

Impact of Audit Committee Characteristics on Financial Performance: A Study of Listed Companies of Pakistan

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Abstract

This study examines the effect of several audit committee characteristics on firm financial performance using evidence from non-financial companies listed on Pakistan Stock Exchange (PSX). The occurrence of high-profile corporate failures involving financial fraud, poor accounting, and lax internal controls, particularly in recent years, has raised concerns about the suitability of audit committee characteristics in carrying out a thorough monitoring and compliance role. The main results of this study suggest that five selected features of audit committee have significant impact on firm performance. Our findings suggest that there is a significant positive relationship between independence and experience of members, frequency of its meetings and firm financial performance. On the other hand, audit committee size and gender diversity appear to be having no impact on firm performance. Results of the study may aid corporate managers and boards in selecting the ideal attributes for audit committee members and in establishing corporate governance practices that will enhance the performance of the organization. The study helps decision makers understand the many requirements which an audit committee must meet in order to protect shareholder interests and the connection between audit committee attributes and business performance. As a result, this study intends to contribute to the body of knowledge by determining how audit committee five different characteristics affect corporate performance and by providing proof that how these characteristics are especially significant in Pakistan.

Keywords: Corporate governance, Audit committee, Firm performance, Pakistan Stock Exchange, KSE-100 Index

1. Introduction

One of the most significant topics under discussion today is corporate governance, which is essential to enhancing the performance and profitability of businesses (Akbar, 2015). With the intention of adding value to their assets through their knowledge and competence, shareholders entrust managers with their money, yet management decisions are centered on advancing their own interests (Jensen & Meckling, 1976). In order to safeguard shareholders' interests, or stakeholder interests in a broader sense, regulators and policy makers establish rules and practices. This practice is known as corporate governance. The presence and operation of audit committee is of the key importance in company's governance.

In past, the audit committee's duties have mainly dealt with matters pertaining to the accuracy of accounting and financial reporting. However, due to recent business failures and ongoing global financial crisis, the audit committees now play a larger role and are mandated by the board to perform a wide variety of tasks. The management of risks, non-financial regulatory requirements, and assurance and audit procedures are a few of them (Klein, 2002). The audit committee improves reporting standards, reduces risk, with enhancing integrity of financial information, according to Contesso and Moroney (2013).

Numerous researches have been done on the connection between audit committees and a number of variables, such as autonomy (Klein, 2002; Vermeer et al., 2006); service charges (Rainsbury et al., 2009); control environment; size of the company (Piot, 2004); expertise (Carcello et al., 2003); responsibility (Raghuandan & Rama, 2007); and also other factors. A increasing research corpus shows certain attributes that are necessary for the audit committee's job to be effective and successful (Abbott et al., 2004). A growing body of research indicates that the effectiveness and success of the audit committee's work depend on certain qualities (Abbott et al., 2004). Commentators underline the necessity of independent audit committees, including some members with competence, as well as regularly scheduled meetings (Carcello et al., 2003; Abbott et al., 2004). Despite the fact that companies follow the rules so as to avoid penalties, not all of these committees are successful in raising the performance of the companies. To put it another way, the committee's qualities, not just its existence, determines how effective the AC is. Therefore, the goal of the study is to determine which AC characteristics, if any, are associated with improved firm financial performance.

Since 2000, there have been a disproportionate number of high-profile company failures including fraud, poor accounting, and insufficient internal controls, which has raised questions about the audit committees' appropriateness for acting in a monitoring and compliance capacity. Today's audit committees do more than just protect the independence of the external

auditor; they also monitor audit operations, risk mitigation, as well as firm performance. One objective of this thematic study is to draw attention to the evidence of distinctive characteristics of an audit committee to assess perceived advantages by implementing them to enhance firm corporate performance. The goal of research is to analyze audit committee attributes including size, independence, experience, gender diversity, and frequency and their impact on business performance in Pakistan.

The fact that there is so little study on the impact of audit committee characteristics on corporate performance in Pakistan is what drives our effort to add to the corpus of knowledge in this area.

2. Hypothesis Formation

2.1 Audit Committee Size and Financial Performance

The effectiveness of the audit committee and the size of it are highly valued according to agency theory. A productive committee ought to be able to reduce agency costs while enhancing internal control. The committee will be used as a control mechanism that may enhance financial transparency that is intellectual, which will benefit the firm (Ho & Wong, 2001). Prior studies have shown that a committee's characteristics, such as its size, can affect how successful the audit committee is (Herdjiono & Sari 2017). The committee must have enough members to fulfill its duties and enough resources to oversee and keep an eye on managers' conduct. For instance, Pucheta et al. (2007) found audit committee's strength affected the risk that organizations would obtain audit reports including errors or qualifications that weren't in compliance. The results of prior studies on relationship between committee number and corporate success, however, were not conclusive. Dalton et al. (1999) concluded that audit committees lose their efficacy due to size. Large committees have a propensity to become disorganized and engage in less active participation. On the other side, a tiny audit committee lacks the variety of knowledge and experience required for efficient operation. The perfect audit committee composition would enable members to provide their knowledge to stakeholders. The size of the audit committee and business performance was shown to have a minor link in studies by Eichenseher and Shields (2007). Smaller committees with more expertise and financial understanding were favorably and significantly connected with business success in the market after studying attributes that influenced performance during economic crisis. The number of the committee and corporate success are also significantly correlated (Al-Matari, et al, 2012).

H1: There is a positive impact of size of an audit committee on firm performance.

2.2 Audit Committee Independence and Financial Performance

The autonomy of the committee, or their independence from the weight and influence of senior management is a crucial component in ensuring the

performance of committees (Jun-Lin et al., 2008). An independent committee outperforms a committee with less independence, despite the fact that previous research on this link has produced mixed results. As the independent committee can withstand managerial pressure, therefore it is more likely to give better results (Al-Matari 2014; Kallamu & Saat, 2015). The audit committee will be able to analyze the firm's process of financial reporting independently and ensure that it is not affected by managers thanks to its independence of management, which will result in greater firm performance (Peasnell et. al., 2005; Kallamu & Saat, 2015). Furthermore, better financial reporting and fewer erroneous reports are positively correlated with independent directors sitting as the audit committee's head (Akhigbe & Martin 2006; Nekhili et al., 2016). However, independent chair of audit committee is not useful for enhancing management supervision if CEO is engaged in selection of members (Carcello et al., 2011). The audit committee is stronger, there are fewer agency issues, and there are fewer risks of insider expropriation because of its independence (Yeh, et. al., 2011). By enabling committee to evaluate the financial reporting's transparency objectively, an impartial committee reduces the agency issue that arises between CEOs and other shareholders. A research by Chan and Li (2008) found a link between committee independence and business performance. Similar studies (Kallamu and Saat (2015) and Naimah (2017) showed a positive correlation between the performance of businesses and independent audit committee members.

H2: There is a positive affect of an independent audit committee on firm performance.

2.3 Audit Committee Member's Experience and Financial Performance

Many studies assert that the knowledge and experience of the audit committee's members directly affect the committee's efficacy. The primary responsibility of the audit committee, according to Jun-Lin et al. (2008), would be to oversee the company's auditing and reporting procedures; as a result, its members must be educated on the topics under consideration or discussion. DeFond, et al. (2005) assert that the inclusion of members with past managerial expertise or fiscal competence is directly connected with business success. Industry expertise of the directors may ultimately be more helpful to a new business in its early stages of development since they may function as a resource through connecting the company to external support like agreements and relationships. Alternatively, directors who will focus on managing the company and have financial or technical knowledge may be more useful for a known and accepted corporation that is in the dying phases of expansion and has scattered investors (Carcello and Neal, 2003). Furthermore, Hamid and Aziz (2012) postulated that the performance of the

business is positively and significantly impacted by the audit committee's members with financial backgrounds.

H3: There is a positive relationship between audit committee members experience and firm performance.

2.4 Audit Committee Gender Diversity and Financial Performance

Men and women have distinct perspectives and information demands; hence gender effects on how a corporation behaves (Peni & Vahama, 2010; Abdul, Hameed & Counsel 2012; Alqatamin et al., 2017). This is similar to the claim made by some feminist analysts suggesting women more likely than males behave in an ethically neutral way (Nelson, 2012). Carter et al. (2003) discovered a significant correlation between a company's profitability and the percentage of women serving on its board of directors. Earnhardt et al. (2003) studied the connection between business performance and female representation on boards of US companies. Their study shows a connection between the number of women on the board and the firm's profitability. Likewise, Campbell and Mnguez-Vera (2008) investigated impact of female representation on the boards. The study's findings confirm this correlation by demonstrating how gender diversity boosts a business's profitability. Miller and Triana (2009) conducted research on the link between board diversity and company success. A diverse board of directors enhances a company's success, according to their research. In a similar vein, Luckerath-Rovers (2013) found a positive and substantial correlation percentage of female on boards and performance of Dutch enterprises. Luckerath-Rovers (2013) discovered that businesses having female representation outperformed against those with all-male members. However, Rose (2007) and Carter et al. (2010) research has showed no correlation between the female board members and financial success for Danish and the USA businesses, respectively.

H4: There is a positive relationship between gender diversity and firm performance.

2.5 Frequency of Meetings of Audit Committee and Firm Performance

Since it represents efficiency of committee's oversight, the literature frequently uses meeting frequency as a proxy for quantifying audit committee activities (Xie et. al., 2003; Lin et. al., 2006). Committees that meet regularly are well educated on business's financial status in addition to offering a more efficient framework for the governance with monitoring of operations, like reporting of firm fiscal information (Al-Matari, 2012). By way of illustration, Abbott et al. (2004) discovered that companies were much less likely to misrepresent their financials if the audit committee met at least four times a year. Facts also back up the idea that audit committee

meetings are less frequent in organizations with financial problems than in those without (McMullen & Raghunandan, 1996). Hsu (2007) discovered a strong and positive correlation in between frequency of meetings and a company's financial performance. This information is in line with the best practice of Code (SECP, 2013), that audit committees convene at least four times annually:

H5: There is a positive relationship between the frequency of meeting and firm performance.

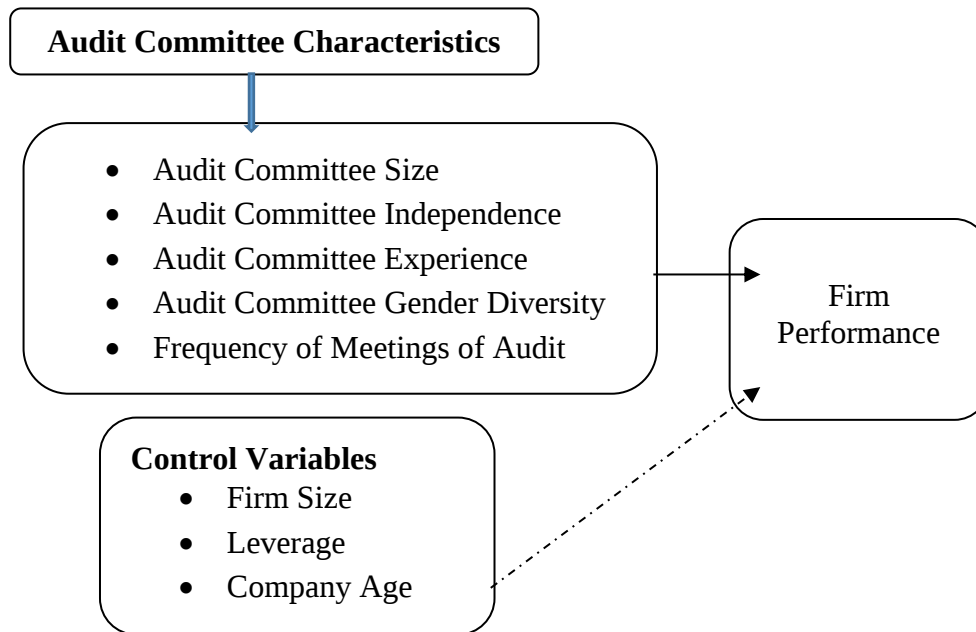


Figure 2.1: Model of the study

3. Research Methodology

3.1 Population and Sample

44 Pakistani non-financial companies are selected randomly from the KSE 100 Index that are listed on the Pakistan Stock Exchange. The study is limited to publicly traded companies because they release the financial information required for our research, and the vast majority of the regulations apply only to publicly traded companies. In this study, data from year 2017 to 2022 is used for analysis. Data for the study is obtained from annual reports of the companies. The table below represents the measurements of the variables:

Table 3.1: Measurement of Variable

Variable	Measurement
Return on assets	ROA is a proxy for firm' performance Measured as profit before tax divided by total assets
Committee size	Number of audit committee members
Committee independence	Portion of independent directors over Overall committee size
Committee experience	Portion of members with education / Experience in accounting or finance
Gender diversity	Portion of females on audit committee
Frequency of meetings	number of audit committee meetings held during the year
Company Size	the natural log of a firm's total assets
Leverage ratio	Total liabilities divided by total assets
Company age	Natural log of company age

3.2 Econometric Model

The econometric model tested in the study is shown below:

$$ROA_{it} = \alpha + \beta_1(ACSIZE)_{it} + \beta_2(ACIND)_{it} + \beta_3(ACEXP)_{it} + \beta_4(ACFEM)_{it} + \beta_5(ACMEET)_{it} + \beta_6(FSIZE)_{it} + \beta_7(FLEV)_{it} + \beta_8(FAGE)_{it} + \varepsilon_{it}$$

In the econometric model,

ROA = Return on Asset

ACSIZE = Audit Committee Size

ACIND = Audit Committee's Independence

ACEXP = Audit Committee Experience

ACFEM = No. of Females in Audit Committee

ACMEET = Audit Committee's Frequency of Meetings in a Year

FSIZE = Size of the firm

FLEV= Firm's Leverage

FAGE = Firm's Age

4. Results

4.1 Descriptive Statistics

The descriptive statistical analysis for the variables utilized in this investigation is shown in Table 4.1. There is a wide variation between the minimum and maximum ROA values 0 and 67.95 percent, respectively and the mean ROA value 12.19 percent indicates that ROA is generally low across all companies. Audit committee's features are listed in Table 4.1, where the average size is 3.65, with a range of 3 and 6, respectively. This is

in line with code's guideline of at least three members. According to the descriptive result, 36.91 percent are independent members. Code recommends audit committee with at least one independent member. Additionally, according to the statistics for member expertise, up to 80% of members have a background in finance and accounting, with an average of 50.94 percent. Code recommends audit committee with at least one member to be financially literate. According to Table 4.1, there is a mean value of 8.92 percent for gender diversity, with range of 0 and 67.00 percent. Women participation in audit committees has slightly higher rates than males, according to the mean value of gender diversity. There are typically 4 to 8 meetings within a fiscal year.

Table 4.1: Description Statistics

Variables	Min	Max	Mean	Std. Deviation
ROA	0.00	0.68	0.12	0.86
ACSIZE	3.00	6.00	3.00	0.87
ACIND	0.00	0.67	0.37	0.16
ACEXP	0.00	0.80	0.51	0.18
ACFEM	0.00	0.67	0.09	0.15
ACMEET	4.00	8.00	4.43	0.65
FSIZE	6.37	11.74	9.87	1.10
FFLEV	0.00	0.13	0.44	0.22
FAGE	10.00	63.00	38.36	0.16

Standard deviation (SD) of 1.09 percent, firm size shows a wide range of control variables, from 6.37 to 11.74. Firm age has range of 10 and 63 years, with average of 38.36 years.

4.2 Correlation Matrix

To determine the basic relationship between variables and check the occurrence of multicollinearity between independent variables, a correlation analysis matrix is used (Abel-Fattah 2008; Dellaportas et al. 2012; Kallamu and Saat 2015; Al-qatamin et al., 2018). As 0.8 is seen to be the first sign of multicollinearity issue that could impair a regression analysis. In no case the correlation between variables is above 0.8 and hence can be said that there is no issue of multicollinearity in the data. Correlation values are given in the Table 4.2 as follows:

Table 4.2: Correlation Matrix

Variables	ACSIZE	ACIND	ACEXP	ACFEM	ACMEET	FSIZE	FLEV	FAGE	ROA
ACSIZE	1.000								
ACIND	-0.221	1.000							
ACEXP	0.024	0.368	1.000						
ACFEM	0.147	0.223	0.270	1.000					
ACMEET	0.063	-0.034	0.104	0.052	1.000				

FSIZE	0.248	0.012	-0.098	-0.055	-0.020	1.000			
FLEV	0.123	-0.095	-0.133	-0.129	0.042	0.321	1.000		
FAGE	-0.131	0.107	0.266	-0.171	0.028	0.058	-0.131	1.000	
ROA	0.100	0.137	0.423	0.199	0.215	-0.266	-0.215	0.221	1.000

4.3 Hausman Test

In order to choose the best regression analysis model to evaluate the effect, the researcher formulates the following hypothesis regarding the Hausman test:

Test Summary Prob.	Chi-Sq. Statistics.	Chi-Sq.d.f.
Cross section random 0.0001	34.867424	10

We reject H0 based on Hausman test results. H0 is rejected and HA is accepted because the probability value of the Hausman test is less than 5%, or 0.05, which indicates fixed effect model to be used for regression analysis.

4.4 Results of Fixed Effect Model

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	21.32308	10.41791	2.046772	0.0419
ACSIZE	0.298084	0.859901	0.346649	0.7292
ACIND	8.186158	3.691502	2.217568	0.0277
ACEXP	11.84294	4.153541	2.851289	0.0048
ACFEM	-1.648908	4.712003	-0.349938	0.7267
ACMEET	2.200000	0.628382	3.501055	0.0006
FSIZE	-0.590818	1.177411	-0.501794	0.6163
FLEV	-0.082516	0.038930	-2.119591	0.0352
FDIV	-0.006589	0.008469	-0.777994	0.4374
FAGE	-0.516721	0.239910	-2.153810	0.0324
BIG_4	0.929293	2.324245	0.399826	0.6897

Effects Specification

Cross-section fixed (dummy variables)

R-squared	0.748252	Mean dependent var	12.19941
Adjusted R-squared	0.684715	S.D. dependent var	8.579570
S.E. of regression	4.817450	Akaike info criterion	6.162616
Sum squared resid	4873.643	Schwarz criterion	6.894060
Log likelihood	-759.4653	Hannan-Quinn criter.	6.456532
F-statistic	11.77672	Durbin-Watson stat	1.819417
Prob(F-statistic)	0.000000		

R-squared value shows 74.82% of ROA determined by attributes of the audit committee specifically the size, meetings frequency, independent members, and financial expertise of members. Our first hypothesis (H1) states that there is a positive relationship between AC size and firm performance as measured by ROA. Previous studies have demonstrated that audit committee size is positively related to firm performance (Bauer et al., 2009; Al-Okaily & Naueihed, 2020; Warrad & Khaddam, 2020). Our findings are in line with

those of Mak and Kusnadi (2005) and Herdjiono and Sari (2017), who found no significant relationship with corporate success in Malaysia, Singapore and Indonesia and the size of committee. Our data does not support the premise that the size influences performance, as evidenced by the audit committee size coefficient's lack of significance. H1 is therefore rejected. The second hypothesis (H2) independent impact on business profitability (P-value = 0.02). The result of the study is consistent with Jamal and Shah (2017). Link between these two variables is investigated by this hypothesis. Such result are consistent with Yasser et. al. (2011). The majority of earlier studies have provided evidence in support of these findings, which are consistent with the agency and resource dependence theories. Previous research has demonstrated a positive relationship between audit committee independence and firm performance (Yameen et al., 2019; Ben Barka & Legendre, 2017). Our findings provide evidence in favor of the agency hypothesis, which holds that independent directors may effectively supervise managers to boost profitability, and lessen chance of misconduct. As result of their ability to resist pressure from the management, independent directors provide superior oversight (Kallamu & Saat, 2015). Our results support Chan and Li's (2008) as well as Kallamu and Saat's (2015) conclusions that the success of the firm is positively correlated with the independent members. This can be explained by the fact that code of corporate governance in Pakistan has also recommendation of at least one independent member and the results show mean of 0.36. Hypothesis H2 is accepted. As per third hypothesis (H3), direct relation exists between financial expertise and the firm performance (P-value = 0.004). This shows that PSX businesses' audit committees perform better financially when they have more members with relevant and significant financial expertise. This result is congruent with Rashidah and Fairuzana's (2006) study, which analyzed 100 Malaysian firms and concluded that financial performance of firm improves when the AC's financial expertise increases. Code of corporate governance in Pakistan has also recommendation of at least one financially literate member and the results show mean of 0.50. Hypothesis H3 is accepted. The fourth hypothesis (H4), according to which there is influence of audit committee gender diversity on business performance, not supported. Our results are in line with those of Rose (2007) and Carter et al. (2010), who found no connection between the percentage of female directors and the performance of Danish & US companies, respectively. H4 is therefore rejected. The fifth hypothesis (H5), according to which meetings frequency is positively and significantly connected to firm performance, supported by study results. The findings provided a connection that was favorable at (P-value = 0.0006). This finding might be explained by the fact that the frequency of meetings directly affects how effective the committee is at containing agency costs. In addition, code also requires convening of

meeting at least once per quarter during a fiscal year and results show mean of 4.4. Therefore Hypothesis H5 is supported.

According to the study, additional factors might have an impact on firm performance. The size of a company has negative bearing on its performance. The so-called "small firm effect" can be used to explain the inverse relationship between ROA and firm size. According to this theory, smaller companies—those with a low market capitalization—perform better than bigger ones. This study finds that company performance is negatively and significantly related to leverage.

5. Discussion

The purpose of this study is to investigate the effect of audit committee features, including size, its independence, the financial literacy of its members, the gender diversity of its membership, and meetings frequency, with ROA-based performance for PSX-quoted blue-chip businesses. The Karachi Stock Exchange (KSE 100 Index) listed 264 non-financial companies over a lengthy six-year period used as part of the data (2017-2022). The study was inspired by the lack of comparable research on Pakistani KSE-100 index-listed companies, and it has made an effort to advance knowledge of governance factors affecting performance, particularly in context of Pakistan. This study builds on earlier research on audit committees in developed and developing countries including European, Asian and MENA (Middle East and North Africa) countries. Previously, only the presence of audit committees with a limited set of characteristics was looked at separately; however, this study went further and looked at the range of five unique characteristics of audit committees and their impact on firm performance in Pakistan corporate governance environment.

Study concludes that local audit committee features are important in determining the company's financial success. Contrary to what was predicted, the study's findings show no relationship between ROA and the size of committee. This conforms to the code requirement of at least three members. The agency hypothesis, which contends that the worse the outcomes will be the more members there are, is supported by this data. On the other hand, additional independent directors being added to the committee is what's responsible for the good business performance as indicated by ROA. Independent directors provide appropriate suggestions to the board due to their adequate technical understanding. This conclusion is consistent with that of Al-Mamun et al. (2014), who showed that by increasing independent directors improves firm efficiency and enables it to produce outcomes. This result is also consistent with agency theory that supports the idea of independence as a means of reducing agency expenses. Higher ROA is also the outcome of holding AC meetings more frequently. The resource dependency hypothesis predicts that more frequent AC meetings would result in improved business performance. Additionally, the

study's findings, which are corroborated by a look at the financial experiences of AC members, show that it has a positive effect on ROA.

5.1 Recommendations

According to study, proper structure of audit committee is a crucial component of success for experts and decision-makers. As a result, when designing the audit committee, the components' effects on the performance of the company should be taken into account. The best audit committee structure combines independence, experience, and frequency, all of which are crucial to boosting the performance of the company in Pakistan. Regulators who persistently call for a rise in the independence and financial know-how of audit committees must notice the findings.

5.2 Future Research Directions

Future research can incorporate additional variables like board size, dual leadership, firm ownership structure, etc. that impact profitability. Studies may also concentrate on other facets of audit committee that are not analyzed yet, such as financial expertise of its chair. Future research may further examine the regulatory mandate, the audit committee's responsibility for timely compliance, risk management reporting, and performance assessment. Moreover, influences of audit committee traits on other factors, such as corporate valuation, company disclosures like Sustainable Development Goals (SDGs), earning management practices, may be explored.

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