno et al., 2018).

The audit committee also oversees the independent auditor. When an organization's stock is listed on an exchange, the audit committee is responsible for not only oversight but also for the appointment and compensation of the independent auditor. It is also paramount that the audit committee correctly identifies if the independent auditor is independent in appearance and fact. AS 1301 issued by the Public Company Accounting Oversight Board (PCAOB) requires communication between the auditors and the audit committee. The auditors must communicate to the audit committee the objective of the audit, the auditor's responsibilities, the overall audit strategy, the timing of the audit, and any other timely observations that arise during the audit that are consequential to the financial reporting process (PCAOB, 2012).

The audit committee is also responsible for evaluating the ethics and compliance in the organization. Ethics and compliance continue to be an important issue that impacts the credibility of an organization's financial reporting system. An organization's management must embrace the "tone at the top" to effectively encourage compliance with a code of ethics. The Securities and Exchange Commission requires that registered companies must disclose whether they have a written code of ethics that applies to executive positions (Bujno et al., 2018). The Securities and Exchange Commission has a written definition for the code of ethics. The audit committee should collaborate with management to ensure that the organization's code of ethics complies with the appropriate standards.

The audit committee is concerned with the internal audit function as well as the external audit function discussed above. The audit committee must establish a proper working relationship with the internal auditors to ensure that the goals and priorities of both are consistent with each other.

Finally, it is important that the audit committee is able to communicate findings and concerns with upper management, the board of directors, and other external parties. Audit committees are required to disclose certain information but can exceed the requirements and offer more information than what is required. According to the 2016 Board Practices Report by Deloitte, 41% of audit committees disclose more than what is required in the proxy statement (Stuckey, DeHaas, and Phillips, 2017).

AUDIT QUALITY ISSUES

Stories of accounting scandals and fraud are likely to make headlines and influence public opinion about the credibility of financial reporting. While it is primarily upper management and the external auditors that take the blame for the fraud or financial collapse, it may be worthwhile to assess what the audit committees could do to mitigate risks of audit failure and mismanagement of the organization. Since the audit committee has the responsibility to appoint, compensate, and oversee the external auditor as well as communicate with upper management and the board of directors, the audit committee has a substantial influence on both parties.

The Center for Audit Quality (CAQ) is a nonprofit organization whose mission is to build investor confidence by advocating for policies and procedures that promote objectivity and independence of external auditors. The final goal of the nonprofit is to enhance audit quality through research, recommendations, and action. According to the CAQ's 2019 Main Street Investor Survey, respondents were asked about their confidence in audited financial statements. When respondents answered that they felt confident making decisions based on audited financial information, 42% of respondents cited a belief that auditors provided honest and independent scrutiny as their top reason. Conversely, when respondents answered that they lacked confidence in audited financial statements only 28% believed that auditors do not provide honest and independent third-party scrutiny (CAQ, 2019).

In comparison when asked why they had confidence in audited financial statements only 8% of respondents listed that their belief that the company was trustworthy as the primary reason. On the other hand, 30% of respondents indicated that they believed companies were not trustworthy as their primary reason for not trusting audited financial statements (CAQ, 2019). This was the top reason given for the respondents' lack of confidence in audited financial statements.

One conclusion that could be drawn from this report is that confidence in the management of companies to present accurate financial statements is lower than the confidence in the credibility of external auditors. In this case, increased responsibility and accountability from the audit committees could provide a boost to investor confidence in audited financial statements.

Interestingly, government regulation and policy were also in the top three responses for why investors had or lacked confidence in audited financial papers. The intersection of the organization, the external auditors, and governmental regulation provide the basis for this investigation. The question is whether the federal government could increase the credibility of the organization by increasing regulations regarding the oversight of audit committees. Since audit committees serve as a valuable conduit of information from upper management to the external auditors and throughout the organization, increasing regulatory oversight could prove to be beneficial to the improvement of third-party confidence in an organization's financial reporting process.

ACFE Report to the Nations Findings

When discussing the effectiveness of audit committees, the Association of Certified Fraud Examiners' (ACFE) 2020 *Report to the Nations* provides excellent data to solidify the necessity of such committees. An audit committee serves as an important control to prevent fraud and enhance the quality of financial statements.

The most common anti-fraud control listed by the respondents to a survey published by the ACFE was an external audit of financial statements with 83% reporting their financial statements were audited. The third most common anti-fraud controls were internal audit departments with 74% reporting that their organization included one. Since both external and internal audit functions are some of the top anti-fraud controls, the role of the audit committee provides extra oversight into these functions. It is important to note that an independent audit committee was also listed by respondents as a common anti-fraud control with 62% answering that their organization possessed such a committee (ACFE, 2020).

Audit committees also serve as an important resource for whistleblowers. The report estimates that in 33% of fraud cases, the whistleblowers reported their suspicions directly to either those within the company or other interested parties. In 6% of cases, the whistleblowers initially reported their concerns to the board of directors or audit committee (ACFE, 2020). Receiving tips from whistleblowers can be an important function of an audit committee. It involves two of its responsibilities: engaging in risk surveillance and monitoring the ethics and compliance of the organization.

While these statistics show that audit committees are used by organizations, it does not quantify how effective they are at preventing fraud. The *Report to the Nations* also includes a section that answers how the presence of anti-fraud controls relates to median loss due to fraud. In the case of audit committees, 62% of respondents indicated that they had an audit committee and 38% indicated that they did not. In the cases where the organization had an audit committee, the median loss due to fraud was $100,000. In the cases where the organization did not have an audit committee, the median loss was $150,000 (ACFE, 2020). This shows that an independent audit committee can help lower the impact of fraud on an organization when it does occur.

The report also looked at how anti-fraud controls played a role in the duration of the fraud scheme. Taking into account the same 62% of respondents with an independent audit committee and 38% without one, the presence of an audit committee reduced the median duration of the fraud scheme. In the cases where the organization had an audit committee, the median duration of the fraud scheme was 12 months. In the cases where the organization did not have an audit committee, the average duration of the fraud scheme was 18 months (ACFE, 2020).

It is also interesting to note that in both cases, median loss and median duration, the most important anti-fraud control was a code of conduct. One of the responsibilities of the audit committee involves the monitoring of ethics and compliance in the organization. The audit committee plays a key role in the effectiveness of this control by ensuring the code of conduct meets appropriate standards. Perhaps the audit committee's responsibility to ensure that every employee, including the executive suite, is complying with the code of conduct is its most important function.

Financial Expert Requirement

When it was introduced, the Securities and Exchange Commission's definition of a financial expert laid out in the Sarbanes-Oxley Act of 2002 was considered by many to be too restrictive. It narrowed the range of expertise that a financial expert sitting on the board could possess so that only those with public accounting experience or certifications such as Certified Public Accountant (CPA) or Chartered Financial Analyst (CFA) could obtain a seat on the committee. After this criticism, the Securities and Exchange Commission broadened the definition of a financial expert under Section 407 of the Sarbanes-Oxley Act to include accounting financial experts and non-accounting financial experts (Bilal, Chen, and Komal, 2018). Those who could be considered non-accounting financial experts include investment bankers and financial analysts. Individuals with experience as a chief executive officer (CEO) or president of an organization also qualify.

A study conducted by the Beijing Institute of Technology and the University of International Business and Economics (Bilal et al., 2018) attempted to discover if the initial, more restrictive, definition of a financial expert was conducive to a higher earnings quality. The study looked to provide evidence that non-accounting financial experts were not as effective, and that the original definition laid out by the Securities Exchange Commission should be reinstated.

The researchers used a technique known as a meta-analysis that looks at the cumulative findings of previous studies to reach a conclusion. A total of 90 studies were used for the meta-analysis. The analytics on the cumulative findings of other studies provided evidence supporting the original definition of financial experts laid out by the Securities and Exchange Commission. They conclude that audit committee financial expertise has a positive relationship with earnings quality and that AFEs (accounting financial experts) are more strongly associated with earnings quality" (Bilal et al., 2018). The section continues, demonstrating that the information obtained in the study can be used by regulators and lawmakers regarding decisions to create legislation and regulation for audit committees. It also concludes that it could be better if each audit committee was required to have at least two financial experts and that the effectiveness of financial experts should be certified through additional disclosures (Bilal et al., 2018).

When it relates to increasing regulatory oversight into the work and composition of audit committees, this study (Bilal et al., 2018) supports a conclusion that the definition of a financial expert should revert to its previous position. It also supports other changes to audit committee requirements that relate to the number of financial experts and disclosures. While the study makes recommendations to regulators, it does not provide adequate proof that there needs to be increased legislation and regulation to increase accountability. Stock exchanges that list public companies and the accounting profession can go above what the law currently requires to avoid government intervention into their industries.

Self-Regulation in the Accounting Profession

Throughout much of the profession's history, accounting was self-regulated. In a speech given by then-commissioner of the Securities and Exchange Commission, John R. Evans (1979) remarked the Commission's relationship with the accounting profession is a good example of our unique approach to regulation. He goes on to say that through the emphasizing of self-regulation, and the participation of the private sector, the Securities and Exchange Commission had been able to protect investors and strengthen the financial reporting process. Since the Securities and Exchange Commission did not have to rely on an inflated agency with employees that oversaw the financial reporting process and the accounting firms that audit financial statements, Evans reasoned that it could be considered the best regulatory agency in Washington (Evans, 1979).

During this time, the AICPA had conducted a peer review system in which one firm would have another firm review its previous audit engagements to ensure effective, high quality audits were being performed.

However, a main criticism of this approach is that the firms that audit one another may not be truly independent. The public accounting industry's ability to self-regulate declined with the passage of the Sarbanes Oxley Act of 2002. SOX created the Public Company Accounting Oversight Board (PCAOB) which was given the responsibility of reviewing the engagements of audit firms that audit public companies. Even with this change, many were still critical of the PCAOB's approach, calling it a "form over substance" approach (Anantharaman, 2012).

A study by Anantharamam (2012) noticed the strengths and weaknesses of both self-regulation and government oversight. The study attempted to determine whether better outcomes were achieved before SOX created the PCAOB, or if the accounting profession was better off in prior years. In order to determine which approach was more effective, the number of clean reports from peer reviewers were compared to clean reports from the PCAOB. The study concluded that firms that chose their own reviewers that had connections with the firm tended to receive peer reviews that were more favorable than reviews by the PCAOB. However, peer reviewers with similar industry experience as the firm they were reviewing were found to likely agree with the PCAOB's findings. In addition to providing about the same results as PCAOB reviews, peer reviews conducted by firms in similar geographic locations and industries tend to be better about providing information about potential future audit failures (Anantharaman, 2012).

This demonstrates that peer reviews done by firms in the same area and industry provide an extra element that reviews conducted by the PCAOB cannot. These findings support a scenario where the AICPA could conduct a system of peer reviews for public companies but require that the reviewing firm conduct audits of similar industries and be located in a similar geographic location.

Aspects of self-regulation play into the discussion about increasing regulatory oversight of audit committees. If the AICPA can effectively design a peer review system for the review of accounting firms that review other firms that audit the financial statements of public companies, the institution could prove its mettle by designing a test of audit committee effectiveness.

CONCLUSION

Audit committees formed to check the earnings quality of organizations as public confidence in audited financial statements deteriorated. From the creation of fake assets and sales at McKesson & Robbins in the 1930s to the financial collapse of major corporations such as Enron and WorldCom in the early 2000s due to accounting scandals, instances of fraud have persisted throughout the last century. Changes have been made regarding the rules and responsibilities of audit committees. These changes have attempted to rectify failings of the past to preserve investor confidence and prevent financial collapse.

The Sarbanes-Oxley Act of 2002 was the last major change to regulation regarding audit committees and it is worth questioning if more regulation would be beneficial. When accounting scandals pop up in headlines, many insist that increasing government control is the only way to correct failings of the past. However, the accounting industry has a long history of self-regulation. This history of working with professional organizations and the Securities and Exchange Commission to improve the quality of audits and the related financial statements have positively impacted the accounting profession. A Rutgers study found that peer reviews were effectively reaching their goals when the peer reviewer was in the same area and had relevant industry experience (Anantharaman, 2012). The input of the peer reviewer was more beneficial to the firm being reviewed than the input was when the review was conducted by the PCAOB. In this case, more stringent rules enacted by the AICPA would have been more effective than government oversight.

In the case of audit committees, the financial expert requirement is essential to the quality of understanding that the audit committee acquires of the processes and financial statements of the business. In a study done by the Beijing Institute of Technology and the University of International Business and Economics, it was concluded that there was a positive relationship between audit committee financial expertise and earnings quality (Bilal et al., 2018). The intent of the study was to help regulators in terms of increasing the specificity of the definition of a financial expert, advocate for at least two financial experts on the audit committee and include disclosures about the effectiveness of the financial experts on the audit committees.

There is no easy answer when it comes to increasing regulatory oversight when it concerns audit committees. The evidence suggests that while regulation is effective at increasing audit quality, industry organizations have also effectively increased the quality of audited financial statements over the last century. However, the evidence in this investigation suggests that if a regulatory agency does not enact legislation regarding the financial experts on audit committees, the industry should require it. There are two ways to accomplish this goal without involving the government. The first way would be if the major stock exchanges enacted this requirement for all public company stock listed on their exchanges. The second way would include the accounting profession using its self-regulatory powers to not allow auditors to conduct an audit of public companies if the composition of the audit committee is not competent to conduct a quality audit. Regardless of which approach is taken, it is not necessary for a regulatory agency to increase oversight into audit committees through regulation.

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