The Role of Audit Committee in Enhancing the Effectiveness of Internal Control in Egyptian Companies: A Field Study

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Abstract

The main objective of this research is to investigate the role of audit committees in enhancing the effectiveness of internal control in Egyptian companies. The researcher dealt with the concept of audit committees, their importance and the basic characteristics of audit committees represented in independence, financial expertise, industry expertise, size and periodic meetings of the audit committee and the powers and duties of audit committees and their effect on the internal control system. To achieve the objectives of the research, a correlation analysis was conducted between audit committees as an independent variable and the effectiveness of internal control as a dependent variable, the study population consists of auditors of joint-stock companies listed on the Egyptian Stock Exchange and faculty members at Egyptian universities. Then the effect of the role of audit committee on the effectiveness of internal control was measured through a regression model.

It was found that the presence of audit committees in Egyptian companies enhances the effectiveness of internal control.

Keywords: Internal control, Audit committee, corporate governance, Independence.

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دور لجان المراجعة في تعزيز فاعلية الرقابة الداخلية في الشركات المصرية دراسة ميدانية

الملخص

يهدف هذا البحث إلي دراسة دور لجان المراجعة في تعزيز فعالية الرقابة الداخلية في الشركات المصرية. تناول الباحث مفهوم لجان المراجعة وأهميتها والخصائص الأساسية للجان المراجعة المتمثلة في الاستقلالية والخبرة المالية وخبرة الصناعة وحجم لجنة المراجعة واجتماعاتها الدورية وصلاحيات وواجبات لجان المراجعة وتأثيرها على نظام الرقابة الداخلية.

ولتحقيق هدف البحث تم إجراء تحليل الارتباط بين لجان المراجعة كمتغير مستقل وفعالية الرقابة الداخلية كمتغير تابع، ويتكون مجتمع الدراسة من مراجعي حسابات الشركات المساهمة المقيدة بالبورصة المصرية وأعضاء هيئة التدريس بالجامعات المصرية. و قد تم قياس أثر دور لجنة المراجعة على فعالية الرقابة الداخلية من خلال نموذج الانحدار.

و قد توصلت نتائج الدراسة الميدانية إلي أن وجود لجان المراجعة في الشركات المصرية يعزز من فعالية الرقابة الداخلية.

الكلمات المفتاحية: الرقابة الداخلية، لجنة المراجعة، حوكمة الشركات، الاستقلال.

1.Introduction:

The importance of effective internal audit and the existence of an effective audit committee (AC), as the foundation of good corporate governance, has been increasingly recognized in the aftermath of various financial collapses. (Bédard & Gendron, 2010, pp. 174-210)
Many collapses occurred in the early 2000s, causing confidence in capital markets to fall. Consequently, more attention has been directed toward the internal audit function (IAF) and the AC's role in helping the board of directors discharge its financial and fiduciary obligations. (Puri, Trehan & Kakkar, 2010, pp. 47-57)
As a corporate governance mechanism, the AC is charged with examining company financial information and with facilitating the work of internal audit and financial accountants. The AC is also obligated to monitor the IAF. To execute these duties, the AC must assist the IAF which acts to discharge the committee's responsibilities on its behalf. In addition, the AC and the IAF must be attached to senior management, so they are not undermined by other organizational functions. (Soh & Bennie, 2011, pp. 605-622)

Dafinone (2001) added that the aim for audit development in USA and Canada was to "(1) increase confidence in the credibility and objectivity of the financial statements, (2) assist directors in discharging their financial reporting responsibilities, and (3) to strengthen the independence of the external auditors". Audit committee links between external auditor and the board and reduces the information asymmetry between them. Through its monitoring and financial control roles, the audit committee enhances the independence of an auditor from management. (Klein, 2002, pp. 375-400)
In response to these accounting failures, the Congress of United

States passed law of Sarbanes Oxley Act of 2002. (SOX, 2002) This significantly changed several issues related to corporate governance and corporate financial reporting. Particularly, it pushed for more focus on internal controls. Hence, it is likely that several companies have shifted their concentration towards internal controls during this period. In addition, the Public Accounting Oversight Board (PCAOB) asserts that an outstanding benefit of its standard on auditing an internal control is encouraging companies to invest in competent and objective internal audit function. (PCAOB, 2004)

The Audit Committee is an independent committee that works alongside the Board of Directors, aiming to activate corporate governance by ensuring the integrity of the internal control system in companies, and the fairness of financial reports. Internal control in the company, by reviewing those systems, and submitting a report to the Board of Directors on the adequacy of the internal control and control systems. (Arens et al., 2013)

Audit committees are currently receiving attention from organizations and scientific academies specialized in the accounting field, and researchers, especially after the failures and financial turmoil that occurred in major global joint stock companies. This attention is due to the role that audit committees can play in reducing business risks. And in improving the degree of accuracy and transparency as one of the corporate governance tools, through its role in reviewing financial reports and supervising the internal audit function in companies, as well as its role in supporting the external audit function and ensuring its independence, and its importance in confirming commitment to the principles of corporate governance.

2.Research Problem:

Several previous studies concentrated on the relationship between the audit committee characteristics and the financial reports quality. On the other hand, some concentrated on the relationship between the audit committee and quality of the auditing which will affect the effectiveness of internal control. However, investors are now less confident in the audited financial statements due to the recent financial scandals. Therefore, the problem of the research stems from the discrepancy in the results of previous studies in determining the audit committee's impact and the quality of auditing on the quality of financial reports.

Therefore, the current research will try to answer the following question:

1. Do the audit committees' characteristics enhance the effectiveness of the internal control of Egyptian companies?
2. Do the audit committees in the framework of corporate governance enhance the effectiveness of the internal control of the Egyptian companies?

3.Research Importance:

1. The research contributes to clarifying the significant role of the audit committees as it is one of the most important topics at the local, regional, or global level.
2. This research is expected to contribute to the statement of the practices of the audit committees and their ability to achieve the efficiency and effectiveness of internal control.
3. Activate the relationship between the audit committees and the improvement of the internal control quality.
4. It can use the results and recommendations of the current research to improve the internal control quality by activating

the professional practices of the audit committees in its corporate environment.

4.Research Hypotheses:

Based on the above discussion and the findings of the previous research, the research hypothesis can be formulated as following:

-There is a significant correlation between the audit committees' characteristics (Independence, expertise, size & frequent meeting) and the effectiveness of internal control.

-There is a significant correlation between the audit committees' framework of corporate governance and the effectiveness of internal control.

5.Research Objectives:

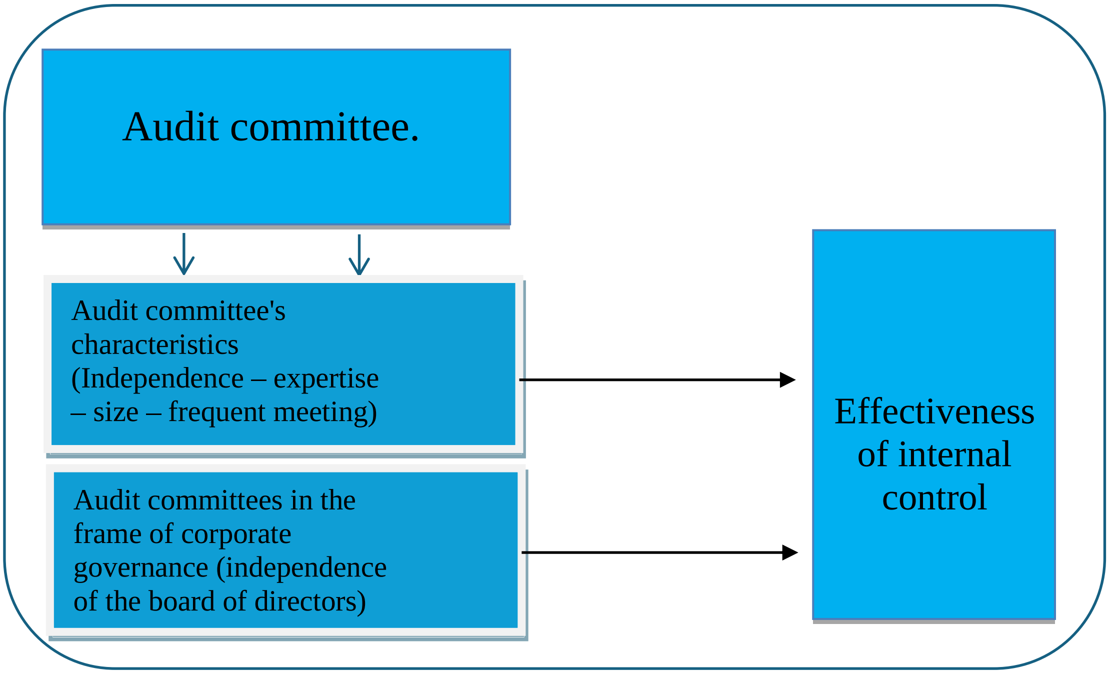
This research aims to achieving the following objectives:

1. Evaluate the role of the audit committees in increasing the level of confidence in the performance of internal control.
2. Determine the extent to which the independence factors, financial and accounting expertise, size, and meetings frequency affect the quality of the performance of the audit committees in enhancing internal control objectives.
3. Highlight on the role of audit committee's performance in enhancing the internal control objectives and the evaluation of recommendations that can contribute to solve the problems that prevent the enhancement of efficiency and effectiveness of internal control.
4. To investigate the obstacles which face the audit committee and their effect on enhancing the internal control objective.

6.Research Methodology:

To achieve the research objectives, and test its hypotheses, a field study will be conducted using a random sample of audit committees of different Egyptian companies and accounting faculty staff. The required data for the study will be collected through a questionnaire.

The following figure presents the research model.



Source: prepared by researcher

7.Literature Review:

Aram Jawhar and Dler Mousa (2017) examine the relationship between the characteristics of the audit committee and the characteristics of the external auditor (independent variable) and financial reporting quality (dependent variable). The study used a sample of Bursa Malaysia companies, which specifically performed in the top one hundred companies based on Bursa Malaysia data. Analysis of annual reports demonstrates the ability (independence, skill, and prudence) of audit committees to predict the quality of financial reporting.
The results show that industry experience has a significant impact on financial reporting quality, but on the other hand, large audit firms have no significant impact on financial reporting quality.

Elias Gebrayel, Hajer Jarrar, Charbel Salloum and Quentin Lefebvre (2018) examine the impact of the audit committee and the impact of the internal audit function on the quality of a firm's financial reporting. In addition, this study focuses on the link between the audit committee and the internal audit function, as well as the quality of firms' financial reporting (as measured by the quality of provisions and absolute discretionary provisions).
The results show that the frequency of audit committee meetings and the presence of an internal audit function have a positive impact on the quality of a firm's financial reporting. Thus, more frequent audit committee meetings provide effective oversight of financial reporting and increase the likelihood of discussing and following up on issues and findings in financial statements and audit reports. Hence, frequent meetings of the audit committee provide a better understanding of the financial statements. Likewise, internal audit is considered an important

corporate governance mechanism that ensures the quality of financial reporting by monitoring organizational risks, assessing internal controls, and detecting potential manipulation, as internal audit evaluates financial procedures. However, the results show that the relationship between else corporate governance mechanisms and financial reporting quality is not significant.

Ling Lei Lisic and Linda A. Myers (2019) investigate whether audit committee accounting expertise helps improve audit quality by incentivizing auditors to conduct diligent internal control reviews and conduct appropriate internal control assessments, as audit committee accounting expertise can protect auditors from negative No dismissal after internal control judgment. Among clients with existing and potential internal control weaknesses (as indicated by future restatements of audited financial statements).
The results show that the likelihood of negative internal control opinions is higher when the audit committee has more accounting expertise (measured by the proportion of accounting experts in the audit committee). For all clients, the study shows that when the audit committee has more accounting expertise, auditors are less likely to be subsequently dismissal for negative internal control opinions. Further analysis of the study also found that auditors were less likely to be dismissal when at least two members of the audit committee had accounting expertise.

Yosra Mnif and Marwa Tahari (2022) discuss the effect of size, independence, and expertise of the audit committee on compliance with the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI's) Financial Accounting Standards (FASs).
The findings show that the size of the audit committee has a

positive impact on compliance with AAOIFI's FASs. The level of compliance is unaffected by the audit committee independence. According to audit committee expertise, there is a positive and significant correlation between compliance with AAOIFI's FASs and accounting financial expertise.
Furthermore, the findings showed that audit committee members with accounting financial and culture expertise are positively and significantly correlated with the level of compliance with AAOIFI's FASs.
Interestingly, findings indicates that member of the audit committee with a combination of culture expertise (expertise in Islamic banking) and accounting financial expertise improves the compliance level more effectively than an audit committee member with only accounting financial expertise.

8.The Audit Committees: An Overview

The Canadian Institute of Chartered Accountants (CICA) audit committee has defined it as: "A committee composed of non-executive directors whose responsibilities are focused on reviewing the annual financial statements before handing them over to the Board of Directors. The Audit Committee is a link between the auditors and the Board of Directors, and its activities are summarized in nominating the external auditor, reviewing the scope and results of the audit, as well as evaluating the company’s internal control system.
Importance of Audit Committee: The primary purpose of a company’s audit committee is to provide oversight of the financial reporting process, the audit process, the company’s system of internal controls and compliance with laws and regulations. (CFA institute, 2022)
The audit committee, management, and the independent auditor all have distinct roles in financial reporting. Management is

responsible for preparing the financial statements, establishing, and maintaining adequate Internal Control over Financial Reporting (ICFR), and evaluating the effectiveness of ICFR. The independent auditor is responsible for expressing an opinion on the fairness with which the financial statements present, in all material respects, the financial position, the results of operations, and cash flows in conformity with GAAP, and, when applicable, evaluating the effectiveness of ICFR. To oversee ICFR successfully, the audit committee should be familiar with the processes and controls management has put in place and understand whether those processes and controls are designed and operate effectively. The audit committee should work with management, the internal auditors, and the independent auditor to gain the knowledge needed to provide appropriate oversight of this area. (Deloitte, 2018, p. 29)

The audit committee, among others, the following responsibilities: monitoring the financial reporting process, monitoring the effectiveness of internal control or internal audit, as appropriate, and risk management of the company, monitoring the statutory audit of annual financial statements and the consolidated annual financial statements, monitoring the independence of the statutory auditor of the company and, primarily, the provision of additional services to the audited company.

The audit committee represents a key element in the corporate governance process. The fight for the integrity of information in the financial statements and confidence in them depends on a balance to be achieved between management pressures, regulators, investors, and the public interest.

Audit Committee characteristics: One of the most important characteristics that must be available in the audit committees so that the committee can play the role for which it was established, according to the recommendations of professional bodies and associations and the proposals of writers and researchers, are summarized as follows:

A. Audit Committee independence

The independence of the members of the audit committees is one of the most important characteristics that must be met, as its presence allows the members of the impartial committee to perform their duties and responsibilities and take decisions without bias. The following is a definition of independence:

Know the New York Stock Exchange (NYSE) and national association of security dealers (NASD): This person is freed from any relationship - from the point of view of the Board of Directors - that may interfere and affect his independent judgment when exercising his role as an audit committee member.

With regards to the effectiveness of the audit committee (AC), it should comprise non-executive directors, who are not related to and are independent from the management. (Ika & Ghazali, 2012, pp. 403-424)

Carson and Simnett (2011, pp. 121-148) argued that independent AC members are a cornerstone for financial reporting process as they promote the quality of financial statements of the firm.

The researcher concludes that the committee member should be independent in form and substance, in accordance with the requirements of the New York Stock Exchange, so the audit committee must be composed of members of the non-executive board of directors, and it must also be objective and completely independent from the organization.

B. Audit Committee industry expertise and financial expertise

Industry expertise of directors was brought to the forefront of the discussion on corporate governance during the latest financial crisis (2008–2009). For example, Citigroup had a lack of finance and investment experts on its board which had a significant adverse effect on its enormous write-downs of mortgage-related asset value. Consistent with agency theory proposition, it has been argued that industry expertise enables directors to better understand the firm's operation and financial conditions, better analyze the relevant information and, therefore, provide better monitoring role. (Alhababsah and Yekini, 2021, p. 17)

Experienced directors tend to be more cognizant and on the lookout for problematic practices. Indeed, directors' knowledge obtained through prior directorships has been shown to increase the effectiveness of monitoring executives' initiatives. Furthermore, this directorship experience was found to be valuable in identifying specific problem areas facing corporations, decreasing the likelihood of corporations being prosecuted for violating environmental laws and reducing earnings management (i.e., legally compliant accounting practices that obscure economic substance. Directors are better able to catch falsification of financial reports if they are also financially competent. Such directors have a more thorough understanding of financial statements and can independently scrutinize the adequacy of financial reports. (Sarbanes-Oxley Act, 2002)

Financial literacy enables them to spot problems in financial reports and skillfully confront executives. Financially savvy directors are also better positioned to make sense of whistleblower complaints and warning signals produced by external auditors. (Gorshunov et al., 2021)

C. Audit Committee size

Based on resource dependency theory, larger audit committees are willing to devote greater resources and authority to effectively fulfill their responsibilities. The complexity of accounting issues requires audit committees to have enough members to achieve their legal responsibilities. In addition, if the audit committee includes members with a broad range of expertise and experience that allows them to undertake different tasks in monitoring financial reporting practices, the committee can be more effective. Therefore, larger audit committees could lead to higher levels of transparency and disclosure, a larger audit committee gives rise to more effective monitoring because it is more likely to possess the essential expertise. In addition, the larger the AC, the more responsibility that can be delegated to the committee and therefore, larger ACs can provide stronger monitoring, leading to a higher level of mandatory disclosure. (Mnif and Tahari, 2022)

D. Audit Committee frequent meeting

The number of meetings held by the Audit Committee reflects the extent of the activity of the Audit Committee and is an influential element in the effectiveness of the performance of the committee and its oversight role.

The meetings are determined according to the size of the company, its responsibilities, and its surrounding circumstances.

The larger the company's size and the complexity of its operations, the more often this led to an increase in the number of times the audit committee meets. (Raghunandan and Rama, 2007, pp. 265-280).

Abbott et al. (2003, pp. 17-32) confirmed that the companies in which the Audit Committee holds four periodic meetings a year, and their financial statements are of a high-quality level, as the meetings positively affect the tasks of the auditor.

Internal Control: includes all the processes and procedures that management puts in place to help make sure that its assets are protected and that company activities are conducted in accordance with the organization’s policies and procedures.

(Sovaniski, 2021, p. 16)
Internal controls can be defined as a process that is influenced by the board of directors, management and employees are designed to provide assurance and capable of ensuring that organizational goals will be achieved through the efficiency and effectiveness of operations, the presentation of financial statements that are trustworthy and compliance with laws and regulations. (Susanto, 2013)
According to COSO (2013) to be another aspect of internal control that reflects the actions established by policies and procedures to guarantee that management directives to mitigate risks to achieving objectives are implemented. (Le et al., 2022, pp. 364-373)
Enterprises should improve the internal control quality and strengthen internal control while reducing the scale of related party transactions, to further improve the accounting information comparability and reduce the risk of financial fraud, provide investors with high-quality financial reporting, and a fair and transparent investment. (Li et al., 2022, pp. 1252-1259)

9.The Role of Audit Committees in Enhancing the Effectiveness of Internal Control

Indicates that it was found that companies that have audit committees with financial expertise (especially financial accounting skills) have a positive impact on the internal control system, and also dealt with the reality of the relationship between the quality of the audit committee and the independence of the auditor and the disclosure of weak control Internal control of companies after the SOX law, where he sees that companies that have audit committees with financial expertise, are less likely to experience internal control problems. (Fakhari et al., 2018)

The audit committees with the most efficient members in the financial aspects are more able to discover the weakness of the internal control. (Bruynseels et al., 2016)

It was found that the establishment of effective internal control leads to a decrease in the opportunistic behavior of managers and an improvement in the quality of profits. (Faghani and Pahlavan, 2018)

As indicated by Doyle et al. (2007, pp. 1141-1170) found that material weaknesses in internal control are likely to be found in smaller, younger, financially weaker, more complex companies that are growing rapidly or experiencing restructuring.

The Sarbanes-Oxley Act of 2002 and the Securities and Exchange Commission (SEC) rules introduced to conduct the directions of the Act indicate that improving corporate internal control is an important policy initiative. The SEC now requires CEOs and CFOs to certify annually and quarterly the effectiveness of their corporate internal control. (SEC, 2002)

Further, the SEC has announced rules for the implementation of Section 404 of the Sarbanes-Oxley Act, requiring every registrant to include an internal control report in its annual report, and its independent auditor to issue an "attestation report on management's assessment of the company's internal control over financial reporting". (Krishnan, 2005, pp. 649-675)

ISA 315 states that the process designed and performed by those charged with control, management, and other employees to provide reasonable assurance about the achievement of the entity's objectives relating to the reliability of financial reporting, the effectiveness and efficiency of operations, and compliance with applicable laws and regulations. (IFA, 2007)

Crises and high-profile corporate failures have always been followed by reflections on the adequacy of corporate governance. Therefore, we expect companies to further strengthen their governance arrangements after the crisis, and audit committees are likely to be an important part of this effort (Ghafran et al., 2022).

That audit committees have played a substantial part in avoiding, or at least limiting, accounting scandals and discretionary management behavior (García-Meca et al, 2021, pp. 223-235) as indicated by Millstein & MacAvoy (1999, pp. 8-20), DeZoort & Lord (1997, pp. 28-86) and Pincus (1989) the best control over companies is through the presence of an audit committee, and it is a direct line of communication between the board of directors and the external auditor and contributes to alleviating the problem of information asymmetry. An effective audit committee can help close the expectations gap by monitoring management and improving the independence of the external auditor. The results of the studies concluded that audit committees have become an important part of corporate governance. Therefore, audit committees are considered a valuable tool of governance tools, but one of the mainstays in its success.

10.Test of Hypothesis:

To measure the role of Audit Committees in Enhancing the Effectiveness of Internal Control in Egyptian Companies a correlation analysis was conducted between audit committees as an independent variable and the effectiveness of internal control as a dependent variable. The effect of this was then measured through a regression model.

The study population consists of auditors of joint-stock companies listed on the Egyptian Stock Exchange and faculty members at Egyptian universities. A random sample of 384 questionnaires was selected, and the number of questionnaires returned was 372, four questionnaires that were not suitable for analysis were excluded, which represents 95.8% of the total forms sent, and thus the number of questionnaires reached 368 forms.

Based on the nature of the data and the approach followed in the study, it was found that the survey list is the most appropriate tool. The study tool was built by referring to literature and previous studies related to the subject of the study. To achieve the objectives of the study and analyze the data collected, several appropriate statistical methods were used using the statistical packages for social sciences, which is abbreviated as SPSS: Frequencies and percentages, Cronbach's Alpha coefficient, T-test, Pearson test and ANOVA test to measure the study hypotheses.

Testing the first hypothesis:

- There is a significant correlation between the audit committee characteristics and effectiveness of internal control.

Table No. (1) relationship between Audit committee characteristics and Effectiveness of internal control Correlations

		Audit committee characteristics	Effectiveness of internal control
Audit committee characteristics	Pearson Correlation	1	.434**
	Sig. (2-tailed)		.000
	N	368	368
Effectiveness of internal control	Pearson Correlation	.434**	1
	Sig. (2-tailed)	.000	
	N	368	368

Table No. (1) shows the relationship between audit committee characteristics (independent) and effectiveness of internal control (dependent) where the moral percentage reached

(0.000), which is less than (0.05), which indicates the existence of a moral relationship and therefore accepting the hypothesis that there is there is a significant correlation between the audit committee characteristics and effectiveness of internal control.

The following table shows the impact of the relationship between the two variables:

Table NO. (2) ANOVA

Estimates			Sig.	F	R_2 Adjusted	R_2
Sig.	T	β				
0.000	9.217	0.782	0.000	84.959	0.186	0.188

Table No. (2) shows a strong degree of influence due to the significance of the value of F and T, which reached (0.000), which is less than the level of significance (0.05). The adjusted R2 value indicates that 18.6% of the independent variable explains the dependent variable.

Testing the second hypothesis:

- There is a significant correlation between the audit committee framework of corporate governance and effectiveness of internal control.

Table No. (3) relationship between Audit committee framework corporate governance and Effectiveness of internal control Correlations

		Audit committee framework corporate governance	Effectiveness of internal control
Audit committee framework corporate governance	Pearson Correlation	**1**	**.635****
	Sig. (2-tailed)		**.000**
	N	**368**	**368**
Effectiveness of internal control	Pearson Correlation	**.635****	**1**
	Sig. (2-tailed)	**.000**	
	N	**368**	**368**

Table No. (3) shows the relationship between Audit committee framework corporate governance (independent) and effectiveness of internal control (dependent) where the moral percentage reached (0.000), which is less than (0.05), which indicates the existence of a moral relationship and therefore accepting the hypothesis that there is a significant correlation between the audit committee framework corporate governance and effectiveness of internal control.

The following table shows the impact of the relationship between the two variables.

Table No. (4) ANOVA

Estimates			Sig.	F	R_2 Adjusted	R_2
Sig.	T	β				
0.000	15.745	1.171	0.000	247.907	0.402	0.404

Table No. (4) shows a strong degree of influence due to the significance of the value of F and T, which reached (0.000), which is less than the level of significance (0.05). The adjusted R2 value indicates that 40.2% of the independent variable explains the dependent variable.
So, the result reached the acceptance of the research hypothesis, which means that the presence of audit committees in Egyptian companies enhances the effectiveness of internal control.

11.Research Conclusion:

After discussing the theoretical framework of the audit committee, the effectiveness of internal control, the role of the audit committee in enhancing the effectiveness of internal control in Egyptian companies, and based on the field study results, the following can be concluded:
- The formation of audit committees was done for the purpose of helping the Board of Directors to conduct its tasks efficiently and effectively, through the availability of a set of mechanisms and components that represent the general framework for their activation, as well as their duties.
- The Audit Committee works to limit the negative effects of unethical practices, such as practicing earnings management policy.

- After the financial scandals that large companies were exposed to, which resulted in cases of the collapse of those companies and their exposure to bankruptcy, it was found that audit committees are an effective means of avoiding those mistakes again - that audit committees played a major role in avoiding, or at least reducing, accounting scandals and behavior.
- The major crises and failures that companies witness is often followed by reflections on the adequacy of corporate governance. Therefore, we expect companies to strengthen their governance arrangements post-crisis, and audit committees are likely to be an important part of this effort.

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