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THE EMERGENCE AND DEVELOPMENT OF AUDIT COMMITTEES IN USA & CANADA - A REVIEW OF THE LITERATURE

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Abstract

The fiasco of the Enron Corporation in late 2001, apart from indicating the largest corporate insolvency in the USA, has also thrown up a heap of queries about the effectiveness of contemporary auditing practice as a part of corporate governance mechanism. Audit committee acts as a key player in supporting the board to complete its fiduciary duties in administering the corporation's finances. Audit committees have a comparatively long history dating back to the 1900. It is only in current years that their practice has been propagated again. Keeping this in view the current paper will shed light on the emergence and development of the audit committees globally. This paper attempts to provide a summary of findings fast-growing theoretical and empirical literature on audit committee development around the world mainly basing on several available articles. It will help policy makers and strategists to have a bird eye view on the development of audit committees in different parts of the world and can analyze the different contextual parameters driving the formation of these committees globally.

Keywords: Audit committee, Emergence of Audit Committee USA & Canada, Role of auditors

INTRODUCTION

It is a known fact that audit committees are a critical constituent in corporate governance since it is responsible for keeping supervision over the corporation's audit and other capacities encompassing financial management. The emergence of these committee in USA, UK, CANADA and Saudi Arabia have been discussed to review the literature in depth and signify the importance of these committees.

The Development of Audit Committees in the USA

As indicated by Collier and Zaman (2005), boards like review council of the East Tennessee and Western North Carolina Railroad utilized to oversee reviewing capacities in 1870, preceding the arrival of auditing function in United States. On 28 February 1870, ET & WNCRR's shareholders made special committee so as to screen the accounts and association's boards of directors and give the input (DeFond, Hann & Hu, 2005). It was said by the researcher that audit committees answering to the directorate of an enterprise could be the first identified example. All things considered, the thought of review panels and their obligations have developed profoundly as they were proposed in the late 1930s. The idea is not new as Deli and Gillan (2000) stated that audit committees were picking up significance in the early 1930s and the SEC and New York Stock Exchange (NYSE) propelled their development after the case of McKesson and Robbins case. DeFond, Hann and Hu (2005) pointed out that American Institute Certified of Public Accountants (AICPA) at first proposed audit committees in 1937 which was approved by SEC since 1940. Literature demonstrates an intriguing improvement that audit committees developed more in the nations where there existed unforeseen organization debacles or corporate blunder (Archambeault & DeZoort, 2001; Turley & Zaman, 2004). Moreover, Goddard and Masters (2000) expressed that corporate audit committees of trustees are also a result of dissatisfactory corporate administration strategies. Archambeault and DeZoort (2001) pointed out that because of the expanding corporate responsibility, review councils have got more pressurized. A large portion of the previous studies pertaining to audit committees are conducted in U.S when contrasted with different countries because US has got the longest history of audit committees (DeZoortet al., 2002). As a matter of certainty, with the expanded size of organizations with divided possession from administration, more monetary responsibility was required by different electorates in the firm (Carcello & Neal, 2000). In addition to this, Krishnan (2005) proposed that with the help of review advisory groups, correspondence can be enhanced with board of directors and inside and outer auditors. North American experience conceived an offspring to the need of audit committees as talked about by Cadbury Committee (1992) (Abbott et al., 2004). Until the late 1960s and 1970s, review panels were not viewed as much (Turley & Zaman, 2004). Zeff (2003) observed that in July 1967 the Executive Committee of the American Institute of Certified Public Accountants (AICPA) acclaimed all publicly owned organizations should have non-director's audit committee which can coordinate with the outside examiners in case of any question identified with budgetary reporting which is solvable at the administration level. The outcomes of a study by Spira (2003) indicated that 32 percent of the organizations reacting had audit committees. The Bar Chris Case in 1968 and the post-Watergate discoveries in the early 1970s came about in the consolation of review boards again for the increment in budgetary reporting accuracy (Chhaochharia& Grinstein, 2007). In response, the SEC issued Accounting Series Release No. 123 titled 'Standing Audit Committees Composed on Non-executive Directors' (Feroz, Park &Pastena, 2008). It stated that: in request to secure speculators depending on the correctness of financial statements, SEC affirms that there must be audit committees which have non-executive directors. The NYSE issued a White Paper in 1973 that contained a comparative suggestion (Marques, 2006). In the 1970s, tremendous issues related to monetary transparency at organizations like Lockheed and Penn Central began a squabble as some held mismanagement in financial accounting and weak connections among company and outside evaluators a reason of those issues (Feroz, Park & Pastena, 2008). To take care of this issue, the US Congress passed the Foreign Corrupt Practice Act of 1977, and securities trade acknowledged rules that an organization should have an autonomous review audit committee (Chhaochharia & Grinstein, 2007). Corporations' executives, as per this demonstration were equally been forced an obligation to have satisfactory interior control frameworks. Due to the expanded issues in the late 1970s and early 1980s, execution of audit committees in US expanded profoundly (Abbott et al., 2004). Turley and Zaman (2004) discovered that the firms with review boards of trustees expanded from almost ten percent in 1958 to about forty percent in 1972 and to over ninety percent in 1982. Commission on Auditor's Responsibilities (1978) highlighted the significance of review advisory groups and autonomous directors in the fulfillment of an adjusted review and administration for the insurance of shareholders' interest. In 1985, Independent National Commission, regularly known as the Treadway Commission on misrepresented budgetary reporting was secured by five supporting private area associations, specifically, AICPA, American Accounting Association, National Association of Accountants, Institute of Internal Auditors, and Financial Executive Institute (Marques, 2006). Agreeing to the perception of Chhaochharia and Grinstein (2007), Treadway Commission went through numerous studies led by key colleges and organizations amid around two years period between commission's foundation and arrival of its last proposals. The center of these studies incorporates bodies of evidence against auditors, administration and organizations for misrepresented monetary reporting, the capacity of SEC in budgetary reporting, corporate codes of convey, accounting training, opinion gathering, review boards, guaranteeing the quality, and different parts. Although there existed many groups who recommended the structure and establishment of an advisory committee, The Report by the Treadway Commission in 1987 was the first one who provided with a clear path (Zeff, 2003).

A report by Treadway Commission has offered eleven specific guidelines so as to increase the performance of audit committees:

1. There should be adequate resources as well as power with the audit committees so that they can perform their duties.
2. Audit committees should be communicated, active and must adequately monitor the financial reporting procedures of firm as well as its internal control systems.
3. Evaluation of management pertaining to the independence of the public accountants of organization should be reviewed by the audit committees.
4. Annual and quarterly reporting procedures should be overseen by the audit committees.
5. The SEC should command an establishment in all public organizations of advisory committees having independent directors.
6. Committees should be needed during and overall annual performance report by SEC.
7. A written contract should be constructed for the committee which must be approved, revised, and reviewed when necessary by the whole board.
8. Plan of management to participate the organization's independent public accountants in performing management advisory activities should be reviewed by the audit committees before the starting of each year.
9. Any substitute solution pertaining to major accounting problems should be informed by the management.
10. Suitable involvement of internal auditing in the overall procedures of financial reporting and a well-coordinated with the independent auditor should be ensured by the audit committee along with the top management.
11. Program of management, monitoring the submission of the code of ethics of organization must be reviewed by audit committee annually.

This report further specified that SEC ought to require all open organizations the foundation of review panels which contain just of non-executive directors. Nonetheless, such recommendations were not reacted by SEC (Marques, 2006). With the Treadway Report, review board of trustees stood as the "cornerstone" of corporate financial governance (Beasley, 2010).

Also, the National Association of Securities Dealers Automated Quotations (NASDAQ) made a necessity in 1989 of review panels' foundation with dominant part of the individuals being independent directors (Westphal &Zajac, 2013). Drees&Heugens (2013) observed expanding interest of US stock trades in the boards of executives and review councils. The

NYSE ordered review panels for organizations exchanged on its trade in 1978. In 1989, the National Association of Securities Dealers joined the NYSE in obliging review boards for organizations recorded on NASDAQ/NMS. The American Stock Exchange (AMEX) in 1979 began supporting clearly the foundation of review boards of trustees with administration's autonomous individuals. In 1989, a necessity for the formal correspondence of outer auditors with review boards of trustees as audit's standard part was introduced (Drees&Heugens, 2013).This development toward the foundation of review advisory groups, as Walls, Berrone and Phan (2012) depicted is predominantly the result of the institutional pressures on corporations both to fortify corporate administration and to increment the outside evaluator's autonomy and execution. Amid the 1990s, when financial transparency began to get managed progressively, the exercise provoked the question of integrity of financial statements. The Chairman of SEC,Arora and Dharwadkar (2011), examined this issue in his mainstream discourse "The Numbers Game". For the examination of financial reporting system, a committee was called by him and this resulted in encouragement by SEC of NYSE and NASD for framing a private sector body for the examination of issues saw by SEC.

On October 1998, Blue Robin Committee (BRC) was framed by NYSE and NASD for the improvement in the effectiveness of audit committees of corporation. Assessment of U.S. corporate financial related reporting and especially evaluating the apparatuses for checking responsibility among corporate audit committees, independent auditors, and monetary and senior administration was the fundamental motivation behind this advisory group (Zalata& Roberts, 2015).The point that review panel's exposures must be an essential part of an association's budgetary divulgences was highlighted by the board (Babalola, 2013). A report, known as BRC Report was issued by the committee in February 1999 (Waweru, Kamau&Uliana, 2011). For the upgrade of committee's adequacy, ten rules were introduced in the report. These rules are further arranged in three general classes for the improvement of the functioning of audit committees (Zakaria, 2012):

1. Supporting the independence of audit committee.
2. Improving the effectiveness of operations of audit committee.
3. Strengthening control mechanisms and communication among the audit committee, the management and external auditors.

On January 10, 2000, the SEC has adopted Release No. 34.42266 titled "Audit Committee Disclosure". According to this, organizations were required to have some disclosures in their proxy statements regarding their audit committees (Li, Mangena& Pike, 2012). These disclosures that were required to make sure that do the committees have three-fourth reviewed and argued the audited financial statements with management, three-fourth discussed with outside auditor the issues needed to be discussed by Statement on Auditing Standards No. 61 (Lee, 2014); and three-fourth received from the outside auditor he disclosures needed by Independence Standard Board’s Standard No. 1 and discussed with the outside auditor the independence of auditor. Additionally, it is also required to make sure the implementation of written contract for the audit committee by the board of directors. If this is not practiced, then a copy of contract should be included as an appendix to the proxy statement of organization at least once in every here years.

Corporate responsibility was once again addressed because of the fear of financial fraud of professional bodies and investors of Enron Corp in 2001, the greatest destruction in United States' history (Christensen, Glover & Wood, 2012). As a result, the US Congress passed enactment, the Sarbanes-Oxley Act 2002 which exhibited different new prerequisites that included structure and obligations of review councils (Hostak, Lys, Yang & Carr, 2013). In this Act, review board of trustees was given significance as the essential individuals to guarantee the integrity of financial reports. Following requirements were proposed in Section 301.

- Each member of the audit committee will be a member of board of directors, and will otherwise be self-governing.
- The assortment, reimbursement as well as monitoring external auditor must be done by audit committee.
- The measures for the “receipt, retention as well as treatment of complaints” received by the organization pertaining to accounting, internal controls, in addition to auditing must be established by the audit committee.
- With the purpose of performing the duties, each audit committee must be authorized to include independent counsel or other advisors.
- Each organization will be funded suitably.

Besides, Section 407 exhibited the need that the SEC issue rules to make public organizations guarantee that no less than one individual from review panel is a financial expert. On 24 January 2003, the SEC received Release Nos. 33-8177; 34-47235 titled "Exposure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002" that obliged non -enlisted public organizations revelation in the yearly report guaranteeing audit committee has at least one autonomous financial expert (SEC, 2003). Likewise, the organization ought to legitimize the nonattendance of financial expert in review board of trustees in the event that it does not have any.On 10 April 2003, the SEC embraced Release Nos. 33-8220; 34-47654 titled "Principles Relating to Listed Company Audit Committees" coordinating the national securities trades and national securities affiliations such as the NYSE and NASDAQ Stock Markets which denies posting of any firm that does not comply with the standards for audit committees set by Sarbanes-Oxley Act (SEC, 2003). Public listed organizations, whose stocks are recorded on a national securities trade or on a computerized between merchant citation framework of a national securities association (e.g., NASDAQ National or Small Cap Markets), are subjected to such rules. Additionally, concurring to SEC’s new principle, audit committees of public companies are obliged to pre-approve all reasonable non-review services offered to the issuer by the auditor (SEC, 2003). This last requirement is subjected to procurement of non-audit services by the examiner starting on 6 May 2003.Taking everything into account, the foundation of review boards of trustees began in the US in the 1940s with the proposal of both SEC and the NYSE to guarantee financial specialists' and other invested individuals' security. Rules and proposals related to review board of trustees were displayed by the SEC, NYSE and proficient bodies such as AICPA. Particular proposals for review advisory group's parts and structure were at first given by the Treadway Commission (Nugent, 2012). Being the basic apparatus of corporate governance; suggestions for the change of review panel's viability were given by BRC in 1999. Later, the SEC and real stock exchanges, for example, the NYSE and NASDAQ settled upon the proposals. After the failure of Enron (2001), US Congress (Sarbanes-Oxley Act 2002) presented the first enactment agreeing to which every public organization needed to have audit committees and approached SEC to present new principles for the exposures of review councils. With the execution of proposals, SEC has currently issued various discharges, for example, Release No. 33-8220 (SEC, 2003).

Development of Audit Committees in Canada

With the collapse of corporations in the middle of 1960s, there grew a need for audit committees in Canada. In the accounting history of Canada, the key event of the Atlantic Acceptance Corporation Limited’s bankruptcy in the year 1965 was contrasted with the case of McKesson & Robbins in the U.S (Bédard&Gendron, 2010). This case was implemented to carry financial practices in Canada also (He et al., 2009) that has lead to the issuance of the Canadian Royal Commission Report in 1965. This report suggested that all public organizations should have an audit committee.

The foundation of the audit committee became essential for all the public listed organizations with the Lawrence Commission, an Ontario Select Committee on Company Law in 1967, and (Canadian Institute of Chartered Accountants 1981). Based on the outcomes of the report of Lawrence Committee, it would become easier to hold their independence with customers. Additionally, the report also showed that the audit committee would be an assisting communication link for the board of directors and the auditors (Braiotta, Gazzaway, Colson &Ramamoorti, 2010).

Legislation was introduced by The Ontario Business Committees Corporation Act 1970 that has made audit committees essential for all the public listed organizations (PricewaterhouseCoopers, 2011). The fundamentals of the Act are stated below:

- Structure of chairman and committee.
- Verification of yearly elected committee.
- Committee must review the accounts before displaying it to the full board.
- Authority of auditor involving the right to appear, to be listened, as well as to attend when needed.
- Right of auditor to have the chairman of the audit committee arrange a meeting for the discussion pertaining to the concerns that auditor wishes to be considered by the shareholders and the board of directors.

In the year 1971, the Canadian Central Government embraced the enactment of the Ontario Business Committees Corporation Act 1970 (Sharma, Sharma &Ananthanarayanan, 2011). This Act was corrected in 1975 in request to have all public organizations an audit council to check and sanction the budgetary explanations before they are exhibited to the main board of director's acknowledgement. In the year 1978, Adams Report further explained the part of review councils (Mustafa & Ben Youssef, 2010).

During the year 1986, the Macdonald Commission, secured by the CICA, fulfilled that reinforcing the viability of audit committee could be one approach to expand the evaluator's power with respect to management. Agreeing to the suggestion related to audit committee by Macdonald Commission discharged report in 1988, entitled "Macdonald Report":

- There should a foundation in all of the public listed organizations of an audit committee consisting of mainly non-executive directors.
- Shareholders should be reported annually by audit committees.
- Before the publication, both yearly and temporary financial statements must be evaluate by audit committees.

On the other hand, notice on audit committee in 1990 by the Canadian Securities Administrators also made significant contributions to the development of committee (Verley, Vidal &MacNeill, n.d). It has highlighted not just the issues of independent as well as roles of audit committee, but also emphasized on the mandate of audit committee. For instance, it comprehended the inclusion of audit committee in the monitoring of non-audit exercises among corporation and the external auditor, and observing its impact on the independence of auditor.

The Trust and Loan Companies Act, The Bank Act, and the Insurance Company Act were all implemented in the year 1992 making it sure the audit committee is having as a minimum of three non-executive directors and they do not have to be employees or officers of the organization or its subsidies. Similarly, certain duties and roles for committees were also displayed by these acts, including the following:

- Yearly financial statements must be assessed before the acceptance from board.
- Utilized internal control is suitable.
- Communication with external auditors for the discussion of financial statement or any specific concerns.
- Meeting with the chief internal auditors as well as management so as to strengthen the control mechanism’s performance.

In 1993, the Toronto Stock Exchange (TSX) created a Committee on Corporate Governance, centering at the change of corporate administration for expanding the honesty of the business sector (Verley, Vidal &MacNeill, n.d). In December 1994, the report entitled "Where Were the Directors?" otherwise called the "Dey Report" was discharged by the Committee (Shipilov, Greve& Rowley, 2010). Fourteen suggestions were given in this report for corporate administration. For, monetary years finishing on or after 30 June 1995, the TSX has actualized a prerequisite for TSX-recorded firms of covering the corporate administration frameworks and guaranteeing the understanding of frameworks with fourteen proposals.

Agreeing to TSX rules, obligation for stewardship ought to be accepted by the company's directorate that additionally incorporates key planning, risk management and inside control. The proposal additionally states that structure of board of directors ought to comprise most of the free executives and the autonomy of the majority of the board individuals ought to be revealed by the firm. In addition, introduction and preparing of new board individuals, compensation, structure and obligations of panels were likewise talked about in the proposals. In any case, it was voluntary to execute the proposals.

Senior officials of TSX-listed firms in 1998 were overviewed by TSX and the Institute of Corporate Directors (ICD) for a subsequent to the Dey Report for the evaluation of advancement in the change of corporate governance’s components since the arrival of the Dey Report (Shipilov, Greve& Rowley, 2010). In June 1999, the consequences of this survey were discharged in the report entitled "Give an account of Corporate Governance, 1999: Five Years to the Dey" (Shipilov, Greve& Rowley, 2010).

In addition, with the survey or corporate governance's revelations of all 300 TSX firms for the 1997 monetary year, inspectors assessed the level of consistence with the TSX corporate administration rules which brought about 94% of TSX 300 organizations who made corporate administration disclosures as per the prerequisite by the TSX. In any case, there were numerous distinctions in quality and amount.

In reaction to one of the rules from the review, corporate administration exposures were overhauled by the TSX in October 1999 (Bujaki&McConomy, 2002). For years finishing on or after 31 December 1999; TSX-recorded firms were obliged to present their corporate administration yearly along with the fourteen suggestions execution. With the development of corporate administration divulgence areas in the 1999 yearly reports of numerous TSX-recorded organizations, the impacts of the amended corporate administration revelations can be watched (Bujaki and McConomy 2002).

The Joint Committee on Corporate Governance (JCCG) was founded by the TSX, the Canadian Venture Exchange (CDNX) and the CICA in July 2000 (Bujaki and McConomy2002). Reviewing the present state of corporate administration in Canada, examination between Canadian and global best practices and rules for the changes to affirm that Canadian corporate administration stand best. In November 2001, the JCCG issued its last report "Beyond Compliance: Building a Governance Culture" (Saucier, 2001).

Three issues having fundamental position in corporate administration quality were the center of this report. These involve:

1. Enhancing the strategies of including the boards in a gainful association with administration – one that roots down in the shared understanding of board's obligations and capacity to satisfy obligations autonomously.
2. The selection of CEO of the company for approving, setting, improving as well as monitoring the strategic direction of the organization is the critical role of board.
3. Particular issues faced by the independent directors in organizations which have significant shareholders.

Fifteen relevant suggestions to enhance quality standard and adequacy of corporate administration in Canada and was also the section of the report (Stevenson et al, 2002). The TSX disclosure necessities and administration rules that were presented in 1995 after the proposals of the De Report were subjected to alterations in this report. The new corrected exposure prerequisites and administration rules must be followed by all organizations paying little respect to their size. While all TSX-recorded organizations are obliged to present administration revelations with respect to the fifteen proposals completely, the prerequisite differentiated from the CDNX-recorded organizations. These organizations are sorted into Tier 1 (large firms) and Tier 2 (small firms) which do not need to satisfy any corporate administration prerequisite. In conclusion of the last report by JCCG, CDNX was prescribed to set suitable timelines for intensive administration disclosures and aid Tier 1 organizations by living up to expectations with them for proposals' usage. Furthermore, Tier 2 organizations ought to be supported by CDNX for the divulgence and usage of rules.

Development of financial education and requirements of accounting expertise for members in review advisory group in JCCG report was the major change for review council. Changes because of the proposals by the JCCG material to TSX recorded organizations were acknowledged by TSX on 26 March 2002. Francis (2011) condensed the roles of audit committee under Canadian corporate and securities laws. These obligations include:

Yearly financial statements require to be surveyed by ¾ the review advisory group former to the endorsement by board of chiefs, the board of executives need to audit the unaudited interval financial statements as needed by ¾ Ontario securities laws, review councils are supported by ¾ Securities controllers to survey discussion of corporate management and are proposing to present a prerequisite that they do as such as a component of the national instrument being proposed by the Canadian Securities Administrators and ¾ The Canadian Securities Administrators recommended the board of chiefs or review council to review profit direction and news discharges containing financial information based in light of the financial statements of organization before the arrival of those announcements.

Taking everything into account, review boards in Canada are forced to reduce lawful requirements. Normally, they require at least three executives comprising larger part of external directors. Yet over the past years, the lawful structure has changed and has been considerably enhanced.

CONCLUSION

It is evident from the literature mentioned above that USA &Canada are committed and are trending towards continuous improvement in their governance practices.. Moreover, they have understood the significance of these audit committees. Due to the uncertain circumstances in political and economic environment especially oversight requirements rise, and risk management issues become more critical, audit committees face many new demands and complex challenges. Due to this reason numerous countries are in a path of continuous improvement for their governance system. They may need to add more and latest techniques and come up with more advance means to maximize governance and minimize any errors that may finally lead to failure.

For future research it is recommended to have greater consideration of the contextual analysis from other parts of the world. Moreover comparative analysis amongst both developed and developing countries will add value to the literature. Moreover categorical theorization of the progressions linked with audit committee operation can be furthered studied.

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