

The Audit Committee in Jordan

Jordan Securities Commission, Act No. 25

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Abstract

This paper studies the Act No. 25 of Jordan Security Commission, which is talking about the Audit Committee. It's about the regulation and practice of the audit committee in the Jordanian environment. I focused on the Act itself comparing it, whenever I could, with other regulations especially in US, Canada, Australia and UK.

The main problems found in this act are:

- 1- It failed to give the members of the committee the independence required to enable them working effectively.
- 2- The act, also, failed in determines the qualifications and authorities given to these members.

And, some other problems and matters that are discussed inside... I agreed with some changes proposed. And, I made some proposals...

Audit Committee

Most worldwide practices and writings define an Audit Committee as:¹

A committee that consists of several of the organization's outside directors, i.e., directors that are not employed by the organization in another capacity. It has three main objectives:

- 1- Overseeing policies and practices of the organization.
- 2- Support the effectiveness of the organization's internal control.
- 3- Alert the board of directors to problems before they become serious.

U.K., Australia, and Canada require that every company, whose stocks are publicly traded, have an audit committee.

[U.K.	Cadbury Committee Report 1992 & Hampel Committees]
[Australia	ASX Listing Rule 4. 10. 2]
[Canada	McDonald Commission & TSE]

In USA, the New York Stock Exchange and the American Stock Exchange require that companies listed on those exchanges have an audit committee.

In 1998, Jordan Security Commission issued its Act No. 25. This act requires companies (that issue stocks) have an audit committee. Also, this act determines the work and responsibilities of this committee.

In this paper, I'll just concentrate on the main aspects of this act of Jordan Security Commission.

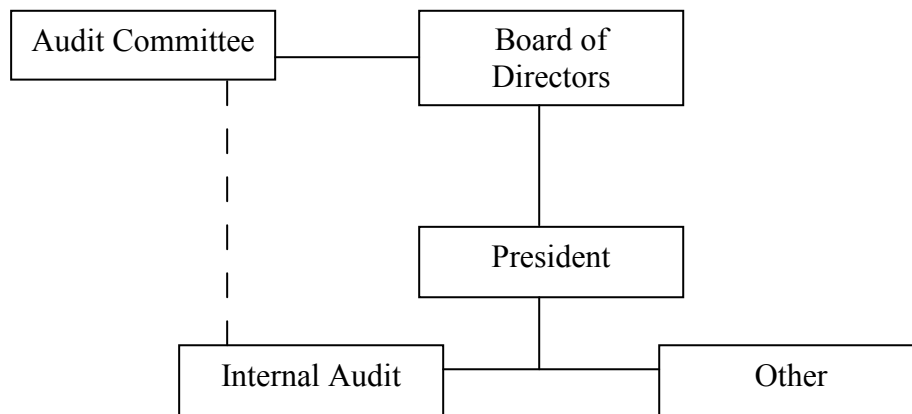
Act No. 25²

- A- Board of directors of a company (that issues stocks) has to form an audit committee at the start of each year. This committee consists of three non-executive members of the board. The Jordan Security Commission has to be informed of this formation, any changes occur relating to it, and the reasons of such changes.
- B- Audit committee is to meet frequently and to submit reports to the board of directors. These meetings not to be less than four times a year.
- C- This committee has the right to ask any employee for any information it needs. Employees have to cooperate with the committee. Also, the committee has the right to use managerial, financial, and legal services from any outsider consultant.
- D- The duties of this committee are:
 - 1- Study and analyze the results of the work of the independent auditor and the internal auditor. Or, study any thing the committee realizes its importance.

- 2- Study the notes of the independent auditor relate the internal control system of the company, and the company's replies to these notes.
- 3- Study the periodic financial reports before they get the approval of the board of directors; especially, the accounting policies and any changes made to them, substantial changes proposed by the auditing procedures, and the extend of the company's compliance with the instructions of the Jordan Security Commission.

Starting with the material No. A of this act, we can see that the board of directors form the audit committee!! This conflicts with the main objectives of the committee. How would it be independent if the board of directors formed it?!

The normal and beneficial position of the audit committee in the organization chart must be like this:³



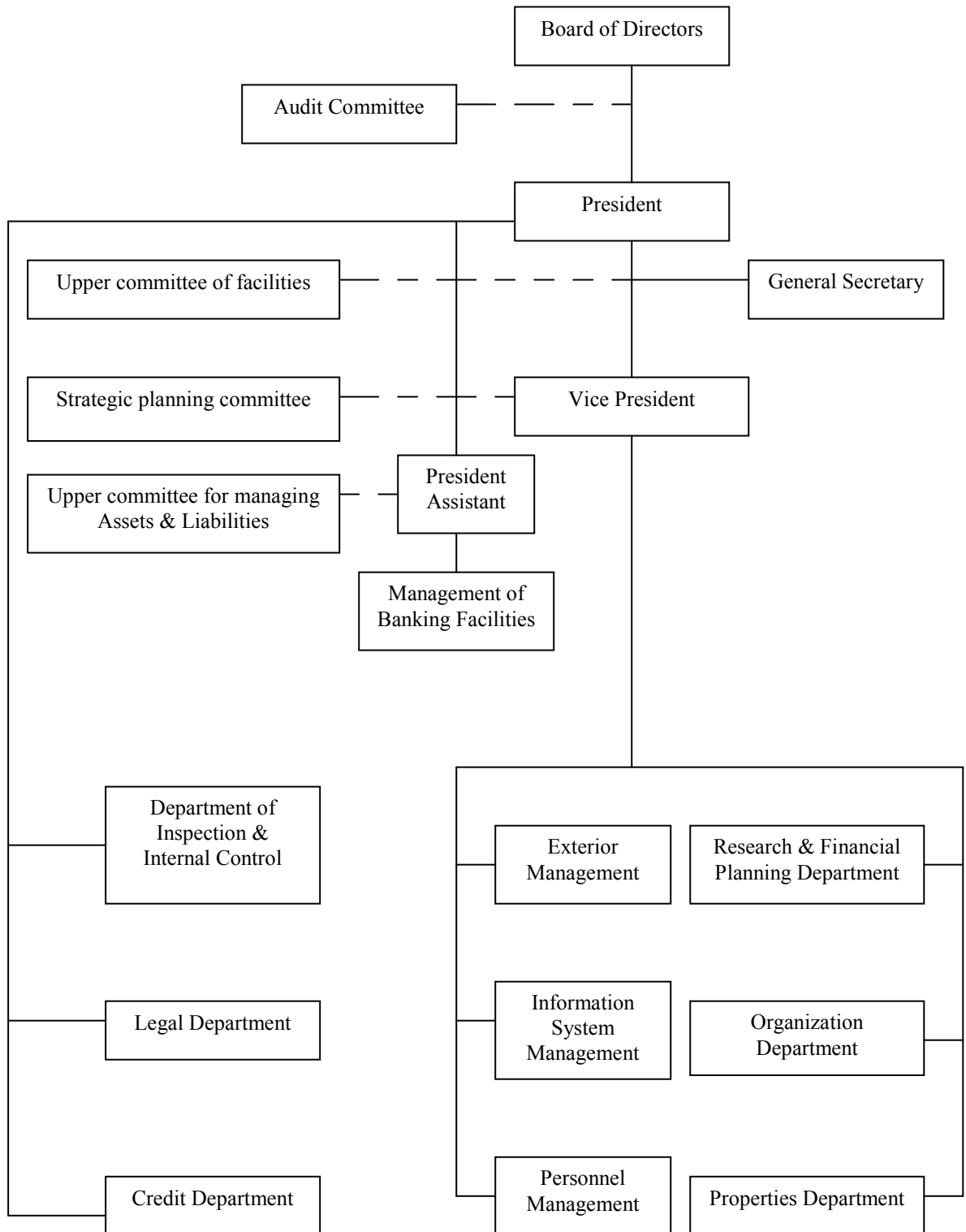
In such position, audit committee can practice its work more effectively. It won't be under the control of the board of directors.

Professor Ahmad Hilme Jomooa mentioned some shortages relating to the control given by law to the board of directors:⁴

- 1- The board of directors forms the audit committee.
- 2- The law doesn't specify the sources that support the committee works.
- 3- No qualifications have been specified for the members of the committee.
- 4- Costs of the committee exceed the benefits of it.

I guess that the final shortage is the reason of why only 29 corporations out of 163 in Jordan are applying this act⁵. These 29 corporations have an audit committee.

Talking about applying this regulation, I expected that some big companies in Jordan would modify the position of the committee in the organization chart. For example, Arab Bank made the following organization chart:⁶



Giving it more thinking, one may argue that it's better for the audit committee not to be at the same level with the board of directors. There would be another board of director!!

This may be considered because the Act No. 25 has only determined the duties of the committee. It hasn't determined the authorities given to the committee.

Act No.25 determined that the member of the audit committee is to be non-executive. This is the main definition of the independent member of an audit committee. This definition was recommended by many agencies in the world.⁷

Recommendation	Report or source of recommendation
Audit Committee to be composed solely of independent directors (non-executive)	<ul style="list-style-type: none"> • Treadway (1987) • Macdonald Commission (1988) • Cadbury (1992) • Public Oversight Board of SEC • Practice Section of AICPA (1993) • Hilmer (1993) • Toronto Stock Exchange (1994) • AIMA (1995)
Audit Committee to be composed of a majority of independent (non-executive)	<ul style="list-style-type: none"> • Bosch (1990), (1993), (1995b) • Price Waterhouse & ASCPA (1990) • Ernst & Young (1992) • ASCPA/ICAA Joint Working directors Party (1993) • ASX (1995) Listing Rules Appendix 33 indicates that where an audit committee exists disclosure should be made of the name of the committee members.

The table above, also, indicates that some agencies recommended the independence in the majority of the audit committee members (Not all of them).

Actually, 97.9 % of all audit committees for the large US firms have *at least* one independent.⁸

But, some papers argue the opposite. For example:

- The presence of insiders (executive directors) on an audit committee has a significant negative impact on audit committee activity.

[Paul Collier (Uni. of Exeter, UK) & Alan Gregory (Uni. of Glasgow, Scotland) (1996). "Audit committee activity and agency costs". Paper presented at the 19th Annual Congress of the European Accounting Association, Bergen, Norway.]

- The greater the percentage of affiliated directors on the audit committee, the lower the probability the auditor will issue a going-concern report.

[Josef Carcello & Terry Neal (1997). "Audit committee characteristics and auditor reporting". University of Tennessee.]

- Contrary to popular suggestions, directors share ownership might cause non-compliance with accounting and financial reporting standards.

[Jihe Song & Brian Windram (2000). Benchmarking audit committee effectiveness in the UK. Napier Uni.]

- There is a negative correlation between the financial reporting quality measures and the presence of insiders on the audit committee.

[David W. Wright. Evidence on the relation between corporate governance characteristics and the quality of financial reporting. Uni. of Michigan]⁹

Any way, the act No. 25 in Jordan has exceeded this problem by requiring that the three members of the audit committee are to be non-executives. But, it failed when it gave the board of directors the authority to form the audit committee. And, I agree here with Prof. Ahmad Hilmee Jomooa: Keeping the act in its existent format means that costs of the committee exceed the benefits of it!

So, the act No. 25 in relating to formation of Audit Committee should be changed in a way that cancels the full authority given to the board of directors in formation the committee. Here, Prof. Ahmad Jomooa recommended:¹⁰

The audit committee consists of the non-executive members of the board of directors. Choosing the members of the committee and determination of their work to be determined by the Companies Controller in Jordan. This choosing made by the controller is upon a proposal of the company's board of directors.

I agree that members must be non-executive. But, I'd prefer that these members not to be members of the board of directors, depending on a definition of the independence given by the Blue Committee:¹¹

An independent committee member is one who has no relationship to the corporation that might interfere with the exercise of independence from management and the corporation.

Finally, *Just for comparison*, material A specified the members' number of the audit committee to be three. In Canada, also, most audit committees required by statute must have at least three members.¹² The Blue Ribbon Committee recommended that the number to be at least three. The Blue Ribbon Committee comments:¹³

It should be small enough to allow all members to participate actively, yet large enough to represent a balance of views.

About the Material No. B, it requires the meeting of the audit committee not to be less than four times a year.

The act did it well by issuing such a material. One of the important points in evaluating the audit committee is the frequency of its meetings. Other worldwide agencies determined less than these numbers of meetings:¹⁴

Recommendation	Report or source of recommendation
At least one meeting with one external auditor to be held without any executive board member present	<ul style="list-style-type: none"> • Bosch (1990), (1993), (1995b) • Cadbury committee (1992) • Hilmer (1993) • Public Oversight Board of SEC Practice Section of the AICPA (1994) • AIMA (1995)
Meetings to be held at least twice each year and preferably more frequently	<ul style="list-style-type: none"> • Hilmer (1993) • Ernst & Young (1992) • KPMG (1995)

In worldwide practice, many committees meet quarterly to review interim financial statements.¹⁵

One paper finds that the number of audit committee meetings is positively related to audit committee independence.

[April Klein (2000). Causes and consequences of variations in audit committee composition. New York University]

Another paper finds that audit committee meeting frequency reduce the probability of standard violations in financial reporting.

[Jihe Song & Brian Windram (2000). Benchmarking audit committee effectiveness in the UK. Napier Uni.]

It's not a matter of how many meetings the audit committee manages. It's a matter how much these meetings are effective. Prof. Ahmad Jomoaa suggests that the material B of the act No. 25 to be maintained; adding that the first meeting is to be start on Sep. 1 of each year. Usually this date is the time for starting the auditing procedures.

For material No. C, Prof. Ahmad Jomoaa thought that it's good and no changes to be made on it.

Material No. D. Here, we can argue that the existence (itself) of an audit committee doesn't mean that things are going well! Many things are supporting the effectiveness of an audit committee. We discussed the independence and number of meetings. Qualifications of the members of an audit committee and determination of the duties and authorities they have are an important factor in evaluating the effectiveness of an audit committee.

The COSO report (Committee of Sponsoring Organizations of the Treadway Commission in the US) indicates that most audit committees of the companies in which fraud was found lacked members who were certified in accounting or who had work experience in key accounting or finance positions.¹⁶

The act No. 25 didn't mention any thing about members' qualifications.

I'm, also, afraid that Material D failed in giving details about the authorities given to the members of the audit committee. Prof. Ahmad Jomoaa said that the act No.25 didn't determine clearly the relationship between Audit committee and the other departments. He also argues that the audit committee practice it works under a full control of the board of directors.

I guess this affects negatively the independence and the main objectives of the audit committee. I've mentioned that because of this, one may think that it's better for the audit committee not to be at the same level with the board of directors. There would be another board of director!!

Moreover, the act didn't determine the sources that would support the committee works. It's a very important thing in revealing the independence of the committee.

The Blue Ribbon Committee recommended that each member should be financially literate.¹⁷ A paper's finding may support the Blue Ribbon Committee recommendation: Financial literacy reduces the probability of standard violations in financial reporting.

[Jihe Song & Brian Windram (2000). Benchmarking audit committee effectiveness in the UK. Napier Uni.]

After all, the Act No.25 is still in need for many adjustments. We, hope that it would be soon, since a lot have begun talking about these defects.

End Notes:

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- ¹ J. L. BoockHoldt, "Accounting Information System", McGraw Hill, 1999, P. 402
 - ² Jordan Security Commission, "Instructions of disclosure, Accounting Standards, and Auditing Standards", No. 1, 1998
 - ³ Bodnar and Hopwood, " Accounting Information System", Prentice Hall, 1995, P. 176
 - ⁴ Ahmad Hilme Jomoaa, " The relationship between audit committees and corporations", Al Mudageq (34 & 35, 1998)
 - ⁵ Jordan Security Commission/Department of Disclosure. This information is up to Dec. 31, 2000
 - ⁶ Arab Bank, Annual financial report 1999.
 - ⁷ Tracie Arkley-Smith, "Audit Committee disclosures: time to regulate?", Australian CPA Publications, (August 1999)
 - ⁸ April Klein, "Economic Determinations of Audit Committee Composition and Activity", New York Uni., March 1998.
 - ⁹ No date was given to this paper. It was posted in 1996 on a page called: www.ssrn.com
 - ¹⁰ Ahmad Hilme Jomoaa, " The relationship between audit committees and corporations", Al Mudageq (34 & 35, 1998)
 - ¹¹ Eric Turner, "Keeping Audit committee effective", CA magazine (November 1999)
 - ¹² Ibid
 - ¹³ SEC Website: <http://www.nasd.com/docs/textapp.pdf>
 - ¹⁴ Tracie Arkley-Smith, "Audit Committee disclosures: time to regulate?", Australian CPA Publications, (August 1999)
 - ¹⁵ Eric Turner, "Keeping Audit committee effective", CA magazine (November 1999)
 - ¹⁶ Ibid
 - ¹⁷ Ibid

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- Ahmad Hilme Jomoaa, “ The relationship between audit committees and corporations”, Al Mudageq (34 & 35, 1998)
- April Klein (2000). Causes and consequences of variations in audit committee composition. New York University
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Websites:

- www.sec.gov & www.nasd.com/docs/textapp.pdf
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