The Impact of Audit Committees on the Performance of Business Entities

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Abstract: Audit committees represent a central instrument of corporate governance. During the last decade a series of studies concerning audit committees and corporate governance have been conducted without providing a comprehensive overview of their impact on the financial aspects of the business entities. Different levels of empirical studies divided into different categories are available on this subject. Corporate governance is necessary to the financial transparency but not sufficient. This paper aims to study and develop the impact which the audit committees have on the performance of the listed business entities.

Keywords: audit committee; performance; stock exchange

1   Introduction

Nowadays, Audit Committees are in the center of interest as a key mechanism for corporate governance. Corporate governance committees and regulators around the world called for the need of creating a supervisory European committee. After the admission, that the establishment of an audit committee by itself does not guarantee its usefulness, the focus shifted towards the composition and activities of these committees. The result of this investigation suggests that there is a considerable divergence between the recommended structure and the role of the audit committees [11].

The concept of the audit committee was introduced in 1939 by the New York Stock Exchange (NYSE). In the early seventies, the Securities and Exchange Commission (SEC) of the United States suggested to the listed companies to create an audit committee composed of non-executive directors. In 1979 the NYSE imposed as a listing obligation that members of an audit committee must be independent.

Corporate governance is a topic of great interest in the present financial system being debated, in specialized scientific fields of economics under a variety of definitions [44] [9] [36] [28] [31] [45[5]. The concept of 'good corporate

governance' was first mentioned in 1932 by Adolf Berle and Gardiner Means in their *agency theory* "The Modern Corporation and Private Property (1932)". Kim et al. (2005) define it as a mixture of different mechanisms that direct and control the entities [29] [26].

Many studies are focused on the correlations involving elements of corporate governance and audit function as, for instance, the relation between internal audit and corporate governance [32] [6] [42] [13] [21] [41] [39] [40] between audit committees and corporate governance [3] [11] [23] [18] [20] [49] between external audit and corporate governance [19] [1] [24] [12] and the implications of the principle of transparency in corporate governance [8] [41] [37] [15] [38] [47].

Corporate governance (CG) deals, on the one hand, with conformance, while on the other hand, with performance [48]. Conformance is related to monitoring and surveillance, thus, being associated with various stakeholders [27] Performance contributes to the improvement of the performance of mongers.

Several empirical studies use a specific governance variable or mechanism in investigating the relation between entity value and performance [46] [4] [50] [51]. Other authors [22] [14] [7], demand the usage of a corporate governance index (CGI - a multi-dimensional variable).

One of the primary European surveys regarding the relation between corporate governance and peformance of entities, was carried out by Drobetz [16]. In this study, the authors used a Corporate Governance Rating (CGR) based on multidimensional answers given to a questionnaire based on the Germany Corporate Governance Code voluntarily adopted by the entities.

Other studies have shown that corporate governance positively influences the financial performance of the entities. It has a positive influence on the performance of the listed entities on stock exchanges [10] [34] [35] [33].

This paper contributes to the literature in the field of audit in special in the field of audit committees and performance of the listed business entities. The remainder of this paper presents in the next section the impact which the audit committees have on the performance of the listed business entities. In the last part of the paper are the conclusions, limits and perspectives for future researches in this challenging and debatable area of knowledge.

2   Methodologies and Model Design

Literature defines the methods of scientific knowledge and the text of the work building that they must follow to achieve their objectives, information and survival. The processes, techniques and tools used in the scientific incursion are the methods, seen as supporting or concrete elements to exploit it [25] [17].

In order to study the impact of audit commitees on the performane of business entities a deductive approach [25] combined with an inductive method [30] relying on observations and induction was used. To achieve the objectives of this research, the scientific approach is based on a deductive approach [25] which starts from the theory, but also, an inductive method [30] relying on observation and induction.

The hypotheses had been formulated and verified by use sing the OLS (squash regression) model. The OSL model has been applied to several independent variables to achieve results as close as possible to reality.

As a measure of association between the X and the A_{it} variables, the multiple correlation coefficients noted with R are introduced. This can be defined as the maximum coefficient of a simple correlation (Pearson) between X and a linear combination of A_{it} variables. This explains the fact that the calculated value of R is always positive and tends to increase as the number of independent variables increases.

Thus, **the method of Ordinary Least Squares (OLS)** can be considered as a way to maximise the correlation between observed values and estimated values. A value of the coefficient R close to 0 indicates a minor regression. The regression is considered to be insignificant when the forecasted regression values are no better than those obtained by random guessing.

Since R tends to overestimate the association between X and A_{it}, the above-defined indicator is preferred, namely the coefficient of determination R^2 which represents the square of the multiple correlation coefficients.

The F-test of global significance, the first test used to analyze regression, is a global significance test of all coefficients. The test hypotheses are:

$$H0:\ \alpha1 = \alpha2 = ... = \alpha p = 0 \tag{1}$$

$$H1:\ (\Xi)i,\ so\ that\ \alpha i \neq 0$$

For the null hypothesis it is determined that the F statistic, calculated in the ANOVA table, is distributed Fisher-Snedecor $F_{p-1;n-p}$, so that the null hypothesis can be verified. If the null hypothesis is not rejected, the observed data will not allow the identification of a valid linear model. Thus the regression is not appropriate for the initially established forecasting aim.

Multicollinearity emerges when a group of independent variables are strongly correlated. In this case, should a variable from the group in the model be included, the rest of the variables from the group will not bring any significant information.

Multicollinearity can be tested using SPSS using tolerance or Variation Inflation Factor (VIF). A low tolerance value (usually less than 0.1) reflects a R_i^2 value close to 1, thus a strong linear correlation between X and the rest of the independent variables. Therefore xi is collinear with the other independent

variables. VIF represents the opposite value of tolerance. This interpretation derives from that of tolerance: a high value of *VIF* (usually over 10) denotes collinearity [2].

3   Research Design and Results

3.1   Methodology Framework

To carry out the case study on the analysis of the role of the audit committee in the context of corporate governance, a sample of 23 entities listed on the Bucharest Stock Exchange has been chosen. These entities are part of the main index of the Bucharest Stock Exchange (Premium category). The following the next steps have been carried:

First step (construction of the sample)	- Analysis of the corporate governance code implementation guide - Selecting the entities included in the study - Selecting the relevant information for each company - Defining the analysis method Appropriate analysis and interpretation of the results
Second step (analysis of several relevant issues for each company in the sample)	- The existence of the audit committee; - The independence of the audit committee chairman; - The expertise of the chairman of the audit committee; - The structure of the audit committee; - The position of the audit committee within the company; - Independence of the audit committee; - The expertise of the members of the audit committee; - The number of the annual meeting of the audit committee;
Third step (analyze the Comply or Explain Statement)	- Recommendation 27 Is there an audit committee within the company - Recommendation 28 Does the Board of Directors or the audit committee, as appropriate, regulatory review the effectiveness of financial reporting, internal control and risk management system adopted by the company?

	• Recommendation 29 the audit committee meets at least twice a year, these meetings being devoted the preparation and dissemination to the shareholders and the public of the half-yearly and annual results • Recommendation 32 the audit committee recommends to the board of directors the selection, appointment and replacement of the financial auditor and the terms and condition of his remuneration
Fourth step (selection of audit committee characteristics)	• Number of members • Number of meetings • Professional experience • Independence of audit committee members • Independence of the audit committee chairman

In 2008, the Bucharest Stock Exchange developed a new Code of Corporate Governance starting from the core principles established by OECD. The new code came into effect only in 2009, and it has been applied voluntarily by listed entities, which have been requested to submit a conformity declaration. According to the new Code of Corporate Governance, „issuers will attach to the Annual Report, starting with the Report for 2010 (optional for 2009), a statement regarding the compliance or non-compliance with the Code of Corporate Governance (The "Comply or Explain" Statement)."

To achieve the objective, the methodology involved quantitative research methods. With this method, information has been classified, statistical models has been build, and results have been explained. For the case study, a sample of 19 listed entities on the Bucharest Stock Exchange has been selected, and the companies' annual financial reports available on their website or the BVB website. Based on these reports, the financial ratios have been calculated for each company, results which were then imported into SPSS to perform an empirical analysis of the impact that the audit committee has on the entity's performance characteristics.

The reasons behind choosing only 19 entities out of the total of 23, in the Premium category is due to the fact that 4 entities did not publish the "comply or explain" statement, had no audit committee mor the data needed to calculate the financial indicators were published.

Based on these elements, five hypotheses (with alternatives) have been formulated:

H1.a The number of members of the Audit Committee does not influence the performance of the entity.	H1.b The number of members of the Audit Committee influences the performance of the entity/
H2.a The number of meetings does not affect the performance of the entity.	H2.b The number of the meeting will influence the performance of the entity.
H3.a The independence of the Audit Committee Chairman does not influence the performance of the entity.	H3.b The independence of the Audit Committee influence the performance of the entity.
H4.a The independence of the Audit Committee does not influence the performance of the entity.	H4.b The independence of the Audit Committee affects performance. Entity.
H5.a The professional experience of members of the audit committee does not influence the performance of the entity	H5.b The professional expertise of members of the audit committee affect the performance of the entity

3.2   Data and Results

This section consists of the analysis on whether there is a correlation between the characteristics of the audit committee and the performance of the selected entities in the sample, represented by:

> • Market Share Value (MSV)

> • Market capitalisation (MC)

> • Stock Dividends (SD)

The initial form of the model is as follows:

$$\text{MSV / MC / SD} = \alpha_0 + \alpha_1\ \text{m\_number} + \alpha_2\ \text{m\_mettings} + \alpha_3 \qquad (2)$$
$$\text{m\_experience} + \alpha_4\ \text{m\_inDependentce} + \alpha_5\ \text{inDependent\_CCA}$$

a.) Market Share Value

The first analysed indicator is the market share value (MSV). Table 1 highlights the result for the ANOVA test, with the dependent variable MSV.

Tabel 1

ANOVA - Dependent Variable MSV

Model	Sum of Squares	df	Mean Square	F	Sig.
Regression	82012.430	4	16402.486		
Residual	118970.410	15	9151.570	1.792	.184[a]
Total	200982.839	19			

a. Predictors: (Constant), m_experience, m_mettings, m_inDependentce, inDependent_CCA, m_number

Analyzing the significance in the Table 1 (SIG), is can be observed that it is greater than 0.1 (Tabel 1), so the linear relation among the variables is not considered significant. Consequently, the general shape of the model is not proper, and removal of variables is necessary. By analyzing the Correlations table (see Table 2), the variables whose significance exceeds the permissible limits Sig are removed, namel: m_mettings, inDependent_CCA.

Tabel 2

Correlation: Dependent Variable MSV

		MSV	m_mettings	m_number	inDependent_CCA	m_inDependentce	m_experience
Person Correlation	MSV	1.000	.002	.333	.267	.508	.489
	m_mettings	.002	1.000	.217	.363	.036	.067
	m_number	.333	.217	1.000	.444	.569	.543
	inDependent_CCA	.267	.363	.444	1.000	.474	.502
	m_inDependentce	.508	.036	.569	.474	1.000	.318
	m_experience	.489	0.67	.543	.502	.318	1.000
Sig.(1-tailed)	MSV		.496	.082	.135	.013	.017
	m_mettings	.496		.187	.063	.442	.393
	m_number	.082	.187		.028	.006	.008
	inDependent_CCA	.135	.063	.028		.020	.014
	m_inDependentce	.013	.442	.006	.020		.092
	m_experience	.017	.393	.008	.014	.092	

By constructing a new regression with the remasive variables, later results of the ANOVA test are obtained, shown in Table 3.

Tabel 3

ANOVA - Dependent Variable MSV

Model	Sum of Squares	df	Mean Square	F	Sig.
Regression	78677.641	2	26225.880	3.216	.053[a]
Residual	122305.198	17	8253.680		
Total	200982.839	19			

a. Predictors: (Constant), m_experience, m_inDependentce, m_number

The final regression obtained:

$$MSV = \alpha_0 + \alpha_2\ m\_number + \alpha_3\ m\_experience + \alpha_4\ m\_independence \tag{3}$$

The value F = 3.216 (see Table 3), tests the global significance of the independent variables. The value of the ANOVA model sig is 0.053, which is less than the significance threshold of 0.1. Consequently, the linear link among the variables analysed is significant. Consequently, hypothesis H1.a and H3.a are rejected, and therefore their alternatives H1.b and H3.b are accepted, namely that the number of meetings and the independence of the president influence the market shares value.

Referring to the coefficients of the selected variants, it is found that the audit committee is directly proportional to the market shares value. From the model summary, the variance of the market shares value is explained by 39.1% of the independent variables, as indicated by the value of R Square.

Tabel 4
Coefficient - Dependent Variable MSV

Model	Unstandardized Coefficients		Standrdized Coefficients	t	sig	Correlations			Collinearity Statistice	
	B	Std.Error	Beta			Zero-oder	Partial	Part	Tolerance	VIF
(Constant)	-115.529	54.060		-2.137	0.49					
m_number	-20.801	35.015	-.164	-.594	.561	.333	-.152	-.120	.531	1.884
m_inDependentce	37.794	19.909	.465	1.898	.077	.508	.440	.382	.676	1.479
m_experience	35.675	19.909	.430	1.792	.093	.489	.420	.361	.706	1.417

In this case (see Tabel 4), the generally significant factor is the variable number of members, the result being the extent to which the number of members of the audit committee greatly influences the market shares value.

b.) Capitalization on the Market

The next analysed indicator is the capitalization on the market (MC). Table 5 shows the result for the ANOVA test, with the dependent variable MC.

Tabel 5
ANOVA - Dependent Variable MC

Model	Sum of Squares	df	Mean Square	F	Sig.
Regression	1.452	3	2.904		
Residual	5.324	16	4.095	.709	.627[a]
Total	6.776	19			

a.   Predictors: (Constant), m_experience, m_mettings, m_inDependentce, inDependent_CCA, m_number

Analyzing the significance in the Table 5 (SIG), it is greater than 0.1 (see results in Table 5), thus the linear relation among the variants is not considered significant. Consequently, the general form of the model is not appropriate, and some variable should be removed. By analyzing the correlation Table 6, the variables whose significance exceeds the permissible limits Sig are removed: m_mettings, independent_CCA, m_experience.

Tabel 6

Correlation: Dependent Variable MC

		MC	m_mettings	m_number	inDependent_CCA	m_inDependentce	m_experience
Person Correlation	MC	1.000	-.021	.392	.218	.365	.117
	m_mettings	-.021	1.000	.217	.363	.036	.067
	m_number	.392	.217	1.000	.444	.569	.54
	inDependent_CCA	.218	.363	.444	1.000	.474	.502
	m_independentce	.365	.036	.569	.474	1.000	.318
	m_experience	.117	.067	.543	.502	.318	1.000
Sig.(1-tailed)	MC		.466	.049	.184	.061	.317
	m_mettings	.466		.187	.063	.442	.393
	m_number	.049	.187		.028	.006	.008
	inDependent_CCA	.184	.063	.028		.020	.014
	m_independentce	.062	.442	.006	.020		.092
	m_experience	.317	.393	.008	.014	.092	

In Table 6, Sig value exceeds the chosen significance threshold. Therefore, the model is not appropriate. Thus, variables that do not meet this criterion are removed, and only the correlation between the number of members and the independence of the members of the Audit Committee and Market Capitalization will be studied.

By constructing a new regression with the remaining variables, the later results and the ANOVA test are presented in Table 7.

$$MC = \alpha_0 + \alpha_2 m\_number. \tag{4}$$

Tabel 7

ANOVA - Dependent Variable MC

Model	Sum of Squares	df	Mean Square	F	Sig.
Regression	1.243E20	2	6.214E19		
Residual	5.534E20	17	3.458E19	1.797	.198[a]
Total	6.776E20	19			

a.   Predictors: (Constant), m_experience, m_independentce, m_number

Table 7 shows the significance is greater than 0.1, therefore the linear relation among the variables is not considered significant, thus the variable m_independence is removed.

The final regression and ANOVA results is (see Table 8).

$$MC = \alpha_0 + \alpha_2 \, m\_number. \tag{5}$$

Tabel 8

ANOVA - Dependent Variable MC

Model	Sum of Squares	df	Mean Square	F	Sig.
Regression	1.039E20	1	1.039E20		
Residual	5.738E20	18	3.375E19	3.077	.097[a]
Total	6.776E20	19			

a.   Predictors: (Constant), m_number

The value for F = 3.077 (as seen in Table 8) tests the global significance of the Dependent variables. The SIG value is 0.097, which is less than the significance threshold of 0.1. Therefore, the linear link among the variables analysed is significant. As a result of this analysis, hypotheses H1.a, H3.a, H4.a, H5.a are rejected, therefore their alternatives H1.b, H3.b, H4.b, H5.b are accepted.

The variables of this regression explain the change in the stock market capitalisation at a rate of 15.3%, as indicated by the value of R Square. Therefore, there is a low correlation between the MC and the non-dependent variables.

Tabel 9

Coefficient - Dependent Variable MC

Model	Unstandardized Coefficients		Standrdized Coefficients	t	sig	Correlations			Collinearity Statistice	
	B	Std.Error	Beta			Zero-oder	Partial	Part	Tolerance	VIF
(Constant)	1.405	2.321		.605	.553					
m_number	2.880	1.641	.392	1.754	.097	.392	.392	.392	1.000	1.000

In this case (as seen in Table 9), the most significant ratio is found in the variable m_number, resulting in the degree of independence of the audit committee members influencing the market capitalisation to the most significant extent.

From the coefficients table (Table 9). the linear regression is:

$$MC = 1.405 + 2.880 * m\_number. \tag{6}$$

c.) Stock Dividends (SD)

Table 10 highlights the result for the ANOVA test with the dependent variable stock dividends (SD).

Tabel 10

ANOVA - Dependent Variable SD

Model	Sum of Squares	df	Mean Square	F	Sig.
Regression	874.627	5	174.925	1.772	.188[a]
Residual	283.306	14	98.716		
Total	2157.933	19			

a. Predictors: (Constant), m_experience, m_mettings, m_independence, independent_CCA, m_number

Analyzing the significance in the Table 10 above (SIG), it is greater than 0.1, thus the linear link among the variables is not considered significant. Consequently, the general form of the model is not appropriate, and some variables need to be removed. Analyzing the Correlations Table 11 the variables whose significance exceeds the permissible limits Sig are removed: member_mettings, m_independence.

Tabel 11

Correlation - Dependent Variable SD

		SD	m_mettings	m_number	inDependent_CCA	m_inDependentce	m_experience
Person Correlation	SD	1000	.001	.327	.279	.510	.486
	m_mettings	.001	1.000	.217	.363	.036	.067
	m_number	.327	.217	1.000	.444	.569	.543
	inDependent_CCA	.279	.363	.444	1.000	.474	.502
	m_inDependentce	.510	.036	.569	.474	1.000	.318
	m_experience	.486	.067	.543	.502	.318	1.000
Sig.(1-tailed)	SD		.498	.086	.123	.013	.017
	m_mettings	.498		.187	.063	.442	.393
	m_number	.086	.187		.028	.006	.008
	inDependent_CCA	.123	.063	.028		.026	.014
	m_inDependentce	.013	.442	.006	.020		.092
	m_experience	.017	.393	.008	.014	.092	

After an analysis of the correlation in Table 11 a new regression with the remaining variables is constructed, with the following results (Table 12).

Tabel 12

ANOVA - Dependent Variable SD

Model	Sum of Squares	df	Mean Square	F	Sig.
Regression	848.278	3	282.759	3.239	.052[a]
Residual	1309.655	16	87.310		
Total	2157.933	19			

a. Predictors: (Constant), m_experience, m_inDependentce, m_number

The final regression is:

$$SD = \alpha_0 + \alpha_1 \text{ m\_number} + \alpha_3 \text{ m\_experience} + \alpha_4 \text{ m\_independence.} \tag{7}$$

The value F = 3.239 (see Table 12) tests the global significance of the Dependent variables. The ANOVA sigma value is 0.052, which is less than the significance threshold of 0.1. Therefore, the linear link between the variables analysed is significant. As a result hypothesis H1.a and H3.a are rejected, therefore their alternatives H1.b and H3.b are accepted.

The independent regression variable explains the variation of dividends per share at a rate of 39.3% (see Table 12), as indicated by the value of R Square. Therefore, an average correlation between the Dependent variable and the independent variable is found.

Tabel 13

Coefficient - Dependent Variable SD

Model	Unstandardized Coefficients		Standrdized Coefficients	t	sig	Correlations			Collinearity Statistice	
	B	Std.Error	Beta			Zero-oder	Partial	Part	Tolerance	VIF
(Constant)	-12.125	5.594		-2.167	.047					
m_number	-2.311	3.623	-.176	-.638	.533	.327	-.163	-.128	.531	1.884
m_inDependentce	3.982	2.060	.473	1.933	.072	.510	.447	.389	.676	1.479
m_experience	3.710	2.060	.431	1.801	.092	.486	.422	.362	.706	1.417

As seen in Table 13, the most significant ratio is found in the variable m_number, resulting in the degree of independence of the members of the audit committee influencing the dividend per share to the most significant extent.

Conclusions

After a literature review on the concept of corporate governance, a relationship between the concept of corporate governance and entity performance has been found. This relationship can be described as being unable to reach a harmony, regarding the nature of the link between the two ideas. Although the empirical evidence is inconclusive, the critical importance of performance governance is recognised globally, particularly in the interests of managers and associates.

The performed regression analysis is limited to a specific corporate governance mechanism, however, this model can be extrapolated to several corporate governance mechanisms, although this action is practically tricky, as different tools are indifferently connected. The Smith Report (2003) emphasises that an audit committee can be effective only in a broader process of corporate governance. Therefore, the results of the present study must be carefully interpreted. Secondly, the independent variable is not a continuous variable as the audit committee is effective within the limits of the variables taken into

consideration. However, the current statistical analysis is probably significant, at least for reference.

Finally, the connection between the audit committee and an entity's performance has been studied:

- The Audit Committee is a corporate governance mechanism which can alleviate the problem of allocating power within the Principal-Agent Theory;

- The contribution of Audit Committees in corporate governance is to assess both the quality of financial reports and their approval. Financial reporting focuses on individual and consolidated financial statements, including the verification of external auditors;

- Creating an Audit Committee can have beneficial effects which can eventually lead to a consolidation of a company's corporate governance.

	H1.a	H1.b	H2.a	H2.b	H3.a	H3.b	H4.a	H4.b	H5.a	H5.b
Market Share Value	X	✓			X	✓				
Market capitalisation			X	✓	X	✓	X	✓	X	✓
Stock Dividends	X	✓			X	✓				

As a general conclusion, it was found that entities listed on BVB are not aware of the role of the audit committee in corporate governance. A proper evolution of the Premium category can be seen, and it is believed that in the coming years these statistics will evolve positively. Last but not least, the audit committee plays an essential role in decision-making within a company and, at the same time, helps the Board of Directors, the Management, and last but not least, the internal and external audit process.

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