

## **The Effect of Audit Committee Characteristics and Firm Financial Performance: An Empirical Study on Listed Companies in Iraq Stock Exchange**

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**Abstract:** This study investigated the effect of audit committee characteristics on the performance of firms listed in the Iraqi Stock Exchange. The study specifically evaluates the impacts of the audit committee knowledge, audit committee existence and audit committee independence on firm performance. A secondary data from a list of company are presented in ISX from 2012-2015 was used to evaluate the relationship between the dependent and independent variables. The independent variables considered are audit committee knowledge, audit committee existence and audit committee independence while the ROA is used to measure the firm performance as the dependent variable from the secondary data collected. The study showed that by using ROA there is significantly positive association between audit committee existence, audit committee independence and firm performance. However, it is revealed that there is also significantly negative association between firm performance and audit committee knowledge. The study reached a conclusion that firm performance is improved by audit committee independence and audit committee existence. The results of this study can be used by the decision and policy makers to establish a reliable relationship between agency and the principal.

**Key words:** Audit committee characteristics, ISX, firm performance, Iraq, independence, investigated

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### **INTRODUCTION**

Meanwhile, towards the same effort of improving board governance, sub-board committees are established and delegated with function. An example of such committee is the audit committee. The function of the audit committee as enshrined in corporate governance's code is to evaluate firm financial procedures and the financial position of the firm (Saat *et al.*, 2012). In addition, the audit committee oversees internal control procedure to ensure adequate compliance with codes (Gendron *et al.*, 2004). With respect to external auditing it is the function of the committee to appoint and mediate between the external auditor and the management to see the termination of external auditors (Gibbins *et al.*, 2010).

To carry out an effective oversight, the audit committee needs to be objective and pay more attention to details (Abbott *et al.*, 2000). Studies establish that the presence of external director on the committee improves the objectivity of the committee (Bedard *et al.*, 2004). The

pro-activeness of audit committee will further improve corporate governance, protect the shareholders and reduce asset pilfering and information asymmetry (Turley and Zaman, 2004). Consequently, the firm performance is improved as the presence of an effective committee will enhance board monitoring, reduce information asymmetry. This will also mitigate the agency problem because the audit committee will demand adequate disclosure of information (Gibbins *et al.*, 2010). Specifically, this study tries to answer the research question.

- Is there any relationship between audit committee characteristics and firm performance among Iraqi listed companies?

### **Literature review**

**Audit committee:** The various financial irregularities have made board accountability to be more imperative. These financial irregularities raised question about the monitoring effectiveness of audit committee in resolving

agency conflict (Ebrahim, 2007). The agency theory suggests that audit committee should preserve financial reporting integrity. Accordingly, audit committee is responsible for preventing irregular financial reporting (Klein, 2000). To improve the communication gap and decrease the differences between management and external auditor is the pivotal role of the audit committee. However, constraint of potential manipulation is expected by behavior of monitoring management and provides the external auditor the needful information.

So far there are conflicting empirical result of the relationship between financial report and audit committee. Consistent with the agency postulation and some empirical findings, firms that establish and audit committee should produce reliable financial information. Carcello and Neal (2000) found that audit committee independence reduces the probability of going concern reports by auditors. However, the findings of Rezaee *et al.* (2003) suggest otherwise. In his findings there is no improvement of financial information reliability in the establishment of audit committee.

The needs for studies on the association between audit committee and firm performance are important for a country like Iraq. This is because of the country's effort in searching for corporate governance mechanisms that will improve firm performance and hence, attract more foreign investment. Despite the numerous studies on audit committee and firm performance in Iraq there are still very few literatures on the study. The next subheadings discuss the factors identified in previous studies that determine the audit committee effectiveness.

**Audit committee existence:** Audit committees provide an oversight function. The audit committee oversight function become more efficient when there is a working relationship between the committee, the management and the board of director. Supposedly, as a board subcommittee, the audit committee oversight function dwells on financial reporting process. Accordingly, their existence is very significant as they monitor the board as well as provide additional assurance. To support in the resolution of conflict of interests between a board and the management is the main duty of an audit committee. When the corporate governance code is perfectly complied with the outcome will desirable. An important factor that strengthens audit committee performance is a well define role, competent personnel and high professionalism. Further still, communication between audit committee, the management, external and internal auditor will improve audit committee effectiveness.

The relationship between audit committee and performance has being examined in prior literature. Puni (2015) investigated and found a positive relationship between ROA, ROE and audit committee existence using a sample of Ghana Stock Exchange from 2006-2010. Ghafran and O'Sullivan (2013) reviewed studies on the various role of audit committee in governance. Their findings on stock market reaction to audit committee reveal that investors appreciate the establishment of audit committees. Beasley *et al.* (2009) stated that high reporting system is in relationship with the establishment of audit committee. Also, Muhammad *et al.* (2016) conducted study on 80 firms listed on Karachi Stock Exchange from 2010-2011. The study found positive relationship between audit committee existence and firm performance using ROA and ROE as measures.

In Bangladesh, Rouf (2012) studied the relationship between firm value (measured by ROA and ROE), audit committee existence using 93 listed non-financial companies in Dhaka Stock Exchange and found a non-significant relationship. In other word, Bremert and Schulten (2009) investigated 60 German listed companies between 2006 and 2007 and found negative association between firm performance and audit committee existence using ROA and Tobin's Q as measures.

From the several arguments posed by the previous researches mentioned above the quality of financial report of any firm can only be approved if there is existence of audit committee. Agency theory confirms this by referring the committee as another internal governance mechanism. Thus, Table 1 summarizes the results of empirical studies concerning the relationship between firm performance and audit committee existence discussed above.

**Audit committee independence:** An effective functioning audit committee as part of corporate mechanism is required in the separation of corporate ownership and problem of agency conflicts in controlling results. The board of directors comprises audit committee working for the good of corporate governance effectively. The audit committee independence has being a central theme in prior studies. According to these literatures, independent of audit committee improves audit committee monitoring (Lin *et al.*, 2006). As noted in corporate governance code, audit committee contributes significantly to ensure values of firm as a result of the independence and professional conduct of members of the committee is necessary. The association between accounting quality and composition of audit committee was investigated by

**Table 1: Summary of empirical findings on the relationship between firm performance and audit committee existence**

Study	Samples	Measure	Findings
Puni (2015)	Listed companies of Ghana Stock Exchange from 2006-2010	ROA and ROE	Positive
Muhammad <i>et al.</i> (2016)	Eighty listed non-financial firms between 2010-2014 on Karachi Stock Exchange Pakistan	ROA and ROE	Positive
Redd <i>et al.</i> in 2010	Top fifty firms within the period of 1999-2007 from New Zealand	Market to book, Tobin's Q and ROA	Positive
Rouf (2012)	Ninety three non-financial companies in 2006 on Dhaka Stock Exchange (DSE) of Bangladesh	ROA and ROE	Not significant
Bremert and Schulten (2009)	160 German listed companies between 2006 and 2007	Tobin's Q and ROA	Negative

**Table 2: Summary of empirical findings on the relationship between audit committee independent and firm performance**

Study	Sample	Measure	Findings
Hamdan <i>et al.</i> (2013)	106 firms listed on the Amman Stock Exchange during 2008-2009	ROA, ROE and ROE	Positive with ROA and ROE and not significant with EPS
Bouaziz (2012)	26 listed firms in Tunisia between the periods 2007-2010	ROA and ROE	Positive
Torniyeva and Werekó in 2012	19 Ghanaian firms, 2005-2009	ROA and ROE	Positive
Al-Matar <i>et al.</i> (2014)	81 firms from 2011 and 2012 in Jordan	Tobin's Q	Positive
Chemweno	42 firms listed in the Nairobi securities exchange between 2010 and 2014	ROA	Positive
Bansal and Sharma (2016)	235 non-financial companies listed between 2004 and 2013	ROA, ROE and Tobin's Q	Not significant
Robin and Amran (2016)	122 family-controlled listed companies in Indonesia Stock Exchange from 2010-2014	ROE	Negative
Dar <i>et al.</i> (2011)	11 companies listed on the Karachi Stock Exchange from 2004-2010 in Pakistan	ROE	Negative
Wakaba (2014)	46 companies from 2006-2011 in Kenya	ROA	Negative

Bradbury *et al.* (2006) using a combined sample of Singapore and Malaysia. The outcome of the study showed that audit committee independence improves the quality of earnings.

Recently, Hamdan *et al.* (2013) using a list of firms on stock exchange in Amman, investigated the link between independence of audit committee and firm performance. The firm performance is improved by the audit committee independence. Bouaziz (2012) reported that the audit committee role affects firm performance proxy by ROA and ROE for a sampled of listed firms in Tunisia between the periods 2007-2010. The independence of audit committee was found to be in relationship with performance of firms. There is significantly positive association between independence of audit committee and financial performance in Oman (Al-Matar *et al.*, 2014).

Contrarily there is no relationship between audit committee independence and financial performance of companies in Indians (Bansal and Sharma, 2016). In contrary there is negative relationship between audit committee independent and firm performance as stated by Robin and Amran (2016). The sample of the study was 122 family-controlled listed companies in Indonesia Stock Exchange from 2010-2014. Dar *et al.* (2011) from Pakistan shows an negative relationship as well. In Kenya, Wakaba (2014) as well found that audit committee does have negative relation with performance of firm.

Therefore, the independence of the director will allow them to compromise less their reputations and provide quality corporate judgment. From Iraq perspective, audit committee independence will enable members to be objective and impartial in their assessment of firm financial reporting procedure, external audit process, improve auditor independence and financial position of the firm Table 2 summarizes the results of studies discussed.

**Audit committee knowledge and expertise:** Issues bothering on audit committee effectiveness have increased in the recent year with more emphasis on experience and knowledge of committee members. The board responsibility is to ensure the credibility and legitimacy of financial statement to ensure that stakeholders can make an adequate assessment of the state of financial affairs (Hamid *et al.*, 2015). The responsibility of delegates from board of directors is to oversight the financial reporting of the management to the audit committee. According to Bradbury (1990), the credibility of the financial reporting process is increased by the audit committee by implementing a sound control system internally and external audit design. To preserve the quality of financial reporting guideline and efficiently monitor the financial report system of the audit committee most have a proper understanding and knowledge of financial statement.

Recently, regulatory initiative have make provisions which requires that the audit committee member should possess one financial expertise at least with the intention of improving audit committee effectiveness (for example, Section 407 of the SOX). Audit committee knowledge should extend beyond accounting and auditing knowledge to include all other aspect of the companies operation. With such knowledge and understanding about the operations of the company, the right question can be posed and management scrutinized. To some extent, previous studies have investigated audit committee financial knowledge as one of the key characteristic of an effective committee.

Extant studies examined the association between board monitoring, financial expertise of audit committee and process of financial report. There are many empirical findings that provide evidence to support the fact that the quality of the reported figures is improved by a financially sound audit committee (Abbott *et al.*, 2002). DeFond *et al.* (2005) empirical findings reveals that the appointment of members with financial expert related with accounting skills on audit committee positively impact the reaction of market. With respect to financial reporting process, study showed that audit committee with financial expertise reduced aggressive financial reporting process (Bedard *et al.*, 2004; Dhaliwal *et al.*, 2006). Zhang *et al.* (2007) reported that companies that exhibit weakness in their internal control have members with less financial expertise and non-financial expertise. Mustafa and Ben Youssef (2010) examined the association between audit committee member financial expertise and their independence. From their analysis they reported that independent directors that possess financial related knowledge reduced misappropriation of asset. Another study Abernathy *et al.* (2014) found that accounting expertise is related to reduce financial reporting lag hence suggesting that accounting expertise of the members of the audit committee improves audit committee effectiveness.

Rahman and Ali (2006) recorded relationship between audit committee knowledge and expert and firm performance to be positive in Malaysia. Furthermore, Zabojnikova (2016) examined the association between audit committee knowledge and expert and firm performance using ROE as measures. The study selected 72 British firms on the list of London Stock Exchange. The study revealed that audit committee knowledge and expert has positive relationship with firm performance (ROE). Similarly, Aanu *et al.* (2014), Wakaba (2014) and Amer (2016) recorded positive association between audit committee knowledge and expert and firm performance.

However, Glover-Akpey and Azembila (2016) examined the relationship between audit committee knowledge and expert and firm performance to be negative. Glover-Akpey and Azembila (2016) examined 36 listed firms in the year 2015 in Ghana. The study found a negative relationship with financial experts for audit committee knowledge and expert and firm performance.

Hamdan *et al.* (2013) in their studies both recorded positive with ROE and EPS and not significant with ROA and Tobin's Q. In contrary, Gunes and Atilgan (2016) examined 10 Turkish banks and 10 UK banks during from 2006-2010. The study found that the association between audit committee knowledge and expert and firm performance is negative in Turkish banks but not significant with UK banks using ROE as measures. Therefore, to ensure active participation in the assessment of the appropriateness of management accounting practice, audit committee knowledge and expertise are necessary. This study considered this variable to be important as the association between audit committee knowledge and expert and firm performance from previous studies are still inconclusive (Table 3).

**Hypothesis development:** There is a positive relationship between audit committee characteristics and firm performance

**Industry classification:** The final sample comprised 69 firms having the necessary data for analysis over 4 years period (2012-2015) resulting into 276 observation (balanced panel).

$$ROE_{it} = \alpha_{it} + \beta_1 ACEXIST_{it} + \beta_2 ACINDP_{it} + \beta_3 ACKNW_{it} + \epsilon_{it}$$

Where:

- $\alpha$  = Intercept term
- $\beta$  = Regression slope coefficient
- ROA = Return on Assets
- ACINDP = Audit Committee Independence
- ACEXIST = Audit Committee Existence
- ACKNW = Audit Committee Knowledge
- $\epsilon$  = Error term

**Variable measurements**

**The dependent variable (Firm performance):** For profitability in firm, ROA is used as the measures. Latif *et al.* (2013) stated that net income divided by total assets at the end of the year is used to measure ROA. Idea of how effective management is used in assets to

Table 3: Summary of empirical findings on the relationship between audit committee knowledge and experts and firm performance

Study	Samples	Measure	Findings
Hamdan <i>et al.</i> (2013)	106 firms listed on the Amman Stock Exchange Market between 2008 and 2009	ROA, ROE and EPS	Positive with ROE and EPS and not significant with ROA
Aanu <i>et al.</i> (2014)	25 manufacturing firms for the period (2004-2011) in Nigeria	ROE, ROA and return on Capital Employe	Positive
Wakaba (2014)	46 companies from 2006-2011 in Kenya	ROA	Positive
Rashidah and Fairuzana in 2006	100 companies listed on Malaysia Stock Exchange in 2006	ROE	Positive
Zabojnikova (2016)	72 companies listed in the London Stock Exchange	ROE	Positive
Amer (2016)	56 Egyptian firms from 2004-2012	ROE	Positive
Gunes and Atilgan (2016)	10 Turkish banks and 10 UK banks during 2006-2010	ROE	Negative with Turkish banks and not significant with UK banks
Glover-Akpey and Azembila (2016)	36 listed firms in the year 2015 in Ghana	Change in stock price	Negative

provide earning is given by ROA. The calculation of ROA is derived by dividing the annual earning of the company by its total asset. In this case percentage is used to measure ROA:

$$ROA_{it} = \text{Net income}_{it} / \text{Total assets}_{it}$$

**The independent variables**

**Audit Committee Existence:** Audit committee existence is measured by dummy variable 1 for companies that have audit committee and 0 if otherwise (Puni, 2015; Muhammad *et al.*, 2016; Rouf, 2012).

**Audit committee independence:** Audit committee independent is measured by the number of independent non-executive directors in audit committee (Nawafly and Alarussi, 2016; Hamdan *et al.*, 2013; 2015; Robin and Amran, 2016).

**Audit committee knowledge:** Audit committee knowledge refers to the number of the audit committee have financial experience (Nawafly and Alarussi, 2016; Aanu *et al.*, 2014; Wakaba, 2014; Hamdan *et al.*, 2013).

**RESULTS AND DISCUSSION**

Panel A gives the descriptive statistics of the continuous variables used in the study. On the mean, about 45% of the Audit Committee (ACINDP) is independent while on the average 0.688 of Audit Committee Member has Accounting Knowledge (ACKNW). Panel B gives the descriptive statistics of the dichotomous variables used in the study. The dichotomous variables is Audit Committee Existence (ACEXIST). From panel B of Table 2, 27.54% of the companies established audit committee (Table 4-6).

**Audit committee existence and firm performance:** The result that audit committee is associated with firm performance is accepted. The coefficient of the audit

Table 4: Descriptive statistic from the period 2012-2015

Continuous variables	Obs.	Mean	SD	Min.	Max
ACINDP	276	0.449	0.899	0	3
ACKNW	276	0.688	0.306	0	2

Table 5: Descriptive statistics (percentage) for Dummy variables

Dichotomous variables	1	0	Total
ACEXIST	76 (27.54%)	200 (72.46%)	276 100%

Table 6: Regression results based on ROA

Variables	Coef.	t-values	p> t
ACEXIST	0.105	4.07	0.000***
ACINDP	0.008	1.71	0.088*
ACKNW	-0.028	-5.01	0.000***
Constant	0.355	1.56	0.118

R<sup>2</sup>, 0.24; F-test, 0.000; No obs., 276

committee existence is positively significance in ROA Model. In the ROA model the coefficient of ACEXIST is 0.105 with a t = 4.07. This study consistent with the agency theory and consistent with previous studies by Puni (2015) and Muhammad *et al.* (2016).

**Audit committee independence and firm performance:**

The result of the current study with respect to audit committee independence indicate a negatively significant relationship between ROA and audit committee independence. In line with argument that audit committee independence improves the committee effectiveness (Cohen *et al.*, 2011). This finding is consistent with the findings of Bansal and Sharma (2016) that found a positive relationship between the degree of audit committee independence and firm performance measured by ROA. This indicate that an independent audit committee ensures that the financial statement is reliable and free from manipulation and self-centred behaviour of managers. Aanu *et al.* (2014); Hamdan *et al.* (2013) and Bouaziz (2012) as well reported a positive relationship between the accounting based performance measure (ROA) and audit committee independence.

**Audit committee knowledge and experience and firm performance:** Table 5 of the summary of regression result reports a significantly negative relationship between ROA and audit committee knowledge and experience. This study not consistent with agency theory and consistent with previous studies like Gunes and Atilgan (2016), Glover-Akpey and Azembila (2016).

### CONCLUSION

The objective of this study is to conduct research and know the purpose of the study. Thus, the objectives to be achieved by this study are: to examine the effect of audit committee existence on firm performance among the Iraqi listed companies to examine the effect of audit committee knowledge on firm performance among the Iraqi listed companies and to examine the effect of independence of audit committee on firm performance among the Iraqi listed companies.

### LIMITATIONS

There is limitation in the response of existence of audit committees to the requirements without paying attention to the professional effect. This shows the independence on the financial performance of Iraqi banks and the impact of the factor of experience on the performance.

### RECOMMENDATIONS

The study showed that through improved performance of the banks listed in the Iraqi Stock Exchange, the presence of audit committees affects the improvement of financial performance. The result indicates the importance of the audit committee existence, however which is found mainly in most accounting and auditing systems adopted by Iraqi companies.

### ACKNOWLEDGEMENT

We would like to express our gratitude to our respective tertiary institutions of learning for their support, and for giving us the opportunity to conduct this beneficial research through their moral and financial aid. Our gratitude also goes to our colleagues and other respondents who helped to facilitate the success of this research.

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