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An Investigation into the Relationship Between Audit Committee and Audit Quality

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Abstract: The research aims at the examination of the relationship between audit committee and audit quality. The present research is a descriptive survey focusing on correlation relationships. The independent variable intended in this study has been audit committee and the focus of the study is mainly on the impacts of this variable on audit quality. The statistical population in this study includes 1146 Official Accountants. Using simple-random sampling to determine the sample size, 94 persons were selected as the statistical sample. The results revealed a statistically significant relationship between audit committee and audit quality. The findings also showed that the audit committee can be promoted the effectiveness of the independent auditors, internal auditors, internal controls, disclosure of the financial statements and the amelioration of the auditing reports.

Key words: Audit Committee, Audit Quality, Independent Auditors, Auditing Reports.

INTRODUCTION

With regard to the development of the large companies, the creation of a gap between the ownership and the management of the companies in the 19^{th} century and the increase of the unlawful practices of the management, it was regarded necessary to have an authority which could establish a communication between the management and the independent auditors. It has been stated in the regulations of the corporate governance that the board of directors ought to form the subsidiary committees (including the audit committee) in order to carry out the affairs such as the wholesale transactions, investments, internal audit and staff appointments in the company while some members and advisors from outside the company attend the meeting. Audit Committees serve an important monitoring mechanism in corporate governance (Chien, et al. 2010). DeAngelo (1981) defines audit quality as the market-assessed joint probability that a given auditor will both detect material misstatements in the client’s financial statements and report the material misstatements. Therefore, audit quality is a function of the auditor’s ability to detect material misstatements (technical capabilities) and reporting the errors (auditor independence) (Chadegani, 2011). There are numerous factors which influence the quality of the auditor's reports; furthermore, there exists so many variables that if any of them is changed it will affect the auditor's reports either directly or indirectly This paper has been written to examine the effects of audit committee upon the structure of the internal controls in the company and to improve the quality of the auditor's reports.

2. Literature Review:
2.1 Audit Committee:

The idea of audit committee was first mooted on a global basis in 1939 while the celebrated case of McKesson and Robbins was under investigation. It was therefore not surprising when the investigation report recommended the establishment of audit committee by public companies to strengthen the structure of corporate governance by improving the status of auditor and offer more protection to the shareholder (Owolabi & Dada, 2011). Based on the requirements, the American Commission of Stock Exchange (SEC) introduced its project of establishing audit committees in the companies in 1940 and the project was generally confirmed in 1970. Then attempts were made to implement the project. In December 1999, in a response to the request made by American Commission of Stock Exchange, obligations were decided to accept the big companies in the stock exchange so as to promote the effectiveness of the audit committees in companies for their supervision of the financial reporting process, New York Stock Exchange (NYSE) and National Association of Securities Dealers Automated Quotations (NASDAQ). Audit committees of corporate boards of directors are central to corporate governance for many corporations. Their effectiveness in supervising financial managers and overseeing the financial reporting process is important to promote reliable financial statements (Cunningham, 2004). The Sarbanes-Oxley Act (SOX 2002, section 2) defines an audit committee as "a committee (or equivalent body)

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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"(Beasley et al. 2009). In the corporate governance regulations, it has especially been emphasized that the internal auditing system, internal audit committee and the audit committee ought to be initiated and settled in the companies. It has also been stated that the managers and the independent auditors need to be connected to each other simply by means of the audit committee. According to Owolabi & Dada (2011) the following sections are defined as the functions of the audit committee:

- To ascertain whether the accounting and reporting policies of the company are in accordance with legal requirements and agreed ethical practices which will strengthen corporate governance
- To review the scope and planning of audit requirements;
- To review the findings on management matters in conjunction with the external auditor and departmental responses thereon;
- To keep under review the effectiveness of the company's system of accounting and internal control, to ensure transparency.
- To make recommendations to the Board in regard to the appointment, removal and remuneration of the external auditors of the company
- To authorize the internal auditor to carry out investigations into any activities of the company that may be of interest or concern to the committee to sustain corporate governance.

The audit committee is a valuable instrument for initiating direct contact with the independent/external auditor, participating in the selection of the external auditor, and promoting effective communication between the independent auditor and corporate directors (Mohiuddin and Karbhari, 2010). According to the Blue Ribbon Committee (BRC), the role of the last supervisor is given to the audit committee in the reporting system of the financial accounting. The audit committee appoints the independent auditors, holds talks and meetings with the senior financial management and the independent auditors separately and questions and inspects both the internal and independent auditors in order that the committee is certain their measures and performances preserve the interest of the company in the best manner. The major areas covered by the Blue Ribbon Committee (BRC) recommendations are audit committee membership requirements, audit committee structure and function, and audit committee communications with the outside auditor and with management. The following are the ten recommendations of the BRC:

Membership Requirements:

- revise the definition of independent director
- require a completely independent audit committee
- require three members (based on size) who are financially literate and one member must have accounting or related financial management expertise.

Committee structure

- require a written charter of duties and responsibilities
- require annual disclosure of audit committee activities.

Committee Communications:

- the outside audit engagement is the responsibility of the audit committee
- require discussion of outside auditor independence by written statement
- require discussion of the Quality of Financial Reporting with outside auditor
- require annual letter to stockholders from the audit committee
- require SAS 71 Interim Financial Reviews at each quarter. (Smith, 2006)

According to Beasley et al. (2009) the audit committee members' goal is to avoid associating with managers who want the board and audit committee to be ceremonial. If management and the other directors take governance seriously, then there is significant potential for the audit committee to function as an effective, independent monitor through its formal and informal processes. Conversely, if management does not take governance seriously, then it may be difficult to attract vigilant board members, such that the audit committee's role is primarily ceremonial and built around over-reliance on management (Beasley et al. 2009).

Carol (2005) investigated whether audit committees that meet the requirements of the Sarbanes-Oxley Act with respect to members' independence and financial expertise would be associated with higher disclosure quality through lower forecast dispersion, forecast errors, revision volatility, and analysts' under reaction to prior earnings information. Findings showed that lower forecast dispersion when all members of the audit committee were independent. In addition, revision volatility and analysts' under reaction were lower when the audit committee is comprised of independent directors, where at least one member is a financial expert.

Rager (2004) evaluated the effect of accounting certified independent audit committee members as part of the recent empirical research examining board composition variables in determining company performance. This study concluded that audit committee effectiveness was not dependent solely on the presence of independent directors with financial literacy or accounting certification. Abbott and Parker (1999) investigated auditor changes and found that the presence of active and independent audit committees is associated with increases in audit quality at the time of auditor changes.

In other study He et al. (2009) reviewed the results of empirical studies of associations between corporate oversight measures and financial reporting quality (FRQ). They examined two oversight components, board characteristics and audit committee characteristics. This research suggested that board independence and audit committee effectiveness can be associated with FRQ; however, different facets of board independence and audit committee effectiveness are associated with different FRQ outcomes. Dao et al. (2010) argued shareholder voting on auditor selection, audit fees and audit quality. Findings of this study show that audit fees are higher in firms with shareholder voting on auditor ratification.

Abbott et al. (2007) discussed about the literature related to non-audit services by investigating internal audit outsourcing to the external auditor. Allen (2006) examined whether board and audit committee independence impact tax reporting aggressiveness. The evidence suggested that more independent audit committees were more effective in reducing aggressive tax avoidance. Elaine (2005) tested the degree to which income smoothing and big bath behavior change the probability of early adoption of SFAS 142, *Goodwill and other Intangible Assets*. Results show that before considering the impact of an effective audit committee, a firm's decision to early adopt is based more on smoothing objectives rather than big bath behavior. Also, frequency of audit committee meetings, financial expertise, and governance expertise are found to change the degree to which smoothing and big bath behavior affect the early adoption decision.

2.2 Audit Quality:

The principles of Auditor Oversight issued by the International Organization of Securities Commissions (IOSCO) in 2002 state that audit quality is an important requirement for the integrity of financial statements (Al-Ajmi, 2009). In assessing the risk of fraudulent financial reporting, most of the audit committee members rely, at least partly, on their own efforts to assess the risk of fraudulent financial reporting, although there was no consensus activity that audit committees use in this regard (Beasley et al. 2009). Libby and Frederick (1990) found that more experienced auditors have a greater understanding of financial statement errors, suggesting that auditor decision quality may be improved with expertise. Willenborg (1999) examined the demand for higher audit quality associated with initial public offerings (IPOs) and found evidence that the choice of auditor impacts both IPO underpricing and the auditors' compensation. DeFond (1992) argues that the greater the ownership interest of managers, the more closely aligned their preferences are with those of the outside owners. Since owner-managers have an opportunity for entrepreneurial gains, they have incentives to increase the value of the firm rather than shirk (Francis and Wilson, 1988). DeAngelo (1981) suggested that larger auditing firms produce higher quality audits because of their desire to maintain a favorable reputation in the market, and because large audit firms have a wide client base and are not unduly influenced by the prospect of losing any individual client. In Another study Al-Ajmi, (2009) documented the perceptions of credit and financial analysts with regard to the relationship between the effectiveness of audit committee, size of the auditing firm and audit quality in the context of Bahrain, which is characterized by a developed financial sector, low-liquidity stock market, low turnover in board of directors of listed firms, an inactive merger and acquisitions market and almost non-extent litigation. He found that effective audit committee enhances the quality of audit reports.

Research Methodology:

The study reported here is a survey which examines the relationship between audit committee and audit quality. Official Accountants are asked to rate each item about the role and function of the audit committee in improving the effectiveness of the independent auditors, internal auditors, internal controls, the disclosure of the financial statements and the amelioration of the auditing reports on Likert scale of 5 in which 1revealed strong disagreement and 5 indicated a strong agreement.

Research Hypotheses:

The audit quality refers to a set of measures taken to promote the capability of relying on the auditing reports. The following hypotheses are presented in accordance with the objectives of the research project so that data could be accumulated on the basis of them. Then, they are either confirmed or repudiated.

The existence of audit committee in a company makes:

1- The independent auditor gain independence from the management of business,
2- The internal auditor become independent from the management of a trading enterprise,
3- The internal controls within a company reinforced,
4- The quality of the financial statements improved and
5- The quality of the auditing reports promoted.

Statistical Research Population:

Given the fact that the independent auditors, members of accountants' association, are of both theoretically and empirically useful information about auditing and audit committee in the companies, they served as the research population of the project to make data collection possible. The research population of this paper consists of the auditors who are members of Iranian Society of Official Accountants. When the paper was written, they were over 1416 persons. They were selected from among the part owners of auditing institutes registered in Iranian Society of Official Accountants employed by the auditing institutes, official accountants working in auditing organization, official accountants self-employed and official accountants unemployed.

Table 1: Respondents qualification.

Qualification	Frequency	Percent
Graduated	48	51.1
Master	46	48.9
Total	94	100%

Table 2: Respondents work experience.

Work Experience (YEAR)	Frequency	Percent
5-10	32	34.0
10-15	38	40.4
More than 15 years	24	25.5
Total	94	100%

5. Sampling Procedure:

The researcher has used the simple-random sampling in the project. To sample and fill the questionnaires, firs, the researcher has specified the respondents by means of the list of their names and the table of random numbers. He referred to the subject during a period of successive days and handed them the questionnaires they were required to answer.

The formula for the determination of the sample size:

$$n = \frac{NZ_{\alpha/2}^{2} * (p * q)}{N\varepsilon^{2} + Z_{\alpha/2}^{2} * (p * q)}$$

In this equation, n equals the sample size, N points to the number of participants in the research population. They were 1416 persons on the date of compiling the papers, Z stands for the normally standardized variable which can be extracted from the table Z with the trust level of 0.975. **ε** represents either the accuracy of the estimate or the maximum acceptable error. Using this sampling formula to determine the sample size, 94 persons were selected as the statistical sample.

6. Data Collecting Tools and Data Analysis Method:

The research aims to at the examination of the relationship between audit committee and audit quality. In order to measure and collect the required data for analysis, a 26-item questionnaire is designed. This questionnaire has 5 parts; part 1 includes 4 questions (5,9,14,19) about H1, part 2 consists of 3 questions(1,24,26) about H2, part 3 involves 8 questions (7,12,17,22,23,4,8,13) about H3, part 4 comprises 6 questions (10,15,20,25,2,6) about H4, part 5 represents 5 questions (11,16,21,18,3) about H5. The reliability of the questionnaire is established through a pilot study including 30 employees from the statistical population, As a result, Cronbach's alpha for questionnaire equal to 0.8491 (≈ 0. 85), therefore the reliability of the questionnaire is confirmed. For testing the hypotheses, relevant statistical tests such as the Chi-squared test (χ2), regression analysis and other required tests were used.

7. Testing of Hypotheses:

Hypothesis 1: The existence of audit committee in a company makes the independent auditor gain independence from the management of business.

Based on results obtained from the tables below and the significance level less than 0.05, we conclude that null hypotheses H0 is refuted because there exists no difference between the observed distribution of frequency and that of the expected one. In addition, with a glance at table 3, we notice that 86 percent of the subjects (81 persons) have selected the alternative of Neither Agree nor Disagree, whereas, 14 percent of them (13 persons) have chosen the option Agree. So, most of the respondents have acknowledged that the presence of the audit committee causes the independent auditor become independent and self-sufficient from the management of the business.

Question No.	Strongly Disagree		Disagree		Neither Agree nor Disagree		Agree		Strongly Agree	
	%	N	%	N	%	N	%	N	%	N
5	30.9%	29	13.8%	13	24.5%	23	30.9%	29	.0%	0
9	.0%	0	9.6%	9	41.5%	39	48.9%	46	.0%	0
14	.0%	0	23.4%	22	69.1%	65	.0%	0	7.4%	7
19	27.7%	26	13.8%	13	20.2%	19	28.7%	27	9.6%	9

Respondents comments	Observed frequency	Expected frequency	Difference
Neither Agree nor Disagree	81	47.0	34.0
Agree	13	47.0	-34.0
Total	94		

Statistic Method	RF1	df	Sig.
Chi-squared test (χ2)	49.191	1	.000

*Correlation Significant at 0.05

Hypothesis 2: The existence of audit committee in a company causes the internal auditor become independent from the management of a trading enterprise.

According to the presented tables and the significance level less than 0.05, we conclude that null hypotheses H0 is refuted because there exists no difference between the observed distribution of frequency and that of the expected one. Moreover, with a glance at tables, we notice that 18 percent of the subjects (17 persons) have selected the alternative of Neither Agree nor Disagree, whereas, 82 percent of them (77 persons) have chosen the option Agree. So, most of the respondents have acknowledged that the presence of the audit committee causes the internal auditor become independent from the management of a trading enterprise.

Question No.	Strongly Disagree		Disagree		Neither Agree nor Disagree		Agree		Strongly Agree	
	%	N	%	N	%	N	%	N	%	N
1	7.4%	7	10.6%	10	20.2%	19	44.7%	42	17 %	16
24	.0%	0	.0%	0	.0%	0	92.6%	87	7.4%	7
26	.0%	0	.0%	0	31.9%	30	68.1%	64	.0%	0

	Observed frequency	Expected frequency	Difference
Neither Agree nor Disagree	17	47.0	-30.0
Agree	77	47.0	30.0
Total	94		

statistic Method	RF2	df	Sig.
Chi-squared test (χ2)	38.298	1	.000

*Correlation Significant at 0.05

Hypothesis 3: The existence of audit committee in a company reinforces the internal controls within a company.

According to the table 1. and the significance level less than 0.05, we conclude that null hypotheses H0 is refuted because there exists no difference between the observed distribution of frequency and that of the expected one. Moreover, with a glance at table 6. we notice that 24.4 percent of the subjects (23 persons) have selected the alternative of Neither Agree nor Disagree, whereas, 54 percent of them (51 persons) have chosen the option Agree and 21.6 percent of them (20 persons) have chosen the option Strongly Agree. So, most of the respondents have acknowledged that the presence of the audit committee reinforces the internal controls within a company.

Question No.	Neither Agree nor Disagree		Agree		Strongly Agree	
	%	N	%	N	%	N
4	34.0%	32	58.5%	55	7.4%	7
7	10.6%	10	58.5%	55	30.9%	29
8	48.9%	46	51.1%	48	.0%	0
12	10.6%	10	68.1%	64	21.3%	20
13	41.5%	39	58.5%	55	.0%	0
17	30.9%	29	40.4%	38	28.7%	27
22	38.3%	36	33.0%	31	28.7%	27
23	47.9%	45	52.1%	49	.0%	0

	Observed frequency	Expected frequency	Difference
Neither Agree nor Disagree	23	31.3	-8.3
Agree	51	31.3	19.7
Strongly Agree	20	31.3	-11.3
Total	94		

statistic Method	RF3	df	Sig.
Chi-squared test (χ2)	18.660	1	.000

*Correlation Significant at 0.05

Hypothesis 4: The existence of audit committee in a company improves the quality of the financial statements.

According to the table 1. and the significance level less than 0.05, we conclude that null hypotheses H0 is refuted because there exists no difference between the observed distribution of frequency and that of the expected one. Moreover, with a glance at table 6. we notice that 92.5 percent of the subjects (87 persons) have selected the alternative of Agree, whereas, 7.5 percent of them (7 persons) have chosen the option Strongly Agree. So, most of the respondents have acknowledged that the presence of the audit committee improves the quality of the financial statements.

Question No.	Strongly Disagree		Neither Agree nor Disagree		Agree		Strongly Agree	
	%	N	%	N	%	N	%	N
2	.0%	0	9.6%	9	83.0%	78	7.4%	7
6	.0%	0	.0%	0	92.6%	87	7.4%	7
10	.0%	0	.0%	0	92.6%	87	7.4%	7
15	.0%	0	55.3%	52	23.4%	22	21.3%	20
20	.0%	0	27.7%	26	72.3%	68	.0%	0
25	11.7%	11	.0%	0	80.9%	76	7.4%	7

	Observed frequency	Expected frequency	Difference
Agree	87	47.0	40.0
Strongly Agree	7	47.0	-40.0
Total	94		

statistic Method	RF4	df	Sig.
Chi-squared test(χ2)	68.085	1	.000

*Correlation Significant at 0.05

Hypothesis 5: The existence of audit committee in a company promotes the quality of the auditing reports.

According to the tables and the significance level less than 0.05, we conclude that null hypotheses H0 is refuted because there exists no difference between the observed distribution of frequency and that of the expected one. Moreover, with a glance at table 6. we notice that 7.4 percent of the subjects (7 persons) have selected the alternative of Strongly Disagree, whereas, 78 percent of them (74 persons) have chosen the option Neither Agree nor Disagree and 14.6 percent of them (13 persons) have chosen the option Agree. So, most of the respondents have acknowledged that the presence of the audit committee promotes the quality of the auditing reports.

Question No.	Strongly Disagree		Disagree		Neither agree nor disagree		Degree		Strongly Agree	
	%	N	%	N	%	N	%	N	%	N
3	28.7%	27	30.9%	29	23.4%	22	17.0%	16	.0%	0
11	.0%	0	7.4%	7	41.5%	39	16.0%	15	35.1%	33
16	.0%	0	20.2%	19	34.0%	32	24.5%	23	21.3%	20
18	11.7%	11	30.9%	29	47.9%	45	9.6%	9	.0%	0
21	.0%	0	.0%	0	48.9%	46	37.2%	35	13.8%	13

	Observed frequency	Expected frequency	Difference
Disagree	7	31.3	-24.3
Neither agree nor disagree	74	31.3	42.7
Agree	13	31.3	-18.3
Total	94		

statistic Method	RF5	df	Sig.
Chi-squared test ($\chi 2$)	87.723	2	.000

*Correlation Significant at 0.05

8. Conclusion:

The aim of this study was to investigate the relationship between audit committee and audit quality. According to defined hypotheses of this study findings showed a statistically significant relationship between audit committee and audit quality. Results confirm that the presence of the audit committee makes the independent auditor gain independence from the management of business, causes the internal auditor become independent from the management of a trading enterprise, improves the quality of the financial statements, reinforces the internal controls within a company and promotes the quality of the auditing reports. If the corporate governance regulations are enforced correctly, the audit will no longer be viewed to be a formality; moreover, if the internal control system, in general, and the supervision of the audit committee in particular are established, they may cause the information exposed on time, the severe fluctuations of the estimated profits avoided and prices not tampered with.

The audit committee is able to inspect the management, internal auditors and the independent auditors so that it will gain the confidence that their measures and activities provide the interests of the company in the best way. The four principle pillars of the effective leadership in companies are as follows: the board of directors, the executives, the internal auditors and the independent auditors. Meanwhile, none of the committees of the board of directors concentrates upon the issue of leadership more and better with the audit committees. The role of the audit committee in the companies is of special place in supervising the financial reports, risk management, internal controls, respects to the regulations, ethics, management, independent auditors and internal auditors. As matter of fact, the audit committee is of organizational structure which enables it to play and impose its supervising role on the management, internal auditor, independent auditors as well as the way the regulations are enforced.

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