EFFECTIVE FUNCTIONING OF THE AUDIT SERVICE FOR SAUDI FIRMS DURING THE RECENT FINANCIAL CRISES

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Abstract

This paper offers a contemporary look at the Saudi market during the financial crisis 2006-2008 which in recent years has become known as a significant adverse economic event in the world. Specifically, we investigate the impact of the audit service on the firm performance. The present study, also, empirically examines the impact of the introduction of Shariah-compliant Principles on the firm performance during the recent financial crisis. We find that firms dominated by independent directors and audited by Big Four auditors show high firm performance. The significantly relationship between Compliant-Shariah principles and stock price performance is proved only in 2007. The Saudi market should provide insight into market response to establish a Shariah Index in order to better capture its impact on firm performance.

Keywords: Governance, Audit, Shariah principles, Crisis, Stock price performance

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1. Introduction

The global financial crisis has captured the attention of investors, regulators and academics in all countries, affected or not affected by such financial failures. As a result, more attention has been given to enhance corporate governance worldwide in order to prevent a various instances of expropriation, to restore the confidence in capital markets and to preserve the firm value in crisis period. Audit Service and compliance with Shariah principles could play a very vital role in improving the stakeholder's confidence and corporate governance by bringing out better internal control systems, better monitoring and oversight, and better disclosures and quality of internal and external reporting.

There is a significant literature insisting that an Audit service is a key fulcrum of any company and investigating this framework that links independence, size, meetings and others characteristics of the audit committees and external audit to improve firm performance and value. Klein (2002) and Chan and Li (2008), for example, find evidence that the presence of independent and expert members on audit committee increases firm value. Kirkpatrick and al (2009) also find that independent members on the audit committees contribute to a better share price because the independent members have a better understanding of firms' risk.

A large quantum of research confirms also that the responsibility for assessing the effectiveness of audit committee and external audit are assuming more and more importance especially during the financial crisis. Mitton (2002), and Fan and Wong (2005) show that having Big Four auditor is associated with an additional higher stock price performance over the Asian crisis period. Empirical evidence of Ezzine and al (2010) show that the key audit committees attributes improve the firms' ability to resist the Asian stock market crisis which assessed by minimization of financial returns' conditional volatility. Conducted on a sample of Australian firms, Aldamen and al (2011), also, find that audit committee characteristics are associated with higher firm performance during the recent financial crisis.

However, the existing research literature pertaining to firm's compliance with Shariah Principles is limited. Rahman and Wajdi (2006) show that Shariah-compliant firms pay higher dividend to their shareholders than non-Shariah compliant firms. They also show that Shariah-compliant firms facing less agency cost than non-Shariah compliant firms. The Shariah Principles contributes towards maintaining market confidence, and strengthening transparency and accountability. The recent financial crisis highlights that corporate governance in Saudi Arabia is in its early stages and is characterised by a lack of accountability, a weak legal framework and protection of shareholders. In fact, the limited investigations on Audit Service in Saudi market (Ibrahim 2006 and Moataz 2003) encourage us to address the question of the impact of audit committee characteristics and compliant Shariah principles on the firm performance the recent financial crisis.

This main purpose of this study is to investigate the impact of the audit service attributes and compliant-Shariah principles on the Saudi performance during the subprime crisis.

The remainder of our paper proceeds as follows. Section 2 provides an overview on the regulation of the audit profession in Saudi Arabia. Section 3 reviews prior literature of the study. Section 4 describes the research design which includes the sample, variable measures and empirical methods. Section 5 tests the hypothesis and presents the results of the data analyses. Finally, we provide concluding remarks.

2. Regulation of audit profession in Saudi Arabia

The global financial crisis is causing a considerable slowdown in Middle East countries. The Saudi Arabia is amongst those who suffered from stock market recession. The recent incidents of corporate frauds have led to increased concerns regarding corporate governance in Saudi firms. They also have brought into sharp focus the importance of the critical role to be played by the audit service in ensuring good corporate governance. Thus, basing on the studies of Ibrahim (2006) and Abdulaziz (2009), we provide at the beginning an overview on the regulation of the audit profession in Saudi Arabia.

2.1 Accounting and auditing regulations

In accordance with the Regulations for Companies, all firms in Saudi Arabia are required to comply with Saudi Arabian Generally Accepted Accounting Principles (SAGAP). The accounting profession in the Kingdom is regulated by the Ministry of Commerce. The professional accounting body, Saudi Organization for Certified Public Accountants (SOCPA) in the Ministry of Commerce is assuming a leading role in organizing and further developing the profession. In fact, the Royal Consent in 1991 for the establishment of the SOCPA was taken in order to handle the regulation of the auditing and accountancy profession.

The Saudi Organization for Certified Public Accountants has issued the following pronouncements: Certified Public Accountant Code, Saudi Arabian Auditing Standards, Saudi Arabian Accounting Concepts and Objectives and the Standard of General Presentation and

Disclosure, and Saudi Arabian Accounting Standards. The SOCPA has issued accounting and auditing statements at times in an effort to establish Saudi Standards for all relevant topics and to update them in accordance with business requirements. Companies are required to follow the International Financial Reporting Standards (IFRS), if the orientation is not available on a particular topic in the Saudi Accounting Standards. The Company Law and the Department of Zakat Income Tax requirements require an annual audit for most types of firms. All listed companies under the Company Law are required to file audited financial statements with the Ministry of Commerce within six months of the end of the fiscal year.

The main objectives of SOCPA are:

- Review, development and adoption of accounting standards and audit
- Development the examination standards for certified public accountants
- Organization and supervision of continuing training
- Conduct of research in accounting, auditing and related fields
- Monitoring adherence to accounting and auditing standards
- Publication of relevant accounting and auditing material
- Participation in accounting seminars and conferences locally and internationally

2.2 Audit committee

Unlike accounting and external auditing, the development of internal auditing in Saudi Arabia has occurred in the lack of state recognition and support. The most challenging facing the audit practitioners of the nation is that to date there has been no specific government initiatives to promote and encourage the internal audit function, nor have the country's professional accounting organisms supported the development of internal auditing. However, the importance of audit committees as a major tool to increase confidence in financial statements and to protect property is recognized. Since January 1994, the Minister of Commerce has issued a resolution (Act 931), mandating all public companies to establish audit committees.

The resolution for the establishment of audit committee in Saudi Arabia comprised guidance to control the selection of their members. These guidelines are:

1) The member should be a shareholder of at least 20 shares and committee size should not be less than three director
2) The director should not be a member of the board of directors or managing a technical, managerial or consultancy works.

3) Saudi Arabia requires that a member of audit committee must have knowledge of accounting or finance.
4) The director should not have a direct or indirect interest in the transactions and contracts of the company.

It is true that Act 931 required all firms to establish an audit committee and provided a set of guidelines regarding the composition, operation and responsibilities of the audit committee, but these recommendations were not compulsory. The worldwide collapses had lead to increased concerns regarding audit profession in Saudi Arabia. That's why, in 2002, the Internal Audit Committee (IAC) reviewed the SMC best practices and recommendations aimed to improve audit committee effectiveness. The first draft is announced in March 2003. The new best practices are more clear and comprehensives. They are presented as follows:

1) All public firms are required to establish audit committees
2) Saudi Arabia requires that at least four committee members be independent directors
3) The audit committee should meet at least four times per year
4) The audit chairperson must be someone other than a member board.
5) Saudi Arabia requires that at least one member of audit committee must have expertise in accounting or finance aspects
6) The audit committee should have a formal charter

This first draft is sent to academics, external auditors, internal auditors and other interested parties for comment. However, no changes have been made on this and it is not clear if such best practices and recommendations will be adopted by the Saudi Stock Exchange Commission (SSEC) or SMC or not. Moreover, the Saudi financial market (Tadawul 2003) does not have any listing rules regarding audit committees. The audit committee framework in Saudi Arabia is a combination of statutes and codes of best practices and guidelines. Such framework lacks any listing rules by the SSEC. SMC is responsible for developing and up-dating the Corporations Law in Saudi Arabia, which should comply with the Islamic rules.

2.3 External audit

An external auditor is an audit professional who conducts an audit in compliance with laws or rules on the financial statements of a company. It permits stakeholders, including users of the financial statements, to rely on the company's financial statements for their decisions. In Saudi Arabia, the role of auditors equally becomes increasingly important especially with the recent corporate collapses. The Big Four Accountancy Firms are the four clear leaders in the industry. This group of companies works in international accountancy and handles audits for many of the largest companies in the world both publicly traded and privately. The companies that are a part of the Big Four accountancy firms are PricewaterhouseCoopers, Deloitte Touche Tohmatsu, Ernst and Young, and KPMG accountants.

The Companies Act 1965, modified in 1985 and in effect today regulates, among other things, the appointment of an external auditor, the relationship between the auditor and management, and responsibilities of the auditor. Articles 129 to 133 describe the arrangements for external audit appointment. The general meeting of the firm is responsible for selecting members of the audit committee and the audit committee is responsible for appointing the external auditor to conduct an external audit and for receiving reports from the auditor. The nomination mandate is for three years. When more than one audit firm is appointed, the appointment process does not recommence until five years after the audit firms began their audit (Saudi Ministry of Commerce, 1994).

The regulators and professional bodies in Saudi Arabia have considered the nomination and selection of external auditors and the protection of their independence to be the primary responsibilities of the audit committee. In fact, the regulations for auditor independence seem with the 1965 Company Act, 1985 Auditing Standards, SOCPA regulations and the 2004 Income Tax and Zakat Law, Professional Code of Ethical Conduct, and Standard of an auditor's objectivity, impartiality and independence.

3. Background and hypotheses

The paper investigates the impact of the audit service and compliant-Shariah principles during times of financial crises. Specifically, the study examines a number of audit service attributes that have been explored in normal market setting to understand their relevance, if any, to Saudi firm performance during the recent financial crisis.

3.1 Audit committee effectiveness

The audit attributes examined include the presence, structure, composition, meetings of audit committee within firms to identify if any of these characteristics impact differentially on the performance of high and low performing companies during the recent financial crisis.

3.1.1 Audit committee on firm

Audit committees are an essential component in corporate governance. Wild (2002) finds that better quality of disclosed financial reporting enhances firm performance. Therefore, the public has been increasingly focused on oversight and governance issues especially in the light of the many recent financial crises and the accounting scandals. Most regulations in the world have made recommendations on the attributes needed to establish and maintain an effective audit committee on the firm in order to improve the quality of financial reporting.

Over time, the role of the audit committee has evolved and has progressively been re-defined from a voluntary monitoring mechanisms employed in high agency cost situations to improving the quality of information flows to shareholders. The audit committee is established with the aim of providing and enhancing oversight over the organization's audit and other areas involving financial management.

Prior literature states that use of audit committee can be considered an important part of the decision control system for internal monitoring by boards of directors (Fama and Jensen 1983). Turley and Zaman (2004) assert that audit committee promote and strengthen the existence of an internal audit function. Other researchers show the significant relationship between the presence of audit committee and financial reporting quality (Defond and Francis 2005). Graham's empirical evidence (2005), also, supports the regulatory focus on governance to enhance the relevance and reliability of financial information. Another current of research found that increased reporting quality also enhances the firm performance, measured as the variability of the earning reports before and after the instalment of an audit committee (Wild 2002). The returns variability increased significantly after the instalment, which indicates that the audit committee contributes to a better performing firm. Ezzine and al's empirical evidence (2010) finds that firms with audit committees are better able to withstand the Asian stock market crisis.

Hypothesis 1: *A presence of audit committee on the firm has a positive effect on the financial performance during the recent financial crisis*

3.1.2 Audit committee size

Establishing and maintaining an effective audit committee is a challenge for any firm. To enhance quality, companies should consider some characteristics of their audit committee in line with most regulations. The audit size is one of attributes that should improve financial reporting quality and help avoid potential trouble in the future. Many researchers argued that increasing in number of audit committee members provides more effective monitoring and hence improves the firm performance (Raghunandan and Rama 2007, Aldamen and al 2010). Mangenka and Pike (2005) find that a higher number of directors on audit committee play a very vital role in improving the stakeholder's confidence by bringing out better quality of financial reporting. The complexity issues in reporting require considerable resources in terms of number of directors on the audit committee. Marrakchi (2000), also, show that audit committees consisting of a high number of directors are able to identify and resolve potential gaps and weaknesses in financial reporting.

The financial crisis and the recent incidents of corporate frauds have brought into sharp focus the importance of the critical role to be played by the size audit in ensuring good corporate governance. The empirical evidences of Sang-Woo and Il Chong (2005) and Mak and Kusnadi (2005) conducted on the Asian firms during the crisis of 1997 find that larger audit committees are likely to discover and resolve potential problems of governance as a whole and to reduce the vulnerability of firms to the Asian crisis. Ezzine and al (2010) find a significant and positive relationship between the number of audit committee members and the firm's ability to resist the Asian crisis; the higher of audit committee members, the lower the financial returns' conditional volatility.

Hypothesis 2: *A larger audit committee has a positive effect on the firm performance during the recent financial crisis*

3.1.3 Audit committee composition

Most of the Audit committee effectiveness literature has focused on composition as a fundamental determinant that influences the effectiveness of the committee. Independence is often heralded as the single most important board and audit committee. The board independence is strongly related to the level of monitoring of management and reduction in agency costs (Fama and Jensen 1983). Similarly, the audit committee independence would contribute positively to the quality of the financial reporting process and risk management practices (Beasley 1996, Carcello and Neal 2003b).

A large quantum of research investigated on the effectiveness of independent audit committees. Beasley (1996) shows that the presence of an audit committee doesn't affect the likelihood of fraud, but more independent directors on the board should reduce the possibility of fraud. The empirical findings by Abbott and al (2004) and Abbott, Parker, and Peters (2004a) confirms that an audit committee composed of independent members decreases the possibility that the firm will associated with misleading and fraudulent reporting. Klein (2002) found that audit committee independence was negatively associated with abnormal accruals and that reductions in audit committee independence were associated with large increases in abnormal accruals.

Other studies show that audit committee independence contributes positively to the quality of the financial reporting process and subsequently a better share price (Wild 2002). This result is supported by recent evidence from Kirkpatrick and al (2009) which shows that independent members on the audit committees contribute to a better share price because independent members do have better understanding of risk appetites of firms. Chan and Li (2008) find also that the presence of independent on audit committees increases firm value. Such result was supported since the empirical study by Rosenstein and Wyatt (1990), who showed the association between the inclusion of outsiders on the audit committee and the abnormal stock return. Ezzine and al (2010) find a positive relationship between the audit committee independence and the firm's ability to resist the Asian crisis. When considering the structure of audit committee, the literature and regulators argue also that the chair of the audit committee should be independent and the most experienced person on the audit committee, and other than firm's CEO.

In addition, the audit committee composition literature regarding expertise of committee was dominated by several studies (Raghunandan and Rama 2007). In accordance with many regulations, theses studies require that the audit committees include members who should have sufficient expertise in oversight areas related to accounting, auditing, law and finance. Their empirical evidences indicate that markets react more positively to the appointment of new audit committee member who has relevant qualifications and experience in finance and accounting.

Hypothesis 3: *The firm performance is high when the audit committee chair is another person than firm's CEO.*

Hypothesis 4: *The firm performance is positively related to percentage of independent directors in audit committee during the recent financial crisis*

Hypothesis 5: *The firm performance is high when the audit committee chair is an independent director.*

Hypothesis 6: *The firm performance is positively related to percentage of directors with finance and accountant degree during the recent financial crisis*

3.1.4 Audit committee meetings

The number of meetings is a potential indicator of audit committee effectiveness in performing its oversight functions. However, if it does not give any information on the work done during these meetings or the effectiveness of the Committee to exercise its functions, an important signal may exist after the number of meetings. Zahra and Pearce (1989) and Marrakchi (2000) assert that intensity and quality of discussions between the members of committee and the formality of meetings are important elements that ensure the good board functioning. The empirical findings by Raghunandan and Rama (2007) show that an increase in meeting frequency provides more effective monitoring and hence better firm performance. Sharma, Naiker and Lee (2009) also find that number of meetings potentially impact on firm performance. The earlier studies generally agree on an average of three or four meetings a year to allow the audit committee to carry out its mission (Coopers and Lybrand (1995), PriceWaterhouseCoopers (2002)). However, Abbot and al (2004) show that an audit committee that meet at least twice a year decreases the possibility that the firm will associated with misleading and fraudulent reporting.

Hypothesis 7: *The firm performance is positively related to number of* meetings of audit *committee during the recent financial crisis*

3.2 Audit quality

Since the outbreak of the recent financial crises, improve corporate governance and increase the ability of firms to guard any possible crisis require a redefinition of the role played by some economic actors first among which are, of course, auditors. The role of audit in agency and corporate governance theories is considered as a mechanism for regulating relations between the firm's partners. Jensen and Meckling (1976) show that the auditing is an important institutional arrangement that could align the interests of managers and shareholders and thus could mitigate agency costs. NG (1978) suggests that audit is one way to open flow of information between audit committee, and management. It helps to avoid mistakes and miscommunications.

The primary mission of an audit is to assess and communicate to shareholders the true situation of firm by reviewing and verifying the company's financial statements to form an opinion about the company's financial statements. They may give a qualified, unqualified, adverse opinion or even a disclaimer. Each one of these opinions can be vital for a firm. These statements tell the public if the firm is truthful and open with their financial information or if they seem to be hiding something they do not want anyone to see. The external auditors are the police and judges of the financial public affairs. The aim is a safe and sound financial set of financial statements to protect private and public investment.

However, most studies suggest that the evaluation or measurement of audit quality is problematic (De Angelo 1981, Lennox 1999). Manita (2005) states that the result of audit quality is not directly or immediately visible: the audit process is very complex and unobservable by third parties, and the audit report (the result of an audit) is so standardized in content and in its formulation that offers little opportunity for differentiation. De Angelo (1981) defined audit quality as the likelihood that financial statement errors or omissions will be detected (competence) and reported (Independence). These two concepts of an external auditor are imperative for him to be successful.

The audit quality literature identified both size and specialization of auditors as proxies for audit quality. The reputation of an audit firm is often associated with its size. The auditor quality is different depending on whether it belonged to one of the "Big Eight" (in the eighties), the "Big Six" (the nineties) and the "Big Four" today. DeAngelos (1981) argued that big audit firms provide investors with more insurance because such auditors are considered as having deep pockets, which enable them to compensate investors in case something goes wrong. The Big Six firms may be more likely to ensure transparency and eliminate mistakes in a firm's financial statements because they have a greater reputation to uphold (Michaely and Shaw, 1995), because they may be more independent than local firms, or because they face greater legal liability for making errors (Dye, 1993).

There are a significant empirical evidences dealing with the effectiveness of big audit firms. Fang and Wong's empirical evidence (2005) find that firms having a greater tendency to engage in big audit firms are those who undergo high agency costs. Mitton (2002) show that the disclosure quality is positively associated with the audit by one of the Big Six international accounting firms which in turn is associated with significantly better stock price performance during the Asian crisis period. As for the co-audit, it appears an interesting solution to the dysfunctions encountered in the audit and corporate governance of larger firms (audit firm Mazars). It delivers cutting edge solutions for enterprise management of internal and external audit processes and systems, helping you keep pace with regulatory compliance requirements. Then, the co-audit strengthens the independence of the audit groups by providing additional expertise and wider additional views. Thanks to the joint audit, the responsibilities are shared and the opinions quality, therefore, is improved.

Hypothesis 8: *The firm performance is positively related to the audit by one of the Big Four international accounting firms during the recent financial crisis*

Hypothesis 9: *The firm performance is positively related to the co-audit during the recent financial crisis*

3.3 Compliance with Shariah Principles

Over the last few years, a significant trend in conventional finance has been leaning towards Islamic Investments. The rapid proliferation and impressive growth of Islamic oriented are placed in order to better protect the interests of the Muslim investors. More attention has now turned towards applying Islamic principles in equity markets. In general, Principles were established after referring to the Quran, Hadith and general Shariah principles, and were formulated according to the activities of a particular company. The Shariah principles are focused on the primary activities of a company with regard to the goods and services offered. This is because these primary activities bring returns for the company that are subsequently distributed to its shareholders in the form of profits and dividends. Such activities need to be identified to see whether they are contrary to Shariah Principles. The business activities related to Pork, Alcohol, Gambling, Financials, Advertising and Media, Pornography, Tobacco and Trading of Gold and Silver as cash on deferred basis are excluded from the list of Shariah-compliant securities. Thus, the firm which complies with Shariah principles is not involved in any non-Shariah compliant activities.

The existing research literature pertaining to firm's compliance with Shariah Principles is limited. Rahman and Wajdi (2006) show that Shariah-compliant firms pay higher dividend to their shareholders than non-Shariah compliant firms. They also show that Shariah-compliant firms facing less agency cost than non-Shariah compliant firms. The Shariah Principles contributes towards maintaining market confidence, and strengthening transparency and accountability. Their emphasis is to be value oriented and promote fairness and justice for all stakeholders of the organization. Sadeghi (2008) have investigated the impact of introduction of the Shariah index on the financial performance. His empirical study finds that the compliance with Shariah principles has positive and strong impact on the financial performance of the Shariah compliant firms. Albaity and Ahmed (2008) explore the relationship between KLSI and

KLCE in Malaysia during April 1999 to December 2005. They find that there is an insignificant return difference and long term bidirectional relationship between both indices. Hakim and Rashidian's empirical evidence (2002) analyzes too the performance of Islamic indices vis-à-vis conventional stock market indices using stock market data. We suppose in this study that compliance of firms with Shariah Principles improve the functioning of audit service and improve the performance of Saudi firms during the recent financial crises.

Hypothesis 10: *The firm performance is positively related to the compliance of Shariah Principles during the recent financial crisis*

4. Research Design

4.1 Sample and Data

The sampling frame includes 95 industrial and listed firms on Saudi Stock Exchange (Tadawul) during the period of financial crisis 2006-2008. The primary business segment of each firm must not be in financial services, that is, not in a Standard Industrial Classification (SIC) 6000-6999. The stock price and financial data were obtained from the Saudi stock market website: www.tadawul.com.sa. All corporate governance data was obtained manually from annual reports downloaded by every firm website. To measure firm performance during the recent financial crisis, I use stock returns over the crisis period, from January 2006 through December 2008. The returns are dividend inclusive and are expressed in local currencies adjusted for local price index changes.

Table 1 and Figure 1 show the movement of stock index for Saudi Arabia from 2007 through 2008. This index had already been trending downward. The median excess return is low; it varies from 0.412% in 2007 to -0.296% in 2008. The domino effect of recent financial crisis has an effect on Saudi firms. We also confirm this result by examining the trend volatility. The volatility nature of Saudi market is also observed in Table 1 and Figure 1. The global financial crisis which triggered by the sub-prime mortgage crisis in the U.S and which emerged in developed countries has been adversely affected and already spread to Saudi economy.

In general, the sample is a representative of larger and more liquid firms that trade on the major stock exchange of Saudi market. Panels A and B of Table 2 present summary statistics of firms for Saudi country. These companies representing different industries, in principle, reflect the overall trend of Saudi economy.

4.2 Variables measures

The dependent variable in our study is the firm performance (PERF). It is coded as 1 for the top performers and 0 for the bottom performers firms.

Table 3 summarised the independent variables.

To measure Shariah compliance, I use a dummy variable that is set to one if the firm complies with the Shariah principles and zero otherwise. The selection of Shariah-compliant takes place through a screening process based on two qualitative and quantitative parameters. The qualitative criteria, in evaluating the status of these companies, are to assure that they are not involved in these activities: Financial services based on riba, gambling, production or trade of prohibited goods (pork, alcohol, etc.) After removing companies with non-compliant business activities, we advance the quantitative criteria or Accounting-Based Screens. In fact, the rest of the firms are examined for compliance in financial ratios, as certain ratios may violate compliance measurements. There are:

- Debt / Market Value of Equity (12 Month average) < 33 %;
- Accounts Receivables / Market value of Equity (12 Month average) < 49 %;
- (Cash + Interest Bearing Securities) / Market value of Equity (12 Month average) <33%;
- In certain cases, revenues from noncompliant activities are permissible, if they comply with the following threshold: (Non-Permissible Income other than Interest Income) / Revenue < 5%

4.3 Descriptive explanatory variables analysis

Our descriptive analysis is conducted on three groups of independent variables for Saudi firms during 2006-2008: Audit Committee, Audit Quality and compliance with Shariah Principles. For Audit Committee, Table 4 shows that all Saudi firms establish an audit committee. The Saudi firms respect the main rules and recommendations which advocated the significant role of audit committee in the oversight of the company's risk management policies and programs. As regards the size, the average audit size is low; it does not exceed 3 members. However, our results show that the independent directors are the most involved group on audit committee during the three sub-periods of crisis (63% in 2008 against 65% in 2006). More than 60% of audit committee have also an independent chairman. Furthermore, this analysis indicates that positions of CEO and audit chairperson are separate for all Saudi firms. The Saudi market has introduced extensive reform measures that making audit committee more effective and more independent of management.

For Audit Quality, we have retained two attributes: the audit by one of the Big Four international accounting firms and the double audit. More than 50% of Saudi firms are audited by one of Big Four during the three sub-periods of crisis. This result corroborate the findings showing that Big Four firms may be more likely to ensure transparency and eliminate mistakes in a firm's financial statements because they have a greater reputation to uphold (Michaely and Shaw, 1995), because they may be more independent than local firms, or because they face greater legal liability for makingerrors (Dye, 1993). Moreover, on average, around 10% of firms are audited by a double audit (7.608% in 2008 against 12.345% in 2006).

For compliance with Shariah principles, after a screening process that based on two qualitative and quantitative parameters, we find that around 40% of firms comply with Shariah principles (38.461% in 2008 against 44.827% in 2006). These firms are involved in compliant business activities and are examined for compliance in financial ratios.

4.4 Empirical Methods

The following Logit-cross-sectional-regression model is used to test the hypothesized relation between the audit service attributes, compliance with Shariah and the dichotomous firm performance variable PERF:

$$\textit{Crisis-Period Return} = a + \beta_1 \textit{(Audit Service' Variables)} + \beta_2 \textit{SHARIAH}$$

$$\beta_3 \textit{FSIZE} + \beta_4 \textit{DRATIO} + \beta_5 \textit{IDUM} + \varepsilon$$

in which all variables are as defined previously.

5. Results

5.1 Univariate Results

Our univariate analysis is essentially based on the Independent sample t-test which used to determine whether the values of explanatory variables differ between two our independent groups (Top performers and Poor performers firms). However, three attributes of audit committee are eliminated from our empirical analysis: presence of audit committee, leadership structure[1] and number of audit committee members with finance or accountant degree[2]. Panels A, B and C of Table 5 summarize the main results.

[1] All firms establish audit committee and separate the positions of CEO and audit chairperson.
[2] Lack of this information in most annual reports of Saudi firms.

In 2006, by examining the mean variables for each group of firms in our sample, our findings fail to show that top performers firms have the highest values for audit service' attributes and compliance with Shariah principles. But, this remark is based on a simple comparison of means, which of course, simple observations can not confirm or deny anything in our assumptions, especially, that no significant differences were raised by applying the Independent sample t-test for the most variables. During 2007 (beginning of crisis), our results show significant differences between the two groups of firms with respect to independence of chairman and directors, and compliant Shariah principles. We note that the top performers firms present the highest means for CHAIND (0.833>0.600), IND (0.733>0.613) and SHARIAH (0.454>0.446) at the 5% and 10% levels. The results in 2008 lead to same findings of 2007 and also suggest significant difference at 5% level between the two groups of firms with respect to the double audit variable (0.100>0.088).

5.2 Logit Results

To interpret the logit results of our model, we follow the same procedure as in any multivariate method. These are two essential steps: Assessment of the overall model quality and Assessment of the partial relations in the model.

5.2.1 Robustness tests

Our model is estimated using the Maximum Likelihood Principle. The obtained results of Table 6 allow us to judge the overall model significance (Chi-Square Goodness of Fit Test) and its quality in terms of explanatory power (Pseudo R-squared) only for 2007 and 2008. A low Chi Square value and a high value of probability and also low Coefficients of Determination indicate the non-robustness of the model. However, we note that in 2007 and 2008, the Chi-Square test is significant at the 10% level and indicates that the models as a whole are significantly different to zero. The model quality in terms of explanatory power (Cox & Snell R Square and Nagelkerke R Square) also marked a good improvement in 2007 and 2008.

5.2.2 Test of hypotheses

We estimate a logit regression to test which audit service attributes and compliant Shariah principles impact firm performance. The interpretation of the valid coefficients is different than with a normal regression as the Logit Model is a probability regression. Therefore, the coefficient of the logit model indicates a probability log odd ratio of the likelihood of the independent variable that is related to the dependent variable, in this case firm performance. The positive coefficient for independent variable increases the probability of better performance of a firm in crisis period. However, a negative coefficient weakens the financial return.

The main results reported in Panels A, B and C of Table 7 can be interpreted as follows:

I. The audit service attributes and compliance with Shariah principles have no significant effect on the financial return except those of independence of chairman and directors. Holding all other variables constant, our model predicts the log odd for firm performance would change 7.375 for every one unit change in the IND. The positive coefficient under the 1% significance level decreases the probability of a higher performance of firm. Our hypothesis H4 that links positively the firm performance to the independence of directors is thus confirmed. Our findings confirmed also the hypothesis H5 that relates positively the financial return to independence of chairman (CHAIND). The independence of audit committee contributes positively to the quality of the financial reporting process and subsequently a better share price.

II. In 2007, the positive effect of chairman independence, independence of directors and audit by one of the big four international accounting firms on the firm performance has been proved. Our hypothesis H4 (H5 and H8) are confirmed. Indeed, with all control variables included, the coefficient on the CHAIND is 0.654. This indicates that each increase of 5% in chairman independence variable is associated with a higher financial return of 6.54% during 2007. In addition, Panel B shows that the coefficient on IND is 0.827 after all controls are included. This positive coefficient increases the probability of a good performance of firm. The positive coefficient for the BIGF at the 5% level suggests firm performance increases 2.299 for each unit change in the Big four audit variable. For firms' compliance with Shariah principles, our hypothesis H10 is confirmed. The SHARIAH variable has a positive and significant effect on the financial return at 5% level. The coefficient on the SHARIAH is 0.412. This indicates that each increase of 10% in Shariah variable score is associated with a higher financial return of 4.12% during 2007. Shariah-compliant firms would be more valued than non-Shariah compliant firms. The Shariah principles contribute towards maintaining market confidence, and strengthening transparency and accountability (Rahman and Wajdi 2006). The results reported in Panel B also show that firm size has a positive and significant effect on the firm performance during 2007 (at 10% level). The coefficient on the firm size 3.325, which suggests that the financial return increases 3.325 for each unit change in the firm size. The larger firms are the better performers firms.

III. After 2007, our results show only the significant effect of an independent chairman and meetings of the audit committee in maintaining firm performance in a crisis period. Our hypotheses H5and H7 are confirmed. The positive coefficient on the CHAIND under the 5% significance level increases the probability of a higher firm performance. The independence of the chairman would contribute positively to the quality of financial reporting process and firm value (Aldamen 2011). Further, the coefficient on the MEET is 0.005. This indicates that each increase of 10% in audit meetings variable is associated with a higher financial return of 0.05%. Such results are supported by Raghunandan and Rama (2007) showing that an increase in meeting frequency provides more effective monitoring and hence better performance of firms. Our results confirm also the hypothesis H8. The BIGF variable is associated with significantly better stock price performance. This finding is consistent with the view the audit by one the Big four international accounting firms benefits minority shareholders by increasing transparency and mitigating expropriation during a period of distress.

6. Conclusion

While most the corporate governance studies focuses directly on firm performance, only a few of them measures firm performance during a period of economic trouble. Stronger corporate governance was especially important during an unexpected period of extreme economic distress when the risk of expropriation of minority shareholders was high. The main purpose of this research is to examine whether governance makes a difference to Saudi firm performance when there is an adverse shock to expected future earnings. Especially, this study examines the relevance of a range of audit service attributes and compliant-Shariah principles during the recent financial crisis.

Our results show a strong evidence of a relationship between independence directors on audit committee and financial performance during the three sub-periods of crisis. An audit committee composed of independent members decreases the possibility that the firm will associated with misleading and fraudulent reporting. This finding affirm that Saudi firms comply with the most corporate governance principles and recommendations in world requiring companies to have an independent audit service. Furthermore, this study contributes to demonstrate in Saudi context that external audit is a tool for encouraging the managers to communicate accurate information to shareholders offset the lack of direct assessment of the firm performance.

Our evidence, also, supports the relevance of compliant-Shariah principles during 2007. The emphasis of Shariah principles is to be value oriented and promote fairness and justice for all stakeholders of the firm. However, this variable would be without effect on firm performance in 2006 and 2008. It is true that all Saudi firms are involved in compliant business activities, but do not show their compliance in financial ratios. Many firms violate certain quantitative parameters that will be important for compliance with Shariah principles. The Saudi market should provide insight into market response to establish a Shariah Index in order to better capture its impact on firm performance and its contribution in preventing firms going bust during an economic recession.

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Tables and figures

Table 1. Evolution of the Tadawul All Share Index return

TASI Statistics	2007	2008
Mean	0.001426	-0.002960
Median	0.001544	-0.000590
Max	0.055000	0.095131
Min	-0.058178	-0.098130
Standard deviation	0.014532	0.026368
Number of observations	247	250

Table 1 focuses on evolution of Tadawul All Share index return from 2007 through 2008. The returns of index are expressed in local currencies adjusted for local price index change. Lower median value is illustrated in 2008. Higher standard deviation value is also observed in 2008.

Crisis Statistics	2006	2007	2008
Stock return (Median)	-0.002047	0.001342	-0.002613
Standard deviation	0.012653	0.009331	0.015075

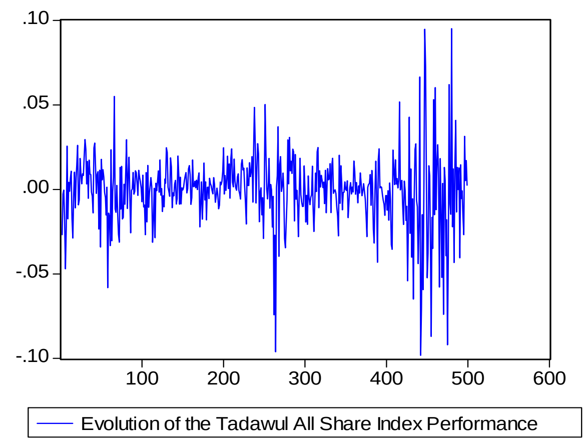

Figure 1. Tadawul Index return

This figure shows the trend in Tadawul All Share index return from 2007 through 2008. Horizontal line delineates the number of observations. The returns of index are expressed in local currencies adjusted for local price index change. A higher fluctuation is observed in 2008.

Table 2. Summary statistics

Panel A. Crisis statistics

Panel A reports crisis statistics for listed Saudi firms during the period 2006-2008. The stock returns are dividend inclusive and are expressed in local currencies adjusted for local price index change. For stock return, a lower median value is observed in 2008. For standard deviation, the lower value is also observed in 2008.

Panel B. Financial statistics

Panel B reports financial statistics for listed Saudi firms during the period 2006-2008. For market capitalization, return on asset and return on equity, lower median values indicate financial difficulties of Saudi firms especially in 2008.

Variables	Measures
PRAU: Presence of Audit Committee	1 if the firm establishes an audit committee and 0 otherwise
AUSIZE: Audit Size	Number of members on audit committee
LS: Leadership Structure	1 if the chairman is also the firm's CEO and 0 otherwise.
CHAIND: Independence of Chairman	1 if the chairman is independent and 0 otherwise
Number of Independent members on Audit Committee	% of independent directors on audit committee
FIN: Number of Audit Committee members with finance or accountant degree	% of directors with a finance or accountant degree
MEET: Number of Audit Meetings	Number of meetings of audit committee
BIGF: Big Four international accounting firms	1 if the firm is audited by one of the Big Four international accounting firms and 0 otherwise
DOUAU: Double Audit	1 if the firm is audited by a double audit and 0 otherwise
SHARIAH: Shariah Compliance	1 if the firm complies with the Shariah Principles and 0 otherwise
FSIZE: Firm Size	Logarithm of total assets

DRATIO: Debt ratio	Book value of total debt divided by the book value of total asset
Industry Effect	Industry sector code dummy (Campbell 1996)

Financial Statistics	2006		2007		2008	
	Mean	Median	Mean	Median	Mean	Median
Total asset (000RS)	14, 100,000	1,160,000	17,400,000	1,560,000	17,200,000	1,910,000
Total Market Volume	6,844,727	2,943,758	9,575,099	2,914,948	2,870,273	971,767.8
Total Market Turnover	201,000,000	166,000,000	141,000,000	115,000,000	82,180,459	36,409,194
Return on asset (%)	7.637	6.703	7.852	6.077	5.042	4.941
Return on equity (%)	10.687	9.852	12.385	8.77	7.424	6.6
Debt ratio (%)	54.365	36.22	62.457	39.269	76.086	43.246

Table 3. Variables measures

Table 3 lists all measures for Audit committee, audit quality, Shariah compliance and control variables..

Table 4. Descriptive explanatory variables analysis

Panel A. Descriptive analysis in 2006

Independent variables				
AUDIT COMMITTEE				
	Mean	Median	Max	Min
Audit Size	3.437	3	7	3
Percentage of grey directors (%)	30.525	10	100	0
Percentage of independent directors	65.386	66.600	100	0
The number of meetings	3.571	3	13	1
Presence of Audit Committee (%)	100			

Leadership structure	0
Independence of Chairman	75.757
AUDIT QUALITY	
Audit by one of the Big Four international accounting firms	59.360
Double Audit	12.345
COMPLIANT SHARIAH PRINCIPLES	
Firms which comply with Shariah Principles (%)	44.827

Panel A reports evolution of independent variables *for Saudi firms in 2006.*

Panel B. Descriptive analysis in 2007

Independent variables				
AUDIT COMMITTEE				
	Mean	Median	Max	Min
Audit Size	3.291	3	7	2
Percentage of grey directors (%)	30.750	0	100	0
Percentage of independent directors	63.206	66.60	100	0
The number of meetings	4.148	3.5	13	0
Presence of audit committee (%)	100			
Leadership structure	0			
Chairman independence	63.157			
AUDIT QUALITY				
Audit by one of the Big Four international accounting firms	63.333			
Double Audit	11.363			
COMPLIANT SHARIAH PRINCIPLES				
Percentage of firms which comply with Shariah Principles	42.696			

Panel B reports evolution of independent variables *for Saudi firms in 2007.*

Panel C. Descriptive analysis in 2008

Independent variables				
AUDIT COMMITTEE				
	Mean	Median	Max	Min
Audit Size	3.209	3	5	2
Percentage of grey directors (%)	29.296	0	100	0
Percentage of independent directors	63.004	66.660	100	0
The number of meetings	4.242	4	9	0
Presence of Audit Committee (%)	100			
Leadership structure	0			
Independence of Chairman	64.285			
AUDIT QUALITY				
Audit by one of the Big Four international accounting firms	66.304			
Double Audit	7.608			
COMPLIANT SHARIAH PRINCIPLES				
Percentage of firms which comply with Shariah Principles	38.461			

Panel C reports evolution of independent variables *for Saudi firms in 2008.*

Table 5. Results of Independent Sample t-Test

Panel A. t-Test Results in 2006

Variables	Mean Value		F	Sig	t	Sig
	TP[3] = 1	PP[4] = 0				
AUSIZE	3.200	3.529	4.219	0.046	-1.524	0.136
CHAIND	0.333	0.846	2.800	0.105	-2.301	0.059
IND	0.277	0.755	0.032	0.860	-3.178	0.013
MEET	2.666	3.809	0.784	0.384	-1.405	0.175
BIGF	0.529	0.549	0.059	0.810	-0.137	0.892
DOUAU	0.062	0.137	2.908	0.093	-0.944	0.352
SHARIAH	0.388	0.500	2.521	0.117	-0.804	0.427

Panel A shows whether the values of explanatory variables differ between two our independent groups (Top performers and Poor performers firms) in 2006.

Panel B. t-Test Results in 2007

Variables	Mean Value		**F**	Sig	t	Sig
	TP = 1	PP = 0				
AUSIZE	3,111	3.350	4.285	0.042	-1.525	0.124
CHAIND	0.833	0.600	13.221	0.001	1.980	**0.032**
IND	0.733	0.613	3.667	0.063	1.834	**0.047**
MEET	3.875	4.142	0.456	0.503	-0.321	0.754
BIGF	0.545	0.621	0.482	0.490	-0.449	0.660
DOUAU	0.100	0.107	0.021	0.884	-0.072	0.941
SHARIAH	0.454	0.446	2.009	0.024	1.750	**0.081**

[3] TP: Top Performers
[4] PP: Poor Performers

Panel B shows whether the values of explanatory variables differ between two our independent groups (Top performers and Poor performers firms) in 2007.

Panel C. t-Test Results in 2008

Variables	Mean Value		F	Sig	t	Sig
	TP = 1	PP = 0				
AUSIZE	3.000	3.222	2.333	0.131	-1.221	0.2470
CHAIND	0.857	0.596	21.868	0.000	1.846	**0.050**
IND	0.729	0.653	3.521	0.065	1.702	**0.082**
MEET	4.142	4.153	2.528	0.117	-0.015	0.988
BIGF	0.700	0.647	0.533	0.468	0.324	0.752
DOUAU	0.100	0.088	4.623	0.035	-2.546	**0.013**
SHARIAH	0.444	0.382	3.301	0.068	1.935	**0.045**

Panel C shows whether the values of explanatory variables differ between two our independent groups (Top performers and Poor performers firms) in 2008.

Table 6. Results of Model Specification

Years	Chi-Square	Sig	Cox & Snell	Nagelkerke
2006	13.550	0.241	0.097	0.129
2007	23.495	0.001	0.637	0.517
2008	20.054	0.005	0.602	0.670

Table 6 reports the overall model significance (Chi-Square Goodness of Fit Test) and its quality in terms of explanatory power (Pseudo R-squared) from 2006 through 2008.

Table 7. Logit Results

Panel A: Audit service attributes, compliant-Shariah Principles and financial performance in 2006

Variables	Estimated Coefficient	Standard Error	Wald	Sig
Constant	15.559	1.169	2.448	0.113
AUSIZE	1.405	0.412	0.001	0.236
CHAIND	7.367	0.724	4.562	**0.007**
IND	7.375	0.824	3.682	**0.007**
AUMEET	0.626	0.080	2.347	0.429
BIGF	0.243	3.399	0.048	0.622
DOUB	0.195	0.080	2.347	0.659
SHARIAH	0.049	0.852	0.280	0.825
DRATO	0.291	0.852	0.280	0.590
FSIZE	2.388	0.852	0.280	0.122

Panel A shows the regression estimates of the equation in 2006. With included firm size and leverage as control variables, our model retains the audit committee, audit quality and compliant Shariah variables.

Panel B. Audit service attributes, compliant-Shariah Principles and financial performance in 2007

Variables	Estimated Coefficient	Standard Error	Wald	Sig
Constant	14.559	1.442	9.305	0.056
AUSIZE	2.175	0.543	2.316	0.140
CHAIND	0.654	0.760	4.043	**0.012**
IND	0.827	1.012	4.317	**0.001**
AUMEET	0.096	0.079	2.393	0.757
BIGF	2.299	0.148	3.399	**0.048**
DOUB	0.730	0.079	2.393	0.393
SHARIAH	0.412	1.201	3.918	**0.041**
DRATO	1.292	1.201	3.918	0.256
FSIZE	3.325	1.201	3.918	**0.068**

Panel B shows the regression estimates of the equation in 2007. With included firm size and leverage as control variables, our model retains the audit committee, audit quality and compliant Shariah variables.

Panel C. Audit service attributes, compliant-Shariah Principles and financial performance in 2008

Variables	Estimated Coefficient	Standard Error	Wald	Sig
Constant	0.071	1.348	5.964	0.790
AUSIZE	0.325	0.531	0.541	0.569
CHAIND	1.395	0.786	3.414	**0.038**
IND	0.087	1.506	0.174	0.768
AUMEET	0.005	0.081	4.786	**0.014**
BIG	0.112	3.399	3.048	**0.048**
DOUB	0.439	0.081	1.786	0.508
SHARIAH	0.266	0.791	1.997	0.606
DRATO	0.071	0.451	1.917	0.790
FSIZE	1.557	0.391	1.867	0.212

Panel C shows the regression estimates of the equation in 2008. With included firm size and leverage as control variables, our model retains the audit committee, audit quality and compliant Shariah variables.

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