

Audit Committee Effectiveness and Audit Quality: Evidence from Saudi Arabia

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Abstract. This study investigates if Audit Committee (AC) effectiveness, measured by size, activity, independence, and expertise, affects audit quality through the appointment of a high quality auditor. This study deepens our understanding of the role of AC in a developing country that recently applied a Corporate Governance (CG) Code, Saudi Arabia. The study employs logistic multiple regression analysis, in which we use two dummy dependent variables: selection of an industry specialist auditor and a Big-4 auditor or not. We examine a sample of 361 firm-year observations from 2007 to 2011. The basic analysis shows that AC size is the only determinant of audit quality, with a negative coefficient. When aggregating the effectiveness characteristics in one score, we find a significant negative correlation with audit quality, which implies that effective ACs are less likely to select an industry specialist auditor, contrary to expectations. The additional analysis shows that none of the AC effectiveness characteristics affects the decision of the AC to appoint a Big-4 auditor, whether individually or collectively. Furthermore, we find that ACs of firms with higher family and managerial ownerships and larger firm size are more likely to select a higher quality auditor. CG regulators and interested parties should recognize that AC effectiveness does not necessarily ensure audit quality or rational decisions, since we find that effective ACs are more likely to select an industry non-specialist auditor. ACs seem to comply with CG regulations in form rather than in substance.

Keywords: Corporate Governance, Audit Committee, Audit Quality, Saudi Arabia

1. Introduction

Recent decades have witnessed financial scandals that led to the collapse of long-lived firms, such as Enron, Xerox, and WorldCom. Financial markets lost confidence in financial reporting and market participants laid the responsibility at the doors of the accountants and auditors. Consequently, government and regulatory bodies around the world began to apply stricter corporate regulating systems, such as Sarbanes-Oxley Act (SOX) in the USA in 2002 and the UK's Corporate Governance (CG) Combined Code in 2003. The main aim of these regulations is to regain the lost confidence in financial reporting, through increasing audit quality, enhancing transparency and segregation of duties, and safeguarding the integrity of firms' financial statements (Ebrahim, 2007; Awad, 2012).

The audit committee (AC) is one of the key elements in CG systems and a powerful tool that helps control and monitor management; it can be an important part of the decision control system for internal monitoring by firms' boards (Fama, 1980; Fama and Jensen, 1983). Almost all CG regulations around the world require or urge firms to construct an AC to conduct certain tasks that ensure audit quality and the integrity of financial statements. For example, the Saudi CG Code (2006) requires that Saudi firms establish an AC in order to monitor the internal audit tasks, evaluate and report on the internal control system effectiveness, and recommend hiring or firing external auditors. According to the UK's CG Combined Code (2003), the AC's role is to monitor the integrity of the financial statements of the company and review any significant financial reporting judgments. Accordingly, we argue that if an AC is to succeed in fulfilling these tasks in reality, it will enhance audit quality, reduce opportunities for earnings management, increase the integrity of financial statements, and, thus, AC could be one of the main pillars of effective CG systems.

However, ACs are not always effective, and their existence may not be sufficient. Sommer (1991) and Abbott and Parker (2000) argue that the mere existence of AC does not necessarily translate into an effective monitoring body, and thus, more attention should be paid to the impact of AC characteristics. Therefore, CG regulations, such as SOX (2002), the UK's CG Combined Code (2003) and the Saudi CG Code (2006), among others, require specific characteristics for AC composition and structure, in order to ensure its effectiveness. For example, the UK CG Combined Code (2003:16) states: "The board should establish an Audit Committee of at least three, or in the case of smaller companies two, members, who should all be independent non-executive directors. The board should satisfy itself that at least one member of the AC has recent and relevant financial experience".

The literature finds that ACs with a higher number of independent directors, specialized and knowledgeable directors, and a higher annual meetings' rate, could be sufficiently effective to enhance the quality of audit process. Since these committees are more likely to hire an industry specialist auditor, select a Big-4 audit firm, expand the audit process time and extent, and recommend fixing internal control problems (Abbott *et al.*, 2004; Monks and Minow, 2008; Krishnan and Visvanathan, 2009; Basiruddin, 2011).

The main objective of this study is to examine the impact of AC effectiveness on audit quality in Saudi firms, in order to evaluate the Saudi CG Code first applied in 2007. The basic analysis finds that the AC size is the only determinant of the AC decision to select an industry specialist auditor, while the aggregated AC effectiveness score was found to be statistically significant and negatively correlated with the AC decision to select a specialist auditor, which contradicts expectations. The additional analysis finds that none of the AC effectiveness characteristics affects the AC decision to appoint a Big-4 auditor, when testing individually or collectively. Furthermore, ACs of firms with higher family and managerial ownerships, and larger total assets are more likely to appoint a higher quality auditor.

The study of the relationship between AC effectiveness and audit quality in Saudi firms is of importance for a number of reasons. First, the Saudi CG Code was only applied recently in 2007, and this code requires firms to establish ACs with specific characteristics; therefore, this study is an attempt to evaluate the Saudi CG Code. Second, the Saudi Arabian economy is globally important, as Saudi Arabia is the world's largest producer of oil and the world's 25th largest in terms of exports and imports (Alsaeed, 2006). Furthermore, Saudi Arabia held 44% of total Arab market capitalization in 2010 and 25% share of total Arab GDP (Alsaeed, 2006). Third, we observe very little research on the effectiveness of AC in Saudi firms.

This study is organized in the following structure. The next section highlights a summary of AC development in Saudi Arabia. The third section reviews the literature. The fourth section formulates the study hypotheses. The fifth section presents the study methodology. The sixth section discusses the study results. The final section provides conclusions, implications, limitations, and potential future research.

2. Audit Committees in Saudi Arabia

Saudi Arabia has recognized the importance of ACs from as early as January 1994, when the Saudi Ministry of Commerce (1994) issued a resolution, which makes it mandatory for all public firms to establish an AC. The resolution guidance determines certain characteristics for the AC in terms of composition and structure. First, in relation to *independence*, the guidance states that the committee members should not have a direct or indirect interest in the transactions of the firms and should not handle technical, managerial, or consultancy work. Second, in terms of *expertise*, the guidance states that the members should hold appropriate qualifications in the financial and accounting field. Third, in relation to *size*, the guidance indicates that the committee size should be odd and not less than three.

Recently, CG was formally institutionalized through the publication of the Saudi CG Code in November 2006 (Al-Nodel and Hussainey, 2010; Al-Moataz and Hussainey, 2012). This code requires each firm to create an AC derived from the board of directors with specific characteristics to ensure its effectiveness. According to Section 14 of the code, the committee should consist of at least three directors. Furthermore, AC directors should be non-executive board directors and each AC should consist of at least one director specialized in financial and accounting affairs.

Accordingly, we examine if AC effectiveness, as measured by size, activity, independence, and expertise, could affect audit quality.

3. Literature Review

Investigating AC effectiveness, as a CG mechanism, is a valuable issue that has received considerable research attention, especially in the developed countries. Some studies hypothesize and test if AC existence or effectiveness can enhance audit quality through selecting a 'Big' auditor or an industry specialist auditor. For example, Kunitake (1983) examines if the existence of AC affects the selection of a Big-8 auditor (at that time, it was Big-8) using a sample of 607 firms listed on AMEX. The results indicate that there is no difference in auditor selection between firms with and those without an AC. However, Eicheneher and Shields (1985) examine 128 AMEX firms during 1973-1980 and find that firms with AC are more likely to switch to a Big-8 auditor, compared with firms without AC. Furthermore, Abbott and Parker (2000) analyze 500 firms listed on the NYSE, AMEX, and NASDAQ exchanges in 1994 and find that ACs with independent non-executive directors and those that meet twice or more a year tend to employ industry specialist auditors. In addition, Chen *et al.* (2005) examine a sample of 458 firms on the Australian Stock Exchange Top 500 in 2000 and find that independent ACs tend to employ industry specialist auditors, while AC expertise and the meeting numbers are not statistically correlated with auditor selection. Al-Lehaidan (2006) assesses the correlation between AC effectiveness and the selection of a high quality auditor for both Australian and Saudi listed firms. The results find a positive correlation between AC effectiveness and the selection of a specialist auditor for only the Australian sample, while no correlation is found in the Saudi sample.

A number of studies use audit fees as a proxy for audit quality. For example, O'Sullivan (1999) examines a sample of 146 UK large firms in 1995. He finds no evidence that the board of directors or AC characteristics influence the audit fees. Likewise, O'Sullivan and Diacon (2002) examine a sample of 117 UK insurance firms in 1992. Although they find that the existence of an AC is positively correlated with audit fees, they find that AC and board characteristics have no significant correlation with audit fees. In addition, Krishnan and Visvanathan (2009) examine a sample of 801 listed firms on the S&P 500, audited by Big-5 auditors for the years 2000 and 2002. They find that board and AC meetings have a positive correlation with audit fees, while ACs equipped with financial expertise is perceived by auditors to have a strong internal control system, which reduces control risk and audit fees.

Another group of studies uses earnings management level as an indicator of audit quality. For example, Dechow *et al.* (1996) examine a sample of 92 firms that are subjected to SEC enforcement action during 1982-1992. They find that there is more likelihood of earnings management when there is no AC. Furthermore, Klein (2002) examines a sample of 692 US firm-year observations and finds a negative significant correlation between AC and board independence and abnormal accruals, and concludes that reductions in board or AC independence are accompanied by a significant increase in abnormal accruals.

In addition, Xie *et al.* (2003) examine 282 firm-years listed on the S&P 500 for the years 1992, 1994 and 1996. The findings indicate that boards and AC consisting of high

levels of independent directors with higher corporate and financial expertise allied to meeting frequently are more likely to alleviate earnings management. Moreover, Lin *et al.* (2006) examine a sample of 106 American firms in the year 2000. They find a negative significant correlation between the AC size and earnings restatement. However, no significant correlation was found between the frequency of AC meetings, expertise, or independence and earnings management.

Soliman and Ragab (2014) examine a sample of 40 listed firms on the Egyptian Stock Exchange during 2007-2010. The results indicate that AC independence, expertise, and meeting frequency have a negative significant correlation with earnings management. However, no significant correlation is found for AC size.

One recent study is that of Sun *et al.* (2014) who investigate the role of AC effectiveness in constraining real earnings management. The study was conducted on a sample of US firms that are more likely to engage in real earnings management during the post-SOX period (2007-2010). The findings indicate that ACs with high additional directorships are less likely to constrain real earnings management. However, the study finds no significant evidence for the impact of other AC characteristics such as expertise, size, board tenure, and block shareholdings.

To conclude, we observe that majority of studies are concentrated in developed countries, especially UK, USA, and Australia. We observe a shortage in this research area in Arab countries, especially in Saudi Arabia, despite the need for evaluation of the recently applied CG codes. Furthermore, we find few studies that address the auditor selection as a proxy for audit quality, as the majority of studies employ audit fees and earnings management as proxies for audit quality.

4. Hypotheses Development

Audit Committee Size

The literature provides mixed and inconclusive results on the impact of AC size. For example, Xie *et al.* (2003), Abbott *et al.* (2004), Madawaki and Amran (2013), and Soliman and Ragab (2014) find no significant correlation between AC size and earnings management, restatements, or financial reporting quality. However, Yang and Krishnan (2005) and Lin *et al.* (2006) find that large AC size reduces earnings management and financial restatements, respectively. On the other hand, Bedard *et al.* (2004) and Baxter and Cotter (2009) argue that large ACs are more likely to resolve potential problems and can affect board decisions effectively, since more members means varied expertise and knowledge, and less alignment. However, Karamanou and Vafeas (2005) argue that too large ACs may suffer from process losses and diffusion of responsibility. Thus, it seems that there is no consensus on the impact of AC size; therefore the first hypothesis is:

H1: There is a significant correlation between AC size and audit quality

Audit Committee Activity

The existence of an AC is not sufficient; it needs to be active. The frequency of AC meetings could be a determinant of its activity, and thus, its effectiveness. Xie *et al.* (2003), Bryan *et al.* (2004) and Soliman and Ragab (2014) hypothesize that AC meeting

regularly improves the financial reporting quality and disclosure level. Empirically, Xie *et al.* (2003) and Ebrahim (2007) find a negative correlation between meetings frequency and earnings management. However, other studies find no effective role for AC activity (see for instance Lin *et al.*, 2006; Baxter and Cotter, 2009). Nevertheless, we believe that the frequent meetings of ACs are a good indicator of its effectiveness. In contrast, fewer meetings imply that committee members are less committed, and that there is no time to discuss and resolve the crucial issues. Thus, the ACs do not perform their tasks well. Accordingly, the second hypothesis is:

H2: There is a positive correlation between AC annual meetings and audit quality

Audit Committee Independence

Agency theory assumes that independence, whether of external auditors, board members, or AC directors, is a crucial factor in reducing agency costs, information asymmetry, and in increasing audit quality. Thus, Madawaki and Amran (2013:1072) state: "It is expected that independent AC members will be more objective and less likely to overlook possible deficiencies in the misappropriation and manipulation of financial reporting". Empirically, Abbott and Parker (2000) and Chen *et al.* (2005) find that independent ACs are more likely to select an industry specialist auditor. Furthermore, the majority of studies find a negative correlation between AC independence and the extent of earnings management or financial reporting restatements, which is consistent with the agency theory assumption (e.g. Klein, 2002; Bedard *et al.*, 2004; Benkel *et al.*, 2006; Ebrahim, 2007; Madawaki and Amran, 2013; Soliman and Ragab, 2014). However, studies such as Xie *et al.* (2003) and Peasnell *et al.* (2005) find no correlation. Nevertheless, we argue that independence is a crucial determinant of AC effectiveness; therefore the third hypothesis is:

H3: There is a positive correlation between AC independence and audit quality

Audit Committee Expertise

Almost all CG regulations require the appointment of at least one accounting and financial expert as an AC member. The literature argues that experts on AC enhance its effectiveness significantly. Moreover, the literature provides empirical evidence supporting the positive impact of AC expertise. For example, Xie *et al.* (2003), Abbott *et al.* (2004), and Soliman and Ragab (2014) find that AC expertise reduces earnings management and financial reporting restatements. In addition, DeFond *et al.* (2005) find that markets react positively to the appointment of accounting and financial experts. Furthermore, Madawaki and Amran (2013) find that AC expertise enhances the financial reporting quality. However, some studies find no correlation, such as Yang and Krishnan (2005) and Lin *et al.* (2006). Nevertheless, we believe that AC with experts are able to discuss and resolve the crucial issues effectively and are more likely to select an independent and specialist external auditor, which enhances the audit quality generally. Therefore, the final hypothesis is:

H4: There is a positive correlation between AC expertise and audit quality**5. Methodology****5.1 Sample Selection and Data Collection**

All firms listed on the Saudi Stock Exchange represent the study population. Table 1 shows that the initial study sample comprises 694 firm-year observations. However, we discarded 172 firm-year observations of financial, banking, and insurance firms, due to their special disclosure, CG, and reporting requirements. Next, we found 161 observations with missing data in the study variables; therefore, we excluded them too. As a result, 361 firm-year observations make up the final sample. Moreover, the study covers the period 2007-2011; the Saudi CG Code was issued formally in November 2006 and applied from the beginning of 2007. Regarding the data collection, the annual reports of the sample firms are the main source of data. We depend on www.tadawual.com.sa and www.argaam.com to collect the requisite annual reports and data about the study variables.

Table (1). The study sample firm-year observations.

	2007	2008	2009	2010	2011	Total
Initial Sample	111	129	146	152	156	694
<i>Less:</i> Financial, Banking, and Insurance firm-year observations	(28)	(32)	(36)	(38)	(38)	(172)
<i>Less:</i> Firm-year observations with missing data	(42)	(38)	(34)	(26)	(21)	(161)
Final Sample	41	59	76	88	97	361

5.2 Study Models and Variables**Models Specification**

To examine if AC effectiveness affects the audit quality, we employ four logistic regression models in the basic and additional analysis. For the basic analysis, we ran Models 1 and 2. The first model examines the correlation between selection of an industry specialist auditor, as a proxy for audit quality, and four AC characteristics individually, while the second model examines the four AC characteristics collectively in an aggregated score for AC effectiveness. For the additional analysis, we ran Models 3 and 4. We repeat the same basic analysis work, but replace the audit quality proxy with the selection of a Big-4 auditor.

Basic Analysis (an industry specialist auditor)

Model (1):

$$Audspec_{it} = \beta_0 + \beta_1 ACsize_{it} + \beta_2 ACmeet_{it} + \beta_3 ACindep_{it} + \beta_4 ACexpert_{it} + \beta_5 Famown_{it} + \beta_6 Stateown_{it} + \beta_7 Manown_{it} + \beta_8 Lev_{it} + \beta_9 ROA_{it} + \beta_{10} Size_{it} + \varepsilon$$

Model (2):

$$Audspec_{it} = \beta_0 + \beta_1 ACscore_{it} + \beta_2 Famown_{it} + \beta_3 Stateown_{it} + \beta_4 Manown_{it} + \beta_5 Lev_{it} + \beta_6 ROA_{it} + \beta_7 Size_{it} + \varepsilon$$

Additional Analysis (a Big-4 auditor)

Model (3):

$$Big-4_{it} = \beta_0 + \beta_1 ACsize_{it} + \beta_2 ACmeet_{it} + \beta_3 ACindep_{it} + \beta_4 ACexpert_{it} + \beta_5 Famown_{it} + \beta_6 Stateown_{it} + \beta_7 Manown_{it} + \beta_8 Lev_{it} + \beta_9 ROA_{it} + \beta_{10} Size_{it} + \varepsilon$$

Model (4):

$$Big-4_{it} = \beta_0 + \beta_1 ACscore_{it} + \beta_2 Famown_{it} + \beta_3 Stateown_{it} + \beta_4 Manown_{it} + \beta_5 Lev_{it} + \beta_6 ROA_{it} + \beta_7 Size_{it} + \varepsilon$$

Dependent Variables

The literature examines a wide range of indicators, such as audit fees, earnings management level, auditor selection, and restatements, as proxies for audit quality. However, we employ auditor selection as a proxy for audit quality, for a number of reasons. First, auditor selection is one of the primary responsibilities of ACs; the Blue Ribbon Committee (1999), SOX (2002), and the Saudi CG Code (2006) require the AC to be responsible directly for the appointment, compensation, and oversight of work of external auditors. Second, according to Gramling and Stone (2001), the industry specialist auditors are more likely to provide higher quality audits, since they have better audit technologies, lower costs, and superior knowledge due to economies-of-knowledge. Third, industry specialist auditors are more reliable for detecting errors and frauds (Wright and Wright, 1997; Basiruddin, 2011). Fourth, if ‘Big’ audit firms fail to report the discovered breaches to a client, they may lose in terms of quasi-rents from a greater number of clients (DeAngelo, 1981). Accordingly, we argue that ‘Big’ audit firms have greater expertise, resources, and professional auditors that are more likely to provide high quality audit. Therefore, the study’s dependent variable is the selection of an industry specialist auditor in the basic analysis and a Big-4 auditor in the additional analysis.

Independent Variables

To determine effectiveness of AC, we employ four characteristics widely recommended by CG regulations, such as the Blue Ribbon Committee (1999), SOX (2002), the UK’s CG Combined Code (2003), and the Saudi CG Code (2006). The four characteristics are size, activity, independence, and expertise. We use the four characteristics as independent variables individually and then collectively in an aggregated score. The aggregated score represents the four characteristics together, and is an indicator for the overall AC effectiveness. Furthermore, the examination of the AC characteristics individually enables us to determine the characteristic that most affects the audit quality, while examination of the four characteristics collectively using the

aggregated score enables us to determine if there is a correlation between the overall AC effectiveness and audit quality. Moreover, prior studies, such as Brown and Caylor (2006), Al-Lehaidan (2006), and Jiang *et al.* (2008) use an aggregated score.

Table 2: Definitions and measurement of the variables.

Measurement	Definition	Symbol
Dependent Variables:		
A dummy variable that takes the value one if the auditor of the firm <i>i</i> during the year <i>t</i> is an industry specialist auditor, and zero otherwise.	An industry specialist auditor	Audspec_{it}
A dummy variable that takes the value one if the auditor of the firm <i>i</i> during the year <i>t</i> is one of the Big-4 audit firms, and zero otherwise.	Big- 4 Audit Firm	Big-4_{it}
Independent Variables:		
The total number of AC members of the firm <i>i</i> and the year <i>t</i> .	Audit Committee Size	ACsize_{it}
The total number of AC meetings of the firm <i>i</i> during the year <i>t</i> .	Audit Committee Meetings	ACmeet_{it}
The ratio of independent non-executive directors to the total number of AC members of the firm <i>i</i> during the year <i>t</i> .	Audit Committee Independence	ACindep_{it}
A dummy variable that equals one if there is at least one expert on the AC, and zero otherwise.	Audit Committee Expertise	ACexpert_{it}
It is a dummy variable that takes the value one if the AC of the firm <i>i</i> and the year <i>t</i> , consists of fully independent members, with at least three members, one of whom is a financial expert, and holds at least three meetings a year, and zero otherwise.	Audit Committee Score	ACscore_{it}
Control Variables:		
The total number of shares held by family members divided by the total number of outstanding shares of the firm <i>i</i> during the year <i>t</i> .	Family Ownership	Famown_{it}
The total number of shares held by government divided by total number of outstanding shares of the firm <i>i</i> during the year <i>t</i> .	State Ownership	Stateown_{it}
The total number of shares held by managers divided by total number of outstanding shares of the firm <i>i</i> during the year <i>t</i> .	Managerial Ownership	Mangown_{it}
Total debts divided by total assets of the firm <i>i</i> during the year <i>t</i> .	Firm Leverage	Levg_{it}
Stands for return on assets, and is measured by dividing total net income by the total assets of the firm <i>i</i> and the year <i>t</i> .	Firm Performance	ROA_{it}
The natural logarithm of total assets of the firm <i>i</i> during the year <i>t</i> .	Firm Size	Size_{it}

Control Variables

Several variables, other than AC characteristics, may affect auditor selection. For example, Firth and Smith (1992) and Al-Lehaidan (2006) find that firms with a higher percentage of managerial ownership are less likely to hire a specialist auditor or a big audit firm. Furthermore, Abbott and Parker (2000) argue that highly profitable firms select a high quality auditor, since these firms have deeper pockets than do others. In addition, Al-Lehaidan (2006) finds that Saudi firms with a higher leverage ratio and a higher percentage of non-executives are more likely to hire a specialist auditor. Consequently, to avoid the correlated omitted-variables problem (Bartov, 1993), we add three ownership structure variables and three corporate

characteristics as control variables. Table 2 exhibits the variables definitions and measurements.

6. Results and Discussion

Descriptive Statistics

Table 3 shows the descriptive statistics of all the study variables. The mean value of the specialist auditor variable is 0.37, indicating that 37%, on average, of auditors appointed by the sample firms during the study period were industry specialist auditors, while the mean value of the Big-4 variable is 0.61, indicating that, on average, 61% of auditors were Big-4 auditors.

Regarding the AC effectiveness variables, the mean value of AC size is 3.12, indicating that the sample AC consist of three members, on average. This mean is comparable with mean value of 3.27 reported by Al-Matari *et al.* (2012) on a Saudi sample. However, some firms do not have an AC, since the minimum value is zero. The average number of AC meetings across the year is 3.25, which is comparable with 3.30 reported by Al-Lehaidan (2006) for a Saudi sample, but lower than 4.86 reported by Al-Matari *et al.* (2012) also for a Saudi sample. The maximum value of 13 and the minimum value of zero indicate that some committees hold 13 meetings a year while others do not hold any. The mean value of independence variable is 0.90, which indicates that 90%, on average, of the AC members are independent, which is higher than 81%, found by Al-Matari *et al.* (2012). The mean value of expertise variable is 0.67, which implies that 67%, on average, of the sample ACs have at least one expert. However, some committees do not have experts, since the minimum value is zero.

Table (3). Descriptive statistics of the study variables.

Variable	Mean	Median	Max	Min	SD.
Audspec _{it}	0.37	0.00	1.00	0.00	0.48
Big-4 _{it}	0.61	1.00	1.00	0.00	0.49
ACsize _{it}	3.12	3.00	6.00	0.00	0.75
ACmeet _{it}	3.25	3.00	13.00	0.00	2.17
ACindep _{it}	0.90	1.00	1.00	0.00	0.30
ACexpert _{it}	0.67	1.00	1.00	0.00	0.47
Famown _{it}	0.13	0.00	0.95	0.00	0.21
Stateown _{it}	0.09	0.00	0.83	0.00	0.19
Mangown _{it}	0.18	0.08	0.89	0.00	0.21
Levg _{it}	0.09	0.02	0.60	0.00	0.14
ROA _{it}	0.07	0.06	0.30	-0.14	0.09
Size _{it}	9.27	9.19	11.47	7.87	0.71

Correlation Matrix

Table 4 shows that the maximum correlations are 0.50 and 0.49 between state ownership and firm size and between firm leverage and firm size, respectively, which indicates that the multicollinearity problem does not exist. Bryman and Cramer (2001) and Al-Lehaidan (2006) argue that a correlation between independent variables less than 0.80 does not represent a multicollinearity problem. Regarding the correlation between auditor selection and the independent variables,

the highest correlations were 0.40 between a Big-4 auditor and firm size, and 0.35 between an industry specialist auditor and firm size. However, the correlations of AC characteristics range from -0.02 to 0.19, which initially implies that AC effectiveness, may not affect auditor selection.

Table (4). Correlation matrix.

	Audsp ec	Big-4	ACsiz e	ACme et	ACin dep	ACexp ert	Famo wn	Stateo wn	Mang own	Levg	ROA	Size
Audspec	1.00											
Big-4	0.57	1.00										
ACsize	-0.02	0.19	1.00									
ACmeet	0.04	0.11	0.30	1.00								
ACindep	-0.07	0.03	0.04	0.12	1.00							
ACexpert	0.03	0.14	0.33	0.34	0.33	1.00						
Famown	0.10	0.18	0.04	0.03	-0.03	-0.05	1.00					
Stateown	0.09	0.13	0.12	0.23	0.05	0.21	-0.22	1.00				
Mangown	0.09	0.17	-0.08	0.005	-0.08	-0.04	0.27	-0.10	1.00			
Levg	0.23	0.24	0.08	-0.03	0.08	0.21	-0.004	0.06	-0.04	1.00		
							4					
ROA	-0.05	0.08	0.06	0.01	-0.03	-0.04	0.13	0.13	0.22	-0.13	1.00	
Size	0.35	0.40	0.33	0.16	0.04	0.29	0.07	0.50	-0.06	0.49	0.004	1.00

Regression Results

Table 5 displays the results of running the logistic regression Models 1 and 2. In relation to the Model 1 variables, the AC size variable was found to be negatively correlated with selecting a specialist auditor, and statistically significant at 1% ($\beta_1 = -0.546, z = -2.530, p < 0.01$). This result implies that lower size ACs are more likely to enhance audit quality by selecting an industry specialist auditor. One possible explanation for this result is that large number of directors on boards or ACs may increase the conflicts and result in inappropriate decisions. Moreover, Karamanou and Vafeas (2005) argue that large AC may suffer from process losses and diffusion of responsibility. However, Al-Lehaidan (2006) finds no correlation between AC size and selection of a specialist auditor for the Saudi sample.

The coefficients of the other three variables of AC effectiveness (meetings, independence, and expertise) were found to be statistically insignificant, which contradicts our expectations and those of many CG regulations that there is a positive correlation between these variables and audit quality.

Other studies find similar results. For example, Chen *et al.* (2005) and Al-Lehaidan (2006) find no influence of AC expertise and activity on selecting a specialist auditor for Australian and Saudi samples, respectively. Moreover, Lin *et al.* (2006) and Baxter and Cotter (2009) find insignificant correlation of AC activity for US and Australian samples, respectively. Xie *et al.* (2003) and Peasnell *et al.* (2005) find insignificant correlation of AC independence for US and UK samples. These results contradict the agency theory expectations that active, independent directors and those with expertise, on the board or on ACs, are effective monitors

and are more likely to make effective decisions, such as selecting an industry specialist auditor.

Regarding the control variables, only two variables were found to be statistically significant, managerial ownership and firm size. The coefficient of managerial ownership is positive and statistically significant at 10% ($\beta= 1.118$, $z= 1.850$, $p<0.10$). This implies that AC directors of firms with higher managerial ownership are more likely to select an industry specialist auditor. One possible explanation may be the convergence of interest's hypothesis, where interests of both managers and shareholders are aligned (Jensen and Meckling, 1976; Donaldson, 1990), and thus, managers of those firms are more likely to encourage and help AC directors select an industry specialist auditor, in order to enhance audit quality.

Table (5). The Logistic regression results of the correlation between AC effectiveness and selecting an industry specialist auditor.

<u>Model 2:</u> Aggregated AC Effectiveness Score			<u>Model 1:</u> AC Characteristics Individually			Definition	Symbol
P> z	z- value	Coef.	P> z	z- value	Coef.		
0.007***	-2.710	-0.342	---	---	---	Aggregated AC score	AC score_{it}
---	---	---	0.011***	-2.530	-0.546	AC Size	ACsize_{it}
---	---	---	0.261	1.120	0.067	AC Meetings	ACmeet_{it}
---	---	---	0.258	-1.130	-0.563	AC Independence	ACindep_{it}
---	---	---	0.768	-0.290	-0.097	AC Expertise	ACexpert_{it}
0.306	1.020	0.607	0.415	0.820	0.498	Family Ownership	Famown_{it}
0.358	-0.920	-0.803	0.138	-1.480	-1.296	State Ownership	Stateown_{it}
0.022**	2.290	1.335	0.064*	1.850	1.118	Managerial Ownership	Mangown_{it}
0.650	0.450	0.483	0.775	0.290	0.313	Firm Leverage	Levg_{it}
0.244	-1.170	-1.642	0.350	-0.940	-1.333	Firm Performance	ROA_{it}
0.000***	4.860	1.382	0.000***	5.280	1.534	Firm Size	Size_{it}
0.000***	-5.030	-12.598	0.000***	-5.060	-12.846	Model Constant	Con.
	361			361		No. of observations	
	50.03			53.09		Wald Chi 2(10)	
	0.000			0.000		Prob> chi2	
	0.14			0.15		Pseudo R2	
	-191.664			-190.007		Log pseudolikelihood	

*Significant at 10%. **Significant at 5%, ***Significant at 1%,
For variables' measurement methods, see Table 2.

Moreover, the coefficient of firm size is positive and statistically significant at 1% ($\beta_{10}= 1.534$, $z= 5.280$, $p<0.01$), indicating that ACs of larger firms are more likely to provide higher quality audit by appointing an industry specialist auditors. Chang *et al.* (2009) conclude that larger total assets of firms, as a measure of firm size, are more likely to have an effective AC, which should enhance audit quality. One explanation may be that larger firms are monitored by many stakeholders and discovering any significant fraud may severely damage the reputation of managers and continuation of the firm.

Model 2 results (see Table 5) show that there is a negative significant correlation between the aggregated AC effectiveness score and audit quality at 1% ($\beta_1 = -0.342$, $z = -2.710$, $p < 0.01$). This means that AC effectiveness is worse when all effectiveness characteristics are taken simultaneously, since directors are less likely to select an industry specialist auditor, which negatively influences the audit quality. However, Jenkins (2002) finds a negative significant correlation between AC effectiveness, measured by an aggregated score, and earnings management, indicating the AC decisions may be better when taking all effectiveness characteristics together.

The control variables' results of Model 2 are consistent with results of Model 1, where we find that coefficients of both managerial ownership ($\beta_4 = 1.335$, $z = 2.290$, $p < 0.05$) and firm size ($\beta_7 = 1.382$, $z = 4.860$, $p < 0.01$) control variables are positive and statistically significant. This implies that both corporate characteristics could enhance the quality of the audit process.

In summary, the Table 5 results indicate that AC size is the only determinant of audit quality. However, when aggregating all AC characteristics into one score, we find a negative significant correlation, which implies that effective ACs are more likely to select a non-specialist industry auditor. Our results contradict our expectations and those of many CG regulations and codes around the world which are based on the belief that activity, independence, and expertise are likely to be the main determinants of audit quality. Therefore, we reject the last three hypotheses of the study. However, the next sub-section provides additional analysis.

A plausible explanation for this unanticipated result is the sensitivity of the measure of auditor industry expertise, or it may be due to the monitoring effect of the board and audit committees are offset by the improved auditor quality. Krishnan (2001) has suggested that the portfolio approach is better suited to capturing the auditors' industry expertise, because some industries which they invest in may not be reflected under the market share approach, thus the present study cautions against drawing inferences from this finding.

Additional analysis

We conducted additional analysis by repeating the basic analysis, but changing the proxy of audit quality to that of selecting a Big-4 auditor. Table 6 shows that when the four AC effectiveness characteristics are tested individually by running Model 3, we find a statistically insignificant correlation for all characteristics. When aggregating the four AC effectiveness characteristics into one score and running Model 4, we also find a statistically insignificant correlation ($\beta_1 = 0.151$, $z = 1.330$). This indicates that none of AC effectiveness characteristics affects ACs' decisions to select a Big-4 auditor, whether individually or collectively. A similar result was found by Al-Lehaidan (2006), who finds no correlation between an AC effectiveness aggregated score and auditor selection in a sample of Saudi firms and finds no correlation when testing six AC characteristics individually, except for AC independence.

Table (6). The Logistic regression results of the correlation between AC effectiveness and selecting a Big-4 auditor.

Symbol	Definition	Model (3): AC Characteristics Individually			Model (4): Aggregated AC Effectiveness Score		
		Coef.	z- value	P> z	Coef.	z- value	P> z
AC score _{it}	Aggregated AC score	---	---	---	0.154	1.330	0.184
ACsize _{it}	AC Size	0.225	1.140	0.255	---	---	---
ACmeet _{it}	AC Meetings	0.036	0.610	0.542	---	---	---
ACindep _{it}	AC Independence	0.209	0.450	0.653	---	---	---
ACexpert _{it}	AC Expertise	-0.008	-0.030	0.980	---	---	---
Famown _{it}	Family Ownership	1.605	2.030	0.043**	1.572	1.980	0.048**
Stateown _{it}	State Ownership	-0.310	-0.290	0.770	-0.427	-0.420	0.674
Mangown _{it}	Managerial Ownership	1.965	2.530	0.011***	1.880	2.530	0.011***
Levg _{it}	Firm Leverage	1.316	1.070	0.283	1.131	0.950	0.343
ROA _{it}	Firm Performance	0.437	0.280	0.777	0.485	0.320	0.752
Size _{it}	Firm Size	1.368	5.000	0.000***	1.423	5.440	0.000***
Con.	Model Constant	-13.765	-5.760	0.000***	-13.672	-5.950	0.000***
No. of observations			361		361		
Wald Chi 2(10)			60.50		62.14		
Prob> chi2			0.000		0.000		
Pseudo R2			0.19		0.19		
Log pseudolikelihood			-184.016		-184.445		

*Significant at 10%., **Significant at 5%, ***Significant at 1%.

For variables' definitions and measurement methods, see Table 2.

Regarding the control variables, Table 6 shows that the coefficients of family ownership, managerial ownership, and firm size are positive and statistically significant, for both models, at 5%, 1%, and 1%, respectively. These results confirm those of Models 1 and 2 that managerial ownership and firm size could be effective corporate characteristics. In addition, the family ownership positive correlation can be justified, since the Saudi community is known for the importance of family and friendship connections, and prevalence of family ownership (Al-Lehaidan, 2006). Therefore, we argue that family owners may encourage AC directors to select a Big-4 auditor, in order to protect their families' reputation and social image against any financial scandals.

The overall conclusion is that AC characteristics recommended by CG regulations do not necessarily ensure the effectiveness of ACs, and thus, the quality of the audit process. The institutional theory can explain our results. This theory argues that many organizational structures, such as AC, are merely symbolic; firms may create ACs merely to comply with the business regulations, and social expectations, which means that no actual impact on reporting or auditing quality could be expected (Meyer and Rowan, 1977; Kalbers and Fogarty, 1993). The literature argues that the mere existence of AC does not mean the existence of an effective monitoring mechanism (e.g. Sommer, 1991; Abbott and Parker, 2000; Al-Lehaidan, 2006). The results of this study contribute by concluding that even the

existence of an effective AC does not necessarily ensure the quality of the audit process.

7. Conclusions, implications, limitations, and future research

This study contributes by investigating if four characteristics (AC size, activity, independence, and expertise) affect the audit quality by selecting an industry specialist auditor or a Big-4 auditor in a developing country, Saudi Arabia, where there is a dearth of research in this area. Moreover, the study is an attempt to evaluate the effectiveness of the Saudi CG Code that was recently applied in 2007.

The logistic regression analysis provides unexpected results. The basic analysis results reveal that AC size is the only determinant of audit quality when using a proxy of independent specialist auditor, with a negative significant correlation. However, when using the combined AC effectiveness score, we find a negative significant correlation with audit quality, which contradicts our expectations and that of many authors who argue effective AC could enhance audit quality by selecting an industry specialist auditor. Furthermore, the additional analysis results indicate that none of the examined AC characteristics is a determinant of audit quality by selecting a Big-4 auditor, either individually or collectively. However, we find that family ownership, managerial ownership, and firm size, when examined as control variables, are positively correlated with audit quality.

Even though, this study finds no significant direct relationship between audit committee and audit quality, it has accomplished the objective of the study by investigating this proposed association in a diverse country where corporate governance code and audit profession are dissimilar to those of western countries.

Overall, the present study concludes that the results do not confirm the proposition of agency theory for audit committee that certifies its monitoring function by demanding a higher audit quality. However, institutional theory can explain our results, since this theory argues that organizational structures, such as AC, are symbolic structures that are constructed only to show compliance with CG regulations, and therefore no real impact from the creation of ACs can be expected. The use of other audit quality measures such as restatements and auditors' litigation may better proxy for real audit quality rather than the perceived audit quality.

The study results provide important implications for CG regulators and other parties. CG regulators should recognize that AC that met the minimum requirements of CG regulations in relation to the AC characteristics do not necessarily ensure their effectiveness or enhance the quality of the audit process. Thus, shareholders and boards should review any AC decisions, especially those related to auditor selection, even if these committees are effective; i.e. they should not rely on the structure of the AC even if this structure complies with the minimum requirements of CG regulations.

When conducting this study we meet a number of constraints. First, ACs are usually derived from firms' boards and the literature provides strong evidence on the influence of boards' characteristics. However, this study does not include any board

variable in its models. We were cautious that the results could overlap between board and AC characteristics. Second, we found difficulty in collecting data on some study variables after the year 2011; therefore, this study is limited to the period 2007-2011. Third, the study sample is relatively small, compared with others in the developed countries, which is an issue as logistic regression prefers larger samples in order to provide better results.

Since we find no significant role for AC effectiveness on audit quality after the application of the Saudi CG Code in 2007, we recommend examining the role of AC before the code was introduced, and then make a comparison. Furthermore, future research can address the correlation between AC effectiveness and internal audit, the effectiveness of the internal control system, and real earnings management, because when we reviewed the literature we found limited research on these themes. Finally, a comparative international study can be conducted on countries in the Arab region that recently applied CG codes, such as Egypt and the UAE, in addition to Saudi Arabia.

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فعالية لجان المراجعة الداخلية في التأثير على جودة مراجعة الحسابات في الشركات السعودية المساهمة

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ملخص البحث. تبحث هذه الدراسة في فعالية لجنة المراجعة مقاسة بحجم اللجنة واستقلاليتها وخبرة أعضائها ومدى تأثير ذلك على جودة المراجعة الخارجية. هذه الدراسة تعزز فهمنا لدور مثل هذه اللجان بالدول النامية وخاصة في دولة تبنت معايير الحوكمة حديثا كالمملكة العربية السعودية. المنهجية البحثية المستخدمة بهذا البحث هي الانحدار اللوجستي مطبقا على عينة من ٣٦١ مشاهدا للشركات المساهمة السعودية ما بين عام ٢٠٠٧ و ٢٠١١. أوضحت النتائج أن حجم لجنة المراجعة هو المحدد الوحيد لجودة المراجعة ولكن عند قياس لجنة المراجعة بشكل موحد فان هناك علاقة ارتباط سلبية بين فعالية لجنة المراجعة وجودة المراجعة وهو عكس توقعات البحث. فيما يخص نتائج خصائص الشركات الأكثر اهتماما بجودة المراجعة من خلال تعيين مراجع متخصص بالقطاع أو تعيين مراجع من مكاتب المراجعة الأربعة الكبار فإن البحث أثبت أن الشركات ذات الملكية العائلية والإدارية المرتفعة بالإضافة للشركات الكبرى أكثر ميولا لضمان جودة المراجعة. نتائج هذا البحث هامة للمنظمين للسوق المالي والمتعاملين فيه من خلال عدم الانسياق وراء التوقع بأن لجان المراجعة تعزز جودة المراجعة الخارجية وذلك لأن تطبيق الحوكمة يبدو شكليا وليس جوهريا مما انعدم مع هذا التطبيق تأثير فعلي على تعزيز جودة المراجعة الخارجية.

الكلمات المفتاحية: حوكمة الشركات، لجنة المراجعة الداخلية، جودة المراجعة، المملكة العربية السعودية