
Auditing in Egypt: A Study of Challenges, Problems, and Possibility of an Automatic Formulation of the Auditor's Report

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This paper presents the findings of an empirical study on the auditing profession in Egypt. A questionnaire was presented to thirty-two auditors. The objective was to find out their perception of what should be the scope of the auditor's work, the challenges and problems faced by the auditing profession, and the possibility of developing a knowledge-based system to formulate the auditor's report on financial statements. The results of the study indicate that auditors believe that the auditor's work would be used as a guide for investment, and valuation of companies. There is a scarcity of experienced auditors as well as a cost/fees squeeze. There was a consensus among the interviewees that the development of a proposed system will help to overcome the lack of experience and expertise.

1. Introduction

The purpose of this paper is to explore the current auditing challenges and problems in Egypt and the possibility of developing a knowledge-based system to formulate the auditor's report on financial statements. Egypt has a history in the field of financial and management accounting. During the 1960s, with the triple movements toward (1) central economic management, (2) nationalization, and (3) expansion of the public sector, the Central Auditing Organization became responsible for auditing the public sector. In the mid-1970s, the Egyptian government had followed an open-door policy to liberalize the national economy, and had initiated several improvements in the accounting and auditing standards and practices. The research problem can be defined in two questions as: (1) what are the current problems in the Egyptian auditing environment? And (2) can the development and use audit knowledge based system help to provide a solution to some of these problems?

The four objectives of this paper are: (1) to determine the extent to which the auditors surveyed, thirty-two

auditors; thirteen auditors of academic nature and nineteen practitioners, are in agreement as to the auditing problems and challenges, as well as the auditing profession's role in Egypt, (2) to determine the extent to which the auditors are in agreement with respect to the sub-models of a knowledge-based system to formulate the auditor's opinion on financial statements, (3) to determine the extent to which the auditors have expectations with respect to using a knowledge-based system in the auditor's opinion task, and (4) to determine the extent to which the auditors are in agreement with the components of a proposed knowledge-based system.

It was found out that auditors believe that the auditor's work would be used as a guide for investment, valuation of companies, and sometimes in predicting bankruptcy. Furthermore, the respondents feel that there is strong relationship between the reliability of the auditor's report and the investment decision. The auditor's work facilitates the process of economic development through the presentation of reliable information concerning the financial position of the companies.

However, there is a general agreement as to the presence of variations of auditors' judgements, resulting from the lack of expertise and experience of performing the audit. The presence of high pressure on the auditors in terms of fees paid by the auditees, and lack of protective regulations, weaknesses and/or vagueness of the professional standards, and weaknesses of the ethical standards in the profession are viewed as important factors behind these problems. Furthermore, the complexity of the environment in terms of changing environment, and the problems involved in the use of computer technology in auditing have aggravated the variations of judgements in reporting. There was a consensus among the interviewees that the development of a knowledge-based system to be used in formulating the auditor's report on financial statements on the theoretical

and practical basis would contribute to minimizing the variations of judgements perceived by them. A prototype of an automated auditor's report has been implemented under the name AREX (Auditor Report EXpert). Preliminary validation by auditors indicates the AREX is a useful tool to formulate the auditor's report on financial statements in practice.

The outline of the paper is as follows. Section 2 deals with the background of current auditing framework in Egypt. Section 3 presents the research methods. Section 4 deals with overview of the auditors' problems. Section 5 deals with causes of the problems. Section 6 deals with the role of a proposed knowledge-based system. Section 7 summarises the results and presents the conclusions.

2. Background

2.1 Legal framework

The main law governing professional accountants and auditors in Egypt, particularly in the private sector, is Accounting Practice Law 133/1951 and its amendments, which are deemed out-of-date by most practitioners. It does not require a qualifying examination for entry. In addition, the Central Auditing Organization is an independent public organization and is affiliated to the People's Assembly (Parliament). It controls the government funds and those of other public corporations as stipulated in the law. It helps the People's Assembly in exercising the financial control, and monitoring performance, following up the implementation of the plan and legal control of decisions issued on financial irregularities. It is responsible for the audit of state-owned enterprises.

Furthermore, the Company Law 159/1981 requires all companies to maintain sound accounting records and prepare annual audited financial statements. The Capital Market Law 95/1992 also requires all listed companies to file annual and semi-annual audited financial statements and quarterly financial statements with the Capital Market Authority and the Cairo and Alexandria Stock Exchange. The Capital Market Law requires all listed companies to publish financial statements in two widely spread newspapers. Finally, the Banking Law 163/1957 requires all banks to follow accounting and auditing requirements and guidelines set by the Central Bank of Egypt.

2.2 Auditing profession

The Egyptian Society of Accountants and Auditors plays a central role in the accounting profession. It is an association of chartered accountants that develops educational and professional standards. It is a member of the International Federation of Accountants (IFAC). In Egypt, there is no effective code of ethics for professional accountants and auditors. The audit practitioners are not required to follow any modern code of ethics in line with the IFAC code. In practice, there is little awareness among

many practicing auditors of international best practice concerning conflicts of interest and auditor independence (Rahman Msadek, & Waly, 2002).

2.3 Auditing education

With regard to the professional standards for accountants and auditors, educational quality suffers from a lack of a modern curriculum and from teacher/students squeeze. According to Rahman, et al. (2002), the teacher-student ratio in accounting departments of public universities is about 1 to 1,000, which hinders instructional quality and constrains essential teacher-student communication. With respect to the length of apprenticeship, the application and the employer's letter are not subject to verification.

2.4 Auditing firms' structure

All the major international audit firms had a presence in Egypt in addition to well-established local audit firms whose clients included listed companies. Among the most prominent international accountancy and legal firms with local partnership are: KPMG, Ernest and Young, Deloitte Touche Tohmatsu, and Price Waterhouse Coopers.

2.5 Accounting and auditing standards

The Ministerial Decree 503/1997 is considered the first Egyptian Accounting Standards to be issued. In 2002, Egypt had twenty-two accounting standards and six Auditing Standards. The Egyptian Standards on Auditing (ESA) deal only with the reporting issues and ignore the other areas of International Standards on Auditing (ISA) (Navady, 2001). Egyptian standards on auditing only handle the auditor's report on financial statements, which enhances the form of the report without covering the whole auditing process. The six Egyptian standards on auditing are as follows (The Ministry of Foreign Trade, 2003).

1. ESA 100 'the framework of Egyptian standards on auditing'.
2. ESA 200 'the auditor's report on financial statements'.
3. ESA 210 'reporting on information accompanying the audited financial statements'.
4. ESA 220 'the auditor's report on the auditing tasks for special purposes'.
5. ESA 230 'testing future financial information'.
6. ESA 240 'limited auditing tasks for financial statements'.

However, the ISA (IFAC, 2004) are applied in the absence of Egyptian standards on auditing, as stated in the introduction of the Egyptian standards on auditing. In addition, the Egyptian Society of Accountants and Auditors had issued auditing standards, which constitute a translated copy of the ISA (Egyptian Society of Accountants and Auditors, Cairo).

2.6 Non-compliance with accounting and auditing standards

The lack of qualification of those who prepare and audit financial statements and inadequate regulatory enforcement mechanisms are considered the main reasons for shortage in compliance with accounting and auditing standards. If the auditor's report refers to compliance with International Accounting Standards (IAS), the investor can have greater confidence in comparing these financial statements to other companies that make the same reference (Street & Bryant, 2000), although full compliance should not be assumed (Dehawy, Merino, & Conover, 2002). The level of compliance with familiar aspects of IAS disclosure requirements in Egypt is significantly higher than for relatively unfamiliar aspects of IAS disclosure, although both sets of requirements are available in Arabic. Where aspects of IAS disclosure requirements are relatively unfamiliar, the level of compliance is lower when regulations are not available in official Arabic translations (Abd-Elsalam & Weetman, 2003).

2.7 Auditing standards in practice

Almost all ISA are applicable in Egypt. Auditors are required to follow the Egyptian standards on auditing that relate to the auditor's report, and any ISA that relates to other aspects of auditing process. Knowledge deficiencies of most practitioners by ISA in practice restrict ensuring sound auditing practice. Although large auditing firms have greater competence to provide high auditing quality, compliance with the applicable auditing standards is not always ensured, and differed from small firms. The international auditing firms in Egypt, in most cases, stated that the financial statements were prepared according to the IAS. They referred, in many cases, to the compliance with the IAS but not the ISA. Local auditing firms, in most cases, stated that the financial statements were prepared according to Generally Accepted Accounting Principles (GAAP) without giving any further explanation of what that phrase meant (Abd-Elsalam and Weetman, 2003).

3. Research method

A preliminary questionnaire survey, consisting mainly of questions requiring a response on a five point Likert-scale (5 = strongly agree, 4 = somewhat agree, 3 = neutral, 2 = somewhat disagree, and 1 = strongly disagree), was presented to thirty-two auditors in Egypt, thirteen auditors of academic nature and nineteen practitioners, within seventeen auditing firms including international auditing firms. In addition, eighteen interviews were carried out with them. With regard to statistical analysis, all results are expressed as a weighted mean.

4. Overview on the auditors' problems

4.1 The auditor's role

An audit expectation gap exists where there is difference in belief between auditors and the auditees about duties and responsibilities assumed by auditors and the messages conveyed by the auditor's report (Monroe & Woodliff, 1993; Monroe & Woodliff, 1994; King, 1999; McEnroe & Martens, 2001). In the present section, the results of the interviews concerning the duties and responsibilities of the auditors as perceived by the auditors will be presented and compared with the results of an earlier study of users' satisfaction. According to Table (1), there is a clear agreement on the significance of the role played by the auditors in guiding investment decisions, minimizing the risk through reliable audit reports, and promoting economic development. As to predicting bankruptcy, auditors are less in agreement with such role. In fact, many interviewees expressed their willingness to do so only in the case of special contracts.

Table 1. The auditing profession role

Question	Mean Score Strongly agree=5.... Strongly disagree=1 n=32
To what extent do you agree that the auditing profession has a role in the following five areas in Egypt:	
1. Investment guide	4.59*
2. Companies evaluation	4.19
3. Predict bankruptcy	3.31
4. Reliable auditor's report and investment decision	4.34
5. Economical development	4.53

*Weighted mean = (24*5)+ (5*4)+ (1*3)+ (2*2)+ (0*1)= 4.59 for example

In earlier studies on users' satisfaction with auditors' performance, users stated their discontent as to ignoring sufficient disclosure, and reporting on management compliance with laws and regulations and disposition of assets. Furthermore, they note the unavailability of the audit information during the annual stockholders meetings, and absence of any disclosure concerning the going concern of the audited companies. Apparently, based on the results of earlier studies, there is a clear gap between the auditor's actual performance as seen by the users and their perception of the auditors' role, duties, and responsibilities (Aly, 2001; Manson & Zaman, 2001).

4.2 The professional ethics

The corporations' limited legal obligations for having auditors have led smaller companies to ignore the auditing process and to ignore the legal procedures of contract auditors. The companies also change the auditor from time to time on purely subjective basis. In addition, the auditor's independence is strongly affected by the prevalence of the closely held companies in which both the majority of stockholders, the Board of Directors, and the company management are all the same. This is further aggravated by the lack of separation between auditing and consultancy services provided by the auditor. Finally, in most companies, accounting for the purpose of tax minimization takes precedence over the sound application of accounting principles. For example, the auditor may be forced to change his opinion to keep the auditee, although this behaviour is against professional ethics and professional due care (Spire, 1990; Louwers, 1998). The perception that companies may change auditors to improve the auditor's opinion has serious implications for auditors' independence and the credibility of their reports (Smith, 1986; Spathis, Doumpos, & Zopounidis, 2003).

Table 2. The lack of professional ethics

Question	Mean Score Strongly agree=5.... Strongly disagree=1 n=32
To what extent do you agree that a lack of code of Professional Ethics in Egypt follows from:	
1. Lack of professional ethics	3.75
2. Misunderstanding of relationship between the auditor and auditee	3.97
3. Auditor's switch because of problems with managers and/or shareholders	3.84
4. Prevalence of closely held companies	4.19
5. Issue clean opinion to retain the auditee	3.70

Questions in this part are on the lack of professional ethics, the presence of misunderstanding of the relationship between the auditor and the auditee, changing the auditor because of problems with managers and/or stockholders, the widespread presence of closely held companies, and the practice of issuing clean opinion in order to retain the auditee. Table (2) shows that auditors agree as to the presence of all of these professional problems and their negative contribution to the professional ethics, with the notable exception of the widespread presence of closely

held companies as a negative contribution to the ethics problems in Egypt.

4.3 The Auditor's judgements

Auditors depend on the personal judgement approach in making decisions throughout the audit. Thus, the outcome may differ from one auditor to another in estimating the audit risk, the extent of disclosure, and the type of report. These differences depend on the auditor's expertise and experience, and his relationship with the client, which may lead to personal bias and/or misleading judgement.

Table 3. The variation of judgements

Question	Mean Score Strongly agree=5.... Strongly disagree=1 n=32
1. To what extent do you agree that the variations of judgements in Egypt follow from Low audit quality	3.78
To what extent do you agree that the following competition polices are applied among auditing firms in Egypt:	
2. Introduce audit with high quality	3.33
3. Issue biased opinion to satisfy the auditees	3.20

The responses in Table (3) show that auditors agree that there is low auditing quality in Egypt. However, they are in mild agreement that introducing high quality audit would be a good competitive policy. Again, respondents appear to be neutral as to the need to issue biased opinion in order to satisfy the client. The results, overall, support the fact that problems existed result from low quality audit. In addition, the quality improvement is not viewed as a likely alternative in supporting the competitive position.

5. Causes of the problems

Back to the problems observed in the role of auditors, professional ethics, and the variations of judgements (discussed in previous section), there exists the issues of legal and organizational problems, the lack of experience and expertise, the presence of competition, cost/fees squeeze, and the complexity of the auditing environment, in particular IT auditing. These issues may be viewed as the main causes behind the problems observed in the last section. The purpose of this section is to present the responses of auditors to these issues.

5.1 Legal and organizational problems

A shortage is observed to exist between the auditing standards and the actual auditing practice. At present, there is a lack of understanding, resulting in non-compliance or partial compliance with the auditing standards which is a problem faced by many auditors who are not part of the international accounting firms framework. This problem results from the insufficient and/or the vague of Egyptian standards on auditing in addition to the legal issues related to the registration of auditors, the auditing obligations on the corporations, and the regulations of getting auditees.

Table 4. Legal and organizational auditing problems

Question	Mean Score Strongly agree=5... Strongly disagree=1 n=32
To what extent do you agree that there are the following six legal and organizational problems in Egypt:	
1. Shortage in auditing standards	3.53
2. Vague in auditing standards	2.97
3. Shortage in the law in relation to getting auditees	3.72
4. Limited legal audited obligation on corporations	3.78
5. Automatic registration of auditors	3.84
6. Complex audit environment	3.28

Table (4) presents the responses to six questions concerning these issues. As to the limited legal auditing obligation of the corporation and the automatic registration of auditors, the auditors are in mild agreement with these problems. As to the shortage of auditing standards and the shortage in the laws and regulations related to getting the auditees, auditors are also in mild agreement with these problems. In addition, they are in a certain level of neutrality regarding the vagueness of auditing standards and the complexity of auditing environment.

5.2 Shortage of experience and expertise

According to the Accounting Practice Law in Egypt, university graduates in the field of accounting are automatically registered as legal accountants. The Law does not require licensed auditors to undertake regular training or

continuing professional education. Furthermore, the Egyptian Society of Accountants and Auditors, which has established qualifying examination requirements, does not require continuing education for its own members. As a result, many auditors suffer from a lack of knowledge and expertise in performing their tasks according the professional standards.

Table (5) presents the response of auditors concerning the lack of experience and expertise, and the possible remedies. They are in mild agreement as to the lack of experienced auditors, and the shortage in accounting education, and training of auditors. A clear agreement, however, exists as to the use of high salaries, incentives and reward systems, non-financial rewards, and promoting auditors to higher level including partnership status, and improving the quality of education and training as strategic remedies, which are actually applied to achieve auditors' retention.

Table 5. The lack of experience and expertise

Question	Mean Score Strongly agree=5.... Strongly disagree=1 n=32
1 To what extent do you agree that the lack of experience and expertise in Egypt follows from:	
1. Lack of experienced auditors	3.84
2. Shortage of education	3.91
3. Shortage of training	3.84
To what extent do you agree that the following strategies are applied within auditing firms in Egypt to achieve the auditors retention:	
4. High salaries	4.30
5. Incentives and rewards	4.30
6. Non-financial rewards	3.87
7. Improving the education and training	4.43
8. Making auditor as a partner	4.47
9. Promotion	4.37

5.3 Competition, and cost/fees squeeze

Competition among auditing firms in Egypt to attract and retain auditees has been increasing. Many managers, due to economic challenges, try to minimize the auditing fees of their firms. In response, several auditing firms have applied cost-free auditing for the first year, and making the auditing fees charges as of the following year. As a result, auditing firms have been suffering from cost/fees squeeze, which would ultimately decrease the quality of their audits,

resulting in misrepresentations in the financial statements. This has been aggravated by the fact that high quality university graduates, especially those with English education, refuse to join the public accounting profession in view of the fact that the rewards and fees are not competitive.

Table (6) shows the results of questions related to the presence of keen competition, cost/fees squeeze, and the competitive policies adopted by auditing firms. As may be seen from responses to question (1) through (4), auditors agree as to the presence of keen competition to attract and retain auditees, resulting in low auditing fees and high auditing cost. However, the low auditing fees factor is ranked higher than the high cost. As to the competitive policies adopted, responses to questions (5) through (8) in Table (6) show that using personal relationships and introducing additional services are regarded as important competitive policies, and are ranked higher than decreasing the auditing fees and costs. In fact, according to interviews, good relationships and, treatment, and help the clients to get bank loans through personal relationships have been considered as key competitive elements to attract and retain auditees. However, this behaviour might ultimately influence the auditor's independence, and thus, the quality of the audit.

Table 6. The auditing fee squeeze and competitive polices

Question	Mean Score Strongly agree=5.... Strongly disagree=1 n=32
To what extent do you agree that auditing fee squeeze in Egypt are followed from:	
1. High auditing costs	3.66
2. Low auditing fee	4.22
3. High competition to attract the auditees	4.13
4. High competition to retain the auditees	4.19
5. Decreasing auditing fee as a competitive policy	3.83
6. Decreasing auditing costs as a competitive policy	3.57
7. Introducing additional services as a competitive policy	4.13
8. Personal relationships as a competitive policy	4.37

5.4 The IT auditing environment

There is no doubt that the use of electronic data processing has served to complicate the auditing

environment in Egypt. In addition, the characteristics of computer systems have resulted in increasing the information risk. The information risk has resulted from the invisibility of permanent system records, the style change of documents, the centralization of data manipulation, and the dangerous role of technicians in the system. Auditing firms have responded to this complexity in different ways. Large firms have acquired IT auditing programs and hired staff consisting of system designers and specialists. In addition, a number of auditing firms have joined service-oriented multinational companies to provide high quality service. Smaller firms, however, have applied parallel auditing by using both the IT auditing program and the manual auditing simultaneously.

Responses in Table 7 show that auditors agree as to the lack of experience regarding the IT auditing environment. This lack of experienced IT auditors would result in higher auditing costs, as experienced IT auditors would command higher salaries and benefits due to their skills.

Table 7. The lack of IT auditors

Question	Mean Score Strongly agree=5.... Strongly disagree=1 n=32
To what extent do you agree that the lack of IT auditors in Egypt is followed from Lack of experience and training regarding IT auditing.	4.22

6. The role of a knowledge-based system

Several auditors in Egypt have stated that a knowledge-based system in auditing would be helpful in training auditors, standardizing the procedures and report, and filling part of the lack observed in expertise and experience and in the application of auditing standards. The questions in Table (8) have been designed to elicit the perception of auditors regarding expectations of a proposed knowledge-based system benefits. Responses to the questions indicate that there is a strong agreement that a knowledge-based system will help to educate and train novices and to provide theoretical and practical basis for formulating the auditor's opinion on the financial statements.

There is a clear agreement that a knowledge-based system will help to decrease the expectations gap, the auditor's bias, and reliance on personal judgement. There is also general agreement as to a knowledge-based system can help to decrease the lack of experience and expertise. Interviewed auditors believe that using a knowledge-based system to overcome the shortage of the experience and expertise depends on amending the law, organizing the

profession, and achieving obligated standards measures. They agree that a knowledge-based system is considered as a practical and theoretical basis of the auditors' knowledge and skills in Egypt, especially for the auditors after training period. A knowledge-based system can decrease the auditor bias after setting up procedures to appoint, or change, the auditors and to enrich the auditor's independence.

Table 8. Knowledge-based system benefits

Question	Mean Score Strongly agree=5.... Strongly disagree=1 n=32
To what extent do you agree that suggested knowledge-based system would:	
1. Decrease expectation gap	4.31
2. Decrease auditor bias	4.13
3. Help in educating and training the novices	4.53
4. Help in filling the lack of experience and expertise	4.25
5. Provide theoretical and practical basis to formulate the auditor's opinion on financial statements	4.50

Table 9. The sub models of a knowledge-based system

Question	Mean Score Strongly agree=5.... Strongly disagree=1 n=32
To what extent do you agree that a knowledge-based system to formulate the auditor's opinion on financial statements should include the following sub models:	
1. A model of examining controls	4.94
2. An auditing standards model	4.84
3. An accounting standards model	5.00
4. A fairness of representation model	4.72
5. A going concern uncertainties model	4.19
6. An auditor's report model	4.44

Given the presence of general agreement as to the need and benefits of a knowledge-based system, questions are asked as to what should be covered by a proposed knowledge-based system (Table 9). The responses indicate that a knowledge-based system for the auditor's report would contain models on examining controls, auditing standards, accounting principles, fair representation, going concern, and auditor's report.

In addition, the responses indicate that the sub-model concerning whether the financial statements are prepared in accordance with accounting principles is more important. Interviewed auditors have suggested that a model of assessing planned detection risk should be added after the model of examining controls to help deciding on the amount of substantive procedures of transactions and balances of accounts. It is noticed that an assessing detection risk has received little attention from Egyptian auditors in practice when planning the audit. In addition, they suggested that a materiality model should be also added before the auditing standards model to select the amount of the audit evidence.

A knowledge-based system has been implemented under the name AREX (Auditor Report EXpert). Preliminary validation of AREX, using test cases, by the Egyptian auditors indicates the AREX perform the auditor's report task well. It is considered as a useful tool for formulating the auditor's report on financial statements in practice.

7. Summary and conclusions

This paper has shown that the Egyptian government has attempted to modify the law to achieve compliance with internationally accepted accounting and auditing standards. These modifications include drafting a new accounting practice law, and modifying the company law, the capital market law, and the banking law.

There is a gap between legislation and the practice of the profession regarding its organization and compliance with accounting and auditing standards. In addition, based on the survey, a gap is observed between auditing standards and actual auditing practice. This lack results from the differences in auditors' expertise and experience. Users of financial statements are unaware of the importance of auditing report types and are dissatisfied with Egyptian auditors' performance. While auditors are unwilling to provide additional information about the results of their audits, they believe that the auditing profession has a central role in investment guidance, companies' evaluation, and economic development.

There is a scarcity of experienced auditors in Egypt, because of a lack of education and training, the absence of a strong independent council [to grant licences, designations, and enforce training and continuous education] and a lack of competitive advantage of the auditing profession. Auditors are not required to follow a code of ethics in line with the IFAC code. This deficiency is accompanied by a

prevalence of the closely held companies and the absence of rules in appointing, or changing, auditors. The auditor's concern, and main priority, has been tax accounting rather than sound financial reporting. There is a scarcity of experienced auditors in IT auditing in Egypt because of the lack of knowledge and skills required for such tasks.

The survey indicated that a knowledge-based system to formulate the auditor's report on financial statements should contain models of examining control, materiality, assessing planned detection risk, auditing standards, accounting principles, a fairness of representation, a going concern, and an auditor's report. A knowledge-based system will help to educate and train novices and provide theoretical and practical basis for formulating the auditor's opinion. It will help to decrease the expectations gap, the auditor's bias, and reliance on personal judgement. The results indicate that there is a need for a knowledge-based system in formulating the auditor's opinion on financial statements within Egyptian auditing firms.

Based on the respondents' answers, it may be concluded that the construction of AREX, according to the international standards on auditing and practical professional standards, will help to overcome the lack of Egyptian auditors expertise and experience, by making expert's knowledge and experience available to the novice. AREX will free experienced auditors from simple and routine advice and activities, and enable them to concentrate on higher levels of managing the audit process, on creative research, and on the development of the auditing profession in Egypt.

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