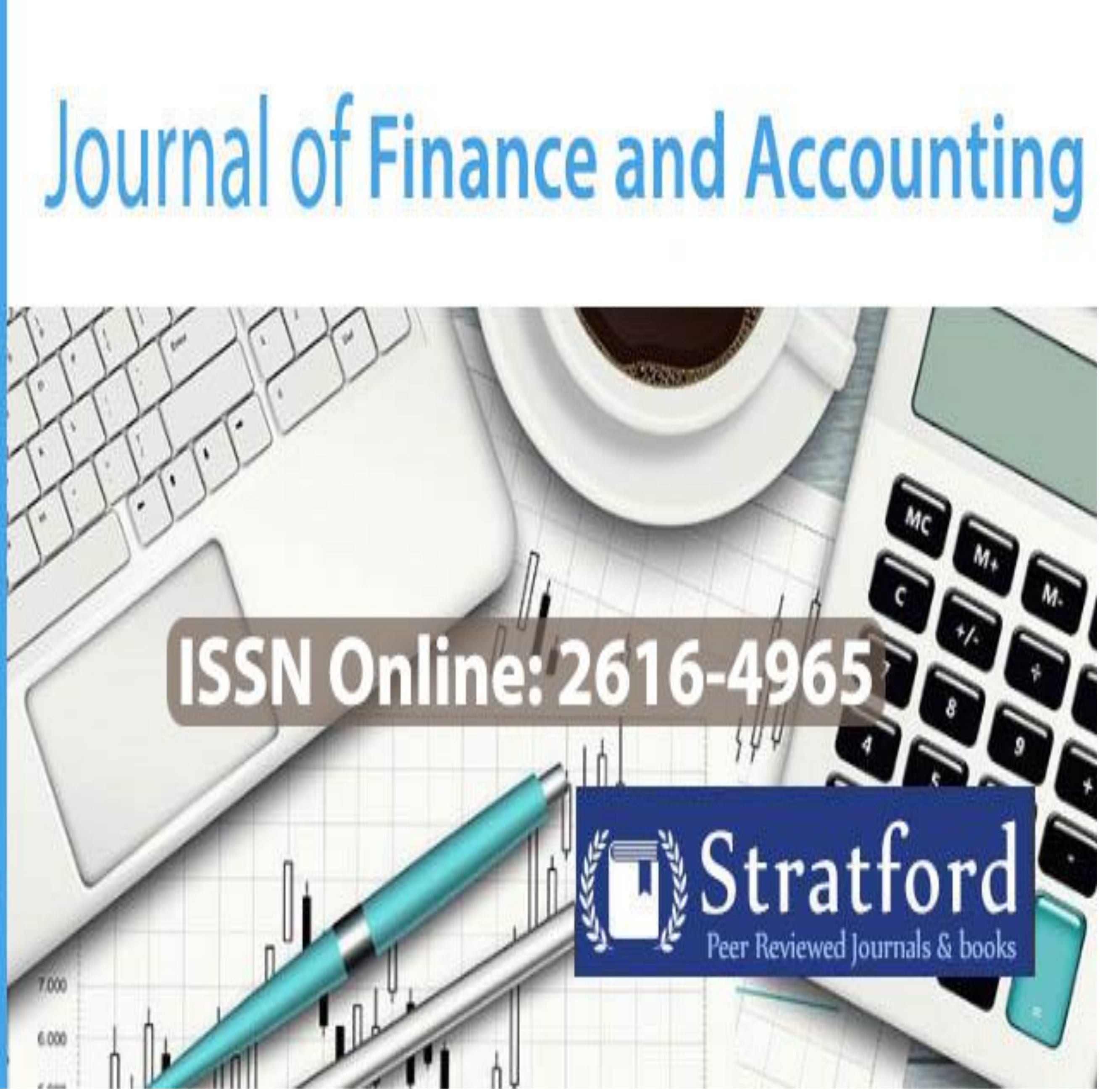

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Governance and Accountability: The Role of Audit Committee

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Abstract

This paper aimed at investigating good governance in and its role in improving the administrative and financial performance, in order to shed light on its financial and administrative transparency practices, accountability indicators, process of information disclosure and accessibility, and the procedures and mechanisms used to control financial and administrative corruption. One can barely come across any term more stimulating than accountability revealing both the idealistic expectations and technical requirements of governance. This paper provided deep insights into the advancements in corporate governance and accountability, and in particular the influence of internal and external factors. In this regard, the paper intended to add onto the available literature on the convergence of national corporate governance systems and the associated implications. The paper further presents important implications for key players in corporate governance development and accountability, audit committee. This paper evaluated and criticized the fragmented contents of the term governance and elaborate the relationships between governance, accountability and audit committee as well. Although accountability is fully considered as a critical element of public administration, it is a crucial question to ask whether there exists an inevitable relation between accountability and governance. The ideal praxis of accountability is best achieved through a centralized concentration of control or through dispersed power and delegated responsibilities. Despite numerous studies done on audit committee and corporate governance, very little empirical research has analyzed the direct and indirect relationships between audit committee and corporate governance and accountability. This paper sought to bridge this research gap by carrying out an in-depth literature review on the audit committee influence on the relationship between audit committee and governance. The paper looks into the role of audit committee on the direct relationship between accountability and governance.

Keywords: *Governance, Accountability, Audit Committee, Transparency*

Introduction

Governance refers to all kinds of institutional structures that promote both good substantive outcomes and public legitimacy (Rose-Ackerman, 2017). Governance is not a new term in the public sector literature but the practice of governance has changed significantly and dramatically over the past 30 years (Osborne, 2006; Bouckaert, 2017). Such changes have begun to attract increasing attention from scholars in the current discussions of legal and moral philosophy (Rose-Ackerman, 2017). The concept of governance is related to that of public action and, consequently, to that of public management. Governance issues are limited to the coordination and efficacy of collective action for the amendment of market weaknesses. Governance may also be understood, from the perspective of political economy, as stabilized articulation of regulations (Le Gales, 2006). Perhaps a fuller definition is provided by Torfing, Peters, Pierre and Sørensen (2012) who define governance as a complex process through which a plurality of actors with diverging interests interact in order to formulate, promote and achieve common objectives. By means of mobilizing, exchanging and deploying a range of ideas, rules and resources. Scholars continually pay considerable attention to expanding the types of governance. For example, Sandu and Haines (2014) explain a new concept, governance's public space, which is framed within the trend of adopting new business methods for the market economy.

Although governance also covers hierarchical forms of steering (''government''), it is usually associated with other governance modes, primarily markets or networks (Bevir, 2009). To indicate control issues in the context of corporations the term ''corporate governance'' was established. Corporate governance can be defined as a concept of structures, rules, procedures and mechanisms for the proper steering and controlling of corporations (Colley *et al*., 2005; OECD, 2004). By attributing different purposes to the different types of governance, Bouckaert (2017) draws our attention to distinctive categories of public sector governance often observed in the literature: corporate governance, holding governance, public service governance, superstructure governance, and systemic macro governance. Bouckaert (2017) finds that each type of governance is related to a different purpose. Corporate governance which is concerned with the management of single public sector organisation. Corporate governance, like many management instruments has moved to the public sector from the private sector, such as quality models, business process reengineering, and human resources management. This paper will focus on the corporate governance aspect of governance.

Governance has become one of the buzz-words in modern social sciences. In the most general sense governance deals with the steering and coordination of various actors, often in network-type

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patterns of collaboration (Kooiman, 2003). Although there are also cases of ''governance without government'', usually a governance structure contains at least one governmental institution. Governance is an umbrella term which includes different meanings and perceptions and is widely used in political sciences as well as in economics and management. In the private sector corporate governance is the umbrella term for all aspects of the powers and competences in the relations among different organizational units and between the organization and its various stakeholders (particularly: shareholders). In the frequent case of separation between ownership and management, the corporate governance concept ensures the influence of the owners of the business on its management.

Governance researchers Bhagat and Black (1998), Kahan, and Rock (2003) highlighted the role of different instruments in implementing corporate governance. These instruments included the board of directors, board. Corporate governance is concerned with the organizational structures and processes for decision-making, accountability, control and behaviour at the top of organisations (Armstrong, Jia & Totikidis 2005) Dahya, Dimitrov and McConnell (2008) defined corporate governance as the mechanism used to discipline organisations. According to Morin and Jarrell (2000), corporate governance is the framework that controls and safeguards the interests of the relevant stakeholders. The independent directors, CEO, board of directors and managers can improve the performance of the institute through the performance of their fiduciaries (Kahan & Rock, 2003). The role of the regulatory authority is important to safeguard the stakeholder rights and implement corporate governance policies. Corporate governance involves a number of inter-related and mutually supportive components. These components centre on creating transparency and accountability (Shore & Wright 2004) and to reinforce these aspects through appropriate governance mechanisms. Furthermore, these intended outcomes are, aimed at mitigating principal-agent problems and promoting the long-term interests of stakeholders (Gilardi 2001). Corporate governance is a multifaceted concept that centres on notions of organisational accountability and responsibility (Williamson, 2005). Corporate governance is considered as enhancing the reliability and quality of public financial information, and thereby enhancing integrity and efficiency (Rezaee 2009). The literature on corporate governance suggests that the role of a regulatory authority is important in improving an entity's performance (Rashid, Islam & Anderson 2008). Good corporate governance is focused on the protection of the rights of stakeholders and their interests (Bhagat & Black 1998, 2005; Kahan & Rock 2003).

Governance includes various types of mechanisms, particularly structures that clarify the responsibilities of the various stakeholders as regards the organization, approaches that foster the capabilities for meeting these responsibilities, and tools such as systems for internal control and external accountability. In his historical review of the governance concept, Goddard (2005) distinguishes at least three dimensions of governance: conformance, performance and structure. Accountability can have different meanings. Basically, it refers to the giving and demanding for good conduct, but some authors (Min, & Smyth, 2012) are more strict in the sense that they emphasize the need for control (sanction and reward) as an instrument to formalize the concept, because otherwise it would be merely associated with answerability and transparency.

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Bovens (2010) provides a rather concise definition of accountability. Bovens (2010) describes accountability as a social relationship in which an actor feels an obligation to explain and to justify his or her conduct to some significant other. The accountability concept is primarily associated with power delegation from shareholders (principal) to managers (agents) and the way to ensure the relationship between the agents and the principals (Gray & Jenkins, 1993; Sinclair, 1995; Broadbent, Dietrich & Laughlin, 2002). In order to define who the principal is and who the agent is, the questions of who is responsible to whom and for what needs to be answered (Bovens, 2010). This issue has resulted in the discussion of accountability towards stakeholders outside the organization as well as among the different levels of the organization, i.e. external and internal relations (Deleon, 1998; Romzek & Dubnick, 1987). Thus, a distinction can be made between internal and external accountability (Argento, Grossi & Thomasson, 2011). Accountability is context-specific. It has to be adjusted to both the type of organization and the object for which the organization is accountable (Romzek & Dubnick, 1987).

Accountability

Dubnick (2005) traces the origins of the concept ‘accountability’ to the emergence of royal legal traditions in England, well before the rise of the modern bureaucratic state. Mulgan (2003) argues that for a long time it was little used outside the sphere of financial accounting and that it first spread to a wider use with the New Public Management (NPM) reforms started in the 1980’s (Mulgan 2003; Bovens 2005). According to Mulgan (2003), the concept of accountability has gained ground on the term responsibility (Mulgan 2000; Dwivedi & Jabbra 1988). Accountability was first conceptually included in the idea of responsibility, but later gained ground as an individual concept, even to the extent of overweighting responsibility in both importance and scope (Mulgan, 2000; Sinclair, 1995). In addition, Dubnick (2005) tends to see responsibility as an integral part of accountability rather than vice-versa. Mulgan (2003) draws attention to what he calls the “core sense” accountability, derived from previous research on the topic. In this sense accountability is defined as a ‘process of being called to account to some authority for one’s actions’, or a process of ‘giving an account’ (Mulgan, 2000; Dubnick 2005). According to Mulgan (2000), this core definition of accountability is characterised by ‘externality, social interaction and exchange and rights of authority’ (Mulgan, 2000).

Roberts and Scapens (1985), quoted by Sinclair (1995) said that accountability requires a relationship where someone is asked to explain and take responsibility for their actions. In the system of constitutional government, there are two types of accountability: (1) Internal accountability, which is a type of direct accountability that applies in a particular organization, where the system involves direct reporting by subordinates to their superiors who hold power. (2) External accountability, which is an indirect type of accountability that involves reporting to parties outside the organization (Akbar, 2011). In this paper, two types of accountability, namely internal and external will be considered. These categories are said to be well suited to the conditions of decentralized government organizations in Indonesia (Akbar *et al*., 2012).

Accountability involves social interaction and exchange in terms of rectification and sanctions (Mulgan, 2000). The account-holder also has rights of authority over the account or implying rights to demand answers and impose sanctions (Mulgan, 2000). In this sense accountability can also be seen as answerability (Dubnick, 2005; Bovens, 2005). Dubnick agrees with Mulgans definition of core accountability but finds it somewhat limited, since it stresses the external authority, disregarding personal ethics as a mechanism of accountability (Dubnick, 2005). The idea of internal control as means of accountability is perhaps best captured in so called 'personal accountability' (Sinclair 1995), which refers to personal values and ethics as guidelines for acting in the public interest (Mulgan 2000). The personal integrity of an individual is largely shaped by shared values, ethics and beliefs communicated within the organisation or within a certain collective (Sinclair 1995). In public administration the mechanisms of personal accountability are closely tied to the prevailing administrative culture and its values and ethics (Sinclair 1995). Since the concept has recently been expanded it can now also be applied to more complex relationships. Greiling and Spraul (2010) point out that the provision of information within the accountability relationship can be supply or demand-driven. Accountability is not limited to a principal–agent relationship, and vice versa, actors can be accountable to a number of parties inside and outside their organizations. To this end, different types of accountability have been identified depending on the type of relationship concerned, which means that it can now involve a broader spectrum of stakeholders (Andre´, 2010; Sinclair, 1995).

Accountability has several forms: authors distinguish between internal and external (Romzek, 2000; Romzek & Dubnick, 1987); direct and indirect (Polidano, 1998); and vertical and horizontal accountability (Barberis, 1998; Bovens, 2009; Mulgan, 2000; Hodges, 2012). Accountability in the public sector is described as a heterogeneous, complex, chameleon-like and multifaced concept encompassing several dimensions (Barberis, 1998; Mulgan, 2000; Sinclair, 1995). According to Shaoul, Stafford and Stapleton (2012) the public sector context with its multiple stakeholders requires a multidimensional external reporting instrument which covers multiple areas, such as the use and stewardship of resources, the cost and quality of services, financial probity and financial control over public resources. Sinclair (1995) even defines a much broader set of accountability forms for the public sector, which goes beyond the scope of financial dimensions, by also including political (or democratic), public, managerial, bureaucratic, professional, and personal accountability (Sinclair, 1995).

Corporate governance consists of a set of internal procedures, laws, and informal guidelines that govern how corporate officials make decisions and who bears responsibility for harms, losses, or injuries that flow from such decisions (Iksander & Chamlou 2000; Monks, Robert & Minow 2004; Thomsen 2008). The objective of this system is to ensure that corporate decisions are made with the best interests of the corporation and its stakeholders; it is supposed to lead to better corporate performance by preventing the expropriation of controlling shareholders and reduce corruption in business dealings (Sale, 2003). Poor corporate governance is often associated with diffuse ownership, poor regulatory control, and a legal system that is not able to protect shareholder rights (Mbaabu, 2010). Ira and Paul (1998) states that, when corporate governance is effective in an institution, it provides managers with oversight and this holds boards and managers accountable in their management. This oversight and accountability when combined with the efficient use of resources and increased responsiveness to societal needs and expectations should lead to improved corporate performance. It is worth to note that effective corporate governance and accountability may not guarantee improved performance at the individual firm level because there are other factors that may impact the firm performance.

Audit Committees

The audit committee plays a vital role in the financial monitoring of a firm (Kevin, 2009). It also acts in a manner that will provide oversight roles over accounting policies and judgments, as well as the quality of the overall financial statements (Blue Ribbon Committee (1999); Security and Exchange Commission Code (2011). The SEC (2011) maintained that, to carry out the assigned tasks of monitoring financial reporting diligently, it will require significant accounting sophistication. That is, it would involve assessing the reasonableness of complex financial matters such as the company's accounting reserves, and management's handling of proposed audit adjustments suggested by the external auditors (DeFond, Hann, & Hu, 2005). The audit committee provides the board of directors with necessary advices and recommendations which include ensuring: that the respective organization complies with relevant regulations and ethical principles and standards; that the internal auditors are independent and competent; that the financial statements have been prepared correctly and accurately; and that the compensations paid to the organization’s executives were according to fairness and professionalism (Al-Baidhani, 2014). As part of improving the integrity of the organization’s financial information, a regulatory body may require a public company to create an independent audit committee (Bhagat and Black, 2002). Audit committees may seek the consulting resources and expertise needed to perform their responsibilities.

According to Beyanga (2011), an effective auditing service can, in particular, help reduce overhead, identify ways to improve efficiency and maximize exposure to possible losses from inadequately safeguarded company assets all of which can have a significant effect on the financial performance of an organization. Beyanga (2011) also stated that auditing is a valuable tool of management for improving performance. Fadzil, Haron and Jantan (2005) also noted that auditors help run a company more efficiently and effectively to increase shareholders value. Hermanson and Rittenberg (2005) argued that the existence of an effective auditing function is associated with superior organizational performance. At the empirical level, a survey conducted by Gilkison, (1999) found that the auditing function in organizations where it exists, contributes substantially to performance improvement and assist in identifying profit evidence in corporate disasters, particularly financial fraud consistently documents an association between weak governance. Thus, auditing committee by acting as a watchdog could save the organization from malpractices and irregularities thus enabling the organization to achieve its objectives of ensuring high level of productivity and profit.

Robinson and Owen- Jackson (2009) have defined the audit committee as selected members of companies who take an active role in overseeing the companies accounting and financial reporting quality policies and practices. In order to promote good corporate governance and enhance the integrity of financial reporting, audit committee as an integral part of corporate governance structure and one of the mandatory committees of the board of directors is established to provide support to the board by offering objective advice on issues concerning risk, control and governance of the organization. Traditionally, the primary role of audit committee has been to monitor the integrity of the financial statements produced by management. In recent times, this major role has been expanded beyond the annual financial statements to encompass the quarterly financial reports. Owing to this, audit committees are becoming more involved in the oversight of corporate reporting matters as contrasted with financial reporting. According to Owolabi and Dada (2011), considering the quantum of corporate collapses and failure, it is imperative that audit committee is taken more seriously in every corporate organization.

The audit committee serves as a liaison between the external auditor and the board of directors, and facilitates the monitoring process by reducing information asymmetry between the external auditor and the board. In addition, BRC (1999) noted that the audit committee is the most important governance mechanism with respect to audit firm appointments because it is responsible for hiring the external auditor and for overseeing audit quality. Therefore, a properly functioning audit committee is critical in ensuring the independence of auditors and high quality financial reporting. Improving the quality of financial statements has been widely proposed as one of the major benefits of companies establishing audit committees (BRC, 1999).

All audit committee members should be able to read and understand fundamental financial statements, including a balance sheet, income statement, and cash flow statement (Bond & Dent, 2008). At least one member must have past employment experience in finance or accounting, requisite professional certification in accounting or any other comparable experience or background that results in the individual's financial sophistication, including service as a chief executive officer, chief financial officer, or other senior position with financial oversight responsibilities or otherwise satisfy standards for financial expertise required for audit committees of companies. The audit committee plays a monitoring role of providing vital information to the legislature, political parties, the media, the citizens, and other organizations to control the government and its bureaucracy, and points to its value in serving the public interest (Baxter & Cotter, 2009). It is therefore important for the audit committee to have its own independence for it to execute its duties of financial management in an appropriate manner. If it lacks independence the audit committee may be puppet committee which cannot execute its duties appropriately. Audit committees are identified as effective means for corporate governance that reduce the potential for fraudulent financial reporting. Audit committees oversee the organization’s management, internal and external auditors to protect and preserve the shareholders’ equity and interests. To ensure effective corporate governance, the audit committee report should be included annually in the organization’s proxy statement, stating whether the audit committee has reviewed and discussed the financial statements with the management and the internal auditors (Basuony, Mohamed, Hussain, & Marie, 2014). As a corporate governance monitor, the audit committee should provide the public with correct, accurate, complete, and reliable information, and it should not leave a gap for predictions or uninformed expectations (BRC, 1999).

Governance, Audit committee and Accountability

Effective corporate governance requires regular and transparent reporting by agents. This reporting should occur not just to principals, but within the organisation itself (Bushman & Smith 2001). While this criterion appears relatively straightforward, meaningful reporting involves a number of aspects: regularity, transparency, content stipulations, links to performance management systems, and approvals. Regularity in reporting by agents is necessary as such mandated regulatory promotes responsibility and accountability (Bushman & Smith 2001, 2003). Transparency refers to report content that is easily understood, is not hampered by frivolous or irrelevant data, and

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provides full-disclosure of all known information used to compile report content and which may affect future organisational performance (Braadbaart, 2007). Transparency in roles and responsibilities is necessary to ensure agents are appropriately accountable. Heath and Norman (2004) explain this in the context of corporatized firms: the ambiguity of objectives provides the managers further discretion to pursue their own interests. Transparency depends, however, on principals (and delegated agents) being able (and willing) to overcome the transaction costs associated with developing such robust systems (Heath & Norman, 2004).

The best practice governance systems rely on the appointment and management of individuals who are independent in terms of their accountability. This independence is necessary in order to establish, monitor and reward or sanction individual performance. In the absence of independence, transparency in performance is diminished (Holm & Schoeler, 2010; Price, Roman & Rountree 2011), and hence accountability of individuals is comprised. It is only through accurate measurement of individual performance that individual responsibility to principals may be meaningfully assessed and reward/punished (O'Meara & Petzall, 2005). The consequence is that institutions need to ensure that accountability systems are transparent, best practice is observed (Higgs, 2002) and the right mix of personalities and expertise are presented. The fundamental requirement of every board is access to good information (McNulty, Roberts & Stiles, 2005). Studies of governance failures have pinpointed corporate governance weaknesses contributing to the failure. For example, Agrawal and Chadha (2005) considered the influence of corporate governance on the probability of firms having to restate their earnings. Clarke (2004) considered the cyclical nature of corporate governance failures, which he predicted was likely to continue.

Audit committee is one mechanism available to the board of directors to limit conflicts of interest between managers and stockholders (Menon & William, 1994). The wide adoption of the formation of audit committees around the world suggests the importance of an audit committee as a governance mechanism (Saidin, 2007). According to Cadbury Report (1992), audit committees would be important governance mechanisms that would protect the interests of the shareholders and ensure transparent reporting and improve audit quality. According to Okaro and Okafor (2013), an effective audit committee provides the following advantages: Strengthen the external auditor’s independence; added credibility of audited financial statements; supplementary assurance that corporate policies are in the best interest of shareholders and society at large; enhancement of the internal auditor position; improving performance of senior management by creating consciousness in them; advance of conflicts arising between management and auditors; and better communication between the director and external auditors and management. Dechow (1996) provides that firms without audit committees are more likely to have financial statements and earnings overstatements (Defond & Jiambalvo, 1991).

Audit committees are board mechanisms to enhance accountability around the financial reporting and accounting functions, and have been extensively researched (e.g. Collier 1992, 1996; Kalbers & Fogarty 1993, 1998; DeZoort & Salterio 2001; Klein, 2002; Collier & Gregory, 1999; Gendron, Be´ dard, & Gosselin, 2004; Collier & Zaman, 2005; Gendron & Bédard 2006; Turley & Zaman 2007). Also, DeZoort and Salterio (2002) provides a comprehensive review of the literature in this area. There has been relatively less research on internal audit. However, Raghunandan, Rama & Read (2001), Davidson, Goodwin-Stewart and Kent (2005), Goodwin-Stewart and Kent (2006), Gendron and Bédard (2006) and Turley and Zaman (2007) have touched on the subject to varying extents. In addition, Gramling, Maletta, Schneider and Church (2005) provided an overview of the role of internal audit in a corporate governance context.

Transparency thereby goes hand-in-hand with effective governance. Regular and transparent corporate reporting must also be supported by stipulated content. In other words, the structure of reports needs to be known, and unchangeable (Bushman & Smith 2001). This is necessary in order to ensure that necessary details are known by principals, which in turn promotes accountability and desired performance. Content stipulations should also be linked to performance management systems (Medori & Steeple 2000). The intention is to clearly articulate and formulate the link between responsibility and accountability, with rewards being closely linked to actual performance (Kaplan 1994). Finally, reports need to be subject to scrutiny and approval before being accepted as true and factual (Braadbaart 2007).

In addition to this, Akinsulire (2010) provides that an audit committee should be established to ascertain that processes and procedures for monitoring those processes are in place. Emphatically, the committee is presently charged to seek assurances from the CEO and CFO, as part of the CEO/CFO certification process, that they have put in place effective disclosure controls and procedures to ensure that all reports in the corporate reporting universe are prepared properly and filed with the appropriate authorities in accordance with applicable requirements. The audit committee is usually a board committee with the main role of overseeing financial reporting (Zheng, 2008). Among the elements of corporate governance, audit committee is the major element that supports the health of financial reporting. (Salehi, Zanjirdar, & Zarei, 2012). Since managers usually do not have to interact regularly with shareholders, a distance in terms of trust might exist due to this communication gap. Audit committee can act as a link in such gaps especially in terms of the integrity of the financial statements of an institution. An effective audit committee will therefore help in aligning the interests of organization with that of shareholders (Chan & Li, 2008).

Conclusion

Accountability is an essential ingredient for a sound system of corporate governance. The reason underlying this argument is that shareholders' interests can only be satisfied by taking account of stakeholder interests, as companies that are accountable to all of their stakeholders are over the long term more successful and more prosperous. Governance therefore rests on the perception that companies can maximize value creation over the long term, by discharging their accountability to all of their stakeholders and by optimizing their system of governance. Governance and accountability have the potential to gather the actors that contribute to health systems to not only generate new knowledge, but also to generate the dialogue, self-reflection and analysis that more directly uses this knowledge for policy change and offsets policy opposition. Whilst several studies examined the effectiveness of audit committee, Okoye and Cletus (2010); Owolabi and Ogbechia (2010) none has explored the association between audit committee formation and characteristics in relation to accountability and governance. Hence, in filling this knowledge gap, this paper makes a number of key contributions to the literature on audit committees, governance and accountability. It provides first evidence on audit committee, corporate governance. This paper also considered the fabric of corporate governance and how to weave it into achieving accountability via audit committees. The role of corporate governance in the matter of accountability has been subject to recent debate. The development has been subject to rigorous analytical and empirical testing. This work agrees that improving governance regulation and audit committee is a key factor to financial accountability.

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