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Audit Committees impact on Company Performance: The Greek & Italian Experience

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ABSTRACT

The current paper examines the impact of Audit Committee Staffing, Independence, Background and Skills, Size and Operation based on the number of committee meetings on the performance of listed companies from Greece and Italy. The study uses research data derived from the stock market, while the analysis was based on a static panel model. The statistical analysis has shown that the Audit Committee Independence and the Number of Audit Committee meetings have a negative impact on the corporate performance. Regarding the Audit Committee Background and Skills, there are no results indicating the existence of a statistically significant relationship with performance. The survey's hypotheses are based on the majority of the academic research concerning this subject. Although these outcomes are different from the underlying hypotheses, the cultural issues and the structure of social and economic environment indicate that there is an impact on the company's decision making process.

1. Introduction

Corporate governance is "a system of principles, on the basis of which a listed company is organized and managed, in order to preserve and satisfy the legitimate interests of all those associated with it, in terms of corporate interest". The consistency of a company and the way it is governed by its competent bodies, is a basic component. An effective corporate governance is the result of the specific interests of stakeholders (shareholders, management, board of directors, employees, suppliers, customers, banks and other lenders, market regulators, and in general the external environment and society) towards the general interest of the company. The board of directors is responsible for the corporate governance and the

organization of adequate and effective system of internal controls. The lack of organized control mechanisms results in the bankruptcy of problematic businesses. Corporate governance includes corporate practices on issues related to risk management, internal systems, internal and external audit and investor protection. Under the Bucharest Stock Exchange (BSE) Corporate Governance Code, organizations are required to treat equally all stakeholders, not to misuse them by their actions or omissions, and to ensure that everyone's rights are respected. Otherwise, compensation for damage should be possible.

At this point, the key role of the board of directors (BoD) emerges, an important administration's behavior control mechanism. In particular, Fama and Jensen (1983) noted that boards have the power to recruit, remove and compensate decision-makers, and evaluate the decisions' implementation as well. This kind of control on the members of the administration ensures the separation of decision – making from the control function over these decisions, aiming to reduce unacceptable administrative behaviors.

The audit committee oversees the process of compiling the financial results of the company, one of the individual responsibilities and duties assigned by the board. The regular meetings of such committees with both the company's external auditors and CFOs aim to analyze the organization's financial statements, carry out internal audits and take on the audit procedure as well (Klein, 2002). The audit committee is responsible for examining the financial statements and related memos, the dialogue with the management and external auditors, the reports of the internal and external auditors, the supervision of their activities, and the holding of private meetings with them as well.

According to DeZoort et al. (2002), a number of factors, including periodic meetings and the management of complex and secondary information, inhibits the effectiveness of an audit committee, which is why it should not be taken for granted. At the same time, top management is more aware of the company's operations and controls than the members of the audit committee. An effective audit committee consists of competent and qualified members, having the power and resources to protect the interests of the stakeholders and ensuring the reliability of the published financial statements, internal controls and risk management, through their supervisory efforts. 'Codes of best practices', stock exchange requirements, legislation and other guidelines were designed to meet the goal of 'making audit committees more effective' (i.e. BRC, 1999: 2).

Nonetheless, Kalbers and Fogarty (1993) specify that the effectiveness of the audit committee depends on its ability to perform the assigned predefined oversight tasks. It has previously been reported that the effectiveness of the audit committee is strongly associated with the individual members of a committee and their individual characteristics. The audit committee independence and the audit committee background and skills are of great importance as well. However, effective oversight goes beyond mere compliance with the rules; it requires careful consideration of an AC framework that facilitates the coordination of activities and information needed to support the committee's understanding and monitoring of a company's financial reporting process (Terrell & Reed, 2003).

Actually, the effective communication between internal and external auditors is carried out through an audit committee, and sometimes its composition is voluntarily, especially in cases of intense agency problem (Pincus et al., 1989). Companies that have audit committees at their disposal in comparison to those who are not are more reliable to stock market (Wild, 1996). In fact, the composition of the audit committee leads to a 20% rise of the positive reaction of the share price, in comparison with the shareholder reaction prior to its composition.

In the following paragraphs, the relevant literature on each of these relationships is presented, whereas the research hypotheses of this paper are developed.

2. Literature review and research proposition

2.1. Audit Committee Independence

The establishment and mostly the independence of the audit committee's members has been the center of attention for many researchers. In general, the classification of an audit committee as "independent" derives from the fact that the majority of its members are outside executives, rather than internal executives (Abbott et al., 2007). When independent managers play an active role in the audit committee, the business's accounting performance ameliorates. According to Kallamu and Saat (2015) and Chou et al. (2013), there is a positive association between the independence of the board and the ROA, while Chan and Li (2008) claimed that the board's independence has a positive impact on corporate performance on the market, only when it is absolute, that is when the majority of its members are external.

The stock performance of a business is not significantly affected by the partial presence of outside directors (non executives) at a board of internal

executives, as other studies suggest. Therefore, Xie et al. (2018) could not show sufficient evidence to prove the significant positive relationship between the Audit Committee Independence and the ROA. However, a higher percentage of independent directors on the board results in higher corporate performance and higher return on the stock market. Also, Mohammed et al. (2019) reported that firm performance is improved by AC independence and AC existence in Iraqi context.

On the other hand, Bhagat and Black (2002) argued that there is insufficient evidence to confirm the positive impact of higher audit committee independence on corporate performance. Respectively, Zabri et al. (2016) failed to identify a statistically significant relationship between the audit committee independence and corporate performance, whereas Fuzi et al. (2016), after an extensive review of the literature, reported mixed results concerning the independence and performance relation. A fact confirmed by surveys supporting both the positive and the negative impact of a higher degree of independence. Therefore, the prior evidence is inclusive. The following hypothesis is formulated:

H1: *There is an association between audit committee independence and firm performance.*

2.2. Audit Committee Background and Skills

The required audit committee background and skills are established by the board of the company, constitutes an important internal control operation. The well - trained members in finance and accounting strive to eradicate undesirable phenomena, such as profits falsification (Carcello et al., 2006).

According to a compelling study, Chan and Li (2008) acknowledge that the presence of executives with financial / accounting background and expertise is insufficient when it comes to increasing a company's performance in the market, no matter how crucial that presence might be. A situation that changed, when the relation between the financial / accounting expertise and the existence of an independent committee became more rigorous. More specifically, when higher performance demands the integration of external members with financial / accounting training and experience in the audit committee.

In addition, Gûner et al. (2008) claim that investment and financing decisions are probably affected by the presence of such members in the audit committee, while they are beneficial for the company's clearer financial statement and the effective operation of the audit committee. The findings of their study in a sample of American firms, revealed that the inclusion of

an Audit Committee Background and Skills should be done with caution, as experts do not always work for the benefit of shareholders, given the fact that knowledge and competence in financial issues are profitable requirements demanded by the members of the Boards (Wan Yusoff & Armstrong, 2012). Johl et al. (2015) have argued that the participation of a higher percentage of executives with financial / accounting experience in the board is associated with higher return on assets. Since the prior evidence shows mixed results, the following hypothesis is formulated:

H2: *There is an association between audit committee members' background and skills and firm performance.*

2.3. Audit Committee Size

On the grounds that the Board Size is another important dimension of the audit committee, a thorough study on a significant number of large North American and European banks by de Andres and Vallelado (2008) revealed that, although a bank's performance rises by the positive contribution of the addition of members to the audit committee, ROA is negatively affected by the overcoming of the maximum membership, setting therefore 19 members as the maximum. There were no sufficient evidence supporting the prevailing viewpoint that corporate performance is affected by the large number of audit committees members according to Adams and Mehran (2005).

In a more recent survey in the banking sector, Adams & Mehran (2012) verified that adding new members who maintain positions in other affiliates, can also lead to an increase in corporate performance. However, there is a number of surveys that have confirmed the positive impact a large audit committee may have on multinational companies (Coles et al., 2008; Linck et al., 2008). Chan and Li (2008) concluded that a large-sized audit committee is expected to negatively affect corporate performance. Rahman et al. (2019) reported in the context of Bangladesh that AC size is significantly positively associated with firm performance. Thus, the prior literature show mixed results. The following hypothesis is formulated:

H3: *There is an association between size of audit committee and firm performance.*

2.4. The frequency of audit committee meetings

A company's operation depends on the frequency of board meetings, which indicates the level of activity and the involvement of the audit committee. Adams and Ferreira (2008) support that the participation in board meetings is the main responsibility of the members. The meetings allow managers to discuss important administrative issues and conduct a more thorough

operation control; however, each additional meeting includes travel costs, extra membership compensation and valuable time expense. Subsequently, Jensen (1993) argued that unlike organizations facing problems, the board of directors is expected to have a more distinctive and detached role in companies with adequate performance.

Researches show that the increased activity of the board and the frequency of board meetings result in the operating performance and profitability of the business (de Andres & Vallelado; 2008). Chou et al. (2013) confirm the positive impact of the meetings, despite an important prerequisite; regarding corporate performance, a successful meeting requires the personal participation of the members on the board meetings. On the contrary, the corporate performance is affected, when the delegates are those who attend the meetings, instead of the actual members. Moreover, Ntim and Osei (2011) acknowledges that the company's frequency of meetings is proportionally related to its performance. Briefly, they verified the positive relation between the number of board meetings and corporate performance. Also, Zraiq and Fadzil (2018) in Jordanian context reported a positive direction but insignificant relationship between AC size and ROA but found positive direction and significant with EPS. Zraiq and Fadzil (2018) found that AC meetings were significantly and positively associated with firm's ROA.

Xie et al. (2018) state that there is a negative relationship between the number of meetings of the audit committee and the corporate performance, as measured by the ROA index. Although barely significant and further related to an individual committee and not to the entire board, it is a relation worth mentioning. Since, the prior evidence shows a positive and significant relationship, the following hypothesis is formulated:

H4: *The frequency of audit committee meetings is significantly and positively related to firm performance.*

3. Data and Methodology

This research focuses on the role of four main audit committee variables in the performance of a mixed sample of 30 companies from Italy and Greece. Data was collected from the Athens & Italian stock market available information. Specifically, 1.857 observations were noted in 251 applicable companies. The selection of the companies based on the size factor (market capitalization). There is no inclusion of financial sector entities. The final sample includes 119 observations. The time horizon for each includes the years between 2008 and 2012. We use static panel models . We analyzed data based on SPSS econometric software. We set the statistical significance level at 5%.

We concluded to the following empirical regression model:

$$(ROA_{i,t}) = \beta_0 + \beta_1(COMIND_{i,t}) + \beta_2(COMBBSK_{i,t}) + \beta_3(COMS_{i,t}) + \beta_4(COMNUMM_{i,t}) + \beta_6(FS_{i,t}) + \beta_7(LEVER_{i,t}) + \beta_8(LIQ_{i,t}) + u_{i,t} \quad (1)$$

in which i represents each of the companies; t represents the period of time; $ROA_{i,t}$ is the performance; $COMIND_{i,t}$ is the Audit Committee Independence; $COMBBSK_{i,t}$ is the Audit Committee Background and Skills; $COMS_{i,t}$ is the Audit Committee Size; $COMNUMM_{i,t}$ is the Frequency of Audit Committee Meetings; $FS_{i,t}$ is the The natural logarithm of its total assets; $LEVER_{i,t}$ is the ratio leverage; $LIQ_{i,t}$ is the ratio liquidity and $u_{i,t} = v_i + e_{i,t}$, with v_i being the non-observable individual effects of companies and $e_{i,t}$ the error which is assumed to have a normal distribution.

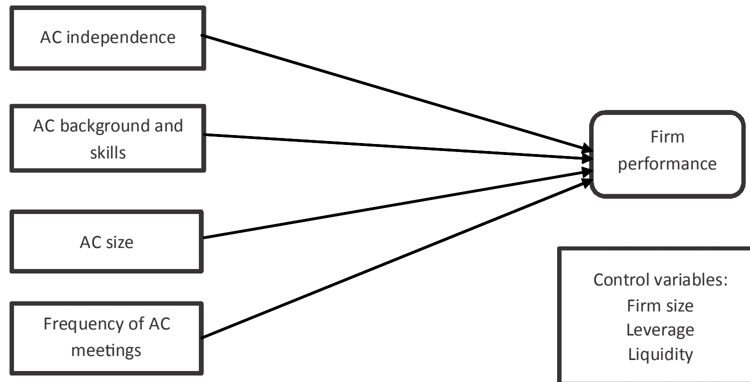

Figure 1: Proposed theoretical framework

3.1. Variable definitions

Certain determinants that affect the efficiency of an organism **(dependent variable)** are taken into account, while conducting the study. This variable is measured by the ROA.

Variables	*Measurement*
Performance	The ratio between EBIT (*earnings before interest and taxes)* and total assets.
Audit Committee Independence	Percentage of independent board members on the audit committee as stipulated by the company**.**
Audit Committee Background and Skills	If at least one Audit Committee member Background and Skills, the variable has a value of 1; 0 otherwise.
Audit Committee Size	The total number of its members.
Frequency of Audit Committee Meetings	The number of meetings of its members during each financial year.

Three **control variables** related to the characteristics of the sample companies were included in the analysis.

Variables	*Measurement*
Firm Size	The natural logarithm of its total assets.
Leverage	The ratio between total current liabilities and total assets.
Liquidity	The ratio between total current assets and short-term debt.

3.2. Descriptive Statistics

Next we present the statistics of the dependent and independent variables considered in this study. The results appear in Table 2. From observation of the descriptive statistics, we can conclude that the ROA measures with 5% average. 70% of audit committee's members, on average, are outside managers. Furthermore, as an average, 47% of its members have financial / accounting expertise. Also, the average size of the Audit Committee Meeting is 2 members. Finally, the Frequency of Audit Committee Meetings, the committees meet 4 times per year.

Table I
Descriptive statistics

Variable	*Observations*	*Mean*	*SD*	*Minimum*	*Maximum*
ROA	119	0.05	0.025	(0.04)	0.15
COMIND	119	0.70	0.19	0.00	1.00
COMBBSK	119	0.47	0.21	0.00	1.00
COMS	119	2.36	1.47	2.00	5.00
COMNUMN	119	3.76	1.62	1.00	6.00
FS	119	20.91	1.18	18.36	20.47
LEVER	119	0.28	0.14	0.10	2.10
LIQ	119	1.24	0.67	0.19	4.79

4. Results

The regression model is overall statistically significant (F statistic = 12.00, P <0.001). The regression model explains 72.4% of the variability of the dependent variable, which a very satisfactory percentage.

Based on the use of static panel model, we can conclude, concerning the relationship between the performance and the factors of audit committee: (1) there is a negative, and statistically significant, relationship between audit committee independence and firm performance; (2) there is a negative, and statistically significant, relationship between frequency of audit committee and firm performance; (3) there is no statistically significant

relationship between audit committee background and skills and firm performance; (4) there is no statistically significant relationship between audit committee size and firm performance; (5) there is a negative, and statistically significant, relationship between firm size and firm performance; (6) there is a negative,and statistically significant, relationship between leverage and firm performance; (7) there is no statistically significant relationship between liquidity and firm performance.

Table II
The results of the regression model

Variable	*Coefficient*	*Std. Error*	*P –value*
COMIND	(0.0001)	0.0001	0.05*
COMBBSK	0.0028	0.0082	0.734
COMS	0.0019	0.0013	0.145
COMNUMM	(0.0025)	0.0008	0.002**
FS	(0.0739)	0.0180	<0.001***
LEVER	(0.0504)	0.0145	<0.001***
LIQ	0.0022	0.0145	0.689
CONSTANT	1.8338	0.4167	<0.001***
R^2 adjusted	72.44%		
F statistic	12.003		

***, ** and *indicate significance at or below the 0.001, 0.01 and 0.05 levels

5. Conclusions

According to data analysis, the negative impact of the high Audit Committee Independence on the performance of the company's assets contradicts the original hypothesis, according to which, the more the number of the external independent non executives in the audit committee increases, the better the corporate performance gets, based on the ROA index. This outcome seems to question previous surveys on the audit committee independence (Chan & Li, 2008; Kallamu & Saat, 2015), which emphasize that increasing the independence of the audit committees, can result in better corporate performance.

Concerning the negative impact of the Frequency of Board and Audit Committee Meetings on corporate performance, the difference between previous research and the current study is that previous research has demonstrated positive relationship (de Andres & Vallelado, 2008; Ntim & Osei, 2011; Zraiq & Fadzil, 2018). However, the results of the current survey have associated the audit committees frequent meetings with low corporate performance.

The findings further suggest to regulators that they should adopt the legislation that encourages and promotes the use of internal audit in businesses and offers auditors incentives in the form of seminars or workshops to enhance their abilities to improve the efficiency and effectiveness of AC function.

The internal audit activity assists an organization to accomplish its objectives by y conducting a systematic and professional approach to evaluate and improve the effectiveness of risk management, control and governance processes. The higher the effectiveness of the audit committee, the better will be the risk management and internal control of the organization. The findings from this study may benefit the management, shareholders and society at large. Some examples are:

- It help the management in detection of errors and frauds.
- It builds up the reputation of the business. If AC is effective, auditors can give concrete suggestions regarding improvement of business on the basis of their findings in records.

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