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Role of Accounting and Audit Committee in Corporation Governance

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Abstract: *Inability of shareholders in investigating financial reports and lack of financial perception turned into a new problem in that era. Thus, in late nineteenth and early twentieth centuries, corporation law made it mandatory to prepare standard financial statements, and companies were required to certify financial statements by independent auditors of the entity and managers. Consequently, auditing became an important component in corporation governance policies in different countries. Independence of the Audit Committee is considered as one of the essential features that influences the effectiveness of audit committee in the process of monitoring financial reports. Accordingly, the greater independence of the Audit Committee (i.e. the ratio of independent auditors in Audit Committee) leads to lower accrued profit management. While existing studies proved the impact of some audit committee features on limited accrued profit management and enhanced quality of financial reports, the effect of these features on limited profit management through real items has not been investigated. This study investigated the role of accounting and corporation governance factors in the level of corporation governance disclosure.*

Keywords: *Accounting, Audit Committee, Corporation Governance*

INTRODUCTION

Introduction and Literature Review

From international point of view, corporation governance is a set of mechanisms in which managers, based on their own profits, make decisions to maximize value of the company which in turn favors owners' interests (Denise 2003). According to national auditing regulations of Iran approved by Tehran Stock Exchange Board of Directors, June 2008, regarding organizational ranking, internal audit committee is observed by board of directors. Given global developments pace, it seems that internal audit plays an important role as one of the key components of corporation governance mechanisms. From representation theory perspective, the presence of independent (non-executive) managers, in the board of directors, as independent individuals who have a supervisory function helps to reduce the interest conflicts between shareholders and directors. Part of corporation ownership is held by shareholders. The group mainly confine to publicly available information (published financial statements). Another part of ownership is held by major shareholders who are provided by valuable information about future perspectives and business strategies through direct contact with the company (Moloudi, 2009). According draft of Corporation Governance Principles, a major shareholder is a shareholder who can independently appoint, at least, one member in board of directors. Financial statement provides information that reduces market information asymmetry and suggests that investors should use this type of information in investment decisions based on market response to profit announcements, which is the first criterion of existence (Rasaeyan, 2006). These information should be confidential. Existence of confidential information indicates the asymmetry of information in market context. Chang et al. (2007) showed that market increases with the reduction of information asymmetry. Liquidity means changing assets with cash without bearing any loss or expense. Discrepancies in the suggested buy and sell equity price of stock and market depth are considered as liquidity criteria, which have been investigated as

representations of information asymmetry in recent studies (Denise 2003). The difference between the highest bid price and the lowest selling price is called the difference between buy and sell bid price. The transaction is done when the highest bid price and the lowest selling price are equal. A steady flow of buy-and-sell orders at lower or higher prices than the equilibrium is called depth of market, in which supply and demand curve around market value of assets is quite flexible and continuous.

Effective Factors in Corporate Governance

The Relationship between Corporation Governance Features and Disclosure Level

The core of representation theory is that managers, as shareholder representatives, act or make decisions that do not necessarily lead to maximizing shareholders' wealth. Based on this theory, an adequate control or observation mechanism should be developed to prevent interest conflicts of shareholders. Transparency of financial statements is considered as a practical approach, but the problem is that transparency of financial statements is a general, non-frame clause that needs to be defined and explained to determine: what is transparency? And where is its position in financial statements?

Meanwhile, a fundamental question should be answered; transparency is for whom and for what purpose; and what is the role of accountants in transparency of financial statements? (Chong and Lesi Moya, 2007) described the relationship between corporate governance and disclosure as follows:

1. Board size: Alishi Miri argued that large boards, including managers with various skills and experience, can improve the efficiency of information transfer. This means that companies with smaller size boards disclose a relatively small portion of information in financial statements; therefore, it is assumed that there is a positive relationship between size of board and disclosure in corporation governance.
2. Independency of the Board: A number of studies have reported a significant direct relationship between ratio of non-executive directors and levels of optional disclosure. Usually, in a board with a large proportion of non-executive directors, one can predict a positive image of independence and responsibility for shareholders, and ensure compliance with corporation governance approvals. Therefore, it is assumed that there is a positive relationship between board independency and disclosure in corporation governance.
3. Dual responsibility of CEO: This situation occurs when the CEO of a company is also selected as chairman of the board. This may lead to interest conflict and loss of independency (Hosey, 1991); therefore, it is assumed that there is a negative relationship between dual responsibility of CEO and disclosure in corporate governance.
4. Structure of audit committee: Audit committee is a mechanism to reduce information asymmetries between managers and non-executives, protect investors, strengthen internal control system, and maintain quality of disclosure of accounting and financial information. Sean and Boot (2009) found that large corporations, that have an audit committee, disclose more information optionally. Large companies with an independent audit committee with independent directors have more effective performance and disclosure; therefore, it is assumed that there is a positive relationship between number of non-executives in Audit Committee and disclosure in corporate governance (Khairollahi 2008).
5. Focused ownership: Delegation theory suggests that multiple and extensive ownership reduces monitoring and surveillance costs and additional information requests. In other words, increasing trust between stakeholders and managers, and reducing surveillance costs and monitoring through plurality of ownership, and the company should focus on disclosure. Bungee and Goukan (2009) showed that investors who own lower percentage of companies share have less access to the information they need. Therefore, companies with a plural ownership reveal a lot of information to meet the information needs of users. By contrast, shareholders who have a focused or major ownership interest in companies' stocks can easily provide their information from internal sources.

Members of Management Board and Accuracy in Financial Reporting

The purpose of accounting and financial reporting comes from information needs and requirements of external users. The main objective of external financial reporting is statement of economic effects of events and effective financial measures on business unit performance for entities outside the business unit to assist them in making financial decisions regarding the unit. The main mean of transferring information to the mentioned entities is financial statements, which are the final product of accounting and financial reporting process. The Standards Accounting Board of Audit Organization specifies the main goals of accounting and financial reporting in accounting and reporting theories, which are providing required information to assess financial and economic situation as well as profitability. There have always been concerns about the quality of provided information, and the

global experience also implies that it is simplistic to assume that having good-quality information is possible without controlled systematic and structured mechanisms. Good-quality information not only should be reliable, relevant and timely, but also must be distributed appropriately and result in rescued information asymmetry. Hence, in recent years, lawmakers have issued several laws to create these mechanisms to improve quality of financial reporting. One of these rules is that companies must establish and evaluate internal controls over financial reporting, as well as, setting up an audit committee to monitor internal controls and ensure that objectives of those controls are met. The audit committee plays an important role in the company as a supervisory mean. The quality of financial reporting should be in a way that users of these reports be able to make assured investment decisions without doubt. It is likely that the interference of audit committee members and board of directors affect quality of financial reporting in different ways. Audit Committee is a subsidiary committee of directors board that is responsible for supervising issues related to finance and audit reports. Establishing and applying an audit committee is effective in preventing unlawful acts, improving financial reporting process, and providing transparent and reliable financial information and reports. (Alavi Tabari and Asabakhsh, 2010).

Audit Committee

History of Audit Committee formation dates back to 1939. After the McCain Robbins fraud case, the US Stock Exchange offered all companies admitted to the New York Stock Exchange to nominate independent auditors who are non-executive directors of the companies, and to negotiate with them about audit contract and related payment settlement. The organization referred to this non-executive group as the "Audit Committee." This proposal was approved by the US Stock Exchange in 1971. After that, in 1978, the New York Stock Exchange made formation of an audit committee obligatory for the public corporations admitted to the stock exchange. The 1929 crisis, whereby accountants were criticized for not providing accounting standards, especially in procedural stability, made presentation of financial audited statements necessary for stock companies on the New York Stock Exchange. After the crisis, the New York Stock Exchange in 1933, for the first time, requested all companies, that were applying for admission to the New York Stock Exchange, to provide audited financial statements. The auditors should comment on fairness and compliance with the principle of procedural stability in their audit reports and for the first time stated that the financial statements were prepared in accordance with the accepted accounting procedures (Hendricson and Van Berda, 1992). Despite 76-year history of the Audit Committee in developed countries, its establishment process was very slow in Iran and sometimes it have been stopped. The audit committee is one of board committees in a company, consisting of 3 to 5 and in some cases 7 members who are non-executive directors, and is responsible for final supervising of all financial activities of the company (Denis & McCullen, 2003). Non-executive members of Audit Committee are members who do not have executive or operational responsibility during their membership in board of directors. Election of committee members outside the organization increases independence of committee members. In other words, absence of executive managers in audit committee results in explicit discussion of issues such as weaknesses in internal controls, disagreements over accounting principles and methods, signs of potential misuse of manager or other unlawful acts of agents in the company (Rafipour, 1999).

For many years, in past, economists assumed that all groups relating to a stock company are working for a common purpose; in the past thirty years, economists have cited many of interest conflicts between groups and the ways companies faced such contradictions. In general, all these are referred to as "governance" in accounting. (Khairollahi, 2008). Corporation governance is laws and regulations, structures, processes, cultures, and systems that achieve goals of accountability, transparency, justice, and respect to stakeholders rights. (Yeganeh, 2006). Corporation governance is a set of relationships between shareholders, managers and auditors of the company that involves establishing a control system to observe shareholders rights and enforcing approvals of the forum properly and preventing potential misuse. This law which is based on accountability and social responsibility system, is a set of duties and responsibilities that must be taken up by members of the company to ensure accountability and transparency. In corporation governance, the goal is formation of an efficient board of directors; in order to achieve this goal, assessment of board characteristics is requires. One of the most challenging topics is the presence of independent individuals in the audit committees. An independent director is selected outside the core company, subsidiaries, affiliates, and controlling shareholders. Audit Committee is a committee consisted of board of director members, typically 3 to 5 non-executive directors (non-executive and non-recruited) in Iran, to guarantee and enhance interests of shareholders and investors; it is also a control mechanism to reduce information asymmetries between stakeholders and other beneficiaries (Yegane et al., 2011). Among audit committee duties are assisting the auditor election, managing audit process, helping board of directors to understand audit results better and collaborating with the manager and independent auditor in solving internal

control problems or weaknesses identified during audit process. Audit committee should be organized and used appropriately. In this case, these committees can have significant benefits to all interested parties. The audit committee can strengthen superintendence responsibility of directors' board. They can also improve the relationship between independent auditors and manager and increase independency of the auditor through service. Audit committees also assist taxpayers and creditors to ensure that their benefits are maximized through audits. On the other hand, the different characteristics of audit committee, including financial expertise, independency, size, etc., can impact the effectiveness of audit committee. Previous studies revealed that financial expertise of audit committee members helps them to supervise financial reporting process more effectively.

Role of Accounting Profession in Corporation Governance

Task of accounting is results measurement and value allocation to assets and liabilities at a specific time. Investors and others rely on accounting information for decision making. Shareholders hire independent individuals outside of the organization as an auditor, whose duty is to ensure that the presented information in financial statements is accurate and fair. Shareholders rely on auditors' judgments because of their expertise and independency. Audit profession creditability and reliability is lost if it is not able to prove its independence and efficiency. This will happen when:

- Changing needs of society are ignored,
- There is no possibility to create advanced audit procedures
- There are doubts about independency of auditor.

Therefore, it is necessary to develop appropriate accounting and auditing standards in order to improve corporation governance. By their compliance, community expectations are reflected on appropriate ways of recording, accounting and reporting transactions and implementation of business operations. In order to reflect society's expectations accurately by these standards, compliance processes should be carried out in such a way that allow stakeholders and enthusiasts to express their opinions broadly and openly. Improvement of accounting and financial reporting is a prerequisite of corporation governance improvement (Narayan Koli). Research on Corporation Governance points out the role of accounting information, as a source of credible information variable, that support the existence of rewards for managers in accordance with their performance, supervised mangers, external investors and lawmakers by board of directors, as well as implementation of investor rights that are governed by the rule of Stock Exchange. The company must be accountable for its activities towards the beneficiaries. Accounting standards ensure comprehensive disclosure of corporation accountability as a fundamental issue and a prerequisite for corporation governance. Indeed, in reviewing accounting standards in order to improve accounting and financial reporting, it is necessary to reflect changing expectations of society regarding company behaviors and create a tool for political and social monitoring and corporation control (Jalali, 2008).

Non-focused Ownership and Corporation Governance

Non-focused ownership is an important source of corporation governance issues, so we first answer this question: what causes non-focused ownership? There are at least three reasons for non-focused ownership. The first and perhaps the most important reason is that wealth of individual investors may depend slightly on certain investments. Secondly, even if a shareholder can take a large share of the company, it may be less likely to invest in the company because of the desire to diversify the risk. The third reason is the investor's concern about liquidity. As the number of shares held by a particular shareholder is higher, his concern about liquidity is greater in the secondary market. Non-focused ownership may not cover interests of all individuals. Managers provide periodic financial reports about their performance. Shareholders can evaluate their investments by the provided information. Considered criteria in this assessment is important for investors and managers. Investors always consider performance of companies to identify optimal investment opportunities. What drives shareholders to invest in a particular activity is the performance of that industry, which will result in an increase in company value and ultimately increase the shareholder's wealth. Managers pay attention to the mechanisms by which their performance is judged. They look for information is directly sensitive to performance rewards. When the bonus system is not sensitive to performance, the company lose its managers and they leave the company. On the other hand, high-focused ownership also has its own problems and causes weaknesses in corporation governance mechanisms. If the ownership is held by certain people and they control the company in accordance with their own goals then minority shareholders' interests and other external beneficiaries will be neglected. (Amir-Rasaiyan, 2009).

Directly ensures that they did commit fraudulent activities and embezzlement. This view is exactly in line with the theory of representation in corporation governance. During the nineteenth century, small companies gradually merged and the gap between management and ownership increased. Although, according to existing laws, directors and shareholders were still components of a business or company, but lack of ability and understanding of shareholders about financial reports turned into a new problem of that era. Thus, in the late nineteenth and early twentieth centuries, corporation law obligated companies to prepare standard financial statements, and they were required to certify financial statements by independent auditors of the entity and managers. As a result, auditing in corporation governance policies became one the most important component in different countries around the world (Khairollahi, 2008).

Conclusion

Regarding the status and function of independency concept in Audit Committee, there are many studies and arguments in the relevant literature. The audit committee should be independent from the managers of the organization to exercise its supervisory role and protect interests of shareholders. It has been argued that if members of audit committee are independent of managers and owners of the organization, they will be able to prevent managers from manipulating financial results. The audit committee has been formed to reassure users about the information. The importance of audit committee role comes from corporation governance. This is due to financial problems of companies in the past. Accounting profession plays a critical role in corporation governance due to ensuring transparency in accounting and financial reporting. Financial statements are one of the most important tools of reflecting economic performance of business units.

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