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Characteristics of Audit Committee and Banking Sector Performance in Oman

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ABSTRACT

Purpose: Oman is the first country among the GCC countries to implement corporate governance (CG) principles. Corporate governance regulates the fundamental principles that govern the activities of businesses, like the responsibilities and roles of the Board of Directors (BoD), financial reporting and auditing, remunerations, and internal control system. Banks play a vital role in the economic development of a country. Adopting CG practices and the audit function in banks paves the way for transparent financial reporting. Furthermore, the audit committee has an impact on the financial performance of a firm as they undertake the task of preventing fraudulent financial reporting. From the above discussion, the purpose of this study is to understand and examine the characteristics of the audit committee by exploring its association with its performance.

Methodology: All the eight listed banks on the Muscat Stock Exchange (MSX) have been selected for the study, and data has been collected from the banks' annual reports for five years (2016-2020). The study has been conducted based on three CG characteristics such as the number of members in the committee, number of committee meetings and number of non-executive members in the committee. Measuring firm performance has been done by calculating Return on Asset (ROA) and Return on Equity (ROE). Correlation and regression analysis has been used to study the relationship between CG factors and bank performance. ROA and ROE are dependent variables. The three CG factors are independent variables, and bank size has been used as a control variable.

Results/Findings: This study shows a positive relationship between the banks' performance and the number of committee meetings and non-executive members and a negative impact between the number of members in the committee and bank performance.

Originality and Practical Implications: Further research on this study area can be conducted after 2021, considering the impact of audit committee characteristics on bank performance before and during COVID – 19.

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1. INTRODUCTION

Financial reports are the source of essential information about an organization to policymakers, shareholders, management, government, creditors, and the general public, amongst others. A more vibrant organization will call for improved observations, measurement and transparent disclosure of operations (Mohammed, 2012). Financial reporting information is a much-needed input for effective decision-making and management of an organization. The financial disclosure policy of an organization can create confidence in the investors or decrease the level of confidence in the organization. An ineffective governance system fails, whereas efficient management will promote ethical values, professionalism and application of best practices (Arif & Anees, 2012).

The corporate governance framework provides transparency, accountability, fairness and responsibility in an organization's financial reporting (OECD, 2004). Corporate governance principles are entangled with a country's banking sector and economic growth (Wolfowitz, 2006). One of the primary goals of corporate governance is to ensure that all stakeholders of an organization receive adequate information. Implementing corporate governance principles ensures that the management will work to maximize the firm's value rather than concentrating on management's personal goals (Belhaj & Mateus, 2016).

Corporate governance principles guide an organization to create committees and appoint committee members based on their qualifications and expertise. This division of work aims to achieve an organization's goals and satisfy its owners' interests. An audit committee is one such board committee which oversees financial reporting and related internal controls (Kallamu & Saat, 2015). The corporate governance codes highlight that the audit committee should be independent to carry out its activities transparently. The audit committee can prevent fraudulent financial reporting and reflect the actual financial status of a firm (Bhagat & Jefferis, 2002; Heenetigala & Armstrong, 2011; Samoei & Rono, 2016).

2. BACKGROUND

Oman was the first country in the GCC to implement corporate governance principles. The corporate governance regulations were issued by Capital Market Authority (CMA) in the year 2002.

Banks play a vital role in the economic development of a country. Banks induce entrepreneurial activities, promote saving habits, diversification of risk and bring financial stability to the country (Ouattara, 2017; Mukherjee, 2017; Ali & Anis, 2018). Hence transparency in the practices of financial institutions boosts the confidence of investors. Moreover, adopting corporate governance practices and the audit committee's role in banks paves the way for transparent financial reporting.

Kallamu & Saat (2015) and Bin-Ghanem & Ariff (2016) indicate that the failure of a corporation happens when the audit committee fails to discharge its duties transparently and independently. The independence and honesty of the audit committee members are essential to performing their role. The audit committee has an impact on the financial performance of a firm as they undertake the task of preventing fraudulent financial reporting (Samoei & Rono, 2016).

The audit committee must regularly review financial, risk and internal control systems. Therefore, the number of members, meetings and percentage of non-executive members are related to a firm's performance (Elbahar, El-Bannany, & Baradie, 2021). The Sarbanes-Oxley Act, 2002 states that the members of an audit committee should have experience in financial and risk management, representing the percentage of qualified members and the percentage of non-executive members in the committee.

From the above discussion, the purpose of this study is to understand and examine the characteristics of the audit committee by exploring its association with performance. Firm performance is measured by calculating Return on Asset (ROA) and Return on Equity (ROE). The study was conducted on the banks listed on the Muscat Stock Exchange (MSX) for five years (2016-2020).

3. OBJECTIVES

The primary objectives of the study are given below:

1. To analyze the relationship between the size of the audit committee and bank performance,
2. To examine the relationship between the number of audit committee meetings and bank performance.
3. To investigate the relationship between the number of non-executive directors on the audit committee and bank performance.

4. LIMITATIONS

The following are the significant limitations of the study.

1. This study is conducted on banks and cannot be generalized to other sectors.
2. The data used are extracted from the banks' audited financial reports without bias on the reports' correctness and fairness.

5. REVIEW OF RELEVANT LITERATURE

This section is intended to acquaint oneself with the existing literature on audit committee characteristics and their effect on firm performance. The relationship between audit committee characteristics and firm performance is highlighted, leading to the development of a hypothesis. The chapter is divided into two segments. Segment 1: Theories of corporate governance. Segment 2: Audit committee characteristics and firm performance.

5.1 Segment 1: Theories of corporate governance

The practice of adopting corporate governance principles has proved to be essential for a firm's operational development. The theories of corporate governance address the challenges faced by a firm's BOD. The current study has adopted agency and resource dependence theories as they are found to be relevant to the topic.

Agency Theory

Adam Smith's book "An Inquiry into the Nature and Causes of the Wealth of Nations" (1776) stated that the board of directors act as agents to manage the funds invested by the principal. Jensen & Meckling (1976) state that agency theory helps understand the problem between agent and principle and provides a solution to the problem. Agency theory indicates that a well-managed firm achieves its strategic and operational objectives more than a poorly-managed firm (Elbahar, El-Bannany, & Baradie, 2021).

Resource Dependency Theory

In order to understand the concept of corporate governance, the resource dependency theory is used. The role of directors is to ensure the availability of resources and information needed for the organization (Pfeffer & Salancik, 1978). The directors are responsible for providing essential resources from the external environment (Elbahar, El-Bannany, & Baradie, 2021). Having more insider members as directors can support arranging adequate resources needed for an organization (Zhou, Owusu-Ansah, & Maggina, 2018).

5.2 Segment 2: Audit committee characteristics and firm performance

The presence of an audit committee on the board ensures transparency and fairness of a firm's financial reports. Therefore, the current study focuses on the impact of audit committee size, the number of audit committee meetings and the number of non-executive directors in the audit committee on the performance of banks listed on the Muscat Securities Market. The reason for choosing these characteristics is that they are readily available and quantifiable.

Audit Committee Size

Several studies have been conducted to understand the effect of audit committee size on financial performance (Dinu & Nedelcu, 2015; Tarek & Mohamed, 2016). The result of these studies (Awinbugri & Prince, 2019; Sattar, Javeed, & Latief, 2020; Ashari & Krismiaji, 2020) showed a positive association between the size of the audit committee and the financial performance of firms. This is because big audit committees can provide quality governance to the users of a firm's financial statements.

On the other hand, Indrawan, Agoes, Pangaribuan, & Popoola (2018) and Baiden (2020) stated that the audit committee size is kept small to improve the process of financial reporting

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The following hypothesis has been proposed following the above studies dealing with the relationship between the variables selected.

H1. There is a negative relationship between the audit committee size and the performance of banks.

Number of Audit Committee Meetings

The results of the past research studies on this topic have concluded that there is a negative correlation between the number of meetings a firm conducts and the firm's performance (Aminul, 2018; Awinbugri & Prince, 2019). For example, in this line of research, Cornett (2009) worked on non-life insurance companies in Thailand and found a negative relationship between the number of meetings conducted by the audit committee and the performance of the companies.

Ashari & Krismiaji (2020) analyzed the relationship between the number of audit committee meetings and firm performance. The results were positive and concluded that there is a relationship between the number of meetings and performance. Abbott, Parker, & Peters (2004) found from their detailed analysis that there are high chances of restatement of financial statements if the audit committee does not meet regularly. Beasley, Carcello, Hermanson, & Neal (2009) stated in their analysis that the chance of fraudulent financial reporting happens when the audit committee meets less frequently.

The above studies have led to the following hypothesis.

H2. The number of meetings conducted by the audit committee positively impacts the performance of banks.

Number of non-executive directors

Past studies conducted with the same research objectives show that the number of non-executive members is impacting the performance of the companies (Dinu & Nedelcu, 2015; Aminul, 2018; Ashari & Krismiaji, 2020). Beasley, Carcello, Hermanson, & Neal (2009) state that the audit committee has the potential to conduct a detailed discussion on the financial reporting area. Having independent directors as audit committee members keeps the committee as a body that detects errors and overcomes the risk. The non-executive members of the committee decide on a timely basis from their experience and expertise. The research conducted by Assenga, Aly, & Hussainey (2018) showed that having non-executive members on the audit committee has been a sign of success in preparing financial statements and solving management conflicts.

Analyzing the past literature, a matching hypothesis has been developed for the current study.

H3. There is a positive relationship between the percentage of independent directors in the audit committee and the performance of banks.

6. RESEARCH DESIGN

The structure of this section is divided into:

- Data collection and analysis
- Nature of the dependent variable
- Nature of the independent variable

6.1 Data collection and analysis

All eight banks listed on the Muscat Stock Exchange are considered for the study. Data has been collected from the banks' annual reports for the years 2016-2020. In order to understand the relationship between dependent and independent variables, regression and correlation tests have been used. In addition, a two-way regression model for ROA and ROE has been used.

6.2 Dependent variable

To measure the bank's performance, return on assets (ROA) and return on equity (ROE) have been calculated. ROE is a measure to understand how investments are employed to achieve higher growth levels. ROA helps to find out how a firm efficiently manages its economic resources.

6.3 Independent variable

The independent variables have been segmented into two groups.

Group 1: Audit committee characteristics.

Group 2: Control variable

Table No: 1 Definition and measurement of variables

Variables	Definitions	Measurements
No. of meetings	No. of meeting per year	Total number of meetings per year
concise	Number of committee members	Total number of committee members
NECM	Non-executive committee members	The number of NECM divided by total number of members
ROE	Return on equity	Net Income divided by Total Equity
ROA	Return on asset	Net Income divided by Total Assets
BankSize	Bank size	The logarithm of total assets

Research Method and Study Model

The Muscat Stock Exchange has eight banks listed under the financial sector. All the banks have been considered for the study purpose for five years (2016-2020). Therefore, data extracted from the annual reports for eight banks have been used for hypothesis testing so that the total data used for five years equals 40 entries. The performance of banks has been measured using ROA and ROE because the size of the bank impacts performance, and it is commonly used as a control variable (Andres & Lopez, 2005). In addition, the corporate governance variables, namely, number of meetings, committee size and number of non-executive members, were studied.

ROA = α + β1AUDSIZE + β2AUDMET + β3AUDNEM + + β4logFSIZE + ε

ROE = α + β1AUDSIZE + β2AUDMET + β3AUDNEM + β4logFSIZE+ ε

Data Analysis and Results

The gathered data has been analyzed using AMOS for data description and hypothesis testing.

Descriptive Statistics:

Descriptive statistics of study variables such as audit committee size, number of meetings, number of non-executive members, ROA, ROE, and Bank size are presented in Table 2. This includes the mean, standard deviation, minimum and maximum.

Table No: 2 Descriptive Statistics

Variable	Mean	Std. Deviation	Minimum	Maximum
No. of meetings	5.79	2.34	3	13
Committee size	3.92	0.71	3	6
NECM	2.49	1.00	1	5
ROA	2.050	0.82	0.021	3.703
ROE	7.10	3.15	0.038	12.16
Bank size	4053880211	3378006691	515995377	12453765000

The number of audit committee meetings ranged between three and thirteen, with mean points calculated as 5.79. On the number of members, the minimum number of members was 3, and the maximum was 6, with a calculated mean value of 3.92. Finally, the minimum number of non-executive members was one, and the maximum was 5, with a calculated mean of 2.49.

Correlation Analysis:

The summary of correlation results is presented in Table 3. Correlation testing has been adopted to explore the association between the variables and better understand the relationship between the study variables. The results presented in the table indicate that number of meetings and the number of non-executive members in the audit committee are significantly associated with ROA and ROE.

Table No: 3 Correlation Analysis

		Members	Meetings	NECM	ROA	ROE
Members	Pearson Correlation	1	.346*	.525**	.195	-.165
	Sig. (2-tailed)		.029	.001	.228	.310

	N	40	40	40	40	40
Meetings	Pearson Correlation	.346*	1	.350*	.177	-.059
	Sig. (2-tailed)	.029		.027	.276	.718
	N	40	40	40	40	40
NECM	Pearson Correlation	.525**	.350*	1	-.128	-.192
	Sig. (2-tailed)	.001	.027		.430	.235
	N	40	40	40	40	40
ROA	Pearson Correlation	.195	.177	-.128	1	.223
	Sig. (2-tailed)	.228	.276	.430		.167
	N	40	40	40	40	40
ROE	Pearson Correlation	-.165	-.059	-.192	.223	1
	Sig. (2-tailed)	.310	.718	.235	.167	
	N	40	40	40	40	40

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

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

Regression Analysis:

Regression analysis is one of the most commonly used statistical tools in social science research (Hair et al., 2010). Regression is a statistical tool allowing the researchers to predict the value of one variable from one or more other variables. A regression equation is formed with dependent variable values through values of independent variables (Elbahar et al.,2021). In this study, regression analysis has been used to determine the relationship between independent and dependent variables. The regression analysis results prove a significant relationship between the number of meetings, the number of non-executive members, and the banks' performance.

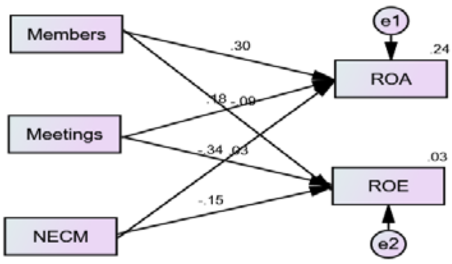

Figure No: 1 AMOS Regression Chart

Table No: 5 Regression Weights

	Estimate	SE.	CR.	P	Label
ROA <--- Members	.247	.115	2.151	.032	
ROA <--- Meetings	.064	.049	1.305	.192	
ROA <--- NECM	-.282	.115	-2.451	.014	
ROE <--- Members	-.279	.466	-.600	.549	
ROE <--- Meetings	.034	.198	.171	.864	
ROE <--- NECM	-.453	.466	-.972	.331	

7. CONCLUSION

This study has been conducted to explore the effect of audit committee characteristics, namely the number of committee members, the number of meetings and the number of non-executive members in the committee, on the performance of banks. ROA and ROE indicate performance. Data comprised of banks listed on the Muscat Stock Exchange during 2016-2020.

The empirical study results showed that the number of meetings conducted and the number of non-executive members in the audit committee positively impact the banks' performance. Hence it can be concluded that the meetings have been very effective in finding a solution to finance and risk elements contributing to the increase in the performance of the banks. The results of the current study are in line with the literature by Ashari & Krismiaji (2020); Abbott, Parker, & Peters (2004); Beasley et al. (2009); Sattar, Javeed, & Latief (2020); Awinbugri & Prince, (2019); Tarek & Mohamed, (2016); Dinu & Nedelcu, (2015).

On the other hand, the audit committee size is not associated with the performance of the banks. Hence, an increase in the number of members will not impact performance. Participation of the members is more essential than the number of members. The study results are in line with the results of Indrawan, Agoes, Pangaribuan, & Popoola (2018); Baiden (2020). Therefore, a firm with even a smaller audit committee size can have sustainable development.

The primary motivation for the study is the inadequate research on Oman banks. This study adds a better understanding of corporate governance, its characteristics and its impact on bank performance. Even though this study is consistent with the previous research, it is unique as only audit committee characteristics are used to analyze the bank performance. As the audit committee forms the basis for financial reporting, it is essential to study the audit committee and its association with bank performance. The applicability of agency and resource dependency theory was found to be more suitable for the banking sector in Oman.

8. SCOPE FOR FUTURE RESEARCH

Further research on this study area can be conducted after 2021, considering the impact of audit committee characteristics on bank performance before and during COVID – 19. Also, further research on other characteristics of corporate governance can be added.

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