

## ORGANISATIONS OVERSEEING THROUGH THE AUDIT COMMITTEE

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**Abstract:** *The article addresses the main responsibilities of audit committees within organizations, starting from the need for knowledge and understanding of the organization by all members of the audit committee, which must consider both internal factors and external factors. Among internal factors, the organization's internal control system is one of the key elements in the financial reporting process, the concern of maintaining an appropriate control environment. Audit committee members should ensure that management gives the organization a "bon ton", "leading tone", developing an organizational culture that promotes the attitude of compliance and internal control findings and conclusions which help to provide default quality of financial reporting. Good practice issues of Anglo-Saxon and internal control assessment tools for organizations are presented further. Particular attention is paid to risk management and specifically the risk of fraud by the media appetite for such issues can easily affect the organization's brand. The second part of the article discusses the influences of financial failures of recent decades on corporate governance system of organizations in the Anglo-Saxon environment. Particular attention is paid to how the audit committees, these "living consciences" of organizations have adapted their roles and behavior to capture, monitor and influence the overall management culture of organizations.*

**Keywords:** management, organization, fraud, internal auditors, internal control, external auditors, audit committee

**JEL Classification:** M42, M48, M49

### 1. ROLES AND RESPONSIBILITIES WITHIN THE ORGANIZATION

A major concern of the audit committee is the need for a better knowledge of the company and its business to fulfill its oversight role, which includes the consideration of the internal control, of the fraud risks and of the financial statements risks.

**The knowledge of the company / organization by the members of the audit committee** should take into account several internal factors, including business area, the risk types faced by the company in the current competitive trends, the major customers and suppliers, the regulatory requirements and the technology affecting its business. Also, it must be taken into consideration a number of external factors on business knowledge, the financial reporting process and the work of the auditors.

The company may be involved in unique transaction of its business type, in sophisticated and complex or derivative transactions, in the form of purchase and sale of goods, in order to meet a specific objective reporting and an economic objective.

Consequently, it is required that audit committee members should understand the company's objectives in terms of transactions and how the investors requirements are satisfied in terms of economic substance.

**The internal control** is one of the key elements of the effective financial reporting process and it consists in maintaining a proper control environment. The control environment sets the tone of the organization and contributes to the awareness of staff on the role of internal control. Meanwhile, the control environment is the foundation for all other components of internal control, providing discipline and contributes to the culture of minimizing the loss through fraud and errors risks.

The members of the audit committee must have a good knowledge on the controls' environmental quality of the organization. The Audit Committee should assess whether the management provides a "good tone" to the higher levels of the organization and if they develop a culture that promotes an attitude of respect for the internal control conclusions and also for the high quality financial reporting.

The appreciation of the control environment will be also achieved by analyzing the organizations' code of ethics. The organization should adopt and enforce written codes of ethics for at least its priority areas, to maintain a strong ethics climate and achieve efficient communication channels to protect against fraudulent financial reporting. Therefore, the audit committee will proceed with the analysis and with the periodic operational procedures of management and financial reporting system verification.

The audit committee should understand the organization's internal control system to determine its suitability to assess smooth and efficient, which includes an understanding of any findings or recommendations of the internal auditors.

An effective internal control includes processes and procedures, which among others, are designed to:

- Promote a control environment and corporate attitude to support appropriate business practices;
- Identify and to address financial risk areas currently;
- Ensure that the organization's assets are protected in a prudent and efficient manner in terms of costs;
- Ensure that only authorized transactions are recorded;
- To minimize the risk of fraud.

***In the USA, from 1977 the Law of external corrupt practices is the base for public companies, managers and employees where they are subject to sanctions if they do not have an adequate internal control and accounting records correct.***

***The law has clearly contributed to the awareness of the company's Board members who appreciated more an effective internal control and the audit committee in overseeing the internal control.***

The audit committee should understand the effects that may occur as a result of major changes in the organization, especially through layoffs, restructurings, mergers and others and pay attention to changes to be made on reorganizing the internal control system after these events. For this purpose, the audit committee should expect regular information from internal auditors and external auditors regarding the internal control system.

For these reasons the Board of directors and the audit committee must have a clear understanding of the concept of internal control system in order for the internal control to support the organization in achieving its objectives.

*The COSO control framework defines internal control as a process established by the board of directors, management or other personnel of a company designed to provide reasonable assurance regarding: the effectiveness and efficiency of operations, reliability of financial reporting and compliance with applicable laws and regulations .*

Based on this definition, the internal control system consists of the following five interconnected components:

- *The control environment* sets the tone of the organization, influencing the control awareness by the staff. It represents the foundation for all other components of internal control, providing discipline and structure;
- *The risk assessment* is the identifying and analyzing relevant risks on the objectives of the company, providing a basis for the risk management;
- *The control activities* represent the policies and procedures that assist in ensuring that management directives are complied with;
- *The information and communication* systems support the identification, the capture and sharing the information that allow people to fulfill their responsibilities;
- *Monitoring* is a process that assesses the quality of internal control performance over time.

In practice, the members of the audit committee are not in a position to determine that the system of internal control over financial reporting works properly and therefore it must rely on other people. In this sense, they will address a number of questions to the management that is directly responsible for the organization and operation of internal control, and will require independent opinions to the internal auditors and external auditors. In order to set correct opinions, the audit committee shall, together with the auditors, evaluate the control system of the organization, including a contact with IT service and security, and to ensure so that significant organization risks are mastered through the undertaken control activities.

The practitioners recommend audit committee members to give time and a special interest for the discussions with managers and auditors in terms of understanding the functioning of the internal control system. Furthermore, it is recommended that the audit committee should set appropriate expectations from the management and the internal auditors regarding the need for the committee to have quality information on internal control, with emphasis on the control environment and forms of control, or lack of it, on financial reporting, including controls over the organization's information systems.

The way to take charge of the main tasks of internal control that the audit committee is recommended to watch could be obtained through a questionnaire which should include at least the following:

NC	QUESTIONS	YES	NO	Comment
1.	The adequacy level of the control character			
2.	The effectiveness of the internal control in the financial reporting process			
3.	Comparing the control system of the organization with generally accepted auditing standards			
4.	Significant improvements of the internal control recommended by the auditors			
5.	Corrective action and taken measures, adequate segregation of duties, checking the existence of persons who initiate and approve transactions			
6.	Analyzing the organization's code of ethics			
7.	The existence of a system whereby the employees can report the organization, under the principle of confidentiality, suspicions of fraud			
8.	The way the Internet is used and the communication in the organization			

9.	Assessing the adequacy of control activities by the management, including security, confidentiality and reliability of the information within the organization			
10.	The existence of an appropriate business continuity plan in case of unforeseen disruptions, and whether this plan has been tested			
11.	The evaluation of the internal auditors procedures and external auditors, including assessing the adequacy of information systems, policies and procedures			
12.	The access to the use of the information technology			
13.	The coverage degree of any evidence of fraud procedures by the external auditors			
14.	The analysis of the internal auditors and external auditors findings on the effectiveness of the control environment of the organization			
15.	The existence of proper controls over the approval and monitoring of special transactions			

**Understanding the fraud risk** must receive special attention from the audit committee considering the media's appetite for such subjects easily affect the organization's brand.

Therefore, the audit committee must have an answer to the question: *What is fraudulent financial reporting for the organization and how this risk can be attenuated?*

Fraudulent financial reporting implies incorrect statements, misrepresentations or omissions on the existence of property transactions in the financial statements to mislead users of the financial statements. In practice, it is often difficult to determine the management intention, to distinguish between genuine mistakes and fraudulent financial reporting and thus it is impossible to determine the degree of non-compliance of financial statement with generally accepted accounting principles.

The audit committee is not responsible for fraud detection, but can play a decisive role in identifying signals of fraudulent financial reporting. The audit committee should assess the risk of fraudulent financial reporting that occurs after the pressures that are put on management, on internal and external factors, such as rewarding senior executives, underperforming, forecast issued earlier etc.

*In practice, the members of the audit committee should try to understand any situation that may create discomfort and always keep an acceptable level of skepticism on all management initiatives.*

In the overseeing activity, the audit committee must take into consideration the company's compliance with laws and regulations affecting the financial statements. In addition to the information obtained from the discussions with the managers and auditors, based on checklists and questionnaires requested, they receive updated information from the management by reporting to regulatory bodies and to the Board of Directors on legal and

compliance issues that may have an impact on financial statements and that may affect the company's compliance policies or financial stability and profitability.

*The "Blue Ribbon" committee Report* on the effectiveness of the audit committee, sponsored by the *Stock Exchange* in New York and the *National Association of Corporations Directors (NACD)* has developed a practical guide on the work of the audit committees (ratio NACD), that is recommending them to assess the tone of the organization - "tone of the top", ensuring the loyalty of directors and employees regarding legal compliance and ethics within the company, through written policies.

NACD report further suggests the audit committee to obtain information on the establishment and maintenance, by the management, of a process meant to ensure compliance with laws, regulations and relevant policies.

The Audit Committee may meet with the board of directors to ensure that legal compliance and ethical standards are observed. At the same time, they can request reports from the internal auditors.

The issues concerning the organizational risks, is meant for the board of directors, which can create a separate risk committee or delegate such responsibilities to the audit committee.

The audit committee may be involved in the risk management by supporting the adoption of a system of effective risk management and risk control, or by acting as a catalyst to ensure that the full range of risks management oversees the company's risks.

*Ernst & Young Audit Committee* presents a detailed list of the risk factors that should be considered by the audit committee:

- Lack of policies regarding values and standards of conduct of the company and the lack of the codes of conduct;
- Lack of adequate attention granting an internal control system, including the effects of the information systems processes;
- The existence of an aggressive financial targets and expectations from the operating personnel;
- The selection of the estimates and the aggressive accounting principles;
- The attempts from the management to reduce the audit purposes (directly, for example by limiting the access to people or information, or indirectly, through unneeded fees or constraints regarding the audit duration) or imposing unreasonable deadlines;
- Lack of the accounting, financial and information personnel competence, or lack of adequate training in rapport with the complexity of the company's business;
- Lack of clear management lines and the existence of contractual arrangements without a goal for the organization;
- Lack of adequate authorization and approval for the transactions;
- Rapid growth in profitability, especially compared with those of other companies in the same industry;
- Changes in the operating environment of the company;
- Inability to generate cash flows while there are reported earnings and the growth;
- Assets, liabilities, income and expenses based on significant estimates that involve uncertainty or subjective judgments;
- Significant transactions, unusual, extremely complex or innovative businesses, especially those that occur at the end of the financial period, which have a determining effect on the financial statements.
- An extraordinary volume of deliveries shortly before the end of the financial year;
- The perception of adverse effect on significant transactions such as combining business, a planned debt or the awards a contract, if poor financial results are reported;

- Significant transactions between third parties that are not part of the ordinary course of business or other entity being audited by the same firm.

When the audit committee was delegated responsibilities for the issues of the organization risks, they should receive periodic updates from the management, including the ones regarded to: the key organizational risks, the company's Internet and the strategies on e-commerce, its infrastructure system, the measures to be taken to protect human and intellectual capital, etc.

In the light of the new trends such as globalization and the growing need among investors about the future of their investments, the audit committees should be informed on events that could affect the company's financial statements and on the way the auditors should respond to these events. In addition, the audit committee may consider the problems that may arise in areas such as security, confidentiality, the reliability of internal and external systems and processes; disclosure of strategic information, non-financial or regarding the performance measurement; the compliance with the contractual obligations.

*The audit committee, the board of directors, the management, and the internal and external auditors are "actors" who have each an important role in the company's financial reporting and the frequent communication between them it is essential for the proper functioning of the financial reporting process.*

A good practice to clarify the role of each of these "actors" and their specific lines of communication *is the regular meeting of key members of each of these groups to discuss roles, responsibilities and expectations of each group*, and subsequent, documenting the meetings conclusions. So:

- *The management* is responsible for organizing the risk management system of internal control and financial reporting activities.
- *The internal auditors* are responsible for assessing the functioning of the internal control system, risk management and the effectiveness of the identification and notification of deficiencies, irregularities and malfunctions by the responsible parties.
- *The external auditors* are responsible for auditing and certification of the reliability of public company financial statements, assessing the internal control system and the degree of implementation of audit procedures.
- *The Audit Committee* is responsible for overseeing the participants in the financial reporting process and reporting to the board of directors.
- *The board of directors*, lastly, is responsible for overseeing corporate performance on behalf of the shareholders.

The audit committee should have the ability to access internal and external resources, if they need to fulfill its responsibilities, including maintaining a legal adviser. In addition, the audit committee has the authority to conduct its own investigation.

The external auditors work directly with the management in the audit process and frequently interact with them when providing non-audit services. However, the audit committee, the board of directors and the representatives of the shareholders are actually the customers of the external auditors.

In the USA, the SEC requires all companies to provide a report of the audit committee in the management financial statement reporting *to disclose their status and the audit committee member's activities*. Specifically, the rules of the SEC requires companies to disclose the identity of each member of the audit committee and the manner of their appointment and to declare the number of committee meetings of the last fiscal year, if the committee reviewed the external auditors services of non-audit and the compliance of the incompatibilities and describe briefly the functions carried out by the committee.

Therefore, the company should consider a model of disclosure regarding the audit committee information and the audit committee charter, as follows:

*The company has an audit committee composed of independent directors. The information on the functions performed by the Committee, the membership and the number of meetings in the last fiscal year is set into the "report to the audit committee" included in the delegation statement of the year. The audit committee is working after the committee charter, written and approved by the board of directors.*

*In addition, the company is required to submit annually written information to the NYSE, attesting the independence, the knowledge of financial language and expertise of the audit committee members in financial management. The statement must also certify the annual mandatory verification of the audit committee charter.*

## **2. THE AUDIT COMMITTEE RESPONSIBILITIES DEVELOPMENT THE IN THE LAST DECADES**

The financial scandals from the recent decades have brought a shadow on the functioning of the corporate governance within organizations. In particular, the collapse of ENRON in the USA created a crisis on confidence in the financial reporting system.

The publicity and the political implications that followed the collapse of ENRON and the controversies regarding possible future solutions aimed at the auditing profession, the relations between internal and external auditors with their clients and at the same time, the role of the audit committee. In particular, the controversy focused on the status of the audit committees, which are in a difficult situation, but this perspective has contributed to the approach of the role of independent auditors and accordingly the scope of the provided services / offered by them.

In the literature they have made several recommendations that focused on the following areas:

- *The prohibitions or restrictions on non-audit services to public customers;*
- *Restrictions on consulting services on the financial reporting;*
- *Further restrictions on outsourcing the internal audit;*
- *Banning the design and the implementation of the IT services.*

However, the (private) organizations require non audit services, mainly services relating to, for example, audit fees and taxes, provided by the independent auditors, or the outsourcing of some internal audit activities. At the same time, the organizations cannot be compelled to proceed with the rotation of audit firms and of the personnel that provides services for them.

*The "ENRON" lesson, beside the criticisms given to the audit committee determined the companies to have major concerns regarding the reliability, control and liability of the financial reporting process to ensure transparency, comparability, consistency and quality. For these reasons, we believe that current and future members of audit committees must develop its own responsibilities for establishing useful guides and guidance to fulfill those responsibilities and to understand the expectations of their organizations.*

The Audit Committee plays a critical role in overseeing the integrity and quality of the financial reporting, the effectiveness of the internal control, risks assessment and mitigation affecting the financial statements and monitoring of legal and ethical compliance of the company because it affects the performance, the financial statements and the independency of the auditors.

***"The audit committees should be proactive, not just reactive, to ensure the quality and integrity of the corporate financial reporting. Critically, it is felt the need to improve***

*the interaction between the members of the audit committee, the management and the external auditors."*

The collapse of the ENRON and the WorldCom in USA helped the renewal of the focus on the role of the audit committee regarding the quality of the financial reporting, the effectiveness of the internal audit process, the auditor independence and the corporate governance efficiency.

Most of the issues that have attracted the media attention after the ENRON "lesson" were related to:

- *the general complexity of the operations, the organizational structure and the possibility that the audit committee would not receive appropriate and timely information in order to ask the right questions about accounting policies and financial statements of the organization;*
- *The economic substance of the transactions with third parties and complete character of the disclosures about such transactions;*
- *The purpose of unusual transactions as well as the benefits or obligations of the financial results;*
- *Codes of ethics and corporate policies on conflict of interest, leading to the company's executive management involvement in contractual relations with third parties.*

Clearly there is a growth on the requirements from the audit committee on the oversight of the responsibilities within the organization, which tends to become a real challenge.

The audit committees must overlook the employment of qualified members, independent, responsible and to maintain strong connections and communication lines with the management, with the internal and external auditors in order to provide the Board that additional insurance they expect on the adequacy and effectiveness of accounting, financial reporting and internal control organization.

*The report of the New York Stock Exchange*, issued in February 1999, reveals that the members of the audit committee should be independent and have certain qualities on the recognition of the importance of their responsibilities, knowledge of financial language and devotion to carry out these responsibilities. Also, the audit committee relationships and communication with the external auditors, the internal auditors and the management should have a critical nature and provide recommendations on good practice in the field.

In 2000, in USA, *the Financial Instruments and Transferable Securities (SEC)* Commission's new rules were designed to improve the disclosures on the structure and practices of the audit committees and to increase reliability and trust of the organizations financial statements. In this sense, the SEC rules requested:

- *The intermediary financial statements should be audited by external auditors;*
- *The management / trustees statements must include a report of the audit committee;*
- *The organizations should reveal in the management statements whether there is a functioning audit committee charter and to attach a copy of it at least once every 3 years;*
- *The organizations should reveal in the management statements information regarding the independence of audit committee members.*

In the same period, *the rules of the New York Stock Exchange and the National Association of Securities Agencies (NASD)* altered the requirements for audit committees to strengthen their independence and qualification with provisions that:

- *Defined the independence of the auditors more rigid than in the past;*
- *Demanded the audit committees to be composed of at least 3 members and to be composed entirely of independent directors with financial language knowledge and to contain at least one director with expertise in accounting or financial management;*



- Asked companies to adopt a written charter for the Audit Committee with specific committee responsibilities, including those related to the independence and accountability of the external auditors;
- Required external auditors to discuss their independence with the audit committee.

In addition to these actions, the *Treadway Commission (COSO)* requested an analysis of the USA public companies, which materialized in the „*Fraudulently financial reporting in the 1989-1997 period*” document issued in 1999. All these reports with many others formed the resources useful for the practice improvement of the audit committee effectiveness.

### **Bibliography**

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\* bill amending and supplementing Law no. 672/2002 on public internal audit