Effectiveness of Audit Committee as Determent of Financial Reporting Fraud
(재무보고 부정 방지책으로서의 감사위원회의 효과성)

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<요약>

경영자는 수탁 받은 주주들의 부를 효율적으로 관리할 책임을 가지고 있으며, 수탁자산의 관리, 운영에 관해 재무보고 책임을 가진다, 이는 주주가 위탁한 자산이 적절하게 관리 운영되었는지에 대한 경영자의 성과평가임과 동시에 기업정보 이용자의 의사결정을 위한 정보제공의 의미도 갖는다. 경영자는 운영의 결과를 회계기준에 따라 투명하게 보고하여야 하나, 다수는 기업이 처한 내외적 어려움 또는 개인적인 욕심으로 인해 부정을 자행하며, 이러한 부정의 파급효과는 경영자와 기업은 물론 금융시장의 마비, 더 나아가서 국가경제의 혼란을 초래할 수 있다. 밝혀진 경영자의 부정은 빙산의 일각에 불과 할 뿐이며, 경영자는 직권을 이용하여 원천서류의 조작, 3자와의 공모 등을 통해 부정을 합법적인 거래로 위장을 하기 때문에 부정의 탐지가 쉽지 않다. 경영자의 부정은 사후발견보다는 사전예방이 훨씬 중요하며, 그러기 위해서는 재무정보가 작성되어지는 기업환경에 대한 전체적인 감시가 필요하며, 이 기능을 감사위원회가 담당한다. 그러나 감사위원회가 본연의 기능을 수행하기 위해서는 감사위원회의 역할과 책임, 자격, 규모, 모임시기 및 빈도, 활동에 대한 보고 등을 명시한 헌장을 채택하여야 하며, 재무나 회계영역의 전문가로 구성이 되어야 한다. 또한 경영자나 기업과의 재무적인 이해관계나 친분관계가 없는 독립성을 확보한 인사들로 이루어 져야지 만 경영자의 재무보고에 대해 객관적인 자세로 감시를 수행할 수 있다. 특히 외관상으로는 독립적인 것처럼 보이나, 기업과 연결고리를 가지고 있는 회색영역의 인사들은 배제되어야 한다

색인어: 경영자의 부정, 감사위원회, 독립성, 회색영역이사

I. Introduction

PharMor, a merchandising company, was founded in 1982 at Youngstown, Ohio. The Company sold household items and prescription drugs at prices lower than its competitors, because its management loaded up on products whenever suppliers offered rock-bottom prices. During the next ten years after its foundation, it expanded its stores in nearly every state to over 300 stores. It appeared to be well on its way to become the next WalMart. Even the founder of WalMart, Sam Walton, said that the only company he feared was PharMor. Relying on PharMor's financial statements, investors and stock analysts viewed PharMor as a sure way to cash in on the retailing business. Investors, including Westinghouse Credit Corp., Sears Roebuck and Co., and banks, poured $1.14 billion into the company, because the financial reports looked so good. But the management committed financial reporting fraud by overstating revenue more than $500 million. To hide its cash flow problems and attract investors, the management altered inventory account to understate cost of goods sold and overstate income. Price cut were so much that each item was sold below cost, resulting in loss for each sale. This strategy helped PharMor obtain new customers and open more than a dozen store each year. Rather than admitting that the Company faced loss, it hid the drain and made PharMor appear more profitable. The management raised gross profit to 16.5% from actual margin of 14.2% by inflating inventory. The management and its subordinates embezzled more than $10 million cash by manipulating income statement accounts and overstating inventory. However the dream of success came to an abrupt end when the Company was involved in management fraud. Investors and creditors of the Company brought suits totalling more than $1 billion against the Company's independent auditor, Coopers and Lybrand LLP.(at then), for its reckless audit failing to uncover accounting fraud amounting more than $500 million.

Motivations behind management fraud vary. Some want to obtain higher prices in stock or bond offering ,while others own large amounts of the company's stock so that boost in stock price would increase his personal wealth. The management sometimes overstates financial results to meet a stock analyst's expectation. Numerous companies, naming a few, such as Enron, WorldCom, Cendant, Sunbeam., Waste Management, Informix, admitted all managements' fraud. The U.S. Chamber of Commerce estimates that annual cost of fraud exceeds $100 billion, but those amounts are paid by innocent third parties such as creditors, investors, and consumers, not by perpetrators. The

General Accounting Office(GAO) estimates that accounting fraud costs the U.S. government almost $100 billion annually. This figure combined with the U.S. Chamber of Commerce's estimate represents total cost of $200 billion to society, which is ultimately absorbed by consumers. As a result, the nation's economy will slow down. Management's fraud destroys not only the company involved, but the stability of the nation's economy. All these stories in management fraud illustrate the devastating effects of accounting fraud on the society.

Responsibilities for preparing financial statements fairly in accordance with the Generally Accepted Accounting Principles(GAAP) rest with management rather than with auditors. The management is an agent entrusted with duties of managing owners(shareholders) wealth efficiently and accounting for its managing activities in accordance with established criteria(GAAP). On the other hand, the auditor's responsibility is to accumulate and evaluate evidence regarding management's assertions embodied in the financial statements to ascertain on the degree of correspondence between those assertions and established criteria, and to report its results to the stakeholders of the company. Hence the management should strive for adopting sound accounting policies, and internal control procedures to ascertain that the corporate environment is properly set for reliable financial reporting.

KPMG's 1998 Fraud Survey reports that employees detect 58% of management fraud, internal control 51%, and internal audit 43%. On the other hand, external auditor detects only 4% of management fraud. This report emphasizes the significance of monitoring corporate environment within which financial reports are prepared, rather than having external auditor detect management fraud. The Treadway Commission(1987) reports that the management often commits financial reporting fraud when it is easier to commit and less likely to be detected. The Commission also mentions that the management fraud may often arise from the following circumstances:

- The absence of board of directors and audit committee that vigilantly oversees the financial reporting process
- Weak or nonexistent internal control system
- Ineffective internal audit functions
- Unusual or complex transactions
- Complex accounting estimates requiring management's subjective judgments

Owners of a company(shareholders) establish the board of directors to monitor management's activities and its accountability for the activities. The need to monitor management stems from the divergence of interests between owners and management, because management may act selfishly to accomplish his own wealth at the expense of owner's wealth. But the board of directors often delegates the responsibility for overseeing entire financial reporting process to audit committee. Pincus, et al.(1989) view audit committee as an effective monitoring mechanism to improve the quality of information flow between owners and management. The audit committee also helps the board of directors perform its monitoring function by providing the financial information the committee has been acquainted to the board of directors. In addition, the Treadway Commission(1987) reports that an informed and vigilant audit committee plays a key role in minimizing fraudulent financial reporting.

The purpose of the current research is to explore ways to prevent management fraud by setting proper corporate control atmosphere, for which audit committee has overall responsibilities. This research is organized as follows: characteristics of financial reporting fraud is discussed in the next section, followed by corporate environment for financial reporting process. Section IV deals with functions of audit committee, followed by conclusions in section V.

II. Characteristics of Financial Reporting Fraud

Management fraud, often called fraudulent financial reporting, is the management's misrepresentations or deception leading to materially misleading financial statements. An example is to overstate sales deliberately near the end of accounting period to increase earnings. Management fraud is more difficult to detect than employee fraud, often called defalcations or embezzlement, because management is in position to manipulate documents to hide misstatements, to override internal control system or to collude with third parties to create fictitious documents. Management fraud often shakes public's confidence in the integrity of financial reporting, which is critical for effective functioning of securities market. But a single incident of management fraud stirs public's confidence for the integrity of financial reporting, thus resulting in shake up or collapse of the securities market, or even the nation's economy. Hence the management fraud is a serious crime, but how much it occurs is difficult to know. Publicly known management fraud is just a tip of iceberg.

The Securities and Exchange Commission(SEC) releases Accounting and Auditing Enforcement Releases(AAERs) when management fraud occurs at publicly traded companies. The Treadway Commission(1999), upon studying on AAERs of management fraud occurred between 1987 and 1997, reports the followings:

-Some companies committing fraud experienced net losses or were in close to break even in periods preceding the fraud. The managements of those companies might have been pressured of financial strain or distress.

-Some were experiencing downward trends in net income in periods preceding fraud, whereas others were experiencing upward trends in net income. The management might have been tempted to reverse downward or to preserve upward trends.

-Most of the frauds were committed by improper revenue recognition, overstated assets, and understated expenses.

-Revenue fraud was perpetrated by recording fictitious revenue or recording revenue prematurely. Assets were overstated by recording fictitious assets, assets not owned, or capitalizing items that should be expensed.

-The top management(chief executive officer) perpetrated 72% of fraud, and chief financial officer(CFO) committed 43% of fraud. When combined, 83% of fraud was committed by CEO or CFO(The figure does not add up, because some hold both positions).

-Most of the companies involved in fraud either had no audit committee or had audit committee that met once per year. In addition, most of the audit committee members(65%) did not have expertises in accounting or finance field.

-Board of directors were dominated by inside directors and "grey" area directors(outsiders with special ties to the company or management). About 60% of the directors were insiders or "grey" area directors.

-Proxy statements showed that directors and officers had family relationships in 40% of the cases. In more than 20% of the cases, the founder served as CEO, and officers held incompatible job functions such as holding both positions of CEO and CFO.

-Members of the board of directors and management hold 32% of their company's stocks.

-The average length of fraud extended 23.7 months and the frequency of fraudulent acts were fairly steady over that period.

-Most of the companies changed their auditors during the fraud period.

-Consequences of the management fraud often ended up with bankruptcy(50%) or significant change in ownership structure.

The Treadway Commission's findings were consistent with those of the Auditing Practices Board(APB) of England in that

-majority of the fraud were perpetrated by management

-management fraud rarely involved actual thefts or embezzlement of assets

-management fraud were rarely detected by external auditors

-more than a half of fraud was committed to boost stock prices or to disguise losses.

Implications of The Treadway Commission's study are as follows:

-Given that some of the companies involved in fraud experienced net losses or were in close to break even in periods preceding fraud, effective monitoring for companies to remain as going-concern status is needed.

-Monitoring the environmental, institutional, or personal pressures, such as pressure to obtain higher prices in stock or bond offering, bonus based on earnings, or stock analyst's expectation, etc., is critical. To that end, the importance of internal control system cannot be overemphasized, In addition, the board of directors, audit committee, internal and external auditors must keep close watches on financial reporting process.

-For effective monitoring, majority of board of directors or audit committee must be composed of members who are truly independent(outside) from management, free from financial interest and family (close) relationships, and experts in accounting or finance.

-Effectiveness of outside(independent) directors' monitoring can be hindered by the quality and extent of information they receive. To discharge their overseeing responsibilities, those outside members should be able to access to reliable financial and nonfinancial information. By transferring information audit committee has obtained through its monitoring process, audit committee helps the board of directors fulfill its prescribed duties.

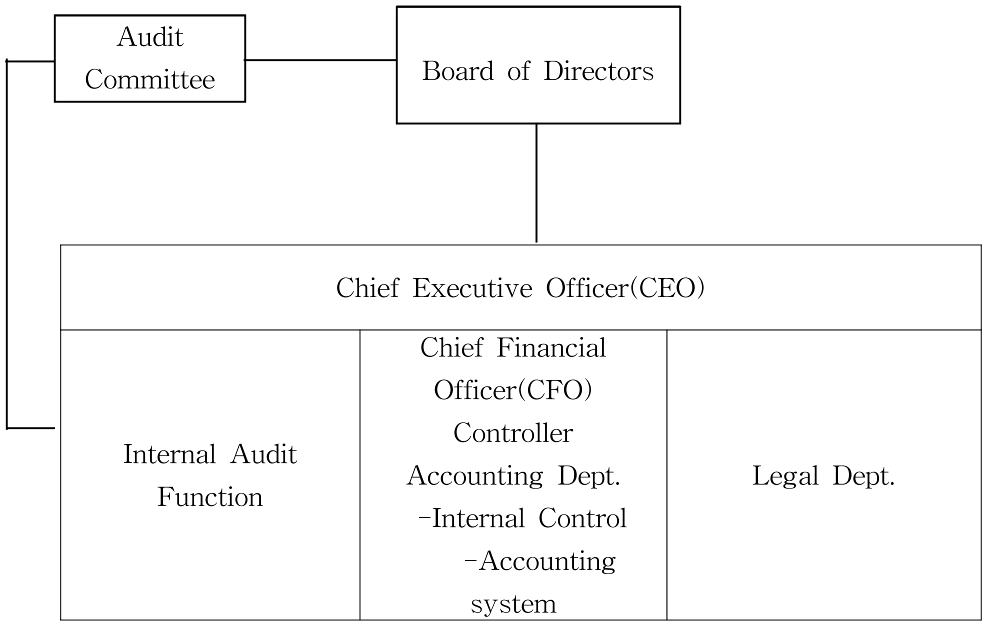
-The multi-period aspect that the fraud was extended over almost 2 years suggests the importance of reviewing interim financial statements, because those interim statements were not audited by external auditors.

In essence, the corporate environment within which financial reports are prepared is the most important factor to the reliability of financial reports. The corporate environment for financial reporting process is discussed next.

III. Corporate Environment for Financial Reporting Process

Figure 1 shows the corporate environment for financial reporting process. The management bears ultimate responsibility for fair presentation of financial statements in accordance with GAAP. Financial statements are management's representation as to the company's financial position and results of operation.

Figure 1 Corporate Environment For Financial Reporting



Accounting department actually prepares the financial statements, but the chain of command supervising financial report preparation typically proceeds from the controller through the chief financial officer(CFO) to the chief executive officer(CEO). The legal department reviews documents for compliance with applicable laws and regulations. On the other hand, the internal audit department performs an appraisal function inside the organization to examine, analyze, and make recommendations on the company's internal control function and accounting records. The board of directors has the ultimate responsibility to the owners(shareholders) for monitoring management's performance and its accountability. But the board of directors generally delegates the responsibility to oversee the company's financial reporting process to audit committee. All these internal environment affects the credibility of financial reporting.

1. Internal Control

Accounting systems are the methods and procedures for collecting, summarizing, and reporting a company's financial and operating information. The management adopts internal controls to guide operations and prevent abuses of accounting systems. In essence, internal controls are policies and procedures that protect assets from misuse, that ensure reliability of accounting systems for financial reporting and that ensure compliance with laws and regulations. Internal control can never be regarded as completely effective, because it has inherent limitations. Even if an organization has an excellent internal control systems, its effectiveness depends on the competency and dependability of the people using the systems. In addition, management may override the procedures and instruct employees to cover up his wrongdoing. Hence, internal control provides only reasonable assurance.

The company's physical assets can be stolen, misused, or destroyed, unless they are protected appropriately. Nonphysical assets such as important documents and records may be damaged, stolen, or misplaced, but adequately designed internal control prevents such damages, theft, misuse, or misplacement, and ensures compliance with applicable laws and regulations such as environmental protection laws or safety regulations. To achieve those objectives, management is responsible for designing and applying five elements of internal control. They are control environment, risk assessment, control procedures, monitoring, and information and communication.

(1) Control Environment

The control environment reflects the management's overall attitude about the importance of controls. One of the factors that influence the control environment is management's philosophy and operating style. The management that overemphasizes operating goals and asks to deviate from control policies to attain the goal may indirectly encourage employees to ignore controls. The company's organizational structure, which is the framework for planning and controlling operations, also affects the control environment. Personnel policies such as hiring, training, evaluating, compensating, and promoting employees, also influence the control environment. In addition, job descriptions, code of ethics, and conflicts of interest policies must be parts of the personnel policies. The quality of internal control will be enhanced if only competent and honest employees are assigned for specific duties.

An effective board of directors must be independent of management to scrutinize management's activities and financial reporting. The board of directors delegates responsibility for internal control establishment, maintenance, and implementation procedures to management, but retains the authority to assess its effectiveness. Also an active and objective board may reduce opportunities that management overrides control procedures. The board delegates responsibility for overseeing financial reporting process to audit committee. The audit committee's independence from management and knowledge of accounting or finance are necessary ingredients to discharge its prescribed duties effectively.

(2)Risk Assessment

All organizations face a variety of risks from internal and external sources. Because economic, industrial, and operating conditions continuously change, management must assess those situations and take necessary actions to control them to achieve objectives of internal control.

(3) Control Procedures

Control procedures are policies and procedures to provide reasonable assurance that the company's objectives, including prevention of fraud, can be achieved. Statements on Auditing Standards(SAS) 94 and COSO Report(1992) note that control procedures include those ones that pertain to separation of duties, informational processing, physical controls, and performance reviews, which fall into the following five types of control procedures.

1) Adequate Separation of Duties

A person who has custody of assets must be separated from the one to account for those assets. For example, if a cashier receives cash from sale and is given the opportunity to record the sale, he may take cash and change the record to hide embezzlement. A person who authorizes transactions should be separated from the one in charge of custody of those assets. If the same person handles both functions, the possibility of defalcations may be doubled. A person with operational responsibility must be segregated from the one with recordkeeping duties. Otherwise, operating results would be manipulated to show improved performance.

2) Proper Authorization of Transactions and Activities

Every transaction must be properly authorized. If anyone in the entity could acquire assets at will, complete disorder may result.

3) Adequate Documents and Records

Transactions are recorded on basis of documents and records, which may include such items as sales invoice, purchase orders, sales journal, and employee time records. The documents must be adequate to provide reasonable assurance that all assets are properly controlled and all transactions are correctly recorded in time. Documents and records must be prenumbered to control over missing documents and prepared at the time when transactions occur, as soon as possible thereafter. Otherwise, chance for misstatements is increased. In addition, they should be designed in a manner that facilitates correct preparation.

4) Physical Control Over Assets and Records

It is vital to protect assets and records. If assets or records are left unprotected, they may be stolen, damaged, or lost. The organization must use physical precautions such as fenced warehouse for inventory to protect its assets from theft, vandalism, or weather. When a company is equipped with highly computerized systems, protecting computer equipment, program, and data files from unauthorized access, temperature and humidity must be considered. Fireproof safes and safety deposit boxes to protect such valuable assets as cash and marketable securities are important physical safeguards.

5) Independent Check on Performance

The last procedure is the continuous and independent check to assess whether the four elements mentioned above are complied, because persons are likely to forget or fail to observe instructions, unless someone monitors their performance. A person responsible for check must be independent from those performing assigned tasks.

(4) Monitoring, Information and Communication

Monitoring function by management deals with continuous assessment to evaluate whether internal control is operating as planned and any modifications are needed to accommodate change in operating environment. These information may also come from, for example, studies on internal control, and internal or external auditors' reports. But for the internal audit department to perform appraisal function effectively, it must be independent from the chain of the command within the organization.

Well designed and operated internal control can safeguard assets by preventing theft, misuse, or misplacement. In addition, the system helps accounting department generate reliable financial information and the entity comply with applicable laws and regulations.

2. Internal Audit

The Institute of Internal Auditors defines internal auditing as "independent and objective assurance and consulting activity that is designed to add value to improve an organization's operations."(IIA 1999)

To perform their assignments effectively, internal auditors must be independent of line functions in an organization, but they cannot be completely independent of the company as long as employer-employee relationship exists. “Independence” must be exerted in all scope of services internal auditors perform and can be enhanced when the internal audit director reports directly to the CEO for matters CEO has not been involved and to audit committee. On the other hand, “objectivity” in the definition means taking impartial attitude in performing duties.. If an internal auditor has subordinated his judgment to others, he lacks objectivity. “Assurance” activities mean those services that improve the quality of financial information, effectiveness of internal control, compliance with company, governmental, regulatory procedures, and efficiency of the company's operational procedures. But those services are limited to the aspects inside the organization. Internal audit department's “consulting” activities range from the one that emphasizes compliance with regulations or laws to that add value to the organization. Consulting services mean that internal auditors are dedicated to work with management to correct problems identified in the audit process, but they do not implement their recommendations, for which the management is responsible.

The Blue Ribbon Committee(NACD 2000) reports that the internal audit function helps audit committee perform its duties by facilitating information flow it has obtained through its appraisal duties regarding integrity of financial information. In essence, the internal audit department plays a watchdog role for the corporate environment within which financial reports are prepared. Its scope of duties include reviewing the reliability and integrity of financial and operating information, assessing internal control system to promote operational efficiency and effectiveness, adherence to the company, governmental, regulatory policies and procedures, and appraising efficient utilization of the company's resources.

3. Board of Directors and Audit Committee

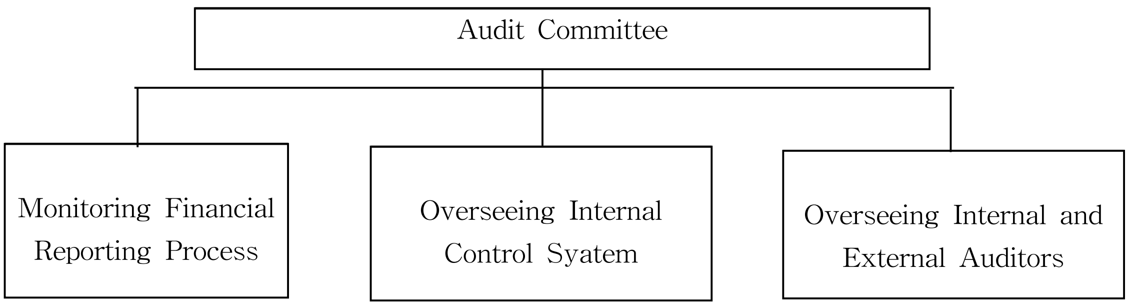
Owners of a company establishes the board of directors to monitor and control management's activities and financial reporting process. But the board delegates responsibility for monitoring financial reporting to audit committee. Although the board of directors delegates responsibilities for establishing, maintaining, and implementing internal control to management, it independently assesses its effectiveness through audit committee's monitoring process. The audit committee also maintains ongoing communication with both internal and external auditors to discuss problems related to financial reporting process, including management's integrity. But the audit committee's independence from management and the company and expertise in accounting or finance are important determinants for effective oversight. Functions of audit committee are discussed in the next section.

IV. Functions of Audit Committee

1. Role of Audit Committee

National Association of Corporate Directors' Blue Ribbon Commission on Audit Committee describes audit committee as "a vital role in corporate governance. The audit committee can be a critical component in ensuring quality reporting and controls, as well as the proper identification and management of risk."(NACD, 2000,p.1) The three key roles of the audit committee are shown in figure 2.

Figure 2 Major Roles of Audit committee



The audit committee is responsible for monitoring the financial reporting process, overseeing the internal control system and the works of internal and external auditors. The Treadway Commission(1987) reports that "the mere existence of an audit committee is not enough. The audit committee must be vigilant, informed, diligent and probing in fulfilling its oversight responsibilities."(p.41) For the audit committee to discharge its duties properly, the board of directors must adopt a charter which clearly describes the membership requirement and terms of office, duties and responsibilities, relationship with management, internal and external auditors, and frequency and timing of meetings. A written charter helps the member clearly understand his role. In addition, it provides the board of directors, management, and internal and external auditors with clear understanding of the committee's role. A written charter usually includes the followings: monitoring internal control system, overseeing internal and external audit function, relationship with management, reviewing interim financial statements, checking compliance with the code of corporate conduct, applicable laws and regulations, and reporting the committee's activities to the board of directors and shareholders.

1) Monitoring Internal Control System

Well designed and implemented internal control structure reduces the risk of financial statements being materially misstated. In addition, it promotes operational efficiency, reduces risk of asset loss, helps ensure the reliability of financial statements, and compliance with laws and regulations. But for the internal control system to function properly as designed, the top management's philosophy and operating style are important factors. Management must provide clear signals to employees about the importance of internal control. In other words, the tone set by top management, such as the corporate environment within which financial reporting occurs, is the most critical factor to the integrity of financial reporting.

The Treadway Commission(1987) reports that audit committee must review the internal control system periodically as a part of ongoing assessment regarding its effectiveness. In addition, the audit committee should occasionally discuss with internal and external auditors regarding their assessments of deficiencies in internal control. The audit committee should also monitor management's operating style to check whether management follows internal control system.

2) Overseeing Internal Audit Function

Internal auditors play watchdog role for the corporate environment. But for internal auditors to discharge their duties, management and board of directors must fully support its staffing, activities, and independence. Management must provide internal audit department with adequate resources and personnel to help them perform audits with moderate frequency at all organizational levels, areas, and activities. Management and board of directors should ensure that internal audit director and staffs must be free of undue influence in performing their assignments. The audit committee should open a line of communication with internal auditors and allow them to access to the committee without limitation. A good relationship with internal auditors assist the audit committee in fulfilling its duties for the board of directors and shareholders. To ensure that internal auditors carry out their assignments, the audit committee should approve and periodically review the internal audit charter in which objectives, goals, internal audit schedules, staffing plans, and budgets.

The director of internal audit must inform audit committee of audit results, significant findings, and recommendations. To help assure independence, the audit committee should have the director talk directly to the committee and attend all the audit committee's meetings. Internal auditors' independence can further be enhanced when audit committee approves for appointment, replacement, reassignment, or dismissal of the director of internal audits. When the director is being replaced or reassigned, the audit committee must make sure that the reassignment does not represent management's attempts to cover up internal auditor's findings. The audit committee must also evaluate the adequacy of the size, staffing, and qualification. In addition, the audit committee must follow up to ensure that management has taken appropriate steps for the internal auditor's recommendations.

3) Relationship with External Auditors

Since the audit committee's primary interest is in the reliability of financial reporting, the audit committee should communicate with external auditors on ongoing basis to discuss the proposed audit scope and approach, restrictions encountered during the audit, disagreements with management regarding accounting principles, and audit findings and suggestions. In addition, the audit committee and management must assist external auditors to preserve independence. On the other hand, auditors must discuss with the audit committee regarding any irregularities or illegal acts they become aware of during the audit process.

The audit committee should be involved in the process of selecting and reappointing external auditors. The audit committee reviews the management's recommendation on the appointment of external auditors and ,in turn, recommends them to the board of directors, which asks shareholders for approval. In reviewing management's recommendation, the audit committee must meet privately with management and internal auditors to discuss quality of the audit services and other appropriate matters.

4) Relationship with Management

Because management influences the integrity of financial reporting, the audit committee should continually assess the management's competence and integrity. Management, in turn, should provide the audit committee with various issues related to the corporate environment, such as business risks the company is facing, planned responses to them, status of any pending lawsuits, current issues affecting the company's operations, and any other major difficulties the company is experiencing.

Management may have different opinions on significant accounting issues from external auditors, especially when transactions are complex or GAAP is not clearly defined on a particular issue. In those cases, management may seek a second opinion from the other accounting firms. The management's decision to do so may be a legitimate attempt to obtain the proper opinion on a disputed issue. But management may be viewed to others as trying to obtain an opinion that coincides with management's interest. In either case, the management may put undue pressure to external auditors. When such a case arises, management should discuss the matter with the audit committee and explain reasons for shopping a second opinion.

5) Reviewing Interim Financial Statements

Users of financial information rely heavily on interim reports ,such as quarterly reports, which were not audited but reviewed with limited scope. Most audit committees overlook the interim financial reporting process, even though that information is an integral part of the annual financial reports. The audit committee must review the process that interim financial reports are prepared to assess the reliability of those reports indirectly. In other words, the audit committee must review the internal control system that management has established to preserve integrity of the interim reporting process. In addition, the audit committee must be informed the extent of internal and external auditors' degree of involvement in interim reports.

To gain more insight into the fairness of interim financial reports, audit committee must have the following information:

-any deviation of actual results from the budget

-any significant change in financial ratio compared to those of the previous period

-any change in accounting principles compared with the one applied in the preceding period

-any change in internal control environment

Well defined ethical standards and written guidelines for acceptable behavior help establish atmosphere that encourages reliable financial reporting and fiduciary duties among employees. A company must establish a written code of corporate conducts for all employees. A code of conduct promotes the appropriate control environment when

management shows clear signs for enforcement of the code. For the code of conduct to function properly as designed, management should establish procedures to monitor compliance with the code, and the audit committee must oversee the entire program.
Audit committee should also check compliance with applicable laws and regulations. To carry out those functions, the audit committee should review the effectiveness of internal control system. Audit committee must report its activities to the board of directors, which helps outside directors of the board gain financial information, and, thereby, discharge their duties properly.

Outside directors have less information than inside directors on the company's operating activities and its financial information, which hinders the outside directors' monitoring activities. By transferring those information that audit committee has obtained to the outside directors, the audit committee act as an efficient means to reduce information asymmetries between outside and inside directors. The Treadway Commission(1987) recommended the SEC to require all public companies to include a letter signed by the chairperson of audit committee regarding the committee's role and responsibilities in financial reporting process in annual report. The Commission believed that such an inclusion would clarify the role of audit committee and encourage its members to fulfill its responsibilities diligently.

2. Formation of Audit Committee

This section deals with formation, including audit committee member's qualification, independence, size, and frequency of meeting.

1) Qualification and Independence

Audit committee's member must possess expertise in business and accounting along with common sense, independent judgment, professional skepticism, willingness to devote for the duties, risk management insights, and ability to offer constructive suggestions. The Treadway Commission(1999) reports that companies involved in management fraud had audit committee mainly composed of insiders and "grey" area directors(60%) and members with no expertise in accounting or finance(65%). If a member is neither independent nor expert, audit committee's role to monitor financial reporting may be severely hampered. Independence is the most important characteristics of an effective audit committee member. Independence means taking unbiased viewpoint in the monitoring process. During that process, audit committee member often questions management judgments and take a position contrary to that of management. To do that, a member should not have biased attitude toward the management. On the other hand, audit committee member must be free from the financial interest, such as owning stocks, to maintain independence. For example, an audit committee member may collude with management for earning manipulation to boost stock price for the member's personal wealth, if he owns material amounts of stocks. The Treadway Commission(1999) reports that the fraud company's management and the board of directors members own approximately 32% of the stocks. Instead of monitoring management's activities and financial reporting, the board colluded with management to distort financial reporting for personal wealth accumulation. In addition, family relationship among directors and/or officers was in nearly 40% of fraud companies, which hampers the directors' independence in their monitoring activities.

The viability of the board as a control mechanism is enhanced by the inclusion of outside directors because they have incentives to develop their reputations as experts in the external market. As a result, the board must include outside members who also act as arbitrators in disagreements among internal managers and ratify decisions that involve serious agency problems.(Fama and Jensen, 1983)

Ideally, the audit committee should be independent of the management, allowing internal and external auditors to remain free of undue influence and interference from the company insiders. In 1978, the New York Stock Exchange(NYSE) required those companies listed on the NYSE to have the audit committee made up solely of directors independent of management and free from any relationships that, in the opinion of the board, would interfere with the exercise of independent judgments. Although the NYSE guidelines specially preclude affiliates, officers, and employees of the company from serving on the audit committee, a director who was formerly associated with the company or its subsidiaries as an officer or employees may qualify for the membership if, in the opinion of the board, he will exercise independent judgment and materially assist the function of the committee. These so-called "grey" area directors may include relatives of management, consultants to the company, interlocking directors and retired executives. Electing "grey" area members to the audit committee may compromise the audit committee's independence and, therefore, reduces its effectiveness as a monitoring mechanism.

Baysinger and Butler(1985) studied the effect of board composition using a three-level(i.e., insider, grey area, and independent outsiders) on the firm performance and conclude that firms with a higher proportion of independent outside directors achieved relatively higher returns on investments(ROI). Weibach(1988) also finds that the likelihood of Chief Executive Officer(CEO) replacement following a period of relatively poor corporate performance was greater as the board's representation of independent outside directors increased. Byrd and Hickman(1992) find that the board monitoring is significantly more effective in the case of tender offers when the independent outside directors dominate the bidding firm's board of directors. They also find that no significant monitoring effect was found when "grey" area directors dominated the board. Vicknair, et al.(1993) examined the proxy statements of 100 NYSE firms to see the portion of "grey" area directors on the board. Approximately 75 percent of their surveyed firms include at least one "grey" area director, while "grey" area directors hold a voting majority in 26 percent of the sample. Out of the "grey" area directors, 34 percent and 30 percent hold interlocking directorships and related-party relationships, respectively. Others are composed of those affiliated with the firm's bank, firm lawyers, retirees, firm's consultants, and relatives of management. The majority of directors derive their income from the lines of business controlled by the management. Independence in those cases is clearly questionable. Independence is a key characteristics for the audit committee to perform their duties effectively. Vicknair, et al. conclude that the audit committee dominated by "grey" area directors may fall short of what they are perceived to do.

In addition, because the function of the chairperson of the board is to run the board's meeting and oversee the process of hiring, firing, evaluating, and compensating the CEO, CEO cannot perform the chairperson's monitoring function apart from his personal interests.(Jensen 1993) It is important to separate the chairperson and CEO/president positions for the board to be an effective monitoring device. When the positions of the CEO and chairperson are combined, the CEO is able to influence the board composition. Having insiders and "grey" area members on the audit committee or the board of directors may be worse than having no committee at all, because such a composition would mislead shareholders to believe that effective monitoring is taking place.

2) Size and Frequency of Meeting

The audit committee should be large enough to represent a balance of views and experiences, yet small enough to operate efficiently. Most of the committees are composed of three to five members; however, the size should be appropriate for each company and its circumstance. The Treadway Commission(1987) recommends that no fewer than three members should constitute the audit committee. The audit committee with insiders, the low activity level and the small size lead to believe that the audit committee may have been established for the cosmetic purposes.

The audit committee usually schedule their meetings in conjunction with the board meeting. Normally a minimum of three meetings a year will suffice.(Merchant 1987, p33) But the frequency of meeting is only a crude measure of the audit committee activity. It does not provide any indication of the work accomplished or of the committee's effectiveness in achieving financial reporting integrity. The audit committee should also meet privately with the internal and external auditors to discuss any problems they have encountered in performing their duties.

V. Conclusion

For the board of directors or audit committee to perform their prescribed duties, they must be independent of management and free from financial interest. Because independent directors who serve on the board have less information about the organization's activities than insiders(management), the board's effectiveness to oversee and monitor management actions is severely hampered. But the audit committee plays an important role to reduce information asymmetry by providing information that the members have been acquainted from internal and external auditors during financial reporting process to the board of directors. Hence the auditor committee assists the board of directors to satisfactorily discharge its responsibilities.

The Wall Street Journal(July 17, 1998) reports that "..... audit committees are not always effectively doing their jobs. Investor activists attack such committees for lacking independence or financial expertise to uncover most financial reporting failures..... Audit committees need independent directors with sophisticated financial backgrounds." Even though the existence of the audit committee or the board of directors can be perceived as high quality monitoring mechanism and as reducing the likelihood of management fraud, the committee may fall short of what it is perceived to do because of lack of independence and financial expertise. Inclusion of so called "grey area" directors into the committee may hamper its independence, because they are indirectly attached to the company. Such committees are considered to be creatures of the management for image making rather than watchdogs over the investors' interests. For the committee or the board to perform their prescribed duties effectively, they must be composed of truly independent , vigilant, informed, and diligent members.

In addition, the audit committee should have a written charter which provides the board, the committee members, management, internal and external auditors with a clear understanding of the committee's role. The charter also needs to include the committee's membership, terms of office, roles and responsibilities, relationships with management, internal and external auditors, frequency and timing of meetings.

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