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Corporate Governance: The Role and Effectiveness of the Audit Committee in Bahrain

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Abstract

Over the last decade or so, the focus on information disclosed in financial statements, corporate governance and the role of the audit committee to monitor and oversee financial reporting has increased. This is largely attributed to the global business scandals caused mainly by fraudulent financial reporting. In response, the role of audit committee was questioned in an attempt to maintain user's confidence in corporate financial reporting and improve the effectiveness of an adequate internal control Not least because, an audit committee is an independent body created by the board to oversee financial reporting and disclosures, monitor effectiveness of internal control, and external and internal audit functions.

At present, there is no conclusive evidence on the role and effectiveness of the audit committee. At one end of the spectrum there are audit committees that see their role as the validation of financial statements, while at the other end, are those who have broadened their role to include oversight of performance and critical high level business and operating tasks.

The purpose of this research is twofold: *First*: to investigate the state of the art of audit committees in Bahrain regarding composition, meetings, independence and role of audit committees. *Second*, since "Blue Ribbon" recommendations were issued in 1999, effectiveness of audit committee has become a cornerstone for corporate governance. Therefore, an objective will be to assess effectiveness of audit committee.

Keywords: audit committee, corporate governance, Blue Ribbon Committee, Sarbanes-Oxley Act

1. Introduction

The corporate failures that shock the business community at the turn of this century have placed corporate governance issues as a major concern for financial statement users worldwide. Corporate governance refers to the internal control system of a company designed to reconcile the conflicting interests of various stakeholders, achieve its objectives and monitor financial performance. Likewise, Levitt (1999) noted that, "corporate governance is the link between a company's management, directors, and its financial reporting system". Implementing sound corporate governance is the responsibility of management to minimize fraud through various preventive and detective measures. The main emphasis of proper corporate governance is on such issues as the integrity of a corporation management, adequacy of controls, ability to continue as a going concern and user's right to have reliable, transparent and timely reports about a corporation performance.

The bankruptcies of multi-billion dollar corporations in different parts of the world, caused by fraudulent reporting, has seriously damaged user's confidence in these reports. In response, most companies around the globe are exerting more efforts to improve corporate governance in a bid to maintain the integrity of financial reporting and user confidence again. A number of other factors have also played a key role in the current interest in corporate governance, such as size of corporations that is growing larger and complex, globalization that has attracted investors worldwide, and the current increasing interest in the social responsibility of corporations.

For these reasons, the need for corporate governance has increased remarkably, which in turn increased the attention on the audit committee as a mechanism for sound corporate governance.

2. Objective of Research

The objective of this research will be to investigate the state of the art regarding the role, composition, meetings

and independence of audit committee and assess effectiveness to oversee financial reporting and monitor internal and external audit functions.

3. Literature Review

As early as 1998, the former SEC chairman, Arthur Levitt, raised serious doubts about the effectiveness of the audit committee as a corporate governance mechanism. In effect, the Blue Ribbon Committee (BRC) on the effectiveness of audit committee was formed. The committee was mandated to recommend ways to improve effectiveness of audit committee to protect investor interest, maintain public confidence in financial reporting and enforce corporate accountability and transparency. In addition, following the scandals of large corporations such as Enron and Worldcom, the US government passed the Sarbanes-Oxley Act on July 30, 2002. The Act was considered by many observers (academicians and professionals) as the most important change affecting the auditing profession since 1933–1934. Indeed, the provisions of the Act have changed the relationship between the public corporations and their audit firms. At present the audit committee is considered to be the audit client rather than the company management. The Act also established the Public Company Accounting Oversight Board (PCAOB) to oversee auditors of public companies, set auditing and quality control standards for public companies audit and perform inspection of the quality control of audit firms performing the audit of public companies. Prior to the introduction of the Sarbanes-Oxley Act, the auditing standards were set by the Auditing Standards Board (ASB) of the American Institute of Certified Pubic Accountants (AICPA) for both public and private companies. The American Institute of Certified Pubic Accountants (AICPA) continued to set auditing and quality control standards for private companies.

The objective of the Sarbanes-Oxley Act was to enhance the role of audit committee and improve corporate governance by imposing stringent reporting and disclosures requirements. In addition, the Act raised membership requirements and committee composition to include more independent directors and companies are required to disclose whether or not a financial expert is on the Committee. In 1999, Blue Ribbon Committee (BRC) issued ten recommendations on the appropriate composition, role and function of audit committee in an effort to improve their effectiveness. The main purpose of Blue Ribbon Committee recommendations was to strengthen the independence of the audit committee, and their effectiveness. BRC first and second recommendations address the definition of director independence and requirements for independent audit committees. The BRC recommends that all listed companies over a certain size have audit committees composed entirely of independent directors. BRC third recommendation requires a minimum of three audit committee directors, each of whom is financially literate and at least one of them has accounting or related financial management expertise. Financial literacy is defined as the ability to read understand and analyze the financial statements and accounting expertise may be demonstrated by employment experience in the field of finance or accounting. BRC forth and fifth recommendations require the audit committee to have a formal charter, disclose the status of the charter and whether the audit committee fulfilled its designated responsibilities and functions. The rest of the recommendations require the audit committee to be directly involved in the selection, supervision and compensation of the external auditor.

3.1 Emergence of Audit Committee

The history of audit committee dates back to 1939, when the concept was first adopted. Now, more than half a century later, audit committee has become a vital force in corporate governance. The need for audit committees originally arises due to the agency relationship. Jensen and Meckling (1976) defined an agency relationship as a contract under which one or more persons (principals) engage another person (the agent) to act on their behalf, which requires the principal to delegate some decision-making authority to the agent. In today's corporate form of business, users of financial statements are not directly involved in the day to day operations of the corporation. Therefore, users, including the board, rely on a third party (executive management) to provide relevant and reliable information. However, executive managers (agents) interests may not coincide with the interest of the principals. Therefore, shareholders need to monitor the activities of the agents to ensure that they live upto the provisions of their contracts (Goddard *et al* 2000).

Audit committees are selected members of company's board of directors whose role, among many others, to improve the quality of financial reporting and help auditors to remain independent (see below). Indeed, audit committees offer various advantages to corporations, such as improving the reliability of the corporation's financial reporting, strengthening the independence of the internal and external auditors, enhancing the adequacy of internal control, and improving the relationship between the board and the auditors.

3.2 Role of Audit Committee

At present, the role of audit committee continues to evolve. In addition, the Sarbanes-Oxley Act of 2002 has

increased the role and independence of audit committees by making the audit committee for public companies the audit client rather than management. The Audit Committee typically oversee the reliability of the entity's financial statements, compliance with rules and regulations, qualifications and independence of the external auditor and effectiveness of entity's internal audit function and internal control.

3.2.1 Financial Reporting and Accounting

An overriding objective of audit committees of publicly held corporations is to oversee reliability of financial reporting and disclosures, monitor management's and the independent auditors' participation in the financial reporting process, and review the transparency. In addition, audit committee members will often assess accounting judgments and estimates made by management, adopt appropriate accounting principles and maintain a tough questioning attitude.

3.2.2 Independent Auditor

According to Sarbanes–Oxley Act of 2002, the audit committee is now directly responsible for the appointment, compensation, and oversight of the work of public accounting firm. In the past the chief financial officer (CFO) of an organization was authorized to hire and fire the auditors, which is potentially damaging the independence of the audit profession. In a bid to strengthen auditor independence, the Act requires the auditing firm to report directly to the audit committee, rather than the chief financial officer. The independent auditor normally reviews the entity's financial statements and express an opinion on whether the financial statements are fairly stated (stated according to GAAP or IFRS). Also audit committees are required to approve all audit and non-audit services. The independent auditors are further required to report to the audit committee on the selection and adoption of accounting principles, and accounting adjustments arising from their audits. The Act further requires the independent auditors to assess and report on key matters arising from the audit and any material weaknesses in internal control in relation to the financial reporting process.

3.2.3 Monitor the Effectiveness of the Internal Control and the Internal Audit

Internal control is defined as "a process designed to provide reasonable assurance regarding the achievement of objectives in the following categories: (a) reliability of financial reporting, (b) effectiveness and efficiency of operations, and (c) compliance with applicable laws and regulations." Internal controls often take the form of financial, operational, or administrative controls. Effective internal control system will enhance reliability of financial reporting. Indeed, section 404, of Sarbanes–Oxley Act requires issuers of financial statements to publish information in their annual reports concerning the scope and adequacy of the internal control structure and procedures for financial reporting. The statement shall also assess the effectiveness of internal controls and procedures. The effectiveness of internal controls depends directly upon the integrity of persons administering and monitoring controls. It is the responsibility of management to create ethical values that discourage staff from engaging in unethical, dishonest or illegal acts.

The internal audit department is required to provide periodic written reports to the audit committee on significant issues, including internal control weaknesses. More importantly, an overriding goal of internal auditor is to investigate and appraise effectiveness with which various units of a corporation are carrying their assigned duties. Much attention is given by internal auditors to the study and appraisal of internal control and to make recommendations for improvements as deemed necessary.

3.3 Composition and Meetings

Although there is no consensus worldwide on the composition of audit committees, the practice indicates that the committee is made up of three to six members. The committee is composed of independent outside directors including at least one member with financial expertise. Institute of Internal Auditors (IIA) best practice states that, "The audit committee will consist of at least three and no more than six members of the board of directors... Each committee member will be both independent and financially literate". This has been the practice in both developed and developing countries. And Bahrain is no exception.

The practice worldwide indicates that audit committees typically meet four times a year. In addition informal meeting are also scheduled between the audit committee, company management and the external auditor.

4. Research Method

For the purpose of this study we used the questionnaire method to collect data. The respondents of the target companies were first contacted and then questionnaire were sent to them. The questionnaire, which was developed from an extensive review of related literature and discussed with a group of academicians and practitioners, had 17 questions directly addressing the specific objectives of the study. The questionnaire

focused on the composition, the role, independence and financial literacy of audit committees, key achievements and challenges.

5. Results and Findings

In this paper we investigated the state of the art regarding the role, composition and independence of the audit committees in Bahrain, using a sample of 30 listed companies on the stock exchange. The findings of the study indicate that all of the 30 respondents (100%) had established their audit committees from the board of directors, none of whom is engaged in a managerial (executive) duty. Likewise, all of the 30 respondents (100%) had developed their charter, but was never updated since inception in 2010. In terms of role of audit committee, the following table summarizes the results.

Table 1. Summarized results

Monitoring integrity of the financial statements	100 %
Review internal control	87 %
Monitor and review effectiveness of internal audit function	87 %
Recommend appointment of external auditor	67 %
Approve remuneration of external audit	67 %
Monitor independence of external auditor	87 %
Others (specify)	0

The committee is composed as follows: 30% of respondents have just three members, while 70% has more than three members (3–6). The term of office of audit committee members indicate that 65% are recruited for three years, and 35 % for more than three years (3–5). Another aspect related to composition of the audit committee is financial knowledge in accounting, auditing, internal control system and financial reporting processes of its members. We found that 30 % of the members are university graduates in Accounting, while 60 % of members are university graduates in other majors. As for meetings, the charters, of 67% of respondents, stated that the committee should meet semiannually, with 33% to meet annually. In reality, however, we found that in more than 60% of cases meetings were irregular and infrequent. Although 70% reported that they were provided with sufficient resources (funds and access to information), however only 20 % of members reported that they are sufficiently remunerated for their duties and responsibilities. The study also shows that the Blue Ribbon Committee recommendations had insignificant impact to improve the effectiveness of the audit committee, where 50% reported that it had little effect, 10% has no effect, 30% reported a moderate effect and 10% are undecided. Finally, 70% of audit committee members are satisfied that the committee has effectively discharged its duties and responsibilities as set out in the charter. None of the respondent, however, disclosed in its annual report a statement on the composition, role and function of audit committee.

6. Conclusions

Joshi and Wakil (2004) concluded that the company size, nature of industry and the audit firm (foreign or local) influenced the establishment of audit committees. Our finding is that neither the type of the industry nor the size of the company was found to be a factor of whether a listed company established an audit committee or not. This inconsistency may be due to the fact that at present audit committees in Bahrain is mandatory as per Article (21) of “the Labor Market Regulatory Authority”. However, almost all respondents did not update their audit committee charters annually as required by the charter, indicating either a shortage in qualified experts or negligence that is dominant in most developing countries. Although all respondents have developed audit committee charter, the charters are typically the same in terms of components which is consistent with experience elsewhere in the world.

The charter requires the committee to meet four times a year. But in almost all cases, we found that meetings were irregular and infrequent. Indeed, in three cases the committee did not meet for a whole year. Worse even the internal auditor in one case was not even aware of the existence of such committee at all.

In sum, independence and qualification of the audit committee are key elements determining the effectiveness of the audit committee. Instead of concentrating on the establishment of audit committees, authorities in Bahrain need to exert more effort on the effectiveness of the audit committee. Although, it is often argued that the Blue Ribbon Committee was “too little too Late”, however, there is sufficient evidence that the implementation of the

BRC recommendations have improved the effectiveness of audit committees. In Bahrain, it was found that audit committees rarely performed their duties nor being assessed in a satisfactory manner. The fact that meetings are irregular and infrequent, has remarkably hindered the effectiveness of audit committees as a corporate governance mechanism. Therefore, increasing the frequency of audit committee meetings is an important step towards more effective monitoring. Finally, unlike the experience elsewhere, in Bahrain the audit committee is rarely being used as a management control and performance evaluation tools. The essence of an effectively controlled organization depends largely on the effectiveness of its audit committee and the attitude of its management towards the functions and responsibilities of audit committee. Therefore, the authorities need to assess the experience of the audit committee so far in a bid to improve effectiveness. Good corporate governance (GCC) requires transparency, accountability, responsibility and fairness. Needless to say all these values depend on an effective, highly motivated audit committee with specific duties. High ownership concentration is likely to have a positive impact on monitoring management attitude and in turn the effectiveness of audit committees.

The role and responsibilities of audit committee is still evolving, continuously changing, challenging, time consuming and more demanding than ever before. Future research is needed to identify specific role of audit committee and make use of Blue Ribbon Committee recommendations to improve effectiveness of audit committee, enhance corporate governance, strengthen auditor independence and compare with emerging stock capital markets in the third world.

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Appendix

1. Is your company listed on Bahrain stock exchange "Bourse"?

Yes	No

2. Do you have an audit committee? (tick √)

Yes	No

3. Do you have an audit committee charter? (tick √)

Yes	No

4. How often is your audit committee charter updated? (tick √)

Yes	No

5. The number of audit committee members (tick √)

Less than three members	Three members	More than three members

6. the main roles and responsibilities of audit committee include: (tick √)

Monitoring integrity of the financial statements	
Review internal control	
Monitor and review effectiveness of internal audit function	
Recommend appointment of external auditor	
Approve remuneration of external audit	
Monitor independence of external auditor	
Others (specify)	

7. Are all committee members selected from the board of directors:

Yes	No

8. The term of office of audit committee members is .

Less than three years	Three years	More than three years

9. Is there any member(s) who is (are) engaged in a managerial (executive)duty

Yes	No

10 – Frequency of meetings:

Quarterly	Semiannual	Annual	Others (specify)

11. Does the audit committee provided with sufficient resources to perform its duties?

Funds	Access to information	Other resources required

12. Are the members sufficiently remunerated for their responsibilities.

Yes	No

13. Qualifications of audit members (how many in each category):

School leavers	University graduatein Accounting	University graduate in other majors	others

14. Is the committee satisfied that it has effectively discharged its responsibilities as set out in its charter?

Yes	No

15.To what extent has the Blue Ribbon recommendations improved the functioning of the audit committee?

No Effect	Little effect	Moderate effect	Great effect	Undecided

16. Do you include in your annual report a statement to disclose composition, role and function of audit committee?

Yes	No

17. How can the audit committee improve its operating efficiency and effectiveness?

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