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The Role of Audit Committee in Enhancing External Audit during COVID-19 Pandemic to Meet Stakeholders' Needs

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ABSTRACT

In addition to being a significant business interrupter for many entities, the impact of the COVID-19 pandemic has created significant financial reporting implications for many companies around the globe. This paper is conceptual in nature and seeks to gain a better understanding of the effectiveness of audit committee in enhancing external audit quality to meeting stakeholders need, especially during the period of COVID-19 pandemic and provides key areas for audit committees oversight duties during challenging time caused by the pandemic. The last decade has been rich in academic insights on how audit committee can enhance the effectiveness of external audit in meeting stakeholders needs. Our paper offers a review of the related literature on this topic and discusses the main attributes that would be needed in enhancing the role of audit committee during challenging times caused by external factors such as the COVID-19 pandemic. This review is organized around three major issues, identified in relation to COVID-19 effects on corporate reporting, audit committees and stakeholders needs in the time of pandemic and the role of audit committees in enhancing external audit at the time of COVID-19 pandemic. This paper has implication for company's audit committee, board of directors, accounting firms and academician on how audit committee roles can enhance external audit during COVID-19 pandemic to meet stakeholders' needs.

Keywords: Audit committee; COVID-19; External audit; Stakeholders need

INTRODUCTION

Financial scandals in developed countries such as the USA and the UK have highlighted the need for greater transparency and credibility in order to protect shareholders and stakeholders needs. There is a general agreement among academicians and practitioners that the quality of corporate reporting depends on a sound firm-level governance mechanisms as well as the quality of external audit and the legal framework in the country in which the firm operate. It has been argued that the audit committee (AC) is a key mechanism for achieving this transparency and protecting shareholders' and other stakeholders' interests. The AC as one of the firm-level governance mechanism is seen as a pivotal attribute in enhancing and improving the quality of the reporting process that includes internal audit quality, external audit quality and financial information quality (Piot & Kermiche, 2009; Bédard & Gendron, 2010; Carcello et al., 2011). Moreover, the AC is a key governance mechanism in the process of monitoring the quality corporate reporting, and has the responsibility of addressing any issues concerning the preparation and the overseeing of the financial statement (Boubaker & Nguyen, 2017; Carcello et al., 2011; Ma'aji et al., 2021). It also influences the efforts and independence of the external auditor, especially in case of disagreements with management. However, the rapid changes in the business environment due to advancement in information technology, the complex nature and dynamic of 21st century businesses and together with some major scandals in the corporate sector has resulted in the AC role to evolve and expand in an attempt to enhance the quality of corporate reporting and governance and restore public confidence.

Furthermore, the novel coronavirus (COVID-19) pandemic has caused a crisis for the global economy and markets. As a consequence of the COVID-19 no business, industry, or economy has been spared from the devastating effects of the pandemic as it shut down many countries' economies for a number of months in order to control the spread of the infectious disease. This has disrupted different macroeconomic or industry factors in the economy such as supply

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chains across international boundaries, demand for goods and services domestically and overseas, and in the labour force supply. This has resulted in regulators and accounting standards setters such as the IASB to revised and amended some accounting standard to better adjust and suit the new reality as a result of the COVID-19 pandemic. In this regard, the AC has a critical role to play for companies in a business environment that have been severely disrupted by the COVID-19 pandemic. The COVID-19 pandemic has affected the recognition and measurement of values of assets (including intangibles, property, inventories, receivables/loans, investments, other financial assets, contract assets and deferred tax assets) and liabilities (including provisions for onerous contracts, financial guarantees and restructuring) (Levy, 2020). Moreover, in the wake of the COVID-19, investors are increasingly asking for more forward-looking information and disclosures.

Moreover, the effect of the pandemic would lead to a number of disclosures on sources of estimation uncertainty and key assumptions and sensitivity analysis and the underlying drivers of results, business strategies, risks and future prospects (Deloitte, 2020; Delicata & Fenech, 2020). These remeasurements and disclosures would definitely affect the bottom-line profit and other comprehensive income (OCI). Primarily, the fiduciary responsibilities of AC are to contributes to ensuring a high-quality oversight of the internal control system, ensuring the independence of the external auditor and the risk management process. However, in the wake of COVID-19 and its adverse effect on businesses, in addition to the AC fiduciary responsibilities for overseeing the external auditor and financial statements, they can contribute valuable oversight duties in areas such as cybersecurity, changes in operations and organizational culture and restricting opportunities or incentive for management to manipulate earnings, which in turn improves earnings quality (Deloitte, 2020; Delicata & Fenech, 2020; IFAC, 2020). This is because stakeholders need to understand that the board of directors and the audit committees will be making reasonable judgements in the context and on the basis of information available currently.

There is a vast amount of corporate governance literature that has been dedicated to the question of the determinants of audit committee effectiveness. This paper is conceptual in nature and seeks to gain a better understanding of the effectiveness of audit committee in enhancing external audit quality to meeting stakeholders need, especially during period of COVID-19 pandemic and provides key areas for audit committees oversight duties during challenging time caused by external factors through a synthesis literature review. To this end, we organize our review by highlighting two levels of analysis. The first level of analysis covers discussions on how COVID-19 has impacted on the quality of the corporate reporting process that includes external audit quality and financial information quality. The second level of analysis brings together the contributions relating to the dynamics surrounding audit committees, in terms of the enhancing the quality of financial reporting process and external audit process in meeting stakeholders needs.

COVID-19 AND CORPORATE REPORTING ISSUES

Given the continuation of economic downturn, financial market volatility, liquidity concerns, deteriorating credit, increases in government sizeable fiscal and monetary stimulus package as a result of COVID-19 pandemic, it probable that businesses may face many accountings and financial reporting challenges. The pandemic also coincided with the deadline for calendar-year entities to prepare and file their annual reports. Furthermore, accounting standards and regulators are already requiring companies to factor COVID-19 related risks into operations, financial condition, and cash flows during this crisis (Deloitte, 2020; Delicata & Fenech, 2020). For example, business that might be profitable in pre-COVID-19 era would be looking at possibilities of charges for once unthought-of circumstances, from fixed asset impairment to inventory and receivables write-downs. Additionally, many companies will also need to account for debt and other contractual modifications, including restructuring, and debt-covenant modifications. Applying this often-complex accounting guidance in these areas may be challenging and will require management to exercise significant judgment. In this regard, the AC should provide necessary oversight to the external auditors to provide assurance and confidence that the assumptions and judgment used by the management reasonable and realistic and are up to date on all the happenings.

Additionally, the primary users of financial statement such as investors and other stakeholders would be very much interest in not just the historical financial performance that is usually reported but to also understand company's future prospects. These users will require those in charge of preparing the financial statement takes additional efforts to ensure that the financial statements meet the users' and the auditors' expectations relating to the impact of COVID-19 on the business (Chalmers & Picard, 2021; Pascal, 2020). However, based on accounting standards, disclosure requirements largely depend on materiality and whether failure to disclose this risk factor would make the financial statements misleading to investors. Additionally, disclosing and recognizing COVID-19 financial effects on companies may require management to exercise significant judgment (Pascal, 2020). The assumptions should be realistic and should not be overly optimistic or pessimistic. Therefore, this will require that good governance and effective oversight arrangements are in place during the COVID-19 crisis, as companies are faced with significant uncertainty, a rapidly changing risk landscape, and an increased need for transparency by the users of financial reports and confidence in reported information and its implications (Delicata & Fenech, 2020). Similarly, the AC needs to be engaged and informed and receive actionable and timely information from management so they can effectively carry out their oversight role.

AUDIT COMMITTEES AND STAKEHOLDERS' NEEDS

The collapse of international giants like Enron, WorldCom, Adelphia Communications, Parmalat, Refco, Northern Rock, Lehman Brothers and Rayco Construction Co. among others and more recently Wirecard, have been an eye-opener for various corporate stakeholders to make realised the emergent need to comply with the principles of good corporate governance. These also called into question by stakeholders of the quality of financial reporting and the effectiveness of the audit process (Cullinan, 2004; Causholli et al., 2015; Khasharmeh & Desoky, 2018). Since the public endorsement of audit committee (AC) in 1940 in the aftermath of the McKesson & Robbins (1939) scandals in the US, the AC has undergone a series of amendments in their roles and responsibilities by many regulators in ensuring that there are good corporate governance mechanisms in place, independence of the audit process and harmonisation in the use of AC internationally. For example, according to Smith Report revised in 2016 by the Financial Reporting Council (FRC), an AC should be established with at least three members, whom should be independent non-executive directors and the committee should have at least one member who is having a recent and relevant financial experience (FRC, 2016). The ACs should be independent of executive director so as to help to ensure quality audit and contributes to financial statement users' reliance on the financial reporting process. AC plays an important role in enhancing the role of audit process in meeting stakeholder's needs (FRC, 2016).

Similarly in the US, the Sarbanes-Oxley Act (SOX) of 2002 clearly states that all committee members must be independent to preserve the integrity of the auditing process. By virtue of ensuring that all ACs are independent, shareholders gain assurance that the company is doing its best to prevent inside employees from manipulating the work of the committee and the external auditors. AC are responsible to choose and oversee the issuer's independent accountant. The board must have procedures in place to manage complaints about the issuer's accounting practices. The audit committee's charter gives the committee the authority to enlist the help of independent advisors and to budget accordingly for them. AC also have the authority for the budget for funding the independent auditor (SOX, 2002).

The audit committee plays an important role in assisting the board to fulfil its oversight responsibilities in areas such as an entity's financial reporting, internal control system, and risk management system. As a representative of the board of directors and main part of the corporate governance mechanism the AC is involved in the organizations both internal and external audits, internal control, regulatory compliance and risk management (Alves, 2013; Al-Rassas & Kamardin, 2015; Aryan, 2015). Stakeholders expect loyalty and trust from auditor and AC while resolving financial facts and exposing at all fraud and fault in organization. The audit committee member's experience, relevant exposures, qualification background and in-depth knowledge need to be highlighted and confirmed because if directors are experts, experienced, qualified, financial wizards, then they can have vision and foresightedness to protect stakeholders (Alqatamin, 2018; Ghafran & O'Sullivan, 2013; Ghafran & O'Sullivan, 2017). If a company has an active and strong AC then independent auditors' working will be supported and at the same time enhancing the effectiveness of external audit.

Moreover, at the time of COVID-19, the ACs who are key component of effective governance, are faced with many challenges on their agendas than ever before as the pandemic has caused a strategic shift in their roles. The AC plays a key role in creating and maintaining a culture and environment that supports the integrity and provision of decision useful information about an organization to its investors and other stakeholders (IFAC, 2020). Transparency is of heightened importance during this time of uncertainty and the AC need to be engaged and informed and receive actionable and timely information from management so they can effectively carry out their oversight role. AC are having to be vigilant on an expanding range of issues and review their agendas and priorities in response to COVID-19 (Delicata & Fenech, 2020; IFAC, 2020). However, at the same time they should ensure that they remain firmly focused on their fundamental responsibilities in respect to the oversight of financial reporting, audit process and internal controls, which have added complexities arising from the crisis. Additionally, with the new normal, AC have to adapt to working and fulfilling their responsibilities without meeting physically. This would mean embracing virtual meetings and much more frequent communication, particularly with the board, management, internal auditors, and external auditors.

AUDIT COMMITTEES IN ENHANCING THE ROLE OF EXTERNAL AUDIT

The rapid changes in business environment together with some adverse events that occurred in the corporate sector in the late 90s and during the global financial crisis in 2008 has put the audit committee (AC) in spotlight and since then the role of AC has been evolving and expanding in an attempt to enhance corporate reporting and governance and restore public confidence. The AC is seen as an operating committee of company's board of directors in charge of overseeing financial reporting and disclosure processes (Zraiq & Fadzil, 2018). AC authorities typically involve the oversight of financial reporting, monitoring of accounting policies, oversight of external auditors, regulatory compliance, risk management, and special investigations in cases of suspect or problematic accounting practices (Dezoort et al., 2002). Moreover, there is a range of views about the role of the AC, particularly in recent years: more attention has been paid to the role of audit committees across the world during the last two decades due to corporate scandals. The considerable number of studies have resulted in many views regarding this role (e.g., Alles et al., 2005; Lin et al., 2010; Tengamnuay and Stapleton, 2009; Fulop, 2014; Akinteye et al., 2015).

Accordingly, numerous regulators and researchers recommend that the AC should have a role in the organisation of the work of the external audit. This role should include monitoring the independence, effectiveness and objectivity of external auditors (Sarbanes-Oxley Act, 2002; Smith Report, 2003) and making recommendations to the board in relation to the appointment and removal of external auditors (Beasley et al., 2009; Rezaee, 2009; Bédard and Compernolle, 2014). It is essential for an external auditor to be independent in the course of auditing in order to ensure true and fair view principle which is the key to enhance and meet the needs of various stakeholders. The AC should assess the independence and objectivity of the external auditor annually in compliance with relevant law, regulations and professional requirement (FRC, 2005). AC should also implement and review policies on relationship between the company and the audit firm including the supply of non-audit services which can easily affects the auditor's independence as seen in the case of Enron. This strengthens the auditor's independence from management and also enables the directors to gain better understanding of the audit functions (Mohamed & Mostaque, 2005).

Furthermore, among numerous criticisms levelled at majority corporate scandals in their financial reporting was the failure in internal audit function (Krishnan, 2005). Management is responsible for establishing and maintaining internal control properly and ACs should monitor and review the effectiveness of the company's internal audit function (FRC, 2010). The AC can strengthen the independence of internal auditors by reviewing internal audit plan and report, and ensuring that the scope and objective of the internal audit work adequately cover all areas of perceived risk. AC should also advice or recommend to management on any trends or current factors relevant to the company's activities market or other aspect of its external environment which is expected to or have increased the risk faced by the company (FRC, 2005). When the internal audit function is effectively managed, it will help the external auditors during their audit process and in return enhance the external audit function as well as the quality of the financial reporting in meeting stakeholders needs.

Moreover, empirical studies have found mixed findings in regards to the effectiveness of AC in enhancing the role of eternal audit. For example, several writers have focused on the importance of the AC in preventing fraud and errors in the financial statements; Beasley et al. (2001) state that companies investigated for financial statement fraud are less likely to have an AC, while Xie et al. (2003) argue that AC plays a significant role in preventing (or revealing) any irregularities in the financial reporting process. Goodwin and Seow (2002) also conclude that AC have an impact on the detection of management fraud and errors in financial statements. They add that companies that have an effective AC seem to have a greater ability to avoid financial statement misstatements and to uncover fraud. However, on the other hand, for example, Alves (2013) and Stewart and Munro (2007) found that the presence of an audit committee is not associated with the quality of financial reporting. Study by Zraiq and Fadzil (2018) found that external auditors view audit committees as generally ineffective, while internal auditors view them more favourably in terms of effectiveness, especially in dealing with internal auditors and discussing the financial statements.

Similarly, in his survey of external auditors, Abdullatif (2006) found that the perceived benefits of audit committees were generally limited in terms of increasing auditor independence, the quality of financial statements, and the probability of detecting fraud and internal control weaknesses. Additionally, Masli (2018) found that AC in the Libyan banking sector are not performing to a satisfactory standard; they play too limited a role in monitoring financial statements and enhancing the external audit process, and their effectiveness is too dependent on the strength of their relationship with the internal audit department. AC can cause or create conflict within the company, as they have direct communication with internal and external auditors. If the management is not informed on the matters discuss, may become concerned that all relevant facts are not given due considerations and will think it's exposed to unjustified criticism without given opportunity to explain (Mohamed & Mostaque, 2005). Although the potential benefits of AC provide a compelling case for enhancing the role of external audit to meet stakeholder's needs, there are certain potential problems which need to be considered. AC may occasionally unwittingly assume management responsibilities even though have no executive power. This danger the independence of the AC and may collude with the management.

Furthermore, COVID-19 have no doubt impacted in the way external audit is conducted. These impacts can be categories into the mechanisms, practice methods and duties of auditing in the light of pandemic challenges. On the level of performance, technological progress has played an important role in preventing serious harms associated with auditing tasks which shall be performed. For example, technology has contributed to the continuation of works, jobs and tasks although various precautionary measures, such as a lack of direct contact, have been taken because of COVID-19. The pandemic, therefore, accelerates the expansion of using electronic audit. For instance, electronic auditing will be used for performing audit tasks; electronic visual techniques will be used in order to perform audit processes such as inventory of goods; electronic authentications will be used as a type of audit evidence; artificial intelligence tools will be used for performing audit works and tasks (Al-Khasawneh, 2021). In addition, it will be noticed that developing and providing these techniques and programs will be demanded by audit offices in order to perform their tasks at a lower cost and in a timely manner.

Moreover, on task level, the companies, especially those affected by the pandemic, increasingly need external auditors who perform damage analyses in order to settle their situations. In the times of crisis such as COVID-19, financial report quality and corporate governance are main components of economy; in addition, checks and balances are required in order to increase confidence on the integrity of the financial report and to meet stakeholder's expectations. Companies need to communicate transparently on the impact of Corona pandemic on their works in terms of liquidity, business continuation, financial position and internal control. In this regard, the AC have to be vigilant on an expanding range of issues and review their agendas and priorities in response to COVID-19. For ACs, who are a key component of effective governance, COVID-19 is causing a strategic shift in their roles, with more on their agendas than ever before. But at their core, AC plays a key role in creating and maintaining a culture and environment that supports the integrity and provision of decision useful information about an organization to its investors and other stakeholders. Transparency is of heightened importance during this time of uncertainty (IFAC, 2020). AC are adapting their way of working to function and fulfill their responsibilities without meeting physically. This means embracing virtual meetings and much more frequent communication, particularly with the board, management, internal auditors, and external auditors. However, any additional responsibilities taken on by the AC need to be clear and carefully considered to ensure the committee is not overburdened, that it has the right experience and expertise, and that new responsibilities do not detract it from its core oversight responsibilities (IFAC, 2020).

CONCLUSION

Good corporate governance in companies help to improve the effectiveness of audit committee (AC) in meeting stakeholders' needs. The AC as one of the firm-level governance mechanism is seen as a pivotal attribute in enhancing and improving the quality of the reporting process that includes internal audit quality, external audit quality and financial information quality. External auditors are independent and legally required in order to ensure that the financial statement gives a true and fair view of the company's financial position and prepared in accordance with the accounting standards, thus addressing agency problem. It is essential for an external auditor to be independent in the course of auditing in order to ensure true and fair view principle which is the key to enhance and meet the needs of various stakeholders. The AC should assess the independence and objectivity of the external auditor annually in compliance with relevant law, regulations and professional requirement. However, the stakeholders and general public started losing confidence in audit profession more importantly misjudging the external auditor's performance due to increase in corporate financial scandals, relationship conflict with management, lack of independence, etc. AC can help in preventing financial fraud, thus improving the quality of financial reporting, strengthening the auditor's independence, maintaining a proper and healthy relationship and open communication between external auditors and management and reviewing the effectiveness of companies' internal audit function.

Furthermore, at the time of COVID-19 pandemic, the AC should embrace virtual meetings and established more frequent communication, particularly with the board, management, internal auditors, and external auditors. The changing nature of the current crisis requires more frequent updates from management. Ongoing engagement with internal auditors and external auditors is essential, to deal with emerging issues and uncertainties on an ongoing basis as they arise. Additionally, to enhance trust and transparency, the AC can play a crucial role in respect to broader corporate reporting, overseeing a wider set of business and reporting risks, and assessing the connectivity and consistency between information in the financial statements and other disclosures. For example, monitoring impact of COVID-19 on profitability, cash flow, capital preservation, and a renewed focus on the strength of the balance sheet, as well as identifying early signs of financial stress, going concern considerations, and other financial reporting implications as a result of the pandemic, such as accounting estimates and events after the reporting period.

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