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**The Oversight Responsibilities of Audit Committees:
The Problems Facing the Development of Audit Committees in Egypt**

By

Mohamed Moustafa Youssef Soliman

A thesis submitted to the University of Durham

for the Degree of Doctor of Philosophy

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Durham University – Business School

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2003



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Declaration

I hereby declare that the material contained in this thesis has not been previously submitted for a degree in this or any other university. I further declare that this thesis is solely based on my own research.

Mohamed M. Y. Soliman

Dedication

This is dedicated in loving memory of my parents, may allah bless their souls and with love and affection to my brother Mahmoued, without whose support this thesis would not have been possible.

بِسْمِ اللَّهِ الرَّحْمَنِ الرَّحِيمِ

The Oversight Responsibilities of Audit Committees:

The Problems Facing the Development of Audit Committees in Egypt

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Glossary of Abbreviations

AICPA	American Institute of Certificate Public Accountants
APB	Auditing Practices Board
BRC	Blue Ribbon Committee
BRT	Business Roundtable
CASE	Cairo & Alexandria Stock Exchange
CMA	Capital Market Authority
CIPE	Centre for International Private Enterprise
FRC	Financial Reporting Counsel
ISB	Independence Standards Board
IIA	Institute of Internal Auditors
NACD	National Association of Corporate Directors
NASD	National Association of Securities Dealers
NYSE	New York Stock Exchange
OECD	Organization for Economic Co-operation and Development
PCSU	Privatisation Coordination Support Unit
POB	Public Oversight Board
SEC	Securities and Exchange Commission

The Oversight Responsibilities of Audit Committees:

The Problems Facing the Development of Audit Committees in Egypt

Abstract

An increasing number of earnings restatements by publicly traded companies in the USA coupled with allegations of financial statement fraud and lack of responsible corporate governance have sharpened the ever increasing attention on corporate governance in general and the audit committee in particular. Over the past three decades, the value of audit committees as a means of enhancing external financial reporting and ensuring the independence of external auditors has been recognised and these committees have become widely established in many parts of the world. In Egypt, the implementation of an economic reform programme has resulted in an active effort by people in authority and those who work in accounting and the auditing profession to enhance the quality of financial reporting which is considered to be one of the factors necessary to increase the effectiveness of economic performance in Egypt. Through these efforts, evolved the idea of implementing audit committees in Egyptian firms.

In this study, old institutional economics is the underpinning methodology. It was selected on the grounds that it has the ability to offer a better understanding of the comparative audit committee practices in Egypt, the USA, and the UK. Also, it is used to explain the interplay between the institutions and actions in the economy, society, and culture which cover the problem of the transference of Anglo Saxon management and accounting theories and concepts such as audit committees to developing countries, such as Egypt. Old institutional economics aims to explain that, the transference between cultures is possible, but the process of transference has to be culturally sensitive.

This study aims to measure audit committees effectiveness in order to have indicators about its oversight responsibilities in general and its development in Egypt in particular. The study involves both theoretical and empirical analysis. It begins with a review of the available literature which provides a basis for constructing the framework of this study. Survey and case study methodologies were the main instruments for the empirical investigation. The surveys were used to gather data from the UK and Egyptian audit committee member samples in order to examine audit committee oversight responsibilities from the internal perspective of audit committee members in both countries to draw comparison with the DeZoort (1997) study in the USA. Scenarios were developed regarding the oversight responsibilities of audit committees on the basis of, literature, CPA professional examinations, current recommendations in the USA, and the UK, and current issues which faced the public banking sector in Egypt. These were used to gather data from audit committee members in the public banking sector in Egypt in order to measure the effectiveness of audit committees and examine the effect of audit committee members' independence and experience on audit committee effectiveness.

In this study, the effectiveness of the audit committee is measured, in particular, on the extent to which audit committee members carry out their oversight responsibilities regarding financial reporting, external auditing, and internal auditing. The results, in general, assert the low effectiveness of audit committee members in carrying out their oversight responsibilities. In this case, the results highlight the important role of the audit committee charter which define the committee's oversight responsibilities. Also, the results indicate that audit committee effectiveness is significantly and positively related to the independence and experience of audit committee members.

Chapter One- Context of the Study: An Overview

Overview of the Problem

1-1. Background

The separation of owners and managers creates the need for corporate governance, which comprises mechanisms that ensure efficient decision-making and maximise the value of the firm (Vinten and Lee 1993). Moreover, through the expansion of capital markets in the 1990s, the increasing numbers of companies listed, and the globalization of investors, there is a growing need for good corporate governance mechanisms, as the separation of ownership and control increases (Cuervo 2002). Corporate governance is not a new issue. It may be traced back to when incorporation with limited liability became available in the nineteenth century, and with it the need for legislation and regulation (Vinten 1998).

Recently, the rising numbers of accounting scandals and cases of mismanagement by top level senior executives in major USA and UK companies are often found to be the consequences of unacceptable corporate governance practices (Demirag and Solomon 2003). The current legislation in the USA and the recent meeting of European Union (EU) ministers to deal with this issue, illustrate the urgency of corporate governance issues on the worldwide platform. There seems to be a common realization that increased corporate transparency and greater accountability to shareholders are essential requirements for improving business worldwide. The Enron and WorldCom accounting scandals have cast the spotlight on an urgent need for corporate governance reform across the globe (Hussain and Mallin 2002). At the individual country level, numerous codes of practice have been developed, with governments worldwide recognizing the need for corporate governance reform in order to improve their country's competitiveness and ability to attract international capital (Demirag and Solomon 2003). The other side of the same coin is that institutional investors, who can invest anywhere in the world, will look to place their funds where standards of disclosure, timely, accurate financial

reporting, and equal treatment of all shareholders are met (Cadbury 2002). As the World Bank Report (1999) states: “what makes corporate governance increasingly important in today’s global market is the demand from growing businesses for external domestic and international capital in quantities and ways which would have been inconceivable just a decade ago”.

In the USA, in response to recent financial collapses, the government passed the Sarbanes-Oxley Act (2002) which aims to protect investors by improving the accuracy and reliability of corporate disclosures and reforming corporate governance practices. A significant part of the Act provides for tighter regulation of the accounting profession and of auditing and financial reporting functions. It is clear that by introducing the Act, the USA Government hopes that company directors as well as major accounting and auditing firms will be deterred from fraudulent and corrupt practices in the future by means of stricter regulation and heavier penalties.

As regards Europe, the EU finance ministers called a special meeting in April 2002 to review the impact of Enron and formulate their reaction to the events. Their focus was on the role of non-executive directors and members of supervisory boards, management remuneration, and responsibility for financial reporting and auditing practices. Auditor independence and reducing conflicts of interest were areas that received primary attention (Demirag and Solomon 2003). Other major issues are possible mandatory disclosure of corporate governance practices, improvements in shareholders’ rights and continued convergence of corporate governance codes of practice in EU Member States (European Shadow Financial Regulatory Committee 2002). Although stricter regulation is being considered, the EU is more likely to adopt a voluntary framework. There is a clear recognition within EU countries that sound corporate governance cannot move forward with either completely free markets or

with prescriptive regulation: the right balance needs to be achieved in order to create a spirit of transparency and accountability rather than compliance with form alone (Van Hulle 2002).

1-1-1. Introducing Non-executive Directors

Boards consist of two types of director, executive and non-executive. Executive directors are responsible for the day-to-day management of the company. They have direct responsibility for aspects of the business such as finance and marketing. They also help to formulate and implement corporate strategy. Their key strengths are that they bring specialized expertise and a wealth of knowledge to the business. They are full-time employees of the company and should have clearly defined roles and responsibilities (Vinten and Lee 1993). However, given that the executive directors are subordinates of the CEO, they are not in a strong position either to monitor or discipline the CEO (Daily and Dalton 1993). It is therefore important that there is a mechanism to monitor the actions of the CEO and executive directors and to ensure that they pursue shareholder interests (Weir and Laing 2001).

It is a common practice to have outside, non-executive directors on the boards of companies. Legally and commercially this is seen as an important guarantee of the integrity and accountability of companies (Dare 1998). It is assumed the interests of those who invest in a company or do business with it, will be safeguarded by the presence on the board of those who can exercise independent judgment. Also, non-executive directors are often considered to bring valuable external business experience which can contribute to the strategic success of a company (Clarke 1998). In defining non-executive directors, Laing and Weir (1999) explained that:

“Non-executive directors are outside directors who monitor the decisions made by the executive directors. They are part time, whereas executive directors are full time employees of the company. As with executive directors, non-executive directors are

eligible to vote at board meetings. They can therefore oppose plans which they believe will be against the interests of shareholders. Non-executive directors may also attempt to remove some of the executive directors after a period of poor performance. Many non-executive directors are also executive directors of other public companies. It is therefore in their interests to ensure that all decisions reflect shareholder interests so that no damage is done to their reputation”.

In the UK four major reports on corporate governance have added weight to the significance and authority of the role of non-executive directors. *The Cadbury Committee* (1992) was commissioned by the Stock Exchange in response to a spate of company failures in the aftermath of the 1980s boom, collapses in which it was clear that boards of directors were not fully in control, or even aware of what was happening to the companies they were accountable for. Given the reluctance to consider continental style two-tier boards, and the unwillingness to admit further statutory regulation, the solution to achieving higher standards of monitoring and accountability was to strengthen the numbers and powers of non-executive directors. *The Greenbury Report* (1995) was instigated as a result of public disquiet about the unprecedented pay increases which senior executives in the privatized utilities paid to themselves which appeared unrelated either to their personal experience and calibre, or to any corporate performance improvement which they could claim to have inspired. Among the recommendations Greenbury offered was the introduction of remuneration committees, composed entirely of non-executive directors, ensuring executives could no longer directly influence the settlement of their own pay awards. *The Hampel Report* (1998) was instructed by the Financial Reporting Council (FRC) to review the implementation of the Cadbury and Greenbury codes of practice, and to inquire into how to promote higher standards of corporate governance in the interests of investor protection and the standing of companies listed on the Stock Exchange. Hampel further confirmed and developed the responsibilities of non-executive directors, recommending that non-executives should make up at least one-third of

the membership of boards, that a leading non-executive director should be identified, even when the roles of chairman and chief executive are separate, and that nomination, remuneration and audit committees should be composed largely of independent non-executive directors. The *Higgs Report* (2003) sets out a determined and realistic agenda for change, building on the existing framework of UK corporate governance. The report envisages a more demanding and important role for non-executive directors. The review focuses directly on the effectiveness of non-executive directors in promoting company performance as well as on issues of accountability. The report's recommendations aim to increase transparency in the appointment process to foster meritocracy and widen the spread of experience in UK boardrooms.

1-1-2. Non-Executive Directors and Company Performance

The Cadbury Committee (1992) recommended that there should be at least three non-executive directors on the boards of quoted companies. This should enable non-executive directors to exercise independent influence over board decisions. It is expected that non-executive directors will be effective monitors of the executive directors and thus the proportion of non-executives on a board should be positively related to performance. Ezzamel and Watson (1993), and Pearce and Zhara (1992) found a positive relationship between the proportion of non-executive directors on the board and performance. Also, Dare (1998) argued that non-executive directors are effective monitors when they question company strategy and ask awkward questions. In addition, they are able to provide independent judgement when dealing with the executive directors in areas such as pay awards, executive director appointments and dismissals.

Weir and Laing (2001) explained that effective monitoring requires that non-executive directors are independent of the executive directors on the board. If non-executive directors were effective monitors, their effectiveness would increase in line with their board representation and should result in improved corporate performance.

A more general consequence of the Cadbury Committee (1992) was that it drew attention to the importance of the role of non-executive directors on boards and strengthened their position in the corporate structure through recommending the establishment of audit and remuneration committees. These committees were to be wholly made up of non-executive directors. This meant that the directors on them were involved in the affairs of the company beyond their attendance at the board meetings and that they worked with senior managers as well as with executive directors (Cadbury 2002). In this way, non-executive directors assist the board to achieve effective management and leadership, and to ensure high standards of financial probity through observation of the internal control system and audits (Treadway Commission 1987, Cadbury Committee 1992, and Blue Ribbon Committee 1999). The establishment of an audit committee provides a platform on which the non-executive directors can perform their duties (Vinten and Lee 1993).

1-2: The Rise of Audit Committees

The rise of audit committees is an international phenomenon. Since 1978, the New York Stock Exchange (NYSE) has required all listed companies to have audit committees made up solely of independent non-executive directors. The Treadway Commission (1987) concluded that audit committees played a crucial role in ensuring the integrity of USA corporate financial reporting. Even where they may have been formed mainly to meet listing requirements, rather than from conviction, American experience has shown that audit

committees soon proved their worth and developed into essential committees of the board (Cadbury 2002). Since 1999, audit committees have been dealing with changes brought about by the reforms resulting from the report and recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (BRC 1999). Also, in contrast to the current environment of reforms, the Sarbanes-Oxley Act of 2002, and the proposals of the New York Stock Exchange (NYSE) and National Associations of Securities Dealers (NASD) represent some of the most sweeping changes and regulations ever to address audit committees' oversight responsibilities. In January 2003, the Securities and Exchange Commission (SEC) proposed new rules regarding audit committee requirements as a consequence of the Sarbanes-Oxley Act.

In the UK, although audit committees are not mandatory, there is effectively a requirement for listed companies to have them because the London Stock Exchange requires UK listed companies to prepare a statement in their annual report of compliance with Cadbury Committee (1992) and to give details of any non-compliance. The Cadbury Committee recognized the important role, which the audit committee can play, and recommended that all listed UK companies form audit committees which should be made up of at least three non-executive directors, the majority of whom should be independent. The audit committee's role in the UK has been expanded following the recommendations of the Turnbull Report (1999) of the need to carry out an annual review of the effectiveness of the internal control system. Recently, following the corporate failures in the USA, the Financial Review Council (FRC) was asked to set up an independent group to clarify the role and responsibilities of audit committees and develop a 'Combined Code' of guidance. This group, under the chairmanship of Sir Robert Smith, published its report in January 2003. The report also proposed significant

changes to the 'Combined Code' for audit committees' oversight responsibilities related to the financial reporting processes, auditing, and internal control.

In Egypt, increasing attention has been paid to audit committees by both regulatory authorities and academics because the role of such committees has become a key element in corporate governance practice. As a result, in 2000, the Central Bank of Egypt (CBE), which is considered a supervisor for all Egyptian banks, required all public banks to establish audit committees as sub-committees of the main board of directors, charged with specific responsibilities relating to the monitoring of, financial reporting, external auditors, and internal control including the internal auditing function. In June 2002 the Capital Market Authority (CMA) issued statement No.30 article No.7, to the listed companies in the Cairo & Alexandria Stock Exchange (CASE) requiring them to have an audit committee. The Board of Directors should, from its members, appoint the audit committee members and the audit committee should comprise at least three non-executive directors, each of whom should be diligent and have good experience of the company's business environment. The audit committee should carry out its duties independently from company management and present monthly reports to the Board of Directors including its suggestions and recommendations.

1-2-1. Defining the Concept

The term audit committee is often not defined on the grounds that the form and composition of the committee may legitimately vary from company to company and that there is a consensus on what an audit committee is (Collier 1994). However for the purposes of clarity of this study it is essential to develop a definition.

Parker (1992) defined an audit committee as “A committee appointed by a company as a liaison between the Board of Directors and the external auditors. The committee normally has a majority of non-executive directors and is expected to view the company’s affairs in a detached and dispassionate manner”.

Collier (1994) defined an audit committee as “An audit committee is deemed to exist if there is a sub-committee of the board which has a membership limited to non-executive directors or at least has a majority of non-executive directors each of whom is independent and financially literate. The responsibilities of the committee must include all of the following: the review of the annual financial statements; the review of accounting principles and practice; meeting the external auditors and discussing their audit of the financial statements; and assessing the adequacy of financial control systems”.

The Sarbanes-Oxley Act. (2002 sec.2) defined an audit committee as “A committee established by and amongst the Board of Directors of an issuer for the purpose of overseeing (1) the accounting and financial reporting processes of the issuer: and (2) audits of the financial statements of the issuer”.

A review of the above definitions of the audit committee shows audit committees are defined by reference to their composition and function .The three features most commonly cited are: a sub-committee of the board, composed exclusively of non –executive directors each of whom is independent and financially literate, and its oversight responsibilities for the review of financial reporting and assessment of the adequacy of financial internal control systems, and the review of external and internal auditing functions. The above characteristics were used to give the following definition of an audit committee for this study.

“An audit committee is a sub-committee of the Board of Directors which has a membership limited to non-executive directors, each of whom is independent and financially literate. The committee is charged with providing oversight of financial reporting and auditing processes”

This definition corresponds closely with the current recommendations and requirements of regulatory and professional committees, such as the Blue Ribbon Committee (BRC 1999), the USA Sarbanes-Oxley Act (2002), and the UK Smith Report (2003).

1-2-2. Research into the Effectiveness of Audit Committees

The issue of corporate governance has brought audit committees under the spotlight. An effective audit committee can be seen as enhancing the corporate governance practices of the company (Carson 2002). The issue of audit committee effectiveness has been a subject of considerable research, which so far has failed to reach definitive conclusions (Pomeranz 1997). Along these lines, Kalbers and Fogarty (1993) stated that “little empirical research has been conducted to investigate the effectiveness of audit committees and conclude that the evidence collected to date is weak”. Also, DeZoort et al. (2003) argued that despite the audit committee’s important role, both the professional and academic literature raise questions about audit committee effectiveness. However, some research into audit committee effectiveness has been undertaken as discussed below.

Knapp (1987) examined audit committee effectiveness in an experimental framework in terms of whether the audit committee sides with the auditors in a dispute and found that the

composition of the audit committee was important in determining audit committee effectiveness.

Kalbers and Fogarty (1993) evaluated audit committee effectiveness in terms of the power of its members. A questionnaire was used to measure power and audit committee effectiveness variables. The results showed that audit committee effectiveness is highly associated with referent power (power derived from the personal qualities of the audit committee members), expert power (level of knowledge of accounting, auditing, and financial controls of the audit committee member), information power (level of knowledge of the company and industry possessed by audit committee members), and diligence (preparation, commitment, vigilance, independence, and level of activity of audit committee members in carrying out their duties). There was also a strong link between effectiveness and “sanctionary power”, in terms of the degree of responsibility given to the audit committee to determine the activities of internal and external auditors and the resources devoted to these internal and external auditors.

In the UK, Collier and Gregory (1996) examined audit committee effectiveness in an experimental study in terms of whether audit committees are effective in ensuring audit quality by protecting the auditors from fee cuts which might affect audit quality, and signal tighter internal controls which help to reduce audit time and hence audit fees. The results showed that the audit committee is effective in its role of overseeing the external audit and ensuring that the scope of the audit is adequate, but that there is no conclusive evidence to suggest that it is effective in engendering a stronger internal control environment that is reflected in audit fees.

Rezaee (1997) discusses a questionnaire survey designed to establish the nature of audit committee activity, including its effectiveness. Rezaee states that “ the effectiveness of the audit committee’s involvement in corporate governance depends on the availability of resources and the degree to which audit committee members are independent of management”, but there is no discussion of the meaning of effectiveness, resources, or independence.

Spira (1998) examines the effectiveness of audit committees over time, finding that audit committees tend to mature by becoming more active in their involvement in the governance of the company. This is subject to the influence of various catalysts in the life and evolution of the audit committee.

Although these studies focus on important areas affecting audit committee effectiveness, the purpose of audit committee activity is not clearly defined and the criteria used to evaluate effectiveness often exhibit the confusion (Spira 1998). Also, these studies did not recognize the distinction between effectiveness and the factors which enable committees to be effective (Kalbers and Fogarty 1993).

Audit committee effectiveness has been defined as the committee’s ability to satisfy fully its oversight responsibilities (DeZoort 1998 and Rittenberg and Nair 1993). Overseeing the financial reporting process and the internal control structure is a critical part of that oversight responsibility. The audit committee, with the assistance of the internal and external auditors, is responsible for ensuring that the financial disclosures made by management are complete and accurate. The audit committee has been charged with reviewing the scope of the external audit, ensuring there is proper communication and coordination between the internal and

external auditors, reviewing the appropriateness of the accounting methods and estimates used in the preparation of the statements, and approving the quarterly and annual financial statements before they are issued to the public (Treadway Commission 1987, Cadbury Committee 1992, BRC 1999, Sarbanes-Oxley Act 2002, and Smith Report 2003). In this study, audit committee oversight responsibilities are used as tools to examine the effectiveness of audit committees in the public banking sector in Egypt. In addition, the study examined the effect of audit committee members' independence and experience on audit committee effectiveness.

1-2-3. Benefits of having an Audit Committees

One major motivation for companies to establish audit committees would derive from the benefits they bring. The Cadbury Committee (1992) suggested that audit committees can provide a range of benefits provided they are effective in carrying out their functions. The benefits which might encourage the establishment of audit committees can be summarized from the viewpoint of the parties involved.

The Board of Directors

The audit committee could assist directors in meeting their statutory and fiduciary responsibilities, especially as regards accounting records, annual accounts and the audit (Collier 1994). Further, the audit committee should improve communication between the board and the external auditors. Menon and Williams (1994) explained that there are two potential monitoring advantages to be gained from assigning these board oversight responsibilities. Firstly, the independence and integrity of monitoring may be enhanced by having internal and external auditors report to a subset of the board which consists of outside

directors. Secondly, board committees could help improve the efficiency of board functioning.

The External Auditors

Recent criticism of the external audit function has spurred standard-setting bodies to adopt several measures to strengthen the effectiveness of the independent auditor's role. Many of these new rules and regulations mandate greater involvement of the audit committees in the audit process (Knapp 1991). The Auditing Standards Board issued several Statements on Auditing Standards (SASs) regarding audit committees' relationship with external auditors. SAS Nos. 53 and 54, *The Auditor's Responsibility to Detect and Report Errors and Irregularities and Illegal Acts by Clients*, respectively require auditors to notify the audit committee of any suspected fraud or illegal acts; SAS No.60, *Communication of Internal Control Structure Related Matters Noted in an Audit*, requires auditors to report a broader set of internal control deficiencies to the audit committee than required previously; and SAS No.61, *Communication With Audit Committee*, requires the auditors to disclose certain potential and unresolved matters pertaining to the audit committee. Also SAS No.71, *Interim Financial Information*, requires the auditors to communicate certain matters to the audit committee, as they relate to interim financial information before the company files its form 10-Q and preferably before it publicly announces its financial results. In 1999, The Auditing Standard Board (ASB) issued SAS No.90, *Audit Committee Communication*, which requires the auditors to discuss with the company's audit committee his or her judgement about the quality, not just the acceptability, of the accounting principles applied in the company's financial reports (American Institute of CPA's 2000). The Independent Standards Board (ISB) in the USA (1999) adopted *Independence Standard No.1, Independence Discussions with Audit Committees*. This standard recommends that auditors communicate in writing with the

audit committee matters likely to influence audit independence. The Blue Ribbon Committee (BRC 1999) recommends that audit committee charters specify that “the outside auditor is ultimately accountable to the board of directors and the audit committee, which have the ultimate authority and responsibility to select, evaluate, and, where appropriate, replace the outside auditor”. It is contended that reporting to an audit committee will enhance the external auditor’s independent position since the external auditors can communicate directly with those directors who are not activity engaged in the management of the company (Collier 1994). An independent audit committee reinforces the independence of the corporation’s external auditor, and thereby helps assure that the auditor will have a ‘free rein’ in the audit process (Deli and Gillan 2000).

The Internal Auditors

The presence of the audit committee often enables the internal auditor to gain a useful higher profile. The very fact that internal auditors meet with the committee and report to it their activities, helps the auditors to gain serious recognition and greater co-operation from management (Vinten and Lee 1993). Also, an audit committee provides the opportunity for internal auditors to report to board members and thus improve communication between the board and the internal audit function (Collier 1994). As with external auditors, reporting to an audit committee should enhance the independence of internal auditors. Through concern for internal auditor independence, the Treadway Commission (1987) discouraged the situation where the internal audit function reports to the senior officer directly responsible for preparing the accounts. Instead it suggests that internal auditors report to the chief executive officer and in many companies there is a dual reporting responsibility to the chief executive and the audit committee. Miller (1988) opines that “the best liability insurance coverage a corporate board can have is an effective internal audit department” and argues that the audit committee is

crucial in determining the effectiveness of the internal audit department as it ensures the independence of the function and reviews the scope, results and quality of its work. When examining the relationship between audit committees and the internal auditor, Scarbrough et al. (1998) found that audit committees consisting of non-executive directors were more likely to be supportive of the role of the internal audit by having frequent meetings with the chief internal auditor, and reviewing the internal audit programme and the results of internal audit work.

The Investors and Other Users of Financial Reports

The Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (BRC 1999) highlighted the importance of audit committees for investors when it stated: “the Committee believes audit committees will be more active in helping to ensure the transparency and integrity of financial reporting and, thereby, maintain the investor confidence that makes our securities markets the deepest and most liquid in the world”. Collier (1994) argued that the existence of an audit committee increases the credibility and objectivity of financial reports by demonstrating the board’s intention to give due weight to reviewing external reporting, auditing, internal controls and other related matters. This argument presupposes the audit committee actually carries out its responsibilities.

1-2-4. Disadvantages of Audit Committees

A review of the literature suggests that the support for audit committees is based upon anecdotal information of their effectiveness rather than objective evidence. Archambeault and DeZoort (2001) explained that, the existence of an audit committee does not ensure monitoring effectiveness. Also, the Treadway Commission (1987), highlighted this problem when it noted 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. Wild (1994) stated that security exchanges and government agencies are concerned with the lack of uniformity in the specific duties and responsibilities assigned to these committees and, therefore, have exhibited a historic reluctance to mandate their existence. At the same time, audit committees are under increasing pressure to accept additional oversight responsibilities. Sommer (1991) points out that the establishment of an audit committee does not necessarily mean that it will be effective in providing the benefits of improved financial reporting and auditing, and states that ‘there is considerable anecdotal evidence that many, if not most, audit committees fall short of doing what are generally perceived as being their duties’. Menon and Williams (1994) support this contention with findings showing that companies, which had nominally formed an audit committee were often reluctant to rely upon it. They concluded that audit committees ‘are often created for the purposes of appearance rather than to enhance stockholders’ control of management’. As noted by Rutteman (1993) “many companies already have audit committees, but the quality and effectiveness of such committees is variable”. One situation in which audit committees may be formed, without regard for quality or effectiveness, is in a highly litigious environment where the mere existence of an audit committee could be used as evidence that directors took due care in performing their duties. Further evidence to suggest that audit committees may be ineffective monitoring mechanisms is provided by Beasley (1996) He found that the composition of the board itself is more effective than the presence of an audit committee in reducing the likelihood of financial statement fraud. Also, along these lines, Carcello et al. (2002) argued that in the wake of Enron and other financial reporting problems, it is important to distinguish between audit committees that function only on paper and those that effectively oversee financial reporting and controls.

1-3. Public Banking Sector in Egypt

Similar to many emerging market economies, Egypt undertook banking sector reforms in the 1990s aimed at moving towards a more liberal system. The new policy environment necessitated refining the methods used in monitoring risks with the emphasis on prudent bank regulation. Banks operating in Egypt can be classified as public sector, private, joint venture, or foreign according to ownership. In the public sector, there are four commercial banks whose volume of business constitutes a significant share in total bank transactions through large branch networks and a close relationship with state-owned companies. They are also major participants in the equity capital of most joint-venture banks. Recently, in an attempt to reduce market concentration and enhance competition, the authorities outlined plans to privatize the four public sector commercial banks (Abdel Shahid 2001).

In Egypt, the Central Bank is the regulator. The Central Bank of Egypt (CBE) is responsible for regulating and managing the banking and monetary system, and acts as the “bankers’ bank” dealing with the daily settlements of clearings. The CBE is also the supervisory authority for deposit-taking banks, with wide powers vested in it by the banking law. Prior to the reforms of the 1990s, the banking sector was heavily regulated through credit controls and portfolio restrictions (El-Mikawy and Handoussa 2002).

On the market transparency front, public disclosure of financial information was generally poor. Before the fiscal year of 1998, banks used to publish their financial statements only at the end of the fiscal year. Meanwhile, the income statements of the four public banks were exceedingly brief with only a couple of lines on revenues and expenditures, which did not show the amount of provisions (Sami 2000). The World Bank Report (1994) argued that “the adoption of uniform accounting and auditing standards and practices besides sharp

improvement in financial disclosure was much needed". Progress on this front was necessary: (a) for the regulatory staff to make policy recommendations and address problems on a sound basis, and (b) to improve corporate governance in banks. In response, the CBE took a decision in 1997 mandating all banks to adopt International Accounting Standards when preparing their financial statements to ensure more frequent disclosure and improve the transparency of the banking sector. From the fiscal year 1998, the banks are mandated to prepare quarterly statements on their financial position as well as profit /loss accounts, and to publish these in widely circulated newspapers. The end-of-year statements must include detailed information while the statements of the preceding three quarters may be brief.

The stability of the banking industry cannot be achieved, however, without enterprise reform. Loan losses are incurred through the failure of bank borrowers to complete their contracts because of bad policies, ineffective management, or weak institutional frameworks (Abdel Shahid 2001). In this regard, improving the accounting and disclosure systems and the legal infrastructure are crucial for information gathering and enforcing debt contracts. The availability of reliable and comprehensive information about firms, and the ability of the legal system to enforce contracts rapidly, effectively, and transparently will add to the banking systems' capacity for financial intermediation. Accounting standards that produce comparable corporate financial statements make it easier for banks to assess the creditworthiness of borrowing firms and to evaluate their management.

With the changing landscape of banking services in the emerging free-market economy, regulators look to the bank's Board of Directors as being ultimately responsible for the control of the bank's directions. These changes have caused the role of the audit committee to become more diverse. Regulators believe that, as one of the most important board

committees, the audit committee can assist in monitoring compliance with board policies and applicable laws and regulations, in ensuring comprehensive audit coverage by both internal and external auditors, and in overseeing the external financial reporting process.

1-4. The Objectives of the Study

This study concentrates on the public banking sector in Egypt. The aim is to measure the effectiveness of audit committees in order to have indicators about its oversight responsibilities in general and in particular its development in Egypt. To achieve this goal, the research has the following objectives:

1. To investigate the differences in audit committee members' perception of their oversight responsibilities between the USA, the UK, and Egypt.
2. To explore in detail and provide measurements of the effectiveness of audit committees in the public banking sector in Egypt.
3. To assess the relationship between the independence of audit committee members and the effectiveness of audit committees in the public banking sector in Egypt.
4. To assess the relationship between the experience of audit committee members and the effectiveness of audit committees in the public banking sector in Egypt.
5. To investigate the obstacles which face the audit committees in the public banking sector in Egypt and their effect on audit committee effectiveness.

1-5. Reasons for Choosing the Topic

The implementation of an economic reform programme in Egypt has resulted in an active effort by people in authority and those who work in accounting and auditing to enhance the quality of financial reporting which is considered to be one of the necessary factors to underpin the effectiveness of economic performance. Through these efforts, evolved the idea

of implementing audit committees in Egyptian firms. Recently, Egypt implemented the audit committee concept in the banking sector to enhance the credibility of financial reports and strengthen communication among directors, auditors, and management, which, it is hoped, will enhance the quality of auditing and financial reporting. In June 2002 the Capital Market Authority (CMA) issued a statement No.30 to the listed companies in the Cairo & Alexandria Stock Exchange (CASE) requiring them to have audit committees. These current requirements evidence the expectation of the important role for audit committees in improving the quality of financial reporting in Egypt.

The reasons for selecting this topic can be summarized as follows:

1. The view that western management theories and concepts are as applicable in developing countries as they are in the UK and USA has been subject to much critical comment.
2. The Egyptian environment, especially with regard to board structure, litigation, and institutions in general, may well be different from those countries which applied the audit committee concept some time ago and designed its oversight responsibilities.
3. In order to improve the audit committee practices in Egypt, there is a need to examine existing effectiveness and investigate any obstacles that may exist in the systems in order to suggest ways for improvement.

1-6. The Research Questions

The wording of the research questions determines the focus and scope of the study (Denzin and Lincoln 1994). Thus, to achieve the main research objectives, five research questions were formulated as focus for this research. They are as follows:

1. Is there a difference in audit committee members' perception of their oversight responsibilities between the USA, the UK, and Egypt?

2. How effective are audit committees in the public banking sector in Egypt, particularly, the extent to which audit committee members carry out their oversight responsibilities?
3. What is the nature of the relationship between the independence of audit committee members and the effectiveness of audit committees?
4. What is the nature of the relationship between the experience of audit committee members and the effectiveness of audit committees?
5. How can the effectiveness of audit committees in Egypt be improved?

1-7. Methodology

To achieve the research objectives and answer the consequent questions, old institutional economic theory is used to provide the underpinning theoretical framework for this study. It was selected on the grounds that it has the ability to offer a better understanding of audit committee practices in Egypt in comparison with the USA and the UK. The choice of the institutional framework followed a detailed examination of new institutional sociology (NIS), new institutional economics (NIE), old institutional economics (OIE), and the socio-economic factors surrounding the development and functioning of audit committee practice as a corporate governance tool in Egypt.

Old institutional economics has been used to explain the interplay between institutions and actions in the economy, society, and culture which also deals with the issues of the transference of western management theories and concepts (eg. audit committees) from western countries to developing countries (eg. Egypt). Old institutional economics aims to explain that transference between cultures is possible, but the process of transference has to be culturally sensitive. The selection of the old institutional economics approach requires a detailed examination of the institutional foundations of audit committee practices in Egypt in

comparison with the USA and the UK experiences. Thus, corporate governance practices in Egypt are explained, as is the social construction of the audit profession and the expectations gap. To place these issues in context, a comparison between the legal framework for audit committees in the USA, the UK, and Egypt is also explained in detailed.

Dittenhofer (2001) defined effectiveness as “the achievement of goals and objectives using the factor measures provided for determining such achievement” and Stevenson (2002) explained that institutional economics is about, in part, problem solving. Problem solving is a purposeful activity involving establishing frames for recognition, processes of remediation, and objectives for resolution, all of which are value-based undertakings. Therefore, in this study, the effectiveness of the audit committees is measured by, particularly, the extent to which audit committee members carry out their oversight responsibilities regarding financial reporting, external auditing, and internal auditing in order to improve audit committee practices in Egypt.

To collect the above information the study involves both theoretical and empirical analysis. The study begins with a review of the available literature concerning all the above matters which provides a basis for constructing a framework. Survey and case study scenarios were the main instruments for the empirical investigation. The survey was used to gather data from the UK and Egyptian audit committee member samples in order to examine audit committee oversight responsibilities from the internal perspective of the UK and Egyptian audit committee members in comparison with the USA DeZoort (1997) study. A case study scenario approach was used to gather data from audit committee members in the public banking sector in Egypt in order to measure the effectiveness of audit committees. The effect

of audit committee members' independence and experience on audit committee effectiveness was examined by using the linear multiple regression model.

1-8. Organisation of the Thesis

The **second chapter** starts by explaining institutional theory and its three broad forms: new institutional economics, new institutional sociology, and old institutional economics. Also this section explains the social construction of risk. The chapter continues by examining the problem of cultural differences in the transference of management theories and concepts such as the audit committee from western countries to developing countries such as Egypt.

Most of the corporate governance and audit committee literature that has grown up over the past two decades is concerned with the analysis of control structures designed to advance and protect the interest of shareholders under various conditions. It has long been recognized that optimal structures depend upon institutional conditions, and the controls may need to change as those conditions change. Thus, the **third chapter** commences by reviewing international corporate governance principles including audit committees based on the principles of the Organization for Economic Co-operation and Development (OECD 1999), the Business Roundtable (BRT 2002), and the National Association of Corporate Directors (NACD 2002). The chapter concludes by giving an institutional perspective of corporate governance practices in Egypt in order to understand the environment which surrounds audit committees practice.

Over the last two decades, the Anglo-Western world has experienced a spate of corporate failures, financial scandals and audit failures which have placed the audit expectation gap debate firmly on the agenda of the accounting profession, regulators and the public

(Humphrey et al. 1993). The **fourth chapter** commences by explaining and defining the expectation gap and the social construction of the audit profession from an institutional economics perspective. This chapter continues by explaining the role of audit committees in narrowing the expectation gap through monitoring the external auditor's independence, pre-approving non-audit services, and demanding a high quality audit.

It is possible that differences in the regulatory environment and the importance assigned to corporate governance, as well as other cultural factors, could significantly influence the nature of the audit committees' relative effectiveness between countries. The **fifth chapter** aims to explain the legal framework for audit committees in Egypt in comparison with the UK and the USA. This chapter commences by illustrating the UK and the USA experience of the audit committee and the requirements for improving its role in both countries. The chapter continues by explaining the comparative legal framework for audit committees in the UK, the USA, and Egypt by over viewing the following factors: audit committee charters, independence and experience of audit committee members, audit committee size, audit committee meetings, resources and authority of the audit committee, audit committee members' training, and audit committee disclosure. That is to say, audit committee effectiveness is viewed as the competency with which the audit committee carries out its specific oversight responsibilities. Audit committee members must be critically aware of their responsibilities; they must also completely understand them. How the responsibilities are carried out may vary, but a failure to address them may be of significant detriment to the audit committee, the board, and most of all shareholders. Thus, the chapter concludes by explaining the legal framework for audit committee oversight responsibilities in the USA, the UK, and in Egypt.

The **sixth chapter** is divided into three sections. The first section starts by explaining the research objectives and questions. This section concludes by explaining why the research uses quantitative methods in the light of an institutional economics framework. The second section aims to describe the survey instrument, which is used to examine the audit committee oversight responsibilities from the internal perspective of the UK and Egyptian audit committee members in comparison with the USA DeZoort (1997) study. This in turn, is used as a basis to assess audit committee members' abilities to recognize their assigned objectives and explore their perceptions of the committees' oversight responsibilities, which in turn is used as a surrogate tool to measure audit committee effectiveness. This section concludes by defining the two study populations, samples, their representativeness, and response rates. The remaining section starts by explaining the case study scenario as a strategy for the quantitative research. This strategy helped the researcher in investigating and understanding the real-life situation facing audit committees in this sector. The section concludes by explaining the administration of the questionnaire and the banking sector's population and response rate.

The **seventh chapter** aims to examine the audit committee oversight responsibility from the perspective of audit committee members in the UK and Egypt in comparison with the USA where DeZoort (1997) undertook a study to assess audit committee members' abilities to recognize their assigned objectives and explore their perceptions of oversight responsibilities. To achieve this target the chapter is divided into three sections. The first section aims to compare the UK audit committee members' responses with the DeZoort (1997) survey results. The second section aims to compare the UK audit committee members' responses with the Egyptian audit committee members' responses. The remaining section aims to provide an overall comparison of the responses of the USA DeZoort (1997), the UK, and the Egyptian surveys.

The **eighth chapter** aims, in particular, to measure audit committee effectiveness in the banking sector in Egypt. Based on the results in chapter seven, audit committee oversight responsibilities, after modification, are used as a tool to examine effectiveness through the extent to which audit committee members carry out their oversight responsibilities. This chapter is divided into three sections. The first section aims to explain how the US and the UK oversight responsibilities for audit committees are modified and adapted in order to fit the Egyptian environment and the nature of the banking sector. The second section aims to examine audit committee effectiveness. The questionnaire that was directed to the audit committee members contained fifteen case studies. Each case study scenario expressed an oversight responsibility by using a case study scenario approach. The case studies provided a generalisable and simple set of circumstances for the audit committee members to consider. Responses were requested to the questions posed on the scenario identifying their oversight responsibilities.

Since the composition of the audit committee has been the focus of many governance reform efforts in the US and the UK, the unanimous view of the proponents of reform is that the audit committee should be composed entirely of outside directors who have sufficient experience in oversight areas related to accounting and auditing. Therefore, the final section examined the effect of audit committee members' independence and experience on audit committee effectiveness, which was measured in previous section.

The **final chapter** explains the research conclusions, and continues by examining the limitations of the research. This chapter concludes with suggested recommendations to the

Capital Market Authority (CMA) in Egypt regarding audit committee composition and oversight responsibilities in order to improve audit committee effectiveness.

Chapter Two: An Institutional Economics Framework

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2-1. Introduction

The purpose of this chapter is to illustrate the importance of looking at social institutions in tracing the development of audit committee practice as a corporate governance tool in Egypt. For this purpose, the chapter starts by explaining institutional theory and its three broad forms: new institutional economics, new institutional sociology, and old institutional economics. The chapter continues by examining the potential impact of cultural differences in the transference of Anglo Saxon management theories and concepts such as corporate governance including audit committees to developing countries such as Egypt.

2-2. An Institutional Theory Framework

There has been an increasing interest in institutional theory in recent years in various areas of the social sciences. Rutherford (1994) explained that institutional economics as a field of knowledge is concerned with studying an economic phenomenon within its entire surrounding environment which includes social, cultural, political, ideological, religious, civilisation, technological factors. Also, Martinez and Dacin (1999) explained that an institutional theory framework is primarily concerned with an organisation's relationship or "fit" with the institutional environment, the effects of social expectations on the organisation and the incorporation of these expectations as reflected in organisational characteristics. The main focus of institutional theory is that an organization's survival requires it to conform to social norms of acceptable behaviour as much as to achieve levels of production efficiency (Hussain and Gunasekaran 2002). In particular, institutional theory extends beyond the focus of contingency theory in an organisational task environment to focus, instead, on its institutional environment. Consequently, it seeks to explain organisation- environment relations from an overarching social viewpoint (Ahmed and Scapens 2000). The theory includes three broad

forms of institutionalism: new institutional economics (NIE), new institutional sociology (NIS), and old institutional economics (OIE). Although these theories have different origins and intellectual roots, they share a concern for institutions and institutional change (Burns and Scapens 2000). Old institutional economics will make the primary contribution to this study.

2-2-1. New Institutional Economics (NIE)

The NIE approach focuses on the analysis of markets and hierarchies as alternative modes of economic organisation, and its main constituent is transaction cost economics. NIE is a vast and relatively new multidisciplinary field that includes aspects of economics, history, sociology, political science, business organization and law (North 2000). This new direction of economics considers that the cost of transacting – determined by institutions and institutional arrangements – is the key to economic performance. It is therefore argued that the institutions of a country – such as its legal, political, and social systems – determine its economic performance, and it is this, according to Coase (2000), that gives the new institutional economics its importance for economists. The purpose of NIE is both to explain the determinants of institutions and their evolution over time, and to evaluate their impact on economic performance, efficiency, and distribution. There are also two-way causality between institutions and economic growth. On the one hand, institutions have a profound influence on economic growth, and on the other, economic growth and development often result in a change in institutions (Nabli and Nugent, 1989). Along these lines, Heldand and Nutzinger (2003) explained that new institutional economics has made a major contribution to the renaissance of institutions in mainstream economics. It analyzes the effects on incentives of various institutional arrangements, in particular the effects of altered institutional specialists. By including institutions' incentives and restrictions, it has made a significant first step toward the ongoing development of economics.

Martinez and Dacin (1999) argued that, while transaction cost economics is useful for explaining organisational actions and outcomes in terms of efficiency maximisation resulting from transaction cost minimisation, it cannot explain all organisational actions and outcomes because efficiency is not the overriding imperative guiding organisational and individual decisions. Also, Ahmed and Scapens (2000) explained that, while this approach seeks to broaden the domain of economic analysis by examining transactions and governance structures internal to the firm, it does not recognise the impact of the broader economic, political and social institutions which can be important in understanding the development of accounting practices. Hodgson (2000) argued that, it is clear that the NIE project is an attempt to explain the emergence of institutions, such as the firm or the state, by reference to a model of rational individual behaviour, tracing out the unintended consequence in terms of human interactions. An initial, institution-free, 'state of nature' is assumed. The explanatory movement is from individuals to institutions, taking individuals as given. According to Khalil (1995) NIE focuses on institutions as constraints, while, in contrast, the main thrust of old institutional economics is the modelling of institutions as determinants of the agent's cognitive ability. Similarly, Hodgson (2000) has argued that "it is a defining characteristic of the NIE that institutions act primarily as constraints upon the behaviour of given individuals".

2-2-2. New Institutional Sociology (NIS)

NIS adopts a broader, multi-dimensional approach for focusing on issues of external and internal organisational contexts (Hill 1999). It has contributed significantly to the understanding of relationships between organisational structures and the wider social environment in which organisations are situated (Hussain and Hoque 2002). NIS also focuses on the process through which organisations and societal agencies initiate and design structures, political and procedural, in order to demonstrate conformity with institutionalised

rules. Scott (1995) argued that the NIS approach, however, also explores broader institutions. Its focus is the processes through which organizations and societal agencies initiate and design structures, policies, and procedures in order to demonstrate conformity with institutionalised rules, values, and expectations. NIS explains the success and survival of firms in terms of the extent to which they encapsulate social values and expectations in their organizational structures and behaviour.

Along these lines, Portes and Sensenbrenner (1993) explained that there is growing need to understand how social structure assists or impedes economic performance. In particular, the competitive advantage of social forms of organization relative to market-based exchange systems, has spawned new conjectures. Central to these conjectures is the 'embeddedness' argument, which offers a potential link between sociological and economic accounts of business behaviour. Crosby and Stephens (1987) explained that embeddedness refers to the process by which social relations shape economic action in ways that some mainstream economic schemes overlook or mis-specify when they assume that social ties affect economic behaviour only minimally or, in some stringent accounts, reduce the efficiency of the price system. Along these lines, Uzzi (1996) argued that although the concept of embeddedness is useful for understanding the sociological failings of standard neoclassical schemes, it does not explain concretely how social ties affect economic outcomes. Also, Ahmed and Scapens (2000) argued that, while this approach focuses on how institutionalised rules, values and expectations influence the firm, it does not explore how the firm shapes the institutionalised rules, values and expectations.

2-2-3. Old Institutional Economics (OIE)

The OIE approach is the most established and oldest of the institutional approaches and has its origins in the work of early American institutionalists. Its main emphasis is on studying economic activities and the production and reproduction of life's day-to-day processes as part of a holistic ongoing process of change (Ahmed and Scapens 2000). Also, this approach makes the 'institution' the unit of economic analysis and provides a potentially useful basis for understanding the institutionalised character of organisational routines and rule-based behaviours, such as accounting and corporate governance. In this approach, human beings, organisations, and the economic system itself are regarded as part of a larger social system (Sugiura 1999). Consequently, understanding the structure and meaning of an economic activity or a social behaviour, such as audit committee practice, requires among other things an understanding of the constituent elements of the social framework.

The OIE has emphasised the importance of studying the role of social institutions in coordinating economic activity. Olsson (2000) explained that, the old institutionalists claim that the individual is a product of his social environment and that "economic man" is not necessarily a universal phenomenon. Rather, economic man is an institution that has emerged from specific historical and social settings. Dequech (2002) asserted that, old institutionalism does not take the individual as given, individuals are affected by their institutional and cultural situations. Institutions are structures comprising sets of rules and procedures that give consistency and patterns of behaviour (Avgerou 2000). Also, Colander (1996) explained that, institutions comprise the organisational routines and ruled-based behaviours which provide the standard operating procedures needed to help economic agents take action and to enable the economic system as a whole to function. Furthermore, Olsson (2000) defines institutions as the rules of human behaviour which act as constraints in economic situations and define

our choice sets and North (1991) explained that, institutions are the human constraints that structure political, economic and social interaction. These consist of both informal constraints (sanctions, taboos, customs, traditions, and codes of conduct), and formal rules (constitutions, laws, and property rights). Institutions provide the incentive structure of an economy; as that structure evolves, it shapes the direction of economic change towards growth, stagnation, or decline. In this way, the framework of rules and institutions prevent some actions and behaviours, and may make others possible.

Burns and Scapens (2000) explained that whilst there is no universal definition of an institution, as discussed above, within OIE a commonly used definition is: a way of thought or action of some prevalence and permanence, which is embedded in the habits of a group or the customs of a people. Also, Burns and Scapens argued that institutions can be regarded as imposing form and social coherence upon human activity, through the production and reproduction of settled habits of thought and actions. However institutions themselves evolve through a process of “routinization” of human activity. Thus, there is a duality between actions (human activity) and the institutions which structure that activity. This duality is essentially the agency-structure relationship which has been widely debated in the social sciences in recent years (Archer 2000). Based on previous discussions, habit, routine, and rule concepts comprise the main lines of argument in old institutional economics (Avgerou 2000, Burns and Scapens 2000, and Dequech 2002) thus, discussing them in more detail may be worthwhile.

Hodgson (1993) defined habits as more or less self-actualizing dispositions or tendencies to engage in previously adopted or acquired forms of actions. However, whereas habits are personal, routines may encompass groups of individuals. In this sense, routines represent the

patterns of thought and action which are habitually adopted by groups of individuals (Burns and Scapens 2000). According to Nelson (1995) routines are the processes through which organizational characters are transmitted through time. Consequently, organizations are typically slow to change as they follow their own routines.

Burns and Scapens (2000) explained that an emphasis on habits and routines does not deny that individuals have reasons for doing things. These reasons will often include following established and accepted rules of behaviour. In this sense, rules can be defined as the formally recognized way in which 'things should be done'. Hodgson (1998) explained that rules are conditional or unconditional patterns of thought or behaviour which can be adopted either consciously or unconsciously by agents. As argued by Scapens (1994), rules are necessary to co-ordinate and give coherence to the actions of groups of individuals. As such, rule-based behaviour may result from an explicit assessment of the available alternatives, and the selected rules followed thereafter in order to avoid the difficulties and costs of undertaking such assessments on every occasion. However, by repeatedly following rules, behaviour may become programmatic and based increasingly on tacit knowledge, which the individual acquires through reflexive monitoring of day-to-day behaviour. Such programmatic rule-based behaviours could be described as routines- as they represent the habits of the group. Here, routines can be defined as the way in which 'things are actually done' (Burns and Scapens 2000). The limitations of human knowledge and the capacity for decision making provide a reason for human reliance on habits and rules (Nau and Steiner 2002). Regarding the relationship between habits and cultures, Stevenson (2002) explained that habits formed through the shaping and shading effects of cultural forces manifesting through social heritage, community sanctioning, and the formal and informal educational processes that mould the

awareness and habits of individuals. Thus, culture both reflects and shapes the knowledge of the collective of individuals.

As argued before, NIE and NIS do not recognize the impact of the broader economics, political, and social institutions which can be important in understanding audit committee practice in Egypt. Also, since this study emphasizes the interplay between institutions and actions in the economy, society, and culture which encapsulate the issues involved in the transference of Anglo Saxon management and accounting theories and concepts such as audit committees to developing countries such as Egypt, these approaches were rejected.

In short, the grounding of this study in the institutional framework, and in the old institutional economics in particular, is mainly because of its suitability and practicality for studying audit committees in Egypt within their intricate societal web. The collected data from pre-field and field studies support such intricacy, and it is concluded that it would be difficult to study audit committee practices within a specific number of institutions, as they are highly influenced and framed by societal institutions in general. Also, old institutional economics (OIE) emphasizes the interplay between institutions and actions in the economy, society, and culture which cover the problem of transference of theories and concepts such as the audit committee from Anglo Saxon to developing countries such as Egypt.

In addition, the selection of an institutional framework has influenced the current and subsequent chapters. For example, in conforming with the institutional framework the current chapter is dedicated to provide a clear picture of the social constructions of risk, and the role of culture differences in the applicability of Anglo Saxon management and accounting theories and practices in Egypt. Also, beside the treatment of rules and routines as the carriers

of organisational memory, Scapens (1994) reported that they can be regarded as a basis for the evolution of organisational behaviour. He also argued that evolution is not the creation of optimal behaviour, but merely the production (and possible adaptation) of behaviour through time. Regarding audit committees, Green (1994) explained that the role of the audit committee is constantly evolving, and as a result of recommendations by the accounting profession and regulators and pressure from the financial press, investors, and academics, the rules and expectations surrounding the practice of financial reporting are in a constant state of flux. Often, these changes are precipitated by a “crisis” such as the collapse of a financial institution or the bankruptcy of a large corporation. The resulting changes, then, can be seen as an attempt to protect the public from inadequate financial statement disclosure and improve audit standards.

Thus, history, as the background to current practice, is essential within old institutional analysis. For this reason, in the next chapter, some aspects of the historical development of corporate governance and audit committee practice in light of the transition process from a command to a market based economy in Egypt, are discussed in detail.

As will be seen, the subsequent chapters are also influenced by the institutional framework. For example, chapter four aims to explain the social construction of the audit profession, the expectations gap, and the role of audit committees in narrowing this gap. Chapter five aims to explain the legal framework for audit committees in Egypt in the light of the framework adopted in the UK and the USA. The chapter commences by illustrating the UK and USA experience of the audit committee and the enforcement practices used for improving its role in both countries. Stevenson (2002) explained that institutional economics is about, in part, problem solving. Problem solving is a purposeful activity involving establishing frames for

recognition, processes of remediation, and objectives for resolution, all of which are value-based undertakings. Therefore, in chapter eight of this study, the effectiveness of the audit committee is measured based on, particularly, the extent to which audit committee members carry out their oversight responsibilities regarding financial reporting, external auditing, and internal auditing in order to improve the audit committee practices. As old institutional economics tends to rely more upon an examination of quantitative empirical information rather than on qualitative information (Stanfield 1999), this study uses the quantitative approach in its data collection process. Also, an institutional framework is used in analysing the differences in results between the USA, the UK, and Egypt.

2-3. The Social Construction of Risk and Institutional Economics

Neubourg and Weigand (2000) explained that institutional economics moved from a position of drawing eclectically on several other disciplines, to a stance of building its arguments almost entirely out of neoclassical materials. Granovetter (1985) argued that, such a stance cannot provide a persuasive account of economic institutions, and suggested a broader foundation based on classical sociological arguments about the embeddedness of economic goals and activities in social oriented goals and structures. Economic institutions do not emerge automatically in response to economic needs. Rather, they are constructed by individuals whose action is both facilitated and constrained by the structure and resources available in the social networks in which they are embedded. Also, Sugiura (1999) explained that, modern economics views the market economy as a single corporate being, which also serves as a basis for the formulation of laws, power, and social relations, and interactions among autonomous individuals. Human beings have a social existence and their collective social structure makes up social relations.

Social welfare in an economy depends on its ability to satisfy the needs of its members and to manage the risks threatening the wellbeing of those people (Neubourg and Weigand 2000). The satisfaction of these needs requires some individual and social action. Both the ability to act and the possibility of realizing positive results are subject to uncertainty and may be threatened by risks. Berry (2000) following Adams (1995), suggested that, we might think of four characteristic positions taken towards risk. These are:

1. *Individualists*: who are enterprising self-made people, relatively free from control by others, and who strive to exert control over their environment and the people in it, the risk-taking entrepreneurial leader of popular capitalism.
2. *Hierarchists*: who inhabit a world with strong group boundaries and binding prescriptions. Social relationships in this world are hierarchical. Leadership is about style or about working with contracts and transactions. Leaders act to manage risk by containment, risk assessment, insurance and portfolios.
3. *Egalitarians*: have strong group loyalties but little respect for externally imposed rules, other than those imposed by nature. Group decisions about risks are arrived at democratically and leaders rule by force of personality and persuasion. Risk is shared and leadership is about both transactions and transformations.
4. *Fatalists*: have minimum control over their own lives. They belong to no groups that are responsible for the decisions that rule their lives. They are non-unionised, outcasts, on the margins. They are resigned to their fate and they see no point in attempting to change it. Risk is ignored and leadership here can become self-destructive.

2-4. The Culture Differences Role

Sugiura (1999) argued that, institutionalisation of each market society is closely related to its corresponding culture. Brown and Humphreys (1996) defined culture as “what provides

human beings with a design for living, with a ready-made set of solutions to problems so that individuals in each generation do not have to start again from scratch". Humphreys (1996) explained that it can be argued that these differences in work-related values are the result of an underlying difference in culture. Also, Hofstede (1991) gives a definition derived from the world of computing, in line with his title *Cultures and Organisations: Software of the Mind*, he suggests that culture is "the collective programming of the mind which categorise people from another". He uses group to mean a number of people in contact with each other and "category" to consist of people who, without necessarily having contact, have something in common.

In management literature, culture is seen as an important influence on practice. Humphreys (1996) and others describe the degree of influence of culture in general and more specifically in the sub-divisions of national, organizational and occupational, as follows:

National Culture

Hofstede (1991) distinguishes between nations and societies. He suggests that the concept of a common culture is more applicable to societies than to nations. However, he recognizes that where there are strong forces for integration within nations such as a dominant language, common mass media, national education system, national political system, national armed forces and national representation in sports events, then nations can be regarded as the "source of a considerable amount of common mental programming of their citizens". Along these lines, Humphreys (1996) in his study on cultural differences between the UK and Egypt in educational institutions, argued that "there is no doubt that there are cultural differences arising from differences in common mental programming between the UK and Egypt which would certainly account for variations in such as attitude to duty and the slow slog up the

hierarchy of single bureaucratic organizations. National culture would seem to be a highly significant factor here”.

Organizational Culture

Organizational culture has seen a plethora of literature in the last 15 years. Heuer (1999) defined organizational culture as “the pattern of shared values and beliefs that help individuals understand organizational functioning and thus provides them with norms for behaviour in the firm”. This notion of culture is similar to the view that culture is an organizational trait manifested in the shared values and beliefs of its members (Hofstede 1998). An imbalance between societal and organizational cultural values may be particularly important for organizations in less developed/developing countries. Trompenaars (1993) categorizes organizational culture as four main types based on two dimensions: equity-hierarchy and person-task orientation. Four organizational cultures emerge and are summarized below.

1. *The Family (a power-oriented culture)*. This culture is characterized by strong emphasis on the hierarchy and an orientation towards the person. Individuals within this organizational form are expected to perform their tasks as directed by the leader, who may be viewed as the caring parent. Subordinates not only respect the dominant leader or father figure but they also seek guidance and approval.
2. *The Eiffel Tower (a role-oriented culture)*. A strong emphasis on the hierarchy and an orientation towards the task characterizes this culture. The “Eiffel Tower” image is intended to symbolize the typical bureaucracy- a tall organization, narrow at the top and wide at the base where roles and tasks are clearly defined and coordinated from the top. Authority is derived from a person’s position or role within the organization, not the person *per se*.

3. *The Guided Missile (a task-oriented culture)*. Trompenaars' third type of organizational culture is characterized by a strong emphasis on equality and an orientation toward the task. The motto for this culture type is "getting things done". Organization structure, processes and resources are all geared toward achieving the specified task/project goals. Power is derived from expertise rather than the formal hierarchy.
4. *The Incubator (a fulfilment-oriented culture)*. This culture is characterized by a strong emphasis on equality as well as an orientation toward the person. Trompenaars states that the purpose of the organization in such a culture is to serve as an incubator for the self-expression and self-fulfilment of its members.

Trompenaars acknowledges that 'pure types' rarely exist. However, he observed a tendency for particular organizational culture forms to dominate in different national cultures. Joiner (2001) explained that, in a climate of increasing globalisation and the concomitant increasing competition, there is enormous pressure exerted on organizations to restructure to enable them to compete successfully in a borderless world. Progressive local firms in less developed/developing countries may, among a repertoire of restructuring strategies, consider changing their organizational culture to mimic the culture of successful organizations from the more industrialized nations. However, the implementation of an organizational cultural change, without reference to the surrounding societal values, may jeopardize the success of that change. Humphreys (1996), in his study argued that, there are certainly huge differences between the organizational cultures of typical technical educational institutions in Egypt and the UK.

Occupational Culture

The notion of an occupational culture would suggest that there are likely to be similarities between the values and actions of the members of the same occupation, which would transcend the differences in nationality or organization (Humphreys 1996). It has already been noted that there are a variety of factors, which contribute to culture differences between nationalities such as a dominant language, common mass media, national education system, national political system, and national armed forces.

Hofstede (1980), has suggested four dimensions of difference in culture between nations, and clusters these differences according to whether they are high or low within each of these dimensions which he labelled “power-distance”, “uncertainty avoidance”, “individualism”, and “masculinity”.

1. *Power-distance* is described as “the extent to which the less powerful persons in a society accept inequality in power and consider it normal”.
2. *Uncertainty avoidance* is described as “the extent to which people in a culture are made nervous by situations which they consider as unstructured or unknown situations, and the extent to which they try to avoid such situations by adopting strict codes of behaviour and a belief in absolute truths”.
3. *Individualist* as OIE claims that the individual is a product of his social environment, individualism pertains to the extent to which individual independence or social cohesion dominates.
4. *Masculinity* refers to the degree to which social gender roles are clearly distinct. Masculine cultures are seen by Hofstede as having vastly different social roles for the sexes, whereas in feminine cultures social roles overlap significantly.

Humphreys (1996) argued that, when using Hofstede's four culture dimensions, differences between cultures in the UK and Egypt are clearly apparent. However, numerical differences in the above four dimensions are only indicators of the deeper and more complex national cultural differences between the UK and Egypt.

2.5. The Cultural Influence on the Development of Accounting Systems

Wallace and Gernon (1991) argued that, while a great deal of observation and hierarchy building has occurred, a comprehensive theory that explains existing cross-national differences in the structure and practice of financial reporting still does not exist. Similarly, Gray (1988) states that:

“While prior research has shown that there are different patterns of accounting internationally and that the development of accounting systems tends to be a function of environmental factors, it is a matter of some controversy as to the identification of the patterns and influential factors involved The influence of culture on accounting would seem to have been largely neglected in the development of ideas about international classifications.”

As a solution, Gray proposed a comprehensive model of accounting values linked to Hofstede's (1980) societal values. These accounting values, in turn, explain and determine the structures and practice of accounting, including the basic tenets of management and disclosure which determine financial reporting practices. Gray's model of culture, societal values and the accounting subculture began with Hofstede's propositions that societal values have institutional consequences in the form of legal, political and economic systems including the pattern of corporate ownership and the capital market. Gray then extended Hofstede's model by hypothesizing the existence of an accounting subsystem which drew its value system from the primary societal value system. As Gray explained:

“The value systems of attitudes of accountants may be expected to be related to and derived from societal values with special reference to work related values. Accounting ‘values’ in turn impact on accounting systems.”

Gray continued by defining four accounting values- Professionalism, Uniformity, Conservation, and Secrecy. These values interact with the other institutional consequences of culture such as capital markets to arrive in the final set of accounting systems that include financial reporting practices and professional structures. These are as follows:

1. ***Professionalism versus Statutory Control***: a preference for the exercise of individual professional judgement and the maintenance of professional self-regulation as opposed to compliance with perspective legal requirements and statutory control;
2. ***Uniformity versus Flexibility***: a preference for the enforcement of uniform accounting practices between companies and the consistent use of such practices over time as opposed to flexibility in accordance with the perceived circumstances of individual companies;
3. ***Conservatism versus Optimism***: a preference for a cautious approach to measurement so as to cope with the uncertainty of future events as opposed to a more optimistic, laissez-faire, risk-taking approach; and
4. ***Secrecy versus Transparency***: a preference for confidentiality and the restriction of disclosure of information about the business only to those who are closely involved with its management and financing as opposed to a more transparent, open and accountable approach.

Values are, in turn, linked to Hofstede’s cultural constructs of Individualism, Uncertainty Avoidance, Power Distance and Masculinity, by four hypotheses. These are as follows:

1. the higher a country ranks in terms of individualism and the lower it ranks in terms of uncertainty avoidance and power distance then the more likely it is to rank highly in terms of professionalism;
2. the higher a country ranks in terms of uncertainty avoidance and power distance and the lower it ranks in terms of individualism then the more likely it is to rank highly in terms of uniformity;
3. the higher a country ranks in terms of uncertainty avoidance and the lower it ranks in terms of individualism and masculinity then the more likely it is to rank highly in terms of conservatism; and
4. the higher a country ranks in terms of uncertainty avoidance and power distance and the lower it ranks in terms of individualism and masculinity then the more likely it is to rank highly in terms of secrecy.

By applying these hypotheses, Gray contends the dimensions of Uncertainty, Avoidance and Individualism are the most influential dimensions in relation to the accounting subculture dimensions. Salter and Niswander (1995) tested Gray's model, based on data from twenty-nine countries, they found that while Gray's model has statistically significant explanatory power, it is best at explaining actual financial reporting practices and is relatively weak in explaining extant professional and regulatory structures from a cultural base. They further found that both the development of financial markets and levels of taxation enhance the explanations offered by Gray.

2-6. The Applicability of Anglo Saxon Corporate Governance Principles in Egypt

Whether western management theories and concepts are as applicable in developing countries as they are in the UK and USA has been the subject of much critical comment. Kanter and

Corn (1994) asserted that, recent findings regarding the cultural propensities of major countries appear robust, replicated in surveys of managers, as well as used to explain institutional patterns within countries. Brown and Humphreys (1995) explained that, this is not to argue that transference between cultures is impossible or unwise, but rather that the process of transference has to be culturally sensitive. The point here is that management theories and concepts which have been developed in the western world, may need to be modified and adapted in order to fit the cultural beliefs, values and expectations of developing nations such as Egypt (Humphreys 1996).

Today, corporate governance literature is concerned with the convergence of corporate governance systems as part of recent corporate trends towards internationalization and globalization (Justin and Batten 2001). As a result, the introduction of Anglo Saxon system of corporate governance has been proposed. Convergence towards this path has primarily been supported through the efforts of international organizations (Rubach and Seborá 1998). Thus, there is an increased resolve to implement global corporate governance standards. This indicates that the convergence of practice is most desirable. Given the signs of convergence mentioned above, the concept of global standards is not totally inconceivable. Indeed, Nestor and Thompson (1999) observe that “despite different starting points, a trend towards convergence of corporate governance regimes has been developing in recent years”. However, Heuer et al. (1999) identified that a recurring theme in national culture research is that while convergence may be seen in practices among managers, these practices do not necessarily signal a convergence in the values embedded in national cultures. The difficulty is encapsulated in Scott’s (1995) comment on the wider nature of governance which brings in the social and cultural norms of society as affecting the nature of governance. Thus, cultural differences must be considered when implementing Anglo Saxon corporate governance

principles. In terms of corporate governance, the difficulty in changing existing systems comes from the concept of path-dependency. Rubach and Sebor (1998) find differences in corporate governance systems reflect the paths by which each came to exist. Bebchuk and Roe (1999) argue that path-dependencies may freeze the institutions of particular countries in a noncompetitive pose. Along these lines, regarding audit committees, Turley and Zaman (2001) argued that cultural and structural differences internationally will be likely to influence the operation of audit committees.

From the convergence literature above, it becomes apparent that each country's path to corporate governance principles will be different. Indeed, the quest for convergence does not mean that corporate governance principles will be implemented identically in each country (Justin and Batten 2001).

2-7. Summary

Institutional economics as a field of knowledge is concerned with studying an economic phenomenon within its entire surrounding environment which includes social, cultural, political, ideological, religious, civilisation, technological factors. Thus, this chapter evaluates different forms of institutional economics and from this discussion, it is concluded that old institutional economics is the most useful framework for this work. It used to explain the interplay between the institutions and actions in the economy, society, and culture which cover the problem of the transference of Anglo Saxon management theories and concepts (e.g. corporate governance including audit committees) to developing countries (e.g. Egypt). Old institutional economics aims to explain that the transference between cultures is possible, but the process of transference has to be culturally sensitive.

**Chapter Three: An Institutional Perspective of Corporate
Governance and Audit Committees in Egypt**

Chapter Three: An Institutional Perspective of Corporate Governance and Audit Committees in Egypt

3-1. Introduction

In this chapter, an institutional analysis helps us to understand some aspects of the historical development of corporate governance. In particular, the emergence of audit committees moving onto focus upon these issues in Egypt. The main emphasis will be on examining how social institutions have influenced corporate governance and audit committee practices. The chapter commences by explaining the main international corporate governance principles. It continues by explaining the importance of corporate governance in transition economies and examines the creation of an institutional infrastructure for the transition process. The chapter concludes with an analysis of corporate governance practice in Egypt in order to understand the environment which surrounds the practice of audit committees.

3-2. Corporate Governance and the Audit Committee

Rwegasira (2000) argued that corporate governance is concerned with structures within which a corporate entity or enterprise receives its basic orientation and direction. According to Monks and Minow (1995), corporate governance seeks to deal with systems, mechanisms and modalities of exercising power and control over the corporation's direction, behaviour, and performance. There are actually many different definitions of corporate governance, but they all have as their fundamental meaning the following ideas: (1) systems of controls within the company; (2) relationships between the company's board, shareholders and stakeholders; and (3) the company being managed in the interests of shareholders and stakeholders (Hussain and Mallin 2002).

The following definitions of corporate governance illustrate that, whilst there are differences in the definitions, the same fundamental ideas are present:

- “the whole system of controls, both financial and otherwise, by which a company is directed and controlled” (Cadbury Committee 1992);
- “a set of relationships between a company’s board, its shareholders and other stockholders. It also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined” (OECD 1999);
- “the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment”. (Shleifer and Vishny 1997); and
- “the process and structure used to direct and manage the business and affairs of the corporation with the objective of enhancing long-term value for shareholders and the financial viability of the business” (Luscombe 1994).

The degree to which corporations observe basic principles of good corporate governance is an increasingly important factor for investment decisions (OECD 1999). Corporate governance principles and guidelines have been established by several organizations to provide best practices or benchmarks against which to assess the appropriateness of the corporate governance system.

In 1999, the Organisation for Economic Co-operation and Development (OECD) published its elements of corporate governance. In doing so, it took into account the views of many different countries on the subject of what constitutes good corporate governance and then published its seven elements of good corporate governance. The OECD states:

“the primary role for regulation is to shape a corporate governance environment compatible with societal values that allows competition and

market forces to work so that a corporation can succeed in generating long-term economic gain. Specific governance structures or practices will not necessarily fit all companies at all times”.

The OECD identifies seven key elements of good corporate governance as: (1) rights and obligations of the shareholders; (2) equitable treatment of shareholders; (3) role of stakeholders and corporate governance; (4) transparency, disclosure of information and audit; (5) Board of Directors; (6) non-executive members of the board; and (7) executive management, compensation and performance. Each of these is dealt with in more detail in Table 3-1.

In 2002, the Business Roundtable (BRT), an association of chief executive officers of leading corporations that represents itself as an “authoritative voice” for American business, has proposed six guiding principles of corporate governance:

1. the Board of Directors should select a chief executive officer (CEO) and oversee the CEO and other top executive activities;
2. management is responsible for operating the corporation in an effective and ethical manner with the goal of creating shareholder value;
3. management is responsible for preparing financial statements, under the oversight of the Board of Directors and its audit committee, that fairly present the financial conditions and results of operations of the corporation;
4. the Board of Directors and its audit committee should engage an independent accounting firm to perform financial statement audits;
5. the independent accounting firm should maintain its independence in fact and in appearance, conduct the audit in accordance with Generally Accepted Auditing Standards (GAAS), inform the board through the audit committee of any concerns

Table 3-1 OECD key elements of corporate governance

-
1. Rights and obligations of the shareholders:
 - Corporate governance framework should protect shareholders rights. 1 share, 1 vote; sufficient and relevant information from companies; participate in an Annual General Meeting; vote; share in residual profit; protection of minority rights; and fairness and transparency of company operations.
 - Obligations: use voting rights.
 2. Equitable treatment of shareholders:
 - Corporate governance framework should ensure equitable treatment of all shareholders, including minority and foreign shareholders.
 - Same voting rights (within same class of shares, etc.).
 - All shareholders of same class should be treated equally.
 3. Role of stakeholders in corporate governance:
 - Corporate governance framework should ensure rights of stakeholders are protected by law and that these rights are respected.
 - Effective redress for voting of rights.
 - Encourage the role of stockholders in the corporation in a manner that enhances the performance of the corporation and the market.
 - Provision for disclosure of information relevant to interests of stakeholders.
 4. Transparency, disclosure of information, and audit:
 - Corporate governance framework should ensure the full, timely and detailed disclosure of information on all material matters, including its financial situations, performance, ownership structure and governance of corporation.
 - Includes establishment of audit committee.
 - Transparency / disclosure includes disclosure of information on:
 - financial / operating results;
 - ownership structure;
 - members of Board of Directors and management;
 - quantitative and qualitative matters concerning employees and other stakeholders in the corporation;
 - governance structures and policies;
 - corporate target and prospects; and
 - executive of unusual and complex transactions, transactions on derivative products and their level of risk.
 5. Board of Directors:
 - Corporate governance should ensure the strategic leadership of the corporation; the efficient monitoring of management by the Board of Directors; and accountability of the board to its corporation and shareholders.
 - Meetings, for example one a month; process; Chair / CEF (separation of duties and responsibilities) etc.
 6. Non-executive members of board:
 - Should form independent judgement, especially with respect to corporation's strategy, performance, asset management, and appointment of management.
 - Non-executive members should be independence from executive members of board (no family relation) and have no business relation with the corporation or other commercial involvement that may affect their independent judgement.
 - Interlocking directorships (should be avoided).
 6. Executive management, compensation and performance:
 - Good practice that management compensation be tied to corporation's general level of profitability and overall performance.
 - Total compensation should be disclosed in financial statements.
 - Procedures for determining compensation be disclosed.
 - Remuneration Committee.
-

Source: OECD (1999).

- regarding the quality and integrity of the financial reporting process; and that
6. corporations have a responsibility to deal with their employees in a fair and equitable manner (BRT 2002).

Also in 2002, the National Association of Corporate Directors (NACD) in the USA, an independent, not-for-profit organization devoted to improving corporate board performance, recommended to Congress a set of core governance principles to improve corporate governance in the USA. The core governance principles set forth by the NACD consist of ten governance principles and related disclosure requirements for publicly traded companies in the USA. These ten governance practices and principles set forth the following expectations for boards of directors. The board of directors should:

1. comprise a substantial majority of “independent” directors;
2. require establishment of key committees (e.g. audit, compensation, nominating) to be composed of independent directors;
3. ensure that each key committee has a board-approved written charter detailing its functions and responsibilities;
4. formally designate an independent director as chairman or lead director;
5. regularly and formally evaluate the performance of the CEO;
6. review the adequacy of their company’s compliance and reporting systems at least annually;
7. adopt a policy of holding periodic sessions of independent directors;
8. require their audit committee to meet independently with both the internal and independent auditors;
9. be constructively engaged with management in corporate strategy; and

10. provide new directors with a “director orientation” programme to familiarize them with their company’s business, industry trends, recommended governance practices, and then ensure “continuing education” for directors (NACD 2002).

The Blue Ribbon Committee (BRC 1999) revealed the following three conclusions regarding the oversight responsibility of corporate governance including the audit committee:

1. Quality financial reporting can only be achieved through open and candid communication and close working relationships among the corporation’s Board of Directors, audit committee, management, internal auditors, and external auditors.
2. Strengthening corporate governance oversight in the financial reporting process of publicly traded companies will reduce instances of financial statement fraud.
3. Integrity, quality, and transparency of financial reports will improve investors’ confidence in the capital market while incidents of financial statement fraud diminish such confidence.

3-3. Corporate Governance in Transition Economies

In developed market economies, a system of corporate governance has been built gradually through centuries, and today it can be defined as a ‘complex mosaic’ consisting of laws, regulations, politics, public institutions, professional associations and ethics codes. However, in transition economy countries a lot of details of the mosaic are still missing (Babic 2001). Trying to develop a system of good corporate governance in these countries is made difficult by problems such as complex corporate ownership structures, vague and confusing relationships between the state and financial sectors, weak legal and judicial systems, absent or underdeveloped institutions and scarce human resource capabilities (CIPE 2002).

The missing element in the context of corporate governance development in transition economies is the lack of institutions associated with successful market economies (OECD 2001). In market economies there is a standard set of institutions that have been successful as the tools used to control corporations. Institutions are the ‘rules of the game’ in a society (Yeager 1999). They are the rules that the society establishes to reduce the uncertainty of human interactions. The institutional framework has three components: formal rules, informal rules and enforcement mechanisms. While both the formal legal environment and the informal institutional constraints affect corporate governance, institutional theory states that when formal institutions are weak, informal constraints play a larger role in shaping firm behaviour (Young et. al. 2002).

3-4. The Transition Economy in Egypt

In 1990, the Egyptian government started its economic reform and restructuring programme and the Egyptian economy is now labelled as a “*transition economy*”; it is moving away from its attempt at a command economy towards the implementation of an economic system based on market forces. El-Issawi et al. (1999) argued that the move towards a free-market economy in Egypt has been remarkably swift. Intriligator (1996) explained that, the goal of rapid transition to a market economy will probably not be realised in the absence of those economic, legal, political, and social institutions that enable such an economy to function. Along these lines, El-Mikawy and Handoussa (2002) argued that Egypt in the 1990s provides an example of an economic environment in which well-defined economic objectives that were accompanied by resolute policy changes have failed to produce the expected good prospects. The lesson of the 1990s turns out to be that policy change without institutional reform results in only modest economic improvement. This is in line with the expectations of commentators in transition economics (Fogarty 1996).

3-5-. Creating an Institutional Infrastructure for the Transition Process

Even in its early years, transition was recognized as a complex process with political, social, and economic dimensions. The first stage of a prospectively successful transition strategy would be to establish an institutional infrastructure of new or modified economic, political, and legal rules and organizations suitable to a more market and private property-oriented society (Elliott 1997). The institutional infrastructure of an economy dominated by a monopoly system, state ownership and centralized planning is radically discordant with the aspirations of capitalist transition. Because new institutions 'cannot be created overnight', the supply of necessary rules, organizations and people trained and skilled in administration and adjudication under the emerging regime, tend to lag behind the demand for them; this gap can be narrowed 'only with the passage of time'. Thus, time is the 'scarcest factor in interdependent institution building' in the context of transitions (Winiecki 1993). The most important institutions needed for a market economy are a legal system, including both business law and property law, a credit system, a system of banks, including both commercial and investment banks, an accounting and auditing system, and other social institutions, including a sound currency and a social safety net (Intriligator 1996). In the absence of these institutions, the enterprises of the Egyptian economy, whether privatised or not, will not have the proper incentives to produce and invest (Abdel Shahid 2001). Hence, it is necessary to establish the relevant economic, legal, political and social institutions so as to prevent the further collapse of the Egyptian economy. The stabilisation, liberalisation, privatisation and other aspects of the current economic reform programme alone will not create these institutions, the Egyptian government should therefore play a major role in their establishment (World Bank Report 2001). Thus, the success of corporate governance and its necessary tools are of concern to the Egyptian government in order to support the market economy. It is

useful to understand corporate governance practices in Egypt in order to understand those of audit committees within an institutional framework.

3-6. Corporate Governance Practices in Egypt

Corporate governance guidelines and codes of best practice arise in the context of, and are affected by, differing national frameworks of law, regulations and stock exchange listing rules, as well as differing societal values. Therefore, to understand one nation's corporate governance practices in relation to another's it is necessary to understand not only the "best practice" documents but also the underlying legal and enforcement framework (Vinten 2000).

It should be pointed out that corporate governance in Egypt has gained more importance in recent years due to the integration of the Egyptian economy with the global economy, internationalisation of capital markets, and the increasingly important role played by the private sector in the economy (Ghali 2001). The Egyptian capital market is in general compliance with international criteria and basic rules of corporate governance (Abul Ayoun 2003). The current corporate governance practices in Egypt will now be analysed, in the light of the World Bank Report of 2001. These can be grouped under six factors: the stock exchange and the legal framework; the rights of shareholders; the equitable treatments of shareholders; the role of stakeholders in corporate governance; disclosures and transparency; and the responsibilities of the board.

3-6-1. The Stock Exchange and the Legal Framework

Egypt's Stock Exchange has two locations: Cairo and Alexandria. The Alexandria Stock Exchange (CASE) was officially established in 1888 followed by Cairo in 1903. The two exchanges were very active in the 1940s and the Egyptian Stock Exchange ranked fifth in the

world. Nevertheless, the central planning and socialist policies adopted in the mid 1950s led to a drastic reduction in activity on the Stock Exchange, which remained dormant between 1961 and 1992 (Abd-Elsalam and Weetman 2003).

In 1990, the Egyptian government started its programme of economic reform and restructuring and the process of deregulation and privatisation has stimulated stock market activity. The Capital Market Authority (CMA) played an instrumental role in initiating and leading the effort for the revival of the Egyptian stock market. According to law No. 95 of 1992, the Capital Market Authority is the entity responsible for the implementation of capital market law and for developing the market. It regulates and controls market activity, and drafts rules and regulations for submission to the Ministry of Economy & Foreign Trade for approval.

The corporate legal framework is primarily French civil law in origin. Anglo-American common law concepts became more prominent in Egyptian corporate law with the drafting of the Central Depository Law in 2001 and the Capital Market Law in 2002. There are no restrictions on foreign ownership of securities and no taxes are levied on dividends and capital gains, thus making the Egyptian market very attractive compared to other markets. Since December 1991, the number of listed companies on the Cairo & Alexandria Stock Exchange (CASE) has grown from 627 companies to 1070 companies in June 2001 (World Bank Report 2001).

Regarding ownership structure, domestic retail investors represent 51% of the market; domestic institutional investors (mainly mutual funds) 22%; and foreigners 27%, with the majority of those shares held by UK and USA investors (PCSU 2000).

3-6-2. The Rights of Shareholders

According to Law No. 95, shareholders have the right of access to the company's balance sheets, profit and loss statements, and audit reports for the previous three years. Also, shareholders have the right to review the directors' report, the balance sheets, the profit and loss accounts, and auditors' reports at the company's headquarters during the two weeks prior to the Annual General Meeting (AGM). The AGM must meet within six months of the end of the previous financial year. Summaries of the financial statements and auditors' report must be published in two daily Arabic newspapers within three months of the end of the financial year. Shareholders have the right to ask questions at the AGM. The board answers the questions to the extent to which they do not cause "harm to the interests of the company or the public interest". Egyptian accounting standards require directors and managers to disclose any material interest in transactions or other matters affecting the company, irrespective of whether such transactions have taken place. Disclosure must be made in the notes to the financial statements (World Bank Report 2001).

3-6-3. The Equitable Treatment of Shareholders

The legal framework allows for multiple share classes, provided that within a given class shareholders are treated equally and have the same rights. There are two main classes of shares: ordinary shares and preference shares. Contrary to the majority of capital markets in the world, preference shares in Egypt have privileges in terms of voting. They are also entitled to earn fixed dividends before other shareholders and have priority during liquidation. Preference shares may also have priority in capital increases. Every shareholder has the right to file a complaint with the Companies Department of the Capital Market Authority regarding violation of law No. 159 of 1981. A shareholder who attends the AGM can register his

opposition to a decision in the minutes, and can initiate a case in court within one year of the meeting.

3-6-4: The Role of Stakeholders in Corporate Governance

Law No.159 of 1981 grants employees the right to share in profits that amount to the lower of 10% profit or the equivalent of one annual salary each year. This right is only exercised if profits are distributed (Abdel Shahid 2001). Nowadays, employee representatives do not generally sit on boards. Instead, companies create 'employee committee' or similar bodies to deal with all matters related to employees, including salary and other compensation issues. A director is assigned the task to liaise with this committee (World Bank Report 2001). Also, the Capital Market Law No. 59 of 1992 gives bond holders special protection. They may form a bond holders' association and elect a legal representative who acts on their behalf and attends the AGM. The association makes recommendations for submission to the AGM or the Board of Directors, but does not have the right to vote at the GAM. The unified labor act approved in Cabinet in May 2001 prohibits child labor and the environmental law No. 4 of 1994 protects the environment.

3-6-5. Disclosures and Transparency

Any listed company must disclose its financial and operational performance to the CMA and the CASE on a quarterly, semi-annual and annual basis. Mandatory information includes hard copies of balance sheets, income statements, directors' reports, information on any change in board composition, material events that may effect business and/or earnings, as well as the external auditor's report. The CMA examines compliance with disclosure requirements and requests more information if needed. In case of non-compliance, the CMA will publish its observations at the company's expense. Financial statements are to be prepared in compliance

with the Egyptian Accounting Standards issued by the Ministry of Economy and Foreign Trade. These standards are generally in line with International Accounting Standards (IAS), except in a few areas (e.g. standard No. 7 regarding cash flow statement). In the absence of an Egyptian Accounting Standard for a specific issue, the IAS is applied (Abd-Elsalam and Weetman 2003).

Annual and semi-annual financial statements of public companies must be fully audited, while quarterly statements are submitted with a limited auditing report. The power of appointing and removing auditors is vested with the AGM, which also sets their remuneration. Consulting fees do not have to be disclosed at the AGM according to law No.159 of 1981, but to ensure independence, the auditor must not become a founder, board member, employee or be otherwise associated with the company or board, or elected to the board until three years after his auditing function has ceased. The auditor has the right to examine all documents, data and other information necessary and can count on the support of the board to fulfil his duty, he does not report to the board, only to the AGM, to whom the auditor's report is submitted (World Bank Report 2001).

3-6-6. The Responsibilities of the Board

Companies have one-tier boards comprising of an odd number of directors, with a minimum of three. There are no rules governing the composition between executive and non-executive directors and the concept of the independence of directors is not well established among listed companies (PCSU 2000). In most listed companies, there is no separation between the role of the chairman and that of the managing director the same person may hold both posts (Abdel Shahid 2001). The board determines each member's compensation. Directors must be

shareholders or represent companies who are shareholders. Two directors should be chosen who are 'experts in the field'.

Board functions include making calls on prospective shareholders, investing the company's funds and making loans, appointing management and submitting financial statements and directors' reports to the AGM. According to the legislative framework, the AGM, board of directors, internal and external auditors and government authorities all monitor management. In practice, shareholders do not play an important role in this monitoring (Abdel Shahid 2001). The internal audit function barely exists in the majority of listed companies, and where it does it has little power. Moreover, boards in general do not include independent directors (World Bank Report 2001).

3-7. Audit Committee Practice in Egypt

Today, Egypt's economic reform process has developed significantly, and consensus exists that sound, uniform accounting and auditing practices must be its backbone (Abdel Shahid 2001). Strict financial reporting and the ability to collect and analyse data are essential to the success of any economy because this data forms the basis of decisions regarding whether to invest or not. An independent audit committee is a prerequisite for getting listed on the vast majority of foreign exchanges. Countries all over the world have been increasingly requiring enterprises to set up audit committees within their legal framework (Carson 2002).

Recently in Egypt, increasing attention has been paid to audit committees by both regulatory authorities and academics because the role of such committees is becoming recognized as a key element for corporate governance practice. As a result, since 2000, the Central Bank of Egypt, which is considered a supervisor for all Egyptian banks, has required public banks to establish audit committees as sub-committees of the main board of directors, charged with

specific responsibilities relating to monitoring financial reporting, external auditors, and internal control including the internal auditing function.

More recently, in June 2002 the Capital Market Authority (CMA) issued statement No.30, article No.7, requiring listed companies to have an audit committee. The Board of Directors should appoint the audit committee from its members and it should comprise at least three non-executive directors, each of whom should be diligent and have good experience of the company's business environment. In addition, if the company does not have sufficient appropriate members for the establishment of an audit committee, it should make up the committee from external professional members. The audit committee should carry out its duties independently from company management and present a monthly report to the board of directors including its suggestions and recommendations. The audit committee's main responsibilities are to:

1. Review and analyse the internal control procedures in the company.
2. Review and analyse applied accounting policies in the company and the significant changes in applying new accounting standards.
3. Review and analyse the procedures, plans, and results of the internal control function.
4. Review and analyse the periodical management information that is presented to the various management levels.
5. Analyse the procedures which are applied in preparing and reviewing the following:
 - A- Periodical and annual financial reporting.
 - B- Private and public share placing on the market.
 - C- Budgets which include cash flow and income.
6. Ensure the implementation of control procedures in order to monitor the company's assets and carry out periodic evaluations of management procedures in order to write reports directed at the board of directors.

The audit committee must ensure that the company's management has responded to the auditor's and CMA recommendations. It must also direct its monthly reports to the Board of Directors which must respond to the recommendations within 15 days. The audit committee has a right to notify the CASE if the Board of Directors does not respond.

3-8. Summary

Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other shareholders. Corporate governance principles and guidelines are established by several organizations to provide best practices or benchmarks against which to assess the appropriateness of the corporate governance system. Trying to develop a system of good corporate governance in transition economies is made difficult by problems such as complex corporate ownership structures, vague and confusing relationships between the state and financial sectors, weak legal and judicial systems, absent or underdeveloped institutions and scarce human resource capabilities (CIPE 2002).

It is expected that the transition economy in Egypt, which is undergoing major economic, regulatory, and political reforms, as well as western market acculturation, will exhibit differences in corporate governance systems. Such differences may be associated with significant differences in attitudes, beliefs and cultural values. These in turn are expected to impact on managerial behaviour, firms' objectives and the market for corporate control (Humphreys 1996 and Dockery and Herbert 2000).

Chapter Four: Expectations Gap and Audit Committees

Chapter Four: The Expectations Gap and Audit Committees

4-1. Introduction

Investors and financial statement users may have differing beliefs about the responsibility of an independent accounting firm performing an audit of a client's financial statements. Concerns about the existence of an expectations gap has led to shareholders having a significant interest in the audit committee's oversight responsibilities. This chapter begins by explaining and defining the expectations gap. It continues by explaining the social construction of the audit profession from an institutional economics perspective. The chapter concludes by explaining the potential role of audit committees in narrowing the expectations gap.

4-2. The Expectations Gap

Over the last two decades, the Anglo Saxon world has experienced a spate of corporate failures, financial scandals and audit failures which have placed the audit expectations gap debate firmly on the agenda of the accounting profession, regulators and the public (Dewing and Russell 2002). There is widespread concern regarding the existence of an "expectations gap" between the auditing profession and the public (Lower 1994 and Koh and Woo 1998). Prior research on the expectations problem is substantial. This is not surprising given that the expectations gap between auditors and financial statement users has existed for the past 100 years although the term has been introduced to the auditing scene only during the last 20 years or so (Humphrey et al. 1993). The expectations gap exists when auditors and the public hold different beliefs about the auditor's duties and responsibilities and the messages conveyed by audit reports (Wolf et al. 1999, Koh and Woo 1998 and Frank et al. 2001). According to Godsell (1992) "there is a widespread belief that a person who has any interest in a company

(shareholders, potential investors, take-over bidders, creditors etc.) should be able to rely on its audited accounts as a guarantee of its solvency, propriety and business viability. Hence, if it transpires, without any warning that the company is in serious financial difficulty, it is widely felt that somebody should be made accountable for these financial disasters, and this somebody is always perceived to be the auditors". These misperceptions of the public feed the legal liability crisis facing the accounting profession (Maccarrone 1993). The accounting profession argues that one cause of the expectations gap is the public's failure to appreciate the nature and limitations of an audit (Frank et al. 2001). That is, the public in general has come to view audits as guarantees of the integrity of financial statements and as an insurance policy against fraud and illegal acts (Epstein and Geiger 1994). Also, Kaplan (1987) explained that the expectations gap has been most conspicuous in legal decisions. Judicial litigants often appear to apply, as a standard, the concept that an audit is a comprehensive check on a corporation's financial activities. A business failure is often interpreted to be an audit failure, regardless of the level of procedures and tests performed by the auditor. Auditors can perform their audits in strict accordance with generally accepted auditing standards and still be found negligent in not preventing risks to financial statement users (Almer and Brody 2002).

Empirical studies on the expectations gap have confirmed that an expectations gap exists, specifically in areas such as the nature of audit function, the perceived performance of auditors, the auditor's duties and role, the independence of auditors, and the non-audit services. For example, Epstein and Geiger (1994), conducted a survey of investors to gather information on various aspects of financial reporting issues, in particular on the level of assurance they believed auditors should provide with respect to error and fraud. The survey results suggested that investors seek very high levels of financial statement assurance and

there exists an expectations gap between auditors and investors on the level of assurance an audit provides.

In the UK, Humphrey et al. (1993) examined the expectations gap by ascertaining the perceptions of individuals of audit issues through the use of a questionnaire survey comprising a series of mini-cases. The respondents included chartered accountants in public practice, corporate finance directors, investment analysts, bank lending officers and financial journalists. The survey revealed a significant difference between auditors and respondents (representing some of the main participants in the company financial reporting process) in their views on the nature of auditing. The results confirmed that an audit expectations gap exists, specifically in areas such as the nature of the audit function and the perceived performance of auditors.

Schelluch (1996) found that the expectations gap detected in prior research studies dealing with auditor responsibilities appeared to be reduced over time with the introduction of the long-form audit report. Differences in beliefs between auditors and users (company secretaries and shareholders) appeared to be reduced in areas specifically addressed in the wording of the expanded report. However, the expectations gap continued to exist after the introduction of the long-form audit report in relation to financial statement reliability. This finding appears to indicate continued difficulties being experienced by users in understanding audited financial statements. The study also appeared to indicate that users were generally unhappy with the role played by the auditing profession particularly with respect to auditor independence and the level of value (i.e. credibility) added to the financial statements from the auditing process.

4-3. Definition of the Expectations Gap

The definition of the expectations gap varies among researchers. The expectations gap can be defined as “the difference between what the public and financial statement users believe auditors are responsible for and what auditors themselves believe their responsibilities are” (AICPA 1993). Monroe and Woodliff (1993) defined the audit expectations gap as the difference in beliefs between auditors and the public about the duties and responsibilities assumed by auditors and the messages conveyed by audit reports. Jennings et al. (1993), in their study on the use of audit decision aids to improve auditor adherence to a “standard”, are of the opinion that the audit expectations gap is the difference between what the public expects from the auditing profession and what the profession actually provides. Porter (1993) did an empirical study of the audit expectation-performance gap and defined the expectations gap as the gap between society’s expectations of auditors and auditors’ performance, as perceived by society. It is seen to comprise two components:

- A- reasonableness gap (i.e. the gap between what society expects auditors to achieve and what the auditors can reasonably be expected to accomplish); and
- B- performance gap (i.e. the gap between what society can reasonably expect auditors to accomplish and what auditors are perceived to achieve).

The performance gap is further subdivided into “deficient standards”, i.e. the gap between the duties which can reasonably be expected of auditors and auditors’ existing duties as defined by the law and professional promulgation, and “deficient performance”, i.e. the gap between the expected standard of performance of auditors’ existing duties and auditors’ performance, as expected and perceived by society. Porter (1993) conducted an empirical study in New Zealand to test the postulated structure of the audit expectation-performance gap and to establish the composition and extent of the gap and its constituent parts. Using a mail survey, Porter ascertained the opinions of interested groups (auditors, officers of public companies,

financial analysts, auditing academics, lawyers, financial journalists and members of the general public) regarding auditors' existing duties, the standard of performance of these duties, and the duties that auditors should perform. The findings from the survey revealed that 50 per cent of the gap is attributable to deficient standards, 34 per cent from society holding unreasonable expectations of auditors, and 16 per cent from perceived sub-standard performance by auditors.

Humphrey (1997) provides an accessible introduction to the expectations gap literature and provides a general definition. He defined the expectations gap as "a representation of the feeling that auditors are performing in a manner at variance with the beliefs and desires of those for whose benefit the audit is carried out". He also notes that the expectations gap can be defined more narrowly as a "role-perception gap", that is, the expectations of users are capable of comparison with a predetermined notion of what is reasonable to expect auditors to provide. In turn this leads to the idea of an "ignorance gap", that is, the expectations gap can be closed (or at least narrowed) by the education of users. Conversely, Humphrey notes that the definition can be broadened to embrace wider issues such as the adequacy of auditing standards and the quality of audit delivery.

4-4. The Social Construction of the Audit Profession and the Expectations Gap

Corporate auditing has been characterized recently as a function facing a crisis critical to its long-term survival as a professionalized activity (Public Oversight Board 1993, and Lee 1994). The focus of this crisis concerns the quality of reported accounting information, the role of the auditor *vis-à-vis* that quality, and the litigious risks and economic costs associated with such a role. In particular, the crisis is strongly connected to the generic phenomenon of the expectations gap, i.e. to familiar dichotomies between what appears to be promised and

what is delivered by the auditor (Humphrey et al. 1992 and Gay et al. 1998). Such a gap is typically associated with perceived business and audit failures (Lee 1994).

According to Freidson (1986), a profession can be characterized as an institutionally-based occupation which uses various explicit characteristics, traits and situations as strategic resources to advance its claim to self-regulate its activities and exercise market control over its services. Of particular strategic concern to a profession in this process is the need to demonstrate publicly the existence of a credible body of knowledge underlying its members' practices, but without revealing sufficient detail to permit access to it by non-members. An example of this strategy is given by Hines (1989) in relation to conceptual framework projects. These studies create perceptions of an objective body of theoretical knowledge supporting prescribed accounting standards. But their written content is sufficiently vague and ambiguous to prevent detailed scrutiny. Power (1993) provides a compatible auditing example in the form of practice guidance documentation issued by auditors as a response to regulatory concerns. Such guidance typically uses a form of words which is acceptable to regulators but prevents external definition of key concepts, thus maintaining a "zone of discretion" for auditors.

Gay et al. (1998) explained that the Anglo Saxon accounting profession's responses to the expectations gap may be described as either defensive or constructive. The defensive responses include emphasising the need to educate the public and reassure them about the exaggerated public outcries over isolated audit failure; codifying existing practices to legitimize them, and attempting to control the audit expectations gap debate by repeatedly propounding the views of the profession. The constructive responses include emphasizing an awareness and readiness to extend the scope of the audit. However, such extensions have been

criticized for resulting in auditing being viewed as a package of services or a commodity for management's benefit, and as a means of legitimizing limited assurance engagements as audit related services (Humphrey et al. 1992). While some commentators argue that the recent change to expand the wording of the review and audit reports represents socially-orientated concessions on the part of the audit profession, others argue that it is a self-serving retreat from responsibility (Neebes and Roost 1987).

Green (1994) explained that financial reporting is constantly evolving as a result of recommendations by the accounting profession and regulators, and pressure from the financial press, investors, and academics, and as a result the rules and expectations surrounding the practice of financial reporting are in a constant state of flux. Often, these changes are precipitated by a “crisis” such as the collapse of a financial institution or the bankruptcy of a large corporation. The resulting changes, then, can be seen as an attempt to protect the public from inadequate financial statement disclosure and improve audit standards, or as a mechanism to reduce the auditors’ potential legal liability for company failures. For capital markets to continue to function effectively, financial reporting must be seen to be credible by the stakeholders that are affected. This, in turn, depends upon the continuing “existence of a consensus within society” which supports the standards, corporations legislation, regulations, and rules of professional conduct currently constraining the parties to the process. Society has certain expectations of the financial reporting process. When these expectations are not met and an “expectations gap” (real or perceived) exists, the profession, the regulators, and the legislatures feel pressure to introduce new standards and legislation. Society’s expectations cover not only the standards and legislative rules but also the enforcement of those requirements (Green 1994). In Canada, the Macdonald Commission Report (1988), *Commission to Study the Public’s Expectations of Audits*, referred to a “standards gap” and a

“performance gap”. This report aimed “to strengthen the recognition on the part of the directors and auditors of their mutual self-interest in good financial reporting for the company by reinforcing the role of the audit committee. Audit committees can play an important role in preventing and detecting fraudulent financial reporting (Treadway Commission 1987).

The audit expectations gap debate consistently centres around a number of perennial issues (Humphrey et al. 1992, Lee 1994, and Jenkins and Krawczyk 2001):

- A- the auditors independence and;
- B- the provision of non-audit services and;
- C- the quality of the audit function.

At the same time, concerns about the existence of an expectations gap leads to significant interest on the part of shareholders in the audit committees’ oversight responsibilities. Thus, in the next section, the audit committee role in narrowing the expectations gap is examined.

4-5. Auditor Independence, the Expectations Gap, and the Audit Committee

In current auditing praxis, few concepts are as important as auditor independence. This and the role auditors play in corporate financial reporting have to be viewed from the right perspective, that is in the overall context of the broader issue of corporate governance. Wolf et al. (1999) argued that the product of an audit is neither the auditor's report nor the investigation itself, but rather the increased credibility attached to the audited financial statements. The key factor in enhanced credibility is the perception of external stakeholders that the external auditor “judge” is impartial and without conflicts of interest. Without this perceived independence, an audit report may be viewed as nothing more than a company advertisement. The auditing profession itself recognizes this and it emphasises its independence in appearance as well as in fact. Independence in fact is the unbiased mental

attitude of the auditor, and independence in appearance, is the perception by a reasonable observer that the auditor has no relationship with an audit client which would suggest a conflict of interest (AICPA, 1993).

In the USA, the American Institute of Certified Public Accountants (AICPA) has dealt with the delicate issue of auditor independence on several occasions. Over the years independence has become the cornerstone of the auditing profession. In 1994, the AICPA's Professional Ethics Division published a proposed interpretation of the profession's *Code of Professional Conduct* to sharpen the distinction between client advocacy and client service (AICPA, 1994a). Firms and individual CPAs should exercise professional independence before committing to client positions on accounting or financial reporting issues. The AICPA Audit Standards and the Code of Professional Ethics both emphasize independence as a precondition in expressing an opinion on financial statements. The AICPA Code of Professional Ethics states that a CPA "shall not express an opinion on financial statements of an enterprise unless he and his firm are independent with respect to such enterprise". An opinion on the fairness of the presentation of financial statements should be issued only if he or she is independent of the client both in fact and appearance. In other words, independence must be perceived by third parties. On 16 March 1994, the Public Oversight Board (POB) announced the formation of a "special panel" to enquire into matters relating to auditor objectivity and independence. The panel recommended appropriate steps to bolster the professionalism of the independent auditor, and to assess the working relationships among the profession, the SEC, and the FASB (AICPA, 1995).

On 13 September 1994, the Public Oversight Board (POB) appointed an advisory panel on auditor independence. The major recommendations of this panel addresses corporate

governance issues and specifically responsibilities of the board of director's audit committee. The panel states "the board must recognize the primacy of its accountability to shareholders". Additionally, "the auditor must look to the board of directors as the client" (Public Oversight Board of the SEC Practice Section, AICPA, 1994b).

In 1997, the AICPA further responded to expectations gap perceptions by mandating a more aggressive stance by auditors with respect to fraud. This proposal resulted in Statement on Auditing Standards (SAS) No. 82, Considerations of Fraud in a Financial Statement Audit, as well as amendments to two existing standards. The new standard provides detailed risk factors that auditors should consider related to internal control and its impact on fraud detection and prevention. In 1998 in the USA, the SEC and the accounting profession (AICPA) formed the Independent Standards Board (ISB). The ISB was officially designated as having authority to issue rules intended to prevent audit firms from taking actions that threaten auditor independence unless and until the rules are rejected by the SEC. The ISB was established in response to the perceived challenges to exercising independence resulting from audit firm mergers, auditors entering new service areas, and the increasing complexity of business and professional relationships. The ISB issued a number of standards and a Discussion Memorandum in February 2000 on *A Conceptual Framework for Auditor Independence*. The SEC incorporated much of the work of the ISB into its new auditor independence rules after conducting public hearings on proposed rules affecting auditor independence in 2000. This culminated in rule changes effective from February 2001 on governing independence.

The standards of independence in the UK are similar to those in the USA, though one major difference is that, in the UK, independent auditors are allowed to perform certain book-keeping functions for private companies (Vanasco et al. 1997). The UK amended the Companies Act of 1985 to implement the European Community's Eighth Directive. This lays

down minimum approval requirements for company auditors, including their education and training. It obliges member states to ensure that company audits are performed with integrity and that there are appropriate safeguards to protect auditor independence (Anderson and Keenan 1990). For over 100 years, the accountancy profession in the UK has built its reputation on the foundation of objectivity, integrity, and competence which include all that is required for auditor independence. Green (1994) has called for greater auditor independence and an in-depth review of the auditing profession in the UK. He argues that such a system would restore the auditor as watchdog and release non-executive directors to a more constructive role.

Regulatory factors concern both accounting and auditing. It is argued that independence is most threatened where all auditors do not agree on the preferred accounting treatment, due to the flexibility of accounting standards (Magee and Tseng 1990). Key aspects of audit regulation which one can argue promote independence are: the existence of unlimited legal liability for auditors (Farmer et al. 1987), the strong enforcement of standards, the effective discipline of companies and auditors, the control over the appointment and remuneration of auditors being taken from directors (POB 1994), and the existence of an audit committee (Treadway Commission 1987, Cadbury Committee 1992, BRC 1999). Audit committees are probably the most widely adopted means of strengthening auditors' independence (Porter et al. 2003).

In January 1999, the Independence Standards Board (ISB) adopted its first standard, *Independence Discussions with Audit Committees*. The standard applies to any auditor intending to be considered as independent auditor within the meaning of the Federal

Securities Acts administered by the SEC. The standard requires that at least annually, an auditor shall:

- disclose to the audit committee of the company (or the board of directors, if there is no audit committee), in writing, all relationships between the auditor (and its related entities) and the company (and its related entities) that, in the auditor's professional judgment, may reasonably be thought to bear on independence;
- confirm in the letter that, in the auditor's professional judgment, it is independent of the company within the meaning of the acts; and
- discuss the auditor's independence with the audit committee.

In the UK, the Cadbury Committee (1992) argued that higher standards of corporate governance can be achieved through improvements in the quality of financial reporting which will facilitate an increased level of auditor independence. The Cadbury solution is to boost auditor independence by a greater presence on company boards of independent non-executive directors and by the establishment of audit committees as sub-committees of the main board charged with specific responsibilities relating to financial reporting, audit, and internal control issues. Spira (1999) explained that “the activities of the audit committee offer a further reassurance that the account of the company’s activities may be relied upon, and that the auditors have, as a result of the protection of the audit committee, been able to report independently, free of any pressure from the management of the company”.

4-6. Non-audit Services, the Expectations Gap, and the Audit Committee

The provision of non-audit services by incumbent auditors is the factor which in recent years has been debated most intensively by policy-makers, the accountancy profession, practitioners, and academics (Beattie et al. 1999). There are many opinions about whether

offering non-audit services may or may not impair the independence of the auditor in different situations and circumstances (Sabri 1993).

Auditors have provided their clients with many types of service since the time when external auditing began in the nineteenth century up to the present day (Previts 1985). The reason why accountants and auditors provide services that complement their principal task is connected, now and in the past, with the considerable economies of scope, or joint production (meaning cost savings obtained when both types of service are provided by the same person or firm). Arrumada (1999) explained that a distinction should be made within these economies of scope between those that originate in the “transformation” process directed toward the production of information and knowledge, often known in accounting literature as “knowledge spillovers”, and those arising from making better use of assets or advantages of a “contractual” nature. Productive economies usually arise from the fact that both types of service need to use the same set of information and/or the same professional qualifications (Houghton and Jubb 1999). For example, the information required to evaluate an internal control system is largely identical to the one needed to improve it. Auditors are therefore in the best possible position to advise on renewing such systems. The existence of economies of a contractual nature is connected with the fact that the exchange of professional services involves high transaction costs due to the informational asymmetry existing between supplier of and client for such services. Therefore, it becomes worthwhile to make use of the safeguards (brand-name, reputation, conduct rules, control systems among professionals, and client confidence) already developed when contracting and ensuring quality in auditing, thereby reducing the total cost of providing such services. For this reason, the ability to use the same contractual resources is particularly valuable in safeguarding or protecting the provision of a variety of services, even

in the absence of economies of scope of a technological or productive nature in the strict sense.

Along these lines, there are studies indicating that the provision of non-audit services has no effect on perceptions of auditor independence. For example, Kinney (1999) reviewed 20 years of empirical research and found no substantial evidence that investors are concerned about non-audit services. Wallman (1996) also encountered little empirical evidence that the performance of non-audit services impairs the external auditor's independence in fact.

On the other hand, Jenkins and Krawczyk (2001) found that an expectations gap may exist between the general public and the accounting profession with respect to how they view the impact of non-audit services on auditor independence. Also, Wines (1994), using pooled, cross-sectional, time-series data for Australian listed companies, finds a negative association between non-audit services and qualified opinions and concludes that there is a potential independence problem in the presence of non-audit services. Although a series of ethical standards has been adopted by the profession relative to management advisory services, critics continue to argue that this mix of services is inappropriate (Briloff 1994 and Wallman 1996). This concern is shared somewhat by the public accounting profession itself. The Public Oversight Board's Advisory Panel on Auditor Independence (1994) noted that the increased reliance on services other than auditing could potentially compromise the external auditor's objectivity. In addition, the American Institute of Certified Public Accountants' (AICPA) Special Committee on Financial Reporting (1994) stated that users of financial statements are concerned that competitive pressures could erode the external auditor's independence.

Section 202 of the Sarbanes-Oxley Act (2002) requires that audit committees pre-approve all audit and non-audit services provided by the company's audit firm. The new rule adds a subsection to Regulation S-X that states that an accountant is not independent in respect of the company unless the accountant's engagement for audit or non-audit tasks is pre-approved by the audit committee. The pre-approval may occur in one of two ways - actual pre-approval by the audit committee or pursuant to pre-approval policies and procedures established by the committee. The committee may directly approve a permitted service before the auditor is engaged for the project. In all cases this approval must occur before the auditor is engaged. Engaging the auditor prior to receipt of audit committee approval would cause the auditor not to be independent of the company. A company may engage the auditor for a permitted service project pursuant to policies and procedures adopted by the audit committee. Companies employing the policies and procedures approach will need to disclose these procedures in their annual filings. To engage an audit firm to provide a permitted service based on policies and procedures established by the audit committee, the policies and procedures must be detailed as to the particular service and the audit committee must be informed of the service. The SEC expects that audit committees will indicate the maximum period in advance of the activity that approval may be granted. In addition, the company's policies and procedures must not be so expansive as to represent a delegation of the audit committee's responsibilities to management.

In connection with the implementation of auditor independence requirements under the Sarbanes-Oxley Act of 2002, the SEC recently adopted final rules requiring audit committees of issuers to pre-approve all "permissible" non-audit services provided to the issuer by the auditor. These final rules will apply to the provision of non-audit services by the auditor beginning on May 6, 2003. The rules specify "that before the accountant is engaged by the

issuer to render non-audit services, the engagement must be (1) approved by the issuer's audit committee or (2) entered into pursuant to the audit committee's established policies and procedures for pre-approval, provided the policies and procedures are detailed as to the particular service and designed to safeguard the continued independence of the accountant".

4-7. Audit Quality, the Expectations Gap, and the Audit Committee

Audit quality is crucial to financial statement quality, but is intangible and hence difficult to measure. A widely used definition of audit quality is provided by DeAngelo (1981) "the consumers' perception of the joint probability that an auditor (a) discovers a breach in the client's accounting system and (b) reports that breach, the former depending upon audit procedures and the latter on the auditor's independence from a given client". The ability of auditors to uncover failures in the accounting system will depend on the auditor being free to determine the appropriate audit techniques and the extent of their application (Collier and Gregory 1996).

The link between audit committees and the quality of external audit work has long been recognized in the literature. For example, Jack (1993) in discussing the relationship between audit committees and external auditors, emphasized the important role of the audit committee in assessing the level of fees and ensuring that the audit fee is not so low that audit quality is compromised. Abbott and Parker (200a) argued that independent and active audit committees can take two actions related to the external auditor to ensure a higher level of audit quality. First, they can ensure that management selects a high-quality external auditor. Second, the audit committee could take actions to ensure that the quality of audit effort by the external auditor is increased.

In terms of the audit committee's ability to influence the level of audit effort, DeZoort (1997) notes that audit committee members generally believe the review of the external auditor's work to be a primary audit committee duty. Abbott and Parker (2000a) posit that outside, independent audit committee directors possess a two-factor audit quality demand function. The first factor is reputation capital enhancement/preservation. More specifically, outside audit committee directors may view becoming part of the directorate as a means of enhancing their reputations as experts in decision control (Fama and Jensen 1983). Although audit committee service increases the reputation capital of these outside directors, it may also exacerbate the reputation damage should a financial misstatement occur. The second audit quality demand factor unique to independent audit committee directors concerns director liability. In cases of financial misstatement, outside *non-audit committee* directors can potentially subrogate their director liability to audit committee members by asserting reliance on the audit committee for issues such as the adequacy of the firm's financial reporting and relationship with its external auditor (Reinstein and Weirich 1996). Recent research supports the notion that audit committees undertake actions designed to mitigate audit committee director reputation and litigation-related losses. For example, Abbott and Parker (2000b) find that audit committees comprised entirely of independent directors that meet at least twice annually are more likely to employ an industry specialist auditor. In a related stream of research, Carcello and Neal (2000a) find that financially distressed firms with independent audit committees are more likely to receive a going concern qualification. Carcello and Neal (2000b) find external auditors who issue initial going concern audit reports are less likely to be terminated when the audit committee is comprised entirely of independent directors. Both sets of results are consistent with a concern for perceived audit quality and/or auditor independence.

4-8. Summary

The audit expectations gap, and how it might be narrowed, has been of interest to audit regulators, accounting academics, and accountancy bodies in all the world. At the same time, concerns about the existences of an expectations gap led to significant shareholders interest in the audit committee oversight responsibilities. The presence of the audit committee enhances the perception of auditors independence. By interposing a committee of non-executive directors between operating management and the external auditors, both sides are given a forum to discuss matters considered to be significant to the corporation on a normal and regular basis. It also provides a mechanism which reduces the possibility of aggressive management being over dominating in its relationship with auditors (Vinten and Lee 1993 and Deli and Gillan 2000).

Chapter Five: The Legal Framework for Audit Committee

Chapter Five: The Legal Framework for Audit Committees

5-1. Introduction

Audit committee guidelines and codes of best practice, like corporate governance, arise in the context of, and are affected by, differing national frameworks of law, regulations, and stock exchange listing rules and differing societal values. Therefore, to understand one nation's audit committee practice in relation to another it is necessary to understand not only the best practice documents but also the underlying legal framework. This chapter commences by illustrating the UK and USA experience of audit committees and the enforcement for improving their role in the both countries. The chapter continues by explaining the legal frameworks for audit committees in the UK, USA, and Egypt through a comparative overview of the following factors: the audit committee charter, the independence and experience of committee members, the size, meetings, resources and authority of the audit committee, audit committee members training, and the audit committee's report. Audit committee effectiveness is viewed as the competency with which the committee carries out its specific oversight responsibilities which is the final sections of the comparison. This sections included Table summarized the legal frameworks for audit committees in the UK, USA, and Egypt.

5-2: The Nature of the Legal Framework of Audit Committees: a Comparison between the UK, USA, and Egypt

Corporate governance has spawned an increasing amount of interest from academics, practitioners, and national and multilateral government bodies. Much of this attention has focused on the way USA and UK companies are governed (Vinten 2000). The USA corporate governance system has been generally characterised as marker-or short-term shareholders-oriented. This characterisation also applies to the UK corporate governance system, given the close economic ties between the UK and the USA both with respect to the degree of market

integration and the organisation of transactions and in relation to other socio-cultural respects including underlying Anglo Saxon accounting frameworks (Dockery and Herbert 2000, and Gray 1988). It is expected that the transition economy process in Egypt will exhibit differences in its corporate governance systems. These may be associated with the significant differences in attitudes, beliefs, cultural values, and the rate of progress in introducing appropriate frameworks. They, in turn, are expected to impact on managerial behaviour, firm objectives and market corporate control (Humphreys 1996 and Dockery and Herbert 2000). Committees, commissions, and regulatory authorities in the USA and the UK have identified the corporate audit committee as a key component of effective corporate governance (Lee and Stone 1997). Consequently, it is possible that differences in the regulatory environment and the importance assigned to corporate governance, as well as other cultural factors, could significantly influence the nature of the audit committees' legal framework in the USA, UK, and Egypt.

5-3. The UK Experience of Audit Committees

The UK is the only major country, within the European Union, where the majority of listed companies have formed audit committees composed of non-executive directors to monitor, financial reporting, the external auditors, and internal control strength (Collier and Gregory 1996). The adoption of the audit committee in the UK did not begin until the late 1980s. In 1987, stimulated by the large and increasing size and incidence of corporate fraud, the Bank of England, the Confederation of British Industry, and other financial institutions urged public companies to adopt audit committees (Vanasco 1994).

In December 1992, audit committees in the UK received a boost from the Committee on the Financial Aspects of Corporate Governance, known as the Cadbury Committee. The Cadbury

Committee issued a report that significantly expanded the role of audit committees in maintaining financial reporting standards for firms listed on the London Stock Exchange. The committee defined the financial aspects of corporate governance as “the way in which boards set financial policy and oversee its implementations, including the use of financial controls, and the process whereby they report on the activities and progress of the company to the shareholders” (Sec. 2.6). Also, the Cadbury Committee argued that higher standards of corporate governance could be achieved through improvements in the quality of financial reporting which would facilitate an increased level of auditor independence. The Cadbury solution boosts auditor independence by there being a greater presence on company boards of independent non-executive directors and by the establishment of audit committees. The Cadbury Committee put forward their recommendations on audit committees and the London Stock Exchange promulgated this as the Combined Code in June 1998.

In 1999, the Internal Control Committee of Chartered Accountants in England and Wales published the *Internal Control Guidance for Directors of Listed Companies Incorporated in the UK* (Turnbull 1999). This guidance is commonly referred to as the Turnbull Report. The report marks an explicit move towards an enhanced role for audit committees regarding internal control system.

Recently, in 2003, following the corporate failures in the USA, the Financial Review Council (FRC) was asked to set up an independent group to clarify the role and responsibilities of audit committees and develop a Combined Code of guidance. The group, under the chairmanship of Sir Robert Smith, published its report in January 2003. The report proposes significant changes to the Combined Code for audit committee’s oversight responsibilities related to the financial reporting process, auditing, and internal control. It also suggests that

audit committee activities should be reported to shareholders in a separate section within the directors' report in the annual financial statements. The provisions of the Smith Report apply to accounting periods starting on or after 1 July 2003.

5-4. The USA Experience of Audit Committees

The exact origin of the audit committee in the USA is unknown, but is largely attributed to the aftermath of the Mckesson & Robbins, Inc. fraud in 1938. The New York Stock Exchange (NYSE) and the Securities and Exchange Commission (SEC) in Accounting Series Release No. 19 of 1940, subsequently recommended that the auditor should be selected by a special committee composed of non-officer board members (Collier 1996).

The audit committee movement gathered steam in the late 1960s and 1970s, acquiring widespread acceptance in the USA as the proper vehicle for exercising financial oversight by 1980. Until 1967 the concept of the audit committee received very little support, and the functions of this committee remained undefined. In July 1967 the Executive Committee of the American Institute of Certified Public Accountants (AICPA) recommended that publicly held corporations establish audit committees of members outside the board of directors, because "the auditors should communicate with the audit committee whenever any significant question having material bearing on the company's financial statements has not been satisfactorily resolved at the management level" (Braiotta et al. 1999).

In March 1972, the US Securities and Exchange Commission (SEC) recommended that all publicly held companies have audit committees composed of outside directors. Accordingly, no members of management would be involved in the review of certain matters, which were once solely the prerogative of management. In the same year, the SEC required that

corporations disclose to shareholders whether or not they had an audit committee (Vanasco 1994), in addition, it recommended but did not require listed companies to have an audit committee. In 1976, Congress debated a law that would have required public companies to form audit committees composed of independent directors. Despite failing to pass this bill, Congress encouraged the voluntary formation of these committees by enacting the Foreign Corrupt Practices Act. (FCPA). Among other reforms, the FCPA required internal accounting controls designed to detect illegal payments and report such payments to the Board of Directors. In 1987, following on the heels of congressional action, the New York Stock Exchange (NYSE) required all listed firms to have an audit committee.

In 1985, the National Commission on Fraudulent Financial Reporting (the Treadway Commission) was established to address fraudulent financial reporting. In 1987, the Commission issued its report, recommending that all public companies form audit committees composed entirely of outside directors. The primary objective was to identify causal factors that can lead to fraudulent financial reporting and to develop recommendations to reduce its incidence. Also, the Commission identified the audit committee as an essential part of any system designed to prevent fraudulent financial reporting. Several recommendations were offered regarding audit committees, including mandatory committee formation for all public companies, and severe penalties for directors involved in fraudulent financial reporting. Audit and management practitioners view these recommendations as having important implications for audit practice and the financial reporting process.

The debate increased in 1998, when SEC chairman, Arthur Levitt, highlighted his concerns regarding financial reporting by public companies. With his speech “The Number Game,” Chairman Levitt initiated a new focus on deceptive accounting practices, in response to the

market's increasing focus on corporate earnings. He focused on "earning management," which he believed had the potential to undercut investor confidence in U.S. capital markets by destroying financial reporting transparency and reliability. Among the initiatives he announced was a call to strengthen the audit committee. In response, the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD) sponsored the formation of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (BRC). The committee made ten recommendations to the Securities Exchange Commission (SEC), the securities markets, the accounting profession, Boards of Directors, external auditors, internal auditors, managers, and audit committees, regarding the enhancement of financial reporting and the oversight of that process. The report is designed to advance awareness and implementation of measures to promote the concept of "quality" financial reporting.

Recently, Congress passed and the President signed into law on July 30, 2002, The Sarbanes-Oxley Act. This Act mandates sweeping corporate disclosure and financial reporting reform to improve the responsibility of public companies for their financial disclosures. It requires the SEC to direct the national exchanges and associations to prohibit the listing of any company not in compliance with the Commission's requirements for audit committees.

5-5. The Legal Framework for Audit Committees: A Comparative Overview

Since the middle of 1978, USA companies seeking a listing are required to have an audit committee. In the UK, although audit committees are not mandatory, there is effectively a requirement for listed companies to have them because the London Stock Exchange requires UK listed companies to prepare a statement in their annual report of compliance with the Cadbury Committee (1992) requirements and to give details of any non-compliance. In Egypt,

since 2002, companies listed on the Cairo & Alexandria Stock Exchange (CASE) are required to have an audit committee.

5-5-1. Audit Committee Charter

To enhance their effectiveness in carrying out their responsibilities for oversight of the financial reporting process on behalf of the Board of Directors, audit committees should have written charters that set forth their duties and responsibilities (Treadway Commission 1987). The audit committee charter provides a framework of the committee's organisation, responsibilities, duties, and relationships with management, external and internal auditors. Often a charter of the audit committee is included in the bylaws of a corporation, and such a charter is approved by the Board of Directors (Vanasco 1994 and Sweeney and Vallario 2002).

In the UK, the Cadbury Committee (1992) recommends that "audit committees should be formally constituted to ensure that they have a clear relationship with the boards to whom they are answerable and to whom they should report regularly. They should be given written terms of reference which deal adequately with their membership, authority and duties". Also, the Smith Report (2003) recommends that "the board should provide written terms of reference for the audit committee. The terms of reference should be tailored to the particular circumstances of the company. The audit committee should review annually its terms of reference and its own effectiveness and recommend any necessary changes to the board".

In the USA, the Treadway Commission (1987) recommends that "all public companies should develop a written charter setting forth the duties and responsibilities of the audit committee. The Board of Directors should approve the charter, review it periodically, and modify it as

necessary". The BRC (1999) recommends that the NYSE and NASD require the audit committee of each listed company to: (1) adopt a formal written charter that is approved by the full Board of Directors and that specifies the scope of the committee's responsibilities, and how it carries out those responsibilities, including structure, process, and membership requirements, and (2) review and reassess the adequacy of the audit committee charter on an annual basis. The committee also recommends that the SEC promulgate rules that require the audit committee for each reporting company to disclose in the company's proxy statement for its annual meeting of shareholders whether the audit committee has adopted a formal written charter, and, if so, whether the audit committee satisfied its responsibilities during the prior year in compliance with its charter, which charter shall be disclosed at least triennially in the annual report to shareholders or proxy statement and in the next annual report to shareholders or proxy statement after any significant amendment to that charter.

In comparison, in Egypt the Capital Market Authority (CMA) in its statement No.30 in 2002 makes no requirements of companies listed on the Cairo & Alexandria Stock Exchange (CASE) to adopt a formal written charters for their audit committees.

5-5-2. Audit Committee Member Independence

Both the business and academic press have recently focused on audit committee composition as an important determinant of financial reporting quality (Vafeas 2001). In particular, there is widespread support for the notion that audit committees should consist of non-executive directors, who are more likely to be independent of management's influence and are thus better suited to oversee the financial reporting process (Beasley 1996). Numerous studies (e.g. McMullen and Raghunandan 1996, Beasley 1996, and Archambeault and DeZoort 2001) highlight that the director's ability to control decisions within the organization is

compromised when independence is lacking because such directors are less likely to challenge management's decisions. Independent directors, on the other hand, have an incentive to challenge questionable management decisions because they seek to develop and protect their status in the marketplace (Archambeault and DeZoort 2001). In this spirit, the Securities Exchange Commission (SEC 2003) states that:

“an audit committee comprised of independent directors is better situated to assess objectively the quality of the issuer's financial disclosure and the adequacy of internal controls than a committee that is affiliated with management. Management may face market pressures for short-term performance and corresponding pressures to satisfy market expectations. These pressures could be exacerbated by the use of compensation or other incentives focused on short-term stock appreciation, which can promote self-interest rather than the promotion of long-term shareholder interest. An independent audit committee with adequate resources helps to overcome this problem and to align corporate interests with those of shareholders”

Arens and Loebbecke (2000) explained that the audit committee's independence from management and their knowledge of financial reporting issues are considered important determinants of their ability to effectively evaluate internal controls and financial statements prepared by management. The empirical literature supports such concerns regarding the independence of audit committee members. Beasley (1996) found that the percentage of outside directors was significantly lower for firms with fraudulent activity than for firms without fraudulent activity, and that fraudulent firms had audit committees with a significantly lower percentage of outsiders than non-fraudulent firms. McMullen and Raghunandan (1996) found that companies without reporting problems were more likely to have an audit committee composed solely of outside directors than companies with reporting problems. Wright (1996) found a direct relationship between the quality of an entity's financial reporting and the percentage of outside directors on the audit committee. Abbott and Parker (2000b) found that firms with audit committees that do not include employees and that

meet at least twice per year are more likely to use an industry-specialist auditor. Also, DeZoort and Salterio (2001) found that independent directors' experience was positively related to audit committee member support for a 'substance over form' position in an auditor-client dispute. Inside members may have increased incentive to seek outcomes desired by management, which may be contrary to those in the best interest of shareholders (Archambeault and DeZoort 2001).

In the UK, the Cadbury Committee (1992) states that "membership should be confined to the non-executive directors of the company and a majority of the non-executives serving on the committee should be independent". Also, the Smith Report (2003) recommends that "audit committees should include at least three members, who should all be independent non-executive directors". In this respect, the Higgs Report (2003) defined "independent" as follows: a non-executive director is considered independent when the board determines that the director is independent in character and judgement and there are no relationships or circumstances which could affect, or appear to affect, the director's judgement. Such relationships or circumstances would include where the director:

- A- is a former employee of the company or group until five years after employment (or any other material connection) has ended;
- B- has, or has had within the last three years, a material business relationship with the company either directly, or as a partner, shareholder, director or senior employee of a body that has such a relationship with the company;
- C- has received or receives additional remuneration from the company apart from a director's fee, participates in the company's share option or a performance-related pay scheme, or is a member of the company's pension scheme;
- D- has close family ties with any of the company's advisers, directors or senior employees;

- E- holds cross-directorships or has significant links with other directors through involvement in other companies or bodies;
- F- represents a significant shareholder; or
- G- has served on the board for more than ten years.

The board should identify in its annual report the non-executive directors it determines to be independent. The board should state its reasons if a director is considered to be independent notwithstanding the existence of relationships or circumstances which may appear relevant to its determination.

In the USA, since 1978, the New York Stock Exchange (NYSE) has required “each listing domestic corporation to have an audit committee made up wholly of ‘independent’ directors. The audit committee must be independent of management and free from any relation that, in the opinion of its Board of Directors, would interfere with the exercise of independent judgement as a committee member”. The Treadway Commission (1987) recommends that “the Board of Directors of all public companies should be required by SEC rules to establish audit committees composed solely of independent directors”. The Federal Deposit Insurance Corporation (FDIC) Improvement Act of 1991 has a similar requirement for large domestic banks. The American Law Institute and the Business Roundtable (BRT 2002) advocate audit and compensation committees comprised solely of directors independent from management. The BRC (1999) recommends that both the NYSE and NASD adopt the following definition of independence for purposes of service on the audit committee for listed companies with a market capitalization above \$200 million (or a more appropriate measures for identifying smaller-sized companies as determined jointly by the NYSE and the NASD): members of the audit committee shall be considered independent if they have no relationship to the

corporation that may interfere with the exercise of their independence from management and the corporation. Examples of such relationships include:

- A. a director being employed by the corporation or any of its affiliates for the current year or any of the past five years;
- B. a director accepting any compensation from the corporation or any of its affiliates other than compensation for board service or benefits under a tax-qualified retirement plan;
- C. a director being a member of the immediate family of an individual who is, or has been in any of the past five years, employed by the corporation or any of its affiliates as an executive officer;
- D. a director being a partner in, or a controlling shareholders or an executive officer of, any for-profit business organization to which the corporation made, or from which the corporation received, payments that are or have been significant to the corporation or business organization in any of the past five years; or
- E. a director being employed as an executive of another company where any of the corporation's executives serves on that company's compensation committee.

A director who has one or more of these relationships may be appointed to the audit committee, if the board, under exceptional and limited circumstances, determines that membership on the committee by the individual is required in the best interests of the corporation and its shareholders, and the board discloses, in the next annual proxy statement subsequent to such determination, the nature of the relationship and the reasons for that determination. The Committee recommends that in addition to adopting and complying the definition of independence set forth above for the purpose of service on the audit committee, the NYSE and the NASD require that listed companies with a market capitalization above

\$200 million (or a more appropriate measures for identifying smaller-sized companies as determined jointly by the NYSE and the NASD) have an audit committee comprised solely of independent directors.

The Sarbanes-Oxley Act. Of 2002, Sec. 301, also establishes an independence definition for audit committee members thus: “independent is defined as not receiving, other than for service on the board, any consulting, advisory or other compensatory fee from the issuer, and as not being an affiliated person of the issuer, or any subsidiary thereof”. Along these lines, the SEC (2003), under the proposed rule, requires that “each member of the audit committee would need to be an independent member of the Board of Directors. In order for a director to be considered independent, audit committee members cannot accept, directly or indirectly, any consulting, advisory or other compensatory fee from the issuer or an affiliate of the issuer, other than in his or her capacity as a member of the Board of Directors and any board committee”

In Egypt, the requirement for independent audit committee members appeared in the Capital Market Authority (CMA) statement No.30. The CMA states that “ the audit committee should comprise at least three non-executive directors”. But the CMA does not define the “independence” requirements for audit committee members. The World Bank Report (2001) argued that the concept of non-executive or independent director is not well established in Egypt.

5-5-3. Experience of the Audit Committee Member

Lee and Stone (1997) explained that despite the presumed independence of audit committees comprised of non-executive directors, they appear unable to monitor adequately such

technical matters as fraud, accounting, auditing, and internal controls. This suggests a need for at least certain audit committee members to have technical skills which relate to accounting, auditing, and control issues. DeZoort (1998) argued that audit committee members' experience is regarded as an important dimension of audit committee effectiveness. Such experience refers to the amount of time spent working in areas related to assigned corporate oversight responsibilities. The Institute of Internal Auditors and Price Waterhouse (1993) articulated a need for audit committees to contain sufficient relevant experience to discharge their responsibilities effectively. Other individuals and bodies have stated similar concerns (e.g. Sommer 1991, Lee and Stone 1997, DeZoort 1997, and the Public Oversight Board 1993). Each of these studies identified either audit committee member experience or awareness of technical issues as a necessary ingredient for effective monitoring.

There are a number of studies which highlight the importance of relevant audit committee member experience as a component of overall committee effectiveness. For example, McMullen and Raghunandan (1996) found that the companies with no reporting problems were more likely to have a CPA on the audit committee than companies that had experienced reporting problems. DeZoort (1998) found that member experience in the areas of auditing and internal control had a positive effect on member performance on internal control evaluation tasks. Moreover, experience is important for audit committee members because, many oversight judgements are subjective and lack clear "right" or "wrong" answers. Therefore, in the absence of objective criteria, members lacking experience are more likely to make suboptimal decisions in primary oversight domains (e.g. accounting, auditing, and business environment) because they may lack the technical knowledge needed.



In the UK, the Smith Report (2003) recommends that “at least one member of the audit committee should have significant, recent and relevant financial experience, for example as an auditor or a finance director of a listed company. It is highly desirable for this member to have a professional qualification from one of the professional accountancy bodies. The need for a degree of financial literacy among the other members will vary according to the nature of the company, but experience of corporate financial matters will normally be required. The availability of appropriate financial expertise will be particularly important where the company’s activities involve specialised financial activities”.

In the USA, the Federal Deposit Insurance Corporation Improvement Act 1991 requires bank audit committees to have some members with banking and related financial management experience. The Institute of Internal Auditors (USA) recently recommended that, in addition to a majority of members with business experience, the audit committees should have at least one member with a background in financial reporting, accounting, or auditing. In 1999, the NYSE and NASD listing standards required each audit committee member to be financially literate or become so within a reasonable period of time after his or her appointment. Also, both required at least one member of the audit committee to have accounting or related financial management expertise. The BRC (1999) recommends that “the NYSE and the NASD require listed companies with a market capitalization above \$200 million (or more appropriate measures for identifying smaller-sized companies as determined jointly by the NYSE and the NASD) to have an audit committee comprised of a minimum of three directors, each of whom is financially literate or becomes financial literate within a reasonable period of time after his or her appointment to the audit committee, and further that at least one member of the audit committee has accounting or related financial management expertise”.

The Committee defined “expertise” as:

- (1) significant past employee experience in finance or accounting;
- (2) a requisite professional certification in accounting; or
- (3) any other comparable experience or background which results in the individual's financial sophistication, including being or having been a CEO or other senior officer with financial oversight responsibilities.

The Sarbanes-Oxley Act. of 2002, Sec. 407, recommends the SEC to require disclosure of whether or not the audit committee has at least one financial expert. If an audit committee does not have a financial expert, the reason for this must be disclosed. The SEC (2003) defines 'financial expert' by considering the following elements:

- (1) being a public accountant, auditor, CFO, controller, CAO or similar of an issuer;
- (2) having an understanding of GAAP and financial statements;
- (3) having experience in (a) preparation or auditing of financial statements of similar issuers (b) accounting for estimates, accruals and reserves (c) internal controls; or
- (4) having an understanding of audit committee functions.

In Egypt, the Capital Market Authority (CMA) has considered the importance of audit committee member experience. Hence, the CMA states that "the audit committee should comprise at least three non-executive directors, each of whom should be diligent and have a good experience in the company business environment". However, this statement does not specify the requirement for financial experience of the audit committee member. The CMA does require that the audit committee review and analyse the applied accounting policies of the company and the significant changes in applying the new accounting standards. This

responsibility for audit committees requires good financial, accounting, and auditing experience among the members.

5-5-4. Audit Committee Size

The audit committee composition may vary from company to company. The number of members is determined by the size of the board of directors and the size of the organisation (Vanasco 1994). However, the size of each committee should be appropriate for the company's circumstances and will depend on the extent of the committee's responsibilities. Importantly, an audit committee should be large enough to represent a balance of views and experience, yet small enough to operate efficiently. From a control perspective, the accounting, auditing, and fraud literature (e.g., Archambeault and DeZoort 2001 and Klein 1998) indicates that increasing the number of people involved in an activity substantially decreases the opportunity for wrongdoing because collusion becomes more difficult. To this end, concern about audit committee size has led to a number of recommendations about the number of members needed to help ensure that committees are large enough to provide adequate oversight.

In the UK, the Cadbury Committee (1992) recommended that "the board should establish an audit committee of at least 3 non-executive directors". Similarly, the Smith Report (2003) recommends that "audit committees should include at least three members, who should all be independent non-executive directors. The chairman of the company should not be an audit committee member".

In the USA, the Treadway Commission (1987) recommends that "an audit committee normally should consist of not fewer than three independent directors. The maximum size

may vary, but the committee should be small enough so that each member is an active participant". The NACD (2000) recommends that audit committees have between three and six members. Similarly, the BRC (1999) recommended that " the NYSE and NASD require listed companies with a market capitalisation above \$ 200 million to have an audit committee comprised of a minimum of three directors".

In Egypt also, the CMA in its statement No.30 (2002), states that " the audit committee should comprise at least three non-executive directors".

5-5-5. Audit Committee Meetings

Audit committee activity is an important dimension of overall effectiveness because activity signals monitoring. As a result, the number of audit committee meetings held during the year is a common proxy for committee activity (Menon and Williams 1994, McMullen and Raghunandan 1996, Beasley 1996, and Carcello and Neal 1998). An audit committee that reports high levels of activity is assumed to take its duties seriously and perform more effectively than a committee that reports low levels of activity (Archambeault and DeZoort 2001). To be effective, an audit committee must meet regularly and must carefully plan its timetable, agendas, and participations. The number of meetings the committee holds is influenced by the objectives established and the scope of activities (Price Waterhouse 1999). Also, the Smith Report (2003) states that " formal meetings of the audit committee are the heart of its work". Archambeault and DeZoort (2001) argued that, it is not enough that audit committees be independent, they must also be active. An independent audit committee that never meets is of little consequence. This suggests that in the examining effectiveness of the audit committee it is important to consider the level of audit committee activity. Menon and Williams 1994, and Deli and Gillan 2000, use the number of audit committee meetings as a

proxy for the level of audit committee activity. But, they note that the number of audit committee meetings is only a rough proxy for activity because, “it does not provide any indication of the work accomplished during these meetings”. They also note, however, that audit committees that do not meet, or meet only a small number of times, are unlikely to be effective. The Smith Report (2003) states that, sufficient time should be allowed to enable the audit committee to undertake as full a discussion as may be required. A sufficient interval should be allowed between audit committee meetings and main board meetings to allow any work arising from the audit committee meeting to be carried out and reported to the board as appropriate. Also, Pomeranz (1997) argued that, the audit committee chairperson should set an agenda including a timetable, the names of any presenters, and the names of operating executives expected to be present. The agenda should also include a preparation section which specifies the homework to be done prior to the meeting. In this spirit, Olson (1999) explained that, meeting schedules and meeting agendas should be planned in advance by the audit committee chair and corporate financial officers to be certain that the important “big picture” issues are not neglected as the number of formal and procedural duties increases.

In the UK, the Smith Report (2003), Sec. 3.5 and 3.6, recommends that “it is for the audit committee chairman, in consulting with the company secretary, to decide the frequency and timing of its meetings. There should be as many meetings as the audit committee’s role and responsibilities require. It is recommended there should be not fewer than three meetings during the year, held to coincide with key dates within the financial reporting and audit cycle. However, most audit committee chairman will wish to call more frequent meetings. Also, no one other than the audit committee’s chairman and members is entitled to be present at a meeting of the audit committee. It is for the audit committee to decide if non-members should attend for a particular meeting or a particular agenda item. It is to be expected that the

external audit lead partner will be invited regularly to attend meetings as well as the finance director. Others may be invited to attend”.

In the USA, the Treadway Commission (1987) recommends that “The committee should meet on a regular basis and special meetings should be called as circumstances require. The committee should meet privately with the internal auditor and the independent public accountant”. Also, the NYSE recommends that, audit committees must meet on at least a quarterly basis, and they must meet privately with the independent auditor.

In Egypt, despite the important role of audit committee meetings which are commonly considered as a proxy for committee activity, the Capital Market Authority (CMA) in its statement No.30 in 2002 does not specify any recommendations related to audit committee meetings. However, the CMA does require audit committee members to direct their monthly reports to the Board of Directors, and this is taken as a proxy for committee activity.

5-5-6. Resources and Authority of the Audit Committee

As a prerequisite to the effective performance of the audit committee, the board of directors should formulate a clear definition of the committee’s responsibilities and authority. Moreover, the board should either pass a formal resolution or amend the bylaws of the corporation in order to document the establishment of the committee (Braiotta et al 1999).

Kalbers and Fogarty (1993) explained that audit committees are established through delegations of responsibility from corporate Boards of Directors, who themselves are charged with ultimate accountability for corporate management. Although the exercise of this charge may be reviewed by the board, audit committees hold an important decision-making

authority. These decisions can have the effect of bestowing rewards and punishments to other parties such as corporate officers, and internal and external auditors, which can be seen as a “sanctionary” power. The Treadway Committee (1987) states that, audit committee must have resources commensurate with the duties and responsibilities assigned to them by their Boards of Directors. Public companies should give audit committees these necessary resources, including in-house staff and administrative support. Also, audit committees should have the discretion to institute investigations of improprieties or suspected improprieties, including the standing authority to retain special counsel or experts. In this respect, the SEC (2003) argued that, to be effective, an audit committee must have the necessary resources and authority to fulfil its function. The audit committee is likely not to be equipped to self-advise on all accounting, financial reporting or legal matters. To perform its role effectively, therefore, an audit committee may need the authority to engage its such outside advisors, including experts in particular areas of accounting, as it determines necessary apart from counsel or advisors hired by management, especially when potential conflicts of interest with management may be apparent. The advice of outside advisors may be necessary to identify potential conflicts of interest and assess the company’s disclosure and other compliance obligations with an independent and critical eye.

In the UK, the Cadbury Committee (1992) recommends that “the audit committee should have explicit authority to investigate any matters within its terms of reference, the resources which it needs to do so, and full access to information. The committee should be able to obtain external professional advice and to invite outsiders with relevant experience to attend if necessary”. Along these lines, the Smith Report (2003) recommends that “the audit committee, should be provided with sufficient recourses to undertake its duties. The audit committee should have access to the services of the company secretary and staff on all audit

committee matters including: assisting the chairman in planning the audit committee's work, drawing up meeting agendas, maintenance of minutes, drafting of material about its activities for the annual report, collection and distribution of information and provision of any necessary practical support. The board should make funds available to the audit committee to enable it to take independent legal, accounting or other advice when the audit committee reasonably believes it necessary to do so".

In the USA, the Treadway Commission (1987) recommends that "audit committees should have adequate resources and authority to discharge their responsibilities". Also, "the committee should meet regularly with the company's general counsel, and outside counsel when appropriate, to discuss legal matters that may have a significant impact on the company's financial statements. In a number of companies the general counsel and/or outside counsel attend meetings". The NYSE also, states that, audit committees shall have authority and funding to engage independent counsel and outside advisors as appropriate without seeking the approval of the Board of Directors. The Sarbanes-Oxley Act. of 2002, Sec. 301, requires that "audit committees have the authority to counsel with and retain legal, accounting and other experts in appropriate circumstances". Also, the SEC (2003) recommends that "each audit committee must have the authority to engage independent counsel and other advisors, as it determines necessary to carry out its duties and each issuer must provide appropriate funding for the audit committee".

In Egypt, despite the important role of audit committee resources and its authority to assign the committee members to fulfil their duties and responsibilities, the Capital Market Authority (CMA) in its statement No.30 in 2002 does not specify any recommendations related to the audit committee's resources and authority.

5-5-7. Audit Committee Members Training:

The National Office of Financial Institutions (2001) states that, it may be beneficial to develop an audit committee training manual to educate new members about the institution, its financial matters and the audit committee requirements and charter. Also, the Institute of Internal Auditors (1993) identified the following as its single most important finding, and the key to audit committee effectiveness: “audit committee members must be provided with more background information and training to enable them to be more effective. Audit committee members can be effective only if they thoroughly understand their responsibilities and how to meet them effectively. Management, internal auditors, and independent accountants are identified as sources of this information”. In this respect, the Smith Report (2003) states that, training should be provided to members of the audit committee on an ongoing and timely basis and should include an understanding of the principles of and developments in financial reporting and related company law. In appropriate cases, it may also include, for example, understanding financial statements, applicable accounting standards and recommended practice, the regulatory framework for the company’s business, and the role of internal and external auditing and risk management.

In the UK, the Smith Report (2003) recommends that “the company should provide an induction programme for new audit committee members. This should cover the role of the audit committee, including its terms of reference and expected time commitment by members, and an overview of the company’s business, identifying the main business and financial dynamics and risks. It could also include meeting some of the company staff”.

In the USA, the Treadway Commission (1987) recommends that “a systematic and continuing learning process for audit committee members will increase their effectiveness. One way is to review various financial aspects of the company on a planned basis”.

In Egypt, the Capital Market Authority (CMA) in its statement No.30 in 2002 does not specify any recommendations related to audit committee members training.

5-5-8. Audit Committee Disclosure

A variety of interest groups have recommended that companies should include an audit committee report in their annual report to shareholders to highlight the importance of, and perhaps improve the effectiveness of, the oversight mechanism (Treadway Commission 1987, Public Oversight Board 1993, Price Waterhouse 1993, Lee and Stone 1997, Turpin and DeZoort 1998, BRC 1999, SEC 1999, Carcello et al. 2002, and Smith Report 2003). The Treadway Commission (1987) stated that “the role of the audit committee is largely hidden from the investing public, it should be more visible and more effectively communicated. Moreover, users of financial statements should be better informed about the roles management and the audit committee play in the company's financial reporting process. The Commission also recommends a letter from the chairman of the audit committee that describes the committee's activities, Both of these communications should appear in the annual report to stockholders”. Price Waterhouse (1993), in a study with the Institute of Internal Auditors, also noted that requiring audit committee reports would clarify the role and responsibilities of the committee in each company and would help ensure that the committee is meeting its responsibilities by focusing the committee's attention on those responsibilities. Also, Lee and Stone (1997) argued that, public disclosures of audit committee responsibilities and member experience backgrounds allow shareholders and others to determine the potential

for a mismatch of responsibilities and backgrounds, and any consequential ineffectiveness. Carcello et al. (2002) studied the extent of disclosure audit committee charters and reports by examining a random sample of 150 annual reports in 2001 in the USA, they found that what audit committees say they are doing in their reports differs from what their charters say they should be doing.

In the UK, the Smith Report (2003) recommends that “ the directors’ report should contain a separate section that describes the role and responsibilities of the audit committee and the actions taken by the audit committee to discharge those responsibilities. The audit committee section should include, *inter alia*: (1) a summary of the role of the audit committee; (2) the names and qualifications of all members of the audit committee during the period; (3) the number of audit committee meetings and attendance by each member; and (4) a report on the way the audit committee has discharged its responsibilities. The chairman of the audit committee should be present at the GAM to answer questions, through the chairman of the board, on the report on the audit committee’s activities and matters within the scope of audit committee’s responsibilities”.

In the USA, the Treadway Commission (1987) recommends that “all public companies should be required by a SEC rule to include in their annual reports to shareholders a letter signed by the chairman of the audit committee describing the committee’s responsibilities and activities during the year”. In 1993, the Public Oversight Board (POB) of the SEC Practice Section of the AICPA issued a report, *In the Public Interest: Issues Confronting the Accounting Profession*. In this report, the POB recommended that the SEC require registrants to include in their annual reports a statement by the audit committee that describes its responsibilities and how they were discharged. The POB expressed the view that mandating registrants to

include such a statement will make audit committee members more cognizant of their responsibilities. The POB recommended that the statement address, in particular, whether the audit committee:

- (1) reviewed the annual financial statements;
- (2) conferred with management and the external auditors about the financial statements;
- (3) received from the external auditors all information that the auditors are required to communicate under generally accepted auditing standards;
- (4) believe that the financial statements are complete and consistent with information known to them; and
- (5) believe that the financial statements reflect appropriate accounting principles.

Also, the BRC (1999) recommends that, the SEC require all reporting companies to include a letter from the audit committee in the company's annual report to shareholders and Form 10-K Annual Report disclosing whether or not, with respect to the prior fiscal year:

- (1) management has reviewed the audited financial statements with the audit committee, including a discussion of the quality of the accounting principles as applied and significant judgements affecting the company's financial statements;
- (2) the outside auditors have discussed with the audit committee the outside auditors' judgements of the quality of those principles as applied and judgments referenced in (1) above under the circumstances;
- (3) the members of the audit committee have discussed among themselves, without management or the outside auditors present, the information disclosed to the audit committee described in (1) and (2) above; and

- (4) the audit committee, in reliance on the review and discussions conducted with management and the outside auditors pursuant to (1) and (2) above, believes that the company's financial statements are fairly presented in conformity with Generally Accepted Accounting Principles (GAAP) in all material respects.

The SEC now requires companies to include an audit committee report in their proxy statement to communicate whether the committee has fulfilled its responsibilities (SEC 1999). According to the SEC, such enhanced audit committee disclosure should: (1) improve the transparency of the committee's oversight of the financial reporting-reporting process, (2) provide additional motivation for committee members to effectively discharge their duties, and (3) promote investor confidence.

In Egypt, however, the Capital Market Authority (CMA) in its statement No.30 in 2002 does not specify any recommendations related to audit committee disclosure.

5-5-9. The Audit Committee's Oversight Responsibilities for Financial Reporting

The Board of Directors and corporate management are jointly responsible for overseeing the company' financial reporting process (Wild 1996, and DeZoort and Salterio 2001). Accordingly, certain corporate governance structures are installed to monitor the financial reporting process, and increasingly these include an audit committee of the Board of Directors (Wild 1996, Klein 2002, and Braiotta 2002). Recently, in light of public concern over business failures and the related criticism of incomplete or fraudulent accounting information reporting prior to such failures, the critical role of the audit committee in the financial reporting processes has been highlighted (Reghunandan et al. 1998, and McDaniel et al. 2002). Regulators and the accounting profession have touted the role of audit committees in

protecting investors, and accounting research suggests that market participants see audit committees as providing a meaningful oversight of financial reporting process (McMullen 1996, Wild 1996, and KPMG 2002). According to the Blue Ribbon Committee, (BRC 1999) the audit committee is the “the ultimate monitor” of the financial accounting system. Audit committees are responsible for overseeing corporate factors that impact on the financial reporting process and ultimately the quality of the financial information disclosed in financial statements and press releases (DeZoort 1998). Factors such as the review of all financial statements, the review of all existing accounting policies, the review of systems of internal control, and the evaluation of exposure to fraud will significantly impact on the financial reporting process and the financial information disclosed, all these factors are included in the audit committee’s oversight responsibilities for financial reporting.

5-5-9-1. The Review of all Financial Statements, Whether Interim or Annual

One of the inherent responsibilities of the audit committee has always been its consideration of the annual report and other major financial information issued by the company, including the usefulness and transparency of these documents (Wild 1996). The primary role of the audit committee is to ensure that financial statements and external filings fairly represent the financial results of the company and to enable independent verification of the systems and controls (Atkins 2002). The audit committee must meet with management and the independent auditors to review audited annual and quarterly financial statements (Sweeney and Vallario 2002). The Treadway Commission (1987) in the USA states that the audit committee’s oversight responsibilities undertaken on behalf of the Board of Directors extend to the quarterly reporting process. The audit committee should review the controls that management has established to protect the integrity of the quarterly reporting process. This review should be ongoing, and timely communication between the Board of Directors or the

audit committee and senior management, the chief of internal auditors, and the independent public accountant is an important element of this ongoing process. Such discussions should normally take place during regular meetings of the audit committee or the Board of Directors.

In the UK, the Cadbury Committee (1992) recommended that audit committee members review the half-year and annual financial statements before submission to the Board of Directors. Also, the Smith Report (2003, Sec. 5.1) recommended that “the audit committee should review the significant financial reporting issues and judgements made in connection with the preparation of the company’s financial statements, interim reports, preliminary announcements and related formal statements. The audit committee should also review the clarity and completeness of disclosures in the financial statements”.

In the USA, the Treadway Commission (1987) recommends that “audit committees should oversee the quarterly reporting process”. The Securities and Exchange Commission (SEC 2003) enacted a requirement that a “report to shareholders” be included in the annual proxy statement and contain an audit committee report stating whether the committee had reviewed and discussed the audited financial statements with management and external auditors. Also, the BRC (1999) recommendation No.10 requires that audit committee members undertake timely reviews of quarterly financial results and discussions of review-related issues with the auditors.

In Egypt, The Capital Market Authority (CMA), statement No. 30 article No.7 (2002), requires audit committee members to analyse the procedures which are applied in preparing the periodical and annual financial statements.

5-5-9-2. Review of all Existing Accounting Policies

As a part of understanding the company's financial reporting process, the audit committee should understand the significant accounting policies used by the company (Ernst & Young 2002). Involvement of the audit committee in this area is a natural extension of their normal responsibilities (Vinten and Lee 1993). The Smith Report (2003, Sec. 5.2) states that "it is management's, not the audit committee's responsibility to prepare complete and accurate financial statements and disclosures in accordance with financial reporting standards and applicable rules and regulations. However, the audit committee should consider significant estimates and judgements". Also, in the USA, the Treadway Commission (1987) explained that a difference of opinion over a significant financial reporting issue between a company and its independent public accountant may prompt management to seek an opinion from a second public accounting firm. On the one hand, the decision to do so may be management's legitimate attempt to obtain a technically correct opinion. On the other hand, it may be an attempt to obtain an opinion that coincides with management's interest in presenting the results in the most favourable light. Management has, and should have, the prerogative to seek second opinion. When such an opinion has been sought on a significant accounting issue, management should discuss the issue with the audit committee and explain why that particular accounting treatment was chosen.

In the UK, the Smith Report (2003) recommended that "the management should inform the audit committee of the methods used to account for significant or unusual transactions where the accounting treatment is open to a different approach. Taking into account the external auditor's view, the audit committee should consider whether the company has adopted appropriate accounting policies".

In the USA, the Treadway Commission (1987) recommends that “ management should advise the audit committee when it seeks a second opinion on a significant accounting issue”. The NYSE recommended that audit committee must review major issues regarding accounting principles and financial statement presentations, including any significant changes in the company’s selection or application of the accounting principles. Also, section 204 of the Sarbanes-Oxley Act of 2002 requires that the registered public accounting firm shall make timely reports to the audit committee of: (1) all critical accounting policies and practices to be used, (2) GAAP alternatives discussed with management and the alternative preferred by the audit firm. Along the same lines, the BRC (1999) recommends that “the General Accepted Auditing Standards (GAAS) require that a company’s outside auditor discuss with the audit committee the auditor’s judgements about the quality, not just the acceptability, of the company’s accounting principles as applied in its financial reporting; the discussion should include such issues as the clarity of the company’s financial disclosures and degree of aggressiveness or conservatism of the company’s accounting principles and underlying estimates and other significant decisions made by management in preparing the financial disclosure and reviewed by the outside auditors. This requirement should be written in a way to encourage open, frank discussion and to avoid boilerplate”.

In Egypt, the CMA has considered the role of the audit committee regarding financial reporting. The CMA in its statement (2002) states that “the audit committee’s main responsibilities are to review and analyse applied accounting policies in the company and any significant change in applying the new accounting standards and also to analyse the procedures which are applied in preparing the periodical and annual financial reporting”.

5-5-9-3. The Review of Systems of Internal Control

The Turnbull Report (1999) in the UK, when defining the system of internal control, states that an internal system comprises all those policies and procedures that, taken together, support a company's effective and efficient operations and enable it to respond to significant business, operational, financial, compliance and other risks. Also, the report by the Committee of Sponsoring Organizations of the Treadway Commission (COSO 1992), in the USA, defined internal control as a "process, effected by an entity's Board of Directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories: (1) effectiveness and efficiency of operations, (2) reliability of financial reporting, and (3) compliance with applicable laws and regulations. The Security Exchange Commission (SEC 2003) requires all companies to devise and maintain a system of internal accounting control sufficient to provide reasonable assurance that (1) transactions are authorized by management, (2) transactions are recorded as necessary to permit preparation of the financial statements and to maintain accountability for assets, (3) access to assets is permitted only with management's authorization, and (4) existing assets are compared with recorded accountability, and appropriate action is taken with respect to any differences. The Treadway Commission (1987) states that controls that affect financial reporting directly include more than internal accounting controls. They also include elements not generally considered part of such controls, such as the internal audit function and the audit committee of the Board of Directors. The Board of Directors usually delegates oversight of the company's internal control over financial reporting to the audit committee, thereby assigning responsibility for financial reporting risks and controls (Frank et al. 2001). One of the responsibilities of the audit committee is to ensure that management has designed and implemented an effective internal control system (Raghunandan et al. 1998). The review of the internal control systems allows audit committee members to obtain an independent

opinion on the strength of the internal controls in the organization and makes the executive accountable for implementing control recommendations (Collier 1993). To fulfil this responsibility, audit committees must ensure that they broadly review the internal audit program to ensure that its scope is adequate. In addition, they need to review the results of the internal audits as they are related to financial reporting and internal controls (Raghunandan et al. 1998).

In the UK, the Cadbury Committee (1992) requires audit committee members to review the company's statement on internal control systems prior to endorsement by the board. Also, the Smith Report (2003, Sec. 5.5, 5.6, and 5.7) recommended that "the audit committee should monitor the integrity of the company's internal financial controls. The audit committee, in the absence of other arrangements, eg. a risk committee, should assess the scope and effectiveness of the systems established by management to identify, assess, manage and monitor financial and non financial risks. Also, the audit committee should receive reports from management on the effectiveness of the internal control systems they have established and the results of any testing carried out by internal and external auditors".

In the USA, the role of internal control in preventing and detecting fraud, has been well recognized in practice for many years and was recognized in federal legislation in 1977. Thus, the NYSE requires the audit committee to review major issues as to the adequacy of the company's internal controls and any special audit steps adopted in light of material control deficiencies. The Treadway Commission (1987) recommends that "the committee should review with the chief internal auditor and the independent public accountant their annual audit plans, including the degree of coordination of the respective plans. The committee should inquire as to the extent to which the planned audit scope can be relied upon to detect fraud or

weaknesses in internal controls”. Also, the Sarbanes-Oxley Act of 2002, Sec. 302, requires signing officers to state that they have disclosed significant deficiencies and material weaknesses in internal controls to the audit committee.

In Egypt, the CMA has considered the important role of the audit committee regarding internal control, and its statement No. 30 (2002), states that “the audit committee’s main responsibility is to review and analyse the internal control procedures in the company. Also to ensure the implementing of the internal control procedures in order to monitor company assets and evaluate management procedures and to write reports including the results of their evaluations to the Board of Directors ”.

5-5-9-4. The Evaluation of Exposure to Fraud

The audit committee is not responsible for detecting fraud, but it can play an important role in identifying warning signs regarding potential fraudulent financial reporting (Bishop et al. 2000, and Zacharias 2000). Prior studies examined the relation between the presence of an audit committee and the incidence of aggressive or fraudulent financial reporting. For example, McMullen (1996) found an association between the presence of audit committee and financial reporting quality, as measured by the absence of five factors (shareholder litigation alleging fraud, corrections of reported earnings, SEC enforcement actions, illegal acts, or auditor turnover involving disagreements between client and the auditor). Also, Abbott and Parker (2000a) found that the presence of an audit committee which meets minimum thresholds of activity and independence will be associated with a decreased likelihood of both fraud and non-fraudulent misstatement.

In the UK, according to the Smith Report (2003) the audit committee should review arrangements by which staff of the company may, in confidence, raise concerns about possible improprieties in matters of financial reporting, financial control, or any other matters. The audit committee's objective should be to ensure that arrangements are in place for the proportionate and independent investigation of such matters and for appropriate follow-up action, and that any matters relevant to its own responsibilities are brought to its attention.

In the USA, the Treadway Commission (1987) states that " the audit committee should review the company's process of assessing the risk of fraudulent financial reporting and the program that management establishes to monitor compliance with the code of corporate conduct".

In Egypt, the CMA has not considered the important role of the audit committee regarding the evaluation of exposure to fraud. Therefore, in its statement No. 30 (2002), it does not specify any requirement for audit committee members regarding their responsibility to review the company's process of assessing the risk of fraudulent financial reporting.

5-5-10. The Audit Committee's Oversight Responsibilities for External Auditing

Braiotta et al. (1999) state that, external auditing is the process not only of examining financial statements but also of testing the underlying accounting records of the company. The examination is conducted by the independent auditors, who express an objective opinion regarding the fairness of the presentation of financial statements. Thus, there is a special relationship between the audit committee and the external auditors. Both share common objectives and their contributions reinforce one another's role in the strengthening of corporate accountability (Vinten and Lee 1993). A primary responsibility of the audit committee is to oversee the financial reporting process (Raghunandan et al. 1998). Through

their involvement with the audited financial statements, the independent auditors are in a position to provide an objective assessment of the financial reporting process. For this reason, the audit committee should inquire about the proposed audit scope and approach, any recommendations management receives from the independent auditors regarding the financial reporting process and related matters (Braiotta 2002).

5-5-10-1. Recommendation for the Appointment of External Auditors

In theory, it is shareholders through the Annual General Meeting who select, appoint, and fix the remuneration of the auditors. However, as Collier and Gregory (1996) point out, in practice it is the company management who undertake such tasks. Consequently, management may prefer to select an accommodating, compliant auditor who will allow management enough flexibility to attain earnings goals, while having sufficient credibility to allow management to appear to be a good steward of the shareholders' investment (Abbot and Parker 2000b). The selection of the independent audit firm is an important responsibility the audit committee should perform in conjunction with management. Goddard and Masters (2000) argued that audit committees can ensure that management selects high-quality external auditors and may require additional work performed to satisfy their own requirements. Also, Bishop et al. (2000) explained that one of the audit committee's most important functions is recommendation or nomination of outside auditors. The committee may also recommend termination of the auditor if appropriate. In either instance, the recommendation is usually subject to ratification by the entire board. Alternatively, the committee can be vested with authority to select the auditors on behalf of the company. Also, in the USA, the Securities Exchange Commission (SEC 2003) states that " the auditing process may be compromised when a company's outside auditors view their main responsibility as serving the company's management rather than its full Board of Directors or its audit committee. This may occur if

the auditor views management as its employer with hiring, firing, and compensatory powers. Under these conditions, the auditor may not have the appropriate incentive to raise concerns and conduct an objective review. One way to help promote auditor independence, then, is for the auditor to be hired, evaluated and, if necessary, terminated by the audit committee". Also, the SEC noted that the proposed requirement that the audit committee appoint an external auditor does not conflict with, and would not be affected by, any requirement under a company's governing law or documents or other home country requirements that may require shareholders to elect, approve or ratify the selection of the issuer's auditor. In such an instance, however, if the issuer provides a recommendation or nomination of an auditor to its shareholders, the audit committee of the issuer would need to be responsible for making the recommendation or nomination.

In the UK, the Cadbury Committee (1992) requires audit committee members to make recommendations to the Board on the appointment of the external auditor and any questions of resignation or dismissal. Also, the Smith Report (2003, Sec. 5.15) recommends that "the audit committee should have primary responsibility for making a recommendation on the appointment, reappointment and removal of the external auditors. This recommendation should be made to the board, and thence to shareholders for their approval in the general meeting if the board does not accept the audit committee's recommendation, it shall include in the directors' report a statement from the audit committee explaining its recommendation and shall set out reasons why the board has taken a different position".

In the USA, the BRC (1999) recommends that audit committee charters specify that "the outside auditor is ultimately accountable to the Board of Directors and the audit committee, which have the ultimate authority and responsibility to select, evaluate, and, where

appropriate, replace the outside auditor”. In this respect, the NYSE requires audit committee members to retain and terminate the independent auditor. The Sarbanes-Oxley Act of 2002, in sec. 301, recommends that “the audit committee is directly responsible for the appointment of the external auditors”. Also, The Securities Exchange Commission (SEC 2003) states that “the audit committee of each listed issuer, in its capacity as a committee of the Board of Directors, must be directly responsible for the appointment of any registered public accounting firm engaged for the purpose of preparing or issuing an audit report or performing other audits, review or attest services for the listed issuer”.

In Egypt, article (103) of law No. 159 of 1981 which was enacted to govern the work of private auditors, requires each corporation to have at least one auditor who is to be appointed by the general assembly in General Annual Meeting, but in practice it is the company management who undertake such tasks. Consequently, the selection process may be distorted by management. For public companies this selection problem does not apply, because “The Central Auditing Organization” appoints the external public auditors for these entities which means that neither management nor directors have the right to select. Consequently, the role of management in selecting external auditors is limited to private entities only. But, the change from a command economy to a free market economy, accompanied by a movement from public to private entities, is likely to increase concern regarding the auditor selection dilemma. At the same time, the CMA in its statement, does not specify any requirements regarding audit committee members making recommendations for the appointment, reappointment or removal of external auditors.

5-5-10-2. Involvement in the Audit Fee Negotiation Process

Abbott and Parker (2000b) argue that the product of the audit process is often viewed as a homogenous, pricing of this product (i.e. the audit fee) that is actually subject to negotiation between the client and the auditor. As in the case of any negotiation process, the outcome of this process, or audit fee, is contingent upon the relative power of the negotiating parties. The existence of competing audit firms who are ready to replace the incumbent auditor provides a major source of client negotiating power. In particular, the threat, supported by the ability to replace auditors with a competitor, provides management with an advantage when negotiating audit fees (Collier and Gregory 1996). Audit committees should keep under review the overall financial relationship between the company and its auditors to ensure a balance between the maintenance of objectivity and value for money (Vinten 1998). The link between audit committees and, the quality of external audit work and the audit fee has long been recognized in the literature. For example, Kalbers and Fogarty (1993) identified the “sanctionary power” of audit committees which was defined as “the audit committee’s responsibility to determine the scope and compensation of external auditors”. Collier and Gregory (1996) find that, audit committees are at least partially effective in preventing reduction in the audit fee to levels where the quality of the audit may be compromised. Also, Carcello and Neal (2000b) postulate that, the existence of an independent and active audit committee could impact on the audit fee negotiation process, specifically, by reducing the overall threat of the auditor’s dismissal and by strengthening the auditor’s relative bargaining position during audit fee negotiations.

In the UK, the Smith Report (2003, Sec. 5.21) requires that “the audit committee should satisfy itself that the level of fee payable in respect of the audit services provided is appropriate and that an effective audit can be conducted for such a fee.

In the USA, the BRC (1999) requires the audit committee to review all auditor-client economic relationships to determine their impact on the objectivity of the auditor's work. Consequently, an audit committee could influence management to lessen audit fee pressures to ensure greater auditor vigilance during negotiations concerning financial reporting matters.

In Egypt, regarding the public auditor's situation in the audit fee negotiation problem, the negotiation of audit fees between entities and public auditors does not exist because "The Central Auditing Organization" which helps the People's Assembly perform its controlling function, does not receive fees from the entities whose financial statements it audits. Consequently, the role of the audit committee in supporting the auditors in the audit fee negotiations with company management is limited to the private auditors only. However recent changes have increased the demand for establishing audit committees in Egypt to support the external auditors in negotiating audit fees which will have an effect on the audit quality. At the same time, the CMA in its statement, does not specify any requirements for audit committee members to keep under review the overall financial relationship between the company and its auditors to ensure a balance between audit quality and value for money, and support the auditors in the audit fee negotiations with company management .

5-5-10-2. Ensure the Independence of the External Auditor

Concern about standards of financial reporting has in part focused on the need to guarantee auditor independence, protecting auditors from management pressure to confirm biased or fraudulent reports (Spira 1999). This reflects the widespread assumption that auditor independence is fundamental to the integrity of financial reporting: if auditors are not independent, their reports may not be objective and this may undermine the public perception

of the value of their attestation (Power 1997). The presence of the audit committee enhances the visibility of the auditors' independence. By interposing a committee of non-executive directors between operating management and the external auditors, both sides are given a forum to discuss matters considered to be significant to the company on a normal and regular basis. It also provides a mechanism which reduces the possibility of aggressive management being over dominating in its relationship with auditors (Vinten and Lee 1993). Deli and Gillan (2000) argue that, an independent audit committee reinforces the independence of the corporation's external auditor, and thereby helps assure that the auditor will have free rein in the audit process.

In this respect, in the UK, the Smith Report (2003, Sec. 5.22) recommends that " the audit committee should have procedures to ensure the independence and objectivity of the external auditor annually, taking into consideration relevant UK professional and regulatory requirements".

Along these lines, in the USA, the Treadway Commission (1987) recommends that "the audit committee should review management's evaluation of factors related to the independence of the company's public accountant. Both the audit committee and management should assist the public accountant in preserving his independence". The Independence Standards Board (ISB 1999), which sets independence rules for public entities, has approved its first standard. This standard requires independent auditors to discuss with, and disclose to, the audit committee any relationships with public audit clients that in the auditor's professional judgement may reasonably be thought to bear on their independence. The BRC (1999) recommends that, the listing rules for both the NYSE and the NASD require that the audit committee charter for every listed company specify that the audit committee is responsible for ensuring its receipt

from the outside auditors of a formal written statement delineating all relationships between the auditor and the company. Also, the SEC has required that companies provide in their annual reports a report from the audit committee to shareholders that disclose that the audit committee has reviewed these issues with the external auditor.

In Egypt, article (104) of law No. 159 of 1981 which was enacted to govern the work of private auditors and article (1) of law No.144 of 1988 which was enacted to govern the work of public auditors, were intended to ensure the auditors' independence by prohibiting them from participating in the formation of corporations, being members of their Boards of Directors, or permanently performing any technical, administrative, or consulting duties. Despite this concern about the importance of auditors' independence in Egypt, the CMA in its statement, does not specify any requirements for audit committee members to have procedures to ensure the independence and objectivity of the external auditor.

5-5-10-4. Information on Auditor-Management Disputes

DeZoort et al (2001) explained that, Any auditor-client negotiation of the client's financial statements affects the flow of accounting information to investors and other information users. Audit committees provide critical oversight of financial reporting and auditing processes (BRC 1999, NACD 2000, and DeZoort et al. 2001). Within this oversight context, matters reported to audit committees are frequently technical in nature and can reflect disagreements between auditors and management. Audit committees play an important role in mediating these disputes (SAS No. 61, SAS No. 89, and DeZoort et al.2001). Carcello and Neal (2000b) argue that, audit committees with external auditor engagement rights can effectively shield the external auditor from dismissal threats arising from disagreements with management. So that, the audit committee must regularly review with the external auditor any difficulties

encountered in the course of the audit, including any restrictions on the scope of the auditor's activities or access to requested information or any significant disagreement with management (Sweeney and Vallario 2002).

Survey research and published cases suggest that auditors are reporting and consulting with at least some audit committees in auditor-management disagreements (DeZoort and Salterio 2001). However, the evidence regarding perceived audit committee usefulness in solving such disputes indicates great diversity in practice. For example, as reported by Reinstein and Weirich (1996), audit committee members tend to support the auditors rather than management in audit disputes. Such support appears to strengthen the auditor's independence when dealing with company management. Beattie et al. (2000) surveyed audit partners and CFOs of large publicly traded UK companies and found a tendency for firms with audit committees to enter into fewer negotiations but more informal discussions about accounting policy disputes than did firms without audit committees. Gibbins et al. (2001) surveyed Canadian audit partners and found they, on average, rated the audit committee as only moderately important in auditor-client negotiations over accounting policy disputes. DeZoort and Salterio (2001) found that, greater independent director experience and greater audit knowledge was associated with higher audit committee member support for an auditor in disputes with client management.

In the UK, the Smith Report (2003, Sec. 3.8 and 5.18) requires that "the audit committee should, at least annually, meet the external auditor, without management, to discuss issues arising from the audit.....if the external auditor resigns, the audit committee should investigate the issues giving rise to such resignation and consider whether any action is required". Along these lines, in the USA, the Sarbanes-Oxley Act of 2002, Sec. 301, requires

that, the audit committee be responsible for resolution of disagreements between management and the auditor regarding financial reporting. In Egypt, law No. 159 of 1981 which was enacted to govern the work of private auditors, and No.144 of 1988 which was enacted to govern the work of public auditors, do not specify how to solve disputes which can exist between auditors and management related to the auditing process and accounting policy. Also, the CMA in its statement, does not specify any requirements for audit committee members to have a role in auditor-management disputes.

5-5-10-5. The Nature and Magnitude of Non-Audit Services

While the audit committee focuses primarily on the effectiveness of the audit, it also should be aware of the other services the audit firm can provide (Price Waterhouse 1999). Non-audit services may include tax planning, consultancy on information technology strategy, system design, executive recruitment and staff training, and pension plan advice (Vinten and Lee 1993). Management may engage the auditing firm for a variety of special services because it is cost-effective, and often audit quality is enhanced by the increased knowledge the auditors gain from performing these services (Price Water House 1999). In this respect, the Treadway Commission (1987) explained that, one issue concerning public accountant's independence (the possible adverse effect of management advisory services performed for audit clients) has been debated continually over the past decade. Strong opinions have been expressed on both sides of the issue. First, some argue that the independent public accountant's performance of management advisory services improves the quality of audits. They claim that in the process of advising management the independent public accountant acquires a deeper understanding of the client's business. Many in the public accounting profession also maintain that benefits accrue to the audit process when the independent public accountant is already familiar with the company's operations. Second, others believe that some management advisory services

place independent public accountants in the role of management, add commercial pressures to the audit examination and, as a result, impair independence. These individuals also argue that, at the very least, the public accountant's performance of management advisory services raises the perception of impaired independence. As a result, the Commission ended by requiring audit committees to weigh carefully the possible advantages of such use against the possible effects it may have on the public accountant's independence.

In the UK, the Smith Report (2003 Sec. 5.26) requires that "the audit committee should develop and recommend to the board the company's policy in relation to the provision of non-audit services by the auditor. The audit committee's objective should be to ensure that the provision of such services does not impair the external auditor's independence or objectivity.

In this context, the audit committee should consider:

- (1) whether or not the skills and experience of the audit firm make it a suitable supplier of non audit service;
- (2) whether or not there are safeguards in place to ensure that there is no threat to objectivity and independence in the conduct of the audit resulting from the provision of such services by external auditors;
- (3) the nature of the non-audit services, the related fee levels and the fee levels individually, and in aggregate relative to the audit fee; and
- (4) criteria which govern the compensation of the individuals performing the audit".

Along these lines, in the USA, the Treadway Commission (1987) recommends that "before the beginning of each year, the audit committee should review management's plans for engaging the company's independent public accountant to perform management advisory services during the coming year, considering both the types of services that may be rendered

and the projected fees”. Also, the NYSE requires the audit committee to have sole authority to approve all significant non-audit engagements with the independent auditor. Also, the Sarbanes-Oxley Act of 2002, Sec. 202, requires that, the audit committee must pre-approve all non-audit services provided by the external auditor, and the company must disclose the audit committee’s approval of any non-audit services in periodic reports filed with the SEC.

In Egypt, despite the above requirements for audit committee members to review the nature and magnitude of non-audit services in the UK and the USA, the CMA in its statement does not recommend any requirements for audit committee related to this issue.

5-5-11. Audit Committee Oversight Responsibilities for Internal Auditing

As part of the monitoring component of the entity’s system of internal control, the scope of the internal audit effort extends to several types of audits: financial, operational, compliance, ethics and fraud, systems and risk audits (Braiotta 2002). Audit committees should review the internal audit plan as well as the organizational structure and composition of the internal audit group (Vinten and Lee 1993 and Scarbrough et al. 1998). The Institute of Internal Auditors (IIA 1993) states that, internal auditing can play an important role in preventing errors and fraud, and is a useful mechanism in the checks and balances of effective corporate governance. Thus, the goals of audit committees and internal auditing are closely intertwined, and the ability of the audit committee and internal auditing to work together significantly impacts on the effectiveness of the audit committee in fulfilling its responsibility to the Board of Directors, shareholders, and other outside parties. Also, the Treadway Commission (1987) states that, the effectiveness of a company’s internal audit function depends a great deal on the objectivity of the chief internal auditor and his staff. Public companies should ensure that their internal auditors are free to perform their functions in an objective manner, without

interference and able to report findings to the appropriate parties for corrective action. Three principal factors contribute to independence and objectivity: the organizational positioning of the function, the corporate stature of the chief internal auditor, and the reporting relationship of the chief internal auditor to the audit committee. Consequently, an important role in the corporate governance and control process is the interaction between audit committees and internal auditing (Scarbrough et al. 1998). Corporate audit committees have assumed a significant role in the financial reporting process (Collier 1993). In fulfilling their expanded oversight responsibilities, audit committees must rely on internal auditors for much of their information concerning corporate activities. In this respect, the Treadway Commission (1987) states that “internal auditors also provide services to the organization broader than those relating to financial auditing. Operational auditing, acquisition reviews, and special investigations are a few examples. These services benefit the company substantially and give the internal auditor in-depth knowledge of many different aspects of the company’s operations. This unique perspective enables internal auditors to be highly effective in detecting fraudulent financial reporting, practically if internal auditors systematically consider the results and potential impact of the non-financial audits on the financial statements”.

Bishop et al. (2000) explained that, when audit committees have only independent directors, there are potential information asymmetries between the independent directors and management. Internal auditing is a valuable resource that can provide the information needed for audit committees to meet their governance mandate (Scarbrough et al. 1998). Internal auditing can play an important role in preventing errors and fraud, and is a useful mechanism in the checks and balances of effective corporate governance. Thus, the goals of audit committees and internal auditing are closely intertwined, and the ability of the audit committee and internal auditing to work together significantly impacts upon the effectiveness

of the audit committee in fulfilling its responsibilities to the Board of Directors, shareholders, and other outside parties (Scarborough et al. 1998 and Atkins 2002).

In the UK, the Cadbury Committee (1992) argued, “where an internal audit function exists, the audit committee must ensure that it is adequately resourced and has appropriate standing within the company. Also, an internal audit function is well placed to undertake investigations on behalf of the audit committee and to follow up any suspicion of fraud. It is essential that heads of internal audits should have unrestricted access to the chairman of the audit committee in order to ensure the independence of their position”.

Along these lines, the Smith Report (2003, Sec. 5.10, 5.11, and 5.12) recommends that the audit committee should:

- (1) monitor and review the internal audit activities. Where there is no internal audit function, the audit committee should consider annually where there is a need for an internal audit function and make recommendations to the board;
- (2) review and approve the internal audit function’s remit, having regard to the complementary roles of the internal and external audit functions. The audit committee should ensure that the function has the necessary resources and access to information to enable it to fulfil its mandate; and
- (3) approve the appointment or termination of appointment of the head of the internal audit.

In the USA, the Treadway Commission (1987) recommends that “management and the audit committee should ensure that the internal auditors’ involvement in the audit of the entire financial reporting process is appropriate and properly coordinated with the independent

public accountant”. The NYSE requires the audit committee to discuss the work plan of the internal audit department to be certain it addresses the company’s significant risks and it is relevant to the financial reporting process. Also, the budget, staffing and reporting lines of this function warrant consideration by the audit committee. The BRC (1999) encourages the audit committee to have mechanisms in place to facilitate confidential exchanges and independent communication and information flow between the audit committee and the internal auditor to improve the effectiveness of both.

In Egypt, despite the CMA having considered the important role of the audit committee regarding internal control, it does not specify any requirement for audit committee members to review the internal auditing function or any interaction between the audit committee and internal auditing.

In summary, it is possible that differences in the regulatory environment and the importance assigned to corporate governance, as well as other cultural factors, could significantly influence the nature of the audit committees’ legal framework in the USA, the UK, and Egypt. Table 5-1 shows a comparison of the legal frameworks for audit committees in the three countries. This Table shows that the oversight responsibilities for audit committees in the USA and UK are very similar but in Egypt there are a number of audit committee oversight responsibilities which are not specified. This finding is consistent with Babic (2001) who argued that in developed market economies, a system of corporate governance has been built gradually through centuries, and today it can be defined as a “complex mosaic” consisting of laws, regulations, politics, public institutions, professional associations and ethics codes. However, in transition economy countries a lot of details of the mosaic are still missing.

Table 5-1 Comparison of audit committees' legal frameworks in the USA, UK, and Egypt

	USA	UK	Egypt
Audit committee charter	Recommended by: Treadway Commission (1987), and BRC (1999)	Recommended by: Cadbury Committee (1992), and Smith Report (2003)	Recommended by: Not available
Audit committee member independence	NYSE (1978), Treadway Commission (1987), BRT (2002), BRC (1999), Sarbanes-Oxley Act. (2002), and SEC (2003)	Cadbury Committee (1992), and Smith Report (2003)	Capital Market Authority (2002)
Audit committee member experience	Institute of Internal Auditors (1993), BRC (1999), and Sarbanes-Oxley Act. (2002)	Smith Report (2003)	Capital Market Authority (2002)
Audit committee size	Treadway Commission (1987), NASD (2000), and BRC (1999)	Cadbury Committee (1992), and Smith Report (2003)	Capital Market Authority (2002)
Audit committee meetings	Treadway Commission (1987)	Smith Report (2003)	Not available
Resources and authority of the audit committee	Treadway Commission (1987), Sarbanes-Oxley Act. (2002), and SEC (2003)	Cadbury Committee (1992), and Smith Report (2003)	Not available
Audit committee members training	Institute of Internal Auditors (1993), and Treadway Commission (1987)	Smith Report (2003)	Not available
Audit committee report	Treadway Commission (1987), Public Oversight Board (1993), and BRC (1992)	Smith Report (2003)	Not available
Audit committee's oversight responsibilities for financial reporting: review all financial statements, whether interim or annual.	Treadway Commission (1987), BRC (1999), and SEC (2003)	Cadbury Committee 1992), Combined Code (1999), and Smith Report (2003)	Capital Market Authority (2002)
review all existing accounting policies.	Treadway Commission (1987), BRC (1999), and Sarbanes-Oxley Act (2002)	Smith Report (2003)	Capital Market Authority (2002)
review systems of internal control.	Treadway Commission (1987), Sarbanes-Oxley Act (2002), and SEC (2003)	Cadbury Committee (1992), Turnbull Report (1999), Combined Code (1999), and Smith Report (2003)	Capital Market Authority (2002)
evaluate exposure to fraud.	Treadway Commission (1987 and SAS No. 82)	Smith Report (2003)	Not available
Audit committee's oversight responsibilities for external auditing: recommend of the appointment of external auditors.	Treadway Commission (1987), BRC (1999), Sarbanes-Oxley Act (2002), and SEC (2003)	Cadbury Committee 1992), Combined Code (1999), and Smith Report (2003)	Not available
involvement in the audit fee negotiation process	BRC (1999)	Smith Report (2003)	Not available

ensure the independence of external auditor	Treadway Commission (1987), BRC (1999), Independent Standards Board (1999), Sarbanes-Oxley Act (2002), and SEC (2003)	Combined Code (1999), and Smith Report (2003)	Not available
Information on auditor-management dispute	NYSE (1999), and Sarbanes-Oxley Act (2002)	Smith Report (2003)	Not available
the nature and magnitude of non-audit services.	Treadway Commission (1987), NYSE (1999), and Sarbanes-Oxley Act (2002)	Combined Code (1999), and Smith Report (2003)	Not available
Audit committee's oversight responsibilities for internal auditing:	Treadway Commission (1987), and BRC (1992)	Cadbury Committee (1992), and Smith Report (2003)	Not available

5-6. Summary

It is possible that differences in the regulatory environment and the importance assigned to corporate governance, as well as other cultural factors, could significantly influence the nature of the legal framework of audit committees in the USA, the UK, and Egypt. This chapter has been concerned with explaining the legal framework for audit committees in Egypt in the light of the legal framework in the UK and the USA in order to understand the differences between the three countries.

The audit committee concept is still a new phenomenon in Egypt. The legal framework for audit committees in Egypt is weak in many areas: (1) the Capital Market Authority (CMA) does not require the listed companies on Cairo & Alexandria Stock Exchange (CASE) to adopt a formal written charter for their audit committees, (2) the requirement for independent audit committee members appears in the Capital Market Authority statement, but, "independence" requirements for audit committee members, are not defined, (3) also, despite the CMA considering the importance of audit committee member experience, its decision does not specify any requirements for financial expertise of audit committee members, (4) the CMA does not specify any recommendations related to the annual number of the audit committee meetings, (5) the CMA does not specify any recommendations related to the audit

committee's resources and authority, (6) also, the CMA does not specify any recommendations to the listed companies regarding audit committee members' training, (7) and finally, the CMA does not require companies to disclose the audit committee report in their annual reports.

Audit committee effectiveness is viewed as the competency with which the audit committee carries out its specific oversight responsibilities. Therefore, audit committee members must be critically aware of their responsibilities; they must also completely understand them. How the responsibilities are carried out may vary, but a failure to address them may be a significant detriment to the audit committee, the board, and most of all the shareholders. Thus, this chapter also aims to provide an insight into the legal framework for the oversight responsibilities of audit committees in the UK, USA, and Egypt.

The researcher found that, in general because the close economic ties between the UK and the USA with respect to the degree of market integration and the organisation of transactions and in relation to other socio-cultural respects, the oversight responsibilities for audit committees in the USA and UK are very similar. However, in Egypt there are a number of audit committee oversight responsibilities which are not specified in the CMA statement: (1) evaluation of exposure to fraud, (2) the appointment, reappointment and removal of the external auditors, (3) involvement in the audit fee negotiation process, (4) ensuring the independence of the external auditor, (5) requesting to be informed in auditor-management disputes, (6) the review of the nature and magnitude of non-audit services, and (7) the review of the internal auditing function or any interaction between audit committee and internal auditing. The remaining oversight responsibilities (the review of all financial statements,

whether interim or annual, all existing accounting policies, and all systems of internal control) in Egypt are similar to the USA and UK legal framework.

Chapter Six: Research Methodology

Chapter Six: Research Methodology

6-1. Introduction

In the previous chapter the literature of institutional economics, the legal framework for audit committees in the USA, the UK, and Egypt, and audit committee effectiveness, helps to shape the theoretical framework for this research and contributes to the selection of its methodology. The objectives of the study, reasons for choosing the topic, and the research questions were explained in chapter 1, and this chapter commences by defining the research methodology. It continues by documenting the research populations, and the response rates. The chapter concludes by describing the research pilot study.

6-2. Methodology of the Study

The methodology usually investigates a contemporary phenomenon within its real-life context when the boundaries between phenomenon and context are not clearly evident (Yin 1994). The research may be categorised into two distinct types: qualitative and quantitative based on the research nature, including the objectives and the questions of the research and the type of the empirical data.

Qualitative research, broadly defined, means any kind of research that produces findings not arrived at by means of statistical procedures or other means of quantification (Hyde 2000). On the other hand the quantitative researcher seeks causal determination, prediction, and generalization of findings (Amaratunga et al. 2002). Quantitative research uses methods adopted from the physical sciences that are designed to ensure objectivity, generalizability and reliability. These techniques cover the ways research participants are selected randomly from the study population in an unbiased manner, the standardized questionnaire they receive and the statistical methods used to test predetermined hypotheses regarding the relationships

between specific variables. The researcher is considered external to the actual research, and results are expected to be replicable no matter who conducts the research (Weerd-Nederhof 2001). The strengths of the quantitative paradigm are that its methods produce quantifiable, reliable data that are usually generalizable to some larger population (Hyde 2000).

In this study the quantitative approach view is appropriate because: firstly, the researcher needs to understand audit committees' oversight responsibilities from the internal perspective of the UK and Egyptian audit committee members in comparison with the DeZoort (1997) study in the USA, and secondly, the researcher needs to conduct the study through intense contact with field or life situations in order to examine the audit committees effectiveness in the public banking sector in Egypt and discover the obstacles which face them. Finally, the researcher needs to generalize this study's findings from public banking sector to the wider business environment in Egypt.

6-3. The Research Strategy

According to Yin (1994), research strategy should be chosen as a function of the research situation. Although each strategy has its own characteristics, there are overlapping areas, which bring complexity to the process of strategy selection. And in order to avoid gross misfits between the desired outcome and the chosen strategy, Yin stresses that the type of question posed; the control over actual behavioural elements; and the degree of focus on historical or contemporary events; are the conditions which should provide the grounds for strategy choice. Table 6-1 depicts the outcome of the intersection between most common research strategies and the three conditions identified above. It may be clear from the table that a case study research strategy is consider to have a distinct advantage when a "how" or "why" (or exploratory "what") question is being asked about a contemporary set of events

over which the investigator has little or no control (Weerd-Nederhof 2001). The key feature of the case study approach is not method or data but the emphasis on understanding processes as they occur in their context (Amaratunga et al. 2002).

Table 6-1. Research strategies versus characteristics

Strategy	Form of research Question	Requires control over behavioural events?	Focus in contemporary events?
Experiment	How, Why	Yes	Yes
Survey	Who, What, Where, How many, How much	No	Yes
Archival analysis	How, Why	No	Yes/No
History	How, Why	No	No
Case study	How, Why	No	Yes

Source: Yin (1994)

This study used survey and case study scenario strategies. Survey strategy to investigate the differences in audit committee members' perception of their oversight responsibilities between the USA, the UK, and Egypt. Case study scenario strategy to measure the effectiveness of audit committees in the public banking sector in Egypt and assess the relationship between independence and experience of audit committee's members and the effectiveness of the audit committees.

6-3-1. Survey Strategy

This study used the survey strategy in order to examine audit committee oversight responsibilities from the internal perspective of the UK and Egyptian audit committee members in comparison with the DeZoort (1997) study in the USA. The survey used Wolinzer's (1995) list of seventeen prescribed audit committee objectives, which DeZoort had used for audit committee members in the USA. The survey related to accounting and reporting, auditors and auditing, and corporate governance in general. This was used as a

basis to assess audit committee members' abilities to recognize their assigned objectives and explore their perceptions of the key tasks.

Wolinzer's (1995) set of seventeen audit committee objectives provided a basis for measuring audit committee members' responses, which DeZoort (1997) used in the USA survey of audit committee members see Table 6-2. The respondents were asked three questions related to their assigned responsibilities: (1) is the objective assigned formally to your committee? (2) is the objective performed, but not assigned to your committee? (3) is the objective appropriate for audit committees? (See appendix C).

Table 6-2: Wolinzer's list of seventeen prescribed audit committee' oversight responsibilities

<p>Financial Reporting: (OBJ1) Review all financial statements, whether interim or annual. (OBJ2) Review all existing accounting policies. (OBJ3) Review systems of internal control. (OBJ4) Evaluate exposure to fraud. (OBJ5) Review all significant transactions. (OBJ6) Appraise key management estimates, judgments and valuations.</p>
<p>Auditing: (OBJ7) Recommend the appointment of and fee for the external auditors. (OBJ8) Review the plans for, and the effectiveness of, the internal and external auditors. (OBJ9) Review the arrangements for coordinating the work done by internal and external auditors. (OBJ10) Review the external auditor's management letter. (OBJ11) Determine that auditors are free from undue influence and management interference. (OBJ12) Request to be informed if there is a dispute between auditors and managers. (OBJ13) Monitor the resources allocated to the internal auditing function. (OBJ14) Review the nature and magnitude of fees paid to the auditors for non-audit services.</p>
<p>Other Corporate Governance: (OBJ15) Facilitate communication between the external auditors and the board of directors. (OBJ16) Review corporate policies and practices in light of ethical considerations. (OBJ17) Monitor compliance with the company's code of conduct.</p>

The first question provides a basis for assessing the association between audit committee members' perceptions of their assigned oversight objectives and assigned responsibilities, which are identified in the annual reports of the sample companies.

The second question addresses the possibility that audit committee members may perform oversight objectives that are not assigned formally.

The third question provides an opportunity for audit committee members to make normative statements about the list of proposed oversight responsibilities. This feedback could provide a useful insight into how audit committee members feel about recommendations to expand the audit committee oversight role in corporate governance (DeZoort 1997).

6-3-1-1. The UK Study Population and Sample

The UK sample consisted of 200 audit committee members randomly selected from the top 250 companies listed on the London Stock Exchange in the Financial Times 1,000 for the year 2002. The Financial Times 1,000 is an annual listing of the largest U.K. companies and provides a mix of organisations, that are significant in the British economy. This is a popular starting point for study populations in finance, auditing, accounting and management research (Collier 1993). The population is limited to the Times top 250 because such companies are likely to be the most responsive to public pressures for the acceptance of a broader range of oversight responsibilities for their audit committee members.

The top 250 companies were firstly checked to ensure that each company was still trading and not the subsidiary of another member of the study population. Therefore, two companies which were defunct, had been taken over by or were subsidiaries of companies already on the list, were identified and excluded (London Merchant Securities Dfd and P Z Cussons A). Secondly, based on the Blue Ribbon Committee (BRC 1999) recommendation that the NYSE and NASD in the USA require listed companies with market capitalization above \$200 million to have audit committees, the top 250 were checked to ensure that each company had

market capitalisation above \$200 million or the equivalent in English pounds. Therefore, one company, which had market capitalisation of under \$200 million or equivalent in English pounds, was identified and excluded (London Merchant Securities Dfd, this company had already been excluded under the first criterion). This reduced the population to 248 companies (See Appendix A for a detailed listing supporting the above analysis).

Each audit committee member received an introductory letter, a copy of the research instrument and a self-addressed stamped return envelope. All individuals were informed that their responses would remain confidential. In addition, all respondents were offered a summary of the results upon request. Also, in order to maximize the response rate, surveys were directed to the audit committee member's home addresses, which were traced using the FAME database.

Data Collection and Response Rate

As is shown in Table 6-3, responses were received from 110 audit committee members giving a usable response rate of 55% (the response rate in the DeZoort survey in the USA was 35%). Table 6-3 shows an alternative classification approach through a comparison of FTSE industrial grouping of respondents and non-respondents. There is some variation among the response rates of different industrial groups especially the 'other' category, which summarised all industrial groups with less than five audit committee members in the sample.

Table 6-3: Analysis of the UK sample and responses by FTSE industrial group

FTSE Industrial Group	Sample of ACMs in U.K Listed Companies	No. Of responses	% Responses Rate
Oil & Gas	11	7	63
Media & Photography	15	8	53
Support service	5	3	60
Speciality & Other finance	9	6	66
Mining	4	2	50
Information technology	5	3	60
hardware	6	4	66
Transport			
Food production & processors	5	3	60
Pharmaceuticals	10	5	50
Software & Computer service			
Life assurance	14	7	50
Utilities other	10	5	50
Aerospace & Defence	10	6	60
Constructions & Building	5	3	60
materials			
Chemicals	13	7	54
Engineering & Machinery	6	3	50
Banks	6	4	66
Insurance	9	5	55
Tobacco	5	3	60
Real estate	5	3	60
Investment companies	10	5	50
General retailers	5	3	60
Others	14	8	57
	18	7	38
Total	200	110	55

6-3-1-2: Egyptian study Population and Sample

The Egyptian sample consisted of 65 audit committee members randomly selected from the top 100 companies listed on the Cairo & Alexandria Stock Exchange (CASE), for the year 2002, based on their market capitalization. The top 100 companies were first checked to ensure that each company was still trading and not the subsidiary of another member of the study population. Secondly, the top 100 were also checked to ensure that each company had a market capitalisation above \$200 million or the equivalent in Egyptian pounds. This reduced the population to 34 companies (See Appendix B for a detailed listing supporting the above analysis).

Data Collection and Response Rate:

As is shown in Table 6-4, responses were received from 41 audit committee members giving a usable response rate of 63%. Table 6-4 shows an alternative approach through a comparison of CASE industrial grouping of respondents and non-respondents. The response rate for the financial services group was 78%, this response rate is through to be high in comparisons with the other groups because the financial services were the first sector to establish audit committees in Egypt following the Central Bank of Egypt Chairman's decision in 2000.

Table 6-4: Analysis of Egypt sample and responses by CASE industrial group

CASE Industrial Group	No. Of Companies	Sample of ACMs in CASE Listed Companies	No. Of responses	% Responses Rate
Financial Services	9	23	18	78%
Building Material & Constrictions	7	16	8	50%
Utilities	3	5	2	40%
Mining & Gas	3	7	3	43%
Entertainment	3	5	3	60%
Food & Beverage	3	4	2	50%
Holding Companies	2	4	2	50%
Housing & Real Estate	2	3	1	33%
Others	2	3	2	66%
Total	34	65	41	63%

Benke and Street (1992) explained that “when conducting survey research, the researcher must show that selection bias and / or non-response bias is not important to the results of the survey. The popular approach to non-response bias is to argue that bias does not exist. Normally this is done by comparing early responses to late responses. The researcher compares the two groups and if no differences are found in their responses, judges the results as unbiased and, therefore, reliable”. In this study, an analysis of ‘early’ and ‘late’ responses for the UK and Egyptian samples was undertaken. In particular, early responses were defined

as those received within 20 days after the surveys were sent and late responses as those received after 20 days from when the surveys were sent (Coram et al. 2001). Thus, in the UK sample, there were 62 early respondents and 48 late respondents and in the Egyptian sample there were 26 early respondents and 15 late respondents. The results in Table 6-4 were based on the Mann-Whitney U test (MWU) and the power-efficiency is close to 95% for moderately large samples (Siegel and Castellan 1988). The results revealed no evidence of a non-response bias for any of the selected parameters ($P > .05$).

Table 6-5: Descriptive statistics comparing early and late response in the UK and Egypt samples

	Mann-Whitney U	Wilcoxon W	Z	Asymp. Sig. (2-tailed)
<u>UK Sample:</u>				
Q 1	1050.5	3396.5	-2.367	.799
Q2	1410.0	2313.0	-.112	.911
Q3	1421.0	2324.0	-.044	.965
<u>Egypt Sample:</u>				
Q1	194.5	314.5	-.014	.989
Q2	170.0	521.0	-.689	.491
Q3	171.0	522.5	-.650	.519

6-3-2. Case Study Scenario Strategy

Yin (1994) defines the case study as “an empirical inquiry that investigates a contemporary phenomenon within its real-life context and where the boundaries between phenomenon and context are not clearly evident”. In this study, case study scenario approach was used to measure the effectiveness of audit committees in the public banking sector in Egypt and assess the relationship between the independence and experience of audit committee members

and effectiveness of the audit committees. The use of a case study scenario approach in measuring effectiveness is reasonably widespread in the audit literature, for example:

Joyce and Biddle (1981) used the case study scenario approach when conducting a series of experiments to test for the presence of anchoring in audit judgments. The first experiment asked auditors to assess the likelihood of significant management fraud among clients audited by the Big Eight firms. In the second experiment, subjects were required to plan the extent of substantive testing. Two final experiments required auditors to assess the likely success of a new product introduction needed by the client to remain a going concern, followed by a decision on the nature of the appropriate opinion. Joyce and Biddle found that anchoring was present in the first set of experiments, which assessed management fraud, but was not clearly exhibited in the other.

Wright (1988) used the case study scenario approach when examining the level of reliance on prior working papers and how such reliance affects: (1) auditor adaptability, (2) audit efficiency, (3) the planned detection of perpetuating errors, and (4) overall effectiveness of audit programmes. Practising auditors were asked to design a substantive audit programme for a case where changes in the client's environment dictated additional procedures. Wright found that the effectiveness and efficiency of an audit largely rests with the nature of the evidence gathered.

Grasso and Kaplan (1998) used the same approach when examining the extent to which educational background and demographic factors are associated with students' personal standards regarding ethical issues involving tax professionals. Students were given ten brief scenarios focusing on the ethical and professional responsibilities of CPAs with tax practices.

For each scenario, the students were asked whether they believed the opinion and whether the situation described was considered appropriate under existing professional standards, and whether they personally believed the opinion or situation described was appropriate. They were also asked whether or not they believed that evading taxes is immoral. The results indicated that female students had higher personal ethical standards regarding issues involving tax professionals than did male students. Also, students aspiring to be tax professionals had higher ethical standards regarding issues involving tax than those that did not.

Lord and DeZoort (2001) used the same approach in an experiment which examined the influence of social pressures within the accounting firm and their affect on auditors' willingness to sign-off on financial statements that are materially misstated. The case scenario instructed the study participants to portray a senior accountant that recently had been assigned to a new client. The participants were told they were replacing another senior that had served the client for several years but who had been assigned other responsibilities. The results indicate that obedience pressure significantly increased auditors' willingness to sign-off on an account balance that was materially misstated.

Coram et al. (2001) used this approach when examining the effects of time budget pressure, risk associated with task, and audit test in reduced audit quality. They defined reduced audit quality as intentional action taken by an auditor during an engagement which reduces evidence-gathering effectiveness inappropriately. The scenario approach was used to formulate two situations depending on whether the audit had 'high time budget pressure' or 'low time budget pressure'. In the high time budget pressure scenario, the auditor received a complaint from the client that the budget was too high. In the low time budget pressure scenario, the audit budget had usually been met without too much difficulty. It was found that

work performed by auditors is not always of an appropriate standard, primarily because of time budget pressure.

Makkawi and Schick (2003) used the scenario approach when investigating how auditors alter their audit programme decisions in response to an increased likelihood of fraud risk. A total of 48 auditors from one big 5 CPA firm were surveyed regarding the type of audit procedures they would use in response to an increased likelihood of material misstatements caused by fraud. The auditors were provided with a scenario that reflected changes in economic and industry factors that increase audit risk and typically require a re-evaluation of the audit programme. They were asked to make choices as to which tests of detailed balances, and analytical procedures to perform. Makkawi and Schick found that auditors emphasize effectiveness over efficiency with respect to the performance of audit procedures.

In this study, the researcher used the case study scenario approach as a strategy for measuring audit committee effectiveness in the public banking sector in Egypt. This strategy helped the researcher in investigating and understanding the real-life practice situations facing such audit committees which are considered a contemporary phenomenon. Moreover, the case study scenario approach helped the researcher in discovering the obstacles that impede the audit committees from being more effective and to try to suggest ways for improvement. Effectiveness is measured by the extent to which audit committee members carry out their oversight responsibilities related to the functions of financial reporting, external auditing, and internal control including the internal auditing function. This objective was tested in the light of the survey results related to the oversight responsibilities for audit committees, after modification for the Egyptian environment. The case study scenario questionnaires that were directed to the audit committee members consisted of two sections.

The first section contained personal questions in order to indirectly measure the audit committee member's independence (questions from 1 to 5) and experience (questions from 6 to 7) by using the linear multiple regression model.

The second section contained fifteen scenarios linked to the survey results and modified in order to measure extent to which audit committee members carry out their oversight responsibilities related to the following:

1. Financial reporting (cases from 1-1 to 1-5);
2. The external auditing function (cases from 2-1 to 2-5); and
3. The internal control including the internal auditing function (cases from 3-1 to 3-5).

A separate scenario is expressed for each responsibility by using the case study scenario approach (See appendix D). The fifteen scenarios were drawn from issues regarding the oversight responsibilities of audit committees addressed by: (1) literature (2) CPA professional examinations (3) current recommendations in the USA, and the UK (e.g. BRC 1999, Sarbanes-Oxely Act. of 2002 in USA, and the Cadbury Committee 1992, in UK) (4) current issues which faced the public banking sector in Egypt. In each of the fifteen scenarios, two questions were asked. The first question asked the participants to recommend the most likely course of action for the issue described in the case study and the second question asked the participants to suggest the party which can solve this issue. This was similar to Margheim and Pany (1986) and Coram et al. (2001) who used this approach to reduce the participant's sensitivity to the questions being asked and thus reduce the probability of misleading responses. The management psychology literature (e.g. Everett and Stening 1983) also uses this approach to elicit greater honesty in responses by obtaining information about the same construct from different angles. The results in chapter eight of this study reported only the

second question responses because the main purpose of the first question was to elicit honesty and provide a benchmark for the second question (the analyses of both types of responses yield the same inferences).

Population, Sample, and Response Rate

For measuring audit committee effectiveness, the population is the audit committee members in the public banking sector in Egypt. The researcher selected this sector because it is considered to be the first and oldest sector in Egypt that mandated the establishment of audit committees, although the other sectors have recently followed suit. The public banking sector in Egypt contains four banks: Alexandria Bank, Bank Misr, Cairo Bank, and the Egyptian National Bank. Every bank's audit committee includes four members. Therefore, this population contained sixteen audit committee members. Sixteen questionnaires were directed to the audit committee members (full sample) and fourteen responses were received, i.e. almost all of the audit committee members participants (an 87% response rate).

In this study, efforts were made to achieve high rates of response. This included firstly, a covering letter recounting the questionnaire explanatory notes and the importance of the study. Secondly, making the questionnaire words and scenarios simple and understandable. Thirdly, the researcher established a strong social network with the audit committee members -who have an externally busy schedule because of the nature of working conditions in Egypt- in order to complete the questionnaires in a timely manner.

6-4. The Pilot Study

The survey and scenario questionnaires were extensively pre-tested. Drafts of the survey and the questionnaire were prepared and tested in small-scale pilot studies, so that maximum

accuracy could be ensured. For the survey instrument, nine audit committee members were selected from outside the selected UK sample and asked to determine any problems in the survey. For the questionnaire instrument, three members of the academic staff of Alexandria University (who are concerned with auditing practice in Egypt), and two audit committee members (selected from outside the selected samples) were asked to identify any problems such as inappropriate terms, confusing words, missing possibilities, or inappropriate sequencing of items. After piloting the questionnaire, some scenarios were identified as ambiguous and were rephrased and redesigned, or, in exceptional cases, dropped. The researcher was involved with the audit committee members and noted that they didn't appear to have a clear vision of audit committee responsibilities and duties.

6-5. Summary

in this chapter, the quantitative approach has been used through the survey and case study scenario methods. This study used survey strategy and case study scenario approach. Survey strategy to investigate the differences in audit committee members' perception of their oversight responsibilities between the USA, the UK, and Egypt. A case study scenario approach was used to measure the effectiveness of audit committees in the public banking sector in Egypt. Moreover, the case study scenario strategy helped the researcher in discovering the obstacles that impede the audit committees from being more effective. The linear multiple regression model was used to assess the relationship between the independence and experience of audit committee members and effectiveness of the audit committees.

Chapter Seven- Audit Committee Oversight Responsibilities
A Comparison between the USA, the UK, and Egypt

Chapter Seven: Audit Committee Oversight Responsibilities

A Comparison between the USA, the UK, and Egypt

7-1. Introduction

It is to be expected that the transitional economic process in Egypt, undergoing major economic, regulatory, and political reforms, as well as Anglo Saxon market acculturation, will exhibit differences in corporate governance systems and their tools. Such differences may be associated with significant differences in attitudes, beliefs and cultural values. These in turn, are expected to impact on managerial behaviour, firm's objectives and the market for corporate control (Humphreys 1996, Dockery and Herbert 2000). This chapter aims to examine the audit committee's oversight responsibility from the internal perspective of the UK and Egyptian audit committee members and by comparison with the DeZoort (1997) study in the USA. These will be taken as a basis to assess audit committee members' abilities to recognize their assigned objectives and explore their perceptions of the committee's oversight responsibilities. To achieve this target, the chapter is divided into three sections. The first section aims to compare the UK audit committee member's responses with the DeZoort (1997) survey results. The second section aims to compare the audit committee member's responses between the UK and Egypt. The remaining section aims to compare the DeZoort (1997) survey results with the UK and Egyptian audit committee member' responses.

7-2. A Comparison between the USA and the UK

Audit committees have received much attention over the past few years in the USA and UK. In particular, concerns persist regarding the scope of the audit committee's oversight responsibilities. Latest developments indicate that the audit committee's oversight responsibilities are constantly evolving and expanding. Therefore, the tasks of defining and understanding the audit committee's oversight responsibilities are critical to improving the

credibility of the corporate audit committee as a corporate governance mechanism. Also, future efforts to improve audit committee performance will depend in part on understanding what audit committees are currently doing (Carcello et al. 2002). Thus, this section contributes to a better understanding of audit committee oversight by evaluating the UK audit committee members' perceptions of their assigned responsibilities in comparison with the DeZoort (1997) survey results for audit committee members in the USA. Although audit committees are not mandatory in the UK, there is effectively a requirement for listed companies to have them. The London Stock Exchange requires UK listed companies to prepare a statement in their annual report in compliance with the Cadbury Committee (1992) recommendations and to give details of any non-compliance. It should be acknowledged that there is a gap in time between DeZoort's study of USA audit committee members (1997) and this study of UK audit committee members. Recommendations which have been adopted after DeZoort study (e.g. BRC 1999 and Sarbanes Oxley Act of 2002 recommendations) are intended to strengthen the requirements for audit committees' oversight responsibilities which Wolinzer identified its in 1995.

As explained in the previous chapter, the UK sample consisted of 200 audit committee members randomly selected from the top 250 companies listed on the London Stock Exchange in the Financial Times 1,000 for the year 2002. Responses were received from 110 audit committee members giving a usable response rate of 55% (the response rate in the DeZoort survey was 35%). Twenty-two of the fifty-five companies represented had more than one respondent. To address the possibility of company policy response bias, an analysis was conducted comparing the results from the 110 respondents to results from only twenty-two respondents (one from each company). Table 7-1 shows that the results of the T-test comparisons revealed significant differences ($p < .05$) for any of the questions evaluated.

Table 7-1: T-test result for the UK sample

One-Sample Test						
	Test Value = 110					
	t	df	Sig. (2-tailed)	Mean Difference	95% Confidence Interval of the Difference	
					Lower	Upper
Q1	-375.968	109	.000	-81.9091	-82.3409	-81.4773
Q2	-176.704	109	.000	-79.9545	-80.8513	-79.0578
Q3	-388.614	109	.000	-89.4364	-89.8925	-88.9802

In order to facilitate comparison between USA audit committee members' responses and the UK audit committee members' responses, the same two methods of analysis, which DeZoort used in analysing the first question "is the objective assigned formally to your committee?" were used in this study. First, a Chi-square test for homogeneity tested for differences between the assigned audit committee objectives listed in the annual reports and the assigned audit committee objectives recognized by audit committee members. Second, a Phi coefficient was calculated to test the strength of association between source (i.e., annual report or audit committee member) and assignment (i.e., yes or no). The Phi coefficient is appropriate when both variables are nominal dichotomous variables (DeZoort 1997). The Phi coefficient calculated by dividing the Chi-squared statistics by N and then take the square root as following (Ronald and Julstrom 1982):

$$\text{Phi} = \sqrt{\frac{\chi^2}{n}}$$

Substitute the value of χ^2 , we obtain the following:

$$\text{Phi} = \sqrt{\frac{\sum_{i=1}^n \frac{(E_i - O_i)^2}{E_i}}{n}}$$

Where:

E = Expected frequency

O = Observed frequency

N = Sample size

The overall Chi-square results in Table 7-2 for the UK sample indicate significant differences between what audit committee members perceive as their assigned responsibilities and their actual assigned responsibilities listed in annual reports (Chi-square = 498.8, *P*-value < .001). The results are in line with DeZoort (1997) survey results in the USA. The Phi coefficient of .378 (*P*-value < .001) indicates that the annual reports tended to list responsibilities and the audit committee members tended not to recognize these as assigned responsibilities.

Table 7-2 Comparison of oversight duties listed in annual reports and respondents' perceptions of duties assigned in the USA and the UK:

Objective	DeZoort (1997) survey in U.S.A					U.K sample				
	Proxy Assigned (Yes/No)	AC mbr Assigned (Yes/No)	Chi-square	p-value	Phi coeff	Proxy Assigned (Yes/No)	AC mbr Assigned (Yes/No)	Chi-square	p-value	Phi coeff
Financial reporting										
OBJ1	83/29	48/64	22.52	.001	.317	106/4	103/7	.282	.595	.051
OBJ2	73/39	44/68	15.05	.001	.259	100/10	69/41	73.64	.001	.481
OBJ3	87/25	80/32	1.15	.283	.072	108/2	101/9	.182	.670	.041
OBJ4	58/54	0/112	78.27	.001	.591	53/57	8/102	52.38	.001	.154
OBJ5	56/56	2/110	67.84	.001	.550	32/78	15/95	19.23	.001	.154
OBJ6	38/74	0/112	45.76	.001	.452	48/62	4/106	94.58	.001	.730
Auditing										
OBJ7	98/14	80/32	8.86	.001	.199	101/9	36/74	.387	.534	.059
OBJ8	89/23	87/25	0.11	.745	.022	107/3	75/35	14.54	.001	.146
OBJ9	59/53	12/100	45.55	.001	.451	86/24	25/85	32.72	.001	.184
OBJ10	91/21	62/50	17.34	.001	.278	102/8	22/88	39.60	.001	.199
OBJ11	75/37	13/99	71.95	.001	.567	88/22	45/65	113.25	.001	.502
OBJ12	49/63	4/108	50.05	.001	.473	87/23	12/98	67.23	.001	.480
OBJ13	61/51	0/112	83.83	.001	.612	81/29	9/101	24.58	.001	.278
OBJ14	85/27	18/94	80.68	.001	.600	103/7	59/51	83.78	.001	.446
Other corporate governance										
OBJ15	68/44	12/100	60.98	.001	.522	67/43	33/77	17.60	.001	.418
OBJ16	60/52	7/105	59.82	.001	.517	38/72	12/98	67.23	.001	.583
OBJ17	53/59	17/95	26.93	.001	.347	36/74	22/88	39.60	.001	.391
Overall	1125/667	486/1306	460.4	.001	.358	1343/527	650/1220	498.8	.001	.378

This finding is consistent with Rittenberg and Nair (1993) and DeZoort (1997), who found that audit committee members believe they need to better understand their assigned duties and responsibility to improve audit committee effectiveness. Furthermore, the results in Table 7-2 for the UK audit committee members sample indicate that, of the audit committee members responsibilities formally assigned, they recognized only three of the seventeen objectives

presented. In particular, (OBJ1) which relates to the review of all financial statements, whether interim or annual (Chi-square .282, P -value $>.05$, and Phi coefficient .051), (OBJ3) which relates to the review of systems of internal control (Chi-square .182, P -value $>.05$, and Phi coefficient .041), and (OBJ7) which relates to recommendations for the appointment of and fee for the external auditors (Chi-square .387, P -value $>.05$, and Phi coefficient .059).

DeZoort found only two objectives were recognized by respondents in his study of USA audit committee members, (OBJ3) which relates to the review of systems of internal control and (OBJ8) which relates to the review of plans for, and the effectiveness of, the internal and external auditors. The results of both countries, indicate it is evident that the review of systems of internal control is considered the most important audit committee oversight area. This finding is consistent with the importance placed on internal control evaluation put forward by numerous bodies and researchers (e.g. Cadbury Committee 1992; Kalbers and Fogarty 1993; Vinten and Lee 1993; Lee and Stone 1997; DeZoort 1997; Spira 1998; Braiotta 2002; BRC 1999; Turnbull Report 1999; Sarbanes Oxley Act 2002; and Smith Report 2003). The results of the chi-square tests on the individual objectives for the UK audit committee members sample reveal that (OBJ1) and (OBJ7) were recognized as formally assigned to the audit committees, but audit committee members in the USA did not. On the other hand, audit committee members in the USA survey recognized objective (OBJ8), but audit committee members in the UK sample did not recognize it.

These findings highlight the important role of disclosures in audit committee charters and reports of oversight responsibilities. Table 7-3 presents disclosure information regarding audit committees oversight responsibilities in the annual reports of USA and UK sample companies. For the USA sample companies, this Table shows that (OBJ3) and (OBJ8), which

were recognized by audit committee members, are disclosed in a high percentage of the annual reports of the sample companies (78% and 79%). At the same time, (OBJ4, 5, 6, 9, 12, 13, 16, and 17), which were not recognized by audit committee members, are disclosed in a low percentage of the annual reports (52%, 50%, 40%, 53%, 44%, 54%, 54%, and 47% respectively). Similar percentages were found in the UK sample companies, Table 7-3 shows that (OBJ1, 3, and 7), which were recognized by audit committee members, are disclosed in a high percentage of the annual reports of the sample companies (96%, 98%, and 92%). At the same time, (OBJ4, 5, 6, 16, and 17), which were not recognized by audit committee members, are disclosed in a low percentage of the annual reports (29%, 44%, 35%, and 33%). Porter and Gendall (1998) support this contention with findings showing that the effectiveness of audit committees could be increased by having their objective and responsibilities clearly defined in a written statement, and by disclosing their existence, membership and objectives in corporate annual reports.

In the USA, the SEC requires that publicly traded companies adopt formal written charters for their audit committee describing their responsibilities, composition, qualification, and functions. The charter should be approved by the Board of Directors and disclosed at least triennially in the annual report to shareholders. Publicly traded companies listed on organized stock exchanges (NYSE and NASD) are required to include the audit committee charter in their annual report at least once every three years (SEC 1999).

Table 7-3 Disclosure of oversight responsibilities of audit committees in the USA and the UK samples

Objective	DeZoort survey in the USA		UK sample	
	Annual reports disclosed (Yes/No)	Percentage	Annual reports disclosed (Yes/No)	Percentage
Financial reporting				
(OBJ1)	83/29	74	106/4	96
(OBJ2)	73/39	65	100/10	91
(OBJ3)	87/25	78	108/2	98
(OBJ4)	58/54	52	53/57	48
(OBJ5)	56/56	50	32/78	29
(OBJ6)	38/74	40	48/62	44
Auditing				
(OBJ7)	98/14	88	101/9	92
(OBJ8)	89/23	79	107/3	97
(OBJ9)	59/53	53	86/24	78
(OBJ10)	91/21	81	102/8	93
(OBJ11)	75/37	67	88/22	80
(OBJ12)	49/63	44	87/23	79
(OBJ13)	61/51	54	81/29	74
(OBJ14)	85/27	76	103/7	94
Other corporate governance				
(OBJ15)	68/44	61	67/43	61
(OBJ16)	60/52	54	38/72	35
(OBJ17)	53/59	47	36/74	33

Also, in the UK the Smith Report (2003) recommends that

“the board should provide written terms of reference for the audit committee. The terms of reference should be tailored to the particular circumstances of the company. The audit committee should review annually its terms of reference and its own effectiveness and recommend any necessary changes to the board”.

The Institute of Internal Auditors (IIA 1993), also noted that requiring audit committee reports would clarify the role and responsibilities of the committee in each company and would help ensure that the committee is meeting its responsibilities by focusing the

committee's attention on those responsibilities. In particular, Turpin and DeZoort (1998) found that in USA firms, annual report disclosure of audit committee oversight typically comes as part of the management report lacking the emphasis provided by a separate report highlighting the audit committee and signed by the audit committee chair. Similarly in UK firms, disclosure of audit committee oversight typically comes as part of the corporate governance section in their annual report.

Table 7-3 shows that other oversight responsibilities (e.g. OBJ14) are disclosed in the annual reports of the USA and the UK companies samples at relatively high percentage (76% in USA and 94% in UK), but audit committee members did not recognize the responsibility as theirs. This finding indicate a limited involvement of audit committee members in the practice of this oversight responsibility. Turley and Zamman (2003) in the UK, support this contention with findings showing that audit committee members had relatively limited involvement in approving and monitoring the dimensions of the relationship between the external auditor and the company.

In both countries, Table 7-3 shows that disclosures related to financial reporting and audit functions were much more common than disclosures related to other corporate governance functions such as reviewing corporate policies and practices in light of ethical considerations (OBJ16), and monitoring compliance with the company's code of conduct (OBJ17). Table 7-3 shows that both objectives are disclosed in a low percentage of the annual reports of the sample companies in the USA and the UK (54%, 47%, and 35%, 33%).

The second question produced responses related to the performance of oversight responsibilities not formally assigned to audit committees. In particular, the results in Table 7-

4 for the UK audit committee members sample indicate that evaluation of exposure to fraud (OBJ4) and the review of all significant transactions (OBJ5) were not assigned but were performed as often as they were assigned (45% and 52% of the time). In comparison with the DeZoort survey results in the USA, DeZoort found that, apprising key management estimates, judgements, and valuations (OBJ6) and requesting information about disputes between auditors and management (OBJ12) were not assigned but were performed (54% and 48% of the time). Also, the results in Table 7-4 indicate that in both countries, for almost half of the objectives, at least one third of the respondents indicated their audit committee performed the duty without formal assignment.

Table 7-4 Analysis of oversight work performed but not formally assigned for both the USA and the UK samples

Objective	DeZoort (1997) survey in U.S.A		UK Sample	
	Objective assigned	Objective performed but not assigned	Objective assigned	Objective performed but not assigned
Financial reporting				
(OBJ1)	83 (79%)	22 (21%)	106 (86%)	17 (14%)
(OBJ2)	73 (73%)	27 (27%)	100 (86%)	16 (14%)
(OBJ3)	87 (87%)	23 (13%)	108 (90%)	12 (10%)
(OBJ4)	58 (60%)	38 (40%)	53 (55%)	42 (45%)
(OBJ5)	65 (62%)	35 (38%)	32 (48%)	34 (52%)
(OBJ6)	38 (46%)	44 (54%)	48 (70%)	20 (30%)
Auditing				
(OBJ7)	98 (98%)	2 (2%)	101 (84%)	18 (16%)
(OBJ8)	89 (88%)	12 (12%)	107 (84%)	19 (16%)
(OBJ9)	59 (65%)	32 (35%)	86 (76%)	26 (24%)
(OBJ10)	91 (87%)	13 (13%)	102 (82%)	21 (18%)
(OBJ11)	75 (74%)	26 (26%)	88 (73%)	31 (27%)
(OBJ12)	49 (52%)	46 (48%)	87 (73%)	32 (27%)
(OBJ13)	61 (67%)	30 (33%)	81 (77%)	24 (23%)
(OBJ14)	85 (83%)	18 (17%)	103 (82%)	22 (18%)
Other corporate governance				
(OBJ15)	68 (65%)	37 (35%)	67 (62%)	41 (38%)
(OBJ16)	60 (64%)	33 (36%)	38 (64%)	21 (36%)
(OBJ17)	53 (65%)	28 (35%)	36 (64%)	20 (36%)

This finding is consistent with Carcello et al. (2002) who studied the disclosure in audit committee charters and reports by examining a random sample of 150 annual reports filed in 2001 in the USA, and found that what audit committees report they are doing differs from what their charters say the committee should be doing.

The third question provided an opportunity for audit committee members to evaluate the list of proposed oversight responsibilities. The results in Table 7-5 for the UK audit committee members sample indicate that reviewing corporate policies and practices in light of ethical considerations (OBJ16) and monitoring compliance with the company's code of conduct (OBJ17) were considered as not appropriate objectives for their audit committee (40% and 39%) in comparison with the DeZoort survey results for audit committee members in the USA for the same objectives (74% and 67%). These results may be seen in the context of legal framework for audit committees in the UK. This framework does not clearly define any requirements or recommendations for audit committee members to review corporate policies and practices in light of ethical considerations or to monitor compliance with the company's codes of conduct. At the same time, in the USA, the Treadway Commission (1987) recommends that "public companies should develop and enforce written codes of corporate conduct. Codes of conduct should foster a strong ethical climate and open channels of communication to help protect against fraudulent financial reporting. As a part of its ongoing oversight of the effectiveness of internal controls, a company's audit committee should review annually the programme that management establishes to monitor compliance with the code". The NYSE recommends that, "companies must adopt and disclose (1) corporate governance guidelines (2) code of business conduct and ethics". Also, the Sarbanes-Oxley Act of 2002, section 406, requires "each issuer to disclose, in its periodic reports, whether it has adopted a code of ethics for its senior financial officers".

Table 7-5 Comparison of Wolnizer oversight objective between the USA and the UK

Objective	DeZoort's (1997) survey in U.S.A		UK Sample	
	No. agreeing objective is appropriate/ No. respondents	Percentage	No. agreeing objective is appropriate/ No. respondents	Percentage
Financial reporting				
(OBJ1)	95/118	81	97/110	88
(OBJ2)	91/118	77	95/110	86
(OBJ3)	97/118	82	104/110	95
(OBJ4)	90/118	76	72/110	66
(OBJ5)	77/118	65	70/110	63
(OBJ6)	73/118	62	72/110	65
Auditing				
(OBJ7)	96/118	81	89/110	81
(OBJ8)	99/118	84	88/110	80
(OBJ9)	82/118	69	82/110	75
(OBJ10)	96/118	81	87/110	79
(OBJ11)	96/118	81	92/110	84
(OBJ12)	94/118	80	81/110	74
(OBJ13)	90/118	76	83/110	76
(OBJ14)	94/118	80	84/110	76
Other corporate governance				
(OBJ15)	92/118	78	78/110	71
(OBJ16)	87/118	74	45/110	40
(OBJ17)	79/118	67	43/110	39

The results in Table 7-5 indicate that in both countries, for the other objectives, the respondents agree that the Wolnizer oversight objectives are appropriate for audit committees and for all of the proposed audit committee objectives, more than 60 per cent of respondents suggested the objective should be part of the audit committee function. This finding suggests that, in line with current recommendations and requirements for expanding the audit committees' oversight responsibilities (e.g. BRC 1999, Sarbanes-Oxley Act of 2002, and the Smith Report 2003), members agree with calls for audit committees to be doing more than they are regarding corporate governance.

7-3. A Comparison between Egypt and the UK

In accordance with the attempts to establish audit committees in the USA and the UK, the establishment of audit committees in Egypt is based on protecting shareholder interests. As a result, starting in 2000, The Central Bank of Egypt, which is considered a supervisor for all Egyptian banks, required audit committees to be established as sub-committees of the main board of directors charged with specific responsibilities relating to monitoring financial reporting, the external auditors, and internal control including internal auditing functions. In June 2002, the Capital Market Authority (CMA) issued a statement No.30, article No.7, to the listed companies in the Cairo & Alexandria Stock Exchange (CASE) requiring them to have audit committees.

As explained in the previous chapter, the Egyptian sample consisted of 65 audit committee members randomly selected from the top 34 companies listed on the Cairo & Alexandria Stock Exchange, for the year 2002, based on their market capitalization (above \$200 million or the equivalent in Egyptian pounds). Responses were received from 41 audit committee members giving a usable response rate of 63%. Four of the thirty-four companies represented had more than one respondent. To address the possibility of company policy response bias, analysis was performed comparing the results from the 41 respondents to results from only four respondents (one from each company). Table 7-6 shows that, the results of the T-test comparisons revealed significant differences ($p < ,05$) for any of the questions evaluated.

Table 7-6 T-test results for the Egyptian sample

One-Sample Test						
	Test Value = 41					
	t	df	Sig. (2-tailed)	Mean Difference	95% Confidence Interval of the Difference	
					Lower	Upper
Q1	-48.535	40	.000	-14.1707	-14.7608	-13.5806
Q2	-39.956	40	.000	-13.3659	-14.0419	-12.6898
Q3	-54.297	40	.000	-15.1951	-15.7607	-14.6295

In Egypt, the Capital Market Authority (CMA) in its statement No.30 in 2002 does not require listed companies to adopt a formal written charter for audit committees. Also, it does not specify any recommendations relating to audit committee reporting, despite the important role audit committee charters and reports play in assessing the audit committee members' ability to fulfil their duties and responsibilities. This means that Egyptian companies do not disclose the assigned responsibilities for audit committees in their annual reports. Thus, regarding the first question, the chi-square test and phi coefficient could not be calculated.

The second question produced responses related to the performance of oversight responsibilities not formally assigned to the audit committee. In particular, the results in Table 7-7 for the Egyptian audit committee members sample indicate that the review of external auditor's management letters (OBJ10) the determining that the external auditors are free from undue influence and managerial interference (OBJ11), and requests to be informed if there is a dispute between auditors and managers (OBJ12) were not assigned by the Capital Market Authority (CMA) statement, but were performed as often as they were assigned (55%, 59%, and 60% of the time). These findings highlight the important role that audit committees can play in enhancing the external auditing function.

Table 7-7 Analysis of oversight work performed but not formally assigned for both Egypt and the UK samples

Objective	Egypt Sample		UK Sample	
	Objective assigned	Objective performed but not assigned	Objective assigned	Objective performed but not assigned
Financial reporting				
(OBJ1)	26 (81%)	6 (19%)	106 (86%)	17 (14%)
(OBJ2)	22 (85%)	4 (15%)	100 (86%)	16 (14%)
(OBJ3)	36 (88%)	5 (12%)	108 (90%)	12 (10%)
(OBJ4)	15 (79%)	4 (21%)	53 (55%)	42 (45%)
(OBJ5)	27 (77%)	8 (23%)	32 (48%)	34 (52%)
(OBJ6)	14 (82%)	3 (18%)	48 (70%)	20 (30%)
Auditing				
(OBJ7)	8 (80%)	2 (20%)	101 (84%)	18 (16%)
(OBJ8)	30 (81%)	7 (19%)	107 (84%)	19 (16%)
(OBJ9)	21 (78%)	6 (22%)	86 (76%)	26 (24%)
(OBJ10)	18 (45%)	22 (55%)	102 (82%)	21 (18%)
(OBJ11)	15 (41%)	19 (59%)	88 (73%)	31 (27%)
(OBJ12)	16 (40%)	24 (60%)	87 (73%)	32 (27%)
(OBJ13)	18 (82%)	4 (18%)	81 (77%)	24 (23%)
(OBJ14)	22 (81%)	5 (19%)	103 (82%)	22 (18%)
Other corporate governance				
(OBJ15)	8 (80%)	2 (20%)	67 (62%)	41 (38%)
(OBJ16)	7 (87%)	1 (13%)	38 (64%)	21 (36%)
(OBJ17)	10 (83%)	2 (17%)	36 (64%)	20 (36%)

In Egypt, as explained before, article (104) of law No. 159 of 1981 which was enacted to govern private auditors' work, and article (1) of law No.144 of 1988 which was enacted to govern public auditors' work, were both intended to ensure the auditors' independence by prohibiting them from participating in the formation of a corporation, being members of their Boards of Directors, or permanently performing any technical, administrative, or consulting duties. Despite this concern about the importance of auditors' independence in Egypt, the CMA in its statement does not specify any requirements for audit committee members to have procedures to ensure the independence and objectivity of the external auditor. This finding reflects the important role that audit committees can play in protecting external auditor independence in Egypt.

Also, the results in Table 7-7 for the Egyptian sample related to (OBJ12), request to be informed if there is a dispute between auditors and managers, are consistent with recent survey research. For example, Reinstein and Weirich (1996) found that audit committee members tend to support the auditors rather than management in audit disputes. Such support appears to strengthen the auditor's independence when dealing with company management. Beattie et al. (2000) surveyed audit partners and CFOs of large publicly traded UK companies and found a tendency for firms with audit committees to enter into fewer negotiations but more informal discussions about accounting policy disputes than did firms without audit committees. Also, Gibbins et al. (2001) surveyed Canadian audit partners and found that they, on average, rated the audit committee as only moderately important in auditor-client negotiations over accounting policy disputes. DeZoort and Salterio (2001) found that greater independent director experience and greater audit knowledge was associated with higher audit committee member support for an auditor in the dispute with client management. Recently, DeZoort et al. (2003) found that audit committee members provided great support for the auditor when the auditor's materiality justification included both quantitative and consequences-oriented factors and when the accounting issue was subject to precise measurement.

In Egypt, law No. 159 of 1981 which was enacted to govern private auditors' work and law No.144 of 1988 which was enacted to govern public auditors' work, do not specify any article concerning the solution of disputes which can arise between auditors and management relating to auditing processes and accounting policy. Consequently, in the light of this finding, audit committees in Egypt expected to play an important role in the auditor-management disputes.

In comparing the Egyptian and UK samples, the results in Table 7-7 indicate that in both countries, reviewing systems of internal control (OBJ3) is considered to be the most important audit committee oversight area (88% and 90%). This finding, as explained before, is consistent with the importance placed on internal control evaluation forwarded by numerous entities external to the audit committee's oversight responsibilities (e.g. Cadbury Committee 1992, Kalbers and Fogarty 1993, Vinten and Lee 1993, Lee and Stone 1997, DeZoort 1997, Spira 1998, Braiotta 2002, BRC 1999, Turnbull Report 1999, Sarbanes Oxley Act 2002, and the Smith Report 2003).

The third question provided an opportunity for audit committee members to evaluate the list of proposed oversight responsibilities. The results in Table 7-8 for the Egyptian audit committee members' sample indicate that the appointment of and fee for the external auditor (OBJ7) was not considered as appropriate objectives for their audit committee (15%), at the same time, article (103) of law No. 159 of 1981, which was enacted to govern private auditors' work, requires each corporation to have at least one auditor who is to be appointed by the general assembly in the Annual General Meeting, but in practice it is the company management who undertake such tasks. Consequently, the selection process may be distorted by management. For the public auditors situation, as explained before, in Egypt the selection process is not found because The Central Auditing Organization appoints the external public auditors on behalf of the entities. Consequently, the role of management in selecting the external auditors is limited to the private entities. However, the change from a common economy to a free market economy, accompanied by a wide movement of privatisation of public entities, will increase concern about the selection of external auditors. At the same time, the CMA in its statement does not specify any requirements for audit committee members to make a recommendation on the appointment, reappointment or removal of

external auditors. Also, the CMA does not specify any requirements for audit committee members to keep under review the overall financial relationship between the company and its auditors to ensure a balance between audit quality and value for money, and provide support for the auditors in the audit fee negotiations with company management .

Table 7-8 Comparison of Wolnizer oversight objective between Egypt and the UK

Objective	Egypt Sample		UK Sample	
	No. agreeing objective is appropriate/ No. respondents	Percentage	No. agreeing objective is appropriate/ No. respondents	Percentage
Financial reporting				
(OBJ1)	35/41	85	97/110	88
(OBJ2)	33/41	80	95/110	86
(OBJ3)	38/41	92	104/110	95
(OBJ4)	27/41	66	72/110	66
(OBJ5)	28/41	68	70/110	63
(OBJ6)	11/41	27	72/110	65
Auditing				
(OBJ7)	6/41	15	89/110	81
(OBJ8)	18/41	43	88/110	80
(OBJ9)	8/41	19	82/110	75
(OBJ10)	32/41	78	87/110	79
(OBJ11)	34/41	83	92/110	84
(OBJ12)	31/41	76	81/110	74
(OBJ13)	12/41	29	83/110	76
(OBJ14)	11/41	27	84/110	76
Other corporate governance				
(OBJ15)	13/41	32	78/110	71
(OBJ16)	6/41	15	45/110	40
(OBJ17)	8/41	20	43/110	39

In comparison with the UK sample regarding the same objective, the results in Table 7-8 indicate that (81%) of audit committee members considered it as an appropriate objective for their audit committee. This reflects the important role for the audit committee in recommending the appointment of and fee for the external auditor. In this respect, recent evidence underscores the importance of the audit committee in the selection and replacement

of the external auditor. Carcello and Neal (2000a) find that external auditors who issue initial going concern audit reports are less likely to be terminated when the audit committee is comprised entirely of independent directors. Abbott and Parker (2000a) observe that companies with an audit committee comprised of independent directors that meet at least twice annually are more likely to select a big 6 auditor (now big 4) when switching auditors. Also, recent evidence underlines the importance of the audit committee being involved in the audit fee negotiation process, Collier and Gregory (1996) find that audit committees are at least partially effective in preventing reduction in the audit fee to levels where the quality of the audit may be compromised. Also, Carcello and Neal (2000b) postulate that the existence of an independent and active audit committee could impact on the audit fee negotiation process. Specifically, by reducing the overall threat of auditors dismissal and strengthening the auditor's relative bargaining position during audit fee negotiations.

Also, the results in Table 7-8 for the Egyptian audit committee members sample indicate that reviewing the external auditor's management letter (OBJ10), determining that external auditors are free from undue influence and managerial interference (OBJ11), and requesting to be informed if there is a dispute between auditors and managers (OBJ12) were considered as appropriate objectives for their audit committees (78%, 83%, and 76% respectively). Also, the results in the previous table, Table 7-7, indicate that these objectives were not assigned in the Capital Market Authority (CMA) statement but were performed as often that they were assigned (55%, 59%, and 60% of the time). These objectives are therefore used in measuring audit committee effectiveness in Egypt in the next chapter.

The goals of audit committees and internal audit functions are closely intertwined, and the ability of the audit committee and internal auditors to work together significantly impacts on

the effectiveness of the audit committee in fulfilling its responsibilities to the Board of Directors, shareholders, and other outside parties (Scarborough et al. 1998 and Atkins 2002). The results in Table 7-8 for the audit committee members sample in Egypt indicate that reviewing the plans of, and the effectiveness of the internal and external auditors (OBJ8) and monitoring the resources allocated to the internal audit function (OBJ13) were considered as non-appropriate objectives for audit committees (43% and 29%). These results were consistent with The World Bank Report (2001) which argued that “in Egypt the internal audit function does not exist in some companies, or if it does, has a little power.” Thus, one of the important recommendations to strengthen corporate governance in Egypt, in this report, is to establish and enhance the internal auditing role in monitoring management. At the same time, the CMA does not specify any requirement for audit committee members to review the internal auditing function, or any other interaction between audit committee and internal auditing. Along these lines, the Smith Report (2003) stated that “the audit committee should review and approve the internal audit function’s remit, having regard to the complementary roles of the internal and external audit functions. The audit committee should ensure that the function has the necessary resources and access to information to enable it to fulfill its mandate, and is equipped to perform in accordance with appropriate professional standards for internal auditors”.

Also, regarding the external audit function, the World Bank Report (2001) argued that “in Egypt there is no formal system of monitoring the external auditors and The Egyptian Society of Accountants and Auditors does not act as a review panel”. This situation has, in turn, been influenced in the audit committee members’ responsibility for the objective. At the same time, a primary responsibility of the audit committee is to oversee the financial reporting process (Ragunandan et al. 1998). Through their involvement with the audited financial statements,

the independent auditors are in a position to provide an objective assessment of the financial reporting process. For this reason, the audit committee should inquire about the proposed audit scope and approach, and any recommendations management receives from the independent auditors regarding the financial reporting process and related matters (Braiotta 2002).

Regarding the audit committee oversight responsibility related to reviewing the nature and magnitude of fees paid to the auditors for non-audit services (OBJ14), the results in Table 7-8 for the Egyptian sample indicate that (27%) of audit committee members consider this objective as an appropriate objective for their audit committee, this ratio in the UK sample was (76%). This finding means that audit committee members in Egypt are not aware of the role that the audit committee can play in reviewing non-audit service. Also, the CMA in its statement does not recommend any requirements for audit committees regarding this issue. Similarly, consulting fees do not have to be disclosed at the companies annual general meeting. In the UK, the Smith Report (2003. Sec. 5.26) requires that “the audit committee should develop and recommend to the board the company’s policy in relation to the provision of non-audit services by the auditor. The audit committee’s objective should be to ensure that the provision of such services does not impair the external auditor’s independence or objectivity”.

The results in Table 7-8 for the UK audit committee members sample indicate that reviewing corporate policies and practices in light of ethical considerations (OBJ16), and monitoring compliance with the company’s code of conduct (OBJ17) were considered as not appropriate objectives for their audit committee (40% and 39%). Similarly, in the Egyptian sample the two objectives were considered as not appropriate objectives (15% and 20%). These results

may be referenced to the legal framework for audit committees in both countries. These frameworks do not clearly define any requirements or recommendations for audit committee members to review corporate policies and practices in light of ethical considerations or to monitor compliance with the company's codes of conduct. At the same time, the results in Table 7-8 indicate that, in both countries and regarding the other objectives, the respondents agree that the Wolnizer oversight objectives are appropriate for audit committees. And for all of the proposed audit committee objectives, more than 60 per cent of respondents suggested the objectives should be part of the audit committee function.

In order to test the variances between audit committee members' responses in the UK and Egyptian samples for the seventeen oversight responsibilities, Table 7-9 shows the Independent-Sample T-test results between the two populations. The results contains the value for Sig.(2-tailed). The observed significance level is (P -value > 0.05). Therefore, there are significant differences in responses for the three questions between two samples with confidence level 95%.

Table 7-9 Independent-Samples T-test between the UK sample and Egypt sample

		Levene's Test for Equality of Variances		t-test for Equality of Means						
		F	Sig.	t	df	Sig. (2-tailed)	Mean Difference	Std. Error Difference	95% Confidence Interval of the Difference	
									Lower	Upper
Q1	Equal variances assumed	.097	.755	3.2	149	.002	1.2616	.39912	4.730	2.0503
	Equal variances not assumed			3.5	87.0	.001	1.2616	.36429	.5376	1.9857
Q2	Equal variances assumed	14.4	.000	3.1	149	.002	2.4113	.76996	.8899	3.9328
	Equal variances not assumed			4.3	144	.000	2.4113	.56270	1.299	3.5235
Q3	Equal variances assumed	3.666	.057	-13	149	.000	-5.2412	.41420	-6.06	-4.423
	Equal variances not assumed			-14	96.2	.000	-5.2412	.36233	-5.96	-4.522

These results are consistent with Hofstede (1991) who argued that there is much evidence that significant cultural differences exist across nations. Also, HassabElnaby et al. (2003) suggested that accounting does not develop in a vacuum, but reflects the particular environments in which it is developed. Hence accounting systems, practices and disclosure may be expected to differ from one country to another.

7-4. Comparison between the UK, the USA and Egypt: An Institutional Perspective

Corporate governance has spawned an increasing amount of interest from academics, practitioners, national and multilateral government bodies. Much of this attention has focused on the way USA and UK companies are governed (Vinten 2000). The USA corporate governance system has been generally characterised as short-term shareholder-oriented. This characterisation also applies to the UK corporate governance system, given the close economic ties between the UK and the USA both with respect to the degree of market integration and the organisation of transactions and in relation to other socio-cultural respects (Dockery and Herbert 2000). At the same time, it is expected that the transition economy process in Egypt, undergoing major economic, regulatory, and political reforms, as well as Anglo Saxon market acculturation, will exhibit differences in corporate governance systems. Such differences may be associated with significant differences in attitudes, beliefs and cultural values. These in turn are expected to impact on managerial behaviour, firms' objectives and markets for corporate control (Humphreys 1996 and Dockery and Herbert 2000). Committees, commissions, and regulatory authorities in the USA and UK have identified the corporate audit committee as a key component of effective corporate governance (Lee and Stone 1997). Consequently, it is possible that differences in the regulatory environment and the importance assigned to corporate governance, as well as other

cultural factors, could significantly influence the nature of the audit committees' legal framework in the USA, the UK, and Egypt. The suggestion that Anglo Saxon management theories and concepts are as applicable in developing countries as they are in the UK and USA has been subject to much critical comment. Kanter and Corn (1994) asserted that recent findings about the cultural propensities of major countries appear robust, replicated in surveys of managers, as well as used to explain institutional patterns within countries. Also Hofstede (1991) argued that for many theories "it is easier to avoid the idea of the culture concept than to face up to it". In management literature, culture is seen as an important influence on practice. Along these lines Brown and Humphreys (1995) explained that the nature and extent of these cultural differences are such that it is unwise to assume that the management theories and practices developed in the west will be appropriate and applicable in Egypt. Thus, this section aims to investigate the problem of institutional difference in the implementation of USA and UK audit committee oversight responsibilities, as these countries applied the audit committee concept a long time ago and considers the oversight responsibilities and ways of measuring its effectiveness, in Egypt.

The strength of the capital market, and indeed, of the economic system, depends heavily on the general confidence engendered by the credibility that attaches to a set of audited financial statements (Vinten and Lee 1993). Within the auditing function, the significance of the cultural dimension lies in the behaviour of auditees, their reaction to workplace requirements and their relationship to the auditor. Woodworth and Said (1996) asserted that the reaction to the audit itself may vary from culture to culture. An auditee from a low power distance culture may not accept the auditor's recommendation for change. On the other hand, an auditee from a high power distance culture will yield without hesitation because he feels powerless to resist a person of authority. Therefore, Vanasco et al.(1997) argued that, auditing has always been

seen as an alien phenomenon in most parts of the third world. In Egypt, the auditing profession has faced a lot of different circumstances. The World Bank Report (2001) assessment conceded that, "all the basic ingredients of sound accounting and auditing practices exist in Egypt". But it went on to qualify that statement by pointing out that the institutions that share the responsibility for setting standards are "fragmented". There is no single regulatory body setting standards for the profession in terms of licensing individuals, monitoring their training and keeping them abreast of developments in the profession. Accountants may be licensed through several different agencies, according to several different sets of requirements. The Central Auditing Organisation (COA) is responsible for all public sector enterprises. The Ministry of Finance and the Egyptian Society of Accountants and Auditors also play a role (El Makawy and Handoussa 2001). Therefore, in order to meet the requirements that true reform would establish, qualified individuals and companies are needed. The accounting profession must undergo the same kind of scrutiny and restructuring that is being applied to every aspect of national business that was once dominated by the public sector. But both private and public sector enterprises will benefit from this process of reform, which will impose performance upgrades on the accounting profession.

In this study, the results in Table 7-10 for the Egyptian audit committee members sample indicate that reviewing the external auditor's management letter (OBJ10), determining the external auditors are free from undue influence and managerial interference (OBJ11), and requesting to be informed if there is a dispute between auditors and managers (OBJ12) were not assigned in the CMA statement but were performed as often as they were assigned (55%, 59%, and 60% of the time). There is a special relationship between the audit committee and the external auditors, both share common objectives and their contributions reinforce one another's role in the strengthening of corporate accountability (Vinten and Lee 1993), this

finding highlights the important role that audit committees can play in enhancing the external auditing function in Egypt.

Table 7-10 Analysis of oversight work performed but not formally assigned in the USA, the UK, and Egyptian samples

Objective	Egypt Sample		DeZoort (1997) survey in USA		UK Sample	
	Objective assigned	Objective performed but not assigned	Objective assigned	Objective performed but not assigned	Objective assigned	Objective performed but not assigned
Financial reporting						
(OBJ1)	26 (81%)	6 (19%)	83 (79%)	22 (21%)	106 (86%)	17 (14%)
(OBJ2)	22 (85%)	4 (15%)	73 (73%)	27 (27%)	100 (86%)	16 (14%)
(OBJ3)	36 (88%)	5 (12%)	87 (87%)	23 (13%)	108 (90%)	12 (10%)
(OBJ4)	15 (79%)	4 (21%)	58 (60%)	38 (40%)	53 (55%)	42 (45%)
(OBJ5)	27 (77%)	8 (23%)	65 (62%)	35 (38%)	32 (48%)	34 (52%)
(OBJ6)	14 (82%)	3 (18%)	38 (46%)	44 (54%)	48 (70%)	20 (30%)
Auditing						
(OBJ7)	8 (80%)	2 (20%)	98 (98%)	2 (2%)	101 (84%)	18 (16%)
(OBJ8)	30 (81%)	7 (19%)	89 (88%)	12 (12%)	107 (84%)	19 (16%)
(OBJ9)	21 (78%)	6 (22%)	59 (65%)	32 (35%)	86 (76%)	26 (24%)
(OBJ10)	18 (45%)	22 (55%)	91 (87%)	13 (13%)	102 (82%)	21 (18%)
(OBJ11)	15 (41%)	19 (59%)	75 (74%)	26 (26%)	88 (73%)	31 (27%)
(OBJ12)	16 (40%)	24 (60%)	49 (52%)	46 (48%)	87 (73%)	32 (27%)
(OBJ13)	18 (82%)	4 (18%)	61 (67%)	30 (33%)	81 (77%)	24 (23%)
(OBJ14)	22 (81%)	5 (19%)	85 (83%)	18 (17%)	103 (82%)	22 (18%)
Other corporate governance						
(OBJ15)	8 (80%)	2 (20%)	37 (35%)	37 (35%)	67 (62%)	41 (38%)
(OBJ16)	7 (87%)	1 (13%)	33 (36%)	33 (36%)	38 (64%)	21 (36%)
(OBJ17)	10 (83%)	2 (17%)	28 (35%)	28 (35%)	36 (64%)	20 (36%)

DeZoort's survey results for the USA and the results for the Egyptian sample in Table 7-10 indicate that in both countries, requesting information about disputes between auditors and management (OBJ12) were not assigned but were performed (48% and 60% of the time). This finding was consistent with the current concern about the audit committee's role in auditor-management dispute. Auditors professional standards (e.g., SAS No. 61, *Communication With Audit Committees*, AICPA, 1998 and SAS No. 89, *Audit Adjustments*, AICPA, 1999) require

audit committees to be notified about auditor-management disagreement. Furthermore, the recently passed Sarbanes-Oxley Act (2002) specifically charges the audit committee with the resolution of financial reporting disagreements between the auditors and management.

Culture has previously been shown by empirical analysis and case study to affect the formulation of accounting regulation (Salter and Niswander 1995 and Vanasco et al. 1997). Hofstede (1991) argued that, culture includes a set of societal values that drive institutional form and practice. Along these lines, Gray (1988) explained that the value systems of attitudes of accountants may be expected to relate to and derive from societal values with special reference to work related values. Accounting “values” will in turn impact on accounting systems. Gray continued by defining four “accounting values” professionalism, uniformity, conservatism, and secrecy. These values interact with the other institutional consequences of culture (e.g. capital markets) to arrive at a final set of accounting systems that include financial reporting practices and professional structure. The relative force of the accounting values and the institutional consequences will vary from country to country in their impact on the final form of accounting systems (Salter and Niswander 1995). At the same time, HassabElnaby et al. (2003) explained that accounting literature suggests that as the business environment changes, the demand and use of financial information changes leading to the establishment and development of accounting.

Recently, in light of public concern over business failures and the related criticism of incomplete or fraudulent accounting information reporting prior to such failures, the critical role of the audit committee in the financial reporting process has been highlighted (Reghunandan et al. 1998, McDaniel et al. 2002). Regulators and the accounting profession have touted the role of audit committees in protecting investors, and accounting research

suggests that market participants see audit committees as providing meaningful oversight of financial reporting processes (McMullen 1996, and Wild 1996).

In this study, for financial reporting objectives, the results in Table 7-11 indicate that audit committee members in the Egyptian, USA, and UK samples were considered (OBJ1), (OBJ2), (OBJ3), and (OBJ4) as appropriate objectives for their audit committees. These results, based on the above analysis, were considered as a normal finding for the USA and UK, but for the Egyptian sample this is considered as abnormal. In particular, these findings can be referenced to changes in the Egyptian business environment through two main aspects which directly effect the development of accounting and reporting practice, these aspects are economic changes and the development of the stock market.

In 1990, the Egyptian government started its economic reform and restructuring programme and the Egyptian economy is now labelled as a “*transition economy*”; it is moving away from its attempt at a command economy towards the implementation of an economic system based on market forces. The United States Agency for International Development in its report, *The Corporate Governance Policy Framework in Egypt, 2000*, states that the supply of shares created by the privatisations in Egypt stimulated the development of the capital market, and led to the creation of modern institutions to support the market. Also, HassabElnaby et al. (2003) explained that “privatisation may impact on the accounting practice and disclosure in specific environments. Government and state-controlled banks often provide capital to state corporations. For these corporations to be privatised, stockholders will mainly provide the capital. The accounting practice and disclosure requirements for the external environment (public) are different from those required for government. Stockholders tend to require a more sophisticated level of public financial disclosure than that required by government”.

Therefore, the implementation of an economic reform programme in Egypt has resulted in an active effort by people in authority and those who work in accounting and auditing to enhance the quality of financial reporting which is considered to be one of the factors to increase the effectiveness of economic performance.

Table 7-11 Comparison of Wolnizer oversight objective between Egyptian, the USA, and the UK samples

Objective	Egypt Sample		DeZoort (1997) survey in USA		UK Sample	
	No. agreeing objective is appropriate/ No. respondents	Percentage	No. agreeing objective is appropriate/ No. respondents	Percentage	No. agreeing objective is appropriate/ No. respondents	Percentage
Financial reporting						
(OBJ1)	35/41	85	95/118	81	97/110	88
(OBJ2)	33/41	80	91/118	77	95/110	86
(OBJ3)	38/41	92	97/118	82	104/110	95
(OBJ4)	27/41	66	90/118	76	72/110	66
(OBJ5)	28/41	68	77/118	65	70/110	63
(OBJ6)	11/41	27	73/118	62	72/110	65
Auditing						
(OBJ7)	6/41	15	96/118	81	89/110	81
(OBJ8)	18/41	43	99/118	84	88/110	80
(OBJ9)	8/41	19	82/118	69	82/110	75
(OBJ10)	32/41	78	96/118	81	87/110	79
(OBJ11)	34/41	83	96/118	81	92/110	84
(OBJ12)	31/41	76	94/118	80	81/110	74
(OBJ13)	12/41	29	90/118	76	83/110	76
(OBJ14)	11/41	27	94/118	80	84/110	76
Other corporate governance						
(OBJ15)	13/41	32	92/118	78	78/110	71
(OBJ16)	6/41	15	87/118	74	45/110	40
(OBJ17)	8/41	20	79/118	67	43/110	39

Also, in the early 1990s, as a part of its privatisation program, the Egyptian government decided to revitalize its capital market by improving its reputation and the confidence of investors (Abd-Elsalam and Weetman 2003). The development of stock markets significantly influences the accounting environment of any country, especially developing countries

(HassabElnaby et al. 2003). The growing number of listed companies on the stock market creates demand for accounting and auditing services. Doupnik and Salter (1993) indicate that as the level of activities increase in the market, investors require more extensive financial and non-financial information about the companies' activities to help in making investment decisions. Therefore, stock markets create the need to improve corporate disclosure, corporate governance practices and accounting standards to attract both domestic and international investors. Establishing and maintaining appropriate accounting standards are critical to the developing of accounting. As stated by Massoud (1998): "accounting standards allow for a more accurate reflection of the business environment. Accounting standards serve to provide relevant information grounded in reliable financial reporting, whereby investors are able to analyse financial performance across time periods and among companies". Successful capital markets are built and maintained by investors' confidence in an accounting system that demands full and fair disclosure (HassabElnaby et al. 2003). Therefore, in Egypt, a new Capital Market Law No. 95 was issued in 1992 which required adherence to the International Accounting Standards by Executive Regulations (ERs) issued in 1993. The requirement to apply International Accounting Standards became fully mandatory for the first time in 1995.

The results in Table 7-11 for (OBJ7), recommending the appointment of and fee for the external auditor, indicate that the USA and the UK audit committee members consider this objective as an appropriate objective for their audit committee (81% and 81%), this ratio in the Egyptian sample was (15%). This finding reflects the nature of the accounting and auditing profession in Egypt and the selection process for external auditors. Article (103) of law No. 159 of 1981 which was enacted to govern private auditors work, requires each corporation to have at least one auditor who is to be appointed by the general assembly in General Annual Meeting, but in practice it is the company management who undertake such

tasks. In addition, Sami (2000) argued that in Egypt many accountants are operating as virtual brokers. Their integrity has been fatally compromised and, rather than acting as independent agents they have become “de facto” defenders of their clients. It is a position in which the credibility of accountants is suffering to an intolerable degree. Consequently, the selection process may be distorted by management. The World Bank Report (2001) suggested that “best practice would recommend taking action to strengthen the standing of the profession and tighten the qualifications necessary to become an auditor. Actions could include supporting the creation of an independent professional body with the authority to impose standards of excellence and of professional conduct based on a code of ethics. Then a list of qualified auditors could be set up from which listed companies choose their auditor”. As a result, the Ministry of Economy in 2001 issued six new criteria for accountancy and auditing in Egypt delineating principles and procedures and outlining a new code of ethics for the profession. Thus, audit committee members in Egypt are expected to play an important role in appointments and determining external auditors’ fees.

Along these lines, in the USA, the Securities Exchange Commission (SEC 2003) states that “the auditing process may be compromised when a company’s outside auditors view their main responsibility as serving the company’s management rather than its full Board of Directors or its audit committee. This may occur if the auditor views management as its employer with hiring, firing, and compensatory powers. Under these conditions, the auditor may not have the appropriate incentive to raise concerns and conduct an objective review. One way to help promote auditor independence, then, is for the auditor to be hired, evaluated and, if necessary, terminated by the audit committee”. Also, the SEC noted that the proposed requirement that the audit committee appoint the external auditor does not conflict with, and would not be affected by, any requirement under a company’s governing law or documents or other home

country requirements that requires shareholders to elect, approve or ratify the selection of the issuer's auditor. In such an instance, however, if the issuer provides a recommendation or nomination of an auditor to its shareholders, the audit committee of the issuer would need to be responsible for making the recommendation or nomination.

Also, the results in Table 7-11 for (OBJ14), reviewing the nature and magnitude of fees paid to the auditors for non-audit services, indicate that in the USA and the UK audit committee members have considered this objective as an appropriate objective for their audit committee (80% and 76%) this ratio in the Egyptian sample was (27%). This finding highlights the lack of public and regulators' concern regarding the non-audit services and the consequent effect on auditors' independence in Egypt which has faced a lot of different circumstances. The addition of such services as a distinct area of an auditor's practice precipitated considerable debate on the social, personal, and economic effects of the provision of non-audit services on auditors' ability to guard their independence (Sharma and Sidhu 2001). Audit committees are the best vehicles for achieving and maintaining balance in the relationship between the independent auditor and management. The disclosure of non-audit fees in the published accounts is also believed to further strengthen independence (Teoh and Lim 1996). Regulators in the USA and the UK have voiced their concern that the provision of non-audit services to audit clients poses threats to auditor independence parallel to exponential increases in the proportion of non-audit services fees to total fee revenue of accounting firms. For instance, in January 1999, The Independent Standards Board in the US adopted *Independence Standard No.1, Independence Discussions with Audit Committees*. The standard recommends that auditors communicate in writing with the audit committee matters likely to influence audit independence. One of the major matters of concern is the provision of non-audit services. Specifically, the standard requires auditors to disclose the level of audit fees, and nature and

level of non-audit service fees derived from the client. In the UK, legislation requires companies to disclose the level of non-audit service fees, so that interested parties can assess independence implications. In Egypt, to date, there is no mandatory requirement for a separate disclosure of non-audit fees. At the same time, consulting fees do not have to be disclosed at the companies annual general meeting. Consequently, the potential impairment of perceptions of auditors' independence by providing non-audit services will be compounded by the absence of a mandatory requirement for separate disclosure of non-audit fees. Therefore, audit committees in Egypt, before the beginning of each year, should review management's plans for engaging the company's independent public accountant to perform management advisory services during the coming year and consider both the types of services that may be rendered and the projected fees.

The results for (OBJ16) and (OBJ17) in Table 7-11 indicate that in the UK and Egypt audit committee members have considered these objectives as non appropriate objectives for their audit committee (40%, 39% in UK sample and 15%, 20% in Egypt sample) these ratios in the DeZoort (1997) USA survey were (74% and 67%). These results may be referenced, as explained before, to the legal framework for audit committees in the UK and Egypt. These frameworks do not clearly define any requirements or recommendations for audit committee members to review corporate policies and practices in light of ethical considerations or to monitor compliance with the company's codes of conduct.

7-5. Summary

Audit committees have received much attention over the past few years. In particular, concerns persist about the scope of the audit committee's oversight responsibilities. Latest developments indicate that responsibilities are constantly evolving and expanding. Therefore,

the tasks of defining and understanding audit committee oversight responsibilities are critical to improving the credibility of the corporate audit committee as a corporate governance mechanism. Also, future efforts to improve audit committee performance will depend in part on understanding what audit committees are currently doing (Carcello et al. 2002). Thus, this chapter contributes to a better understanding of audit committee oversight by evaluating UK and Egyptian audit committee members' perceptions of their assigned responsibilities in comparison with the DeZoort (1997) survey of audit committee members in the USA.

Because of the close economic ties between the UK and the US both with respect to the degree of market integration and the organisation of transactions, and in relation to other socio-cultural respects (Dockery and Herbert 2000), the results in general indicate that, in the UK sample, audit committee members tend not to recognize their responsibilities as assigned in annual reports, but perform many functions not listed formally in its, this is similar to DeZoort's USA survey results. The results also provide evidence that, in the USA, the UK, and Egypt, audit committee members perceive internal control evaluation as the most important oversight area. In addition, the results show that audit committee members, in the USA and the UK, agree with the current requirements and recommendations for expansion of the audit committees oversight responsibilities, except in the case of the UK regarding objectives (OBJ16) and (OBJ17). But in Egypt, audit committee members agree with eight oversight responsibilities. The results, in general, indicate that, there are differences in the institutions of those countries which applied the audit committee concept a long time ago and constituted the oversight responsibilities for measuring its effectiveness, and Egypt. The point is that management theories and concepts which have been developed in the western world, may need to be modified and adapted in order to fit the cultural beliefs, values and expectations of developing nations such as Egypt (Humphreys 1996). Also, the finding highlights the important role of disclosures in audit committees charters and reports for their

oversight responsibilities. The focus of the charter should define the scope of the committee's oversight responsibilities and the report should explain how these are to be discharged.

**Chapter Eight- Audit Committee Effectiveness and Composition
in Egypt**

Chapter Eight: Audit Committees Effectiveness and Composition in Egypt

8-1. Introduction

Audit committee effectiveness and composition have come under close scrutiny in recent years from a variety of policy-makers, interest groups, and researchers. In particular, this chapter is concerned with examining the research questions number 2, 3, and 4. Therefore, the chapter sets out to address two issues. The first one is to measure the effectiveness of audit committees in the public banking sector in Egypt. The effectiveness is measured by the extent to which audit committee members carry out their oversight responsibilities related to the functions of financial reporting, external auditing, and internal control including internal auditing. This issue is tested in the light of the results in the previous chapter regarding the oversight responsibilities of audit committees, after modification. The questionnaire that was directed to the audit committee members contains fifteen case studies. Each set of questions examined a responsibility by using a case study scenario approach. The second issue is to empirically examine the relationship between audit committee effectiveness and audit committee composition. The composition of the audit committee has been the focus of many governance reform efforts in western countries, the unanimous view of proponents of reform is that the audit committee should be composed entirely of outside directors who have sufficient experience in oversight areas related to accounting and auditing. Therefore, this section is concerned with the effect of audit committee members' independence and their experience in audit committee effectiveness.

8-2. Modification of Audit Committee Oversight Responsibilities for the Egyptian Environment

Regarding the problem of institutional differences when transferring Anglo Saxon management theories and concepts, such as the audit committee, to developing countries,

Humphreys (1996) explained that such theories and concepts may need to be modified and adapted in order to fit the cultural beliefs, values, and expectations of nations such as Egypt. Consequently, based on the results in the previous chapter, and evidence from prior research i.e. Hofstede (1980), Gray (1988), Wallace and Gernon (1991), Salter and Niswander (1995), and Humphreys (1996), audit committee oversight responsibilities need to be modified and selected in order to match the Egyptian environment. For this purpose, two factors have been considered in the modification and selecting process. Firstly, the importance of each oversight responsibility and secondly, the appropriateness of each oversight responsibility for the legal framework and institutions in Egypt. Thus, the researcher has identified some of the oversight responsibilities which are not currently relevant in the Egyptian banking sector environment, at least in the current period.

Examples of these less relevant practices, are those which require audit committee members to make recommendations to the Board of Directors regarding the appointment of external auditors, audit fees, and any questions of resignation or dismissal (Cadbury Committee 1992). These responsibilities have been considered as inappropriate for the public banking sector in Egypt (the only sector that has applied the audit committee concept since 2000) as law No. 159 of 1981 which states that “where companies with more than twenty five percent state ownership, the Central Auditing Organization has the right to inspect the company”. Consequently, an audit committee member does not have the right to make recommendations to the Board of Directors regarding the appointment of the external auditors or to determine the audit fee. Also, the oversight responsibilities, relating to corporate governance were not relevant because of the nature of the public banking sector which considers financial institutions and audit committee roles in such institutions, as different from other corporations. The National Office of Financial Institutions (2001) reported that, directors of

financial institutions are responsible not only to their shareholders' and depositors' interests, but also to the regulatory authorities. In some instances, regulators take on significant monitoring activities and may serve as a substitute monitoring mechanism (Beasley and Salterio 2001). Therefore, these oversight responsibilities were considered as not relevant in order to achieve the validity of the study.

Table 8-1 Selected audit committee oversight responsibilities and scenarios code

Responsibility Type	Audit committee' oversight responsibilities	Scenarios Code
Financial Reporting Responsibility	1. Review and analysis of the application of the alternative generally accepted accounting principles (GAAP), and assessment of whether financial reporting reflects the appropriate accounting principles.	F.R. scenario 1
	2. Review and analysis of significant changes in the accounting policies.	F.R. scenario 2
	3. Review significant accounting and reporting issues, including recent professional and regulatory pronouncement, and understand their impact on the financial reporting.	F.R. scenario 3
	4. Review financial reporting and the results of the audit process before submission to the main board.	F.R. scenario 4
	5. Review interim financial reports, and assess whether they contain adequate and appropriate disclosures.	F.R. scenario 5
External Auditing Responsibility	1. Evaluation of independent auditor's performance, including determination of independence.	E.A. scenario 1
	2. Review and analysis of the scope and activates of the annual audit by the external auditors.	E.A. scenario 2
	3. Discuss with the external auditors the auditors' judgments about the quality, not just the acceptability, of the bank's accounting principles as applied in its financial reporting.	E.A. scenario 3
	4. Monitoring of corrections by management of reported deficiencies in the external auditor's management letter.	E.A. scenario 4
	5. Must be informing if there is an auditors-management dispute.	E.A. scenario 5
Internal Control Including Internal Auditing Responsibility	1. Review and analysis of the adequacy and effectiveness of internal accounting and financial control of the bank.	I.C. scenario 1
	2. Review and analysis of the internal audit reports, budgets, and findings.	I.C. scenario 2
	3. Evaluation of internal auditors' performance.	I.C. scenario 3
	4. Monitoring of corrections by management of reported deficiencies reported by the internal auditors.	I.C. scenario 4
	5. Review the internal auditing plan with the director of internal auditing to ensure that internal auditing involvement in control systems.	I.C. scenario 5

Regarding the first objective of this chapter, Table 8-1 lists fifteen audit committees oversight responsibilities relating to financial reporting, external auditing, and internal control including the internal auditing function, which were selected in order to measure the effectiveness of audit committees in the public banking sector in Egypt. Table 8-1 further shows the scenarios code for every oversight responsibility, which is used in the data analysis. Therefore, the questionnaire that was directed to the audit committee members contains fifteen scenarios. A separate scenario is expressed for every oversight responsibility by using the case study scenario approach (see appendix D).

8-3. Effectiveness of Audit Committees in the Public Banking Sector in Egypt

As already explained, audit committee effectiveness is measured using a questionnaire directed to audit committee members in the public banking sector. This sector contains four banks: the Alexandria Bank, the Bank Misr, the Cairo Bank, and the Egyptian National Bank. Every bank's audit committee includes four members. Therefore, this study population contained sixteen audit committee members. Sixteen questionnaires were directed to the audit committee members (full sample) and fourteen responses were received, i.e. almost all of the audit committee members participants responded (an 87% response rate). Table 8-2 shows the results for audit committees effectiveness in the Egyptian public banking sector for the fifteen oversight responsibilities.

The **first** oversight responsibility requires audit committee members to review and analyse the application of the alternative generally accepted accounting principles (GAAP), and assess whether financial reporting reflects the appropriate accounting principles. Vanasco (1994) explained that bank audit committees need to review accounting principles to determine that financial statements reflect an appropriate consideration of changes in the bank's operating

conditions or reporting requirements. In this study, the result in Table 8-2 indicated that four responses (30.8 %) from audit committee members were in favour of the first financial reporting oversight responsibility and nine (69.2 %) were against.

Table 8-2 Audit committees effectiveness in the public banking sector in Egypt

Responsibility Type	In favour	%	Against	%
Financial Reporting				
1. Review and analysis of the application of the alternative generally accepted accounting principles (GAAP), and assessment of whether financial reporting reflects the appropriate accounting principles.	4	30,8	9	69,2
2. Review and analysis of significant changes in the accounting policies.	5	38,5	8	61,5
3. Review significant accounting and reporting issues, including recent professional and regulatory pronouncement, and understand their impact on the financial reporting.	6	46,2	7	53,8
4. Review financial reporting and the results of the audit process before submission to the main board.	9	69,2	4	30,8
5. Review interim financial reports, and assess whether they contain adequate and appropriate disclosures.	10	76,9	3	23,1
External Auditing				
6. Evaluation of independent auditor's performance, including determination of independence.	7	50	7	50
7. Review and analysis of the scope and activates of the annual audit by the external auditors.	5	41,7	7	58,3
8. Discuss with the external auditors the auditors' judgments about the quality, not just the acceptability, of the bank's accounting principles as applied in its financial reporting.	5	38,5	8	61,5
9. Monitoring of corrections by management of reported deficiencies in the external auditor's management letter.	6	46,2	7	53,8
10. Must be informing if there is an auditors-management dispute.	5	38,5	8	61,5
Internal Control Including Internal Auditing				
11. Review and analysis of the adequacy and effectiveness of internal accounting and financial control of the bank.	10	71,4	4	28,6
12. Review and analysis of the internal audit reports, budgets, and findings.	9	75	3	25
13. Evaluation of internal auditors' performance.	9	69,2	4	30,8
14. Monitoring of corrections by management of reported deficiencies reported by the internal auditors.	9	69,2	4	30,8
15. Review the internal auditing plan with the director of internal auditing to ensure that internal auditing involvement in control systems	11	78,6	3	21,4

The **second** oversight responsibility requires audit committee members to review and analyse significant changes in accounting policies. The results in Table 8-2 show that, (38.5 %) of the audit committee members were in favour with the oversight responsibilities and (61.5 %)

were against. These results are consistent with Vinten and Lee (1993) who found little evidence that the committees play a part in reviewing changes on accounting policy and identifying such policies. The involvement of audit committees in this area is a natural extension of their normal responsibilities. Thus, Vinten and Lee suggested that, on accounting policy, it is common for committees to review changes in such policies when management or auditors propose these. This view is consistent with the recommendations of the Cadbury Committee (1992) and the Smith Report (2003) in the UK, and those of the Blue Ribbon Committee (1999) in the USA.

The **third** oversight responsibility requires audit committee members to review significant accounting and reporting issues, including recent professional and regulatory pronouncements, and understand their impact on the financial reporting. The results in Table 8-2 indicate that (46.2 %) of the audit committee members were in favour of this oversight responsibility and (53.8 %) were against.

For the first three oversight responsibilities, the results asserted the low effectiveness of audit committees in carrying out such responsibilities. In their answers, a majority of the audit committee members (69.2%), (61.5%), and (53.8%) transferred these three responsibilities to other parties such as external auditors and internal auditing departments. These oversight responsibilities have been considered as matters for the external auditor and internal auditing department. There is therefore, evidence of the low effectiveness of audit committees in carrying out these oversight responsibilities, implying a lack of understanding among audit committee members of their responsibilities and duties. These results are consistent with Rittenberg and Nair (1993) and DeZoort (1997), who found that audit committee members believe they need to better understand their assigned duties and responsibilities to improve

audit committee effectiveness. In this case, the absence of a requirement in the Egyptian legal framework for audit committees to establish written charters, is considered an important reason for the low effectiveness in these oversight responsibility areas. Along these lines, the Treadway Commission (1987) states that “to enhance their effectiveness in carrying out their responsibilities for oversight of the financial reporting process on behalf of the Board of Directors, audit committees should have written charters that set forth their duties and responsibilities”. Also, regarding the importance of audit committee charters, Vanasco (1994) suggests that the audit committee must have a written charter that provides a clear understanding of the committee’s role. The audit committee charter provides a framework for the committee’s organization, responsibilities, duties, and relationships with management, and external and internal auditors. Often such charters are included in the bylaws of corporations, and approved by the Board of Directors. The Cadbury Committee (1992) in the UK recommended that the board should establish an audit committee of at least 3 non-executive directors with written terms of reference dealing clearly with its authority and duties. Also, in the USA the Blue Ribbon Committee (1999) recommended that the NYSE and NASD require the audit committee of each listed company to first, adopt a formal written charter that is approved by the full board of directors and specifies the scope of the committee’s responsibilities, and how it carries out those responsibilities, including structure, processes, and membership requirements, and secondly, review and reassess the adequacy of the audit committee charter on an annual basis.

The Auditing Practices Board (2002) states that “ the audit committee may discuss with the auditors details of significant misstatements identified by the auditors that have been adjusted as a result of the audit process. This may assist the committee in appraising the actions and judgements of management as they relate to the financial reporting process”. Thus, the **fourth**

oversight responsibility requires audit committee members to review financial reporting and the results of the audit process before submission to the main board. Table 8-2 shows that (69.2%) of the audit committee members are in favour of this oversight responsibility. In contrast to the first three best practices, the results show an increase in the audit committees' effectiveness. these results were also consistent with Goddard and Carol (2000) who indicated that audit committees should review the financial statements prior to submission to the board. This should lead to higher quality financial reporting in compliance with accounting standards. Also, Collier (1993) asserted that, the function of the audit committee was to review all audited or unaudited financial statements prior to their submission to the board and to report thereon to the board.

The **fifth** oversight responsibility requires audit committee members to review interim financial reports, and assess whether they contain adequate and appropriate disclosures. Table 8-2 shows that (76.9%) of the audit committee members are in favour of this responsibility. In contrast to the first three oversight responsibilities, the results, as with the fourth oversight responsibility, show an increase in the audit committees' effectiveness. These results are consistent with the USA Blue Ribbon Committee (1999) recommendation 10, which requires audit committee members to undertake timely reviews of quarterly financial results and discuss review-related issues with the auditors. Also, the USA Treadway Commission (1987) states that the audit committee's oversight responsibilities undertaken on behalf of the Board of Directors extend to the quarterly reporting process. The audit committee should review the controls that management has established to protect the integrity of the quarterly reporting process.

The **sixth** oversight responsibility requires audit committee members to evaluate the independent auditor's performance, including the determination of independence. The results in Table 8-2 indicate that (50%) of the audit committee members were in favour of this responsibility and show that the audit committee members are ineffective in their role. In contrast, Reinstein and Weirich (1996) surveyed 731 CPAs nationwide to ascertain if they perceived that audit committees enhanced their auditing independence, they found moderate support. Similarly, historical analysis suggests that audit committees were established primarily to safeguard the independence of external auditor (Carcello and Neal 2000b). Also, Archambeault and DeZoort (2001) asserted that, with respect to audit function, the audit committee is expected to determine that auditors are free from managerial restrictions and interference.

In terms of the audit committee's ability to influence the level of audit effort, DeZoort (1997) notes that audit committee members generally believe the review of the external auditor's work to be a primary audit committee duty. The UK Cadbury Committee (1992) recognized that audit committees had a role in ensuring audit quality. This principle is reflected in the audit committee's duties, which should normally include a discussion with the auditor on the nature and scope of the audit. Along these lines, the USA Blue Ribbon committee (1999) stated that "if the audit committee is to effectively accomplish its task of overseeing the financial reporting process, it must rely, in part, on the work, guidance and judgement of outside auditors". Therefore, in this study, the **seventh** oversight responsibility requires audit committee members to review and analyse the scope and activities of the annual audit by the external auditors. The result in Table 8-2 indicate that (41.7%) of the audit committee members were in agreement with this responsibility. Although the oversight responsibility is

considered as a primary audit committee's duty, the results indicate a low level of audit committee effectiveness.

Regarding communication between audit committees and external auditors, the USA Blue Ribbon Committee (1999) requires that "a company's outside auditor discuss with the audit committee the auditor's judgements about the quality, not just the acceptability, of the company's accounting principles as applied in its financial reporting; the discussion should include such issues as the clarity of the company's financial disclosures and degree of aggressiveness or conservatism of the company's accounting principles and underlying estimates and other significant decisions made by management in preparing the financial disclosure and reviewed by the outside auditors". Consequently, the **eighth** oversight responsibility, in this study, requires audit committee members to discuss with the external auditors the auditors' judgments about the quality, not just the acceptability, of the bank's accounting principles as applied in its financial reporting. The results in Table 8-2 show that (38.5%) of the audit committee members were in favour of this responsibility and (61.5%) were not. Regarding this responsibility, the lesser effectiveness may be related to the nature of the public banking sector in Egypt, which is audited by the Central Auditing Organizations not by a private auditor, as explained before, based on law No. 159 of 1981. Thus audit committee members in this sector do not have a full right to discuss with the external auditors the auditors' judgments about the quality, not just the acceptability, of the bank's accounting principles as applied in its financial reporting.

While management is responsible for the financial reporting process, the audit committee contributes to the integrity of that process by its oversight function. Because management at all levels influences the accuracy of financial reporting, the committee should continually

assess management's competence and integrity. Effective oversight requires the committee to have significant interaction with management, to ask difficult questions, and to obtain reasonable answers (Reinstein and Weirich 1995 and Price Waterhouse 1999). In this study, the **ninth** oversight responsibility requires audit committee members to monitor corrections by management of reported deficiencies in the external auditor's management letter. The results in Table 8-2 indicate that (46.2%) of the audit committee members were in favour of this responsibility and (53.8%) not.

The **tenth** oversight responsibility requires audit committee members to be informed if there is an auditor-management dispute. The results in Table 8-2 indicate that (38.5%) of the audit committee members were in favour of this responsibility. The results show a low level of audit committees effectiveness. In contrast, Beattie et al. (2000) surveyed audit partners and CFOs of large publicly traded UK companies and found a tendency for firms with audit committees to enter into fewer negotiations but more informal discussions about accounting policy disputes than did firms without audit committees. Gibbins et al. (2001) surveyed Canadian audit partners and found they, on average, rated the audit committee as only moderately important in auditor-client negotiations regarding accounting policy disputes. Also, DeZoort and Salterio (2001) found that, greater independent director experience and greater audit knowledge was associated with higher audit committee member support for an auditor in disputes with client management.

The National Office of Financial Institutions (2001) states that "it is imperative that the audit committee determine annually that the financial institution has an effective and efficient system of internal controls in place to safeguard assets and to prevent and detect fraud". The effectiveness of audit committees regarding internal control, including internal auditing

responsibility, is measured using next five case studies as a proxy for internal control oversight responsibilities.

The **eleventh** oversight responsibility requires audit committee members to review and analyse the adequacy and effectiveness of internal accounting and financial control of the bank. The results in Table 8-2 show an increase in audit committee effectiveness for this responsibility; (71.4%) of the audit committee members were in favour. This finding is consistent with the importance placed on internal control evaluation forwarded by numerous entities external to the audit committee's oversight responsibilities (e.g. Treadway Commission 1987, Cadbury Committee 1992, Sarbanes Oxley Act 2002, SEC 2003, and Smith Report 2003). Also, this finding is consistent with the survey results in the previous chapter which concluded that audit committee members perceive internal control evaluation as the most important oversight area.

The Institute of Internal Auditors (IIA 1993) states that internal auditing can play an important role in preventing errors and fraud, and is a useful mechanism in the checks and balances of effective corporate governance. Thus, the goals of audit committees and internal auditing are closely intertwined, and the ability of the audit committee and internal auditing to work together significantly impacts on the effectiveness of the audit committee in fulfilling its responsibility to the Board of Directors, shareholders, and other outside parties. In this study, the **twelfth** oversight responsibility requires audit committee members to review and analyse the internal audit reports, budgets, and findings. The results in Table 8-2 indicate a moderate level of audit committee effectiveness regarding this responsibility, (75%) of the audit committee members are in favour of it and (25%) otherwise. This finding is consistent with Scarbrough et al. (1998) and Atkins (2002) who state that the goals of audit committees and

internal auditing are closely intertwined, and the ability of the audit committee and internal auditing to work together significantly impacts on the effectiveness of the audit committee in fulfilling its responsibilities to the Board of Directors, shareholders, and other outside parties.

The review of the internal control systems allows audit committee members to obtain an independent opinion on the strength of the internal controls in the organization and makes the executive accountable for implementing control recommendations (Collier 1993). In this study, the **thirteenth** oversight responsibility requires audit committee members to evaluate the internal auditors' performance. The results indicate that (69.2%) of the audit committee members were in favour of this responsibility and (30.8%) were against it. This finding is consistent with the Price Waterhouse survey (1997) of large European companies which found that (88%) had an internal audit function and, in most cases, audit committees reviewed and approved the scope of work and activities of the internal auditors.

Research by Price Waterhouse (1993) published by the Institute of Internal Auditors Research Foundation in the USA, suggested that the audit committee should consider and review with management and the director of internal auditing; significant findings during the year and management's responses thereto. The **fourteenth** responsibility in this study requires audit committee members to monitor corrections by management of reported deficiencies reported by the internal auditors. The results in Table 8-2 indicate a moderate level of audit committee effectiveness regarding such responsibility, (69.2%) of the audit committee members are in favour of it and (30.8%) otherwise. This finding is consistent with the UK Institute of Internal Auditors survey (2002), carried out among almost 200 organizations, which found that in most cases the primary internal audit reporting line was to the audit committee, which, in banks and building societies is often comprised of non-executive directors.

Scarborough et al. (1998) explained that one of the responsibilities of the audit committee is to ensure that management has designed and implemented an effective internal control system. To fulfill this responsibility, audit committees must review the internal audit programme and ensure that its scope is adequate. Therefore, in this study, the **fifteenth** oversight responsibility requires audit committee members to review the internal auditing plan with the director of internal auditing to ensure that the involvement of internal auditing in control systems. The results in Table 8-2 indicate a moderate level of audit committee effectiveness regarding this responsibility, (78.6%) of the audit committee members are in favour with it and (21.4%) otherwise. This finding is consistent with Scarborough et al. (1998) who state that audit committees must review the internal audit programme and ensure that its scope is adequate.

In general, the results indicate that regarding internal control, including internal auditing responsibility, there is greater audit committee effectiveness than is the case for the results regarding the external auditing responsibilities. This increase in audit committee effectiveness may be referenced to the nature of the public banking sector, which are considered as financial institutions. The National Office of Financial Institutions (2001) reported that, audit committee roles in financial institutions are different from other corporations. Financial institution directors are responsible not only to their shareholders' and depositors' interests, but also to the regulatory authorities. But this increase in audit committee effectiveness for these oversight responsibilities may be different for other sectors in Egypt. The World Bank Report (2002) argued that the internal audit function of Egyptian companies, if it exists, is weak.

One Sample T-Test

In order to test the overall differences in audit committee members’ responses for the fifteen best practices, Table 8-3 shows the result of One Sample T-Test for the audit committee members sample. The results contains the value for Sig.(2-tailed). Since the observed significance level is less than 0.0005, SPSS displays it as 0.000. This does not mean that the probability is 0. It is less than 0.0005 (Norusis 2000).

Table 8-3 One-Sample T-Test results for audit committee members sample

One-Sample Test						
	Test Value = 14					
	t	df	Sig. (2-tailed)	Mean Difference	95% Confidence Interval of the Difference	
					Lower	Upper
F.R. Case 1	-92.376	12	.000	-12.31	-12.60	-12.02
F.R. Case 2	-88.183	12	.000	-12.38	-12.69	-12.08
F.R. Case 3	-86.593	12	.000	-12.46	-12.78	-12.15
F.R. Case 4	-95.263	12	.000	-12.69	-12.98	-12.40
F.R. Case 5	-104.988	12	.000	-12.77	-13.03	-12.50
E.A. Case 1	-90.139	13	.000	-12.50	-12.80	-12.20
E.A. Case 2	-83.531	11	.000	-12.42	-12.74	-12.09
E.A. Case 3	-88.183	12	.000	-12.38	-12.69	-12.08
E.A. Case 4	-86.593	12	.000	-12.46	-12.78	-12.15
E.A. Case 5	-88.183	12	.000	-12.38	-12.69	-12.08
I.C. Case 1	-101.476	13	.000	-12.71	-12.98	-12.44
I.C. Case 2	-97.658	11	.000	-12.75	-13.04	-12.46
I.C. Case 3	-95.263	12	.000	-12.69	-12.98	-12.40
I.C. Case 4	-95.263	12	.000	-12.69	-12.98	-12.40
I.C. Case 5	-112.349	13	.000	-12.79	-13.03	-12.54

Based on the observed significance level, this study concludes that there are differences in the audit committee members’ responses for the fifteen best practices. These differences may be referenced to the differences in the qualifications between audit committee members regarding independence and experience in accounting and auditing. Klein (2002) argued that

differences in audit committees' performance might result if audit committee members are not independent of management and lack experience in accounting and auditing. The qualifications of audit committee members will be tested in the next section.

8-4. Impact of Audit Committee Composition on Audit Committee Effectiveness

This section empirically examines the relationship between audit committee composition and audit committee effectiveness. Since the composition of the audit committee has been the focus of many governance reform efforts in western countries, the unanimous view of the proponents of reform is that the audit committee should be composed entirely of outside independent directors who have a sufficient experience in oversight areas related to accounting and auditing. Therefore, this section is concerned with examining the effect of the level of independence and experience of audit committee members on audit committee effectiveness, which is measured in the previous section using the linear multiple regression model. In addition to the independent variables of interest, the researcher controlled for the effect of other factors likely to affect audit committee effectiveness. These control variables are outside directors in the board, audit committee meetings attended by audit committee members, and audit committee size.

8-4-1. Independence of the Audit Committee Member

The independence of audit committee members was determined based on the definition of independence used by various committees, reports, and trading venues, (for example, the Treadway Commission 1987, the Cadbury Committee 1992, BRC 1999, the Sarbanes Oxley Act of 2002, SEC 2003, and the Higgs Report 2003), see chapter five. The definition is characterized as follows: no director who, (1) is a current or former employee (within the last 3 years), or (2) has a business relationship or is an executive officer for a firm that has a

business relationship with the firm, or (3) is part of a cross compensation committee link between boards, or (4) is a member of the immediate family of an executive officer, shall be considered independent. Using the above definition of independence (INDEP), Table 8-4 shows that (50%) of audit committee members are classified as independent and (50%) are classified as non-independent.

Table 8-4 Classification of audit committee members' independence

	Frequency	Valid Percent	Cumulative Percent
Independence	7	50.0	50.0
Non-independence	7	50.0	100
Total	14	100	

In the context of audit committee effectiveness, this study expects that the independent audit committee member is more likely to achieve a higher level of audit committee effectiveness than a non-independent member. Therefore, this study hypothesises that:

H1: There is a significant positive association between the independence of the audit committee members and audit committee effectiveness

8-4-2. Audit Committee Member Experience

The experience of audit committee members was determined based on the definition of experience used by various committees and reports (for example, the BRC 1999, the Sarbanes Oxley Act of 2002, and the Smith Report 2003). Thus, audit committee member experience was coded using two levels. The first level included audit committee members who have (1) the highest level of education in accounting and auditing, or (2) professional certifications in auditing, or (3) their background indicates either formal training or familiarity with the review

of financial reporting and auditing. Members in this group included auditors, accountants, CFOs, and accounting academics. The second category included all other members not captured in the first category.

Using the above definition of experience (EXPER), Table 8-5 shows that (57.1%) of audit committee members were classified as experienced in accounting and auditing and (42.9%) were classified as non-experienced.

Table 8-5 Classification of audit committee members' experience

	Frequency	Valid Percent	Cumulative Percent
Experience	8	57.1	57.1
Non-experience	6	42.9	100
Total	14	100	

In the context of audit committee effectiveness, this study expects that if audit committee members have experience of accounting and auditing they are more likely to achieve a higher level of audit committee effectiveness than members with no such experience. Therefore this study hypothesises that:

H2: there is a significant positive association between the experience of the audit committee members and audit committee effectiveness.

Control Variable

In addition to the independent variables of interest, the researcher controlled for the effects of other factors that are likely to affect the audit committee effectiveness. The control variables are outside directors in the board, audit committee meetings, and audit committee size:

Outside directors in the board

Deli and Gillan (2000) and Abbott and Parker (2000a) asserted that audit committee composition is, to some degree, mechanically related to the composition of the full board. Also, Menon and Williams (1994) find that, audit committee activity increases with the independence of the full board. This suggests that it may be appropriate to control for full board independence when examining the composition of the audit committee. Therefore, in this study, in order to control for the possibility that the percentage of outside directors on the board is the driving force in audit committee effectiveness, the researcher included a control variable (OUTSIDER %) defined as the percentage of outside directors serving on the board.

Audit Committee Meetings

Since the primary role of the audit committee is to monitor financial reporting and internal controls on behalf of the shareholders, one would expect that effective monitoring necessarily requires audit committee activity. Menon and Williams (1994) argue that to be effective monitors it is not enough that audit committees be independent- they must also be active. An audit committee activity is an important dimension of overall effectiveness because activity signals monitoring (Archambeault and DeZoort 2001). As a result, the number of audit committee meetings held during the year is a common proxy for committee activity. Therefore, in this study, in order to control for the possibility that the number of meetings attended by audit committee members is the driving force in audit committee effectiveness, the researcher included a control variable (# MEET) defined as the average number of audit committee meetings attended in the year by audit committee members.

Audit Committee Size

The audit committee composition may vary from company to company. The number of members of the audit committee is determined by the size of the board of directors and the size of the organisation (Vanasco 1994). To this end, concern about audit committee size has led to a number of recommendations about the number of members needed to help ensure that audit committees are large enough to provide adequate oversight. For example, the Blue Ribbon Committee (BRC 1999) recommends that the NYSE and NASD require audit committees to be comprised of a minimum of three directors, each of whom is financially literate. Similarly, the UK Cadbury Committee (1992) recommended that “the board should establish an audit committee of at least 3 non-executive directors”. Also, the Smith Report (2003) recommends that “audit committees should include at least three members, who should all be independent non-executive directors”. However, the size of each committee should be appropriate to the company’s circumstances and will depend on the extent of the committee’s responsibilities. Therefore, in this study, in order to control for the possibility that the audit committee size is the driving force in audit committee effectiveness, the researcher included a control variable (# MEMBERS) defined as the number of directors on the audit committee.

Table 8-6 provides a summary of the research test and control variables. Information related to the number of outsider directors, number of audit committee meetings attended by the audit committee member, and the number of directors in the audit committee, was gathered from the banks’ annual reports in the Central Bank of Egypt database.

8-4-3. Audit Committee Effectiveness Model

This study uses logistic regression to analyze relations between audit committee effectiveness and audit committee composition variables. The general model used to test the research hypotheses is:

$$\%EFFECT = B0 + B1 INDEP + B2 EXPER + B3 \%OUTSIDER + B4 \# MEET + B5 \# MEMBERS + E$$

Where the dependent variable is a number of audit committee member responses considered as in favour of the oversight responsibilities as a percentage of overall responsibilities numbers. The independent and control variables are:

- INDEP* = 1, if audit committee member is considered as independent, 0 otherwise.
- EXPER* = 1, if the audit committee member consider as experienced in accounting and auditing.
- % OUTSIDER* = Number of outsider board directors as a percentage of overall board members
- # MEET* = Number of audit committee meetings attended by audit committee member in the year
- # MEMBERS* = Number of directors on the audit committee
- E* = Residual

Table 8-6 Definitions of dependent; independent; and control variables

Variable Name	Description	Source
<p><u>Dependent Variable:</u> %EFFECT</p>	<p>The extent to which audit committees carries out its oversight responsibilities related to financial reporting function; external auditing function; and internal control including internal auditing function</p>	<p>Wolnizer 1995, DeZoort 1997, and Lee and Stone 1997</p>
<p><u>Independent Variables</u> INDEP</p>	<p>No director who, (1) is a current or former employee (within the last 3 years), or (2) has a business relationship or is an executive officer for a firm that has business relationship with the firm, or (3) is part of a cross compensation committee link between boards, or (4) is a member of the immediate family of an executive officer, shall be considered independent</p>	<p>BRC 1999, Archambeault and DeZoort 2001, and Deli and Gillan 2000</p>
<p>EXPER</p>	<p>Audit committee member experience was coded using two levels. The first level included audit committee members whose have highest level of education in accounting and auditing; professional certifications auditing; background indicates either formal training or familiarity with review of financial reporting and auditing. The second category includes all other members not captured in the first category.</p>	<p>Dezoort 1998, BRC 1999, and Archambeault and DeZoort 2001</p>
<p><u>Control Variable:</u> % OUTSIDER</p>	<p>Number of outsider board directors as a percentage of overall board members</p>	<p>Deli and Gillan 2000, and Abbott and Parker 2000</p>
<p># MEET</p>	<p>Number of audit committee meeting attended by audit committee member in the year</p>	<p>Menon and Williams 1994, McMullen and Raghunandan 1996, Carcello and Neal 1998, BRC 1999, Song and Windram 2000, Deli and Gillan 2000, and Archambeault and DeZoort 2001</p>
<p># MEMBERS</p>	<p>The number of directors on the audit committee</p>	<p>Deli and Gillan 2000, Archambeault and DeZoort 2001, and Collier and Gregory 1999</p>

Linear Multiple Regression Model Results

Table 8-7 contains the results from the multiple linear regression used to empirically test the research hypothesis (H1 and H2). Panel (B) in Table 8-7 shows that the adjusted R square is

(.785). The value means that the observed variability in audit committee effectiveness is explained by independence and control variables.

Table 8-7 Multiple Linear Regression Results
Panel (A):

		Coefficients ^a				
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	.167	.363		.461	.657
	INDEP	.180	.034	.812	5.280	.001
	EXPER	8.245E-02	.033	.368	2.524	.036
	# MEETS	2.139E-02	.031	.136	.686	.512
	%OUTSIDER	.573	1.034	.284	.554	.595
	# MEMBERS	-7.69E-02	.065	-.552	-1.189	.268

a. Dependent Variable: Effectiveness of Audit committee

Panel (B):

Model	Adjusted R Square	F	Sig.
1	.785	10.468	.002

The test of null hypothesis (H1 and H2) is based on the ratio of the regression mean square to the residual mean square (Norusis 2000). Panel (B) in Table 8-7 which shows the overall significance of the model, F is (10.468). Since the observed significance level is less than (0.05), so that the researcher rejected the null hypothesis that the observed variability in audit committee effectiveness is not explained by independence and control variables. The coefficient for the independent and control variables are listed in the column labelled “B” in panel (A) of Table 8-7. Using these coefficients, the estimated regression equation is:

$$Y = .167 + .180 * INDEP + .082 * EXPER + .573 * \%OUTSIDERS + .021 * \# MEET - .076 * \# MEMBERS$$

Where Y is the predicated audit committee effectiveness.

Results of Hypothesis Testing

The first hypothesis predicted that, there is a significant positive association between independence of audit committee members and audit committee effectiveness. The results in Table 8-7, panel (B) provide support for H1. The observed significance level for the independence of audit committee members is “.001” (P-Value < .05) and the coefficient with audit committee effectiveness is positive. These results suggest that firms with high levels of outside independent audit committee members are significantly more likely to have effective audit committees than other firms. The results are consistent with the empirical researches, which support such concerns about audit committee member independence. McMullen and Reghunadan (1996) found that companies without reporting problems were more likely to have an audit committee composed solely of outside directors than companies with reporting problems. Also, DeZoort and Salterio (2001) found that independent director experience was positively related to audit committee member support for a ‘ substance over form’ position in an auditor-client dispute. Beasley (1996) found that the percentage of outside directors was significantly lower for firms with fraudulent activity than for firms without fraudulent activity, and that fraudulent firms had audit committees with a significantly lower percentage of outsiders than non-fraudulent firms.

The second hypothesis predicted that, there is a significant positive association between the experience of audit committee members and audit committee effectiveness. The results in Table 8-7 panel (B) provides support for H2. The observed significance level for audit committee member’ experience is “.036” (P-Value < .05) and the coefficient with audit committee effectiveness is positive. The results suggest that firms with higher levels of audit committee members who have sufficient experience in oversight areas related to accounting and auditing are significantly more likely to have effective audit committees. These results are

consistent with a number of studies which highlight the importance of relevant audit committee member experience as a component of overall committee effectiveness. Also, the results are consistent with survey research of audit committee effectiveness, which suggests that audit committee members' perceived expertise in accounting and auditing is related to committee effectiveness as defined by a panel of audit partners, internal audit directors and chief financial officers (Kalbers and Fogarty 1993). For example, McMullen and Raghunandan (1996) found that the companies with no reporting problems were more likely to have a CPA on the audit committee than companies that had experienced reporting problems. DeZoort (1998) found that member experience in auditing and internal controls had a positive effect on member performance in internal control evaluation tasks. Similarly, DeZoort and Salterio (2001) found that independent director experience was positively related to audit committee member support for an auditor who advocated a 'substance' approach to accounting in a 'substance versus form' dispute with client management.

Results of Control Variables

The research control variable results do not generally support the predictions of the prior literature. In this study, results for control variables often lack significance. Table 8-7 panel (B) shows the observed significance level for (%OUTSIDERS), (# MEET), and (# MEMBERS) variables are (.512); (.595); and (.268) respectively (P-Value > .05). The results indicated that there is no significant association between the control variables and audit committee effectiveness. Also, (# MEMBERS) variable has a negative relation to audit committee effectiveness (B = - .076).

Matrix of Pearson Correlation Coefficients

To assess multicollinearity, the researcher calculated a matrix of Pearson correlation coefficients. Correlation matrices are useful for looking at the strength of the linear relationship between pairs of variables (Norusis 2000). Table 8-8 shows results of Pearson correlation coefficients.

Table 8-8 Matrix of Pearson Correlation Coefficients results

		Correlations					
		Effectiveness of Audit committee	INDEP	EXPER	# MEETS	%OUTSIDER	# MEMBERS
Pearson Correlation	Effectiveness of Audit committee	1.000	.780	.633	.129	.136	.100
	INDEP	.780	1.000	.289	-.102	.260	.359
	EXPER	.633	.289	1.000	.293	.218	.130
	# MEETS	.129	-.102	.293	1.000	.560	.346
	%OUTSIDER	.136	.260	.218	.560	1.000	.934
	# MEMBERS	.100	.359	.130	.346	.934	1.000
	Sig. (1-tailed)	Effectiveness of Audit committee	.	.001	.008	.330	.322
INDEP		.001	.	.158	.365	.185	.104
EXPER		.008	.158	.	.155	.227	.329
# MEETS		.330	.365	.155	.	.019	.112
%OUTSIDER		.322	.185	.227	.019	.	.000
# MEMBERS		.367	.104	.329	.112	.000	.
N		Effectiveness of Audit committee	14	14	14	14	14
	INDEP	14	14	14	14	14	14
	EXPER	14	14	14	14	14	14
	# MEETS	14	14	14	14	14	14
	%OUTSIDER	14	14	14	14	14	14
	# MEMBERS	14	14	14	14	14	14

The correlation matrix in Table 8-8 indicates significant pairwise correlations among the two independent variables and audit committee effectiveness. These findings are consistent with prior audit committee studies (Kalbers and Fogarty 1993, Menon and Williams 1994, McMullen and Reghunadan 1996, Beasley 1996, Carcello and Neal 1998, DeZoort 1998, and DeZoort and Salterio 2001). Table 8-8 shows that, Pearson correlation between the independence of audit committee members and audit committee effectiveness is .780 and the Pearson correlation between the experience of audit committee members and audit committee effectiveness is .633. These results indicate that there is strength in the linear relationship

between independence and experience of audit committee members and audit committee effectiveness. At the same time, the results indicate that there is a lower linear relationship between the control variables (number of audit committee meetings, number of outside directors on the full board, and number of directors in the audit committee) and audit committee effectiveness (.129, .136, and .100 respectively). Table 8-8 reveals the value for Sig.(1-tailed), it is .001 and .008 respectively (P-Value < .05) for the independence and experience of audit committee members. For control variables it is .330, .322, and .367 respectively (P-Value > .05).

8-5. Summary

This chapter contains two objectives. The first one was to measure the effectiveness of audit committees in the public banking sector in Egypt. The effectiveness is measured by the extent to which audit committees carry out their oversight responsibilities regarding the functions of financial reporting, external auditing, and internal control including internal auditing by using fifteen oversight responsibilities. The results asserted low effectiveness of audit committee members in carrying out their oversight responsibilities related to financial reporting functions. The results are consistent with Rittenberg and Nair (1993) and DeZoort (1997), who found that audit committee members believe they need a better understanding of their assigned duties and responsibilities to improve audit committee effectiveness. In this case, the absence in the Egyptian legal framework of a requirement for audit committees to establish written charter in the Egyptian legal framework, is considered an important reason for low effectiveness in these responsibilities areas. Accordingly, the audit committees need a reference guide setting out its responsibilities. A detailed charter focuses the efforts of the audit committee and increases its effectiveness.

In contrast, some case study results indicated increases in audit committee effectiveness such as in the financial reporting responsibility 4 and 5, and internal control best practices. This increase in audit committee effectiveness may also be related to the nature of the public banking sector, which are considered as financial institutions. The National Office of Financial Institutions (2001) reported that, audit committee roles in financial institutions are different from other corporations. Financial institution directors are responsible not only to their shareholders' and depositors' interests, but also to the regulatory authorities. The result of the One Sample T-Test for the audit committee members sample indicated that there are differences in the audit committee members' responses for the fifteen responsibilities. These differences may be referenced to the differences in qualifications between audit committee members regarding independence and experience in accounting and auditing.

For the second objective, the results provide support for the research hypothesis that the independence and experience of audit committee members are significantly and positively related to audit committee effectiveness. The results indicate that banks with audit committees that consist solely of independent directors who have experience in accounting and auditing are likely to have higher audit committee effectiveness. The results support the view of a variety of policy-makers, interest groups, and researchers, who have argued for a heightened role for the audit committee in matters related to accounting and auditing. The results also have implications for policy makers who have the ability to prescribe who may sit on audit committees, for corporate boards in appointing audit committee members, and for auditors in developing strategies for communicating with audit committees and assessing their effectiveness.

Chapter Nine: Conclusions, Limitations, and Recommendations

Chapter Nine: Conclusions, Limitations, and Recommendations

9-1. Introduction

This study aims to measure audit committees effectiveness in order to have indicators about its oversight responsibilities in general and particular its development in Egypt. To achieve this aim, the research objective was broken down into the following key components:

1. To investigate the differences in audit committee members' perception of their oversight responsibilities between the USA, the UK, and Egypt.
2. To measure the effectiveness of audit committees in the public banking sector in Egypt.
3. To assess the relationship between the independence of audit committee members and the effectiveness of audit committees in the public banking sector in Egypt.
4. To assess the relationship between the experience of audit committee members and the effectiveness of audit committees in the public banking sector in Egypt.
5. To investigate the obstacles which face audit committees in the public banking sector in Egypt and their effect on audit committee effectiveness.

9-2. Conclusions

Companies in both developed and emerging markets have learnt that corporate governance has become a vital issue in order to be able to merge with local and foreign companies, to tap international financial markets and to operate in a truly competitive environment. Corporate governance all over the world has become a powerful tool for attracting foreign direct investment (OECD 1999). A transparent and effectively monitored market environment for international equity flows enhances the stability of these flows and serves as an early warning system for corporate and financial distress. In Egypt, corporate governance has gained more importance in recent years due to the integration of the Egyptian economy with the global

economy, internationalization of capital markets, and the increasingly important role played by the private sector in the economy. This study is concerned with the audit committee as one of the most important corporate governance tools and measures their effectiveness in the public banking sector in order to investigate the obstacles which have been faced and suggest ways to overcome these obstacles.

This study is grounded in an institutional framework, and old institutional economics in particular, this is because of its suitability and practicality for studying audit committees in Egypt within their intricate societal web. Old institutional economics (OIE) emphasises the interplay between institutions and actions in the economy, society, and culture which are involved in the issues surrounding the transference of Anglo Saxon management and accounting theories and concepts such as audit committees to developing countries such as Egypt. In conforming to the institutional framework, this study provides a clear picture of the social constructions of risk, and the role of cultural differences in the applicability of Anglo Saxon management and accounting theories and practices in Egypt (see chapter 2). Also, beside the treatment of rules and routines as the carriers of organisational memory, Scapens (1994) reported that they can be regarded as a basis for the evolution of organisational behaviour. He also argued that evolution is not the creation of optimal behaviour, but merely the production (and possible adaptation) of behaviour through time. regarding audit committees, Green (1994) explained that the role of the audit committee is constantly evolving, and as a result of recommendations by the accounting profession and regulators and pressure from the financial press, investors, and academics, the rules and expectations surrounding the practice of financial reporting are in a constant state of flux. Often these changes are precipitated by a "crisis" such as the collapse of a financial institution or the

bankruptcy of a large corporation. The resulting changes, then, can be seen as an attempt to protect the public from inadequate financial statement disclosure and improve audit standards.

Audit committee guidelines and codes of best practice, like corporate governance, arise in the context of, and are affected by, differing national frameworks of law, regulations, and stock exchange listing rules as well as differing societal values. Therefore, to understand one nation's audit committee practice in relation to another one must understand not only the best practice documents but also the underlying legal framework. Consequently, it is possible that differences in the regulatory environment and the importance assigned to corporate governance, as well as other cultural factors, could significantly influence the nature of the audit committees' legal framework in different countries. Therefore, this study compared the legal framework for audit committees in Egypt in the light of the frameworks in the UK and the USA (see chapter 5). This comparison shows that there are differences between the three legal frameworks, particularly in respect to Egypt.

The audit committee concept is still a new phenomenon in Egypt and therefore audit committee experience is relatively limited. The legal framework in Egypt, in particular the Capital Market Authority (CMA) statement No.30 article No. 7 of 2002, fails in many areas. (1) The CMA does not require the listed companies in the Cairo & Alexandria Stock Exchange (CASE) to adopt a formal written charter for audit committees. (2) The requirement for independent audit committee members appeared in the CMA statement, but "independence" requirements for audit committee members, was not defined. (3) Despite the CMA considering the importance of audit committee member experience, the statement does not specify the requirements for financial experience of audit committee members. (4) The CMA does not specify any recommendations related to the annual number of audit

committee meetings. (5) The CMA does not specify any recommendations related to the audit committee's resources and authority. (6) The CMA does not specify any recommendations to the listed companies related to the audit committee members training. (7) The CMA does not require companies to disclose the audit committee report in their annual reports. Also, regarding audit committees' oversight responsibilities, this comparison shows that in Egypt the CMA statement does not specify the necessary oversight responsibilities as: (1) The evaluation of exposure to fraud. (2) The appointment, reappointment and removal of the external auditors. (3) Involving in the audit fee negotiation process. (4) Ensuring the independence of the external auditor. (5) Requesting to be informed of the auditor-management disputes. (6) Reviewing the nature and magnitude of non-audit services. (7) Reviewing the internal auditing function or any interaction between the audit committee and internal auditing. (8) Reviewing corporate policies and practices in light of ethical considerations. (9) Monitoring compliance with the company's codes of conduct. At the same time, in Egypt, oversight responsibilities such as (1) the review off all financial statements, whether interim or annual (2) the review of all existing accounting policies (3) and the review of systems of internal control, are similar to those in the USA and the UK legal framework. On the other hand, in the UK, the legal framework for audit committees does not clearly define requirements for audit committee members to review corporate policies and practices in light of ethical considerations or to monitor compliance with the company's codes of conduct.

Based on the above comparison of legal frameworks for audit committee in the USA, the UK, and Egypt, the legal framework in Egypt is considered weak. This finding is consistent with Babic (2001) who argued that in developed market economies, a system of corporate governance has been built gradually through centuries, and today it can be defined as a

“complex mosaic” consisting of laws, regulations, politics, public institutions, professional associations and ethics codes. However, in transition economy countries a lot of details of the mosaic are still missing. Trying to develop a system of good corporate governance in these countries is made difficult by problems such as weak legal and judicial systems, and absent or underdeveloped institutions and scarce human resource capabilities (CIPE 2002).

The missing element in the context of corporate governance development in transition economies is the lack of institutions associated with successful market economies (OECD 2001). In market economies there is a standard set of institutions that have been successful as the tools used to control corporations. Institutions are the ‘rules of the game’ in a society (Yeager 1999). They are the rules that the society establishes to reduce the uncertainty of human interactions. The institutional framework has three components: formal rules, informal rules and enforcement mechanisms. While both the formal legal environment and the informal institutional constraints affect corporate governance, institutional theory states that when formal institutions are weak, informal constraints play a larger role in shaping firm behaviour (Young et. al. 2002).

It is expected that the transition economy process in Egypt, undergoing major economic, regulations, and political reforms, as well as Anglo Saxon market acculturation, will exhibit differences in corporate governance systems. Such differences may be associated with significant differences in attitudes, beliefs and cultural values. These in turn are expected to impact on managerial behaviour, firms’ objectives and market for corporate control (Humphreys 1996 and Dockery and Herbert 2000). This study used a survey strategy in order to examine audit committee oversight responsibility from the internal perspective of the UK and Egyptian audit committee members in comparison with the DeZoort (1997) study in the

USA. The survey used Wolnizer's (1995) list of seventeen prescribed audit committee objectives, which DeZoort had used for audit committee members in the USA. The survey related to accounting and reporting, auditors and auditing, and corporate governance in general, it was used as a basis to assess audit committee members' abilities to recognize their assigned objectives and explore their perceptions of the key tasks. Wolnizer's (1995) set of seventeen audit committee objectives provided a basis for measuring audit committee members' responses, which DeZoort (1997) used in the USA survey. The respondents were asked three questions related to their assigned responsibilities. (1) Is the objective assigned formally to your committee? (2) Is the objective performed, but not assigned to your committee? (3) Is the objective appropriate for audit committees? (See appendix C).

Because of the close economic ties between the UK and the USA, both with respect to the degree of market integration and the organisation of transactions and in relation to other socio-cultural respects (Dockery and Herbert 2000), the results in general indicate that, in the UK sample, audit committee members tend not to recognize their responsibilities as assigned in annual reports, but perform many functions not listed formally in annual reports, similarly with the DeZoort USA survey results (see chapter 7). The results also provide evidence that, in the USA, the UK, and Egypt, audit committee members perceive internal control evaluation as the most important oversight area. The results also provide evidence that audit committee members, in the USA and the UK, agree with the current requirements and recommendations for expansion of their oversight responsibilities, excepting the UK for objectives (OBJ16) and (OBJ17). But in Egypt audit committee members agree with only eight oversight responsibilities. The results, in general, indicated that, there are differences between the institutions of those countries which applied the audit committee concept a long time ago, and constituted the oversight responsibilities for measuring its effectiveness, and the

evidence from Egypt. The point being that management theories and concepts which have been developed in the Anglo Saxon world may need to be modified and adapted in order to fit the cultural beliefs, values and expectations of developing nations such as Egypt (Humphreys 1996). Also, the findings highlight the important role of disclosures in audit committee charters and reports in their oversight responsibilities. The focus of the charter should define the scope of the committee's oversight responsibilities and the report should explain how these are to be discharged.

Stevenson (2002) explained that institutional economics, in part, is about problem solving. Problem solving is a purposeful activity involving establishing frames for recognition, processes of remediation, and objectives for resolution, all of which are value-based undertakings. Therefore, in this study the effectiveness of the audit committees in the public banking sector in Egypt was measured by looking at, particularly, the extent to which audit committee members carry out their oversight responsibilities regarding financial reporting, external and internal auditing in order to find ways to improve audit committees practice in Egypt. In this study, audit committee oversight responsibilities, after modification based on the results in chapter seven, is used as a tool to examine the effectiveness via a questionnaire instrument. The questionnaire that was directed to the audit committee members contains fifteen scenarios. A separate scenario is expressed for every oversight responsibility by using the case study scenario approach. The results, in general, asserted the low effectiveness of audit committee members in carrying out their oversight responsibilities (see chapter 8). The results are consistent with Rittenbery and Nair (1993) and DeZoort (1997), who found that audit committee members believe they need a better understanding of their assigned duties and responsibilities to improve audit committee effectiveness. Also, Menon and Williams (1994) support this contention with findings showing that companies which had nominally

formed an audit committee were often reluctant to rely upon it. They concluded that audit committees are often created for the purposes of appearance rather than to enhance stockholders' control of management. According to Fogarty (1996) the key attribute of institutional theory lies in its ability to highlight the distinction between what organizations actually accomplish and what their structure suggest to the external environment they should accomplish. In this case, the lack of requirements in the Egyptian legal framework regarding audit committee disclosure (committee charters and reports) is considered an important reason for low effectiveness of these oversight responsibilities. Accordingly, the audit committees need a reference guide setting out its responsibilities and a detailed charter to focus the efforts of the audit committee and increases its effectiveness.

Since the composition of the audit committee has been the focus of many governance reform efforts in the USA and the UK, the unanimous view of proponents of reform is that the committee should be composed entirely of outside directors who have sufficient experience in oversight areas related to accounting and auditing. Therefore, in this study, the effect of audit committee members' independence and experience on audit committee effectiveness was examined by using the linear multiple regression model. The results indicate that audit committee effectiveness is significantly and positively related to the independence and experience of audit committee members (see chapter 8).

9-3. Limitations

It is important to recognise the limitations inherent within the research study. In this study there are some limitations.

Firstly, the Egyptian sample included only audit committee members from the public banking sector. This is because the public banking sector is considered as the only sector which has established audit committees in Egypt since 2000 following the Central Bank of Egypt Chairman's decision. Thus, audit committee members in this sector have appropriate experience in audit committee oversight responsibilities which enabled the researcher to measure their effectiveness.

Secondly, the survey results for the UK and Egyptian samples should be interpreted cautiously. As with all mail survey research, the possibility of a non-response bias limits the interpretability of the results (DeZoort 1997). Although no significant differences were found between early and late respondents, it is possible that audit committee members who chose not to participate might have substantially different opinions from those who participated.

Thirdly, interpretation of the survey results is also tempered by the lack of information about the relationships between objectives. In this study, all of the Wolnizer objectives are assumed independent. In fact, many of the objectives listed could be correlated. For example, respondents might have perceived OBJ3 (Evaluate internal control) as an important general objective that subsumes another objective such as OBJ4 (Evaluate exposure to fraud), which failed to emerge as an important objective.

9-4. Recommendations

El-Issawi et al. (1999) argued that the move towards a free-market economy in Egypt has been remarkably swift. Intriligator (1996) explained that, the goal of rapid transition to a market economy will probably not be realised in the absence of those economic, legal, political, and social institutions that enable such an economy to function. In the absence of

these institutions, the enterprises of the Egyptian economy, whether privatised or not, will not have the proper incentives to produce and invest (Abdel Shahid 2001). Hence, it is necessary to establish the relevant economic, legal, political and social institutions so as to prevent the further collapse of the Egyptian economy. The stabilisation, liberalisation, privatisation and other aspects of the current economic reform programme alone will not create these institutions, the Egyptian government should therefore play a major role in their establishment (World Bank Report 2001). Thus, the success of corporate governance and its necessary tools, such as audit committees, are of concern to the Egyptian government in order to support the market economy. In this study, one important step toward solving the low effectiveness of audit committees in Egypt is to create relevant legal institutions for the Egyptian environment context. To do so, there is a need to increase the awareness of the government in general, and the Capital Market Authority (CMA) in particular, about other audit committees requirements, which are not included in the current legal framework. These requirements are suggested based on this study results, and the relevance of these requirements in the Egyptian environment. Thus, the study suggests below recommendations for increasing the effectiveness of audit committees in Egypt.

Recommendations Regarding Audit Committee Disclosure

1. The CMA should require the listed companies in the Cairo & Alexandria Stock Exchange (CASE) to adopt formal written charters for their audit committees describing their responsibilities, compositions, qualifications, authority, and functions. The charter should be approved by the Board of Directors and disclosed at least once every three years in the annual report to shareholders;
2. The CMA should recommend that listed companies in the Cairo & Alexandria Stock Exchange (CASE) contain in their annual reports a separate section that describes the

role and responsibilities of the audit committee and the actions taken by the audit committee to discharge those responsibilities. The audit committee section should include: (a) a summary of the role of the audit committee, (b) the names and qualifications of all members of the audit committee during the period, (c) the number of audit committee meetings and attendance by each member, and (d) a report on the way the audit committee has discharged its responsibilities during the year. The chairman of the audit committee should be present at the AGM to answer questions, through the chairman of the board, on the report on the audit committee's activities and matters within the scope of the audit committee's responsibilities.

Recommendations Regarding Audit committee Composition

1. The World Bank Report (2001) argued that the concept of non-executive or independent directors is not well established in Egypt. Thus, the study recommends the CMA define the independence requirements for audit committee members. The study suggests the following definition for independence:

“a director is independent if he or she has no relationship to the company that may interfere with the exercise of his or her independence from management and the company. A director is not independent if the director is:

- (a) an employee (including non-employee executive officers) of the company or any of its affiliates (three year cooling-off period following termination of employment);
- (b) a partner, controlling shareholder or executive officer of an organization that has a business relationship with the company or a person who has a direct business relationship with the company, unless the company's board of directors determines in its business judgment that the relationship does not interfere with the director's

exercise of independent judgment (the board's determination is unnecessary in case of a three-year cooling-off period after the termination of the relationship);

(c) an executive of another corporation where any of the company's executives serves on that corporation's compensation committee; or

(d) an immediate family member of an individual who is an executive officer of the company or any affiliates (three-year-cooling-off period after the termination of such employment relationship)".

2. Each member of the audit committee must be financially literate, as such qualification is interpreted by the company's Board of Directors in its business judgment, or must become financially literate within a reasonable period of time after his or her appointment to the audit committee. Further, at least one member of the audit committee must have accounting or related financial management expertise. In this respect, the study recommends the CMA to define the experience requirements for audit committee members. The study suggests the following definition for "experience" as: (a) significant past employee experience in finance or accounting, (b) a requisite professional certification in accounting, or (c) any other comparable experience or background which results in the individual's financial sophistication, including being or having been a CEO or other senior officer with financial oversight responsibilities.
3. Each audit committee must have the authority to engage independent counsel and other advisors, as it determines necessary to carry out its duties and each company must provide appropriate funding for the audit committee.

4. The Capital Market Authority should recommend that listed companies in the Cairo & Alexandria Stock Exchanges (CASE) provide audit committee members with more background information and training to enable them to be more effective.

Recommendations Regarding to Audit committee Oversight Responsibilities

1. The audit committee should review the interim and annual financial statements before submission to the Board of Directors.
2. The audit committee should review the company's process of assessing the risk of fraudulent financial reporting and the programme that management establishes to monitor compliance with the code of corporate conduct.
3. The audit committee should have primary responsibility for making recommendations regarding the appointment, reappointment and removal of the external auditors. These recommendations should be made to the board and thence to shareholders for their approval in the annual general meeting.
4. The audit committee should review all auditor-client economic relationships to determine their impact on the objectivity of the auditor's work. Consequently, an audit committee could influence management to lessen audit fee pressures to ensure greater auditor vigilance during negotiations concerning financial reporting matters.
5. The audit committee should have procedures to ensure the independence and objectivity of the external auditor annually. At the same time, the external auditors should discuss with, and disclose to, the audit committee any relationships with public audit clients that in the auditor's professional judgement may reasonably be thought to bear on their independence.
6. The audit committee should develop and recommend to the board, the company's policy in relation to the provision of non-audit services by the auditor. The audit

committee's objective should be to ensure that the provision of such services does not impair the external auditor's independence or objectivity.

7. Despite the CMA having considered the important role of the audit committee regarding internal control, it does not specify any requirement for audit committee members to review the internal auditing function or any interaction between the audit committee and internal auditing function. Thus, the study recommends that the audit committee should: (a) monitor and review the internal audit activities, where there is no internal audit function, the audit committee should consider annually where there is a need for an internal audit function and make recommendations to the board, (b) ensure that the function has the necessary resources and access to information to enable it to fulfil its mandate, and (c) approve the appointment or termination of appointment of the head of the internal audit.

9-5. Summary

Over the past decade, dramatic changes have occurred in the roles of Boards of Directors, audit committees, management, internal auditors and independent auditors as well as in the relationships among these groups. The principal motivation of these changing dynamics is the growing public pressure for greater corporate accountability. Corporate accountability can be achieved through improvements in the quality of financial reporting which will facilitate an increased level of auditor independence based on the establishment of audit committees. So, the role of the audit committee has become a key element for the quality of financial reporting.

The implementation of an economic reform programme in Egypt has resulted in an active effort by people in authority and those who work in accounting and auditing to enhance the

quality of financial reporting which is considered to be one of the factors necessary to increase the effectiveness of economic performance. Through these efforts, evolved the idea of implementing audit committees in Egyptian firms. Recently, Egypt introduced the audit committee concept to the Egyptian banking sector to enhance the credibility of financial reports and strengthen communication among directors, auditors, and management, which will, in turn, enhance the quality of auditing and financial reporting.

This study surveys the literature relating to audit committees and their role in enhancing the quality of auditing and financial reporting. Also this study discusses the role of various authoritative bodies and accounting organizations in enhancing the effectiveness of audit committees. In this study, survey and case study scenarios were the main instruments for the empirical investigation. Surveys were used to gather data from UK and Egyptian audit committee member samples in order to examine audit committee oversight responsibilities from the internal perspective of UK and Egyptian audit committee members in comparison with the DeZoort (1997) study in the USA. The results provided evidence that audit committee members in the USA and the UK agree with the current requirements and recommendations for expansion of audit committees oversight responsibilities, while the Egypt audit committee members agree with only eight oversight responsibilities. The results, in general, indicate that, there are differences in the institutions of those countries which applied the audit committee concept a long time ago and constituted the oversight responsibilities for measuring its effectiveness, and Egypt. The point is that management theories and concepts which have been developed in the Anglo Saxon world may need to be modified and adapted in order to fit the cultural beliefs, values and expectations of developing nations such as Egypt. Case study was used to gather data from audit committee members in the public banking sector in Egypt in order to measure the effectiveness of audit committees

and examine the effect of audit committee member's independence and experience on audit committee effectiveness. The results, in general, asserted the low effectiveness of audit committee members in carrying out their oversight responsibilities. In this case, the results highlighted the important role of the audit committee charter which should define the oversight responsibilities. Also, the results indicate that audit committee effectiveness is significantly and positively related to the independence and experience of the audit committee members.

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Appendices

Appendix (A):

UK Listed Companies in the Times Top 250 (FTSE) 31/12/2002

#	Company Name	Market Capitalisation £ m	Comments
1	ARM Holdings	485.639124	
2	AWG	764.211419	
3	Abbot Group	235.62057	
4	Aberforth Smaller Companies Tst	270.93325	
5	Acambis	271.813898	
6	Aegis Group	860.842604	
7	Aga Foodservice Group	262.678892	
8	Aggregate Industries	951.647944	
9	Aggreko	394.8575	
10	Alba	212.497722	
11	Alliance Trust	1161.72	
12	Amec	427.133656	
13	Amlin	460.371171	
14	Antofagasta	1232.320869	
15	Aquarius Platinum	248.116181	
16	Arriva	548.863615	
17	Associated British Ports Hldgs	1303.182559	
18	Autonomy Corporation	218.644097	
19	Avis Europe	558.102	
20	BBA Group	854.116835	
21	BPB	1201.286772	
22	Balfour Beatty	599.254297	
23	Bankers Investment Trust	290.08025	
24	Barratt Developments	927.246119	
25	Beazley Group	224.889863	
26	Bellway	494.13	
27	Berkeley Group	798.885933	
28	Bodycote International	208.251	
29	Bovis Homes Group	418.449406	
30	Brambles Industries	1097.44	
31	Brit Insurance Holdings	567.315066	
32	Britannic Group	643.21	
33	British Assets Trust (Ord)	332.095841	
34	British Empire Sec & General Tst	255.727942	
35	British Vita	508.463311	
36	Brixton	544.8615	
37	Brown (N.) Group	397.936	
38	Burberry Group	1122.5	
39	Cable & Wireless	1066.000799	
40	Cairn Energy	458.519259	
41	Caledonia Investments	481.072175	
42	Candover Investments	249.755243	
43	Capital Radio	403.904086	

44	Carillion	237.099381	
45	Carlton Communications	900.8175	
46	Carpetright	442.8075	
47	Carphone Warehouse Group	660.961932	
48	Cattles	943.538589	
49	Celltech Group	941.85	
50	Chelsfield	849.169045	
51	Chrysalis Group	327.712	
52	Chubb	727.039228	
53	City Of London Investment Trust	377.712	
54	Close Brothers Group	798.218753	
55	Coats	344.764	
56	Cobham	1034.363232	
57	Collins Stewart Holdings	335.674997	
58	Colt Telecom Group	685.785909	
59	Computacenter	518.927506	
60	Cookson Group	382.08105	
61	Corus Group	850.4725	
62	Countrywide Assured Group	368.896152	
63	Cox Insurance Holdings	237.224429	
64	Croda International	330.966	
65	DFS Furniture Co	375.26107	
66	Dairy Crest Group	422.113476	
67	Davis Service Group	533.530886	
68	De La Rue	541.163016	
69	De Vere Group	310.80525	
70	Debenhams	1017.520682	
71	Derwent Valley Hldgs	286.74	
72	Dimension Data Holdings	389.144399	
73	Dunedin Income Growth Inv Tst	248.155	
74	EMI Group	1095.32	
75	Easyjet	1070.327578	
76	Edinburgh Investment Trust	640.983325	
77	Edinburgh US Tracker Trust	378.713288	
78	Egg	1179.36	
79	Electra Investment Trust	329.419242	
80	Electrocomponents	1245.58	
81	Enodis	195.7648	
82	Enterprise Inns	963.265477	
83	Euromoney Institutional Investors	229.58	
84	Eurotunnel/Eurotunnel SA	451.837859	
85	Expro International Group	247.667705	
86	FKI	510.761941	
87	Fidelity European Values	258.866167	
88	First Choice Holidays	450.963523	
89	FirstGroup	981.40138	
90	Fleming Claverhouse Inv Trust	229.898027	
91	Fleming Continental Euro Inv Tst	248.217585	
92	Fleming Japanese Inv Trust	254.48515	
93	Fleming Mercantile Inv Trust	599.557	

94	Foreign & Col Invest Trust	1548.996943	
95	Foreign & Colonial Eurotrust	237.256	
96	Forth Ports	366.933237	
97	GWR Group	215.313595	
98	Galen Holdings	938.069505	
99	Game Group	134.978569	
100	Geest	327.006991	
101	Go-Ahead Group	292.395	
102	Grainger Trust	246.14	
103	Great Portland Estates	452.783624	
104	Greene King	502.0275	
105	Greggs	389.459308	
106	HIT Entertainment	329.856304	
107	HMV Group	479.066202	
108	Halma	404.561313	
109	Hammerson	1303.25724	
110	Hiscox	455.173943	
111	Holidaybreak	248.380147	
112	ICAP	997.4965	
113	IMI	922.425	
114	ISIS Asset Management	266.119067	
115	Inchcape	553.189532	
116	Informa Group	213.988923	
117	Intermediate Capital Group	501.0525	
118	International Power	1069.5275	
119	Interserve	188.564878	
120	Intertek Testing Services	620.419989	
121	Investec	615.728405	
122	JJB Sports	336.858879	
123	JPMorgan Fleming American IT	273.158033	
124	JPMorgan Fleming Overseas IT	237.801856	
125	Jardine Lloyd Thompson Group	1321.475645	
126	Jarvis	393.793929	
127	Johnston Press	1036.959	
128	Kelda Group	1665.896	
129	Kidde	586.188324	
130	Kingston Comms	254.096757	
131	Laing (John)	179.82148	
132	Laird Group	213.187	
133	Lastminute.Com	243.405276	
134	Law Debenture Corp	224.2625	
135	LogicaCMG	1119.641572	
136	London Merchant Securities	287.541229	
137	London Merchant Securities (Dfd)	91.064549	Subsidiary of No. 136 and also, the market capitalisation was under \$200 m or equal in England pound

138	London Stock Exchange	937.7775	
139	Lonmin	1212.376835	
140	Luminar	285.051036	
141	MFI Furniture Group	664.097719	
142	MITIE Group	259.107272	
143	Manchester United	272.79	
144	Marshalls	360.787705	
145	Matalan	882.21	
146	McAlpine (Alfred)	250.855691	
147	McCarthy & Stone	323.303981	
148	Meggitt	506.294988	
149	Merchants Trust	296.92575	
150	Merrill Lynch Euro Inv Tst	290.293884	
151	Mersey Docks & Harbour Co	399.885605	
152	Michael Page International	398.484515	
153	Millennium & Cophorne Hotels	592.41	
154	Minerva	288.6195	
155	Misys	1013.76	
156	Monks Investment Trust PLC	410.597737	
157	Murray Income Trust (Ord)	270.114138	
158	Murray International Trust (Ord)	258.741432	
159	National Express Group	540.208271	
160	Nestor Healthcare Group	187.660096	
161	New Look Group	478	
162	Northern Foods	885.055509	
163	Northgate	243.808	
164	Novar	467.067716	
165	PHS Group	408.465907	
166	PZ Cussons	196.874931	
167	PZ Cussons A	155.710625	Subsidiary of No. 166- PZ Cussons
168	Paragon Group of Companies	202.339838	
169	Peninsular & Oriental Steam Nav Co	1116.955	
170	Pennon Group	790.785587	
171	Persimmon	1190.43328	
172	Pilkington	729.003592	
173	Pillar Property	459.59176	
174	PizzaExpress	239.29598	
175	Powderject Pharmaceuticals	376.237311	
176	Premier Farnell	684.886977	
177	Premier Oil	448.659	
178	Provident Financial	1510.100189	
179	Punch Taverns	468.72	
180	Quintain Estates and Development	321.315951	
181	RAC	412.96	
182	RIT Capital Partners	594.272	
183	RMC Group	967.779	
184	Rank Group	1577.234018	
185	Rathbone Brothers	219.413878	
186	Redrow	373.197	

187	Renishaw	214.76	
188	Rotork	253.2905	
189	SIG	206.360784	
190	SMG	302.458903	
191	SSL International	485.9025	
192	Schroder Ventures Intl.Inv.Tst	426.345696	
193	Scottish Investment Trust	536.295229	
194	Scottish Mortgage & Trust	748.411258	
195	Second Alliance Trust	390.72	
196	Securicor	529.289422	
197	Securities Trust of Scotland	255.30525	
198	Selfridges	340.854839	
199	Serco Group	665.114902	
200	Shaftesbury	271.5475	
201	Shanks Group	237.354	
202	Signet Group	1154.948964	
203	Singer & Friedlander Group	252.268933	
204	SkyePharma	248.557042	
205	Slough Estates	1401.765	
206	Smith (DS)	466.764	
207	Smith (WH) Group	888.7315	
208	Soco International	278.175756	
209	Somerfield	422.028	
210	South Staffordshire Group	287.941136	
211	Spectris	354.206582	
212	Spirax-Sarco Engineering	304.704	
213	St.Ives	369.411772	
214	St.Jamess Place Capital	553.039284	
215	Stagecoach Group	388.998874	
216	Stanley Leisure	491.056978	
217	T & S Stores	345.231	
218	TBI	244.516528	
219	TR Property Investment Trust	264.95359	
220	Tate & Lyle	1517.355	
221	Taylor & Francis Group	387.43131	
222	Taylor Nelson Sofres	589.456	
223	Taylor Woodrow	934.670441	
224	Temple Bar Inv Tst	275.706	
225	Templeton Emerging Markets IT	453.9695	
226	Thistle Hotels	527.133	
227	Tibbett & Britten Group	186.001989	
228	Travis Perkins	1125.498284	
229	Trinity Mirror	1254.834	
230	Tullow Oil	348.885102	
231	Ultra Electronics Holdings	295.7325	
232	Ultraframe	228.694689	
233	United Business Media	967.15	
234	VT Group	375.730553	
235	Viridian Group	652.878	
236	Waste Recycling Group	222.473	

237	Weir Group	427.11678	
238	Wellington Underwriting	389.216754	
239	Wembley	241.273386	
240	Westbury	311.0395	
241	Wetherspoon(J D)	356.691125	
242	William Hill	957.511222	
243	Wilson Bowden	684.01	
244	Wilson Connolly Hldgs	302.50838	
245	Wimpey(George)	993.024537	
246	Witan Inv Tst	924.9255	
247	Wolverhampton & Dudley	449.091443	
248	Wood Group (John)	771.115082	
249	Woolworths Group	505.6875	
250	Xansa	182.787806	

Appendix (B):

The Top 100 Companies In Terms of Market Capitalization(CASE) 31/12/2002

	Company Name	Currency	Market capitalization	Comments
1	Telecom Egypt	LE	17,112,149,000	
2	MIDOR	\$	3,511,200,000	
3	Cairo Barclays Bank	LE	3,360,000,000	
4	Egyptian Company for Mobile Services (MobiNil)	LE	2,881,000,000	
5	Orascom Construction Industries	LE	2,310,000,000	
6	Suez Cement Building Materials & Construction	LE	2,112,000,000	
7	Golden Pyramids Plaza	\$	1,854,930,000	
8	Commercial International Bank (Egypt)	LE	1,820,000,000	
9	Assiut Cement	LE	1,674,534,224	
10	Egyptian Media Production City Entertainment	LE	1,628,840,000	
11	Abou Kir Fertilizers Chemicals	LE	1,601,435,011	
12	Egyptian Iron & Steel	LE	1,448,967,215	
13	Al Ahram Beverages (ABC)	LE	1,328,981,400	
14	Exxon Mobil (Egypt)	LE	1,300,498,635	
15	Eastern Tobacco Food & Beverage	LE	1,270,750,000	
16	Arab International Investment Co. (LAFICO)	\$	1,155,000,000	
17	Commercial International Investment Company (CIIC)	LE	1,149,120,121	
18	Delta Sugar	LE	1,135,434,550	
19	HSBC Bank Egypt	LE	1,001,083,500	
20	Alexandria National Iron & Steel	LE	1,000,890,577	
21	National Cement	LE	937,056,000	Under Limit
22	Sugar & Integrated Industries	LE	900,000,000	Under Limit
23	ECEM.CA Egyptian Cement Company (EEC)	LE	812,000,000	Under Limit
24	National Societe Generale Bank (NSGB)	LE	807,600,000	Under Limit
25	Orascom Telecom Holding (OT)	LE	799,700,000	Under Limit
26	Dreamland Urban Development	LE	790,430,000	Under Limit
27	Torah Cement	LE	781,044,264	Under Limit
28	Delta International Bank	LE	740,000,000	Under Limit
29	CA Misr Exterior Bank	LE	723,276,700	Under Limit
30	Tholathia Manufacturig and Trade	LE	700,000,000	Under Limit
31	National Tourism & Hotels	\$	693,000,000	
32	BIOC.CA Glaxo Wellcome	LE	692,172,000	Under Limit
33	EKHO.CA Egyptian Kuwaiti Holding	\$	681,912,000	
34	HELW.CA Helwan Portland Cement	LE	655,192,669	Under Limit
35	National Gas Company (NATGAS)	LE	650,000,000	Under Limit
36	Misr Romania Bank	\$	623,700,000	

37	Tholathiya Investment	LE	600,000,000	Under Limit
38	Egyptian International Pharmaceuticals (EIPICO)	LE	584,204,400	Under Limit
39	Oriental Weavers	LE	576,450,000	Under Limit
40	World Trade Center Co. Cairo	\$	554,400,000	
41	Arab Insurance Group	\$	548,856,000	
42	Ameriyah Cement	LE	525,000,000	Under Limit
43	Nile City Investment	LE	515,000,000	Under Limit
44	Reach Trade & Marketing	LE	500,000,000	Under Limit
45	Egyptian Arab Engineering Real Estate & Investment	LE	490,500,000	Under Limit
46	Arab Iron Factory	LE	485,500,000	Under Limit
47	Egypt Aluminum	LE	484,400,000	Under Limit
48	Alexandria Containers and goods	LE	477,732,000	Under Limit
49	Marine and Petroleum Services	\$	475,629,000	
50	Misr International Bank (MIBank)	LE	464,906,250	Under Limit
51	Misr Iran Development Bank	\$	462,000,000	
52	Arab African International Bank	\$	462,000,000	
53	Orascom for Investment	\$	462,000,000	
54	Amoun	LE	440,460,000	Under Limit
55	R.G. Investment	LE	439,185,000	Under Limit
56	Chipsy Food Industries	LE	431,271,141	Under Limit
57	Natural Gas & Mining Project (Egypt Gas)	LE	420,180,000	Under Limit
58	Misr Shipping	\$	415,800,000	
59	Amoun Pharmaceutical Industries	LE	400,000,000	Under Limit
60	Arabia Tourism Development and Real Estate Investment	LE	400,000,000	Under Limit
61	Arab Company For Touristic Projects	LE	400,000,000	Under Limit
62	Egyptian American Bank (EAB)	LE	381,168,000	Under Limit
63	Zahraa Maadi Investment & Development	LE	380,000,000	Under Limit
64	Suez Canal Bank Financial Services	LE	361,790,000	Under Limit
65	Export Development Bank of Egypt (EDBE)	LE	350,500,000	Under Limit
66	Societe Arabe Internationale De Banque (SAIB)	\$	349,272,000	
67	El Watany Bank of Egypt	LE	334,750,000	Under Limit
68	Beni Suef Cement Company	LE	330,000,000	Under Limit
69	Medinet Nasr Housing Housing & Real Estate	LE	323,840,000	Under Limit
70	Cairo & Paris Bank	\$	315,315,000	
71	Dreamland Pyramids Golf	LE	313,464,130	Under Limit
72	Misr Cement (Qena)	LE	312,000,000	Under Limit
73	Delta Industries (IDEAL)	LE	302,250,000	Under Limit
74	Remco for Touristic Villages Construction	LE	301,530,000	Under Limit
75	El Masreyah Tourism & Hotels (EGOTH)	LE	300,000,000	Under Limit
76	Canal Shipping Agencies	LE	298,000,000	Under Limit
77	Arab Banking Corporation	LE	293,325,000	Under Limit
	Paint & Chemicals Industries	LE		

78	Paint & Chemicals Industries	LE	289,400,000	Under Limit
79	IDEAL Trading	LE	277,200,000	Under Limit
80	Americana Group for Food & Tourism Projects	LE	275,000,000	Under Limit
81	DINA For Agriculture Investment	LE	275,000,000	Under Limit
82	Faisal Islamic Bank of Egypt	\$	274,219,067	
83	Heliopolis Housing	LE	273,939,704	Under Limit
84	Arab Cables Company	LE	270,288,000	Under Limit
85	Mantrac	LE	260,000,000	Under Limit
86	Orascom Hotel Holdings (OHH)	LE	259,775,100	Under Limit
87	Suez Canal Educational Services	LE	259,490,000	Under Limit
88	Sinai Cement	LE	256,250,000	Under Limit
89	Al Amal Clay Brick	LE	255,450,000	Under Limit
90	El Masreyah Glass	LE	253,750,000	Under Limit
91	Amreyah Pharmaceuticals Industries	LE	252,000,000	Under Limit
92	Taba Tourism Development	LE	250,000,000	Under Limit
93	Misr Beni Suef Cement	LE	246,300,000	Under Limit
94	Egyptian Real Estate Group	LE	242,316,279	Under Limit
95	Isiss for Hotels & Touristic Real Estate	LE	236,994,862	Under Limit
96	Alexandria Cement	LE	232,800,000	Under Limit
97	Saudi Egyptian Construction	\$	231,000,000	
98	Misr Hotels (Hilton)	LE	226,908,000	Under Limit
99	Credit Agricole Indosuez (Egypt)	LE	225,011,808	Under Limit
100	South Egypt Drug Industries Co.	LE	223,768,000	Under Limit

Appendix (C)

Dear Audit Committee Member

I am a PhD Student at Durham Business School. The topic of my research is “Audit committees: an investigation of their effectiveness”. I am conducting a survey to investigate Audit Committee Members’ perception of their oversight responsibilities related to financial reporting, internal control, internal and external auditing, and overall corporate governance. This survey contributes to a better understanding of audit committee oversight by evaluating U.K audit committee members’ perceptions of their assigned responsibilities.

The survey will only require five minutes of your time to complete. Respondents are not required to disclose their company or their personal details. Furthermore, I can assure you that the responses in the questionnaires will be used solely for the purpose of academic research and will not be made available to anybody other than the examination markers at the University. Your contribution will be highly appreciated.

I would be grateful if you could complete the questionnaire in full and return it in the reply paid envelope provided at your earliest convenience. Please ensure that replies are posted by Friday 28 February to provide me adequate time to analyse the results. Should you require any further information as to the nature of my research or the results of the survey, then you may contact me via the telephone number or email address provided below.

Please accept my deepest gratitude for your assistance and participation in this survey.

Yours truly

Mohamed Soliman

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Oversight Responsibilities		Is the duty assigned formally to your committee?		Is the duty performed, but not assigned, to your committee?		Is the duty appropriate for audit committees?	
		Yes	No	Yes	No	Yes	No
Financial Reporting:							
1	Review all financial statements, whether interim or annual.						
2	Review all existing accounting policies.						
3	Review systems of internal control.						
4	Review exposure to fraud.						
5	Review all significant transactions.						
6	Appraise key management estimates, judgements and valuations.						
Auditing:							
7	Recommend the appointment of and fee for the external auditor.						
8	Review the plans for, and the effectiveness of, the internal and external auditors.						
9	Review the arrangements for coordinating the work done by internal and external auditors.						
10	Review the external auditor's management letter.						
11	Determine the auditors are free from undue influence and managerial interference.						
12	Request to be informed if there is a dispute between auditors and managers.						
13	Monitor the resources allocated to the internal audit function.						
14	Review the nature and magnitude of fees paid to the auditors for non-audit services.						
Other corporate governance:							
15	Facilitate communication between the external auditors and the Board of Directors.						
16	Review corporate policies and practices in light of ethical considerations.						
17	Monitor compliance with the company's code of conduct.						

Appendix (D)

Dear Audit Committee Member

In order to evaluate the establishment of the audit committees in the Egyptian banking sector, measure its effectiveness, and determine the obstacles they face in fulfilling the monitoring role for the financial reporting, external auditing, and internal control- which include internal auditing- this study is directed to you as an audit committee member in the Egyptian banking sector which established audit committees in 2000, in light of the USA and the UK best practice.

This study contains two parts. First a group of personal questions. Second a group of suggested issues related to financial reporting, external auditing, and internal control. You are required to study every issue and determine your recommendations and the party that can solve the issue, in light of your responsibility as an audit committee member.

Your contribution will be highly appreciated, and will be used for academic purposes only.

Thank you.

The researcher

Mohammad Soliman

Part One: Personal Data

1. What is your position in the bank?

Current employee Previous External professional

2. If you were a previous employee, when did you leave?

Year -----

3. If you are considered an external professional member, are you a partner in, or an executive officer of, any organisation to which the corporation (bank) made, or from which the corporation received payments in any of the past five years?

Yes No

4. Are you accepting any compensation from the bank or any of its affiliates other than compensation for board services?

Yes No

5. Are you a member of the immediate family of an individual who is, or has been in any of the past five years, employed by the bank or any of its affiliates as an executive officer?

Yes No

6. Please complete the following table.

Degree	Major	Year acquired
University degree	-----	-----
Diploma	-----	-----
Master	-----	-----
PhD		

7. If you have other training qualifications, please mention below.

-----year-----

-----year-----

Part Two: Suggested/Expected issues

First: scenarios related to financial reporting

F. R. scenario 1. During the audit committee's meeting, a memorandum has been presented from the internal auditing department's chairman, explaining that revenues -from services the bank presented to its customers in the past year- have been collected this year, and were included in the current year's income statement. This represents a deficiency in the application of the alternative generally accepted accounting principles. Therefore the internal auditing department's chairman required the proper application of alternative generally accepted accounting principles (GAAP) be reviewed and analyzed.

Recommendations

Suggested party to solve this issue

- External auditor Internal auditing department Board of Directors
- Audit committee Accounting department

F. R. scenario 2. The accounting department presented a memorandum to the audit committee during its meeting explaining that, because of the nature of the computer equipment in the bank characterized by a rapid depreciation rate, the accounting department has changed the depreciation method from fixed instalments to reducing balance.

One of the audit committee members rejected this action because it represented a change in the accounting policies impacting on the accuracy of the bank's financial reporting, and demanded the other audit committee members review and analyze to see if there were significant changes in the accounting policies and their impact on the financial statements.

Recommendations

If you do not agree with the audit committee member's opinion, suggest the other party that can solve this issue:

External auditor Internal auditing department Board of Directors

Accounting department

F. R. scenario 3. During the audit committee's meeting, a memorandum has been presented from the accounting department's chairman recommending that the bank and its affiliates implement standard No.10 of the Egyptian Accounting Standards which was issued recently. This standard will allow the re-evaluation of the bank's assets and state the required accounting procedures governing this issue. The reason for this re-evaluation was that the assets' book value was clearly lower than its fair market value.

The internal auditing department's chairman demanded the audit committee to review the recent professional and regulatory pronouncements, and evaluate their impact on the financial reports. One of the audit committee members rejected this demand alleging that this matter is not one of the audit committee responsibilities.

Recommendations

If you agree with the audit committee member's opinion, suggest the other party which can solve this issue:

- External auditor Internal auditing department Board of Directors
- Accounting department

F. R. scenario 4. One of the audit committee members rejected the inclusion of the meeting between the external auditor, the audit committee, and the management in the next committee's scheduled meeting, based on the assumption that this is not within the committee's range of responsibilities.

The purpose of the meeting was to review the financial reports and the results of the audit before submission to the board of directors.

Recommendations

If you agree with the audit committee member's opinion, suggest the other party with which the external auditors and the management should meet:

- Accounting department Internal auditing department Board of Directors

F. R. scenario 5. The next schedule for the audit committee meeting included the review of interim financial reports and the assessment of whether they contained adequate and appropriate disclosures. The reason was that the internal auditing department chairman directed a memorandum to the audit committee chairman explaining that the interim financial reports did not have the appropriate disclosure.

One of the audit committee members rejected the request and demanded that the committee members concentrate their attention on the review of the final financial reports at the end of the year and assess whether they contain adequate and appropriate disclosure.

Recommendations

If you agree with the audit committee member's opinion, suggest the other party that can solve this issue:

External auditor Internal auditing department Board of Directors

Accounting department

Second: scenarios related to the external auditing

E. A. scenario 1. Audit committee members were informed that the accounting department manager in one of the bank's branches is an immediate family member of a member in the Central Auditing Organization, which is considered to be the external auditor for the bank. When this matter was discussed in the audit committee meeting, an audit committee member demanded from the accounting department chairman an evaluation of the independence of The Central Auditing Organization members and that this evaluation be directed to The Central Auditing Organization managers in order for them to take the appropriate actions to monitor the independence of its members.

Recommendations

If you don't agree with the audit committee member's opinion, suggest the other party that can solve this issue:

External auditor Internal auditing department Board of Directors

Audit committee

E. A. scenario 2. At the beginning of this year, the accounting department chairman directed a memorandum to the audit committee demanding that it direct a letter to The Central Auditing Organization (which is considered the external auditor) requiring it to present the scope and activities of the annual audit to the accounting department in order for them to be reviewed and analyzed.

During the audit committee meeting, one of the audit committee members explained that, the scope and activities of the annual audit must be reviewed and analyzed by the audit committee members and not by the accounting department.

Recommendations

If you don't agree with the audit committee member's opinion, suggest the other party that can solve this issue:

- Accounting department Internal auditing department Board of Directors

E. A. scenario 3. The audit committee received a suggestion from The Central Auditing Organization (which is considered to be the external auditor) stating that the bank and its affiliates should implement the principles of The Uniform Accounting System, which is applied in industrial/trading companies, in order to improve the accuracy in the bank's financial reporting. But one of the audit committee members rejected the discussion about this suggestion in the audit committee meeting and required the chairman to convert this suggestion to the accounting department which, in general, is more capable of discussing the external auditors' judgment about the quality, not just the acceptability, of the bank's accounting principles as applied in its financial reporting.

Recommendations

If you don't agree with the audit committee member's opinion, suggest the other party that can solve this issue:

- Audit committee Internal auditing department Board of Directors

E. A. scenario 4. The Central Auditing Organization directed a report to the audit committee including a group of suggested corrective actions related to some of the accounting mistakes which were made by the accounting department, and required the audit committee members to monitor the corrections which must undertaken by the accounting department.

Regarding the same matter, the audit committee received a letter from the internal auditing chairman requiring the audit committee chairman to transfer the corrective actions, that were suggested by the external auditor, to the internal auditing department in order to monitor the corrections, based on the fact that this matter is one of the internal auditing department responsibilities not the audit committee's responsibility.

Recommendations

If you don't agree with the internal auditing chairman's opinion, suggest the other party that can solve this issue:

Audit committee

Accounting department

Board of Directors

E. A. scenario 5. During the audit committee meeting, a memorandum was presented from the accounting department chairman explaining that, there is a conflict of opinions between the accounting department and The Central Auditing Organization members regarding how to deal with the fire equipment which the bank bought a the beginning of this year.

This memorandum explained that, the accounting department's opinion was that the fire equipment must be treated as a capital expense, but the Central Auditing Organization member's opinion was that it must be treated as an income expense.

Recommendations

The party that you suggest to solve this issue

Audit committee Internal auditing department Board of Directors

Third: scenarios related to the internal control including internal auditing

I. C. scenario 1. The board of directors transferred a memorandum received from the external auditor to the audit committee explaining that, the internal accounting and financial control systems applied in the bank are not adequate for the nature of the bank.

The board of directors required the audit committee to review and analyze the adequacy and effectiveness of these control systems.

During the audit committee meeting, one of the audit committee members suggested that the adequacy and effectiveness of internal accounting and financial control must be reviewed and analyzed by the board of directors and not by the audit committee members.

Recommendations

*

If you don't agree with the audit committee member's opinion, suggest the other party that can solve this issue:

Audit committee Internal auditing department Accounting department

I. C. scenario 2. The audit committee chairman demanded the internal auditing chairman supply him with the internal audit reports, budgets, and findings in order for them to be presented to the audit committee members during the next audit committee meeting for review and analysis. The internal auditing chairman rejected the suggestion of sending these reports to the audit committee based on the fact that the audit committee does not have the right to review and analyze these reports, and that they must be sent to the board of directors.

Recommendations

If you don't agree with the internal auditing chairman's opinion, suggest the other party that can solve this issue:

Audit committee

Accounting department

External auditor

I. C. scenario 3. Based on a group of recommendations, related to the internal control system applied in the bank, received from the Central Auditing Organization, the audit committee chairman requested the internal auditors performance reports from the internal auditing department chairman in order for the audit committee members to be able to evaluate their performance and suggest corrective actions to improve the internal auditors' performance.

The internal auditing chairman rejected the suggestion of sending these reports to the audit committee based on the fact that this matter is not one of the audit committee duties.

Recommendations

If you don't agree with the internal auditing chairman's opinion, suggest the other party that can solve this issue:

Audit committee

Accounting department

Board of Directors

External auditor

I. C. scenario 4. The audit committee chairman has received a memorandum from the external auditors stating a group of fraudulent, illegal acts, and deficiencies in the internal control system implemented in the bank. The memorandum requires the audit committee members to take corrective actions in order to avoid these occurrences in the future.

When the audit committee chairman presented this memorandum during the audit committee meeting, the members were divided into two groups. The first recommended that this memorandum must be directed to the board of directors in order that the proper corrective actions be taken.

The second group recommended that, the audit committee must be informed of the fraud, illegal acts, and deficiencies in the internal control system in order for them to take the proper corrective actions.

Recommendations

The party that you suggest to solve this issue

- External auditor Internal auditing department Board of Directors
- Audit committee Accounting department

I. C. scenario 5. The audit committee chairman demanded to meet with the internal auditing chairman to review the internal auditing plan in order to ensure that internal auditing was involved in the control system.

The internal auditing chairman rejected this meeting based on the fact that it must be conducted with the full body of the board of directors

Recommendations

If you don't agree with the internal auditing chairman's opinion, suggest the other party that can solve this issue:

Audit committee

Accounting department

External auditor

