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Corporate Governance and Auditor Independence in Saudi Arabia: Literature Review and Proposed Conceptual Framework

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Abstract

This study aimed to propose a theoretical framework that explains the relationship between internal corporate governance mechanisms namely audit committee and board of directors, and auditor independence. It is a descriptive study that explored the Saudi corporate governance reforms and the Saudi auditing market. In recent years, Saudi Arabia has been pursuing corporate governance reforms, as evidenced by the setting up of the Capital Market Authority (CMA) in 2003 and the publication of the Saudi Corporate Governance Code (SCGC) in 2006. In the Saudi Organization for Certified Public Accountants (SOCPA), the accounting standards committee holds the responsibility of developing and reviewing accounting and auditing standards in the country. According to the agency theory, corporate governance mechanisms and external audit have a key role in improving the process of financial reporting. Basing the primary argument on the above premise, this study attempted to achieve the following objectives; 1) to explore the issue of auditor independence, and 2) to determine the extent of the effect of corporate practices in Saudi Arabia on the external audit independence. This conceptual work's outcomes revealed that the regulatory authorities and the CMA have to expend more efforts to improve the awareness and appreciation level of effective corporate governance practices among major internal mechanisms (audit committee and board of directors) and external mechanisms (external auditors) of corporate governance in Saudi Arabia.

Keywords: corporate governance, auditor independence, Saudi Arabia

1. Introduction

External auditor is considered, in the traditional agency theory, to be one of the major monitoring mechanisms used to mitigate costs of the lack of alignment between managers and shareholders (Jensen & Meckling, 1976). In this regard, Hossain *et al.* (2013) related that auditing effectiveness largely depends on the independence of the auditors, and therefore, when agency costs are higher, there is a corresponding increase in the demand for the quality of audit. The premise states that the capital suppliers take managers' incentives into consideration in that they are wont to adopt actions that satisfy their interests, and as such, through incentives the manager' opportunistic behaviors can be limited and their actions overseen (Fama & Jensen, 1983; Watts & Zimmerman, 1986). On the basis of this viewpoint, the audit function serves as a major corporate governance mechanism for shareholders as it monitors and controls the management of the organization (Shan, 2014).

Capital providers consider various issues in order to mitigate their risk (Riasi, 2015). One of these issues is auditor independence that can be extremely beneficial for risk mitigation purposes. Auditor independence is a crucial feature that efficient capital providers and regulators have long considered due to the possible threats that can be posed towards it (DeFond *et al.,* 2000). Auditor independence can mitigate agency costs related with the contractual owner-management relationships and the relationships among the various stakeholder groups (Lin & Liu, 2009). Auditors are responsible for certifying that the financial statements of the company are accurate and they provide the required disclosure to a sufficient level. On the basis of Remero's (2010), study, owing to the different users' reliance on the financial information for their decision making, auditor independence has been an issue of concern for regulators, practitioners as well as researchers.

Moreover, auditor independence issue is not a new one as it has been touched upon, time and again, by studies in literature (e.g., Ashbaugh *et al.,* 2003; Mayhew & Pike, 2004). The issue lies in the effect of auditor independence on audit quality, as the auditor's ability to report errors and misstatements hinges largely on his independence level. Also, the auditor's independence provides value and significance to the audit reports in terms of its viability (Lavin, 1976). Generally speaking, the auditor's role has evolved over the years to satisfy local as well as global demands for services and such evolution has led to examination of auditor's quality (Haniffa & Hudaib, 2007).

Moreover, the independence of the auditor from management is deemed be a pre-requisite for an audit that is effective and of high quality (Al-Ajmi, 2009). Judging from the recent corporate scandals involving major firms like Enron and WorldCom, the auditor quality concerns have caused serious concern, attention and they have brought about intense debates as explained by Allehaidan (2012). More specifically, Enron's collapse that was attributed to the involvement of its auditor, Arthur Andersen, led to the enactment of certain provisions, known as the Sarbanes-Oxley Act (U.S. Congress, 2002) (SOX). The SOX primarily safeguards the independence of the auditor (Albring, Robinson, & Robinson, 2014).

To this end, in their quest to reform their governance mechanisms, both developed and emerging markets' academics and policy makers are challenged by the auditing quality issue (Ghosh, 2011). In the context of the Arabian Gulf countries, including Saudi Arabia, Haniffa and Hudaib (2007) related that as yet, the role of auditing profession has received little to no attention although some of the countries in the region are considered to be developing economies that are undergoing high economic and social growth levels, with international business connections and considerable international investments. Hence, in this study, the issue of auditor independence, in the case of Saudi Arabia, in relation to the internal corporate governance mechanisms is examined based on theoretical and empirical studies in relevant literature.

On the basis of related studies conducted by Carcello *et al*. (2002) and Abbott *et al.* (2003), firms having robust internal governance structures are more demanding for higher quality audit. In relation to audit quality, auditor independence has been evidenced to be influenced by several factors and activities creating threats and risks to it as explained through the consensus among scholars. Among such threats to the auditor independence is an ineffective corporate governance mechanism.

Based on its objective, this study contributes to literature in several ways; first, this is the pioneering study in the case of Saudi Arabia that examines the way agency conflict influences auditor independence comprehensively, as far as the researcher's best knowledge is concerned. It is the first study to examine corporate governance structure by employing an integrated framework in both country categories (developed and developing). This study provides a deeper insight into the effect of the internal corporate governance of the firm on external auditors' independence as it delves into the discussions on globalization and convergence of corporate governance systems. In particular, the study's primary objective is to examine internal corporate governance from two integrated points of view namely audit committee and board of directors. Through this developed integrated framework, it is expected that the study provides new insights and fills the literature gap pertaining to corporate governance mechanisms and auditor independence relationship.

The second contribution of the present study is related to the fact that although some studies in literature investigated factors that serve as barriers to auditor independence (e.g., Gul, 1989; Creswell, 1999), only a few studies have explored the factors that serve to promote the same, specifically in the context of Saudi Arabia. This lack of studies was stressed by DeFond and Francis (2005) and Kasai (2014) who highlighted that studies that integrated between corporate governance mechanisms (auditor and audit committee) are few and far between. Hence, our study attempts to examine and integrate governance mechanisms while focusing on the Saudi listed firms' practice of audit monitoring. This is expected to assist investors and public to be aware the corporate governance mechanisms employed by listed firms to safeguard their interests.

The rest of the study sections are organized in the following way; while the second section contains an overview of the Saudi institutional setting, the third section provides a review of the relationship between corporate governance and auditor independence. This is followed by the fourth and fifth sections that contain the explanation of the theoretical basis of the study and a review of literature. The sixth section presents the research framework, and in the final section, the study is concluded.

2. Institutional Background

In Saudi Arabia, the corporate governance structure is mostly designed according to the Anglo-American model, with a stress on the protection of the interests of the shareholders (Alshehri & Solomon, 2012). This is attributed to the fact that the corporate law and legislation in the country stems from British corporate law; for instance, the Companies Act issues in 1965, was primarily based on the British Companies Act (Hussainey & Al-Nodel, 2008).

Along a similar line of argument, the Saudi Corporate Governance Code is largely based on the UK Cadbury Report 1992 (Aguilera & Cuervo-Cazurra, 2009; Seid *et al.,* 2013) despite some contextual differences (e.g., social norms, hierarchical social structure, concentrated ownership, state ownership). Such differences may act as barriers to the effectiveness of establishing formal corporate governance mechanisms in the country (Haniffa & Hudaib, 2007; Baydoun *et al.,* 2013) and they are considered as an important issues of corporate governance (Ammer & Ahmad-Zaluki, 2014).

Moreover, the corporate governance environment in Saudi Arabia comprises of external and internal frameworks, where the former is comprised of the Ministry of Commerce and Industry (MCI), the Capital Market Authority (CMA), the Saudi Stock Exchange (*Tadawaul*), and the Saudi Organization for Certified Public Accountants (SOCPA). Saudi firms are regulated, supervised and monitored by the above mentioned entities. As for the latter (internal corporate governance mechanisms), it comprises of the Saudi Corporate Governance Code (SCGC), the listing rules, and the Saudi Companies Act (Albassam, 2014).

2.1 Accounting and Auditing Standards

In comparison to other countries with an enriching history of professional and practical application of accounting and auditing (e.g., U.S. and U.K.), Saudi Arabia is still a novice. This may be attributed to the different commercial practice in the Arabian peninsula, with Mecca occupying the most importance trade area, with pilgrims visiting the city even prior to the Islamic era.

Saudi Arabia made a decisive move to issue its national accounting and auditing standards in 1986 that is adopted from the U.S. standards. Although majority of the banking firms and the financial firms use the international accounting standards, almost all the Saudi listed firms use the Saudi National Accounting Standards (IFRSs, 2011). As explained, the responsibility of the developing and reviewing the accounting and auditing standards in the country falls on the SOCPA.

In 2006, SOCPA made an attempt to incorporate the national standards into the international financial standards (IFRSs), which led to majority of the financial institutions' use of the latter. The final report drawn up by SOCPA highlighted that ongoing efforts are expended to identify the integration issues and the opportunities that would enable the full implementation of IFRSs. Despite the lack of real statements by SOCPA in relation to the determination of financial barriers, it expects that some barriers will arise.

Furthermore, the National Accounting Standards has a key role in the Saudi market environment in light of creating disclosure and of addressing financial transactions. The standards consist of 23 standards that cover disclosure requirements, revenues standard, inventory standard, among others. Such standards assist in heightening the competence of external auditors in enhancing the quality of audit. More specifically, seventeen standards address the competence and independence of auditor, the audit plan and audit report and other standards that are relevant and related to them (Al-Ghamdi, 2012).

The development of a professional accounting and auditing profession was deemed to be a pivotal phase in developing the Saudi corporate governance framework, which will be examined in the coming section.

2.2 The Saudi Corporate Governance Code (SCGC)

It was not until 2005 that marked the Saudi CMA's stress on the firm's performance issues that Saudi Arabia began paying attention to the significance of corporate governance mechanisms, and the 2006 market crisis highlighted financial reporting critical issues and weaknesses including lack of transparency, disclosure and accountability (Saudi Journal of Accountancy, 2006). By November 2006, the CMA of Saudi Arabia issued the Saudi Corporate Governance Code (SCGC) (Corporate Governance Regulations in the Kingdom of Saudi Arabia) and since then the SCGC is viewed to be a major driver of good corporate governance practices implementation among Saudi listed firms. The SCGC comprises of four parts namely preliminary provisions, shareholders' rights and the general assembly, disclosure and transparency and board of directors.

More specifically, the CMA Board set up corporate governance in 2006, and amended it in 2010 with the aim to regulate and improve the Saudi capital market and support the authenticity and transparency. The Code served as a guide from until the onset of 2010 when a mandatory regulation was required after which Saudi listed companies were mandated to disclose the implemented provisions in the annual report otherwise they had to state justifications for their non-compliance to the provisions.

The board of directors as well as the board committee is deemed to be the top solution to ineffective management. In the present study, the role of board of directors and audit committee in improving the quality of auditor's independence is examined.

2.3 Justification of the Study Context

The study selected Saudi Arabia to examine the phenomenon in because of four primary reasons; first, in Saudi Arabia, auditor independence is a real issue. The Companies Act 1965 of Saudi Arabia mandates listed firms to audit their financial statements by an independent auditor (Al-Eissa, 2009). In relation to this, the accounting scandals have also made its way to Saudi firms and were not merely confined to the Western firms. Specifically, the audit failures in the Saudi market included Mohammad Al-Mojil Group (2014) and Etihad Etisalat Co., the Saudi phone operator, known as Mobily (2014). These failures highlighted the accounting irregularities in Saudi firms and provided a negative view of the role of auditors in mitigating fraud. In the past few years, major organizational collapses have been linked to poor audit quality related with the perceived lack of auditor independence (Jr & Walker, 1999). Audit failures have been attributed to auditors' failure to detect or report erroneous information and claims in the financial statements.

Added to the above, the Saudi market crisis has indicated a serious weakness in light of the lack of compliance, lack of transparency, disclosure and accountability among Saudi firms (Saudi Accountancy Journal, 2008). Generally speaking, the financial crisis and collapses of major firms beginning from February 2006 until 2008 have led to low investors' trust and increasing concerns on the mechanisms role in the Saudi accounting environment (Alrehaily, 2008). To compound the matter further, the increasing occurrence of issues has led to a thorough review and assessment of the monitoring mechanisms so that professional regulations can put pressure on legislators and academics to determine means to enhance the monitoring mechanisms (Saudi Accountancy Journal, 2009). As a consequence, auditor independence and the role of corporate governance mechanisms in improving such independence should be examined in order to contribute to literature and fill the existing gap in studies, specifically in the context of a developing nation with an emerging market like Saudi Arabia – one that possesses distinct regulations and culture.

Another justification for the selection of Saudi Arabia is that the country is considered to be one of the largest and fastest growing emerging nations whose auditing practice is well established albeit limited efforts have been expended to systematically investigate the factors that influence the practices in the country. More importantly, studies on the issue of internal mechanisms of corporate governance and its relationship with auditor independence are still lacking.

The third reason lies in the fact that Saudi Arabia is currently acknowledging and attracting extensive foreign investments – in turn, it considerably invests in developed as well as developing nations (Al-Filali & Gallarotti, 2012). This shows that any failure in the corporate governance mechanism in Saudi Arabia has serious implications that go beyond the region and developing economies. For instance, ineffective corporate governance practices may result in losses to both domestic and foreign shareholders. The Gulf countries importance lies in their production of oil and they are led by Saudi Arabia but despite this fact, few studies have been done to examine such countries' commercial and financial activities (Baydoun *et al.,* 2013). This in turn attracted the researcher's attention to investigate the Saudi corporate governance practices.

The fourth reason lies in the importance of corporate governance and auditing in the current times in the Kingdom as competition is expected to intensify in the future. According to Iskander and Chamlou (2010), in emerging market economies, the business environments may still lack the required elements to promote competitiveness in the market and to establish a culture of enforcement and compliance. To this end, it is important for Saudi Arabia to examine the way other countries' systems function to maintain the effective functioning of their own. As a result, a research that delves into the effectiveness of audit committees and board of directors and the relationship between them and auditor independence among Saudi listed firms appears to be a valuable contribution to literature dedicated to the topic.

The above reasons justify the carrying out of the present study to examine corporate governance and auditor independence in Saudi Arabia in the hopes of evaluating the corporate governance framework and its influence on auditor independence.

3. Corporate Governance and Auditor Independence

Weak corporate governance practices are the reasons behind the collapse of major companies in the developed world (e.g., Enron and WorldCom) (Hussainey & Al-Najjar, 2012). Considering the crucial aspects of corporate reforms, it is not surprising that corporate governance has garnered increasing attention from the circles of policy-makers and academics alike (Aguilera & Cuervo-Cazurra, 2009). Performance-related issues of auditors in the Saudi context and other developing nations have been extensively debated on and has been largely related to the lack of corporate governance owing to several reasons; first, the lack of coordination and cooperation between audit committee and external auditors – a relationship that encapsulates the mechanism via which corporate governance will lead to fruition in terms of enhancing external auditors' independence.

In support of the above argument, studies dedicated auditor quality evidenced that in corporate governance the demand for audit services is a means to enhance quality of audit and auditor assurance (Anderson, Kadous, & Koonce, 2004; Krishnance & Ye, 2005). Several studies like Cohen *et al.* (2002) and Farbar (2005) found a positive relationship between corporate governance quality and the credibility of financial reporting. Based on this, it is important for auditors to ensure the financial integrity of the company as the auditor's effective and objective function is one of the top crucial corporate governance aspects (Low, 2002).

3.1 Audit Committee and Auditor Independence

The audit committee forms a sub-committee of the full board and it is the conduit between the full board, internal auditor, external auditor, executive officers and finance directors (Song & Windram, 2004). This stresses the importance of the committee's effectiveness – such effectiveness has been defined in various ways for different situations. Among the prominent definitions, Kalbers and Fogarty (1993) referred to it as the competency with which the audit committee conducts its responsibilities of oversight and Rittenberg and Nair (1993) described an effective audit committee as a committee that achieves its responsibilities.

Additionally, according to the National Association of Corporate Directors (NACD) (2000), an effective audit committee can contribute to the board of directors of the firm in terms of its value. As evident from the above definitions, an effective audit committee is one that effectively performs its roles and responsibilities and ultimately adds value to board of directors and the firm. In fact, the audit committee is a part of the board committee that implements the guidelines of corporate governance.

A particular aspect that has attracted immense concern is the companies' relationship with their external auditor and in response to this, Cadbury (1992) suggested the use of audit committees whose composition will be limited to non-executive directors in order to make sure that the external audit process is dealt with in an objective and effective manner. As mentioned earlier in the study, the recent financial collapse of major firms that has notably stemmed from manipulation of accounts has highlighted issues concerning the role of audit committees, specifically their protection of investors' interests and monitoring of the self-serving behavior of management (Ebrahim, 2007; Al-Mamun, Yasser, Rahman, Wickramasinghe, & Nathan, 2014).

More importantly, the audit committee is primarily responsible to protect the external auditor's independence as evidenced by prior studies (e.g., Carcello & Neal, 2003; Albring *et al.*, 2014) and in turn, an effective independent audit committee is viewed as one of the determining factors of the quality of audit (Dhaliwal, Naiker, & Navissi, 2006). The committee suggests the use of external auditors and oversees the relationship between external auditors and the company. In other words, an effective audit committee should improve the quality of audit.

Extending from the above argument, audit committee can play a key oversight role in the process of auditing and in assisting to be mediators in board-auditor disputes (Helen & Arnold, 2011). Added to this, owing to the audit committee's role in corporate governance, audit committees are capable of ensuring the credibility of the processed financial reports through their oversight and conduit role between management and auditors, both external and internal (Bradbury, 1990; DeZoort, 1997). In a related study, Beasley *et al.* (2000) reported that audit committees that lack the resources of oversight, such as inaccessibility to internal and external auditors, in firms, there is a greater possibility that fraud exists in such firms.

Furthermore, audit committee may mitigate the agency problem between the firm and external shareholders through their monitoring of the process of financial reporting. On the basis of the agency theory, the audit committee is responsible for monitoring and overseeing that the financial reporting has integrity and to this end, Klein (2002) stressed that the audit committee's role is to stop irregularities and fraud from being included in the accounting statements. In the case of Saudi Arabia, the audit committee is appointed by the firm and it should consist of at least three or more members – one of which should be a specialist in financial matters. The audit committee's primary role is to improve communication and minimize external auditor-management conflict. Additionally, the committee is also responsible for limiting managerial self-serving behaviors and in furnishing the required information to the external auditors (Al-Ghamdi, 2012).

In the present study, the researchers' focus is directed towards the role of audit committee in protecting auditor independence based on two reasons; first, several authors, regulators and professional entities (e.g., the Blue Ribbon Committee, 1999; Ramsay, 2001) have pinpointed that the primary responsibilities of the audit committee is to select and nominate external auditors and to protect their independence; for instance, the Saudi Ministry of Commerce (SMC) (1994) established that the audit committee is responsible for the nomination of external auditors and the determination of the audit function in terms of its scope and fees. Additionally, SMC also established that the audit committee's recommendations concerning the external auditors' engagement should be stressed on in the process of selection. This is supported by Ramsay (2001) who stated that the audit committee should ensure external auditors engagement and their independence. The report of Ramsay (2001) added that the audit committee should control non-audit services provided by the auditors in order to maintain their independence.

To reiterate, the scandals created by the collapse of major corporations like Enron in 2001 has led to the first legislation to be passed by the U.S. Congress pertaining to corporate governance improvement called the Sarbanes-Oxley Act 2002. The act mandates that the audit committee of a public firm holds the responsibility of appointing, compensating and overseeing the work of registered public accounting firm used by the firm (Sarbanes-Oxley Act, 2002).

Moreover, audit committee effectiveness stems from their effective oversight of financial reporting, external auditor and internal control (Kalbers & Fogarty, 1993). In the context of Saudi firms, audit committees' role is confined when it comes to corporate governance practices that cover financial statements, internal control systems, external auditor, internal auditor and risk management as evidenced by prior studies (e.g., Al-Twaijry *et al.*, 2002; Al-Moataz & Basfar, 2010). In Saudi firms, audit committee members do not have an effective communication with internal and external auditors as evidenced by Al-Aali, Chang, and Elnaby (2014).

This further justifies the present study's examination of the efficacy of the corporate governance regulations in the context of Saudi listed firms employed best practices, and the recommendation of audit committees when it comes to auditor independence.

3.2 Board of Directors and Auditor Independence

The board of directors is considered to be one of the top internal corporate governance mechanisms. In this regard, the board of directors forms the core of the internal governance of the firm (LeFort & Urzua, 2008) as its primary monitoring function is to mitigate agency issues that are often found in firm management (Hermalin & Weisbach, 2003).

The board-quality of audit services relationship may be formal or informal. In the former kind of relationship, the board of directors basically collaborates with management in the selection of external auditor, while in the latter the board may bring about audit quality through informal methods. The commitment of the board to oversee may indicate to management and auditors that the expectations towards quality audit are very high. In other words, once the auditor perceives that the board/client would expect high quality, the auditor may perform higher quality audit to meet the client's expectations and to maintain the relationship (Carcello *et al.*, 2002).

On the basis of the perspective of the auditor, a more independent, diligent and expert board that has a stronger control over the environment could mitigate the auditor's assessment of control risk and the level of audit procedures and eventually, this will lead to reduced auditing fees (Carcello *et al.*, 2002).

4. Theoretical Foundation

Theories primarily form meanings and they assist in analyzing concepts and the implications behind them (Riahi-Belkaoui, 2000). Several theoretical frameworks have been employed in exploring the governance relationship in terms of its nature in the corporate surroundings. From the several theories, the present study adopts the agency theory as the main theoretical underpinning of the study – and the selection of this theory determines the study approach to a large extent.

The agency theory primarily addresses the conflict of interest between principals and agents, where the former appoints the latter as an agent to execute duties on their behalf (Jensen & Meckling, 1976). The clashing and dissimilar interests that arises between the two creates asymmetries in information and the presence of such asymmetries lead to two major agency issues, which are moral hazard and adverse selection (Basiruddin, 2011).

In relation to the above premise to corporations and issues that arise concerning corporate control, the corporate governance mechanisms are invaluable in overseeing agents to mitigate the issues between two parties. Hence, various corporate governance internal and external mechanisms have been examined to steer clear of agency conflicts and to lessen the agency-related costs. This is the most general situation that is addressed by the agency relationship that relates to corporate governance.

For effective corporate governance, the board should comprise more of independent non-executive directors and a number of board sub-committees have to be set up. This is expected to maximize management transparency and eventually minimize monitoring and control expenditure, and extend reduced agency costs related with the mentioned activities because of lowered information asymmetry. Moreover, based on the agency theory by Jensen and Meckling (1976) and Fama and Jensen (1983), the board and audit committee are responsible for monitoring management's self-serving interests and not those of shareholders. Along a similar line of argument, audit committees should directly influence the quality of reporting through their oversight functions and the enhancement of such functions should lead to enhanced reporting and auditing quality of the firm, and reduced agency costs related to them. In other words, the committees can monitor and bring about smooth communication between management, external and internal auditors (Bradbury, 1990; DeZoort, 1997).

While the agency theory advocates for the firm's appointment of an independent auditor and the protection of its independence, it is notable that the disparity in the agency conflict degrees results in differences in the need for independent audit for its oversight. The auditor's review of the financial statements leads to increased accounting reliability and the viability of the contracts' value to various stakeholders (e.g., bondholders, stockholders and firm managers).

5. Literature Review

In literature, different definitions of auditor independence have been proposed (Romero, 2010). For instance, DeAngelo (1981) defined the term as the conditional probability of reporting a noted error, while Carey and Doherty (1966) explained the importance of an accurate definition of the term independence as semantic issues arise when the definition of terms is lacking. The authors defined independence as the steering clear of circumstances that would prevent or disturb objectivity and promote personal bias to affect sensitive judgments. From this definition, it is clear that a definition of the term auditor independence calls for a consensus on standards of terms relating to the maintenance of objectivity and the avoidance of personal bias.

The authors (Carey & Doherty, 1966), further explained auditor independence based on three senses; in the sense of not being subordinate, in the sense of steering clear of circumstances that may prevent objectivity of auditors, and in the sense of avoiding a relationship where a conflict of interest may arise. According to Flint (1988), other words that could provide a description of independence are, completely objective, unprejudiced by prior involvement in the audit subject, uncompromising interest in the results or outcomes, and unbiased and unaffected by external considerations to the issue at hand.

Generally speaking, there are two kinds of auditor independence namely independence in fact and independence in appearance. The former is also known as actual independence and is defined as the ability of the auditor to be objective and unbiased in their auditing decisions (Dykxhoorn & Sinning, 1982), whereas the latter is defined as the perceptions of the financial statement users of the independence of auditor. The significance in considering the latter type of independence arises because of the general realization that independence in fact is not easy to assess by the users of the financial statements as explained by McGrath *et al.* (2001). Despite the potential of the auditors to independently act and provide unbiased audit financial reporting, the users of the financial statements may still expect them to display independent in appearance.

As mentioned, several studies have extensively explored the audit fees/pricing determinants in developed as well as developing audit markets (e.g., Simon, Ramanan, & Dugar, 1986; Francis & Simon, 1987; Low, Tan, & Koh, 1990; Chan *et al.*, 1993; Johnson, Walker & Westergaard, 1995). However, the above studies have primarily addressed the firm-specific factors affecting the level of paid fees for audit services provision – with some of the factors including the size of the auditee, the complexity of the auditee, auditee risk, and size of the audit firm. Similarly, studies have also investigated the effect of corporate governance mechanisms on financial reporting and audit quality in literature albeit they are only a few in number (e.g., Gul & Tsui, 1998; Carcello *et al.*, 2002; Abbott *et al.*, 2003; Mitra *et al.*, 2007). These expansive studies have been conducted owing to the corporate governance issue's permeation into business organizations.

Among the studies, Carcello *et al.* (2002) looked into the relationship between a board's composition, meetings and directorships and the audit fees level. They found that firms with a higher percentage of independent non-executive directors and higher meeting frequency and multiple directorships had a tendency to demand for greater audit quality and assurance. Moreover, in Abbott *et al.*'s (2003) study, the authors revealed that audit committee independence that was defined as the composition of the audit committee of outside, independent directors, and financial expertise that was defined as an audit committee having at least one financial expert, are significantly and positively related with audit fees. Meanwhile, Gul and Tsui (1998) related that firms having low growth opportunities coupled with high free cash flows are related with greater audit fees as auditors exert higher audit efforts to mitigate the risk involved.

Along the same line of study, O'Sullivan (2000) revealed that independent board members have a greater ability to improve the audit scope in order to support their oversight function without cost. This complementary relationship between board independence and audit fees was supported by an empirically findings by the same author in the context of the U.K., and by Hay, Knechel, and Ling (2008) in New Zealand.

As for the frequency of board of directors meetings, Lipton and Lorsch (1992) contended that boards that have frequent meetings are more able to effectively perform their duties that benefit the shareholders. Hence, a board that is diligent in their oversight duty is likely to bring about enhanced oversight of the process of financial reporting (Yatim *et al.,* 2006).

Moving on to non-audit service fees, only a few studies in literature have been dedicated to the relationship between non-audit service fees and board of directors/audit committee effectiveness (e.g., Abbott *et al.,* 2003; Lee & Mande, 2005; Lee, 2008; Zaman *et al.,* 2011), where the studies primarily focused on major U.S. firms. More specifically, in Abbott *et al.*'s (2003) study, their study sample comprised of 538 firms, where they employed the ratio of non-audit services fees to total audit fees to examine the quality of audit. They noted that firms with audit committees that are independent and at least have four meetings annually are more likely to confine the number of non-audit service purchased as higher levels of such service may potentially lead to the impairment of the quality of audit. Also, Lee and Mande (2005) extended the above study by their model of audit and non-audit service functions in a simultaneous manner. They revealed that firms with only independent committee members who have at least four meetings annually displayed lower non-audit service purchase rate.

Moreover, in Zaman *et al.*'s (2011) study, the authors investigated the relationship between corporate governance quality, audit fees and non-audit service fees, as measured by natural audit fees log and non-audit service fees log respectively. Their findings showed that larger firms possessing effective audit committees had a greater tendency to purchase higher non-audit service owing to their operations' complexity.

To sum up the above reviewed studies, their findings indicate that corporate governance mechanisms minimizes agency problems in financial reporting and mitigates the risk towards accounting errors and irregularities.

In literature, studies dedicated to the relationship between the effectiveness of audit committee and quality of audit have been confined largely to the audit committees characteristics including incidence of outside directorships (DeZoort & Salterio, 2001; Yang & Krishnan, 2005), proportion of non-executive members (Baxter & Cotter, 2009), expertise (Bedard *et al.,* 2004), and diligence (Abbott *et al.*, 2004). In other studies, the audit committee members that are interlocked with auditors have been suggested to have a higher influence on the decision making of the clients compared to other parties (e.g., board of directors) that also have the potential to have interlocking relationships with the auditor (Seabright *et al.,* 1992; Jubb, 2000). Furthermore, Kalbers and Fogarty (1993) stressed on the audit committee legitimacy and power and the importance of both that may be represented by the committee size. In their study, a positive association was expected between the size of the audit committee and their activity, and in extension of this argument, a negative association was expected between audit committee size and the fee of external auditor.

Meanwhile, according to Sori and Karbhari (2006), auditor independence would be supported and promoted by independent audit committee that enables internal and external auditors to audit and assess financial information in an objective manner, and thus strengthening the internal control function. In other words, audit committee independence can mitigate fraud in financial reporting (Abbott *et al.*, 2004). Also, a significant negative relationship was reported between audit committee independence and auditor change by Owens-Jackson, Robinson, and Shelton (2009). This was supported by the findings of Archambeault and DeZoort (2001) that showed audit committee independence to be adversely related to suspicious auditor switching. This was evident in audit committee with more independent members that dismissed Andersen and hired a Big 4 to succeed him as the auditor of the firm (Chen & Zhou, 2007).

A clearer clarification of audit committee activity/diligence is the increasing function of the independent proportion of the non-executive directors on the board. This indicates that in consistent with the Blue Ribbon Committee, the Smith Report and the Sarbanes Oxley Act, a greater proportion of external non-executive committee directors indicates greater diligence and performance of committee in light of their oversight responsibilities.

With regards to the board and committee meetings, the frequency of such meetings was reported to be related to minimized discretionary current accruals levels, where active audit committees discharge effective monitoring functions. However, in relation to this, some prior studies reported contrasting results concerning the relationship between audit committee activity and the fees of external auditors. Some studies found a significant positive relationship (e.g., Stewart & Munro, 2007), while some others like Abbott *et al.* (2003) failed to find any significant relationship between frequency of audit committee meeting and audit fees.

In relation to the above studies in literature, independent audit committee members were suggested to minimize management switching threats by Carcello and Neal (2003) in cases where highly contentious circumstances arise between the auditor and management. Their study sample comprised of 374 firms observed from 1998 to 1999. On the basis of their findings, audit committee independence led to decreased potential for dismissal of auditor after the issuance of a going-concern report. Their findings also showed that firms possessing independent committee members have a greater tendency to take part in negotiations between the auditor and management concerning the audit plan or scope, and they are often incentivized to mitigate audit fees. On the basis of such negotiations, an independent audit committee can safeguard the auditor from management urging to conduct an expedient audit and to accept management report without evidence, and with limited audit scope.

Concerns regarding the close auditors-clients relationships have been underlined by regulators as they expect it to have a negative influence on the independence of the auditor and the quality of audit. From the audit firm's viewpoint, such a close relationship developed in both levels (firm and audit partner levels) may improve the possibility of future dealings between the two parties (Myers *et al.*, 2003; Huntley, 2006; Ye *et al.*, 2011). Even worse, a relationship between the audit committee of the client and its auditor may result in personal relationships that could strengthen loyalty, trust and emotive bonds (psychological dependence) in a way that the auditor loses his independence and staying logical is no longer an option (Arel *et al.*, 2005). This holds particularly true at the audit partner level where close relationships with audit committee members may threaten the independence of the auditor.

On the basis of several studies, such threats often arise from longer auditor tenure and it negative influences the quality of audit (e.g., Ghosli & Moon, 2005; Ryken *et al.*, 2007; Boone *et al.*, 2008). Despite the findings of the above studies being limited to the auditor tenure, en expected minimized quality of audit could happen when the audit committee and audit partner interlocks lead to more interactions between the two.

In a similar line of study, Davidson *et al.* (1984) reported a significant influence of interlocking directorates on the auditor selection and this has been deemed as a good corporate governance mechanism. Moreover, independent audit committee members holding down different directorships may not be able to effectively perform their monitoring function (Sharma & Iselin, 2012). Also, from the viewpoint of the supply-side, directors with multiple directorships have less time for their oversight role and audit risk may be perceived by auditors as greater and this might lead to increased audit work. It is thus expected that a positive relationship exists between independent committee member in multiple directorships position and audit fees and the possibility of the selecting a quality auditor proxied by the Big 5.

6. Proposed Research Framework

The agency theory is the underlying theory used in this study to examine whether or not the hypothesized relationships between corporate governance mechanisms and external auditors are supported. The agency theory framework is expected to provide an insight into the motivations for auditor independence and to explain the relationship between corporate governance (audit committee and board of director) and external auditor independence as a monitoring mechanism as presented in the flow chart below (See Figure 1 below). The study framework could serve as a guideline for future empirical studies that aim to examine the determinant factors of auditor independence.

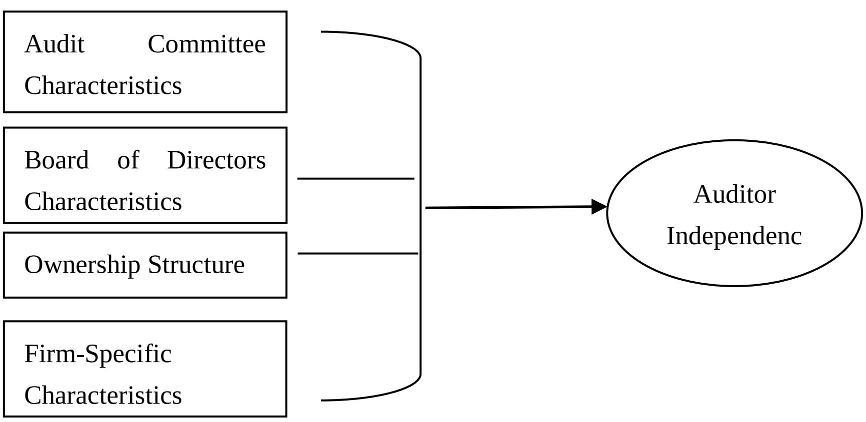

Figure 1. Theoretical research framework

7. Conclusion

The present study primarily aims to achieve two objectives; to explore the auditing practices in Saudi Arabia, and to explore the corporate governance internal mechanisms role in improving auditor independence. The study used a descriptive review to shed light on the auditor independence phenomenon. The study contributes to literature by focusing on a developing country that is characterized by a distinct legal system, regulations and auditing environment.

To achieve the above, the study provided an extensive review of literature concerning corporate governance practices and their relationships with external auditors' independence. The study also presented an overview of Saudi Arabia to highlight the existing issues to assist the researcher in identifying the determinants of auditor independence.

Added to the above, the paper also provided an explanation of the agency theory as the underlying theory of the study that examines the relationship between corporate governance and auditor independence. In other words, the agency theory was employed in this study as it is the most suitable theory to achieve the study objectives in that it predicts that the board of directors and audit committee can enhance audit quality. In sum, the study drew attention to corporate governance practices and their role as monitoring mechanisms in the Saudi Arabian context.

This study contributes to the body of knowledge by being the first study to examine corporate governance structure by using an integrated framework in both country categories (developed and developing). This study provides a deeper insight into the effect of the internal corporate governance of the firm on external auditors' independence as it delves into the discussions on globalization and convergence of corporate governance systems. Future studies should focus on examining the impact of corporate governance on another aspect of auditor quality (i.e. auditor selection and auditor switching).

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