



The Influence of Audit Committee Effectiveness on Banks' Performance in Yemen

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ABSTRACT

This study aims at examining the effect of audit committee (AC) effectiveness characteristics namely, the frequency of meeting between AC and internal auditors, AC reviews of the internal audit proposals and AC reviews of the internal audit results on the performance of the bank's performance. The study utilized a survey questionnaire method targeting 20 banks operating in Yemen. The result of the study was based on 112 usable questionnaires. The findings showed that there is a significant relationship between the three AC effectiveness characteristics and the performance of banks. Review of literatures concerning the AC characteristics used in this study are presented, the practical implications and the suggestions for future research works are also highlighted.

Keywords: Corporate Governance, Internal Audit, Audit Committee, Banks' Performance, Yemen

JEL Classifications: G21, M4

1. INTRODUCTION

The corporate collapses and highly publicized scandals such as Enron, Global Crossing, Tyco and World Com have revealed the problems related to the quality of financial reporting and auditing function (Yasin and Nelson, 2012). These scandals have been shaken the confidence of investors making it difficult for firms to raise equity from the stock market (Agrawal, 2005). Various reports suggest that these scandals were as a result of ineffectiveness of the board and its committees in supervising the management. In the case of Enron for instance, its financial statements were simply manipulated through off-balance sheet financing and the board was not able to reveal the perverted statements due to their lack of independence of the senior executives (Deakin and Konzelmann, 2004). World Com overstated its earnings soon before it was filed for bankruptcy. Investigation of World Com case pointed to the fact that the audit committee (AC) had failed to effectively oversee the managers duties (Weiss, 2005). Such cases of corporate scandals in addition with the Asian financial crisis in 1997 have emphasized the significant role of good corporate governance practices for the sustainable success and superior performance of firms (Mokhtar et al., 2009).

According to Yasin and Nelson (2012), the role of the AC and internal audit as the firm's internal control mechanisms are considered to be crucial and vital to ensure the accuracy and reliability of the financial reporting. This is because of the AC's responsibility towards the internal audit, including reviewing the internal audit programme and ensuring the adequacy of the scope of the internal audit activities. Thus, it is argued that it is a prerequisite to establish a good relationship between AC and internal auditors to ensure the effectiveness of internal control mechanisms and improve the quality of financial reporting.

Theoretically, the agency theory assumes that the principal-agent conflicts are likely to occur when the roles of the management are separated from the roles of the ownership, accompanied by the asymmetric information (Shleifer and Vishny, 1986; Jensen and Meckling, 1976). They also emphasize that this usually occur as a result of inappropriately utilization of corporate assets arising from manager's self-interest in running projects that involves high risk and as well not in accordance with the intent of the providers of the capital.

Based on this, various external and internal mechanisms have been given more attention via corporate governance in order

to avoid agency conflicts and minimizing costs associated with such agency. One of the mechanisms identified to achieve this purpose is through the AC's role and its relationship with internal audit function which seeks to reduce information asymmetry between managers and stakeholders and subsequently prevents agency conflicts. According to previous studies (Dechow et al., 1996; DeFond and Jiamnalvo, 1994), firms that do not have ACs are more vulnerable to produce deceiving financial reports and earnings overstatement.

A very important function of internal auditing is to assist the AC and the board to effectively perform their responsibilities and improve their ability to monitor the performance of managers. However, earlier researches that have studied the association between AC effectiveness and firm performance are considered not conclusive. Therefore it is essential to study in details whether an AC as a governance mechanism could result to increase profit generation for investors (Turley and Zaman, 2004).

Moreover, the relationship between ACs and internal auditors should be strengthened through extending the AC's responsibilities to include reviewing the efficiency of internal audit functions. This gives the AC the right to carry out meetings with external and internal auditors without even the attendance of other employees and directors. Respectively, this study makes an endeavour to examine the impact of AC effectiveness on banks' performance especially in the Yemeni bank sector where there is a limited research works in this area. The following sections present the literature review, methodology, data analysis, findings and finally conclusion of the study.

2. LITERATURE REVIEW

2.1. The Frequency of Meeting between AC and Internal Auditors and Bank Performance

It is assumed that there will be positive impact on the internal audit function with subsequent improvement in firm's performance when there is frequent meeting between AC and internal auditors. Thus, this study attempts to examine the effect of this relationship on the performance of banks.

It was suggested by different reports such as the Blue Ribbon Committee Report (BRC, 1999); Toronto Stock Exchange Committee on Corporate Governance (TSECCG, 1994), and Treadway Commission (1987) that internal audit and AC should communicate directly for reviewing and examining essential issues. Also, some earlier studies such as Goodwin (2003), Raghunandan et al. (2001) and Scarbrough et al. (1998) have examined the situations when AC interacts with the internal audit and when they work independently.

The Institute of Internal Auditors (IIA, 1993) suggests that effectiveness can serve as a benchmark for how frequent the ACs meet the chief internal auditor, where it should exceed four times a year. This suggestion was supported by the results of Mazlina (2005) who found a significant positive relationship

between the frequency of meetings between AC and internal auditors. Moreover, such meeting provide more information and knowledge to AC especially in issues related to auditing and accounting.

Thus, the first hypothesis is postulated as follow:

H₁: The frequency of meeting between AC and internal auditors is significantly related to banks' performance.

2.2. AC Reviews of Internal Audit Proposals and Bank Performance

Reviewing of internal audit plans and programmes is another main duty of ACs where it is essential to ensure that each program with its allocated resources including the annual budget is sufficient (BRC, 1999). The duties of AC should also ensure that effective internal control system is designed and implemented within the company (BRC, 1999; TSECCG, 1994; Treadway Commission, 1987). In other words, the AC must ensure that the management plans and accomplish internal control system efficiently. To accomplish these duties, the AC should review the internal audit program in order to be sure that its scope is acceptable. This requires reviewing of each internal audit program proposals. It also requires that the AC collaborate with external auditors to ensure that its scope is appropriate.

In the same context, Mazlina (2005) has proposed that the contribution of internal audit to the financial statement audit is expected to be greater when there is a high internal-external audit relationship and the AC reviews the internal audit plans and budgets. However, the result of the study was contrary to the expectations and did not support the hypothesis in which the relationship was non-significant. Justification was expressed in terms of variable measurement that might not be sensitive enough to capture the expected result.

Findings from the study of Gendron et al. (2004) have suggested that ACs become active after reviewing the internal audit activities, programmes, plans and outcomes in terms of the effectiveness of internal controls, accuracy of financial statements, and their collaboration with external auditors. In addition, ACs may notice deficiencies in the internal audit plans and supply proper corrective measures to be taken for improvement at the level of budgetary provisions and plans (Mazlina, 2005).

Some earlier researchers (Goodwin, 2003; Raghunandan et al., 2001; Scarbrough et al., 1998) have studied the effect of AC independence on AC interactions with the internal audit. Therefore, it can be argued that the higher the extent to which AC reviews internal audit plans and programs, the more efficient the functions of the internal audit become, which will subsequently improve the firm's performance.

Accordingly, the second hypothesized relationship is suggested as follow:

H₂: There is a positive relationship between the extents of AC reviews of internal audit proposals and firm performance.

2.3. AC Reviews of the Internal Audit Results and Bank Performance

It is incumbent on the AC to review the outcomes of all the programs of the internal audit. Therefore, the internal audit should provide the AC with the reports of each program they successfully conducted. The AC will then review the results to check if they are in accordance to the aim of the programs (Braiotta, 1999).

This point was also recommended by several private sectors and regulatory authorities, emphasising that the AC must assess the outcomes of all financial reports, internal controls and compliance with rules and regulations that are presented to them by the internal audits (BRC, 1999; TSECCG, 1994; Treadway Commission, 1987). According to the Canadian Securities Administrators Notice (1992), the AC should assess the internal auditor reports with the management's response in order to address any inadequateness.

As stated earlier, the study of Mazlina (2005) has showed a negative relationship between the proposed variables due to sensitivity in variable measurements. The findings did not support the relationship between internal audit's contribution to the financial statement audit and the AC reviews related to internal control, financial reports and compliance with rules and regulations.

Thus, the third hypothesis is proposed as follow:

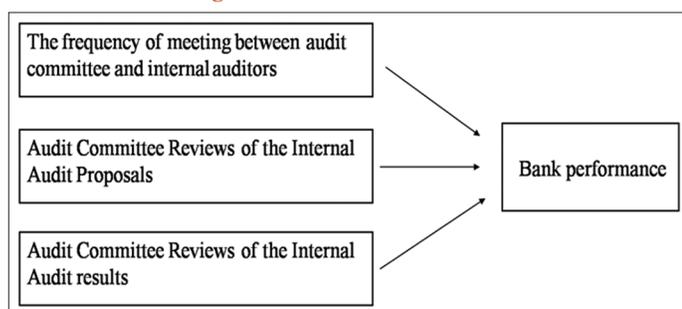
H₃: There is a positive relationship between the extents of AC reviews of the results of internal audit activities and bank performance.

Based on the theoretical gaps in the literature regarding the AC effectiveness and the bank performance, a theoretical framework is presented in Figure 1.

3. METHODOLOGY

A questionnaire was developed to address the research objectives of this study. According to the Central Bank of Yemen (2015), there are currently 20 operating banks in Yemen. Thus, questionnaires were distributed among these banks where each bank received 10 questionnaires. Out of 200 questionnaires, 112 questionnaires were received and used for the analysis. The response rate was 48%. The chief audit executive and the internal auditor members were asked to answer the questions regarding the frequency of meetings between the AC and the committee of internal audit (CIA) by stating the number of meetings of the AC and the CIA

Figure 1: Theoretical framework



during the year 2014. They were also asked to answer some questions regarding the AC effectiveness by answering Yes or No. For the bank performance, 5-Likert scale were used to rate the perspective of the respondents where 5 = strongly agree and 1 = strongly disagree.

The bank performance measurement was adopted from Jaworski and Kohli (1993), Kaplan and Norton (1993), and Narver and Slater (1990). As for the main three independent variables, the measurement was derived from previous literatures (Mazlina, 2005; Goodwin, 2003).

The frequency of AC meeting with the chief internal auditor (ACIAM) was measured by the number of meetings between the chief internal auditors. As for the AC reviews of internal audit proposals (ACREV1), it was measured by three separate questions in terms of (1) program/plans, (2) budget and (3) coordination with external auditors. Finally, the AC reviews of the result of internal audit's activities (ACREV2) represent the extent to which AC reviews the results of internal audit, namely their reviews of (1) financial reports, (2) internal control, (3) compliance with laws and regulations and (4) management responses to internal auditing findings. In this study, the regression as the analytical procedure using SPSS software was employed to test the hypotheses postulated by the study.

4. DATA ANALYSIS AND RESULTS

Prior to regression analysis, the descriptive statistics was conducted. The descriptive statistics of the independent variables include mean, standard deviation, minimum, and maximum were also computed using SPSS 21. The results of descriptive statistics in Table 1 show that the minimum number of meetings between the AC and the CIA is 3 and the maximum is 6. In addition, Table 2 shows the correlation among the variables at the significant value of 0.05.

Finally, the regression analysis was carried out in order to test the hypothesized relationships of the study variables. Based on the results shown in Table 3, The F value is significant at the 0.001 level and the adjusted R² is 61%. The AC meeting with the chief internal auditor (ACIAM) is significantly related to the performance of banks in Yemen ($\beta = 0.371$, $t = 5.148$, $P < 0.01$), hence Hypothesis 1 is supported. The AC reviews of internal

Table 1: Descriptive statistics

| Variables | Minimum | Maximum | Mean±standard deviation |
|--|---------|---------|-------------------------|
| Meetings between the AC and the CIA (ACIAM) | 3 | 6 | 4.46±0.652 |
| AC reviews of IA proposals (ACREV1) | 0 | 1 | 0.87±0.215 |
| AC reviews of the result of IA activities (ACREV2) | 0 | 1 | 0.86±0.229 |
| Bank performance (B PER) | | | |

The correlation analysis also shows that all correlations are less than the cut-off point of 0.90 suggested by Hair et al. (2010). AC: Audit committee, CIA: Committee of internal audit

Table 2: Correlations

| Variables | ACIAM | ACREV1 | ACREV2 | B PER |
|-----------|---------|---------|---------|-------|
| ACIAM | 1 | | | |
| ACREV1 | 0.244* | 1 | | |
| ACREV2 | 0.306** | 0.837** | 1 | |
| B PER | 0.547** | 0.660** | 0.700** | 1 |

*Correlation is significant at the 0.05 level (2-tailed). **Correlation is significant at the 0.01 level (2-tailed)

Table 3: Regression results

| Variables | Beta | T value | P value |
|--|---------|---------|---------|
| Audit committee meeting with the CIA (ACIAM) | 0.371** | 5.148 | 0.000 |
| Audit committee reviews of IA proposals (ACREV1) | 0.262* | 2.096 | 0.039 |
| Audit committee reviews of the result of IA (ACREV2) | 0.368** | 2.882 | 0.005 |
| R ² | | 0.634 | |
| Adjusted R ² | | 0.619 | |
| F value | | 44.948 | |
| F significance | | 0.000 | |

**P<0.01; *P<0.05

audit proposals (ACREV1) is also found to be significantly associated with the performance of banks in Yemen ($\beta = 0.262$, $t = 2.096$, $P < 0.05$), hence Hypothesis 2 is supported. AC reviews of the result of internal auditors (ACREV2) are also found to be insignificantly related to the performance of banks in Yemen ($\beta = 0.368$, $t = 2.882$, $P < 0.01$), hence Hypothesis 3 is supported.

5. CONCLUSION

The current study attempts to examine the effect of AC effectiveness on the performance of banks in Yemen. The focus has been given to three main characteristics of AC, namely the frequency of meeting between AC and internal auditors, AC reviews of the internal audit proposals and AC reviews of the internal audit results. The findings show that all the variables of the study influence significantly the banks performance. Specifically, the frequency of AC meeting with the CIA has been found to be the most significant variable to influence bank performance. The AC reviews of the result of internal audit and AC reviews of internal audit proposals have been concluded to be the next antecedent variables affecting banks performance respectively.

This study emphasizes the important role of AC as an effective corporate governance mechanism. This shows that the frequency of AC meeting with the CIA and the different AC reviews are significant aspects of corporate governance that direct to a better firm performance. Therefore, it is possible to suggest that the regulators in Yemen should focus more on these aspects when providing their supervision. The role of AC should be improved in Yemen by increasing the number of meeting between AC and the committee internal auditors and providing training programs for AC members to enhance their skills and ability to gain better firm performance.

There are some limitations for this study. First, it is a cross sectional study in Yemeni bank industry, therefore longitudinal study can be

carried out in future studies. Moreover, the findings of the study should be interpreted with caution as it has been conducted in specific context so that it is possible to generalize the results on similar sectors. This study deals only with three characteristics of AC so future studies may include other ones which may show other insights.

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