A Proposed Model of Audit Committee to Reinforce Corporate Governance System in Jordan

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Abstract
Audit committees are the cornerstone of corporate governance. They play a vital role in overseeing accountability, and work as a liaison between internal auditors, external auditors, executive management and the board of directors. Corporate scandals, such as the demise of Enron-Arthur Andersen in the U.S.A. and Petra Bank in Jordan, have undermined stakeholders’ confidence in the capital markets. Such scandals might be caused by the lack of a corporate accountability system and by management pressure exerted on audit scope or the auditor’s fee. These scandals imply a message that relying on the perceived independence of external auditors may not be sufficient and, therefore, corporate governance systems must be restructured because financial collapses may harm society and cost the government both economically and socially. This analytical research paper proposes and outlines a model of audit committee to reinforce the effectiveness of the corporate governance structure. The study recommends a Governmental Representative Member (GRM), appointed and supervised by the Audit Bureau, to be among the audit committee members of listed companies. The study model suggests that the presence of the GRM among audit committee members strengthens their effectiveness and, therefore, reinforces external auditors’ independence, performance, and their ability to operate in the face of pressure from company management to issue a favourable audit opinion, thus, increasing the integrity and the soundness of the financial reporting system.

Keywords: audit committee, corporate governance, auditors independence, audit bureau, non-executive members, agency theory

INTRODUCTION
“Where were the auditors?” is the notorious question that auditors hate to hear whenever corporate scandals occur, because the blame is almost always first directed at the external auditors. Corporate governance reform has become a major global issue over the last decade. The Asian crisis in 1997 and corporate scandals such as Barings, WorldCom, Enron (Demirag and Solomon, 2003) and Lehman Brothers have highlighted the need for corporate governance reform at a global level and brought into question the role of audit committees (Rezaee et al., 2003) and the independence of external auditors. Some of these corporate failures were attributed to the agency problem as the separation of ownership and control in corporations caused opportunistic managers to take actions that served their own interests rather than the interests of shareholders and stakeholders (Bowie & Freeman, 1992; Hill & Jones, 2007).

Audit committees are defined as sub-committees of the board of directors, consisting of at least 3 members and established by and from the members of the board of directors of a company, whose main responsibilities are to review the annual financial statements and reports before they are submitted to the board of directors, safeguard the internal audit function, nominate and review the findings of the external auditors, and to work as a liaison between internal auditors, external auditors, executive management and the board of directors.

Audit committees have the responsibility to discuss and solve any dispute between the auditors and the management. Among the most important roles of the audit committee are to ensure the external auditor's ongoing independence and to reinforce internal audit effectiveness. These roles were emphasized by the International Standard on Auditing (ISA) (IFAC, 2010), the Institute of Internal Auditors (IIA, 2014) and The Jordanian Corporate Governance Codes (Corporate Governance Codes in Jordan, 2009, Chapter five, section two). Due to these vital and manifold roles of the audit committee, the author would argue that effective, independent and powerful audit committees guarantee effective and strong corporate governance systems.

This paper will be structured as follows: following this introduction, section two addresses the motivations for establishing this paper’s audit committee model and reviews, discusses and analyzes related literature and corporate governance in Jordan. Section 3 sheds light on the calls for government intervention in the Jordanian capital
markets. Section 4 presents this paper’s proposed model for the audit committee. Section 5 justifies the choice of the government party that should be involved in this model. In section 6, the main conclusions of the paper are summarized and recommendations made for Jordanian regulatory bodies of the capital markets. In section 7, future directions for research are presented, and the limitations of the study preserved for section 8.

BACKGROUND & MOTIVATIONS OF THE STUDY

The main purpose of this paper is to develop a model of audit committee structure to reinforce the independence and the effectiveness of corporate governance systems in Jordan. While external auditor independence is the cornerstone of the auditing profession (Leung et al., 2010), the audit committee has been identified as a cornerstone of effective corporate governance (Gramling et al., 2005). Independence from company management should not be required from the external auditors only; audit committees should also be independent from the company management and employees, and independence should be in the mind of the internal auditors and external members of the board of directors. Porter (2009) argued “However, since the 1970s, the extent and severity of the impact of unexpected corporate failures, and revelations of instances of misconduct and reckless management by senior company officials, have demonstrated that the twofold approach to securing corporate accountability is inadequate. Initially, attempts were made to strengthen the external audit function by means of establishing audit committees comprised of non-executive directors. However, unexpected corporate failures and revelations of misconduct by corporate officials continued ….. In order to be effective in securing adequate discharge of accountability by company management, each member of the trinity must be strong and have operational independence from the company” (p, 172).

In the wake of the Enron-Arthur Andersen scandal, the United States Congress passed the Sarbanes Oxley Act to reform corporate governance. Under SOX, The U.S. established the Public Company Accounting Oversight Body (PCAOB) to supervise the auditing profession and to protect the public interest. Moreover, academicians proposed models to reform corporate governance such as Abdel-khalik’s proposal (2002) of establishing Shareholders’ Board of Trustees (SBT). The main argument of Abdel-khalik’s (2002) proposal for establishing the SBT was that auditor independence is critically affected by the body which has the responsibility of nominating, dismissing, and setting the external auditors’ fees. The researcher would argue and add that the maintenance of the independence of the overall corporate governance mosaic, not only the external auditors, depends on the parties they deal with and get support from. This party, typically, should be an independent, effective and well-established audit committee based on a clearly defined charter.

Having several qualified members amongst the audit committee does not guarantee the soundness of corporate financial reporting; the members should also possess the power and the authority to work objectively and effectively. In the case of Enron’s audit committee, Felo et al (2003) pointed out that among the committee’s six members, four were experts: an accounting professional, a professor of accounting and two top executives of other companies. In spite of this, they did not identify Enron’s malpractices and irregularities.

The government, through its financial regulatory bodies, control and oversee the capital market and the corporations indirectly via legislating corporate and commercial laws, setting regulations and rules, monitoring the stock exchange, and requiring corporate disclosure. Examples of these governmental bodies include the Securities Commission, the Stock Exchange, the Companies Control Department and the Central Bank. Governments are among the biggest losers when giant financial collapses occur because governments bear the burdens of the bailout plans (the bailout after the global financial crisis triggered by the collapse of the Lehman Brother Bank as an example from the U.S., and the case of Petra Bank in Jordan).

Khsharmh (2003) conducted an empirical quantitative study investigating the factors affecting the selection process of the external auditors, based on the perceptions of external auditors and the financial managers of listed Jordanian companies. The study concluded that external auditor’s appointment must be left in the hand of the Ministry of Industry and Trade to maintain them independent from the board of directors. A working paper by Albasheer (2003), presented to the 5th scientific conference of the Jordanian Association of Certified Public Accountants, pointed out that the Central Bank of Jordan (CBJ) had clearly violated the rules of the auditing profession when the Central Bank’s law empowered the CBJ to prepare a list of the high ranked certified public accountants in Jordan and mandated the banks in Jordan to choose external auditors from that list.

Jordan experienced, as many other countries did, some severe cases of corporate failure and scandal. In addition to the notorious case of Petra Bank, which affected the exchange rate of the Jordanian Dinar in the eighties of the last century, the Jordanian Central Bank governor employed local and foreign media to mitigate the effects of administrative mismanagement.
conducted by members of the board of directors of Capital Bank in 2009 (Reuters, 2009).

According to Al-Saudi (2007) and to a study conducted by the World Bank (World Bank: Accounting and Auditing, 2004), lack of a written audit committee charter, in addition to personal relationships between audit committee members, executive management and auditors, adversely effected the selection of external auditors in Jordan. Swaiti (2006), Abdullahif (2006) and Al-Khadash and Al-Sartawi (2010) pointed out that, due to their poor composition, audit committees did not play their role in supporting auditor independence against management pressure. Swaiti (2006) also added that audit committees were created simply to comply with regulations, in disregard of the intent behind those regulations. Management pressure on the auditors and weak accountability systems discourage the auditors from expressing an independent opinion on the entity’s ability to continue as a going concern in Jordan (Malkawi, 2008; Qadamani, 2007, Omari, 2003).

External auditors in Jordan rejected the proposed role of audit committees in appointing, dismissing, and determining their fees (Abdullatif, 2007; Swaiti, 2006). Abdullahif (2007) attributed this partially to external auditor criticisms of the weak composition of audit committees; at that time, audit committees were not required to be independent or include financial experts. Abdullahif (2007) also partially attributed this rejection by external auditors to their unwillingness to be forced to undertake additional tasks or change their personal relationship with their clients. Swaiti (2006) revealed that there was consensus between auditors and company executives in rejecting the role of audit committees in selecting the external auditors. Swaiti’s (2006) study pointed out that auditors refused the role of unqualified audit committee members, unspecialized in auditing and accounting, to evaluate their work. On the other hand, the study also attributed this rejection to external auditors’ desire to maintain a direct and personal relationship with their clients (i.e. company management).

This paper suggests and urges the Jordanian government to participate in the capital market directly by mandating a government representative be a member of each audit committee. The researcher would argue that having the Governmental Representative Member (GRM) amongst the audit committee means that the state has installed a controlling eye in the heart of corporate governance and the financial reporting system.

The GRM should be appointed and work under the supervision of Central Bank of Jordan, in the case of bank audit committees, the Jordanian Insurance Regulatory Commission, in the case of insurance company audit committees, and, for other publically traded companies, under the Audit Bureau. The reason for involving these three bodies is to insure the availability of industry-specific knowledge within the audit committee, because industry-relevant experience is associated with improvement in the probability of detecting errors and detecting fraudulent income reporting (Johnson et al. 1991).

The Calls for Government Intervention in the Jordanian Capital Markets

Financial experts and economists in Jordan have asked for the revival of the state committee for capital market reform, a committee which had stopped working after the resignation of the government in early 2011. This call came after a decline in volumes and values of securities. The experts also criticized the absence of the Jordanian Securities Commission’s role in dealing with the prevailing stock market decline since 2006 (Abu-Qaood, 2011)

In addition to the call by Khsharmh (2003), in which he suggested handing the role of selecting the external auditors to the Companies Control Department, there have been many debates which have called for the Jordanian Audit Bureau to audit publicly traded companies. Abu-Tair (2010) suggested that the funds of the professional associations should be subject to the control of the Jordanian Audit Bureau because it is a public body with the desired expertise and independence. In reaction to this suggestion, opinions of the presidents of the Jordanian professional associations were varied; some accepted the idea of government intervention, some were against, and some even asked to expand the scope of the Audit Bureau to include shareholding companies (Ghabayen, 2010).

The Proposed Model of Having the GRMs amongst the Audit Committee Members

As mentioned earlier, audit committees are among the most important pillars of corporate governance, and could be made even more effective by including a GRM amongst the audit committee members, as shown in figure number 1 as follows:

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1 Clients in this case means the management of the company. This is a fundamental failure in that shareholders or stakeholders, particularly financial stakeholders, are not seen as the client.
Figure (1): The proposed System: In this system the GRM is appointed and supervised by the Audit Bureau and acts as member of the audit committee

While the following points describe the main functions of the work of the GRMs under the supervision of the Audit Bureau, similar procedures are applicable to the work of the GRMs under the supervision of the Central Bank or the Insurance Regulatory Commission.

1. The GRM nomination decision should be taken at the highest level of the audit bureau.
2. The Audit Bureau should ensure that the GRM is independent from the company, as per the independence stipulations in the Jordanian corporate governance codes, and ensure that they have no direct or indirect interest or shares in the company in which the GRM will be a member of the audit committee.
3. The Audit Bureau should establish a special department/directorate to organize the work of the GRMs, called the Department of Private Sector Audit (DPSA). All GRMs must have an office in the DPSA beside offices in each company in which they serve as audit committee members.
4. GRMs are accountable to and report to the DPSA for any violations of the laws, regulations and the best practices of corporate governance codes.
5. The Department of Private Sector Audit (DPSA) should establish a mail box and e-mail to receive complaints from shareholders and stakeholders; these complaints should be handed to the respective GRMs in order to use their power and authority as an audit committee member to investigate the claims.
6. The GRMs should not get direct remuneration from the companies they serve as audit committee members; they get their salaries and their provisions only from the Audit Bureau. A GRM’s remuneration from the company should be equal to what the directors on the audit committee receive and should be paid directly to the Audit Bureau and not to the GRM.
7. GRMs might serve as a committee member with more than one entity, up to a maximum of five, based on the risk and the size of those entities.
8. The Audit Bureau should maintain rotations and replacements for the GRMs.
9. Priority of choosing the GRMs should be given to those who are certified public accountants and have the skills or receive training to maintain best practices of corporate governance codes.
10. The GRM should not participate in the nomination process for the external auditors as long as the selection procedures comply with the corporate governance codes. The GRM should only have the veto right to reject the nominations of any particular external auditor provided that the GRM appropriately disclose the justifications for the veto. For example, a GRM serving large companies or banks can be expected to reject the nomination of very small audit firms or audit firms without the proper industry experience.

Another benefit of employing GRMs in this way is that this solution can be seen as a reasonable compromise between calls for governmental bodies to select external auditors or audit publicly traded companies in Jordan, on one hand, and other positions, including those in internationally accepted conventions and the existing Jordanian codes, that the shareholders, members of the board of directors and the audit committees have the right to nominate and select the external auditors.

For the GRM to be successful, the appointee should have the following characteristics:

a) They must have a high degree of technical expertise;
b) They must have a high degree of self confidence so as to be able to stand up for what they think is correct;
c) They must possess a high degree of scepticism;
d) They must be politically aware so that the other audit committee members bypass them; and
e) They must have a strong sense of public service to break out of the mentality that management is the client.

Furthermore, there is a need for GRMs to be supported by whistle-blower type mechanisms and protections so that individuals in the company feel protected when they advise the GRM of fraud or inappropriate accounting.

The Auditing Bureau VS Companies Control Department

The Companies Control Department (CCD) has been established as an independent department from the Ministry of Industry and Trade since early 2003. Objectives of the CCD include developing and implementing control tools for companies. The CCD supervises the assembly meetings of listed companies, and delegates members to verify that assembly meetings have been conducted according to the regulations (Companies Control Department, 2012). Some would argue that the GRM should work under the supervision of the CCD; in this regard, the researcher suggests that the Audit Bureau (AB) should supervise the work of the GRM. The AB was founded in the early stages of the establishing of the Hashemite Kingdom of Jordan, and works under the law of 1952 (Audit Bureau, 2012).

Over the years, the AB has come to be appreciated for its protection of public funds. The AB has plenty of officers who possess accounting, auditing and finance qualifications. Those officers audit the public sector; they are spread all over the various Jordanian ministries and public departments. The AB gets its authority from the Jordanian parliament, and its annual report is sent to the parliament and the government. Decisions to nominate or dismiss the president of the AB need the approval of the parliament. The AB is also involved with regulating and supervising the auditing profession in Jordan. In November 2011, in order to allow the Audit Bureau to fulfill its functions effectively, donor countries demanded the Jordanian government vest the Audit Bureau with powers of judicial police enforcement as a prerequisite condition to providing grants and assistance to Jordan. This reflects the extent of the respect that foreign parties have towards the performance and the effectiveness of the Jordanian Audit Bureau (Khreisat 2011). Given this degree of respect, the researcher believes that the AB is more than capable of undertaking the role proposed in this paper.

CONCLUSIONS AND RECOMMENDATIONS

Financial crisis, corporate failure, and audit firm scandals have undermined the stakeholders’ trust of the auditing profession and of the capital markets. Corporate collapses also place burdens on states all over the world. In this situation and given that the audit committee is the backbone of the corporate governance structure, the role of governments in regard to the private sector should move from indirect supervision to direct oversight by having a Govermental Representative Member (GRM) amongst the audit committee members.

Adopting the proposed model of the audit committee with the GRM addresses criticisms that the Jordanian regulators need to become more involved or that the government audit body expand its role to cover the audit of public listed companies. Furthermore, giving the GRM the veto right to reject the nomination of specific auditors, addresses the criticisms directed to the Central Bank of Jordan for its mandate to banks in Jordan to select auditors exclusively from a list prepared by the central bank. The JCGC stipulated that " the company shall take appropriate actions to ensure that the external auditors perform their duties impartially without interference from the board of directors or the executive management" (Corporate Governance Codes in Jordan, 2009 Chapter Five, section four). Since the audit committees are formed by the board of directors, it would be difficult for the auditors to avoid their interference; the presence of the GRM would help support the auditors in the face of any such pressure or interference.

The GRM will reactivate the vital role of audit committees in Jordan and will ensure that they are not formed just to meet the letter of the law, as found by Swaiti (2006). Taking in to consideration their direct reporting to the Audit Bureau, their auditing, accounting and financial qualifications and experience, coupled with skills in corporate governance codes and the fact of being independent of the company, GRMs can work objectively. Given these benefits and the support of the audit committee members, including the GRM, under a proper audit committee charter, the independence and the effectiveness of corporate governance structure in Jordan can be reinforced.

Audit committees in Jordan do have their jobs and duties stipulated in the Jordanian Corporate Governance Codes, but they are not specified in a systematic charter. Furthermore, there are some weaknesses affecting the composition and work performance of audit committees. In this regard the study suggests that all audit committees must work under an accredited charter with minimum conditions and requirements to be set by the Jordanian Securities Commission. The charter should have separate sections to specify the authorities, duties, and responsibilities of the audit committees under categories such as:

1) Audit committee composition; this should include audit committee members’ election and qualifications, and audit committee remuneration which should be in line with activities and
performance. All members of the audit committee must be independent. In case the elected board of directors does not have enough members who meet the conditions for eligibility, the board of directors will be responsible for nominating qualified members from outside the board.

2- The role of the audit committee in nominating, retaining and compensating the external auditors.

3- The role of the audit committee in communicating with the external auditors, taking ISA No. 260 into consideration.

4- The role of the audit committee in nominating the head of the internal audit function.

5- The role of the audit committee in communicating with the internal auditors, with and without the presence of company management.

6- Audit committee powers and authorities to oversee company management, and to ensure their accountability.

7- Communications with the board of directors.

8- Audit committee’s functions and meetings; in this section, scheduled and regularly occurring meetings of the audit committee with other parties should also be stipulated. The researcher suggests that audit committee members must work based on a flexible and pre-scheduled part-time basis, the justification being that the audit committee’s heavy responsibilities and the vital roles and duties set by legislators can’t be achieved by conducting a small number of meetings each year. The flexibility of the schedule should also ensure avoidance of routine procedures in order to get practical and efficient outcomes of the meetings.

9- In a separate section of a company’s annual report, the audit committee should report its main activities during the year. Unsolved disputes with the company management or any outstanding irregularities should also be expressed in this section. The researcher suggests establishing a certified professional Corporate Governance Certificate (CGC), and recommends that the board of directors, audit committee members and the GRMs obtain this certificate. During the first stage of implementation, the researcher suggests the application of the proposal to the big, influential companies and to those who are associated with high risk; application to other companies is optional based on their financial soundness, noting that the Audit Bureau should have the right to appoint the GRM at any time during the financial year. Finally, GRMs should be required to attend the general assembly meetings of corporations and fulfill their duty as representatives of the Companies Control Department.

FURTHER STUDIES
1- Future studies should be conducted if this model adopted. Objectives of future research are expected to focus on practical feedback.

2- The proposed model has the potential to be implemented in other countries, even developed countries; for instance, the “GAO” in the U.S. and the “Audit Offices of the Australian States or the Federal Government” in Australia might play the role of the Jordanian Audit Bureau in their own countries, overseeing and appointing the state representative members in those countries’ publicly traded companies.

3- For further development to this model; the researcher suggests that future studies investigate the impact of electing the audit committee members directly by the shareholders, whereby only eligible qualified members who satisfy the conditions and the requirements stipulated on the corporate governance codes of best practices are allowed to be candidates.

4- Further studies are suggested to investigate merging the Companies Control Department with other governmental departments. In this regard, it is noteworthy to mention that there have been many criticisms of the number of governmental bodies involved with regulating the capital market in Jordan, which complicated the efforts towards reforming corporate governance. There were many calls to merge government departments that shared common tasks, and the government itself called for that merge after meeting with the financial committee of the Jordanian parliament (Abu-Hamour, 2011; Malkawi, 2008; Abu-Qaood, 2011).

LIMITATIONS OF THE STUDY
This study has two potential limitations. Firstly, the model of this study is based on the Jordanian context. It takes into consideration the Jordanian environment, laws and the nature of the governmental regulating bodies of the Jordanian capital market. Therefore, caution must be exercised when considering the practical applicability of this model in other countries. Secondly, while the proposed model was supported by a literature review and analysis of related articles, the study could be further enhanced and expanded by surveying the perceptions of audit committee members, auditors, directors and governmental regulating bodies. This may result in more robust and practical implementations of the proposed model.

REFERENCES


