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THE ROLE OF AUDIT COMMITTEE IN MAINTAINING AND IMPROVING INTERNAL CONTROL SYSTEM OF PRIVATE OIL REFINING COMPANIES

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ABSTRACT

The audit committee of each company is considered as one of the pillars, which is expected to be effective on maintaining the interests of individuals and legal entities and other groups that use accounting information and financial reporting. According to the 80-year history of audit committees in developed countries, it is obvious that the process of establishing audit committees in our country, Iran, is very slow and long, and it has been stopped in most cases. This research aimed to further understand and recognize the audit committees' duties and role in maintaining and improving the existing internal control system for private oil refining companies. Two hypotheses are designed in this research, that the information needed to test the research hypotheses have been collected through questionnaires, several books and other articles. The results of this study indicate that the role of the audit committees in preventing the occurrence of illegal acts improves the process of financial reporting, the information provision and a variety of transparent and accountable financial statements.

Keywords: *Internal Control System, Financial Reporting Process, Internal and Independent Auditor, Audit Committee*

INTRODUCTION

Developed countries have witnessed the emergence and rapid development of audit committees in recent years. The development and expansion of international operations, the intensification of the activities of corporations to achieve competitive advantages, the increase in debt caused by environmental damage, the role and impact of management estimates in the figures contained in the financial statements and reports, the lack of a reliable foundation for reviewing management claims regarding the adequacy of the structure internal controls by independent auditors, the expansion of the use of computer systems and, consequently, the more difficult monitoring of control of these systems, have exacerbated the process of establishing and applying the audit committee (Rahimian, 2003). An Audit Committee is considered as one of the key elements of corporate governance system, which strengthens financial reporting and its safety and improves the independence of independent auditors. Despite the importance of audit committees and the growing need for such committees in companies, there are unfortunately no comprehensive guidelines on the nature, structure, features of members, duties, functions, and other aspects of such committees in Persian literature (Salehabadi, 2010). Today, proper management, control and supervision of the affairs of public corporations is one of the fundamental issues raised in the economic system of each country through the world, including Iran. The maintenance and provision of the

interests of equity as capital providers and the most important group of users of accounting information and financial reporting have also become more and more necessary considering the developments in the current world. Nowadays, in some developed countries, many companies have formed an audit committee to play the role of supervisor in the procedures and function of accounting and financial reporting of firms (Arbab Soleimani and Nafari, 2008). The Audit Committee is an influential factor in improving the financial reporting desirability and an efficient and effective committee plays an effective and key role in filling out the financial reporting reliability gap.

Audit Committee

The Audit Committee is one of the key elements of the corporate governance system and is also one of the most important specialized board committees, which enhances the health and quality of financial reporting, improves the quality of internal controls and the performance of auditors, assists the board of directors to be responsible for accountability and to ensure that the activities of these units are consistent with the customary rules and regulations and also prevent the illegal actions of management (Ebrahimi et al., 2014).

Farber (2005), by providing a broad definition of financial expertise of the committee members showed that the existence of financial experts in the audit committee would result in fewer financial frauds in the company.

Defond et al. (2005) distinguished the accounting and non-accounting financial expertise in their research and showed that there are a positive and significant relationship between the members with financial accounting expertise in the corporate audit committee with the abnormal returns of the market. However, there was no relationship with non-accounting financial expertise.

Abbott et al. (2004) in their research investigated the relationship between the financial expertise of the members of the audit committee and the adjustment and presentation of financial statements, and concluded that the presence of financial experts in the audit committee has a negative and significant relationship with the rate of renewal of presentation of financial statements.

David San, Zay (2004) investigated stock returns on the appointment of members of the audit committee. Their results showed that if the new members of the Audit Committee had a financial expertise, we would see a significant impact on stock prices.

Abbott Parker and Peter (2000) found that the lack of members with financial expertise in the Audit Committee has a significant relationship with the increased likelihood of wrong event and financial fraud. Their results also showed that the existence of an independent audit committee of board members would reduce the probability of financial fraud and error.

Wild (1996) examined a number of companies with an audit committee in his research and concluded that the information content of the profit reports of these economic units increased after the formation of the audit committee.

Audit committees do not prepare financial reports and do not carry out independent audits, but they play a key role in ensuring the integrity and transparency of financial reporting. The market currently expects the published information to be objective and impartial and to be considered at the board level. Thousands of pages have been published up to now on corporate governance rules. However, these regulations rarely provide useful guidelines on how audit committees perform, the required knowledge or experience, the emphasized areas, and the



way in which committee activities are reported (J. Frank Brown, 2003). The book of Audit Committee entitled "Good practices to meet market expectations" was first published in May 1999. The second edition of this work reflects the evolving role of the audit committee and the latest proper procedures, such as the need for competent financial professionals, and more emphasis on training and performance review. The audit committee is an essential part of the corporate reporting process. Its main responsibility is to monitor the financial procedures and financial reporting controls applied by the management to protect shareholders' equity and other stakeholders on behalf of the board of directors. New criteria and requirements in many countries have focused attention on reaffirming the importance of unbiased monitoring of financial reporting (Bolo and Madahi, 2010).

Structures of one-board and two-board structures

There is a one-board structure (only the board of directors) in many countries where audit committees are present. The board of directors mainly includes non-executive directors in some countries such as the United States. In other countries, the board consists of non-executive and executive members, that their number is almost the same. The audit committee is one of the board committees and its members are selected from non-executive boards. The two-board structure in some markets is subject to legal or optional acceptance. Evaluations for some countries such as Germany, Spain, Britain, Austria, Finland, Greece, etc. show that this structure is mainly observed in the countries of the European Union. These structures consist of a board of directors and a supervisory board that are responsible for everyday operations of the company and for monitoring the management and strategy of the company. The members of the supervisory board are selected by the shareholders at the general meeting of the company. According to the common laws in some countries, a number of board members should be representatives of the company's staffs. Other staffs may also be members of major stockholder representations or corporate finance providers. The law usually lays down specific responsibilities, including in some cases, the responsibility for financial reporting issues for the supervisory board. In these countries, members of the audit committee are logically selected from among the members of the supervisory board.

The Supervisory Board may form a separate audit committee among its members depending on local terms and conditions. Alternatively, the entire supervisory board can be considered as an audit committee. Some other countries, e.g., Japan, have a different structure, such as the Board of legal auditors, which is responsible for supervising the managers. The basic requirement (regardless of the structure type) is that independent managers must be qualified to review the company's financial statements and the underlying processes and controls of these reports. Regardless of how the audit committee performance organizes to help the Committee achieve its effectiveness, several steps are required as follows:

- Developing the written charter or the principles of reference;
- Selecting qualified members for audit;
- Defining the roles and responsibilities of the committee chairman;
- Considering the independence of the members of audit committee;
- Determining the term of office for the members of audit committee;
- Planning and timing properly for committee meetings;
- Providing high-quality reports and documents for regular and timely delivery;



- Ensuring adequate resources and professional advisers available to the Committee;
- Providing the field for accepting new members of the committee and familiarizing them with relevant issues (Bolo and Madahi, 2010).

Internal control system

Internal controls are a process that ensures the achievement of goals in three groups of effectiveness and operational efficiency, financial reporting reliability, and compliance with applicable laws and regulations that are established by the management, the board of directors and other employees.

Internal controls consist of five interrelated components. These components emerge from the management practice of economic units and are integrated with the management process. These components are:

Control environment. This creates a space in which employees perform their control activities and responsibilities. The control environment is the basis of other internal control components. Management in this environment evaluates the fulfilling risks of determined objectives.

Risk assessment. Economic entities should be aware of the nature of their encountered risks and act in the best way to deal with them. It should also establish mechanisms for identifying, analyzing and inhibiting the corresponding risks.

Control activities. Controls policies and procedures must be designed and implemented to ensure the effectiveness of measurements which management has required dealing with the risks associated with the achievement of objectives.

Information and communication. Information and communication systems are the environment for control activities. The economic unit with the help of these systems can collect and exchange information required for the implementation, management and control of operations.

Supervisory. Monitoring the internal control process and making the necessary adjustments are very important. The monitored system can react dynamically and change in appropriate circumstances (Pouria-Nasab and Maham, 2011).

The board of directors adopts policies and monitors the management that is responsible for the design and implementation of internal control systems. Management responsibilities related to internal controls include:

- Establishing and maintaining an internal control structure and appropriate financial reporting procedures;
- Assessing the effectiveness of internal controls, at least annually;
- Immediately determining the weaknesses of internal controls and to take the necessary measures to adjust them;
- Declaring deficiencies with the importance of internal controls and any fraud to independent auditors and audit committee.

The audit committee should have an appropriate understanding on the system of financial reporting controls implemented by the management. This recognition includes control over the accuracy of systems and financial accounting records and existing controls to ensure fair presentation and financial information disclosure in accordance with standards. When the treasury activities of the company are widespread, the audit committee recognizes and understands the controls related to such activities implemented by management. The committee gains this recognition through reports from management, independent and internal



auditors, or negotiations with them. The audit committee should also consider the scope of controls by internal and independent auditors. The active role of audit committee is important and can help to dominate a strong control culture in business. If internal controls are weak, the audit committee should require the board to improve controls.

When the management has outsourced the control and information system, e.g., a service center, the committee must ensure that a proper service contract is concluded and the performance of the service provider is controlled and monitored. The contract must specify the services to be provided (for example, the processing of sales data), as well as the access rights and procedures for reviewing the performance of the contracting party (service provider). In some cases, the Audit Committee or Management may require an independent auditor to provide a specific report on the various aspects of the internal control and risk management systems. In this case, the audit committee should determine the nature of the work and review the basis of the report with the independent auditor (Bolo and Madahi, 2010).

The audit committee should be convinced that there is a desirable system and appropriate division of duties and responsibilities for day-to-day supervision of financial controls, but the committee should not monitor this itself (Smith, 2003).

Coso

Coso is an organization that provides leadership and guidance for internal control, business risk management, and fraud detection. Coso published the integrated framework of its updated internal controls in May 2013. The early version of the framework, published in 1992, was widely accepted and widely used.

The aforementioned framework is considered as a reference framework and criterion in relation to the reporting of the effectiveness of internal control over financial reporting (ICFR), particularly by companies operating in the United States under the Section 404 of the Sarbanes-Oxley-Sax (SOX) Act. As well as, the framework outside the United States was typically required by other legal requirements, such as Section 404 of Japan. The framework has currently tried and true advocacy through passing time and is still recognized a leading resource as the guideline for designing and evaluating internal control.

While companies will likely continue to use the COSO framework for their financial reporting, they can also use it to evaluate internal operational and compliant controls and non-financial reporting. The new framework released by COSO is an important development since organizations' efforts to create cost-effective systems for internal controls in order to achieve significant business goals facilitate sustainability and performance improvement. In addition, a new framework provides a support for organizations facing a new business environment, manages risks at an acceptable level, and enhances reliance on information for decision-making. Companies that use the 1992 framework to comply with SOX and other objectives should be familiar with the new framework and its accompanying cases, determine their framework change plan, and proclaim and announce the release of the new framework and its applications to the organization to the stakeholders. Hope this guideline will help them get started in this work.

This guideline provides various questions about the new framework of COSO, including "What has been the reasons for updating the framework?", "What has changed?", "How is the transition process to the new framework?", "Which steps should companies pass for transition



from the old framework to the updated framework?" This version has been updated in response to questions raised in previous editions.

The committee of sponsoring organizations, formed in 1985 to sponsor the National Commission for Fraudulent Financial Reporting, is an independent private entity that studies the causal factors that could lead to fraudulent financial reporting. This entity also provides proposals to public corporations and their independent auditors for the US Securities and Exchange Commission (SEC) and other law-makers and academic institutions. The entity is jointly funded through five professional institutions with their headquarters in the United States, which include: American Accounting Association (AAA), American Institute of Certified Public Accountants (AICPA), the Institute of Internal Auditors, the Institute of Management Accountants and International Financial Executive (Ganji and Menati, from COSO 1992 to COSO 2013).

Audit Committee background through the world

The idea of establishing audit committees was introduced by the Securities and Exchange Commission in a report related to Mckesson and Robbins companies in 1940. However, its general idea and acceptance returns to 1970. Currently, most companies in Canada are required to have an audit committee under the law. The Securities and Exchange Organization required all companies listed to the stock exchange to establish a national audit committee in 1976 and this committee should be selected from the non-executive board.

The Cadbury committee in the UK recommended that all companies listed to the stock exchange be required to establish audit committees. In recent years, the idea of establishing audit committees, especially in banks and insurance companies, is being accepted in India. The Confederation of Indian Industries (CII) has recommended companies to form audit committees in the corporate governance system. Under the New York Stock Exchange and the US Securities and Exchange laws, the listed companies are required to have an audit committee comprised of non-executive directors. It also applies to companies that are on National Association of securities Dealers Automated Quotation System (NASDAQ).

The research background in Iran

Such research with this subject has not been carried out in Iran up to now, but some researches related to the present study can be summarized as follows:

- Fatahi et al. (2014) conducted a study entitled "Study of the role of the Audit Committee and Internal Audit on the efficiency of the internal control system." The article attempts to outline the definitions, objectives, necessity and importance of the system, as well as how to form the audit committee and the internal audit unit and their duties to improve the controls. The results showed that the establishment of an internal control system through its components, including control environment, control activities, risk assessment, information and communication, and supervisory would be feasible. Internal audits as an aid management tool assesses all parts of the organization, and in the event of a normal and efficient operation of the system, it assures investors that the controls are properly observed and their benefits are reserved.
- Hasas-Yeganeh and Beheshtian (2002) through their research "Impact of the presence of audit committee on independent audit, internal control and financial reporting" found that changes in developed countries in recent years have increased the independence of auditors from management during auditing. One of these changes is



the use of audit committees in companies. These committees act as agents for monitoring the financial reporting process.

- Accounting literature also emphasizes the importance of the board of directors and the audit committee as corporate assurance agents. In leading countries, the audit committee in companies has become an important tool to monitor the reliability of the financial reporting process. The audit committee acts as a determinant in the financial reporting process. Effective audit committees increase the reliability of the audited financial statements annually, and their members cooperate with the board of directors who are responsible for protecting the interests of shareholders, in this regard, the monitoring of the quality and desirability of financial statements, accounting, auditing, internal control, and financial reporting process to management is in the role of their own responsibilities.

Research hypotheses

To investigate the role of the audit committee in maintaining and improving the internal control system in privatized oil refining companies, two hypotheses were designed and tested as follows:

1. The companies' audit committee helps preserve the relationship between the board of directors and the internal and independent auditors.
2. The companies' audit committee increases the efficiency and effectiveness of internal and independent auditors.

Statistical population and sample

All privatized oil refining companies listed in stock exchanges were analyzed despite introducing audit committee in the recent years and the lack of familiarity of executives and managers of the privatized oil companies with the role, duties and benefits of the audit committee in Iran and, as a result, its creating in the privatized oil refining companies. In this regard, seven oil refining companies listed in the stock exchange were selected as the statistical population of the study and the research questionnaire was distributed among the audit committees of these companies, such as the chairman of the committee, the non-executive member of the board of directors, independent members with financial expertise outside the company, and financial management and internal audit units. Due to the fact that the method for collecting data and information of this research through the questionnaire, it should be acknowledged that the scope of this research is not limited to a specific time period. Although the research questionnaires were distributed in late 2017, they were collected and analyzed at the beginning of 2018. The sampling method has not been used due to the limited statistical population and in order to prevent sampling errors. It should be noted that the entire statistical population was tested in the form of the number of employees in the audit committee, internal audit and financial management of each company and the responses provided by them as summarized in Table 1.



Table 1: The statistical population for this research

Company's name	Bandar Abas oil refining company		Tehran oil refining company		Tabriz oil refining company		Shiraz oil refining company		Lavan oil refining company		Isfahan oil refining company		Kermanshah oil refining company	
Unit name	Available number	Presented response number	Available number	Presented response number	Available number	Presented response number	Available number	Presented response number	Available number	Presented response number	Available number	Presented response number	Available number	Presented response number
Audit committee	5	4	5	0	3	2	4	2	3	1	5	2	3	2
Internal audit	3	3	4	4	2	1	1	1	3	3	4	4	1	1
Financial management	30	5	34	5	22	0	20	0	17	0	43	0	15	0
Total	38	12	43	9	27	3	25	3	23	4	52	6	19	3

Demographic information of the surveyed population

Demographic features analysis

From analyzing the demographic structure of participants, it can be observed that the population occupied in this profession and career is mostly males, and women have little role.

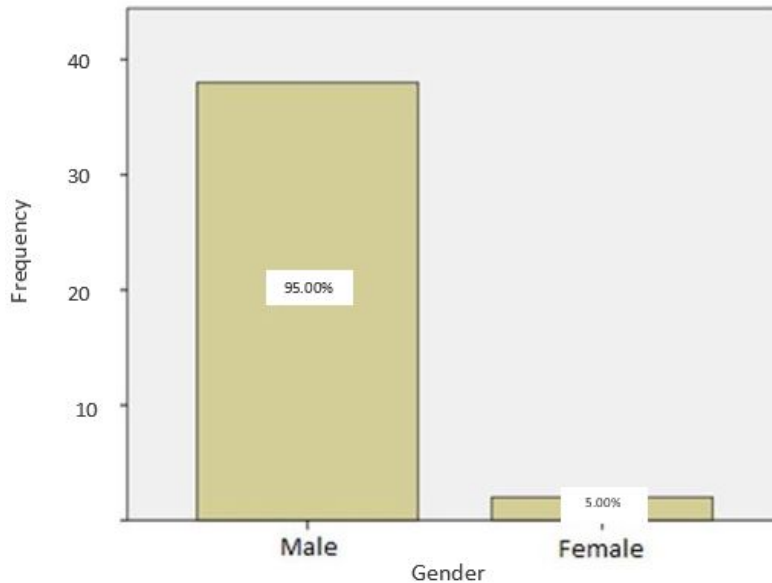


Figure 1: Research population gender distribution

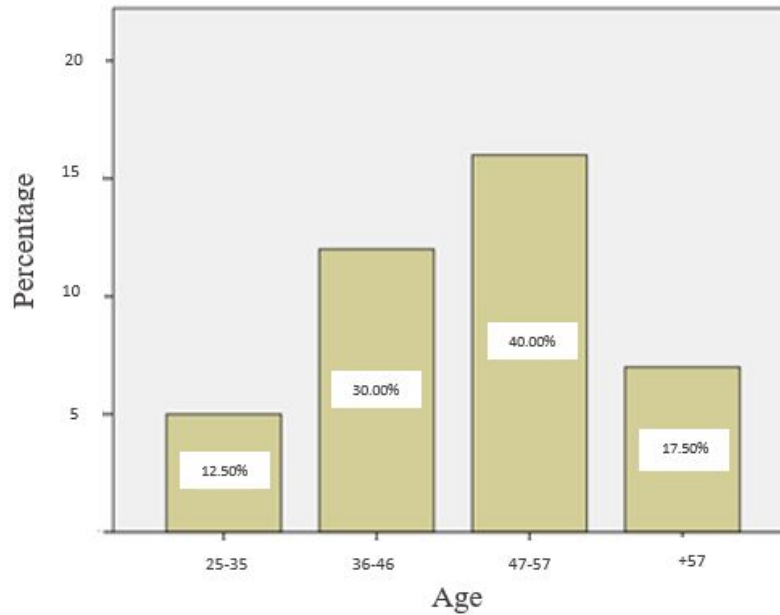


Figure 2: Age distribution

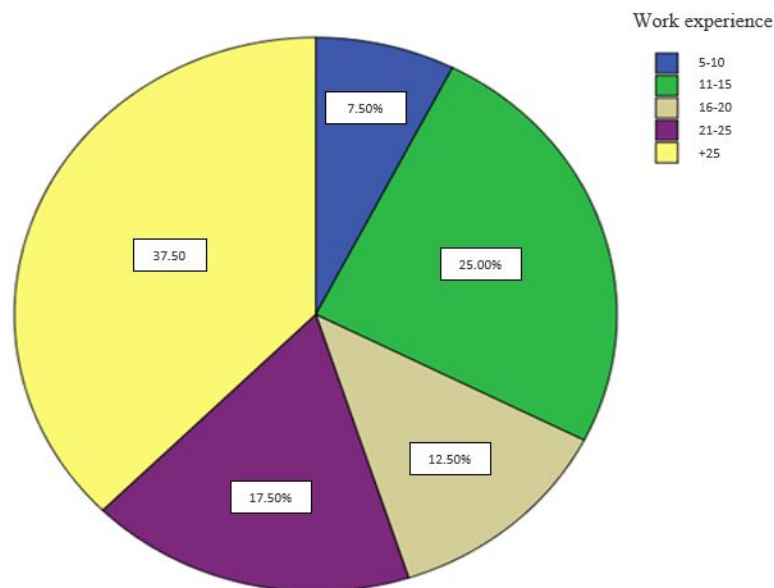


Figure 3: Work experience of studied people

RESEARCH FINDINGS

The results of analyzing questionnaires

The validity of the questionnaire was verified facedly and by 5 elites. As well as, Cronbach's alpha method was used to assess the reliability of the questionnaires. The result $\alpha=0.84$ shows that it indicates the reliability of the questionnaires. The test of equality hypothesis of t-student's mean was used to analyze questionnaire questions. The results indicate that the questions marked with red color in Table 2 are significant.

Table 2: Hypothesis test for questions

Questions	Mean	Mean different	Significant level	t-statistics	Test result
1. Does the Audit Committee have experienced, skilled, and trained staffs?	3.9750	.97500	.000	7.706	Significant
2. Does the board of the company have the relevant academic education, experience and required capabilities?	3.8500	.85000	.000	8.119	Significant
3. Does the board have clear and accessible objectives regarding the internal control system?	3.7250	.72500	.000	5.414	Significant
4. Has the Audit Committee arranged mechanisms to ensure reasonable assurance of the efficiency and effectiveness of the internal and independent auditors?	3.6250	.62500	.000	4.150	Significant
5. Does the Audit Committee, considering its objectives and decisions, engage in identifying the involved risks for the company and decide on the risks?	3.5750	.57500	.001	3.695	Significant
6. Does the Audit Committee identify opportunities, threats and deviations and take the necessary measures in a timely manner?	3.3750	.37500	.017	2.490	Significant
7. Does the Audit Committee meetings be continuously held to determine the policies and objectives and to assess the company's performance and determine the measures required to achieve the result?	4.0256	1.02564	.000	7.901	Significant
8. Are the proceedings issued by the Audit Committee at the right and appropriate time approved by the members of the Committee and communicated to the board of directors and other units in a timely manner?	3.9250	.92500	.000	6.195	Significant
9. Does the Audit Committee provide necessary arrangements for the protection and maintenance of property, machinery, equipment, inventory, spare parts, supplies, securities, cash or other assets?	3.7250	.72500	.000	4.774	Significant
10. Does the Audit Committee take the necessary measures to follow up and address the issues raised in the reports of internal and independent auditors?	3.8500	.85000	.000	7.309	Significant
11. Does the Audit Committee document the structure of internal controls and conduct control tests?	3.4250	.42500	.020	2.429	Significant
12. Does the Audit Committee carry out other necessary control activities to establish a system of internal control over financial reporting appropriate to the type of company's operation?	3.2750	.27500	.133	1.536	Not-significant
13. Does the Audit Committee provide the internal control system according to the internal control framework, on an annual basis, under the title of Internal Control Report?	3.5250	.52500	.000	4.423	Significant



14. Are the audit committee meetings effective and efficient with independent and internal auditors?	3.6500	.65000	.000	4.333	Significant
15. Does the audit committee include resources and tools required to improve the efficiency and effectiveness of internal and independent auditors?	3.5750	.57500	.000	3.908	Significant
16. Does the increase of the efficiency and effectiveness of internal and independent auditors increase profitability and added value in the company?	4.0000	1.00000	.000	7.464	Significant
17. Does the Audit Committee assess the advises of internal and independent auditors, and accordingly follow-up measures are considered appropriately?	4.1250	1.12500	.000	7.173	Significant
18. Are training seminars, scheduled meetings and required meetings held on effective and efficient internal controls?	2.8750	-.12500	.463	-.741	Not-significant
19. Are there follow-up measures by the audit committee for monitoring in the company and reports on the strengths and weaknesses of the internal control system are reported to the board timely?	3.4000	.40000	.019	2.449	Significant
20. How much does the board supervise the activities carried out by the audit committee?	3.7500	.75000	.000	4.598	Significant
21. Does the Audit Committee have sufficient knowledge and time to perform its duties effectively and effectively?	3.7750	.77500	.000	4.206	Significant
22. Does the Audit Committee meet privately internal and external auditors to discuss the logic of the financial reporting process of the internal control system, their perspectives and recommendations, and management's performance?	3.4250	.42500	.025	2.333	Significant
23. Does the audit committee assess the activities of internal and independent auditors annually?	3.5750	.57500	.002	3.286	Significant
24. Does the Audit Committee receive regular financial statements, major marketing initiatives, and important contracts and agreements?	3.5000	.50000	.004	3.047	Significant
25. Does the Audit Committee specifically monitor the board's compliance with the behavioral regulations?	3.3250	.32500	.096	1.704	Not-significant
26. Does the Audit Committee play a role in evaluating and establishing a healthy organizational environment?	3.1750	.17500	.377	.894	Not-significant
27. What are the duties and responsibilities of the Audit Committee for independent and internal auditors, compliance with laws and regulations, risk management, financial reporting and internal reporting and controls?	3.3250	.32500	.062	1.918	Not-significant
28. Has the Audit Committee provided guidance to the board of directors in which the necessary measures are specified in detail?	3.3250	.32500	.085	1.767	Not-significant



29. Does the Audit Committee assess the design related to the adequacy and fitness of the internal control system that is provided by a flowchart or system description or a combination of both of them?	3.0250	.02500	.889	.141	Not-significant
30. Does the Audit Committee evaluate the effectiveness of the effective implementation of the designed internal controls?	3.4250	.42500	.013	2.597	Significant

CONCLUSION AND DISCUSSION

1. The lack of knowledge of the financial management unit's personnel in private oil refining companies with the subject of the research can be mentioned among the limitations of this study. It should be noted that most of the personnel employed in the financial management unit of these companies did not have the required knowledge about the questions in this questionnaire, which made financial management units unable to complete and submit their questionnaires. Moreover, the purpose of this research was not specified for the personnel.
2. Among other constraints, we can point out the conservatism of some internal audit unit's personnel and some of the members of the audit committee in answering the questions of the questionnaire.
3. As private oil refining companies recently have an audit committee, this research is based on the perspectives of financial managers, internal auditors, and members of the audit committee, that such perspectives can be varied with other financial and internal auditors' and the audit committee's perspectives in other non-oil companies.

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