Corporate Governance Role of Audit Committees in the Banking Sector: Evidence from Libya

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Abstract—This study aims at identifying the practices that should be taken into consideration by audit committees as a tool of corporate governance in Libyan commercial banks by investigating various perceptions on this topic. The study is based on a questionnaire submitted to audit committees ‘members at Libyan commercial banks, directors of internal audit departments as well as members of board of directors at these banks in addition to a number of external auditors and academic staff from Libyan universities. The study reveals that the role of audit committees has to be shifted from traditional areas of accounting to a broader role including functions related to financial reporting, audit planning, support the independence of internal and external auditors, acting as a channel of communication between external auditors and board of directors, reviewing external audit, and evaluating internal control systems. Although the study is a starting point in developing a framework of good audit committees’ practices in Libya, it is believed that the adoption of its results can result in enhancing the corporate governance practices not only in the banking sector but also in the entire corporate sector in Libya.

Keywords—Audit committees, Corporate Governance, Commercial Banks, Libya.

I. INTRODUCTION

Corporate governance is defined as “the system by which companies are directed and controlled” [1]. In recent decades, the use of this notion has broadly spread in the areas of academia and policymaking. More recently, the interest in corporate governance has been increasingly growing as a result of the collapse of many large companies around the globe such as; Enron and WorldCom in the US, HIH in Australia, Parmalat in Italy. The corporate governance concept relates to a wide range of activities, rules, guidelines, processes and procedures that aim to ensure that the companies’ resources are optimally managed and employed by boards of directors which, in turn, lead to achieve the stated objectives of the companies and eventually protect the interests of corporate stakeholders. As such, it is reported that investors are increasingly basing their investment decisions on the records of the companies’ corporate governance and are willing to pay more for shares of companies which are well-governed and reluctant to do so for shares of poorly governed companies with comparable financial results [2]. Thus, this explains why good corporate governance is seen as a sign of strength whereas poor corporate governance is perceived as risky [2], [3].

In addition to both internal and external auditing audit committees have a significant role in improving the quality of corporate governance system [4], [5]. In this respect, within the company the role of the audit committee is central as a supervising body which has the ability to provide a carefully monitoring of the process of financial reporting and ensuring that the audited financial statements are reliable [6]. Moreover, through their role in supervising the financial reporting process audit committees also enhance the quality of information flow between the company owners (shareholders and potential shareholders) and the managers [7], [8].

In Libya, as in many other countries in the region, the banking sector has witnessed significant changes over the past few years. The entry of international banks such as the European bank “BNP Paribas” and the Jordanian bank “Arab Bank” exemplifies just one of those changes. This is in addition to adopting the recommendations of Basel Committee on Banking Supervision’s Accord which set standards for capital adequacy and sound banking practices. These changes have put more pressure on domestic banks to be able to grow and compete. Essentially, good corporate governance practices are supposed to positively and greatly affect their performance and hence building effective competitiveness [9].

Taking into consideration the significant importance of the banking sector in the current transitional period taking place in the country in addition to the vital central role of audit committees in the corporate governance system this paper attempts to examine the potential role of audit committees in activating the methods of corporate governance, with a special focus on Libyan commercial banks by investigating different perceptions and opinions over the practices of audit committee that should be taken into account for an integrated framework of good practices in the context of corporate governance.

The remainder of this paper is structured as follows: Section II briefly reviews the related literature on audit committees and their role as a corporate governance mechanism. Section III presents the methodology employed. Section IV reports the empirical findings. Finally, a summary of the results and a conclusion of the study are presented in Section V.

II. LITERATURE REVIEW

As a result of the collapse of many large companies around the globe and the associated questions about the role of accounting and auditing in such collapses as in the case of the collapse of the American company of energy “Enron” and the role of the external auditor “Arthur Anderson”, and the legal proceedings against the company of “KPMG” with respect to the accounting and ethical issues at “Xerox” in the late 1990s
there has been an increasing importance of implementing corporate governance mechanisms in which auditing in general and audit committees in particular have a vital role to play [9].

Definitions of audit committee can be found in a number of reports and studies. For instance, the Canadian Institute of Chartered Accountants defines audit committee as “a committee of directors of an organization whose specific responsibility is to review the annual financial statements before submission to the board of directors. The committee generally acts as liaison between the auditor and the board of directors and its activities may include the review of nomination of the auditor, overall scope of the audit, results of the audit, internal financial controls, and financial information for publication” [10, p. 20]. Another definition is that of Arthur Anderson (1992) which states “an audit committee is a committee of directors who are charged not with the running of the business but with overseeing how the business is controlled, reported on and conducted”[11, p.5].

The reasons for establishing audit committees were discussed by Bradbury [12]. These reasons include contributing to the reliability of audited financial statements; assist the board of directors in fulfilling their responsibilities, and enhancing and ensuring the independence of the external auditor. In another study based on the American experience Cobb [13] explored the drives of audit committees’ formation in the US during the 1980s. In spite of some disagreement among commentators regarding such drives the study was able to identify four main objectives for the formation of such committees, namely, the reduction of illegal activity, the prevention of fraudulent financial reporting, reduction of board liability, and establishing links between the external auditor and the board of directors. In the UK, the results of a survey conducted by Marrian [14] showed that financial collapses was the main reason for the formation of audit committees in the country. Interestingly, following fashion was another reason revealed by the participants in that study.

In line with establishing audit committees their structure has received special focus. According to the Australian Stock Exchange Corporate Governance Council [15] audit committee should be structured to consist of no less than three members from only non-executive directors among them an independent director, who is not the chairperson of the board with at least one member who has financial expertise. In the same vein, Cadbury Report [1] emphasized the importance of audit committee’s structure and membership to effectively accomplish its role. The report stressed that the membership should be a minimum of three members and should be confined to non-executive directors of whom the majority should be independent.

In the context of corporate governance audit committees are considered as an essential element of effective corporate governance [16], [17]. As such, the establishment of Audit committees has been mandatory in many countries [18]. A significant number of studies mainly took place in Western countries have studied various dimensions of audit committees’ role in corporate governance. Next are some examples of such studies.

Typically, the main role of audit committee was, almost exclusively, to supervise the process of financial reporting. However, recently as a tool of corporate governance audit committee’s role has been expanded to be, in general, concerned with all aspects of corporate governance. This is reflected, for example, in the report of the South African Institute of Chartered Accountants [19] which states (p. 6):

“The establishment and operation of an effective audit committee assists directors in the discharge of their duties relating to the safeguarding of assets, the operation of adequate systems and controls, risk management, and the preparation of financial statements. An audit committee’s overriding objective is to see that management has created and maintained an effective control environment in the organization”.

In consistent with this, Porter [20] emphasized that in the context of corporate governance audit committees are expected to perform a broader role. This role includes, according to Porter [20], supervising the internal and external audit functions making sure that these functions are properly coordinated. Moreover, audit committees are responsible for evaluating the company’s internal control, risk management, and environmental management systems. This is in addition to monitoring the company’s compliance with legal and regulatory requirements.

The study of Bhasin [16] strongly recommended that in addition to their role in enhancing external auditor independence and improving transparency in financial reporting audit committees must be given the role to approve and review audit fees. Therefore, audit committees can be effective in neutralizing the bias of management influence on the negotiations with external auditors. Likewise, in the context of external auditing, audit committee should review with executive management and the external auditors the company’s financial statements, and based on the conclusions of the external auditor make a recommendation to the board for these financial statements to be approved then published [21].

The experience with internal controls was included in the new definition of audit committee expertise introduced by the American Securities and Exchange Commission (SEC) [22]. According to Turley and Zaman [23] after reviewing financial statements, internal control evaluation is ranked as the most important duty for audit committee. Similarly, surveying a randomly selected sample of audit committee charters Carcello et al. [24] found that the majority of audit committees claim that reviewing the entity’s internal control is one of their responsibilities. Zaman [25] argued that audit committees are expected to regularly receive internal control reports form management and review them. When reviewing those reports, the author added, a number of factors should be considered. Those factors are:

- Consider what are the significant risks and assess how they have been identified, evaluated, and managed;
• Assess the effectiveness of the related system of internal control in managing the significant risks particularly any failing or weaknesses of significant in internal control system that have been reported;
• Considering whether that are necessary to remedy any significant failing or weaknesses are being promptly taken; and
• Consider if the findings indicate that a more extensive monitoring of the internal control system is needed.

The National Commission on Fraudulent Financial Reporting (NCFFR) [26] in the US advocated that the appointment and dismissal of the chief internal auditor should be reviewed by audit committees. Puri et al. [27] examined the effectiveness of audit committees as a tool of corporate governance in ten companies belong to the Indian corporate sector. The results of the study showed that in all the companies under study audit committees properly reviews internal auditors’ performance. However, the effectiveness of follow up system varies from company to company.

Emphasizing the importance working relationship between audit committees and internal auditing in preventing financial reporting problems Scarbough et al. [28] empirically examined the interaction between the two bodies in the context of the Canadian manufacturing companies. The results revealed some aspects of this interactive relationship that can lead to enhancing the effectiveness of audit committees. These aspects are; the involvement of audit committee in dismissing the chief internal auditor, regular meeting, three or four times a year, with the chief internal auditor, and reviewing both the internal auditing program and the internal auditing results.

As a tool of corporate governance audit committee also has a role in risk management. Turley and Zaman [23] ascertained that audit committees should be responsible for reviewing the management’s assessment of internal and external business risks. Moreover, audit committees perform corporate governance in India were found effectively managing the future risk by using ‘whistle blow’ policy which cautions all the concerned parties about the uncertain happenings in future that may include fraud [27]. Furthermore, Vera-Muñoz [29] concluded that good corporate governance requires an effective audit committee whose members have a general understanding of the company’s operations and financial risks.

A reach detailed study by Braiotta et al. [21] dedicated a very extensive and valuable work to the role of audit committee and its practices in the context of corporate governance. Based on sections 205 and 301 of the Sarbanes-Oxley Act (SOX) of 2002, the authors highlighted the major roles for audit committees in corporate governance:

- The audit committee has oversight responsibility for the accounting and financial reporting processes of the company and for its financial statements audited;
- The audit committee is responsible for appointing, compensating and supervising the external auditor;
- The audit committee must establish the procedures for solving different complaints about accounting, internal control or auditing matters, ensuring in the same time the confidentiality for different questionable accounting or auditing issues submitted by employees;
- The audit committee also should ensure that the company has the appropriate systems implemented for the effective monitoring and management of risk.

III. METHODOLOGY

In order to achieve the objective of this study a questionnaire was chosen and employed as a method for data collection. The questionnaire was developed based on some prior studies e.g. Al-Muneeef and Al-Hameed [30]. The targeted participants in this study were audit committee members in the major four Libyan commercial banks namely; Wahda Bank, Sahara Bank, Jumhouria Bank, and the National Commercial Bank in addition to directors of internal audit departments as well as members of board directors at these banks. Also a number of external auditors and academic staff participated in the study.

Three different aspects in relation to activating the role of audit committees in the context of corporate governance in Libyan banks were covered by the questionnaire. These aspects were; the criteria for audit committee composition, the characteristics of audit committee members, and audit committee’s role, duties and responsibilities. However, specifically, the objective of this paper is to present the results regarding the third part which is audit committee’s role and good practices in the context of corporate governance. As such, the results with regard to the first two parts; the criteria for audit committee composition as well as the characteristics of audit committee members will be presented and discussed in another study.

The questions about audit committees’ practices of corporate governance in the Libyan banking system covered four areas. These areas were; the role of audit committee in financial reporting, the role of audit committee in supervising internal audit and internal control systems, its role in overseeing external audit, and finally audit committee’s role in risk management. To enable respondents to express their agreement or disagreement about the proposed functions of audit committees the statements in the questionnaire were given five possible answers on a Likert-scale ranging from 5 (Strongly agree) to 1 (Strongly disagree). In addition to the ones mentioned within the questionnaire, all the respondents were offered the opportunity to propose other practices of audit committees to enhance the practices of corporate governance in the Libyan banking sector.

A total of 37 questionnaires were distributed using E-mail addresses of the targeted participants wherever applicable, otherwise the questionnaire was self-administrated by the researcher with the assist of some friends who have close relationships with some of the targeted respondents. Fourteen questionnaires were received of which (100%) were valid and usable questionnaires were making a response rate of (37.8 %). Considering the fact that this study is the first of its kind based on the Libyan context regarding audit committees in
general and their role in corporate governance in particular, a response rate of (37.8%) can be considered as relevant.

IV. FINDINGS

Following the structure of the questionnaire this section is divided into four sub-sections each of which briefly discusses the participants’ responses regarding the proposed functions of audit committees in Libyan commercial banks in the areas of overseeing the financial reporting process, supervising internal audit and internal control systems, overseeing external audit, and finally participating in the risk management respectively.

A. Oversight the Financial Reporting Process

From the point of view of the respondents the best practices of audit committees in supervision the process of financial reporting in the Libyan banking sector should include new unconventional functions. Approximately (86%) of the participants agreed that audit committees checking and reviewing the accounting standards and policies adopted and employed when preparing the annual financial statements of the bank to be included as an audit committee practice of corporate governance. Exactly the same situation was for another audit committee practice which entails ensuring the adequacy and quality of the information annually displayed in the financial statements of the bank for both internal and external users. Another audit committee function that had a high agreement rate among the respondents (71.4%) was the function that requires audit committee in the bank to periodically (each three months) report to the board of directors informing its work progress and its recommendations. The highest rate of agreement in this section (100%) was for the statement suggests that during the process of financial reporting audit committee should monitor the compliance with the legal framework applied, including the ethical code specific for the bank. However, only a mere of (14.3%) of the respondents agreed that audit committee report to the board of directors regarding the status of corporate governance practices in the bank should be amongst the duties of audit committees while the remainder chose either disagree or neutral.

It can be noticed that all the proposed functions of audit committees included in this section, with the exception of reporting on corporate governance practices, had high rates of agreement ranging from (71.4%) to (100%). This is consistent with audit committee literature which emphasizes the important and significant role of audit committee with respect to improving the financial reporting outputs and prevents the fraudulent financial reporting which was a main cause of the high profile corporate collapses.

B. Supervising Internal Audit and Internal Control Systems

Both of the proposed functions; the board of directors of the bank should authorize audit committee to ensure the quality and effectiveness of the internal control systems and ensuring the necessary independence for the internal audit function that enables it achieving its objectives with respect to disclosure and transparency had a high rate of agreement (85.7%). All the respondents chose either strongly agree or agree as an answer to the suggested task that audit committees should review internal auditing reports. Similarly, (100%) of the participants agreed audit committees to ensure the recommendation issued by the internal auditor are seriously considered by the board of directors of the bank. However, the statement proposes audit committees to be involved in the selection, appointing and dismissing the employees in the internal audit department within the bank had a low percentage of agreement equals to just (14.3%).

Referring to the responses regarding audit committee’s role in supervising both internal audit and internal control systems in the bank it is obvious that review and evaluate of the effectiveness of internal control systems, interaction with internal audit reflected in reviewing the internal audit program and ensuring internal auditor’s recommendations are going to be considered by the board were rated very highly by the respondents. As such, the results presented in this section indicate the importance and significance of the interaction between audit committees and internal audit including internal control systems in enhancing the corporate governance process in the banking system.

C. Overseeing External Audit

More than two-thirds of the respondents (85.7%) advocated audit committees reviewing and discussing the program and scope of external auditing and the duration for it which are proposed by the external auditor. The proposed function that audit committee monitors external auditor’s independence and objectivity was supported by (71.4%) of the respondents. Audit committee at the bank overseeing and evaluating the work of the external auditor, likewise, had a high rate of agreement of (71.4%).

Intriguingly and in the contrary to the expectations, audit committee to be responsible for developing procedures and policies regarding the contractual provisions referring to the non-audit services provided by the external auditors ensuring that they would not affect the independence of the external auditor was only supported by (28.6%) of the respondents. Whereas, other proposed functions such as; acting as a communication channel between the board of directors and the external auditor, participating in selection and appointing the external auditor as well as discussions and recommendations of audit fees had a higher rate of agreement each with (85.7%) and (71.4%) respectively.

To a large extent the perceptions of the participants of the interaction between audit committees and external audit function are in line with those suggested by the literature. In this context, the key feature of this role is reviewing with the external auditors and executive management the financial statements of the bank and based on the external audit’s conclusions the committee to make a recommendation to the Board for these financial statements to be approved and published.
D. Risk Management

In stark contrast to what is documented in the corporate governance literature with respect to audit committees playing a role in risk management, this role was entirely omitted by the respondents in this study. A high number of the respondents (71.4%) disagreed with the suggestion that audit committees in Libyan commercial banks have any role in neither identifying nor evaluating operation risk. This can be attributed to the fact that the Central Bank of Libya in 2010 has assigned all functions pertaining to risk management in the bank to another independent committee within the bank which is risk management committee. However, the only proposed function in this section that received high rate of agreement was audit committee of the bank to be responsible for overseeing and reviewing the risk management report.

V. Conclusion

This study examines the potential role of the audit committees in activating the methods of the corporate governance, with a special focus on Libyan commercial banks. The society of the study was composed of all members of audit committees at Libyan major commercial banks, directors of internal audit departments as well as members of board directors at these banks. In order to offer a broader picture of these practices also a number of external auditors and academic staff participated in the study. The data collection method used was questionnaire. The study concluded that the role of the audit committees at Libyan commercial banks is to activate the corporate governance through; the supervision on preparing the financial reports, supervision upon the internal audit and the systems of the internal control, beside the supervision upon the external audit, in the meantime there was omission of the role of the audit committee in risk management.

Whilst this study demonstrates the importance of the potential role of audit committees in activating the methods of corporate governance, it has focused only on major Libyan commercial banks. Consequently, even though banks in general have many similarities, the generalizability of this study is limited. Wider research of other contexts within Libya and beyond is needed to illuminate further the influence of social and cultural factors, communication and greater technological unification on the practice of this issue. It would be useful to replicate the study in other private sectors within Libya. The use of a questionnaire, while revelatory at one level, limits the interpretation of data. A different theoretical approach, or different research methods, for example, a larger style of survey or a different kind of qualitative study, could provide different or additional insights.

This study has the ability to increase awareness of the role of the audit committees in activating the methods of the corporate governance and its potential contribution to economic development at the macro and micro levels and is a starting point for making a difference in Libya. It provides a contribution to practical knowledge of the role of the audit committees in activating the methods of the corporate governance in developing countries with special reference to Libya.

Most previous research in this area has focused on the suitability of audit committees in meeting controlling needs, with little attention being paid to addressing how these audit committees can be made more useful in decision-making, planning and control. By identifying issues in the Libyan environment, acknowledging the present of powerful global influences, the way forward to use audit committees in a more significant way can be identified. This study acknowledges that the challenge for developing countries, such as Libya, in activating the role of audit committees, is to adapt them successfully to their own regulatory, legal, political, cultural and religious setting.

REFERENCES


