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The Effect of the Independence, Expertise and Activity of the Audit Committee On the Quality of the Financial Reporting Process

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Abstract: This paper critically assesses the importance and impact of 3 main characteristics of audit committee independence, expertise and activity on the overall effectiveness of audit committees and the quality of the financial reporting process, based on corporate governance and regulatory debates and relevant research evidence, combined with statistics and analysis of data relating to these characteristics of audit committees of significant international companies. The results found that audit committee independence plays an important, but questionable, role in the monitoring of financial information, disclosure of internal controls and the company's financial reporting process. Secondly, the expertise of audit committee professionals can enhance the quality of financial reporting. Finally, a diligent audit committee can, to some extent, improve the level of oversight of the financial reporting process of the activity.

Keywords: Corporate Governance, Audit Committee Characteristics, Financial Reporting Process Quality.

1. Introduction

As corporate governance issues advance and develop, the regulatory organizations that surround corporate activities are a necessary outcome of the separation of ownership and control, as well as the associated accountability difficulties. Audit functions have been developed as a means of assuring effective management within this framework (Spira, 1999). For a long time, the audit committee has been regarded as the sub-committee of the board of directors (Burke and Guy, 2001), responsible for monitoring the integrity of the financial reporting process, and providing a formal channel of communication between the internal control system, the external auditors and the board of directors (Bradbury, 2006), their main task is to strengthen the reliability of audited financial statements and to oversee the objectivity and independence of external auditing (Collier and Gregory, 1996; Pomeroy and Thornton, 2008) to pledge that the benefit of shareholders is properly protected about internal control and financial reporting (Smith Report, 2003: p 3). The audit committee has several characteristics, including independence, expertise, and activity, which influence its role to a certain extent. In this essay, these three key characteristics will be evaluated by analysing their importance and impact on the overall effectiveness of the audit committee and the quality of the financial reporting process. Firstly, authoritative recommendations will be cited to determine the importance of these characteristics. Secondly, this study will combine the statistics and analysis of data connected to these features of the audit committee of significant international firms, based on current literature and research conclusions, and discuss the impact of these attributes on the audit committee's overall performance, with a focus on the successful monitoring of the company's internal control and the influence on the financial reporting process's timeliness and quality.

2. The Main Characteristics of the Audit Committee

2.1. The value of audit committee independence

The independence of the audit committee is regarded as a prerequisite for the effectiveness of its work (Abbott et al., 2000) and it is critical to the financial information monitoring, internal control disclosure, and corporate financial reporting processes. For starters, according to The UK Corporate Governance Code (2012), the audit committee for financial information monitoring should be made up of at least three independent directors. The theory of the significance of independent directors is closely combined with the agency theory. Independent directors, on the other hand, have no personal or financial ties to corporate executives, making them better suited to execute supervisory duties. (Fama & Jensen, 1983). At the same time, independent directors pay attention to their reputation to keep their value in the market of external labor (Fama, 1980). As a result, the audit committee's independence allows it to perform a more effective monitoring role while also improving the transparency and quality of financial information given to shareholders (O'Sullivan, 2000). Furthermore, audit committee independence influences whether or not the firm's internal control weaknesses are exposed. According to Zhang et al. (2007), auditors may choose to ignore potential problems when there have very close economic ties between auditors and client companies, and issue clear recommendations on internal control of client companies. An independent audit committee can considerably diminish the audit committee's interest relationship with customers. The audit committee's independence is positively related to internal control quality, according to the findings, meaning that the audit committee's independence can help enhance internal control quality to some extent (Krishnan, 2005). On the other hand, some researches have shown that more independent audit committees can monitor financial reporting processes more effectively (Klein 2002; Marra et al., 2011). Due to the independence, there is no clear interest relationship with the company. As a result, when confronted with critical financial accounting concerns including the quality of earnings, dispute mediation and dealing with external auditors, the independent audit committee will proceed with caution and resolve the issues as quickly as possible (Klein, 2002; Bedard et al., 2004). At the same time, according to Goodwin (2003), an audit committee with a majority of independent directors is more likely to have a greater level of accounting conservatism, allowing the company's financial reports to be continuously upgraded and improved by hiring industry professional auditors and hiring the company's internal audit function. Using Sultana's research in 2015 on the lag of audit reports and the independence of audit committee as an example, it was discovered that if a company has an independent director on the audit committee, the delay of audit report held by other audit committees of the company will be reduced by nearly 4 days, implying that there is a significant negative correlation between the independence of audit committee and the lag of audit report. Similarly, Bradbury et al. examined the relationship between the management of earnings, board, and audit committee independence from the data of 687 large publicly traded US financial services companies. The findings reveal that anomalous accruals and the proportion of independent directors have a negative relationship. According to several researches, having a more independent audit committee can help reduce erroneous and misleading financial reporting while also enhancing corporate governance (McMullen and Raghunandan, 1996; Bedard et al., 2004). According to above illustration, the independence of the audit committee has a positive impact on financial information monitoring, the corporate financial reporting process and internal control disclosure. On the contrary, several academics have suggested that audit committee independence has not benefited corporations. The existence and composition of the audit committee have no bearing on the possibility of financial statement fraud, according to Beasley's 1996 study, and similarly, the independence of audit committee members has no bearing on the possibility of an earnings restatement, according to Agrawal and Chadha's (2005) research. From the conclusions of these studies, the audit committee's independence is of no advantage to the corporate governance. Above all, the audit committee's independence is essential for financial data monitoring, internal control disclosure, and the company financial reporting process. Some academics, however, question the independence of the institution.

2.2. The value of audit committee expertise

The expertise of audit committees, in addition to independence, is required to ensure the corporate responsibility and the quality of financial reporting (Carcello and Neal, 2000). The expertise of the audit committee has a profound influence on the committee's overall performance and financial reporting quality. The Blue Ribbon Commission (1999) have mentioned that each audit committee is suggested to contain at least one financial expert, which aims to improve the effectiveness of corporate audit committees by emphasizing the importance of financial knowledge and expertise of audit committee members. In the meantime, numerous studies have shown that the audit committee's financial expertise has a direct influence on a variety of issues connected to financial reporting quality (Carcello et al., 2006; Dhaliwal et al., 2010). According to a research of 987 FTSE 350 companies conducted between 2007 to 2010, it was found that the longer the term of office, the more successful the experienced auditor is, and the supervision skills of the head of the audit committee reduce the lag of audit report, which can negatively affect the lag of audit report. Similarly, according to research on audit committee professional knowledge, from a continuous sample analysis of 100 businesses listed on the ASX, having an audit committee with an experienced director can reduces the lag if audit report by roughly 7 days (Sultana et al., 2015). It may be concluded that audit committees with expertise directly related to financial statement quality play an significant part in reducing the lag of audit report and thus enhancing timeliness of financial reporting (Ghafran and Yasmin, 2018). On the other hand, audit committees without financial expertise tend to rely on external auditors to ensure critical financial accounting data (such as earnings) regardless of whether they are relevant or reliable to external decision-makers (DeFond et al., 2005; Sultana and Van der Zahn, 2013). According to similar studies, audit committee members with financial expertise are less likely to be involved with internal control problems, whereas audit committee members without financial experience are unable to ensure audit quality to some extent (Zhang et al., 2007; Zaman et al., 2011). Furthermore, the possibility of financial misrepresentation and fraud will increase if the audit committee lacks financial expertise, according to some researches (Xie et al., 2003). What is more, DeFond et al. suggested that appointing accounting and finance professionals to audit committees results in high positive cumulative abnormal returns. The outcomes indicate that an audit committee comprised of accounting and finance experts can strengthen corporate governance. In an analysis of audit committee data for 36 North American mining companies from January 1993 to December 1999, according to Dionne and Triki (2005), companies with financial expertise have more advantages in understanding financial decisions, acting in the interests of shareholders, risk assessment and management than companies without financial expertise. At the same time, audit committee members with financial reporting knowledge and audit understanding were more likely than members without audit experience to understand audit judgements and support audits in audit management disagreements (DeZoort and Salterio, 2001). These studies illustrate that a financial audit committee can better assist organisations in developing more effective internal control and risk management systems. (McDaniel et al., 2002; Cohen et al.,2013). In addition, audit committee members with financial expertise can conduct monitoring functions during financial reporting, such as the detection of material misstatements. To summarise, to properly fulfil the supervision job, an audit committee with competence can improve the quality of financial reports, shorten the lag of audit reports, and to some extent prevent financial fraud.

2.3. The value of activities of audit committee

On the other hand, activity, as another crucial characteristic of the audit committee, have a material influence on the overall efficacy of the audit committee and the process of financial reporting. If audit committee maintains a high level of activity they can perform its duties better (Sultana et al.,2015), and it must work diligently to successfully supervise the process of financial reporting (Carcello, 2009). However, it is difficult to precisely assess the committee's efforts (Raghunandan and Rama 2007), so the diligence of the audit committee would be judged by measuring the frequency of meetings. According to FRC's recommendation, "The Audit Committee shall convene no less than three times a year". Nonetheless, authoritative statements according to Sharma et al.(2009), are often quiet on meeting frequency, sometimes implying four meetings, although in actuality there is no clear agreement on how often the audit committee should meet. The activities of a diligent audit committee can have a favourable influence on the overall performance of the audit committee and the governance of the financial reporting process. According to studies, through more frequent meetings, audit committees will effectively and proactively address changes in the uncertain business and financial climate and better respond to the challenges and complexities of financial operations (Vafeas, 1999; Stewart & Munro, 2007). Furthermore, for the internal control, an active audit committee can ensure that the integrity of the report earning by detecting and preventing the opportunism behavior of the management, the consistent conclusion with prior research of Krishnan & Visvanathan in 2007, who found that a more diligent audit committee is less likely to misleading statement and make a fraudulent, because they use discretionary accruals for earnings management. This approach is more likely to identify and report weaknesses in internal controls. Furthermore, audit committees that meet at least three times a year have a material and negative influence on the lateness of audit reports, according to Ghafran and Yasmin(2018), implying that diligent audit committees make a profound effect on improving financial reporting timeliness and that more frequent meetings can reduce the incidence of reporting problems to some extent (DeZoort et al. 2002). According to the researches results, the most active boards prefer to communicate more frequently with audit committee members in order to improve the diligence of the audit committee (Haniffa et al, 2006; Ferreira et al., 2011), allowing them to take their oversight responsibilities to a degree and improve the level of financial reporting process monitoring (Adam and Ferreira, 2007). Furthermore, audit committee activities are positively connected with high-quality responsible auditors, according to the findings of a study on the impact of firm-specific agency characteristics on audit committee activities of significant UK corporations, (Collier and Gregory, 1999) and that the frequency of operations by industry specialised auditors is related to audit committee independence positively (Abbott and Parker, 2000). Meanwhile, surveys of fraudulent organisations in the financial services, healthcare, and technology sectors revealed that fraudulent companies held audit meetings once a year on average, which were fewer and less frequent than non-fraudulent companies (Beasley et al., 2000). In conclusion, to a certain extent, frequent audit meetings are more conducive to the audit committee to play its regulatory role, and the audit committee's diligent operations may better respond to the challenges and complexities of the financial process, effectively strengthen the internal control of the company, and deliver higher-quality services to improve the level of financial reporting process.

3. Conclusion

To summarize, the independence, experience and activities of the audit committee, as main characteristics of audit committee, have a beneficial and significant influence on the entire effectiveness of the audit committee and the quality of the financial reporting process. In the process of financial information supervision, internal control disclosure and corporate financial reporting, the independence of the audit committee plays a vital role, although some scholars have questioned the effectiveness of independence. Secondly, with its professional knowledge, the expertise in audit committee can strengthen the financial reports quality, reduce the lag of audit reports, prevent financial fraud to a certain extent and effectively perform its supervision function. Finally, for the activities of the audit committee, a diligent audit committee can better deal with the complexity of the financial process, effectively enhance the internal control, provide a higher level of services, and improve the supervision level of the financial reporting process of the activities. In the future research, we can deeply study other aspects of the characteristics, for example, the size of the audit committee, gender ratio and impact of the characteristics of audit committee on audit fees. Combined with the current corporate governance scandals, based on the relationship between these characteristics and their influence on the effectiveness of the audit committee and the financial reporting process, we can discuss how these characteristics reflect their role and how they are ignored in these negative cases.

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