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The Impact of Audit Committee Effectiveness on Corporate Performance – Evidence from Saudi Arabia

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ABSTRACT: The main aim of this study is to investigate the relationship between the effectiveness of audit committee (AC) of transportation firms listed on TASI and firm performance (FP) for the period 2010-2019. Employing Pooled OLS multiple regression analysis, the results indicate that the AC independence is negatively associated with FP. Therefore, the results contradict previous research which found that such relationship is significantly positive. Moreover, the results of two Pooled OLS regression analysis models reveal that frequent annual AC meetings do not have statistical association with FP. The findings of this study are relevant to investors and policy makers in Saudi Arabia regarding the reliability of AC in today's competitive markets.

KEYWORDS: Corporate governance, Audit committee, Firm performance, Return on Equity, Earnings per share

JEL Classification: M40, M41

1. Introduction

Following series of financial scandals of high profile North American and Western European corporations over the last twenty years or so, several critics and researchers questioned the effectiveness and competence of corporate governance tools in safeguarding shareholders' interests and maintaining the integrity of corporate financial information (Zamansky 2011; Sunderland 2010; Sikka 2008a). Such critics pointed to the passive role of corporate governance pillars, namely external auditors and ACs in exercising their responsibilities vis-a-vis the financial reality of the firm. Therefore, many researchers investigated the possible impact of ACs on FP especially with regards to the basic characteristics that enable the committee to exercise its power in protecting the interests of shareholders such as composition, authority, resources, and diligence (Dezoort et al. 2002). Recently, many studies attempted to examine the possible association between AC characteristics and FP (Klein 2002; Klapper & Love 2004; Claessens & Yurtoglu 2013; Kao et al. 2019).

It has long been perceived by researchers such as (Jensen and Meckling 1976) that firm directors, who are the defacto agents are hired by the shareholders to manage firm operations and act in the best interests of the owners. However, it is widely believed that directors may not in fact act in the best interests of the owners but for their own personal goals. Such behaviors are mainly driven by financial incentives which benefits the interests of the directors not the owners (Graham et al. 2005). Therefore, the effectiveness of AC should, in fact, act to mitigate the agency problem by providing robust mechanism to align the objectives of directors and owners.

Previous research in Saudi Arabia provides insights on the statistical association between AC characteristics and FP in which many of these studies found conflicting results (Al-Matari et al. 2012; Bagais and Aljaaidi 2020). However, this study attempts to contribute to the growing AC literature new insights regarding the possible relationship between FP and two fundamental AC characteristics, namely the frequency of AC meetings and AC independence based on data derived from corporate annual reports of the transportation sector listed in the Saudi Exchange market Tadawul All Share Index (TASI). Such research design offers new insights about the impact of AC effectiveness on FP. The importance of investigating the effectiveness of corporate governance of rapidly growing industry such as transportation sector at TAIS stems from the crucial role of this sector vis-a-vis Saudi vision 2030. This is evident in the selection of the developing the transportation and logistics as one of main objectives of vision 2030 in an effort to elevate this industry and consequently achieving the vision's key indicators to make Saudi Arabia a leading logistics hub in the region.

The reminder of the paper is constructed as follows: in the next section I am going to highlight the recent research endeavor that attempted to shed lights on the phenomenon of AC characteristics and FP. The third section will consist of a brief description of the research methodology in use, followed by a presentation and discussion of the empirical results, and finally a brief conclusion of the study.

2. Literature Review and hypothesis development

Over the last few decades, stories of prestigious multinational corporations such as, inter alia, Enron, WorldCom and Lehman Brothers contributed to a growing scrutiny regarding the watchdogs of the firms, namely ACs and auditors (Zamansky 2011; Sunderland 2010; Sikka 2008a, 2008b, 2009). This was, in part, due to the apparent malpractices of corporate directors particularly in the form misrepresenting corporate financial reality. Such practices are chiefly motivated by market incentives to meet unrealistic financial KPIs and shareholders expectations, hence enhancing the firm's performance image, particularly profitability and growth prospects (Graham et al. 2005).

The prominent agency theory proposed by Jensen and Meckling (1976) offers outstanding insights vis-à-vis management (agents) behavior where they are hired to lead daily activities and operations of the firm to, apparently, contribute to the interests of firm owners (principals). However, in fact, management of the firm may engage in opportunistic practices and exercise their power in order to achieve personal objectives. These practices are driven by economic pressures to meet market expectations, hence enhancing the firm's performance indicators, such as profitability and earnings figures (Graham et al. 2005). This issue may in turn offers additional understanding on the role of auditors in mitigating the agency problem despite critics of their economic dependence on audit clients (Sikka 2009).

On the other hand, and in a closely related oversight mechanism, AC is becoming increasingly crucial in mitigating the agency problem and safeguarding the interest of the principal through its oversight mechanism over external auditors. Recent research suggests the necessity of robust AC in an increasingly competitive and complex financial markets (Dezoort et al. 2002). This is particularly important since the external auditor is required to report directly to the AC and that such relationship offers invaluable importance in enhancing the detection of financial irregularities and elevating the audit quality (Cohen et al. 2007). Hence, the presence of robust AC is crucial in improving the performance of the firm (Aldamen et al. 2012).

2.1 AC independence

The effectiveness of AC is one of the pillars of modern corporate governance structure and embodies an oversight mechanism within corporations in an increasingly complex market (Abbott et al. 2004). However, certain characteristics of effective AC are particularly linked to achieving its overarching aims, namely AC members' independence which is expected to enable the committee to exercise its duties free from the board of director pressures (Jun Lin et al. 2008). Previous literature focused on the possible relationship between AC and FP to advance our understanding about effectiveness of AC in today's complex markets (Dezoort et al. 2002). AC is perceived to exercise its responsibilities more effectively when its composition includes more independent members (Kallamu and Saat 2015; Al-Matari et al. 2012). Independent AC members may enable the committee to act independently without pressure in overseeing the external auditor and the financial reporting process which in turn would yield higher audit quality (Kallamu and Saat 2015; Peasnell et al. 2005). Moreover, it is generally perceived that the independence of AC would enhance financial reporting quality and lower financial fraud that is mainly committed by top management (Nekhili et al. 2016; Akhigbe and Martin 2006). This relationship is facilitated by previous research, which found that the effectiveness of ACs are more apparent at enhancing audit quality through avoiding auditor resignations (Pomeroy and Thornton 2008).

Moreover, the study by Kallamu and Saat (2015), which was conducted in the Malaysian market, documents a positive association between AC independence and FP. Other similar results were reported by Naimah (2017). Additionally, a study that utilizes a sample of the largest 20 financial firms in the G8 countries, conducted by Yeh et al. (2011), found a direct effect of committee independence on FP. The results also confirm that this relationship is stronger for civil law countries. They also found that the relationship between independence and performance is more apparent in financial firms with higher risk-taking tendencies. Nevertheless, some studies did not confirm the above results, such as the study by Kota & Tomar (2010). In their study which investigate the possible relationship between AC independence and FP of 106 mid-size Indian firms, their analysis did not find significant statistical relationship. Based on the previous literature review, I expect that AC independence will have a positive impact on FP. Therefore, the first hypothesis will be as follows:

H_1: There is a positive statistical relationship between AC members' independence and firm financial performance, ceteris paribus.

2.2 AC Meetings

Previous research demonstrates that the frequency of AC meetings is an important corporate governance oversight tool that effectively enhances the monitoring mechanism of the firm (Xie et al. 2003; Lin et al. 2006). It is believed that frequent AC meetings would prompt necessary corrective actions against auditing and accounting irregularities (Al-Matari et al, 2012). Previous research document rich insights about the impact of AC meetings on FP. Abbott et al. (2004) examine the relationship between the likelihood of financial statements restatements and AC meeting and they document statistical evidence that when firm hold at least four meetings a year the degree of financial statements restatement is lower. Moreover, another study by McMullen and Raghunandan (1996) reveals that financially distressed firms do not usually hold frequent AC meetings. Additionally, the study by Hsu (2007) offers supporting evidence about AC meetings and FP relationship which reveal a significant positive relationship. In a study conducted based on Saudi market data, Bagais and Aljaaidi (2020) find that the relationship between AC meetings and FP is negative, which contradicts the mainstream literature that confirms a positive effect. Such findings only stand for ROE model whereas ROA model did not report significant results. Therefore, based on previous review, I expect that frequent AC meetings have a positive impact on FP. The second hypothesis will then be as follows:

H_2: There is a positive statistical association between the frequency of AC meetings and firm financial performance, ceteris paribus.

3. Research methodology

The sample of this study is based on the transportation sector of firms listed on the Saudi Exchange market Tadawul All Share Index (TASI). The population consists of the transportation sector of TASI. The rational behind this selection is because that this sector is one of the highly growing sectors over the last few years. Despite such importance, this sector has not been examined before within this area of research. The sample comprises of five transportation firms over the period of ten years (2010-2019). The final observations represent 50 firm-year after excluding one firm that was only listed in early 2021. The variables have been collected from the published annual reports which are summarized in table 1 below.

Table 1. Summary of variables

Variables	Definition	Predicted Sign
(PERF) ROE	Natural logarithm of of the net income divided by shareholder equity	D. Var
(PERF) EPS	Eearnings per share	D. Var
ACMT	Frequency (number) of AC meetings (on yearly bases)	+
ACINDR	Ratio of independent AC members (to total number of members)	+
SIZE	Natural log of firm total assets at year end	+
LEV	Ratio of firm long-term debt-to-total asset at year end	+

To analyze the collected data, this study utilizes Pooled Ordinary Least Square regression model (Pooled OLS).
The statistical model is formulated as follows:
PERF = β0 + β1 ACMT + β2 ACINDR + Control Variables + e

The control variables, SIZE and LEV, were selected following several previous researches in the field (e.g., Bhatt & Bhattacharya 2017; Aljifri and Moustafa 2007; Haniffa and Hudaib 2006). Such variables account for firm characteristics which may in turn influence financial performance.

4. Empirical Results

Table 2 offers summary statistics of the variables utilized in this study. Statistics include the mean, standards deviation, minimum and maximum and the final number of observations of all variables utilized in the analysis. The table shows that the ROE mean is 0.06 with standard deviation of 0.13 and total number of observations for this variable is 50 firm-year. Similarly, the mean for EPS is 1.72 where standard deviation is calculated at 2.01. additionally, the mean of ACMT is found to be at 4.14, where its standard deviation is at 2.51. ACINDR scores a mean of 0.39 and standard deviation of 0.21. Similarly, SIZE has a mean of 9.57 and standard deviation of 5.98. finally, the LEV mean is 0.34 and standards deviation is calculated as 0.14.

Table 2. Descriptive Statistics

Variables	Mean	Standard Deviation	Minimum	Maximum	Count
ROE	0.06	0.13	-0.67	0.30	50
EPS	1.72	2.01	-6.64	5.50	50
ACMT	4.14	2.51	1	10	50
ACINDR	0.39	0.21	0.40	0.67	50
SIZE	9.57	5.98	1.83	15.19	50
LEV	0.34	0.14	0.12	0.60	50

Table 3 presents correlation matrix of the independent variables to demonstrate the statistical relationships among the utilized variables in all models reported in this study. Looking at the table we can see clearly that the independent variables do not show any signs of multicollinearity.

Table 3. Pearson's Correlation Matrix

	ACMT	ACINDR	SIZE	LEV
ACMT	1			
ACINDR	0.599	1		
SIZE	0.317	-0.156	1	
LEV	0.316	0.249	0.176	1

To test H1, which aims to examine the possible association between the independence of AC members and FP, table 4 reports the results of pooled OLS of the first model which account for the dependent variable ROE. Looking at the regression results we can see that ACINDR is negatively associated with ROE. Therefore, the results contradict previous research that document strong positive association between independence of AC members and FP (Kallamu and Saat 2015; Yeh et al. 2011; Naimah 2017). Moreover, to test $H_{2,}$ as we can see from the regression results that ACMT does not has strong statistical association with ROE. This is evident in the P-value score of 0193. This finding signifies that the increase of AC meetings does not actually influence FP. Such finding does not lend support for previous research which promote a positive association between the number of AC meetings and FP (Hsu 2007; McMullen and Raghunandan 1996).

Table 4. Pooled OLS Results (ROE)

Variables	Predicted sign	Coefficients	t Stat	P-value
Intercept		0.146	2.392	0.021
ACINDR	+	-0.254	-2.092	0.042
ACMT	+	0.014	1.321	0.193
SIZE	+	-0.002	-0.568	0.573
LEV	+	-0.064	-0.4591	0.648
R Square	0.102			
No. of Obs	50			

Moreover, table 5 below provides similar results to the analysis offered in table 4 with the dependent variable of EPS that confirmed the sign and direction of ROE. Notably, the R square reported of both models are similar with 0.102 of the first model and 0.124 of the second model. These figures suggest that additional research is needed to deeply understand this phenomenon, particularly in the Saudi market.

Table 5. Pooled OLS Results (EPS)

Variables	Predicted sign	Coefficients	t Stat	P-value
Intercept		2.806	3.014	0.004
ACMT	+	0.196	1.191	0.239
ACINDR	+	-3.457	-1.871	0.067
SIZE	+	-0.126	-2.257	0.028
LEV	+	1.941	0.908	0.369
R Square		0.124		
Observations		50		

5. Conclusion

This study attempted to examine the possible association between selected characteristics of AC of transportation industry at the Saudi stock market with firm financial performance. The AC characteristics were the independence of AC members and the number of AC meetings. Using pooled OLS regression analysis and two proxies of FP, namely ROE and EPS, this study finds that the AC independence is negatively correlated with FP. Therefore, the results contradict previous research which found a positive association between independence of AC members and FP. Moreover, the results of two Pooled OLS regression analysis find that the frequency of AC meetings does not have strong statistical association with FP.

Therefore, the results provide insights for policy makers and a variety of interested parties such as investors, owners, shareholders, and creditors about the relationship between the quality and characteristics of ACs in the transportation sector and firm financial performance. The findings particularly suggest that the ratio of AC independence to the total number of members have a negative impact on the performance of the firm, holding all other variables constant. Additionally, the results also provide insights regarding the effect of the number of meeting on FP. The analysis showed no such statistical relationship which contradict some previous research that confirmed positive relationship.

Future research may attempt to examine and explore the effect of AC characteristics on FP by considering different industries within TASI. Additionally, suggested future research may attempt to investigate this phenomenon by considering the mitigating effect of audit quality attributes such as the presence of BIG4, auditor switching, and audit fees.

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