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The Impact of Audit Committee Characteristics on Firm Performance: Evidence from Jordan

Mohammad Ahmad Abu Zraiq[1*]
Faudziah Hanim Bt Fadzil[2]

[1]Student, Othman Yeop Abdullah Graduate School of Business, Universiti Utara Malaysia
[2]Prof, Othman Yeop Abdullah Graduate School of Business, Universiti Utara Malaysia

Abstract

This study is an attempt to achieve the main objective by examining the association between audit committee and firm performance of the Jordanian firms. This study used OLS regression to test the relationship between independent variable and dependent variable as discussed in the section explaining the study method. The data comprised of 228 firms industrial and services. As this study Jordan attempts to bridge the gap. in the existing literature by investigating the association between audit committee and firm performance in the emerging market of Jordan.

The findings indicated a positive direction but insignificant relationship between audit committee size and ROA. Whereas, audit committee size with EPS is positive direction and significant. Farther more, the result shows audit committee meetings significant and positive direction with ROA. Correspondingly, audit committee meetings with EPS represent positive direction but insignificant. Finally, this study provides recommendations for future research.

Keywords: Audit committee, Firm performance, Amman stok exchange.

Introduction

governance has created significant changes in business environments in general, and in the accounting and auditing professions in particular. Interest in the role of audit committees has increased in the last few years because it is the tool of corporate governance, whose aim is to increase the questioning of the board of management and to increase the role of audit and its independence after in several financial failures of many local and international companies [1]. During the last years, there was, as well, an increasing organizational interest in the role of the audit committee in preparing financial reports [2]. The credibility and fairness of financial reports issued by companies depends on the existence of an audit committee emerging from management councils of such companies. The importance of the effectiveness of audit committees has increased in the wake of the financial scandals that occurred in the last two decades. Their perceived importance has been witnessed by their inclusion and increased roles given to them in numerous international regulations related to corporate governance.

The trend towards regulating corporate governance has witnessed an increase in developing countries, in an attempt to reduce the chances of financial scandals and company failures, given the negative consequences such events have on the national economies of developing countries. According to Shehata [3], Jordan was an early reformer in terms of adopting corporate governance regulations in the Middle East. However, Jordan tended to adopt corporate governance regulations that are generally very similar to those adopted by developed countries,

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***Corresponding author:** Dr. Mohammad Ahmad Abu Zraiq, Student, Othman Yeop Abdullah Graduate School of Business, Universiti Utara Malaysia, Malaysia. Email: mabuzreiq(at)yahoo.com

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while the nature of corporate governance systems in its companies is very different. This is due to the Jordanian companies being significantly smaller than those in developed countries, and the majority of them being closely-held family businesses. It is known that in family businesses, agency costs between owners and managers are generally low, due to the overlap and relations between owners and managers [4]. This arguably affects the level of demand for effective corporate governance mechanisms, including audit committees [5].

These committees aimed to develop recommendations which help improve firm performance through consolidating their role. It also put down a series of qualities which should prevail in order to have an active audit committee. Such qualities include: size and meetings. As for Jordan, much legislation supporting corporate governance was issued in order to regulate the work of audit committees in Jordanian companies. This study attempts to discuss such legislation related to audit committees to ensure their application by Jordanian companies. Afterwards, the study tries to test the role played by audit committees in improving firm performance.

The real contribution of the current study to existing literature is to provide additional evidence about the relationships between audit committee characteristics and firm performance from developing countries. It also uses (ROA and EPS) models to measure the firm performance in Jordanian listed firm, which was not used in previous studies in this environment. The importance of this study is to look for relationships between the audit committee characteristics and firm performance in Jordan, which regularly takes steps towards the regulatory and legislative structure to support economic development. This distinguishes study from other studies conducted.

Based on the above explanation, the contribution of the current study lies in selecting industrial and service sectors in Jordan that faced and contributed to two kinds of decline; one is in the performance of its firms and the other in the Jordanian economy in general as mentioned by The World Bank (2014). Thus, the current study aims at testing the impact of audit committee on firm performance in one of the emerging markets, namely Jordan. Furthermore, the significant role made by the current study is considered as an attempt to fill a gap in the previous studies. There is a scarcity in testing corporate governance in the Jordanian context, where, to the best knowledge of the researcher, there is no previous study that has investigated the variables of the current study in Jordanian industrial and service sectors in the time that such a sector needs to be investigated by researchers to deal with its firms' problems. The data used in the current study is based on the recent two years, 2015 and 2016 for the firms belonging to industrial and service sectors and belonging to non-financial sector listed in Amman Stock Exchange (ASE) in Jordan [6].

Literature Review and Hypotheses

Previous studies have revealed findings that audit committee in the company is an important issue that decreases agency problems and pushes managers to promote firm performance [7,8]. In Jordan context, a study conducted by [9,10] shows that there is a positive relationship between audit committee and firm performance.

An audit committee is a corporate governance mechanism that started to appear significantly [11]. Several definitions were given for an audit committee. For example, Rezaee [12] defines it as "a standing committee of the company's board of directors to act as a liaison between management and the external auditor". Verschoor [13] defines an audit committee as "A standing committee of the board of directors organized under the by-laws of the corporation. Duties of the committee are prescribed by statute, regulation, and best business practice. They involve oversight of financial reporting, auditing, ethics and compliance, and risk management processes". Arens et al. [10] define an audit committee as "a selected number of members of a company's board of directors whose responsibilities include helping auditors remain independent of management". Most audit committees consist of members of the board of directors who are not members of the company's executive management [10].

The concept of audit committees differs according to the goals, functions, and responsibilities assigned to them. Al-Thuneibat [14] defined it as the committee that is composed of nonexecutive directors in the establishment. The major goal behind forming the audit committee is to increase auditing quality and questioning of board of directors. Arens et al. [15] defines it as a group of persons selected from members of the board of directors who are responsible for retaining independence of the auditor.

From these definitions, it can be concluded that an audit committee is a corporate governance tool that uses non-executive directors as a means of control and oversight over several managerial roles such as internal auditing, risk management, compliance, and financial reporting, and that this role includes intervention when a conflict occurs between executive management and the external auditor over financial reporting matters. For an audit committee to effectively operate and achieve its goals, it members have to be independent from the executive management, have financial knowledge, and meet frequently under a well-defined agenda [12].

Audit committees were first introduced into the Jordanian legislation in 1998, when the Jordan Securities Commission (JSC) instructions (JSC, 1998) required public listed companies to establish audit committees that consist of three non-executive members of the board of directors. These committees were to meet at least four times annually and were responsible for discussing the work of external and internal auditors and the annual and interim financial statements, and compliance with the required laws and regulations. Updated legislation with some more details was enacted in 2004 (JSC, 2004), but these instructions did not add any new responsibilities for audit committees [16].

In 2009, the JSC issued a code of corporate governance for public listed companies. This code (JSC, 2009) added more details regarding audit committees, including the requirement of financial knowledge for all audit committee members. The code required audit committees to meet at least four times in a year, and to meet with the external auditor independently from the company's management at least once in a year. The code added more detail to the nature of the duties of audit committees, but these duties were not significantly expanded, and remained in the areas of oversight over the financial reporting function and reviewing the work of the external auditor on financial reporting and evaluating internal controls.

Numerous studies of the characteristics and roles of audit committees were conducted worldwide. A large portion of these studies included relating audit committee characteristics (such as independence, financial and/or industry experience, and frequency of meetings) with some output measure of the implementation of their roles (such as improving the processes of internal auditing and external auditing and improving the firm performance). Similarly, Alzeban and Sawan [9] found that audit committees characterized by more expertise and frequency of meetings lead to better firm performance. Similar results were found by Naiker and Sharma [17], who reported that external audit experience of audit committee members is associated with better firm performance, while Sultana [18] found that frequency of audit committee meetings is positively associated with firm performance. Finally, in Tunisia, Adel and Maissa [19] found a positive relation between audit committee frequency of meetings, and firm performance.

Few empirical studies were conducted in Jordan regarding audit committees. An early study by Al- Farah [20] found that external auditors view audit committees as generally ineffective, while internal auditors view them more favorably in terms of effectiveness, especially in dealing with internal auditors and discussing the financial statements. In his survey of external auditors, Abdullatif [16] found that the perceived benefits of audit committees were generally limited in terms of increasing auditor independence, the quality of financial statements, and the probability of detecting fraud and internal control weaknesses.

However, Hamdan et al. [21] found that size of the audit committees is positively related to company financial performance and share performance. Finally, Aljaaidi et al. [22] found that more frequent meetings of audit committees are associated with a firm performance.

As mentioned above, studies on audit committees in Jordan are limited in their number and in their coverage of relevant issues regarding audit committees. There are very few studies that covered the actual performance of audit committees in Jordanian public listed companies, and this study is, to the best of the researcher knowledge, by far the most detailed study to cover this topic in Jordan. This study therefore has the potential to be useful and contribute extensively to our knowledge about the performance of audit committees, and be therefore useful to Jordanian companies, legislators, and policy makers.

Several prior studies provide theoretical and practical support for a cross-sectional association to show the relationship between audit committees and firm performance. This research used prior studies as secondary data to show the impact audit committees and firm performance by Jordanian companies. In addition, this study examines the audit committee on the performance over a period of time. It is necessary to consider changes of ROA and EPS to determine whether these ratios influencing the impact decision of committee auditing either positively or negatively.

H1: Audit committee size will be positively associated with ROA.

H1a: Audit committee size will be positively associated with EPS.

H2: Audit committee meetings will be positively associated with ROA.

H2a: Audit committee meetings will be positively associated with EPS.

Research Design

In order to achieve the objectives of study, the correlational studies are utilized to investigate the relationship between audit committee characteristics such as (size and meetings) and firm performance (ROA and EPS) as dependent variables. The collection of data to accomplish all objectives are derived through data of secondary in nature, primarily obtained through published annual reports, ASE website, as well as the respective firms' website from 2015 to 2016.

In respect to excluding financial firms from the sample, that is subsequent to their distinguished regulations and reporting standards in comparison to other sectors. Thereby, considering the above-mentioned conditions, 228 non-financial firms were selected as statistical sample, and the data gathered from two sources; Amman Stock Exchange and Jordan's Depositary Center. In order to analyze and test the hypotheses, the variables were entered in SPSS software.

Regarding the explanatory variables; such as ROA measured earnings before tax divided by total assets of the firm, while EPS measured net income divided by number of outstanding shares. Notably, audit committee size measured by total number of members serving on the audit committee; audit committee meetings measured by the frequency number of meetings during a year for the audit committee.

$$ROA = \beta0 + \beta1ACSZEit + \beta2ACMETit + \varepsilon it$$

$$EPS = \beta0 + \beta1ACSZEit + \beta2ACMETit + \varepsilon it$$

In both equations, each independent variables are calculated for each firm 'i' and each year 't', with '$\beta 0$' as the intercept, 'ε' as the error term, and $\beta 1$, $\beta 2$ as the coefficients.

Data Analysis and Results

Descriptive Statistic

The continuous variables' descriptive statistics included the mean, standard deviation, and minimum. and maximum, which are obtained with the help of SPSS, version 22.

Regression Results of Model (Based on Accounting Measure)

The finding suggests the audit committee size is positive associated but not significant with ROA. Thus, hypothesis

H1 is not supported. This finding is consistent with previous studies that found a positive relationship between audit committee size and firm performance such as Al-Matar et al. [23]. As for the hypothesis H1a is supported, the audit committee size is positive associated and significant with EPS. Thus, hypothesis H1a is supported. The finding is consistent with Patrick et al.; Hamdan and Sarea [2] that found a positive relationship between audit committee size and firm performance.

The finding illustrates the audit committee meetings is positive associated and significant with ROA. So, hypothesis H2 is supported. This finding is inconsistent with previous studies that found a positive relationship between audit committee meetings and firm performance such as Issarawornrawanich [24], Mohd [25]. Unlike this, the hypothesis H2a is not supported, the audit committee meetings are positive associated but not significant with EPS. The finding is consistent with Sultana [18], Hamdan and Mushtaha [1] that found a positive relationship between audit committee meetings and firm performance.

Conclusion

This study is considered to have achieved. its main target, which is to test the relationship between the ownership structure and firm performance among Jordanian firms.

The present study employed several. assumptions to examine the association between independent variable and dependent. variable as discussed in the research. methodology section. The data used for this study. comprised of 228 firms and according to the findings, a significant positive relationship between audit committee (size and meetings) and firm performance in Jordanian listed firms.

This study has many recommendations. for future studies. Firstly, this study examined the direct relationship between audit committee and firm performance but there is a lack of previous research examining the moderating or mediating effect of other variables on the relation between audit committee and firm performance such as, family, managerial and institutional ownership, among others that will lead to help in improving performance. Secondly, future authors should investigate the relationship between audit committee and firm performance in- depth, by adding new variables such as expertise, educational and independence. Finally, based on the previous studies, there is a paucity of existing literature that examined the association between audit committee and firm performance in the emerging countries like Middle East.

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