ISSN: 2230-9926

Available online at http://www.journalijdr.com

IJDR

International Journal of Development Research
Vol. 07, Issue, 10, pp.15862-15865, October, 2017

ORIGINAL REVIEW ARTICLE OPEN ACCESS

A ROLE OF AUDIT COMMITTEE AND ITS IMPACT ON FIRM PERFORMANCE IN INDIA

[1]Sujatha, N., [1]Dr. Muninarayanappa, M. and [*,2]Dr. Sathyanarayana

[1]Department of Commerce, Bangalore University, Bangalore
[2]Department of Commerce, Government First Grade College, Hosakote

ARTICLE INFO

Article History:
Received 19th July, 2017
Received in revised form
05th August, 2017
Accepted 27th September, 2017
Published online 10th October, 2017

Keywords:

Audit committee Firm Performance, Financial Reports, Corporate Governance.

***Corresponding author**

ABSTRACT

The purpose of this study is to investigate the association of audit committee expertise and firm performance. Nowadays, an audit committee (AC) is being looked upon as a distinct culture for corporate governance and has received a wide publicity across the globe. Government authorities, regulators and international bodies all have indicated that they view an AC as a potentially powerful tool that can enhance the reliability and transparency of financial information. Being mandatory under SEBI Clause 49 of the listing Agreement, an AC can be of great help to the board in implanting , monitoring and continuing good corporate governance practices to the benefit of the corporation and all its stake holders in firm performance.

Copyright ©2017, Sujatha et al. *This is an open access article distributed under the Creative Commons Attribution License, which permits unrestricted use, distribution, and reproduction in any medium, provided the original work is properly cited.*

Citation: Sujatha, N., Dr. Muninarayanappa, M. and Dr. Sathyanarayana. 2017. "A Role of Audit Committee and its Impact on Firm Performance in India", *International Journal of Development Research*, 7, (10), 15862-15865.

INTRODUCTION

A system of good corporate governance fosters a system of accountability. Both foreign and domestic investment is very important for growth of any economy. However, occurrence of financial frauds gives a bad image not only to the firm in which the fraud occurrence, but also to the country (bhasin 2013). Such instances result in lower investment from domestic and foreign investors, hampering the economic growth of the nation. In the light of such scandals, corporate governance assumes much prominence. Infamous frauds such as Enron, WorldCom, satym etc. highlights the importance of strong corporate governance. The essence of the audit committee is based on two stands of accountability; first, management's accountability to the board, second, board's accountability to the shareholders. The role of the audit committee and internal audit as the firms internal control mechanisms are very important to ensure the reliability of financial reporting. The audit committee's role stems directly from the board's oversight function as it oversees, both, internal as well as external, audit processes of the firm (Collier and Gregory, 1999; Bédard *et al*., 2004; Lee *et al*., 2004). One of the foremost functions of the audit committee is to review the financial data of the company on continuous basis and strengthen internal accounting controls, in order to enhance reliability and integrity of financial reporting.

Firm Performance

A wide variety of definitions of firm performance has been proposed in the literature. Performance can be related to the organisational ability in meeting its targets and goals. Firm performance is thus the effectiveness of a firm in achieving goals and targets within specified time frame. The performance of a firm can be measured using two kinds of measures: Market based and accounting based. The existing literature on Audit committee and Firm Performance is used both the type of measure. Market based measures are based on the market value. These measures are helpful for investors as they help them in taking their investment decisions on future performance of the company based on its past and present performance. The various market based measures are Price to Earnings Ratio, Earning per Share, Economic Value Added,

Tobin's Q, Market Value Added, and Market to Book Value Ratio etc. In corporate governance literature Tobin's Q as a proxy for firm performance was used extensively. However accounting based measures are considered more reliable as the firms listed in various exchanges have to follow various national and international principles while recording their financial statements. These measures correspond to the past performance of the firm. Various accounting based measures like Return on Assets (ROA), Return on Equity (ROE), Return on Capital Employed (ROCE), Net Profit Margin, Return on Sales (ROS) etc. were used in past studies.

Historical background of audit committee in India

It is claimed that the auditing system in India is comprehensive and well supported by law, which ensures that impartiality, objectivity and independence of statutory auditors are maintained. However, experience has shown that certain weaknesses and lacunae do exist in Indian systems. Accounting manipulations, irregularities and leakages go unnoticed to the detriment of the public and shareholders. Furthermore, the emphasis during the past few years has been limited to only some of the recommendations of the Cadbury Committee, such as the role and composition of the ACs and the importance of making all the necessary disclosures with annual statements of accounts. These are considered important for investors' protection. The Companies Act (Amendment), 2000 has, among others, provided for the formation and functioning of ACs (section 292A). Following this, the Bombay Stock Exchange (BSE) and the Securities and Exchange Board of India (SEBI) have formed regulations on corporate governance and included it under clause 49 of the listing requirements. This is done on the recommendations of the Kumar Mangalam Birla Committee on Corporate Governance (SEBI, 1999). One of the main recommendations which was adopted by the SEBI is the establishment of independent1 and qualified2 ACs. Therefore, this paper seeks to contribute to our understanding of the value and potential of ACs, as a corporate governance mechanism in a developing country like India. It seeks to examine the structure and functions that are currently performed by audit committees, in the Indian corporate world. ACs are spread throughout the world and the establishment of ACs has been mandatory in several countries.

- 1939- The New York Stock Exchange (NYSE) first endorsed the Audit Committee Concept
- 1972- The U.S. Securities and Exchange Commission (SEC) first recommends that publicly held companies establish audit committees composed outside (non-management) directors.
- 1977- NYSE adopts a listing requirement that audit committees be composed entirely of independent directors.
- 1988- AICPA issues SAS 61"communication with audit committees" addressing communications between the external auditor, audit committee and management of SEC reporting companies.,
- 1999- NYSE, NASDQ, ASDP AMEX, SEC and AICPA finalised major rule change based on blue- ribbon committee on improving the effectiveness of the corporate audit committee.
- 2002- Sarbanes-Oxley act is passed in wake of corporate scandals and includes whistle blower and financial expert disclosure requirements for audit committees.

Regulatory aspects companies' act 2013 and the amendments of SEBI

The Companies Act was enacted on August, 2013 which provides for major overhaul of corporate governance norms for all companies. The Companies Act 2013 envisages radical changes in the area of corporate governance and is set to have far reaching implications. Securities Exchange Board of India (SEBI) with the objective to align with the provisions of the Companies Act 2013, issued revised Clause 49to adopt best corporate governance practice and to make corporate governance norms more effective. The revised Clause came into effect from October 1, 2014 except for the clause relating to the constitution of a risk management committee which shall apply to the top 100 listed companies by market capitalisation, as at the end of the immediate previous financial year. Revised clause 49 lays down the principles of corporate governance. The listed companies have to adhere to the principles and are expected to interpret and apply those provisions in alignment with the principles. The key components of the principles are (a) Rights of Shareholders (b) Role of stakeholders in Corporate Governance (c) Disclosure and transparency (d) Responsibilities of board of directors and other responsibilities. Many of the principles laid down in this framework are aligned with powers, duties and expectation from various stakeholders especially directors and management in the Companies Act 2013. The key impact areas of corporate governance in the Companies Act 2013 includes Board structure and responsibility; disclosure and reporting; risk, control and compliance; secretarial compliances; related party transactions (RPT), loans and investments; audit and auditors; and corporate social responsibility.

Literature review

IIaboya.O.J, Obaretin.O (2015) examined board characteristics and corporate financial performance dynamics using a combination of co-integration and error correction mechanism. The estimated results suggested positive relationship between board size and corporate financial performance. It suggests need for a competent and sizeable board, independent directors on audit committee to strengthen the independence of audit committee to continuously achieve the control mechanism and oversight function. Mamta Mishra, Dr.Amarjeet Kaur Malhotra (2016) examines the influence of audit committees in restraining earnings manipulation. Audit committees constitute one of the most important limbs of corporate governance. The Indian companies are in compliance of the companies Laws with respect to the existence and constitution on audit committees. Nizamulmulk Gunus and M Serkan Aftigan (2016) the study aims to measure the emphasize of effective audit committees on bank performance via using some of the main bank performance indicators which are return on asset, return on equity and net interest margin in the Turkish and the UK banks. Yusef Hassen, Kamal Naser, Rafig.H.Hijazi (2016) the study explores the relationship between corporate performance and corporate governance by companies listed on the Palestinian stock exchange, Accounting and Market performance measures were used to proxy corporate performance. It is represented by the BODs size, the frequency of the Annual Meetings of the board, existence or otherwise of n audit committees, institutional investors ownership and foreign investors. Mishra S. and Mohanty P. (2014) in their study examined the corporate governance issues in India in

order to establish the relationship between corporate governance and financial performance using a sample of 141 companies belonging to the A group stocks listed in the Bombay Stock Exchange of India covering 18 industries. They developed a composite measure of corporate governance comprising of three indicators-legal, board and proactive indicators. The results of the multiple regression performed step-wise using ROA as a proxy for firm performance revealed that the board indicators (CEO-duality, board size, board composition, number of board meetings, Frequency of attendance in the board meetings) and proactive indicators influence the firm performance significantly. The results concluded that composite corporate governance measure is a good predictor of firm performance. Sahu T. K. and Manna A. (2013) empirically investigated the effect of corporate board composition and board meetings on performance of 52 Indian manufacturing companies listed in Bombay Stock Exchange over a period of 5 years (2006-2011). They represented Board composition by board size, number of executive directors, board independence, and Chairman's identity. Corporate performance is measured through Net sales, Net Profit, Return on Capital Employed, Earning per share, Tobin's Q, Economic value added and Market value added. Multiple regression Ordinary Least Square model results indicated that board size and board meetings have a positive impact on corporate performance whereas the independence of the board and presence of non-executive chairman in the board has negative impact whereas the proportion of executive directors in the board was found insignificant.

Bijalwan J. G. and Madan Pankaj (2013) analysed the relationship between board composition and firm performance for 121 firms listed on BSE for the year 2010-2011. Financial performance of the firm is measured with the financial ratios viz. Return on Capital employed, Return on the equity, Profit after tax and Return on assets. The study found that there exist a significant positive relationship between board composition and firm performance. Also board size and firm Performance are significantly related but the strength of relationship is not strong. Larger boards are less effective than smaller boards except in case of PSUs in India. Also the standard board sizes vary according to the nature of the industry. Kumar N. and Singh J.P. (2012). Using Tobin's Q as a performance measure, it was found that outside directors has a negative effect on the firm value mainly due to non-executive non-independent directors, where as independent directors have a positive but insignificant effect. It was concluded that the companies with a greater proportion of independent directors have more market value. Thus independent directors require a greater representation on board in lieu of other non-executive outside directors. Kota, H.B., and Tomar, S. (2010) examined the effect of corporate governance practices on the performance of 106 mid-sized firms in India between 2005 and 2007. When Tobin's Q was used as a measure of financial performance, it was found that the ratio of non-executive directors to total directors have no significant relationship with the performance. However it was found that CEO duality structure contributes positively and significantly to the firm performance. A significant inverse relationship between board size and firm performance was also reported. GargA. K. (2007) studied the data of 164 companies from the BSE 200 companies for six financial years from 1997-98 to 2002-03 to examine the relationship between board independence, board size and firm performance. He used Tobin's Q, Ratio of operating income to assets, ratio of assets to sales and Market-adjusted stock price returns as measures of firm financial performance. According to the findings of his study smaller boards are more efficient than the larger ones; the board size limit of six was suggested as ideal, as the study founded an inverse association between board size and firm performance. Also board independence was inversely related with firm performance and the study suggested that the proportion of independent directors should be between 50 and 60 percent. Board size and performance as also board independence were found to be inversely related which means that a bad performance leads to an increase in both size as well as board independence. Ghosh Saibal (2006) examined the nexus between corporate performance and boards of 127 non-financial listed manufacturing firms for the year 2003 by using two accounting measures i.e. ROA and PERF(arithmetic mean of ROA, ROS, ROE) and market based method i.e. Tobin's Q. The results suggested that board size exerts a negative influence on corporate performance irrespective of accounting and market based measures. This means that larger boards tend to have a dampening influence on firm performance. Also there exists a positive association between the number of non-executive directors and firm performance. The study also found evidence to suggest that CEO compensation has a positive influence on corporate performance, judged in terms of accounting measures.

Conclusion

Audit committee and firm performance relationship studies in India companies gained positive trend. The literature on audit committee in India examines the effectiveness in various parameters of the company. The issue shows that audit committee independence and frequent audit committee meetings improve the performance of some corporate governance mechanisms. This could be due to timely detection of financial statement frauds and presentation of actual financial position in front of board of directors. Ultimately governance structure needs to be determined by a combination of the above factors and their dynamics.

REFERENCES

Bijalwan, J. G. and Madan, P. 2013. Board Composition, Ownership Structure and Firm Performance. Research Journal of Economics and Business Studies, 86-101.

Cadbury Committee, 1992. Committee on the Financial Aspects of Corporate Governance. Report of the Committee on the Financial Aspects of Corporate Governance London, Gee.

Garg, A. K. 2007. Influence of board size and independence on firm performance: A study of Indian companies. Vikalpa, 32(3), 39.

Ghosh, S. 2006. Do board characteristics affect corporate performance? Firm-level evidence for India. Applied Economics Letters, 13(7), 435-443.

IIaboya, O.J. and Obaretin, O. 2015. Board Characteristics and firm performance; evidence from Nigerian quoted companies. Academic journal of interdisciplinary studies MCSER publishing, 2281-4612, Vol-4

Irani, J. J. 2005. Report of the committee on corporate law reforms. Ministry of Company Affairs, Government of India.

KM Birla Committee, 2000. Report of the Kumar Mangalam Birla Committee on Corporate Governance.

Kota, H. B. and Tomar, S. 2010. Corporate governance practices in Indian firms. Journal of Management and Organization, 16(02), 266-279.

Kumar, N. and Singh, J. P. 2012. Outside directors, corporate governance and firm performance: Empirical evidence from India. Asian Journal of Finance and Accounting, 4(2), 39-55.

Mamata Mistra and Dr. Amarjeet kaur Malhotra, 2016. Audit committee characteristics and earnings management; evidence from India. *International journal of Accounting and Financial reporting,* Vol. 6, 2162-3082.

Nizamilmulk Gunes and Serkan Aftigan, M. 2016. Comparison of the effectiveness of audit companies in the UK and Turkish Banks. International lournal of financial research, Vol.7.

Yousef Hassan, Kamal Naser, Rafig H. Hijazi, 2016. The influence of corporate governance in corporate performance; Evidence from Palestine, research gate.

****