

Impact of Audit Committee characteristics on Financial Performance of companies listed under materials sector in CSE

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Audit committee functions as an indispensable mechanism by effectively communicating between internal and external auditors. This study aims to evaluate how the audit committee affects the entities' financial performance using a sample of companies from the material industry, out of 20 GICS industries listed in CSE. Only 14 companies were chosen out of the 23 companies in the material sector using the random sampling method. This study was based on secondary data where the data was obtained for these 14 companies from annual reports for the period from 2012 to 2019. The statistical techniques of Descriptive Statistics and Regression Analysis were utilized for analyzing the data. Earnings Per Share as a dependent variable and the audit committee size, audit committee independence, audit committee financial expertise, audit committee meetings were considered as independent variables, furthermore firm size as control variables were utilized for undertaking the study. The findings revealed that the audit committee meetings had a significantly positive impact on earnings per share, whereas all the audit committee attributes excluding audit committee independence showed a positive influence over earnings per share.

Keywords: *Audit Committee Financial Expertise, Audit Committee Independence, Audit Committee Meetings, Audit Committee Size, Earnings per Share*

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Introduction

The audit committee plays a key function in the mechanism of corporate governance especially in the process of oversight of financial reporting, risk management and internal control systems. The audit committee is a sub-group of the full board. The audit committee plays a correspondent role between the full board, internal auditor, external auditor, executive officers, and the fund executives.

Audit Committee inspects and manages the process of ascertaining the financial outcome via analyzing the financial statements, carrying out internal audit and significant audit procedures (Klein, 2002). An effective audit committee possesses a qualified and an experienced audit team with sufficient resources, power and supervisory efforts to confirm the reliability of the financial statements, risk management and internal control as well as to protect the interests of stakeholders (Koutoupis and Bekiaris, 2019).

Pincus, Rusbarsky and Wong (1989) stated that during the occasion of severe agency conflict, it is important for the audit committee to communicate to the internal and external auditors. The effectiveness of the audit committee depends on its ability to oversee the financial results with strong individual members and their characteristics of the audit committee (Kalbers and Fogarty, 1993). Moreover, an effective audit committee is expected to focus on the optimization of shareholders' wealth and prevent the maximization of personal interests by the top management (Wathne and Heide, 2000).

According to CA (2017), the audit committee should be composed of at least 3 non-executive directors of which two must be independent. All the members of the audit committee must possess general knowledge on area of finance whereas at least one of whom the chair should have adequate knowledge on regulatory framework, recent and relevant experience financial reporting and control and past experience in finance or accounting. Thus, it is crucial to investigate how the audit committee attributes could impact on the firms' performance. However, it is proved that Audit Committee effectiveness can be built up and improved if the audit committee is comprised of members who are well resourced, independent and are of financial expertise (Iyer, Bamber and Griffin, 2012).

Research Problem

Audit Committee acts effectively in order to limit the agency problems arising from the separation of ownership and control (Abbott L., Parker, Peters, & Raghunandan, 2003; Jensen & Meckling, 1976). It is vital for an audit committee to inspect the preparation of financial statements, manage the risk and follow internal control systems. Sri Lanka as a developing economy has faced several collapses of a few companies during the period of the past 20 years. Among them, failure of Pramuka bank in 2002, Golden Key Plc in 2012 and Touchwood Investments in 2013 were major significant corporate failures (Pakianathan, Samanthi and Ajward, 2019). At the same time, auditors failed to identify the errors and act ethically and as a result they were accused and imprisoned. So, audit committees are criticized and blamed for the misrepresentation of financial statements. Thus, it is of great importance to carry out a study on the audit committee and firms' performance in the context of Sri Lanka.

Most of the studies in relation to audit committee attributes are focusing on different industries in Sri Lanka. However, in recent years a study has not been carried out on the impact of audit committee attributes over the financial performance in the context of the materials sector in Sri Lanka. In addition to this, arguments of different authors are conflicting. Some authors argued that greater the independence of the audit committees', the more it elevates the financial performance of entities (Dissanayake and Bandara; 2018). On the contrary, when the

Audit Committee consists of a large number of independent auditors, then the performance of the firm gets deteriorated (Balagobei; 2018). Since different opinions have been put forward by different scholars, the problem statement of the study could be defined as "to what extent the Audit Committee characteristics impact on the Earnings Per Share?".

Literature Review

Ravindran, Nagarajah and Anandasayanan (2018) revealed that there is a significant negative relationship between size of the audit committee, audit committee meeting and share price of banking and finance companies, while board size and company age is significant and positively related with share price. The audit committee independence is non-significant and negatively related with share price. Also, they proved that there is negative and non-significant relationship between firm size and share price.

Pratheepkanth (2016) substantiated that the size of the audit committee is not significant, reflecting that more members in the committee is associated with sluggish earnings management practice. Also, the proportion of the audit committee members with accounting knowledge is not significant because active characteristics are effective to deter earnings management practices. Addition to this, it is argued that when performance is significant, two other control variables 'firm size' and 'leverage' become insignificant.

Amer, Ragab and Shehata (2014) investigated the audit committee characteristics and performance of the firm using a sample of 50 Egyptian listed companies in Sri Lanka. Their findings showed a positive relationship between the proportion of independent directors on the board and the financial performance of the firm, as measured by ROE, results of board meetings showed a positive significant relationship with ROE, CEO duality showed a significant positive relationship with ROE, and the director ownership is positively associated with firm performance as measured by ROE, but the relation is not significant.

Dakhlallah, Rashid, Abdullah and Al Shehab (2020) undertook a research on the Audit Committee and Tobins Q, using a sample of 180 Jordanian companies. Their findings showed evidence that there is a positive and significant association between the audit committee size, audit committee independence, and audit committee financial expertise with Tobin's Q. Their findings were consistent with the concept of both the agency and resource dependence theory, that the audit committee's independence has a positive effect on the performance of the firm. They proved that the performance of the firm can be improved by further financial knowledge and the abilities of the audit committee.

Balagobei and Thirunavukkarasu (2018) evaluated how the audit committee impacts on the organizational performance of 15 companies listed in hotels and travels in Sri Lanka. Their findings revealed that the audit committee attributes such as audit committee independence, audit committee experts and audit committee meetings have a significant impact on the organizational performance of the listed hotels and travels in Sri Lanka. Further, audit committee size was not found to have had a significant impact on the organizational performance.

Balagobei (2017) examined the impact of the audit committee on the value relevance of the accounting information of listed hotels and travels in Sri Lanka. She pointed out that audit committee attributes such as audit committee independence, audit committee experts and audit committee meetings have a significant impact on the book value per share of the listed hotels and travels in Sri Lanka. Further, only the audit committee experts influence the earnings per share. Audit Committee Independence did not show a significant impact on the value relevance of the accounting information.

Dissanayake and Bandara (2018) conducted a study on the impact of audit committee characteristics on the financial performance of 20 listed finance companies in Sri Lanka for the period from 2012 to 2016. The analysis exhibited that audit committee independence and audit committee financial literacy reflected a significant positive relationship with the firms' financial performance. Audit committee meeting frequency significantly affected the return on equity. However, audit committee size did not have a significant impact on the performance of the firm. Gunathilaka and Ranasinghe (2015) in a research conducted on Audit Committee Effectiveness in Sri Lanka, revealed knowledge and experience, role in financial reporting and the role in external auditing of the audit committee positively and significantly affected their effectiveness.

Methods

This study focuses on identifying the impact on earnings per share by the Audit Committee characteristics of listed companies in the material sector. As of 30th June 2020, the companies listed in CSE are 289 under 20 GICS industries. The population of the study was the companies listed under the material sector. There are 23 companies existing under the material sector and the researcher has chosen only 14 companies for a 7-year period from 2012 to 2019 due to the lack of data of some companies. The random sampling method was utilized to select the samples for this study. The data was collected from the annual reports of companies for the years ranging from 2012 to 2019. The research analysis was undertaken with the use of statistical techniques such as descriptive statistics, regression analysis and variance inflation factor test.

The regression model is as follows.

$$EPS = \beta_0 + \beta_1 ACS + \beta_2 ACI + \beta_3 ACFE + \beta_4 ACM + \beta_5 FS + \varepsilon$$

where,

EPS	=	Earnings Per Share
ACS	=	Audit Committee Size
ACI	=	Audit Committee Independence
ACFE	=	Audit Committee Financial Expertise
ACM	=	Audit Committee Meetings
FS	=	Firm Size
$\beta_0, \beta_1, \beta_2, \beta_3, \beta_4$ and β_5	=	coefficients
ε	=	Error

Conceptual Framework

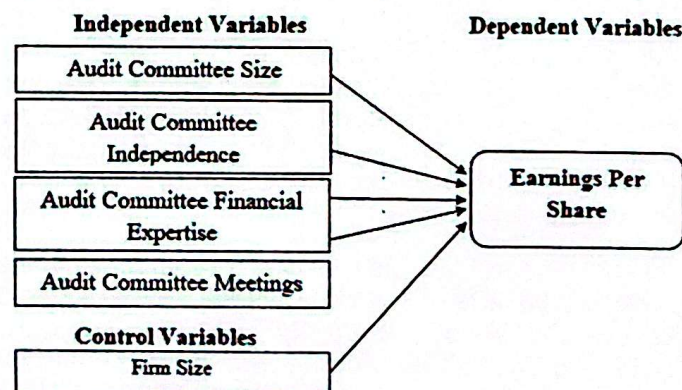


Figure 1: Conceptual Framework

Table 1: Operationalization of the variables

Variables	Acronym	Measurement
Independent Variables		
Audit Committee Size	ACS	Number of audit committee members
Audit Committee Independence	ACI	Proportion of independent directors to audit committee size
Audit Committee Financial Expertise	ACFE	Proportion of audit committee members with financial expertise to the total number of audit committee members
Audit Committee Meetings	ACM	Number of meetings held in a financial year
Control Variable		
Firm Size	FS	The natural logarithm of total assets
Dependent Variable		
Earnings Per Share	EPS	Net profit after tax divided by number of outstanding shares

Hypotheses Formulation

The following hypotheses were formulated as follows:

- H1 - Audit Committee Size has a positive impact on Earnings Per Share.
- H2 - Audit Committee Independence has a positive impact on Earnings Per Share.
- H3 - Audit Committee Financial Expertise has a positive impact on Earnings Per Share.
- H4 - Audit Committee Meetings has a positive impact on Earnings Per Share.

Findings of the study**Table 2: Descriptive Statistics**

	EPS	ACS	ACI	ACFE	ACM	FS
Mean	14.13291	3.428571	0.878022	0.807871	4.250000	14.69951
Median	4.859100	3.000000	1.000000	0.833300	4.000000	14.92015
Maximum	711.1937	7.000000	1.000000	1.000000	9.000000	17.23780
Minimum	-19.18650	2.000000	0.500000	0.333300	0.000000	11.43710
Std. Dev.	67.47218	1.340393	0.177862	0.207016	1.545117	1.243298
Observations	112	112	112	112	112	112

The Table 2 shows the Descriptive Statistics of all the variables. Based on the output, the average value of Earnings Per Share is Rs. 14.13 and its median is Rs. 4.86. The maximum and minimum value of Earnings Per Share are Rs. 711.19 and Rs. -19.19 respectively. The audit committee consists of 3 members on average and it ranges from minimum 3 members and maximum 7 members. Also, the mean value of the Audit Committee Independence is 0.878 which reflects that 87.8% of the audit committee members are independent. Audit Committee Financial Expertise's mean value is 0.808 which reveals that 80.8% of audit committee members are with financial expertise. Additionally, the average audit meetings held by the companies in the material sector are 4 with a minimum of 4 meetings and a maximum of 9 meetings. And, the firm size is on average of 14.69 with the standard deviation of 1.24.

Table 3: Regression output

Dependent Variable: EPS				
Method: Panel Least Squares				
Date: 07/12/20 Time: 22:34				
Sample: 2012 2019				
Periods included: 8				
Cross-sections included: 14				
Total panel (balanced) observations: 112				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-1415.562	323.8087	-4.371599	0.0000
ACS	0.506933	16.92842	0.029946	0.9762
ACI	-73.94711	77.80907	-0.950366	0.3444
ACFE	64.37568	62.96664	1.022378	0.3093
ACM	9.735045	5.402316	1.431802	0.0456
FS	95.78573	19.81697	4.833520	0.0000
R-squared	0.304799	Mean dependent var		14.13291
Adjusted R-squared	0.290243	S.D. dependent var		67.47218
S.E. of regression	61.46107	Akaike info criterion		11.22807
Sum squared resid	351304.0	Schwarz criterion		11.68925
Log likelihood	-609.7720	Hannan-Quinn criter.		11.41518
F-statistic	2.265232	Durbin-Watson stat		2.509471
Prob(F-statistic)	0.005936			

The Table 3 regression analysis describes the impact; the independent variables have over the dependent variables. Accordingly, the R squared value shows 0.3048 which highlights a 30.48% variation in the dependent variable is explained by the variation in the independent variables. At the same time, the value of F statistic is 2.26 and its p value is 0.005936. Hence, the regression is the best fitted model as its p value is less than 0.05. Additionally, the Durbin Watson stat is 2.50 which reveals that there is a negative auto correlation as it ranges from 2 to 4.

The Audit Committee Size has a coefficient value of 0.506933 and its p value is 0.9762. This clearly reveals that the audit committee size has a positive impact on Earnings Per Share but not at a significant 95% confidence level. Audit Committee Independence negatively and insignificantly effects on Earnings Per Share as the p value is greater than 0.05 ($r = -73.94711$, $p > 0.05$). Also, Audit Committee Financial Expertise possesses a positive coefficient reflecting positive effect on Earnings Per Share and its effect is insignificant ($r = 64.37568$, $p > 0.05$). However, Earnings Per Share is significantly affected by Audit Committee Meetings but shows a positive impact ($r = 9.735045$, $p < 0.05$) whereas Firm Size also impacts on Earnings Per Share positively and significantly.

Table 4: Variance Inflation Factor test

Variance Inflation Factors			
Date: 07/12/20 Time: 22:42			
Sample: 1 112			
Included observations: 111			
Variable	Coefficient Variance	Uncentered VIF	Centered VIF
C	9737.780	232.9422	NA
ACS	70.00757	22.81193	2.977762
ACI	3858.742	73.89065	2.907755
ACFE	1153.255	19.10092	1.173052
ACM	20.01646	9.761961	1.140689
FS	33.40321	173.7800	1.233237

The Table 4 depicts the Variance Inflation Factor test. The values of Centered VIF of independent variables are less than 10. Thus, the researcher can conclude that there is no multi collinearity problem among the independent variables.

Discussion and conclusions

According to the presentation and analysis, it can be concluded that the audit committee attributes audit committee size, audit committee financial expertise and audit committee meetings excluding the audit committee independence, effect on earnings per share with a positive effect. So, with regard to the findings, the hypotheses H1, H3, H4 and H5 are accepted.

Larger the Audit Committee improves, the greater the firms' financial performance. This clearly shows when the audit committee possesses competent, qualified and experienced members it would enhance the earnings per share. While audit committee independence gets improved, there is a fall in the earnings per share which states that the entity's performance gets weaker when entity appoints more independent directors. Insufficient technical knowledge of independent directors as well as their poor internal control systems and wrong recommendations would have led to the poor performance of the firm. This is consistent with the findings of Balagobei (2018).

Financial performance of organizations improves when audit committee financial expertise gets improved. This represents that whenever the audit team consists of well qualified, competent and experienced members, this would boost the earnings per share. Further, the earnings per share grow with the number of audit committee meetings. When meetings are conducted at a higher frequency, the entity's performance gets upgraded. This is supported with the previous studies made by Pratheepkanth (2016). Based on the above key findings it can be concluded that this study supports the agency theory where agency conflicts can be mitigated.

It would be more beneficial if further attributes can be evaluated and at the same time if all the companies can be considered from the material sector for future studies. Even though the audit committee size improves the financial performance of companies, it is better recommended to reduce the audit committee size which can lead to an increased proportion of earnings due to cost reduction.

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