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Significance of Audit Committee Roles in India: A Study of Auditors' Perception Using Analytic Hierarchy Process

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Abstract

The need for strong governance mechanisms has become increasingly louder after the spate of corporate accounting frauds over the last few decades. In India, the Satyam fiasco tarnished the reputation of the audit profession and underlined the need for overhauling the corporate governance framework. The Companies Act, 2013 ushered in a new era of corporate governance in India, with enhanced focus on audit committees. The present study aims to examine the significance of board audit committee roles from the perspective of auditors.

Analytic Hierarchy Process (AHP) is used to analyze the responses collected from 50 auditors, wherein the auditors were asked to assign ranks to various audit committee roles through paired comparison method. The AHP analysis shows that as per auditors' perception, the most significant responsibility of audit committee is to monitor auditor independence and performance, and review the effectiveness of the audit process. There is an implied acknowledgement that the audit process is not free from managerial intervention.

The research findings could guide regulators and lawmakers to empower audit committees with more definitive authority over the company's financial reporting process. Audit committees, though a part of the board, need to be perceived as a neutral body by both the company and auditors. Considering the pool of available talent in India, a 100% independent audit committee might emerge as a feasible answer for neutrality.

Keywords: audit committees, AHP, companies act 2013, auditors, Satyam, fraud.

I. INTRODUCTION

Adequate governance norms can go a long way in ensuring fair accounting practices and transparency in reporting systems. Corporate governance is a widely acclaimed tool for enhancing investor confidence and promoting wider participation in capital markets. A strong system of corporate governance is also essential as businesses look to go global and tap international markets (Mintz & Krishnan, 2009). This would apply more to emerging market economies like India where companies are now looking beyond domestic frontiers, to enter previously unchartered territories and tap new markets for funds.

Corporate governance norms in most developed and developing countries require the constitution of a board audit committee to oversee the financial reporting and auditing process. Professional accounting and auditing bodies endorse the constitution of an audit committee as it lends greater credibility to financial statements

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and enhances public confidence in the integrity of the external auditor. Puri et al. (2010), mention that audit committees act as a communication channel between the board of directors and external auditors. In recent times, and more particularly after the passage of the SOX (Sarbanes-Oxley) Act in 2002, there has been an increased focus on the role of audit committees in companies. Audit committees are one the main pillars of corporate governance and constitute the crux of most governance models. Singh et al. (2010), in their study, endorse the importance of powerful audit committees in preserving the integrity of the financial reporting process in companies. Their view is supported by Puri et al. (2010), who recognize audit committees as an integral part of a strong corporate governance framework.

In India, the requirement of audit committees was introduced in the year 2000 vide an amendment in the Companies Act. The amendment required public companies with paid-up capital of Rs. fifty million or more to constitute an audit committee of the board. Clause 49 of SEBI's listing agreement required all listed companies to constitute an audit committee, with prescribed set of responsibilities.

The new Companies Act (2013) calls for expansive changes in the scope and constitution of audit committees. Under the new Act, every listed company and certain other classes of companies are required to constitute an audit committee of the board. An audit committee is required to have a minimum of three directors, with independent directors forming a majority. Majority of audit committee members, including the chairperson, should be persons with ability to read and understand financial statements. The Act also requires the board report to disclose composition of audit committee and reasons for non-acceptance of audit committee recommendations, if any (Companies Act, 2013).

II. ROLE AND RESPONSIBILITIES OF AUDIT COMMITTEES

The Companies Act (2013) has greatly widened the scope of responsibilities for audit committees. The terms of reference of the committee specifically provided in the Act (section 177 of the Companies Act (2013)) and clause 49 of SEBI's Listing Agreement are listed below:

1. R1 - recommendation for appointment, remuneration and terms of appointment of auditors of the company;
2. R2 - review and monitor the auditor's independence and performance, and effectiveness of audit process;
3. R3 - examination of the financial statement and the auditors' report thereon;
4. R4 - approval or any subsequent modification of transactions of the company with related parties;
5. R5 - scrutiny of inter-corporate loans and investments;
6. R6 - valuation of undertakings or assets of the company, wherever it is necessary;
7. R7 - evaluation of internal financial controls and risk management systems;
8. R8 - monitoring the end use of funds raised through public offers and related matters.

Apart from above, the scope of audit committee responsibilities also includes:

1. R9 - oversee of the company's financial reporting process and disclosure of financial information to ensure their accuracy and credibility;
2. R10 - review effectiveness of internal audit function and findings of internal audit report thereon;
3. R11 - review financial statements with management, before their submission to the board for approval;

4. R12 - investigate reasons for substantial payment defaults by the company;
5. R13 - review functioning of the whistle blower mechanism.

III. RESEARCH OBJECTIVES AND METHODOLOGY

The present study is an attempt to evaluate the role of audit committees as a corporate governance mechanism, for strengthening the financial reporting, accounting, and audit process. Given the realm of functions that audit committees need to discharge, this paper seeks to examine the perception of auditors on the significance of various audit committee roles, in the Indian context.

For this purpose, primary data was collected from chartered accountants, practicing as auditors mostly in the Delhi-NCR region. We obtained responses from 50 auditors through a structured questionnaire, wherein the respondents were asked to assign ranks to audit committee roles though a paired comparison method. Respondents assigned ranks, using their judgment to weigh the importance of one role against its paired role. Responses collected were analysed using the AHP (Analytic Hierarchy Process) tool.

3.1. Audit Committee Roles and AHP

Audit committees of companies have a multitude of roles to perform. Each of these roles is designed with the objective of protecting investor interest and overall integrity of the financial reporting process. This paper uses AHP technique to do a prioritized ranking of the different roles of audit committees, as perceived by auditors.

AHP is a framework designed to make effective decisions on complex issues by simplifying the natural decision-making process. More often than not, people tend to base their judgments on individual perceptions of reality, and then try to defend the same through use of logic. AHP organizes feelings, intuition, and logic in a structured approach to decision making, by combining both the deductive and inductive approach.

3.2. Structure of AHP

AHP is a tool to solve complex problems that involve multiple criteria. It is designed to handle situations in which subjective individual judgments have a bearing on the overall decision.

The AHP method involves the following steps:

a. Breaking down a unstructured situation into its component parts;
b. Arranging these parts, or variables into a hierarchic order;
c. Assigning numerical values to subjective judgments on the relative importance of each variable; and
d. Synthesizing the judgments to determine which variables have the highest priority and need to be acted upon to influence the outcome of the situation.

In steps 1 and 2, we highlighted 13 important roles of audit committees and arranged them as per the terms of reference specifically provided in the Companies Act (2013) and the listing agreement of SEBI.

In step 3, the 50 respondents were asked to assign ranks based on their judgment of the relative importance of a role, using paired comparison of variables. The assigned ranks took a value between 0 – 9, where 9 denotes absolute importance of the role and 0 denotes negligible importance of the role in a paired comparison between two variables.

The average of the 50 scores was determined to arrive at the relative ranking for a particular paired comparison. Table 1 below shows the ranking matrix by pair-wise comparison of variables.

Table 1
Paired Comparison Matrix of Audit Committee Roles

	R1	R2	R3	R4	R5	R6	R7	R8	R9	R10	R11	R12	R13
R1	**1.00**	0.15	0.16	1.22	1.22	2.73	0.18	1.83	0.12	0.18	0.56	1.13	1.16
R2	6.61	**1.00**	3.67	6.33	6.33	3.67	1.44	4.71	1.40	4.33	4.07	4.33	4.33
R3	6.18	0.27	**1.00**	5.67	4.33	2.78	1.89	2.73	0.29	0.51	2.05	2.33	2.11
R4	0.82	0.16	0.18	**1.00**	1.67	1.89	0.18	1.38	0.18	0.23	1.18	1.44	1.13
R5	0.82	0.16	0.23	0.60	**1.00**	2.51	0.16	1.40	0.16	0.45	1.08	1.22	1.80
R6	0.37	0.27	0.36	0.53	0.40	**1.00**	0.21	1.16	0.20	0.26	1.78	0.73	1.18
R7	5.53	0.69	0.53	5.53	6.18	4.85	**1.00**	4.33	1.67	3.00	3.67	3.00	2.33
R8	0.55	0.21	0.37	0.72	0.71	0.86	0.23	**1.00**	0.23	0.20	1.16	1.22	0.51
R9	8.22	0.71	3.46	5.53	6.18	5.11	0.60	4.44	**1.00**	3.00	3.67	3.00	2.33
R10	5.53	0.23	1.96	4.44	2.23	3.86	0.33	5.00	0.33	**1.00**	2.51	3.67	1.67
R11	1.80	0.25	0.49	0.85	0.92	0.56	0.27	0.86	0.27	0.40	**1.00**	2.73	2.05
R12	0.88	0.23	0.43	0.69	0.82	1.36	0.33	0.82	0.33	0.27	0.37	**1.00**	1.44
R13	0.86	0.23	0.47	0.88	0.56	0.85	0.43	1.96	0.43	0.60	0.49	0.69	**1.00**

R1 – R13 denote the various audit committee roles, as mentioned earlier in this paper.

IV. RESULTS AND DISCUSSION

We have obtained responses from 50 practicing chartered accountants, all of whom possess audit experience of listed companies. About 52 per cent of the auditors have audit experience of more than three years, and about 40 per cent of them have been practicing since over five years. Almost all the respondents unanimously agree that audit committees constitute one of the most powerful mechanisms of corporate governance and that their degree of independence is likely to be the most impactful factor in determining the effectiveness of audit committees.

Table 1 shows the relative importance of a role against its paired variable. Monitoring the independence and performance of statutory auditors' (R2) is considered to be 6.6 times a more critical function for audit committees than formalizing the appointment and remuneration of auditors (R1). Conversely, the weightage of R1 against R2 is 1/6.6 or 0.15.

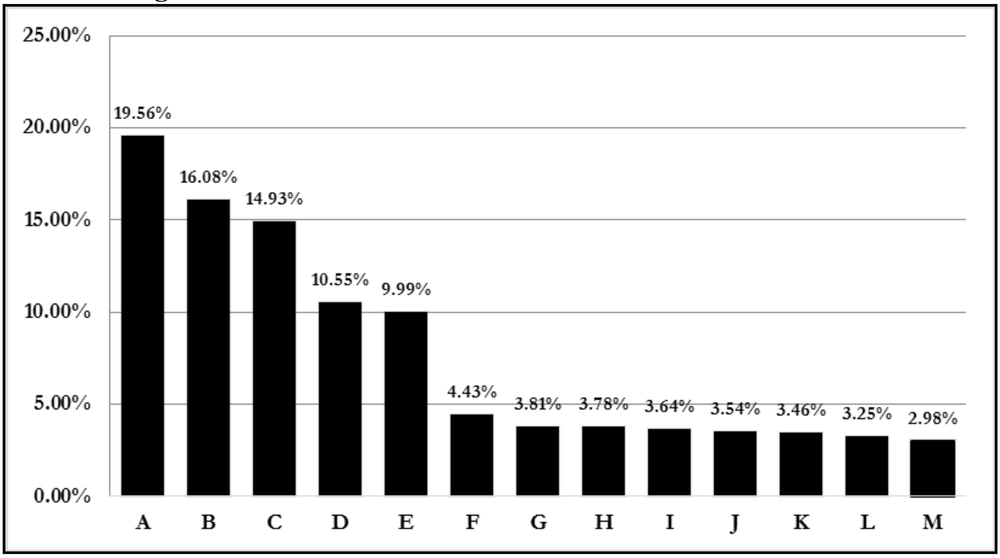
The paired comparison matrix reflects auditors' perception of the importance of a role only in relation to another role. We make use of the AHP tool to further synthesize these ranks by assigning relative weights, and then average out the weights to arrive at the overall importance of various audit committee roles.

Figure 1 plots the various audit committee roles and their overall significance (as perceived by auditors) quantified in percentage terms.

Insert Figure 1 here.

Monitoring the independence and performance of statutory auditors' (R2) is perceived as the most significant of all roles thrust upon audit committees by the Companies Act (2013). Corporate accounting scandals (Satyam included) have largely been the outcome of negligent audit procedures, and willful collaboration of auditors and management in fraudulent accounting practices. Diligent review and monitoring the work of statutory auditors by an independent audit committee is a strong governance mechanism, for preserving integrity of the audit process and ultimate sanctity of reported financial numbers.

Figure 1
Perceived Significance of Various Audit Committee Roles



Notes:
A: monitor auditor's ind and performance;
B: oversee financial reporting process;
C: evaluate internal financial controls;
D: examine financial statement, auditor's report;
E: review effectiveness of internal audit function;
F: review financial statements with management;
G: review whistle blowing mechanism;
H: scrutiny of inter-corporate loans and investments;
I: approve related party transactions;
J: auditor appointment and remuneration;
K: investigate reasons for substantial payment default;
L: review asset valuations, and M: monitor use of funds raised thru' public offers.

Overseeing the financial reporting process and evaluation of the company's internal financial controls and risk management systems are the other critical functions of audit committees.

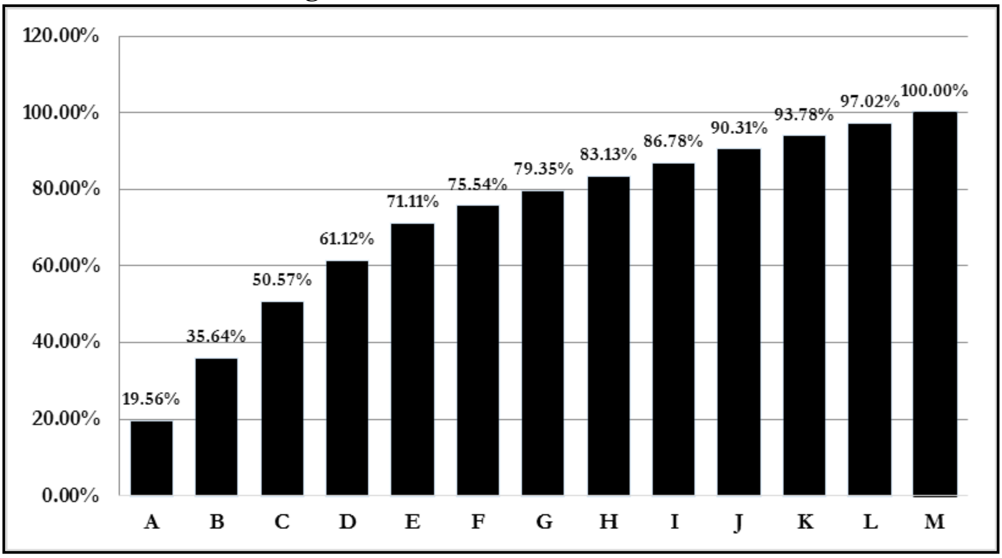
Figure 2 shows the cumulative significance of the various roles performed by audit committees. Of the 13 functions analyzed, more than 70% significance is constituted by five roles. These primary responsibilities of audit committees include:

1. R2 - review and monitor auditor's independence and performance, and effectiveness of audit process;
2. R9 - oversee of the company's financial reporting process and disclosure of financial information, to ensure their accuracy and credibility;
3. R7 - evaluation of internal financial controls and risk management systems;
4. R3 - examination of the financial statement and the auditors' report;
5. R10 - review effectiveness of internal audit function and findings of internal audit report.

The findings of auditors' perceptions about audit committee roles clearly indicate that audit committees constitute the single most important link between management and statutory auditors. Managerial intervention in the audit process is very often the underlying cause of friction between managers and the statutory auditors of a company. Auditors are bound by the principles of integrity and objectivity in performing their professional duties. However, in the wake of recent corporate scandals, the general investor community is aware that these principles can get easily compromised in spirit.

A strong system of corporate governance is the need of the hour, and audit committees have emerged, as perhaps, the ideal solution to bridge the gap between management and auditors.

Figure 2
Perceived Cumulative Significance of Various Audit Committee Roles



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J: auditor appointment and remuneration;
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Table 2 lists the other secondary responsibilities of audit committees, as derived from the above analysis.

Table 2
Secondary Roles of Audit Committees

Review financial statements with management, before their submission to the board.
Review functioning of the whistle blower mechanism.
Scrutiny of inter-corporate loans and investments.
Approve related-party transactions of the company.
Recommend appointment and remuneration of the company auditors.
Investigate reasons for substantial payment defaults by the company.
Valuation of company assets, wherever necessary.
Monitor the end use of funds raised through public offers.

V. CONCLUSION

The results of the analysis highlight the most crucial functions that audit committees need to discharge. Independence of statutory auditors and their adherence to professional codes of conduct are vital to ensure sanctity of the audit process.

Application of AHP tool to analyze importance of various audit committee roles show that monitoring auditor independence and performance is the most significant responsibility entrusted to audit committees. Since, this analysis is a reflection of auditors' perception, there is an implied acknowledgement that auditor independence and performance carries a veiled threat from managerial interference in the audit process.

The Institute of Chartered Accountants of India (ICAI), which regulates the accounting and audit profession, has in a place a strict code of conduct for auditors. Auditor independence, professional competency, cap on proportion of audit fees from a single client, and restriction on provision of certain types of non-audit services, are some of the ethical guidelines that ICAI requires auditors to observe while performing their duties. However, recent corporate accounting frauds have exposed the lacunae that exists in the system, and that allowed auditors and company management to take investors for a ride. The frauds committed at Satyam Computers highlighted the inefficiencies of the audit process, and re-iterated the demand for a governance mechanism that can monitor the work of auditors and review the effectiveness of an audit.

The Companies Act (2013) has empowered audit committees with various responsibilities, the crux of which focus on reviewing the audit and financial reporting processes, as well as evaluating the financial controls and risk management systems. The Act has also made it mandatory for companies to have a vigil mechanism in place, whereby employees and managers can report their concerns of any suspected fraud or unethical practices. The audit committee has been entrusted with the overall responsibility of the whistle-blowing mechanism.

It would perhaps, not be wrong to add that the new corporate laws in India assign final responsibility of the reported financial numbers to board audit committees. However, laws and regulations will prove effective only when they graduate from being mere rules on paper, and their non-enforcement entails harsh punitive action for violators.

The findings of this research could guide regulators and lawmakers to empower audit committees with more definitive authority over the company's financial reporting process. Audit committees, though a part of the board, need to be perceived as a neutral body by both the company and auditors. Considering the pool of available talent in India, a 100% independent audit committee might emerge as a feasible answer for neutrality.

5.1. Scope for Further Research

Previous studies confirm the existence of earnings management in India, though the scale of it can vary widely. Managers tend to get off with small amount of earnings manipulation in financial statements, as it is not easily discernible. It is only when earnings management takes place on a large scale through deceptive accounting practices, that its gets translated into an accounting fraud. With the responsibility of overseeing the financial reporting process delegated to audit committees, further research in this field can examine the impact that audit committees have had on constraining earnings management in Indian companies.

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