Accounting 9 (2023) 241–248

Contents lists available at GrowingScience

Accounting

homepage: www.GrowingScience.com/ac/ac.html

Does audit committee improve audit quality? The case of Saudi Arabia

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C H R O N I C L E

Article history:
Received March 1, 2023
Received in revised format March 18 2023
Accepted May 6 2023
Available online
May, 6 2023

Keywords:
Audit committee
Corporate governance
Audit quality
Big 4

A B S T R A C T

This paper investigates the potential correlation between the performance of Audit Committees (AC) and Audit Quality (AQ). Data is derived from capital goods firms listed on the main stock exchange of Saudi Arabia (TASI). Logit regression analysis is used for this purpose and the dependent variable of BIG4 is used as a proxy for AQ, while AC meetings (ACMT), size (ACSZ), and AC members with a financial background (ACEX) are used as explanatory variables. The results show no statistical association between ACMT and AQ. However, the analysis indicates a positive statistical relationship between ACSZ and AQ, and a strong negative association between ACEX and AQ. These findings provide insights into the impact of AC attributes on AQ, and would be of interest to decision makers, policy-makers, investors, and senior management.

1. Introduction

The notion of AQ is an issue that has generated immense debate over the last three decades or so. This has been primarily due to the involvement of external auditors in a series of corporate financial fraud and failures (Sikka, 2008a, 2008b, 2009; Sunderland, 2010; Zamansky, 2011; Wang et al., 2014). The involvement of such auditors in high-profile corporate scandals has triggered strong scrutiny and questioned the role of auditors in today's complex capital markets. However, since the demise of Enron and that of many other multinational corporations, there has been a growing demand for auditors to be made accountable and for the reform of the accounting and auditing industry, together with corporate governance (CG) development such as the Sarbanes Oxley Act in the United States and United Kingdom's CG Code (SOX).

Subsequent research has sought to investigate the causes and sources of the impact that CG attributes have on audit quality (Watkins et al., 2004). This has highlighted the critical position of CG in overseeing and monitoring effective reporting and auditing (Altass, 2022). Drawing on the dilemma of the agency problem proposed by Jensen and Meckling (1976), these studies have analysed the effects of CG attributes on AQ with the aim of uncovering the advantages that such accountability mechanisms can bring (Altass, 2022; Watkins et al., 2004). Notably, recent research has examined the impact of AC attributes on AQ in an attempt to uncover the possible value added capability of AC in enhancing the audit function (Xie et al., 2003; Abbott et al., 2004; Dhaliwal et al., 2006; Lin et al., 2006; Al-Matari et al, 2012; Salawu et al., 2017; Mustafa et al., 2018; Asiriuwa et al., 2018; Amin et al., 2018). The Saudi Arabian capital market has been developed largely in the past decade, in an attempt to empower CG tools when it comes to exercising monitoring and oversight responsibilities, which in turn may safeguard the market participants' interests. Some of these developments have been in the form of amending CG regulations in terms of imposing stronger AC characteristics and increased diligence (Ministry of Commerce, 2016). Therefore, this paper attemptس to investigate the possible relationship between AC attributes - namely ACMT, size, and members' financial expertise - and AQ with regard to capital goods companies listed on TASI for the period 2010-2019.

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doi: 10.5267/j.ac.2023.5.001

The importance of such an investigation stems from the need to study the effectiveness of AC following recent CG and companies law developments in a fast-growing market. This paper attempts to bridge a gap in the previous literature by providing evidence of the possible association between AC attributes and AQ. The findings of this paper are of interest to a variety of parties such as policy-makers, investors, academics and financial analysts.

2. Literature Review

The notion of AQ has been an issue of considerable interest over the last three decades. This was a reaction to a growing debate vis-à-vis the involvement of auditing firms in the demise of large public companies, mainly in the US and the UK. Notorious examples of such corporate scandals are WordCom, and Lehman Brothers. There are also other cases of prestigious multinational corporations such as Carillion - where KPMG was accused of rubber-stamping, Enron when Arthur Andersen was accused and convicted of destroying legal documents, engaging in a conflict of interests, and apparently taking part in hiding Enron debts and misleading shareholders, and more recently, in the third quarter of 2022, and the auditor Grant Thornton who knowingly gave Patisserie Valerie a clean bill of health when the bakery chain business engaged in disclosing misleading accounting information. In fact, some of the accounting research community has been critical of the audit function in such financial malpractices (Sikka, 2008a, 2008b, 2009; Sunderland, 2010; Zamansky, 2011).

The perception of the need for high quality external auditing stems from the theory of the firm proposed by Jensen and Meckling (1976). They posit that the management of a company acts primarily as agents of the owner in order to operate the company. Therefore, they are expected to act in the best interests of their principal. Nevertheless, the aforementioned financial scandals shed light on the opposing view that management are, in fact, acting in their own best interests, not that of their principals. What actually underpins such a tendency is that it is driven by self-interested behaviour on the part of management as a result of their seeking short term financial gains (Graham et al., 2005). However, to mitigate such an agency problem the owners install CG mechanisms that provide protection against agent self-interest goals in such a way as to align the benefits of agents and owners.

Moreover, the other CG mechanism that is deemed crucial in safeguarding the owners' (shareholders') interests is that of ACs. Previous research has confirmed the importance of such committees as a CG mechanism that safeguards the credibility of financial reporting and assists the external auditor in delivering high-quality audits (Altass, 2021; DeZoort et al., 2002; Cohen et al., 2007). Consequently, this paper attempts to investigate the association between AC attributes, namely, ACMT, ACSZ, and ACEX and AQ.

2.1 The Concept of Audit Quality

The investigation of AQ is one of the most commonly-researched areas within accounting. Nevertheless, there is no universal agreement on the notion and nature of AQ. DeAngelo (1981) views AQ as being subject to market assessment, and that external auditors are capable of first detecting irregularities, and secondly reporting such irregularities. The IAASB (2011) contributed to the ongoing debate regarding AQ by issuing an initiative entitled "AQ: an IAASB Perspective" by stressing a multi-perspective approach to AQ in the form of an investor perspective and an AC member perspective. They argue that the notion of AQ differs in terms of how each camp perceives it. For example, from the AC perspective, AQ is based on the following:

- Evaluation of quality on the part of the auditor
- The quality of the audit function
- Auditor communication and interaction (ibid, p.3)

The overarching responsibility of the AC is, inter alia, to primarily orchestrate the audit process and provide an adequate oversight over the process of financial reporting, in addition to overseeing internal control systems (Rezaee et al., 2003). However, recent research has attempted to investigate the relationship between AC and AQ as the former is perceived to excel act in the best interests of owners by monitoring external auditing quality. AQ is widely measured in terms of the audit firm size, i.e., the BIG 4 auditor vis-a-vis non-BIG 4. The previous research has hypothesized that large audit firms exercise greater AQ due to the perception that they enjoy a larger client base and display high-quality auditing expertise and their auditors receive quality training (Khanh and Nguyen, 2018; Behn et al., 1997; Krishnan, 2003).

2.2 Audit Committee Meetings

Extant research has investigated the significance of ACMT which serves as an available mechanism that functions effectively within a robust CG structure (Xie et al., 2003; Abbott et al., 2004; Lin et al., 2006; Al-Matari et al., 2012; Mustafa et al., 2018). There has been a noticeable increase in recent research investigating the relationship between ACMT and AQ, particularly in developing markets. For example, Asiriuwa et al. (2018) examined the effect of AC attributes such as number of meetings, size, and expertise with regard to AQ in Nigeria. They considered AQ in terms of a company being audited by a BIG4 auditing firm. They reported a strong positive association between AC attributes and AQ. This, essentially, indicates that highly frequent ACMTs are related to higher AQ represented by hiring a BIG4 auditing firm. It appears that frequent ACMTs leads to recommendations by the committee to hire and maintain primarily BIG4 auditing firms which may reflect the perceived higher quality of such firms.

Additionally, Bryan et al. (2004) cited in Madawaki et al. (2013) argued that regular ACMTs enhance the transparency and credibility of financial reporting. They also believe that frequent ACMTs during the course of the financial year improve their position in terms of increasing the monitoring responsibility of the committee, as opposed to less frequent ACMTs. Moreover, Amin et al. (2018) studied the interacting impact of AQ on the association between AC attributes and earnings quality in the Indonesian market. Their results show that ACMTs have an adverse effect on earnings quality and that AQ plays an essential role in moderating such a relationship. Therefore, based on previous research on the relationship between ACMT and AQ, especially in developing markets, it is evident that frequent ACMT is statistically associated with higher AQ, indicating that the effectiveness of auditing is enhanced with more regular ACMT. However, the findings regarding the relationship between the two variables are mixed, as demonstrated by Amin et al. (2018), who posit that ACMT has an adverse effect on earnings quality and that AQ is a moderator of such an association. In light of this, it is expected that frequent ACMT is associated with higher AQ in Saudi Arabia. Hence, this analysis leads to the formulation of the following hypothesis:

H_1: *There is a positive relationship between ACMT and AQ, ceteris paribus.*

2.3 Audit Committee Size

Recent studies suggest that ACSZ plays a vital role within the CG mosaic (Amin et al., 2018; Hsu & Petchsakulwong, 2010; Mustafa et al., 2018). In Saudi Arabia, public limited companies must have an ACSZ of between 3 and 5 members. This number varies depending on company size, industry, and age. Large AC is perceived as comprising more sophisticated and better-experienced members that increase the monitoring capacity of the committee (Baxter and Cotter, 2009). The study by Asiriuwa et al. (2018) investigated the possible relationship between ACSZ and AQ (BIG4 proxy for AQ). They identified a strong positive statistical relationship between ACSZ and AQ, meaning that large AC is likely to enhance AQ. Similarly, in a study based on the Turkish market, Mustafa et al. (2018) examined the potential association between board characteristics, AC attributes, and AQ. They noted a strong association between ACSZ and AQ (measured as a binary variable of BIG4). Such a finding supports the common perception that large numbers of AC members may increase the monitoring power of the committee, which lends support to the resource dependence advocates (Pfeffer & Salancik, 1978). The theory studies the influence external resources have on an organization's behaviour. Originally introduced in 1978 by Pfeffer and Salancik, it provides insight into the importance of securing external resources for both strategic and tactical management. It also has consequences on the distribution of responsibility within an organization, recruitment of personnel, production techniques, agreements, and connections with other external organizations. Thus, it can be inferred from previous literature studying the relationship between ACSZ and AQ that ACSZ have an important role in increasing AQ. This could be attributed to the increased capacity of the AC with additional highly qualified members that provide strong monitoring and oversight of the external audit function. Therefore, this hypothesis is hereby proposed:

H_2: *There is a positive association between ACSZ and AQ, ceteris paribus.*

2.4 Audit Committee Financial Expertise

AC members' financial background has been one of the overarching AC effectiveness measures that are largely utilized in the accounting and auditing past literature. Cheung (2019) posits that the financial proficiency of AC members is related to superior AQ. He suggests that AC members' financial expertise enhances their ability to oversee the audit function in a robust manner, as well as managing financial reporting practices and policies. According to the Companies Law in Saudi Arabia, an AC should consist of at least one member with an acceptable degree of financial knowledge (Ministry of Commerce, 2016). Such a requirement is in line with the basic AC roles and responsibilities which enable AC members to exercise their monitoring capacity regarding auditing and financial reporting. Dhaliwal et al. (2006) assert that the accounting and financial background of AC members is the only AC members' financial attribute that may impact AQ. Salawu et al. (2017) examined the possible relationship between AC members' expertise and AQ. Their analysis shows little evidence of the association between ACEX and AQ. Similarly, Livingston (2003) argues that financially literate AC members do not insure effective committee oversight or enhancement of its monitoring role. Based on the reviewed literature which examined the possible association between ACEX and AQ, it appears that there is an overall perception that such a relationship is strong. Therefore, I would expect a significant positive relationship between ACEX and AQ. This leads to formulate the next hypothesis:

H_3: *There is a significant positive association between ACEX and AQ, ceteris paribus.*

3. Methodology

This section elaborates on the methods used to test the hypotheses detailed above. To analyse the hypothesized association between AC attributes and AQ, this study focuses on companies listed on the Saudi main stock exchange (TASI). The sample is made up of 120 firm-years of capital goods firms listed on TASI, Saudi Arabia, for the period 2010-2019. Capital goods companies were selected due to their distinctive characteristics and their high growth potential, and especially due to their importance for the Kingdom's Vision 2030. The variables used in the regression model were hand-collected from corporate annual reports. These include ACMT, size, and financial expertise as independent variables and AQ (BIG4 accounting firms) as a binary dependent variable. Table 1 below summarises the final variables used in the analysis.

Table 1
Model Variables

Variables	Definition	Predicted Sign
AQ	Represents audit by BIG 4 with a value of one; 0 otherwise	D. Var
ACMT	Frequency (number) of ACMT (on yearly basis)	+
ACSZ	Number of AC members at the end of the financial year	+
ACEX	Number of AC financial members at the end of the financial year	+
SIZE	Natural log of firm total assets (at year-end)	+
LEV	Long-term debt-to-total asset (at year-end)	+

The current study uses the logit regression analysis technique due to the class of the dependent variable, AQ, which is a binary (dichotomous) variable. The model can be formulated as follows:

$$AQ = \alpha_0 + \beta_1\, ACMT + \beta_2\, ACSZ + \beta_3\, ACEX + \beta_4\, SIZE + \beta_5\, LEV + \varepsilon$$

The logit regression model includes AQ as a dependent variable where it takes the value of 1 when the company is audited by a BIG4 accounting firm, zero otherwise. In addition, the independent variables include three measures of AC attributes in the form of ACMT, ACSZ, and ACEX. As shown above in Table 1, ACMT represents a measure of AC meeting numbers at during the financial year, ACSZ denotes the size of the committee at the year end, and ACEX is utilized as a proxy for AC financial expertise and is expressed as the number of AC members with financial expertise within the AC mosaic. The model furthermore includes two widely-used control variables - SIZE and LEV. SIZE represents company size in terms of the natural logarithm of the total assets at year-end. Finally, LEV is included to account for the ratio of long-term debt-to-total assets at year-end. These two control variables have been commonly used in the relevant literature (e.g., Haniffa & Hudaib, 2006; Aljifri & Moustafa, 2007; Bhatt & Bhattacharya, 2017; Khudhair et al., 2019).

4. Empirical Results

This study attempts to examine the possible association between AC characteristics and AQ, based on three AC metrics. These are ACMT, ACSZ, and ACEX which denote ACMT, size, and members' financial expertise respectively. Table 2 below summarizes the most common descriptive statistics. Looking at the table we can note that ACMT has a mean of 4.9 with a standard deviation of 0.5 with a minimum value of 3 meetings during the financial year and 21 meetings of AC members at year-end. Such statistics show the relative variability in terms of diligence on the part of AC members. ACSZ scored a mean of 4.15 and a standard deviation of 3.3 with a minimum value of 3 and a maximum of 5, which is in line with the AC composition requirements in the Kingdom of Saudi Arabia.

Table 2
Summary Statistics

Variable	Mean	Standard Deviation	Minimum	Maximum	Count
ACMT	4.87	0.50	3	21	120
ACSZ	4.16	3.32	3	5	120
ACEX	1.67	1.91	1	5	120
LEV	0.50	1.10	.09	.93	120
SIZE	6.06	0.23	4.28	6.68	120

Moreover, ACEX shows a mean of 1.67 which signifies the commitment of companies to AC regulations that require a minimum of one member with an expertise in accounting or finance. The variable also displayed a standard deviation of 1.9 with a minimum value of 1 and a maximum of 5, which shows reasonable compliance with AC regulations in the Kingdom. In the case of LEV which is a control variable of company financial leverage, the table indicates a mean value of 0.49, a standard deviation of 1.09, a minimum value of .09, and a maximum of .93. Finally, SIZE has a mean value of 6.06, a standard deviation of 0.23, a minimum of 4.28 and a maximum of 6.68. In addition, Table 3 offers Pearson's correlation matrix of the independent variable in order to demonstrate that the regression model does not suffer from multicollinearity.

The main aim of the test is to eliminate possibilities of multicollinearity where there might be a correlation between the independent variables. Such a deficiency could undermine the validity of the regression model and make it impossible to draw any meaningful conclusions. As can be seen from the table, there are no signs of multicollinearity as shown by the weak association between the independent variables, all of which are less than 0.8.

Table 3
Correlation Matrix

	ACMT	ACSZ	ACEX	LEV	SIZE
ACMT	1.00				
ACSZ	0.67	1.00			
ACEX	0.45	0.70	1.00		
LEV	0.11	0.07	0.28	1.00	
SIZE	0.14	0.18	0.36	0.58	1.00

Logit regression analysis results are reported in Table 4 below. The model is attempting to estimate the relationship between AC attributes and AQ in capital goods companies listed at TASI of Saudi Arabia. For AC attributes, this study uses ACMT, ACSZ, and ACEX and a binary dependent measure of AQ which is BIG4 accounting firms auditing client financial statements. The table below shows that the regression analysis failed to document a notable statistical association between ACMT and AQ. Such results do not lend support to the previous research which argues that ACMT enhances AQ, or at the very least the function of quality corporate financial reporting (Asiriuwa et al., 2018; Amin et al., 2018; Bryan et al., 2004).

Table 4
Regression results of the relationship between AC attributes and AQ

	Coefficients	Standard Error	t Stat	P-value
Intercept	-0.34	0.41	-0.84	0.40
ACMT	0.01	0.02	0.36	0.72
ACSZ	0.07	0.04	1.82	0.07
ACEX	-0.14	0.06	-2.36	0.02
LEV	0.78	0.24	3.30	0.00
SIZE	0.06	0.08	0.81	0.42
R Square	0.17			
Observations	120			

Moreover, the analysis also shows a trivial positive statistical relationship between ACSZ and AQ which agrees with the previous literature that documents a strong impact of ACSZ and AQ (Baxter and Cotter, 2009; Asiriuwa et al., 2018; Mustafa et al., 2018). Such findings indicate that larger ACs tend to enhance AQ through their robust monitoring capability. The analysis, in addition, documents a strong negative statistical relationship between AC expertise and AQ. This signifies that more AC members with a background in accounting and finance may not necessarily lead to higher AQ. In contrast to expectations, such a result contradicts the proposition which was stated in the previous literature (Dhaliwal et al, 2006). Moreover, the results support Livingston's (2003) view that the financial expertise of AC members does not guarantee effective committee oversight or enhances the monitoring role of the AC.

5. Conclusion

The principal aim of this paper is to investigate the expected association between AC attributes and AQ in terms of capital goods companies listed on TASI of Saudi Arabia. In this study the AC variables are ACMT, ACSZ, and ACEX, whereas AQ is measured as a dichotomous variable being the company that is audited by BIG4 companies. The study utilizes logit regression analysis to test three hypotheses regarding the relationship between the three AC attributes and AQ. The logit regression analysis results show no statistical correlation between ACMT and AQ. Such a result does not agree with previous studies that document a strong association. However, the context of the fast growing, yet strongly regulated market of Saudi Arabia, presents a unique picture of the efficiency of AC within public limited companies and the CG mosaic. Moreover, the analysis documents a strong positive relationship between ACSZ and AQ. Such a result indicates that a larger AC is in a better position to exercise its monitoring power over both financial reporting and the audit function. Surprisingly, the findings also reveal a strong negative statistical correlation between ACEX and AQ. Such a result contradicts the age-old belief that more financial experts on the AC enables it to exercise stronger power over the audit function and is perceived to enhance its quality. Recent developments in terms of CG advances in Saudi Arabia have attempted to empower the role of ACs and strengthen their capacity to exercise monitoring and oversight responsibilities. Nevertheless, this study documents a supporting result that the ACs of publicly listed companies are still in need of stronger regulations in order to enable the ability of such committees to act strongly in terms of monitoring financial reporting and auditing, which in turn would elevate the quality of auditing, both internally and externally. Several parties such as investors, shareholders, financial analysts, hedge fund managers, and regulators may leverage these findings. The overarching message of the findings is that AQ may not be better viewed in isolation from AC attributes. This suggests that in order to better understand AQ, we must exercise due diligence regarding the quality of AC. Nevertheless, this paper has some limitations as it only focuses on capital goods listed companies in Saudi Arabia. Therefore, the results may not be generalized. Future research could usefully attempt to investigate the association between AC and AQ using data from other industries in order to draw additional conclusions about such a relationship. It would also be ideal to sample all TASI companies in order to maintain better generalizable results.

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