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Impact of Board's Characteristics, Audit Committee Characteristics Over Firm Performance

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Abstract

The purpose of the study was to identify the significance of selected components of corporate governance over performance of companies listed in Bursa Malaysia. In this study the most important components of corporate governance; including board independence, board size, board expertise, audit committee size, audit committee independence, and audit committee expertise have been examined as the independent variables that influence the financial performance of companies listed in Bursa Malaysia. This study has been carried out over a sample of 150 best non-financial listed companies of Malaysia. The study is different from previous studies, as in previous studies either the board characteristics are observed or the audit committee characteristics are observed, but in this study the combined effect of both have been analysed in relation to return on equity. The study is based on cross sectional analysis and the year 2014 has been analysed. Regression analysis was conducted using Statistical Package for Social Science Version 22 (SPSS 22). The outcomes of this study identified that all the variables have a significant positive impact over performance of financial performance of the companies. The study ended up with certain suggestions on the basis of limitations that have been faced while conducting this study.

Keywords: Corporate governance, board characteristics, audit committee characteristics, firm performance

1. INTRODUCTION

In the last decade world has witnessed several financial scandals and corporate collapses. As a result corporate governance has gained significant importance in the corporate sector. Researchers, academicians, and practitioners have paid significant importance over the subject and have identified it as a need of the time. Financial crisis of Asia in the past years has affected several countries and Malaysia is no exception to it. Major corporate frauds of Malaysia include; Bank Bumiputra, Perwaja Steel, and Bank Islam (Haniffa & Cooke, 2002); (Puthenpurackal & Upadhyay, 2013). In Malaysia the government has started paying attention over corporate governance in 1993. Because of major corporate frauds, Malaysian government in 1993 made compulsion on all listed companies of Kuala Lumpur stock exchange, that they must develop Audit committee. In March, 2002 major initiative was taken when Malaysian Code of Corporate Governance (MCCG) was implemented (Haniffa & Hudaib, 2006). Likewise, in 2001 the government setup Minority Shareholders Watchdog Group (MSWG) (Ameer & Rahman, 2009). Later on, for improvement, in 2007 and 2012 revised versions of code of corporate governance were issued. The key aim of implementing MCCG was to toughen the role of board of directors as well as audit committee by increasing their accountabilities (Saad, 2010).

Previous studies highlighted that board characteristics have a significant impact over performance (Shukeri, Shin,

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& Shaari, 2012; Johl, Kaur, & Cooper, 2015). On the other hand, certain studies identified that audit committee has a significant impact over performance (Aldamen, Duncan, Kelly, McNamara, & Nagel, 2012; Puasa, Salleh, & Ahmad, 2014). Impact of board characteristics and audit committee characteristics has already been analyzed but independently. However, there is a gap in the body of knowledge that this impact has not been analyzed collectively. Therefore, this study combines the two to identify the significant factors among them. In actual audit committee is the part of board of directors. Therefore, it would be right to say that boards of directors have a substantial role in protecting the rights of the shareholders (Shukeri, Shin, & Shaari, 2012). Likewise, several researches have been carried on over the significance of audit committee in protecting the shareholders (Aldamen, Duncan, Kelly, McNamara, & Nagel, 2012).

Considering the importance of board of directors and audit committee in refining the performance of listed companies of Bursa Malaysia (Johl, Kaur, & Cooper, 2015; Puasa, Salleh, & Ahmad, 2014), the current study aims to give an empirical evidence regarding the impact of significant components of corporate governance like board size, board independence, board expertise, audit committee size, audit committee independence, and audit committee expertise, over performance of companies listed at Bursa Malaysia. Therefore, it would be right to say that this research will bring new approaches for academicians over the importance of estimating board of directors and audit committee over the performance of companies listed at Bursa Malaysia.

2. LITERATURE REVIEW

The literature on corporate governance is very vast. Many scholars have conducted research on the dependence of corporate governance practices over corporate performance (Haniffa & Cooke, 2002; Puthenpurackal & Upadhyay, 2013; Shukeri, Shin, & Shaari, 2012). Corporate governance has gained significant importance worldwide particularly after big corporate collapses. Board of directors play a significant role in corporate governance (Haniffa & Hudaib, 2006). In corporate governance, board of directors form committees (Peters & Romi, 2015). Among the committees of the board, audit committee is measured as the most vital committee.

Board of directors are responsible for monitoring, maintaining discipline, and removing ineffectiveness in the organization (Baber, Liang, & Zhu, 2012). If the board of directors are under any influence then it is difficult for them to perform their responsibilities, therefore, it is considered that independent board of directors are effective for getting high performance from the board. Independent directors at times have least interest in the company, at the same time when the board size is very large then there are chances that decision making may become difficult.

Large board size is closely linked with large number of outside directors (Bai, 2013). It is argued that independent board should be free from commercial or personal ties (Kim, Mauldin, & Patro, 2014). Therefore, outside directors being free from influence are considered are best for the board. Along with independence, large size of board is also important because more brains can produce better results but beside their importance and advantages there are some disadvantages. It is difficult to determine the ideal size for the board. The studies on board size as an indicator of performance of the companies have conflicting arguments. Several researchers revealed that larger board size is good for the financial performance of the company (Li, Du, Armstrong, & Clarke, 2012). Companies that have small board, the performance of CEO is better as compared to the otherwise. Likewise, researchers have also shown an unfruitful effect of board size over the performance of companies (Haniffa & Cooke, 2002). There are studies in favour of large and independent board (Bai, 2013). At the same time several researchers argued that there is an adverse effect of independent directors and large board size. Even few studies claim that independent or non-independent board has no impact over performance of the company.

Another important aspect besides board size and board independence is expertise of board of directors. It is argued that board of directors should have competence to deal with ambiguous situations. Board of directors can only perform well if they have good knowledge about accounting, finance and auditing, therefore, the board expertise is also a vital feature of the corporate governance and have the responsibility of board performance, and consequently the performance of the company. The corporate scandals in Malaysia have given rise to the need for financial and accounting expertise of the board of directors. This will ensure higher accountability by the board of directors. The qualitative study conducted by Yusoff and Amrstrong (2012) highlighted that board expertise are essential for getting better financial performance of the companies. Knowledge about accounting and finance helps the board of directors in having an oversight on performance of management for the best interest of the company.

Therefore, it would be right to say that there are three major components of board of directors; independence, size and expertise. For independence non-executive directors are important for size sufficient members of the board are necessary whereas for expertise diversified board is important. In line with that when non-executive directors

are considered, it is also argued that non-executive directors have only part time commitment with the company, non-executive independent directors may have the deficiency of expertise required for better understanding of technicalities of the company. This problem may occur especially in developing countries. The addition of non-executive directors may only be because of legal requirements which may have an adverse effect over the performance of the company. But contrary to this, several researchers argued that independent non-executive directors usually have a positive effect over the performance of company.

Another important pillar of corporate governance is audit committee. In audit committee there are three important things which have supreme importance. The fore most is audit committee independence, the next is audit committee size, and the third one is audit committee expertise. Audit committee is considered as a significant component which has a significant effect over the financial performance of the companies (Aldamen, Duncan, Kelly, McNamara, & Nagel, 2012). Therefore, all the three variables are important for the effective performance of audit committee and as a results good financial performance of the companies.

Audit committee independence has been discussed by several researchers. Audit committee independence is considered crucial for the effective performance of audit committee (Baber, Liang, & Zhu, 2012). It has become a major concern among academicians and practitioners. Audit committee in order to produce unbiased results can only perform if it is independent of any influence (Klein, 2002). The level of integrity in the financial statements can be improved by increasing the number of independent directors (Aldamen, Duncan, Kelly, McNamara, & Nagel, 2012). An independent audit committee is more likely to conduct effective monitoring over the management. Several researchers have argued that there is a positive relationship between audit committee independence and financial performance of companies.

Audit committee independence is somehow dependent on the size of audit committee, larger the size of audit committee greater are the chances to have independent directors (Xiea, Davidson, & DaDalt, 2003). Audit committee size ensures that audit committee has a noteworthy importance in the board (Xiea, Davidson, & DaDalt, 2003). There is a strong positive relationship among audit committee size and performance of audit committee (McMullen, 1996). Larger the size better would be the performance. Larger audit committee usually has better monitoring which is the main function of an audit committee. Therefore, there is no harm in saying that audit committee size has a positive influence over the financial performance of the companies (DeZoor, Hermanson, Archambeault, & Reed, 2002). Larger size increases the number of meetings which ultimately improves performance by reducing the chances of errors and frauds. But if the audit committee becomes too large then it may suffer because of diffusion of responsibilities.

Independence and size both becomes immaterial if the members do not have required expertise. The members of audit committee must be independent, so that they may not be under any influence but the can only detect frauds and errors if they have good financial, accounting and auditing expertise. It is imperative that the members of audit committee must have the skills to correctly comprehend and deduce the financial information. Theoretically the financial expertise of the members of audit committee include financial accounting expertise (Saleh, Iskandar, & Rahmat, 2007). This is important if the corporation want to convey the correct financial information to the shareholders. It is also crucial to reduce the agency cost. These expertise improves the effectiveness of the audit committee. If the audit committee members do not have accounting sophistication, they cannot fulfill the responsibilities that are expected from them. The expertise of members of audit committee are the most important dimension of audit committee quality for enhancing internal control mechanism.

Therefore, for an audit committee to be operative in an influential way, majority of the members of audit committee should be independent and should have proper knowledge of accounting and finance. If they are independent but lack financial accounting expertise, they cannot fulfill the responsibilities. Likewise, if they are expert but are under the influence even then they cannot perform well.

Agency theory is main theory that sustain the argument built in this study. According to agency theory management is self-interested. Therefore, increased members of independent directors in the corporate board can resolve the issue of agency cost. Secondly, resource dependency theory sustains the argument that if the board members and the audit committee members have required knowledge of financial accounting they can perform well. In short, this research is built on the combined approach of agency theory and resource dependency theory (Zajac, 2013).

On the basis of literature reviewed and the theories that support the argument that is built in the study that board independence, board size, board expertise, audit committee independence, audit committee size, audit committee

Table (2) Summary of Regression analysis

Predictors	Nature of Relationship	Beta Values	t-statistics	VIF
BSIZ	+	.275	2.803 ***	1.121
BIND	+	.044	2.492***	1.224
BEXP	+	.030	2.328**	1.292
ACZISE	+	.208	2.452**	1.100
ACIND	+	.129	1.974**	1.191
ACEXP	+	.108	1.984**	1.334
Constant				
ANOVA		0.000		
Durbin Watson		2.011		
Std.Error		10.87		
F Statistics		6.735		
Significance level of F		0.000		
R ²		0.31		
Adjust R ²		0.30		

*** Significant at 0.001,

** Significant at 0.01,

* Significant at 0.1

5. CONCLUSIONS

The aim of this study was to investigate the effect of board independence, board size, accounting expertise of board of directors, audit committee independence, audit committee size, and audit committee financial expertise over return on equity. The calculated values of the statistical analysis have been drawn from the data gathered from the annual reports of 150 companies listed at Bursa Malaysia. The results have shown that board independence, board size, accounting expertise of board of directors, audit committee independence, audit committee size, and audit committee financial expertise have a significant and positive impact over the return on equity. Therefore, larger the board sizes with majority of the independent directors have a fruitful effect over financial performance of the companies listed at Bursa Malaysia.

Despite the fact that model is a good fit, this study has certain limitations. Initially this study has not focused on all the companies. Secondly, the financial performance has been measured with only one variable i.e. return on equity; there are other ways of measuring financial performance as well. In future studies the authors may identify other measures for estimating financial performance of the companies. Along with measuring financial performance other aspects of corporate governance like financial reporting may also be measured.

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