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Optimizing Financial Auditing through Effective Audit Committees: A Comprehensive Literature Review

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Abstract

The proliferation of financial scandals worldwide has sparked a revolution in the way audit quality is conceived and assessed, highlighting the shortcomings of traditional approaches to the preparation and production of financial statements. Faced with this situation, the business and legal communities reacted by introducing new legislation on financial security. The new legislation shifts the focus of audit quality assessment towards an in-depth analysis of the audit process. Collective action has been taken by entrusting this task to the audit committee, which embodies the relational pivot within the control process, interacting in a concerted manner with both the internal and external audit functions. The aim of this article is to quantify the importance of setting up an effective audit committee within a company, by demonstrating the preponderance of its role as a central body in enriching and carrying out the audit mission, as part of an overall audit process.

Key words: Audit process; audit committee; internal audit; external audit; collective action.

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Introduction

As companies become increasingly sophisticated, the scope of financial auditing is expanding all the time. This mission is not limited exclusively to the intervention of external auditors, but is part of a complex process that also encompasses all the work carried out by internal auditors. The two main players, the internal and external auditors, form a framework for cooperation with the Audit Committee. The Audit Committee's task is to reconcile these two services, thereby optimizing the use of the resources required for this control process.

As Pentland (1993) points out, the practice of auditing is essentially perceived as a collective activity. Even if the audit report has only two signatories, the external auditor's judgment is fundamentally the result of a collective effort.

A number of researchers, such as Knapp (1991), Carcello, Hermanson & McGrath (1992), and Pigé (2003), have argued for a shift away from classical evaluation approaches towards an analysis of audit quality based on the auditor's process. These authors stress that the evaluation of this process should be carried out by an audit committee, given its crucial importance in the audit process, and its privileged access to information.

Regulators are focusing their efforts on increasing the involvement of audit committees in the control process. This mainly involves board members, especially those considered independent of management. The aim is to maximize the likelihood of detected irregularities being revealed at a sufficiently senior level. Thus, an effective audit committee is seen as a factor in the quality of the audit process, on a par with the competence and independence of the external auditor.

This article aims to answer a crucial question:

To what extent can the existence of an effective audit committee influence the quality of the audit process?

To this end, our analysis will be divided into three main sections: the first will provide an overview of the financial audit process, the second will highlight the growing role of the audit committee, and the third will conclude with an analysis of the contribution of audit committees to improving the quality of the financial audit process.

The Evolution of the Financial Audit Process: A Literature Review

The financial audit process encompasses all operations orchestrated by the external audit, internal audit and audit committee departments, all of which interact with each other. This collaboration between these three entities should undoubtedly make a positive contribution to improving audit quality, thus ensuring the reliability of published financial information. Indeed, the notion of effective governance remains incomplete without the presence of this rigorously structured collective action, bringing together these three major players in the auditing process.

Various research projects are currently underway to explore the interdependent relationships between these players, thus contributing to the emergence of knowledge linked to audit effectiveness criteria. These studies successively examine each actor individually, then explore the bipolar interactions within the overall framework.

According to these investigations, the criteria of independence and competence of these actors, as well as the quality of their formalized relationships, appear to be essential elements in enhancing the effectiveness of the audit process.

The importance of a quality audit process

Companies with substantial governance requirements should be encouraged to distinguish themselves through the quality of their audit process, in order to increase the societal-contractual relevance of the financial information they disseminate. In other words, as financial information becomes integrated into various governance-related contracts in the interactions between management, shareholders and creditors, the imperatives in terms of the quality of this information intensify. Consequently, investing in a high-quality audit process takes on added significance.

According to agency theory, the aim of a high-quality audit process is to strengthen the control function, thereby freeing management from the responsibility inherent in the quality of accounting data.

The Advent of Audit Committees: An Exploration through Literature

Genesis:

The obligation to set up audit committees has been in place for several years in North American listed companies, and has become widespread practice in Europe since the late 1990s, as well as on the world's major stock markets. The audit function has experienced significant limitations following a crisis in the production of financial information, giving rise to a loss of confidence among the various users of financial statements. To remedy these challenges, a significant effort was made to reorganize the company's governance bodies internally, resulting in the creation of audit committees within the Board of Directors.

Audit committees are now internationally recognized as an essential component of corporate governance systems. Their adoption has been the subject of numerous recommendations, notably in reports such as those by Treadway in 1987 and Cadbury in 1992. Audit committees have undergone rapid standardization, particularly for companies listed in Anglo-Saxon countries. The American stock exchange authorities formally made the setting up of audit committees compulsory, starting on the NYSE in 1978, then extended in 1989 to the NASDAQ and in 1992 to the AMEX.

In the early 1980s, audit committees began to be introduced in the UK for large companies, albeit on a voluntary basis, and gradually spread to small and medium-sized companies too. In France, the substantial development of audit committees in large listed companies followed the recommendations of the first Vienot report in July 1995.

Expanding the Role of Audit Committees:

Over and above the apparent impact of setting up an audit committee, questions about its effectiveness emerge in a similar way to those raised for the board of directors. This concern often stems from observations of inefficiency, particularly in the United States, where the Treadway report reveals, on the basis of established statistics, that 69% of the cases of financial fraud reported by the SEC1 between 1981 and 1986 were associated with the presence of an audit committee. Consequently, the work of the Treadway and Cadbury groups underlined the inadequacy of the mere existence of an audit committee, specifying that it must possess essential characteristics, notably independence and vigilance, in order to contribute effectively to the quality of auditing and financial reporting.

Against this backdrop, the late 1990s and early 2000s saw an intensification of institutional pressures on audit committees in the USA. This development stemmed from the recommendations of the Blue-Ribbon Committee's report in February 1999, which focused primarily on strengthening the requirements for independence and competence of audit committee members.

The Sarbanes-Oxley Act (SOX) increases the pressure on audit committees by charging them with responsibilities relating to the selection, remuneration and independence of the external auditor, in addition to ensuring that internal controls in high-risk areas are properly aligned and put into practice. As a result, audit committees play a central role in preventing and detecting accounting irregularities and fraud.

Various contributions have highlighted the increasingly prominent role played by audit committees (Saada, 1998). Composed of directors, this committee requires independence from the company's management, as well as skills in controlling and understanding the business. These two criteria are essential, but in reality, often prove insufficient. For example, the directors on Enron's audit committee met both these conditions, but lacked a complementary characteristic, namely involvement and access to information.

The introduction of audit committees, by creating an interface between the controller and the controlled, alleviates the pressure exerted by the company on the shoulders of the auditor, positioning him or her in such a way as to ease conflicts (Ledouble, 1996). However, it is sometimes observed that the willingness and ability of audit committees to play an active intermediary role in audit conflicts may be insufficient. Criticism is often levelled at the ineffectiveness of audit committees, particularly with regard to the appointment of members representing the management of other companies, who may be reluctant to enter into conflict with those of the audited company in situations of disagreement.

Audit Committee Performance Indicators:

The field of research on audit committees has evolved beyond the simple observation of their existence to explore their relationship with the quality of financial information. It is undoubtedly moving towards the evaluation of their effectiveness. The variables likely to characterize this effectiveness can be grouped into three major categories: independence, competence and the level of involvement of the audit committee.

Independence:

Anglo-Saxon working groups, in particular reports such as Treadway (1987) in the USA and Cadbury (1992) in the UK, confirm and clarify the role of the audit committee in relation to the board of directors. The audit committee is considered an integral part of the board of directors, comprising at least three members, most or all of whom must be independent of the company's day-to-day management. By formalizing managerial limits on accounting policy, an independent audit committee should minimize illegal behavior. Particular vigilance is required in all sensitive accounting areas. SOX requires regular exchanges between the audit committee and the internal and external audit departments on significant accounting estimates.

In a theoretical framework, independence, as an efficiency factor, should be positively associated with the quality of financial information. Work in this area is largely based on the American tradition, due to the nature of the variables involved in the quality of financial information. Based on the study by Kalbers and Fogarty (1993), numerous empirical studies have focused on the effectiveness of audit committees and their impact on the quality of financial information. The results of these studies indicate a positive correlation between the quality of financial information and the independence of audit committee members (Beasley et al., 2000; Abbott & Parker, 2000; Abbott et al., 2004; Bédard et al., 2004).

Expertise:

Research into competence is still less numerous than that into independence, but is growing significantly, given that this second characteristic plays an indispensable role in the quality of the audit committee's work.

From an operational point of view, competence encompasses expertise in the fields of corporate governance, company-specific knowledge and financial accounting, evidenced by a public accounting designation or proven experience and responsibility in the preparation of financial statements, in accordance with the criteria established by the Securities and Exchange Commission (SEC). Expertise in the field of corporate governance is measured by the number of mandates held by an individual acting as an independent member of other audit committees, while specific expertise can be assessed on the basis of the average length of the director's mandate (Bédard et al., 2004). Audit committee expertise appears to make a significant contribution to the prevention of accounting errors, earnings management and the perceived quality of financial information. Consequently, particular importance should be attached to the competence of directors sitting on audit committees, both as an indispensable complement to independence, which although necessary, is insufficient.

Commitment and thoroughness:

Over and above its composition, the audit committee must demonstrate its involvement and vigilance in its mission to monitor and control. This notion was originally raised in the Treadway report (1987), which pointed out that many audit committees were perceived as mere "cosmetic" bodies, unable to truly appreciate the real activity and efforts made to ensure the quality of financial information. From an operational point of view, the researchers mobilized two types of variables in this respect, namely the number of meetings held by the audit committee and its size. Audit committee activity is generally assessed by the annual number of meetings, although this indicator remains imprecise for measuring the scope of the work carried out. Indeed, an audit committee that does not hold meetings is less likely to contribute effectively to the audit process. The Treadway Commission stresses the importance of audit committees meeting frequently, a recommendation reinforced by the subsequent findings of the Committee of Sponsoring Organizations (COSO, 1999) in its review of financial fraud cases over the period 1987-1997 in the USA.

The Audit Committee's Essential Contribution to the Excellence of the Financial Audit Process

Roles and interactions within control bodies

The first area concerns the review of financial statements and risk assessment. It also involves making judgments on the accounting methods adopted, with particular attention paid to their relevance and consistency.

The second area of intervention focuses on the company's internal control system. The Audit Committee ensures that all internal data collection and control procedures guarantee the credibility of the financial statements. It is responsible for overseeing the work carried out by the internal audit department, and keeps abreast of the main risks to which the company may be exposed.

Finally, the third area covers the monitoring of the statutory audit of the financial statements, as well as the review of questions and recommendations put forward by the external auditor. It also includes monitoring the independence of the external auditor.

Collaboration between the Audit Committee and the Internal Audit Function

The audit committee plays a central role as the key interlocutor of the internal auditor, establishing a relationship based on mutual needs. This relationship has been explored in numerous studies, which have examined its influence on the effectiveness of the internal audit function.

According to the work of Dezoort (1997), the role of the audit committee vis-à-vis the internal auditor focuses on two main concerns: the reliability of the internal control system and the evaluation of the internal audit program. Research by Raghunandan, Read and Rama (2001) and Goodwin (2003) highlights the impact of audit committee members' independence and level of experience on this relationship.

Goodwin and Yeo (2001) argue that direct and frequent interaction between the audit committee and the internal audit department reinforces the independence of the internal audit function. Regular meetings between these two departments, as Verschoor (1992) and Scarbrough et al. (1998) point out, are crucial to increasing the effectiveness of this independence.

In addition, Gendron et al. (2004) point out that the results of internal audit's work serve as an essential basis for the audit committee to form its own judgement on the effectiveness of internal control. According to Sarens et al. (2009), Gendron et al. (2004), and Gendron and Bédard (2006), internal audit can be considered a "provider of comfort" due to its in-depth knowledge of internal control systems and risk management, as well as its privileged position within the company.

Collaboration between the Audit Committee and the External Audit Function

According to the work of Bradbury et al (2003), the presence of audit committees within a company contributes significantly to effective control, thereby reducing audit risk. This, in turn, rationalizes the scope of work planned by the external auditor.

According to Compernolle (2009), the audit committee plays a crucial role in reinforcing the independence of the external auditor. However, it is stressed that this relationship is reciprocal, with the external auditor also having to provide information to the audit committee to help it carry out its duties. The author questions the idea that the Audit Committee's close judgment provides an absolute guarantee of the objectivity of the external auditor's opinions, particularly in situations where the latter may encounter obstacles.

Research by Beattie et al (2000) and Awadallah (2007) indicates that the active presence of the audit committee acts as a resistance factor for the external auditor in the face of pressure from the company being audited, particularly during evaluations linked to various transactions. The audit committee can also act as an intermediary in resolving conflicts between external auditors and management, as suggested by Stewart & Munro (2007).

When it comes to recommendations on accounting adjustments, the audit committee provides significant support to the external auditors. This support is linked to behavioral factors on the part of the external auditor, including the nature of his reasoning and the evidence he uses to justify materiality (DeZoort et al., 2003a), as well as the authority of his position (DeZoort et al., 2003b).

Measuring the role of the Audit Committee in the audit process

The Audit Committee is entrusted with the essential mission of safeguarding the integrity of the audit process, thus assuming the role of quality vector for the entire process, provided that it fully discharges its responsibilities towards the internal and external auditors. Its central function is to supervise the control system and internal audit, while playing a crucial role as the privileged interlocutor in relations between the external auditor and the audited company.

The Audit Committee's contribution to the quality of the audit process can be summed up in two basic points:

Monitor the effectiveness of internal control and internal audit

The robustness of the internal control system is the core element of a quality audit process within large entities. In these large-scale structures, the growth in transactions encourages external auditors to base their audit approach on information systems. In reality, auditing a company's entire operations becomes an insurmountable task. Auditing standards require the auditor to assess the credibility of the internal control system before developing an audit strategy for each of the company's business cycles. Reliable and correctly applied internal controls help to reduce the risk of errors in accounting records, thus limiting the extent of testing required to validate all financial statement items.

Monitor external auditors and assess their autonomy

According to SEC guidelines, the role of the audit committee is to monitor and maintain the independence of the external auditors. It is also held responsible for the complete administration of the external audit function, thus implying a significant change through the legal involvement of directors in the independence of the external auditor. These major provisions encompass three main aspects:

1. Increasing the Audit Committee's responsibility for selecting, remunerating and supervising the work of the independent auditors, and specifically intervening in the resolution of any conflicts between the latter and management.
2. The obligation for the Audit Committee to approve any services performed by the external auditor outside the scope of its certification mission. Stock market regulations strictly prohibit any engagement in the fields of accounting, financial information systems design, actuarial services, valuation, and outsourcing of internal audit services. However, this prohibition may be lifted if the results of such engagements remain outside the scope of the audit of financial statements.
3. A commitment by the external auditor to inform the Audit Committee, prior to the preparation of the financial statements, of any critical issues relating to accounting practices, as well as any deviations from generally accepted accounting principles. In addition, all written correspondence with the company's management must be disclosed.

Conclusion:

The purpose of this article is to undertake a theoretical exploration of the role played by the audit committee in the quality of the financial audit process.

A thorough review of the research carried out in this field has revealed that the presence of an effective audit committee, characterized by its independence, competence, involvement and diligence, has a significant influence on the quality of the audit process.

The main contributions of this committee include:

- Its leading role in guiding and monitoring the internal control system and the internal audit function;
- Encouraging external auditors to adopt and maintain an independent attitude;
- Resolving conflicts of interest and arbitrating disputes between auditors and management;
- Its function as a vehicle for the improved circulation of information on the progress of controls, which contributes directly to the detection of irregularities.

However, it is important to stress that our field of research has certain limitations. A more in-depth analysis could be undertaken to study in detail the specific contribution of an effective audit committee to the quality of financial information.

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