

Audit Committee Effectiveness: Evidence from an Emerging Market Economy

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Abstract

This paper examines the effectiveness of corporate governance in an emerging market economy, especially the role of audit committees in Saudi corporations from the perspective of audit committee members. Using a hybrid methodology that combines archival data of annual reports and survey data from audit committee members in 91 firms listed on the Saudi Arabian Capital Market Authority (SACMA) in 2011, we find that audit committee members are consistently more focused on performing selected general assigned and voluntary duties and less actively engaged in the mandatory oversight responsibilities over internal control and the quality of financial reporting process. The findings from this study suggest that there is an urgent need for continuing to develop audit standards and accounting regulations that are legally enforceable and easier to understand by the audit community in Saudi Arabia.

Keywords: Corporate Governance, Audit Committees Effectiveness, Emerging Market Economy, Saudi Arabia

I. Introduction

The issue of corporate governance and its effectiveness has been subjected to intense scrutiny in the wake of the recent global financial crisis and economic recession. Although the majority of the discussion is focused on western developed countries, there is a small stream of literature on the development of corporate governance in emerging economies. These studies suggest that many developing countries tend to emulate the corporate governance regulations of western countries to attract oversea funds from international financial agencies such as the World Bank and to gain legitimacy in global society, often with dismal results (Mukherjee-Reed 2002; Paredes 2005; Reed 2002; Rwegasira 2000; Siddiqui 2010; Uddin and Choudbury 2008).

In this paper, we empirically examine the effectiveness of corporate governance and especially the role of audit committees (ACs) in Saudi Arabia, one of the pioneers in corporate governance in the Middle East.¹ Similar to other developing and emerging economies, corporate governance in Saudi Arabia remains in the embryonic stage at which governance practices and audit committees are currently neither mandatory nor legally enforced. Moreover, ACs play a very limited role in corporate governance in Saudi companies (Al-Moataz and Basfar 2010; Al-Motairy 2003; Al-Twajjry et al. 2002). The aforementioned studies are often exploratory and thus lack a broader interpretation with conclusions that are based on either interview with

¹ In 1994, the government of Saudi Arabia issued Ministerial Resolve 903 (the Resolve) to address the audit problems of large joint stock companies and protect the interest of shareholders. The subsequent circulars in 1997 and 1998 issued by Saudi Ministry of Commerce further extend and clarify the AC requirements documented in the Resolve and to encourage more Saudi companies to establish ACs that are in compliance with the Resolve. In 2003, the Saudi Arabian Capital Market Authority (SACMA) was established to oversight the exchange of Saudi stocks. In 2006, SACMA issued a draft for reporting requirements of corporate governance for listed companies based on Organization for Economic Co-operation and Development (OECD) principles of corporate governance: the rights of shareholders, the equitable treatment of shareholders, the role of stakeholders in corporate governance, disclosure and transparency, and the responsibility of the board of directors.

internal and external auditors or surveys from corporate insiders. What has not been examined is the effectiveness of ACs from the perspective of audit committee members. Although the perception of auditors and managers are extremely valuable to understanding the current role of ACs in Saudi corporations, it is also important to explore how audit committee members view themselves and their roles in discharging the prescribed oversight responsibilities.

In order to address this research void, this paper uses a theory-based approach and employs a hybrid methodology to investigate the following research questions: (1) how do audit committee members define AC effectiveness in terms of independence, financial literacy, and financial expertise? (2) what are the perceptions of audit committee members of their assigned oversight responsibilities? and (3) are audit committee members effective in executing their oversight responsibilities? First, we use a survey instrument to explore the characteristics and roles of ACs as a significant component of the corporate governance in Saudi companies. Second, we examine whether audit committees are effective in executing their assigned oversight responsibilities in the Saudi companies by comparing the *perceived* oversight responsibilities of audit committee members and the oversight responsibilities actually *assigned* in the annual reports.

Based on archival data of annual reports and survey data from audit committee members in 91 firms listed on SACMA for 2011, our results indicate that audit committee members consistently show a lack of focus on executing their assigned oversight responsibilities, specifically in the area of internal controls and the quality of the financial reporting process. For example, members of ACs generally regard issues and duties related to reviewing systems of internal control and associated procedures and plans, reviewing interim financial reports, and reviewing and approving accounting changes as relatively unimportant compared to other general assigned and voluntary duties. Consistent with prior studies, this study offers additional empirical evidence that ACs have played a minor role in the current corporate governance practices in Saudi companies. It provides timely information that can inform policy debates and help developing audit standards and accounting regulations in Saudi Arabia.²

The remaining paper proceeds as follows. In the next section, we discuss the theoretical foundation of audit committees and review relevant literature. We describe our sample selection and the research design in Section III. The main results are presented in Section IV. We offer a brief conclusion in Section V.

II. Theory and Literature

Corporate governance is the system by which companies are directed and controlled, manifested in the nature and extent of accountability of people in business and mechanisms that are intended to mitigate the agency problem. One of the main features of corporate governance is the audit committee, which is a subcommittee of the Board of Directors responsible for the oversight of financial reporting process and disclosure. The desired effect of audit committees is two-fold: (1) to prevent fraudulent financial reporting; and (2) to maintain and/or strengthen investor confidence in the quality of financial reporting and financial markets (BRC 1999; CSA 2004).

² The General Auditing Bureau (GAB) of Saudi Arabia lists the development of audit standards and accounting regulations as its top strategic priority of the second strategic plan (2012-2014). Please see April 2010 issue of International Journal of Governance Auditing, available on-line at: <http://www.intosajournal.org/currentedition/current.html>

A. Theory

A number of theories underpinning AC research include perspectives from legal, economics, psychology, and sociology. Security exchange laws and regulations often contain mandates for the presence of an audit committee at companies whose stocks are publicly traded. From the legal and economic perspectives, corporate ACs are viewed as an important monitoring device to mitigate the potential conflict of interests between stakeholders by focusing on the committee's structural characteristics as specified in regulation (e.g. independence, expertise, responsibilities). Such views are essentially based on agency theory (Jensen and Meckling 1976), which suggests that the existence of ACs is primarily motivated by the agency problem provoked by the separation of ownership and control. For example, stakeholders will impose agency costs on the firm when managers are in (or attempt) pursuit of self-interest strategies. Serving as a bridge between management and the auditors (both external and internal), ACs reinforce the quality of financial reporting process by monitoring both top management and auditors.

However, the mere establishment of an AC that structurally conforms to prescribed codes does not guarantee its effectiveness. An AC needs to have qualified members to be effective (Sabia and Goodfellow 2005). Therefore, psychological perspectives such as the expertise paradigm, credibility theory, and accountability theory are used to explain how AC members can be effective in carrying out their assigned responsibilities. The expertise theory suggests that experts and non-experts differ in their problem-solving behavior and decision-making process; it has been used to examine the link between the financial expertise of AC members and the identification of financial reporting issues (McDaniel et al. 2002). Source credibility theory indicates that the credibility of information depends on the perceived providers' competence and trustworthiness; information from a more credible auditor, manager, or director may have strong influence on AC decisions (DeZoot et al. 2003). Likewise, accountability theory proposes that accountable individuals tend to incorporate large amounts of information, make less biased evaluations of decision choices, and consider preferences of those that they are accountable to; an AC that is comprised of more accountable members would critically analyze information and make fair evaluations that result in a decision closer to investor preference (Gaynor et al. 2006).

B. Audit committee effectiveness

Prior literature on AC effectiveness is largely U.S. based research with a focus on the fundamental determinants of AC effectiveness, such as composition, authority, resources, and diligence (DeZoort et al. 2002). In this paper, we focus on the composition and authority components of AC effectiveness.

The composition of ACs considers the structural attributes of an audit committee, including member independence and financial background. There is a direct and positive relationship between AC effectiveness and AC member independence. For example, studies suggest that member independence, expertise, and financial literacy have strongly influenced the effectiveness of ACs (Buckby et al. 1996; Vafeas 2001). Independent ACs are more likely to select industry-specialist (high quality) external auditors (Abbott and Parker 2000), have stronger relationship with internal auditors (Raghunandan et al. 2001; Scarbrough et al. 1998), and are more effective in monitoring senior management and enhancing financial reporting quality (Abbott et al. 2002; Bedard et al. 2004; Beasley et al. 2000; Klein 2002). In addition, the higher the proportion of independent audit committees members, the less likely there is to be earnings

overstatement (Dechow et al. 1996; McMullen and Raghunandan 1996), earnings management (Bédard et al. 2004; Klein 2002), and financial fraud (Beasley et al. 2000). The composition of AC members also influences the auditor's opinion. For example, Carcello and Neal (2000) find that financially stressed firms with a higher percentage of AC "grey" directors – individuals who are not insiders but have a close relationship with management - are less likely to receive a going-concern opinion.

Although AC members often over-estimate their own expertise relative to the perception by their internal and/or external auditors (Kalbers 1992a, 1992b), studies suggest that an organization is less likely to have financial reporting issues (McMullen and Raghunandan 1996), suspicious auditor switch (Archambeault and DeZoort 2001), or engage in earnings management (Bedard et al. 2004) if its AC members are experts in finance and accounting and are more experienced in dealing with governance or internal control issues. With respect to AC members' financial literacy, there has been considerably less research conducted due to a lack of financial literacy benchmarks (Vafeas 2001). Using an experimental design, Song and Windram (2000) find a negative association between higher financial literacy of AC members and incidences of financial reporting issues within an organization. Similarly, McDaniel et al. (2002) demonstrate that financial experts differ significantly from financial literates in their assessment of financial reporting quality and identification of reporting issues.

The audit committee receives its authority from the Board of Directors, corporate laws and exchange listing requirements (DeZoort et al. 2002). By definition, the concept of authority is closely related to the responsibilities and the influence of the audit committee, most often communicated by the audit committee charter of an organization. Because of the rapidly expanding roles of ACs, the charter can help AC members to understand their specific responsibilities, including financial statement review, internal auditor assessment, and external auditor evaluation (DeZoort 1997).

Several studies examined AC responsibility disclosed in AC charters and reports contained in proxy statement. Haka and Chalos (1990) investigate the perception of agency conflicts among AC chairs, management, and auditors and find the evidence that agency conflict exists between AC and management in terms of financial disclosure and discretionary accounting procedures. Lee and Stone (1997) find a mismatch between stated AC responsibilities and members' experiences in dealing with accounting, auditing and control issues. Similarly, Carcello et al. (2002) find a gap between the information in AC charters and reports in proxy statement, suggesting a need to improve the AC disclosure process. HassabElnaby et al. (2007) find that although audit committees made a substantial commitment to increase their assigned responsibilities after the passage of the Sarbanes-Oxley Act of 2002 (SOX), they still need to do more to meet additional challenges facing ACs in a post-SOX environment.

Another line of research under authority has examined the relationships between AC characteristics and AC effectiveness. For example, Kalbers and Fogarty (1993) suggest that AC effectiveness was the result of oversight of financial reporting, external auditor and internal control. Moreover, the power of AC within an organization comes from a combination of written authority and top management support. Bedard et al. (2004) find a negative association between the presence of a clear mandate defining the responsibilities of ACs and earnings management.

In summary, the extant literature identifies several critical components of AC effectiveness, such as the financial expertise, experiences and independence of AC members who have a clear understanding of their oversight responsibilities in the areas of the financial statement review and the assessment of internal and external auditors. These important AC characteristics have been linked to the ability of ACs to engage higher quality external auditors, interact effectively with internal auditors, and improve the quality of financial reporting process.

C. Audit committee effectiveness in Saudi Arabia

Given that corporate governance was a nascent concept in the Middle East a decade ago, it is not surprising to see very limited, often exploratory, AC research in the context of Saudi Arabia. The following paragraphs briefly review the existing research pertaining to the effectiveness of ACs in Saudi corporations.

Al-Twaijry et al. (2002) conduct a series of interviews with academics, external auditors, and internal auditors to examine the role of audit committees in the Saudi Arabian corporate sector. They conclude that both the role and the scope of ACs varied across Saudi companies as a result of different interpretations of Ministerial Resolve 903. Moreover, the existing Saudi ACs are at the *infant* stage of the development trajectory, evidenced by the lack of clearly defined objectives and work scope, independence of AC members, a working relationship with external and internal auditors, and financial expertise. Similarly, Al-Motairy (2003) investigates the extent of current corporate governance practices in Saudi companies and concludes that there is a critical need for (1) a review of existing regulations that provide guidance for current practices of corporate governance; (2) the issuance of guidance for best practices in managing corporate affairs; and (3) the establishment of an organization to accelerate the adoption of best practices of corporate governance.

Unlike the exploratory nature of the studies mentioned above, Al-Moataz and Basfar (2010) empirically analyze the role of ACs in the implementation of corporate governance practices in Saudi corporations. They developed and administered a survey of Chief Executive Officers, Chief Financial Officers, and internal auditors from a sample of listed companies in the stock market. The overall result indicates that ACs of Saudi companies play very limited or no role in corporate governance practices, including financial statements, internal control systems, external auditor, internal auditor, and risk management.

To summarize, these studies consistently document the obviously inadequate role of ACs in the corporate governance of Saudi companies from perspectives of auditors and corporate insiders. Next, we will examine our overall research question of whether audit committees are effective in Saudi corporations from the viewpoint of AC members.

III. Research design

We employ a hybrid methodology to explore the AC characteristics, responsibilities, and effectiveness for a sample of listed companies in the stock market. We first search the annual reports and SACMA's Corporate Governance Regulations (CGRs), where responsibilities assigned for audit committee members could potentially be reported. We then compare the duties *assigned* to audit committee members disclosed in the annual reports and the CGRs to audit

committee members' *perceptions* of their assigned responsibilities in order to test whether audit committees are effective in executing their assigned responsibilities. Although the annual reports and CGRs identify certain tasks as oversight responsibilities of the audit committee, members of the audit committee might actually believe that their tasks differ from those identified in the proxies (HassabElnaby et al. 2007). In this paper, audit committees are effective when members' *perceptions* of what they are doing meet or exceed what the annual reports and CGRs say they should be doing.

A. Participants

According to the Saudi Stock Exchange Company (Tadawul), there were 149 listed companies in the stock market at the time of the study.³ All listed firms were included in our sample. We administered the survey in 2011 by hand delivering 149 surveys to audit committee members in 149 firms identified by Tadawul. We hand collected all surveys except for 5 surveys, which were sent by respondents via emails or faxes. The respondents were directed to make their answers relevant to the company mentioned on the enclosed envelope if they serve on more than one audit committee. We made a follow-up telephone call to those participants who did not respond to the initial data collection.⁴ Of the 58 individuals who did not return a completed survey instrument, 3 indicated that they were no longer members of audit committees, 7 were unwilling to respond within a reasonable period of time, and the remaining 48 non-respondents gave no reasons. As a result, we have a final sample of 91 useable instruments representing a 61 percent response rate. The 91 respondents represent a total of 91 firms (as shown in Table I).

Refer Table I

We examine annual reports to identify audit committees' assigned duties and firms' definition and description of independence, financial literacy, and financial expertise. Unfortunately, the vast majority of our sample provided very limited disclosure about characteristics of ACs in their annual reports. In addition, Saudi companies are not required to file a proxy statement and publicly disclose their audit committee charters. The unavailability of proxy statements and audit committee charters made it impossible for us to learn whether ACs fulfilled their responsibilities as specified in the charter or other documents. The lack of mandatory proxy statements and disclosure of AC charters not only discourage ACs becoming more effective, but also increase the information asymmetry between the firm and its shareholders, which in turn further weakens the confidence of investors in the capital market. Therefore, it is extremely important to have a mandatory disclosure of AC charters in the annual reports because a complete and fair disclosure is critical to the healthy development of the capital market.

Because firms in our sample have not revealed much information about how they define independence, financial literacy, and financial expertise in the AC section of the annual report, we compare only the audit committee duties disclosed in annual reports to audit committee members' *perceptions* of their assigned responsibilities to test whether audit committees are effective in executing their assigned responsibilities.

³ We called 60 audit committee members to seek their agreement on participation in our pilot sample. Forty five audit committee members agreed to participate in our pilot sample. For those individuals who agreed to participate, we conducted telephone interviews to clarify the issues under investigation, to draw out new issues, and to explain the terminology used in our instrument.

⁴ Our analysis did not reveal any significant differences in the early and late respondents.

B. Survey Instrument

The survey instrument of ACs has seven sections: (1) member demographics; (2) expertise and composition; (3) independence, financial literacy, and financial expertise; (4) impact of financial crisis on the responsibilities of audit committee; (5) general issues and duties; (6) financial reporting oversight; and (7) auditor oversight. A five-point Likert-type questions is used in Sections 2 and 4. Section 3 of the survey largely follows Carcello et al. (2002) by providing different choices on how the firm defines independence, financial literacy and financial expertise. Sections 5 through 7 consist of yes-no type questions that explore whether the AC perform certain functions in terms of mandatory and voluntary AC responsibilities. The list of mandated responsibilities is derived from CMA resolution Number (1-36-2008) dated 12/11/1429H corresponding to 10/11/2008G making Article 14 of the Corporate Governance Regulations of 2009. The voluntary responsibilities list is derived from prior literature (Carcello et al. 2002; HassabElnaby et al. 2007; IIA 2000).

IV. Empirical Results

A. Sample demographics

Table II presents the demographic information of AC members in our sample. Our respondents have a mean age of 42 with 11.2 years of work experience in the industry. With a comparable level of industrial work experience, AC members in Saudi companies are much younger than (> 10 years) their counterparts in the United States (HassabElnaby et al. 2007).⁵ Notice that all of the audit committee members are men with roughly half of them with an advanced degree (M.A. or Ph.D.); whereas U.S. sample consists of 81.2 percent of men with 66.6 percent of members holding an advanced degree (HassabElnaby et al. 2007). It is interesting to observe that approximately 96 percent of AC members in our sample have an undergraduate degree in various business disciplines (with the most in Accounting, followed by Finance and Marketing majors), compared to the U.S. sample of 64 percent reported by HassabElnaby et al. (2007). The work experience of AC members is divided among three industry classifications - 18.6 percent in retail, 44 percent in service, and 37.4 percent in manufacturing. However, despite approximately 78 percent of AC members holding a business degree with a concentration in Accounting and Finance, only 41 percent of members considered themselves financial experts.

Refer Table II

B. Audit Committee Expertise and Composition

Table III provides results on audit committee perceptions of the importance of expertise, possession of the expertise, and the formation of the audit committee. The audit committee members generally believe that it is equally important for all audit committee members to have a sufficient level of technical accounting and auditing expertise (mean responses of 4.3 and 4.2; respectively). To a moderate extent, they believe it is important for audit committee members to have sufficient industry expertise (mean responses of 3.6). The audit committee members believe that they possess a high level of expertise related to legal issues (mean response of 4.5) and technical auditing standards (mean response of 4.6), and to a lesser extent the Generally Accepted Accounting Principles (GAAP) (mean response of 3.9). Although AC members consider technical accounting standards expertise as the most important element of AC

⁵ HassabElnaby et al. (2007) reported a mean age of 53.4 with 10.9 years of industrial work experience for audit committee members in the U.S sample.

effectiveness, they do not appear to possess the same level of such expertise as indicated by their GAAP familiarity. With respect to auditing familiarity, the opposite is observed in that AC members believe they are most familiar with auditing standards (mean response of 4.7), which, however, are considered less important (mean response of 4.2) relative to GAAP (mean response of 4.3). Finally, to a moderate extent, the participants believe that their audit committee is composed of independent members (mean response of 3.9) and that the committee is properly funded to effectively carry out their duties (mean response of 4.1).

Refer Table III

C. Definitions of Independence, Financial Literacy, and Financial Expertise

In the absence of the audit committee charter disclosed in the proxy statements, we ask our respondents about their perception of definitions related to independence, financial literacy, and financial expertise requirements of audit committee members. Table IV presents the results. It should be noted that several companies mentioned more than one item as a base for their definitions of independence, financial literacy, and financial expertise. Panel A of Table IV lists items for member independence. The result suggests that a majority of companies define audit committee member independence based on the standards of Tadawul or Board of Directors alone (82 percent and 30 percent, respectively). A large number of companies mentioned the opinion of the Board of Directors (55 percent) and non-executive directors (48 percent) as elements in defining independence.

Panel B of Table IV displays some variation in the definition for financial literacy requirements of AC members across companies. Two more common definitions of AC members' financial expertise are members who "have a working familiarity with basic finance and accounting practices" and "have a basic understanding of finance and accounting and be able to read and understand fundamental financial statements." The least commonly employed definition is that the audit committee member must "be financially literate as determined in the BOD judgment."

Panel C of Table IV shows how companies describe financial expertise. The most common definition of financial expertise for audit committee members is members who "have past employment experience in finance or accounting" or "have accounting or related financial management expertise". This is in contrast to Carcello et al. (2002) who find these definitions to be less commonly employed for a sample of U.S. firms. A less commonly employed definition, in our sample, is that the audit committee member must "have accounting or related financial management expertise as determined by the BOD".

Refer Table IV

D. Impact of the Global Financial Crisis on Audit Committee

If corporate governance has a role in increasing firm performance and firm value as suggested by prior studies (Chan and Li 2008; Klein 2002), this effect should be most evident when a firm faces adverse economic circumstances such as global financial crises. Table V provides results on audit committee perceptions of the impact of the global financial crisis on AC members' oversight responsibilities and disclosure. To a moderate extent, the audit committee members generally believe that the global financial crisis expanded their assigned responsibilities and

performed responsibilities. In addition, the global financial crisis increased the disclosure level of the assigned responsibilities, performed duties and voluntary disclosure.

There is a tremendous concern over the potential liability risk associated with audit committee performance and disclosure. Some audit committees choose to limit their disclosures due to concerns about legal liability (Carcello et al. 2002). To a moderate extent, the audit committee members in our sample indicated that the concern about private litigation precludes audit committee members from disclosing some performed assigned duties (mean of 2.7), disclosing some performed voluntary duties (mean of 2.9), and disclosing some assigned but not performed responsibilities (mean of 2.9).

Refer Table V

E. General Audit Committee Issues and Duties

Table VI presents the results of the general audit committee issues and duties. There are several interesting results in this table. First, AC members perceive that they are doing more than what their annual reports mentioned, evidenced by a much higher percentage of members' perceptions than what is reported in the annual reports for all 12 survey items. One must exercise caution in interpreting such results because survey items might not exactly represent the amount of information contained in the annual reports. For example, the survey identified more general issues and duties than what actually appeared in the AC section of the annual reports. As previously discussed, there is no legal requirement for audit committee charter disclosure in Saudi Arabia. Consequently, many listed companies are reluctant to voluntarily provide a detailed listing of audit committee activities in their annual reports. Therefore, investors and users cannot rely on the audit committee section of the annual report alone to know whether the audit committee is actually fulfilling its prescribed responsibilities.

Second, item 2 of Table VI indicates that only 57% of the AC members perceived it as a duty or perceived that they have investigative power, while approximately 5% of the sample indicated that in the AC section of the annual reports, despite the CMA resolution Number (1-36-2008) mandated the investigative power of the AC. Third, to our surprise, all but three items (4, 5 and 8) of the perceived voluntary general duties have a higher percentage than the investigation power mandatory duty (item 2), suggesting that AC members are more focused on voluntary duties than the mandatory responsibilities when dealing with general governance issues. A similar pattern can be observed in the annual report disclosure where AC members are more interested in voluntary duties, such as reassessing charter on an annual basis (item 3), inquiring about business risks and steps taken by the management (item 6), and reviewing management succession planning (item 5), than the mandatory duty of investigative power of ACs.

Refer Table VI

F. Financial-Reporting Oversight

Table VII provides details on the audit committee's oversight responsibilities of the company's financial reporting function. Several observations can be made from this table. First, the rates of the mandatory duties are quite low, with one exception related to item 1 "audit committee reviews and discusses financial statements with management." Second, audit committee perceptions of their mandatory duties have quite higher rates than in the reports. Third, per the

survey and report, most audit committees (or the chair) appear not to review the interim financial statements prior to the filing the annual reports (Item 4). This is problematic as the AC oversight of interim financial statement review is an important step for maintaining the quality of the financial reporting process, given that the review may help to identify potential risks associated with weak internal controls (Carcello et al. 2002). Fourth, the vast majority of the audit committee perceptions and reports indicate that audit committees neither review nor approve accounting changes (Item 6). Such practices may further erode the quality of the financial reporting process that includes required communications between audit committees and external auditors. As for the voluntary duties of financial reporting oversight, audit committee members assigned extremely low rates to these functions. This lack of interest on voluntary financial reporting oversight duties is consistent with the duties reported in audit committee section of the annual reports.

Refer Table VII

G. Auditor Oversight

Table VIII shows the audit committee's oversight of the external and internal auditing function. Overall, the compliance rates are very low from both perceptions of AC members and disclosures in the annual reports. The fear of private litigations (Table V) could explain the lack of sufficient disclosure in the annual reports related to auditor oversight duties. One interesting observation is that AC members, who think they have adequate knowledge about auditing standards (Table III), grossly neglect these mandatory or voluntary auditor oversight responsibilities. Of all items under mandatory auditor oversight, the authority of AC to hire or fire the external auditor (item 1) is rated most important, while reviewing the system of internal control is rated the least important (item 5). Near the bottom of the list includes the review of internal audit procedures and plan (item 8), internal audit scope (item 19), and audit results (item 20). Regarding the voluntary auditor oversight, the dominant duty is reviewing the internal audit personnel decisions (item 12) rather than focusing on communications with internal and external auditors. To summarize, audit committee members show a lack of interest in auditor duties related to internal controls, which is inconsistent with the audit committees' increasing focus on internal controls in the U.S.A. and other developed countries.⁶

Refer Table VIII

V. Summary and Conclusion

This paper examines the effectiveness of ACs in Saudi corporations from the perspective of audit committee members using a hybrid research methodology that combines data from archival annual reports and a survey instrument. The descriptive analysis reveals that AC members believed their committees consist of largely independent members who should have sufficient levels of accounting and auditing expertise. Moreover, AC members overwhelmingly defined the member independence based on the standards of Saudi Stock Exchange Company and the financial literacy as understanding financial statements or familiarity with financial practices. Different from the U.S., having related work experience in finance or accounting was viewed as the most important element to financial expertise by AC members in Saudi companies. With respect to the impact of global financial crisis on corporate governance, the result indicates an

⁶ We plan to conduct analysis of audit committee characteristics and its mandatory and voluntary performance in the future once the data is available.

expanding role of ACs in both assigned and performed oversight responsibilities, as well as increased voluntary disclosure, consistent with findings from literature mainly focused on U.S.

By comparing the perceptions of AC members about the assigned oversight responsibilities and actual responsibilities disclosed in the annual report, we are able to examine the research question of whether or not AC members are effective in executing their oversight responsibilities. Recall that audit committees are considered effective when the *perceptions* of what they are doing meet or exceed what the annual reports and CGRs say they should be doing. The results reveal some interesting and detailed observations. First, to the extent of general audit committee issues and duties, respondents reported a much higher percentage than the one disclosed in the annual report, apparently suggesting that AC members are doing more than what the annual report has mentioned. However, such observations should be interpreted with caution because the lack of voluntary disclosure in the annual report may be a factor in this huge discrepancy.

Second, respondents normally rated their financial reporting oversight responsibilities quite low except for discussion of financial statements with management (item 1) and external auditor (item 2). It is surprising to observe that there is a general lack of interest among AC members in overseeing the financial reporting process, despite the fact that many AC members are trained to be accounting and financial experts (Table II) and considered themselves as accounting and auditing experts (Table III). It is in contrast to what the theory of expertise has suggested and the findings from empirical studies based in western countries. Such lack of focus on quality control of financial reporting process would contribute to the failure of ACs as an oversight body of corporate governance and increase the risk of fraudulent financial reporting, which in turn, negatively affect organizational performance over time.

Third, with respect to auditor oversight function, we observe that AC members' perceived compliance rate is relatively higher than what is reported in the annual report. While the ability to hire or fire external auditors is rated most important, items related to internal controls are rated lowest in the order of importance, suggesting that audit committees in Saudi companies are not proactive in reviewing systems of internal control, inquiring about internal audit procedures and plans, and reviewing internal audit results, which starkly contrasts to corporate governance practices of companies in the U.S. especially post-SOX (HassabElnaby et al. 2007). Finally, we observe that Saudi companies currently do not disclose their proxy statements and AC charters; such practices increase the information asymmetry between the firm and their shareholders, which in turn, further weaken the confidence of investors in the effectiveness of corporate governance and likely increase the cost of capital. Therefore, we believe that the SACMA should require proxy statements as an integral part of the annual report and should mandate the filing of AC charters.

In conclusion, this paper offers more detailed and timely information from the perspective of AC members about AC effectiveness in Saudi corporations. The most important finding from this study is that members of ACs are more focused on performing selected general assigned and voluntary duties and less actively engaged in the mandatory oversight responsibilities over internal control and the quality of financial reporting process. Whether or not such behavior is a

result of political or religious influences, organizational culture, or other contexture factors deserves more academic attention.

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Table I: Sample and Response Rate

	No. of Respondents
Questionnaires Mailed	149
Non-Responses	
Not a member of the audit committee when the survey mailed out	3
Not willing to participate	7
No Reason Provided	48
Total Non-Responses	58
Total Responses	91
Response Rate	61.07%

Table II: Sample Demographics

Variable	Current Study
Mean Age	42
Mean years experience in the position	6.08
Mean years experience in industry	11.24
Percent Male	100.0%
Percentage holding degrees	
Bachelor's degree	100.0%
Master's degree	46.0%
Ph.D.	2.2%
Undergraduate majors	
Accounting	68.1%
Finance	9.9%
Law	14.3%
Management	0.0%
Marketing	0.0%
Other	7.7%
Industry	
Retail	18.6%
Service	44.0%
Manufacturing	37.4%
Audit Committee Composition*	
Audit Committee chair	18.0%
Audit Committee Chair who is financial expert	12.0%
Financial experts (76)	41.0%
Audit Committee member	29.0%

Table III: Audit Committee Expertise and Composition

Importance of Expertise*	
Accounting Expertise	4.253
Auditing Expertise	4.176
Industry Expertise	3.593
Possession of Expertise**	
GAAP Familiarity	3.857
Auditing Familiarity	4.659
Legal Familiarity	4.538
Audit Committee Composition**	
Independence	3.901
Funding	4.055

* The 5-point Likert scale range is 1 = strongly disagree, 2 = moderately disagree, 3 = neither agree nor disagree, 4 = moderately agree, and 5 = strongly agree.

** The 5-point Likert scale range is 1 = don't know, 2 = to small extent, 3 = to some extent, 4 = to moderate extent, and 5 = to great extent.

Table IV: Independence, Financial Literacy, and Financial Expertise

No.	Item	Perception
Panel A: Definition of Audit Committee Independence		
1	Based on Saudi Stock Exchange Company (Tadawul)	82%
2	Based on opinion of Board of Directors (BOD)	30%
3	Have no relationship to the Company that may interfere with the exercise of their independence from management and the Company	18%
4	Opinion of the BOD and the requirements of the principal exchange or system on which the Company's common stock is traded	55%
5	Non-executive directors, free from any relationship that would interfere with the exercise of their independent judgment	48%
6	Free from any relationship that might interfere with the exercise of independent judgment	51%
7	Other definitions	4%
8	No definition provided	0%
Panel B: Description of Financial Literacy Requirements		
1	Have a working familiarity with basic finance and accounting practices.	76%
2	Be able to read and understand fundamental financial statements	60%
3	Become able to read and understand fundamental financial statements within a reasonable period of time after appointment.	41%
4	Be financially literate	40%
5	Have a basic understanding of finance and accounting and be able to read and understand fundamental financial statements	71%
6	Have a basic understanding of finance and accounting practices.	62%
7	Be financially literate as determined in the BOD judgment	25%
8	Other definitions	8%
9	No definition provided	0%
Panel C: Description of Financial Expertise Requirements		
1	Have accounting or related financial management expertise.	70%
2	Have past employment experience in finance or accounting.	71%
3	Have professional certification in accounting.	62%
4	Have comparable experience or background that result in the individual's financial sophistication.	54%
5	Have accounting or related financial management expertise as determined by the BOD.	36%
6	Other definitions	3%

Table V: Impact of the Global Financial Crisis on Audit Committee Oversight Responsibilities and Disclosure

<i>Variable</i>	
<i>Impact of the International Financial Crisis on</i>	
Audit committee assigned responsibilities expansion	3.637
Audit committee disclosure level of assigned responsibilities expansion	3.846
Audit committee performed responsibilities expansion	3.692
Audit committee disclosure of performed responsibilities	3.714
Audit committee expansion of voluntary responsibilities	3.637
Audit committee voluntary disclosure expansion of fulfilled responsibilities	3.714
<i>Impact of Private Litigation</i>	
On precluding audit committee from disclosing some performed assigned responsibilities	2.703
On precluding audit committee from disclosing some performed voluntary responsibilities	2.857
On precluding audit committee from disclosing some assigned but not performed responsibilities	2.857

Table VI: General Audit Committee Issues and Duties

No.	Item	Perception	Report
Mandatory General Duties			
1	Audit committee charter provides a description of AC responsibilities	97.80%	1.20%
2	Audit committee has investigation power	57.14%	5.00%
Voluntary General Duties			
3	Audit committee reassesses Charter on annual basis	69.23%	15.12%
4	Audit committee Chair can act for entire audit committee at interim	27.47%	1.50%
5	Audit committee reviews management succession planning	48.35%	5.81%
6	Audit committee inquires about business risks and steps taken by management	91.21%	30.23%
7	Audit committee has unrestricted access to all company records	79.12%	2.00%
8	Audit committee has responsibility for code of conduct or ethics content	49.45%	2.33%
9	Audit committee has overall responsibility for compliance program	70.33%	3.49%
10	Audit committee has some responsibility for compliance program	83.52%	4.65%
11	Audit committee familiar with the legal issues facing the audit committee members	82.42%	2.33%
12	Audit committee has a clear policy for hiring of former employees of the external auditors	61.54%	1.00%

Table VII: Financial Reporting Oversight

No.	Item	Perception	Report
Mandatory General Duties			
1	Audit committee reviews and discusses financial statements with management	77.91%	4.65%
2	Audit committee reviews and discusses financial statements with external auditor	12.79%	2.33%
3	Audit committee discusses all matters required by GAAP with external auditor	1.16%	2.33%
4	Audit committee or chair reviews interim financial statement prior to filing with the SCMA	2.33%	2.33%
5	Audit committee reviews accounting changes	1.16%	2.33%
6	Audit committee approves accounting changes	1.16%	2.33%
Voluntary General Duties			
7	Audit committee discusses issues with external auditor	1.16%	2.33%
8	Audit committee recommends to BOD inclusion of financial statement in annual report	1.16%	2.33%
9	Audit committee obtains management representation that financial statements use GAAP	0.00%	2.33%
10	Audit committee appraises key management estimates, judgments and valuations	0.00%	2.33%

Table VIII: Auditor Oversight

No.	Statement	Perception	Report
Mandatory Auditor Oversight			
1	Audit committee has the authority to hire/fire the external auditor.	1.68	0.1
2	Audit committee approves the appointment of the external auditor.	1.31	0.1
3	Audit committee assesses independence of external.	1.23	0
4	Audit committee approves and reviews external auditor fees.	1.33	0.08
5	Audit committee reviews systems of internal control.	1.02	0.08
6	Audit committee reviews external audit scope.	1.23	0
7	Audit committee reviews external audit procedures/plan.	1.29	0.06
8	Audit committee reviews internal audit procedures/plan.	1.07	0.1
9	Review the nature and magnitude of fees paid to independent professional advisers or counsels.	1.27	0
Voluntary Auditor Oversight			
10	Audit committee receives information regarding auditor independence	1.21	0
11	External auditor is ultimately accountable to the BOD and the audit committee.	1.22	0.27
12	Audit committee reviews internal audit personnel decisions.	1.59	0.05
13	Audit committee assesses independence of internal audit.	1.04	0.62
14	Audit committee has private meetings with external auditor.	1.25	0.03
15	Audit committee has private meetings with internal audit.	1.16	0
16	External Auditor has unrestricted access to audit committee.	1.4	0
17	Internal Auditor has unrestricted access to audit committee.	1.41	0
18	Audit committee reviews external audit results.	1.26	0.06
19	Audit committee reviews internal audit scope.	1.09	0.07
20	Audit committee reviews internal audit results.	1.09	0.1
21	Audit committee coordinates efforts of internal auditor and external auditor.	1.12	0.12
22	Audit committee evaluates exposure to fraud.	1.12	0.02
23	Audit committee requests to be informed if there is an auditor-management dispute.	1.13	0.02
24	Audit committee reviews the external auditor's management letter.	1.21	0
25	Determine that auditors are free from undue managerial influence.	1.09	0.01
26	Monitor the resources allocated to the internal audit function.	1.1	0
27	Review the use of other auditors or counsels for second opinions.	1.22	0.01