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Audit Committee Independence and Financial Performance: A Quantitative Assessment of Private Limited Companies In Uganda

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Abstract

Purpose: Correlation of the financial performance and audit committee independence of private limited companies is the grounds that the study sought to explore.

Methodology: The questionnaire was used to gather measurable data by utilising a cross-sectional strategy from the 394 companies picked in central as well as Western Uganda. Two methodologies, correlation and regression tactics, were deployed to carry out analytical, empirical data processing.

Findings: Nonetheless, the study did not find any connection between the financial performance and audit committee independence of private limited companies institutions in Uganda.

Recommendation: The study therefore endorses a blended structure of directors not only in executive posts to constitute an auditing committee. Consequently, this would eradicate information asymmetry and ensure flawless monitoring of management.

Keywords: *Audit committee Independence, Financial Performance, Uganda.*

Introduction

In September 1998, the Wall Street Journal in the U.S discovered that some accounting anomalies, prompting the incomes of the firms in question to restatement (McMullen, 2017). This scenario motivated interest in the audit committee's efficacy as an central part characterising the corporate governance arrangement. Probably, in accordance to this argument, the auditing committee is the utmost dependable body in shielding the interest of the public. In its recommendation, Cadbury Commission maintained that auditing committees comprising at least three members is optimal and ought to be composed entirely of NEDs (Al Ahmary, 2018; Muropawembwa, 2018; De Gannes, 2018). The small size of such committees makes them autonomous. It is thus posited that ideally, an entirely autonomous audit committee should be made up of NEDs in its entirety in addition to those not affiliated to the company (directors who served previously in the firm). These committees are a representation of a governance mechanism with a mandate to bolster the sound management of a firm, and as a result, its financial performance stabilizes. According to Bajra (2018), markets are more inclined to indicate a positive response to income reports after the establishment of audit committees.

Consistent with the agency theory, there is a palpable connection between the value of financial statements and the existence of an auditing committee (Ugwunta & Ugwuanyi, 2018; Beasley, 2016). As per the agency theory (Beasley, 2016; Pérez-Cornejo, 2019), the objective members of the auditing committee can help the principals in the supervision of management activities as well as decreasing probable benefits from censorship of information, as derived from the theory of agency. It, therefore, ratifies the presence auditing committee as adequate to guarantee the dependability of fiscal reports (McMullen, 2017). Therefore, an auditing committee comes in handy to alleviate agency problems in addition to addressing deficits in a firm such as the absence of objective external auditors and inefficient monitoring systems, which escalates agency fights (Crane et al., 2019). To guarantee that the auditing committee fulfils its principal responsibility of formulating judgments that satisfactorily serve the welfare of shareholders of the firm as well as overseeing the monetary statement process, then independent of the audit committee is essential (Baxter & Cotter, 2016; Munro & Buck, 2018). Furthermore, Crane (2019) commends audit committees' efficiency in serving the welfare of shareholders and improving the trustworthiness of financial report disclosed. One role mandated to an auditing committee is the management of financial reports transparently in addition to ensuring that an external audit is an objective by availing and facilitating communication (Pierre & de Fine, 2019).

Literature Review

Prior studies have disclosed that a firm with autonomous members is destined to enhanced audit committee effectiveness as well as a successful overall corporate governance (Ciftci et al., 2019; Yee et al., 2017). Nonetheless, existing empirical outcomes pertaining to the objectivity of the auditing committee and performance of the firm correlations are depicted with varied indications of a positive, negative, or null relationship by various scholars. For instance, the findings exposed that organizations with a significant percentage of independent auditing committee members record a positive deviation in their performance (Salehi et al., 2019). Similarly, Aggarwal et al. (2015) established that institutions with many autonomous members in the auditing committee have efficiently executed board supervision as well as a rise in institutional financial performance. Barka. (2017) noted a desirable connection of the firm's performance to auditing committee

independence. Nevertheless, according to assertions by Kajola (2018), the link between membership of the auditing committee and the performance of the company is non-existent. He had singled out 20 non-Limited financial organisations in Nigeria. Cohen et al. (2017), moreover, didn't establish a substantial connection of percentage of objective members and auditing committee organisation value. Correlation of company performance and auditing committee's independence is deduced from the preceding survey. Supervision responsibility of independent audit committees, in line with agency theory, remains a key approach of governance of corporates. Its mission is to bring down information incoherence between managers and shareholders, henceforth alleviating agency challenges (Hutchinson & Zain, 2016). The ongoing study contends the audit committee is taken as an essential recipe to improve firm performance in Uganda.

In addition, organisations having independent auditing committees in place may not easily be exposed to unwarranted cases of fraudulent activities (Barka, 2017). More research from Bukit and Iskandar (2009) contend that the performance of a firm was, to a considerable extent, reduced by instituting an independent auditing committee in an institution. However, Adafula (2019) noted a contrary connection of the existence of an autonomous auditing committee and company performance. Khalifa (2018); Ntim (2017); and Eyenubo et al. (2017) maintained that such an independent auditing committee enhanced reliability in the context of audited fiscal results, thus bolstering firm success.

Contrariwise, a section of scholars posits that an independent audit committee will always improve the ease of monitoring fiscal reports (He et al., 2017; Fontaine, 2016; Zhou et al., 2018). Conversely, absolute detachment from company administrative operations perhaps implies that the Audit Committee members are not kept abreast of organisation matters. Hence they have very scanty knowledge of day to day firm activities. Henceforth, they may tend to collude with auditor requiring minimal negotiations as well as deliberations resulting in few meetings. This may yield a negative and undesirable effect on monitoring (Fiolleau et al., 2018). As sourced from various literature and some researchers, the ideal case would be if the chairman of the auditing committee as well as a highly experienced individual seated in the committee because of the crucial role he plays. Going by Reinecke (2019) assertions, detached members on auditing committee hamper checking as well as monitoring by debt holders the moment leverage is suppressed. This prompts directors on the audit committee to heightened supervision as well as monitoring from the organisation's debt holders.

Arising from the above debate, the hypothesis below was devised:

H1: Audit committee's independence is positively associated with firm performance

Methodology

This survey followed a cross-sectional research design, collecting quantitative data from 394 private limited companies in western and Central Uganda, which are the main business centers of Uganda (UBOS, 2016). The study population comprised of 30,000 private limited companies registered with the Uganda Registration Services Bureau, and the sample was determined using the formula by Yamane (1973) as follows;

$$n = \frac{N}{1 + N(e)^2}$$

Whereby N = population, n = sampled size, and e = standard error of estimate (5%).

Private companies were initially classified by sector, region and, then selected from each category using simple random sampling. Information was gathered through a self-administered questionnaire with Accountants, board members, CEOs, and auditors purposively selected (Yuliansyah & Amelia, 2018) as the unit of analysis. These participants were preferred as they were effectively used by other researchers (Mohamed, 2018; Foster, 2017) in studies on corporate governance. A preliminary analysis was conducted to confirm the parametric assumptions of normality, autocorrelation, and homoscedasticity. Consequently, correlation and regression were the critical data analysis techniques employed due to their statistically reliable predictive power.

The independence of the audit committee was determined by deriving the population of independent directors on the audit committee of a firm. Directors' objectivity was obtained by dividing the sum of autonomous members by the total members of the auditing committee in a firm. Consequently, a dummy variable was formed whereby audit committee independence (section of autonomous members on auditing committee equal or above 50%) was coded "1" and lack of independence (fraction of members on the committee below 50%) was coded "0". This is consistent with numerous scholars that have used and confirmed this technique in their studies on the governance of corporate and financial performance (Rotich, 2017; Kraakman, 2017; Widodo, 2017). Researchers conceptualised financial performance as the efficiency and effectiveness with which companies carry out their tasks in the process of providing products and services (Jiang et al., 2018). The present study used Net profit margin, liquidity, solvency, and asset turnover ratio and operating expense ratios to measure financial performance. These financial ratios were determined from the financial reports of companies. These are extensively applied proxies for business performance in other studies (Haat, Rahman, & Mahenthiran, 2018; Imam & Malik, 2017; Romelli, 2018).

A model of linear regression was specified to establish the connection of the study variations, (Tabachnick and Fidell, 2001) as shown below;

$$FP = \beta_0 + \beta_1ADTCOMIND + e$$

Where, F.P. = Financial performance, β_0 constant, $\beta_1ADTCOMIND$ coefficient of audit committee independence, and e = error term.

Results

Descriptive statistics

The assessment of sample characteristics yielded the following descriptive results.

Table 1: Frequency Distribution by Audit Committee's Independence

	Frequency	Percent	Cumulative Percent
NEDs on Audit Committee Below 50%	357	90.6	90.6
NEDs on Audit Committee 50% and above	37	9.4	100.0
Total	394	100.0	

Source: Primary Data

Table 2: Sector of Private Limited Companies

	Frequency	Percent	Cumulative Percent
Agriculture	62	15.7	15.7
Industry	139	35.3	51.0
Services	193	49.0	100.0
Total	394	100.0	

Source: Primary Data

Table 3: Location of Private Limited Companies

	Frequency	Percent	Cumulative Percent
Western Region	119	30.2	30.2
Central Region	275	69.8	100.0
Total	394	100.0	

Source: Primary Data

Findings revealed that most private institutions still had merged responsibilities of the board chair and CEO, with the majority (55.3%) practicing CEO duality compared to 44.7% that had separate leadership structures (table 1). These results mean that majority of the private companies had the CEO also working as board chairman, hence overriding board decisions. More so, a significant proportion (49%) of private limited companies that participated in the study operated in the service sector, with a substantial (35%) in the industry sector and 15.3% in agriculture (table 2). The majority (68.9%) of these companies were in Central Uganda, compared to 32.2% in Western Uganda (table 3). This means that most of the private limited companies operate service businesses, mainly in the central region of Uganda.

Table 4: Correlation and Regression Results

a) Model Summary

Model	R	R Square	Adjusted R Square	Std.Error of the Estimate
1	.038 ^a	.001	-.001	.40706

b) ANOVA

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	.093	1	.093	.563	.454 ^b
	Residual	64.955	392	.166		
	Total	65.048	393			

c) Coefficients

Model		Unstandardized Coefficients		Standardized Coefficients		
		B	Std. Error	Beta	t	Sig.
1	(Constant)	2.548	.080		32.014	.000
	AUDTCOMINDP	.053	.070	.038	.750	.454

Source: Primary Data

In contrast, results from the correlation analysis (Table 4a) indicate the non-existence of significant connection of fiscal performance and the auditing committee's independence ($r=.04, p>.05$). In a related case, the results indicate that the objectivity of auditing committee members had a mild impact ($B = 0.05, p >.05$) on financial performance. Consequently, from the regression model (Table 4a), it was established that the auditing committee's independence accounted for an insignificant 0.1% ($r^2 = .001, p > 0.05$) in the financial performance variations of private firms in Uganda. This is an implication that the section of autonomous members present in the auditing committee is not linked to the institution's financial performance. This is true as regards operations of private companies whereby outsiders usually are part-time workers. As such, they are detached from the daily activities of the entity, which renders their effort in managing company affairs ineffective. This also points to the fact that a company that already has competent board members can coordinate with external auditors to ensure checks and balances in administration and dependability of financial reporting by the executive hence rendering the audit committee less relevant. The above results, therefore, indicate that hypothesis H1 was not supported.

Discussion of Results

State of Audit Committees' Independence among private limited companies

Results (table 1) indicate that most (91%) of private companies did not have independent audit committees as only 9% had audit committees comprising of a substantial proportion of independent members. These outcomes indicate non-compliance to the Financial institutions Act of 2004, Companies Act of Uganda of 2012, in addition to the CMA corporate governance code of 2003, demanding all companies to have a significant proportion of NEDs on their audit committees for effective monitoring of the executive. The above results also contradict the Cadbury Commission (U.K.) of 1992, which recommends that auditing committees need to at least three members who are solely non-affiliates to management (Lmbert et al., 2017). Furthermore, contrary to the current practice by private companies in Uganda, the agency theory recommends a more substantial percentage of autonomous members of the auditing committee. These will support the principals in supervising administration activities and decreasing possible benefits from censorship of information, and consequently, ensuring the reliability of financial statements (McMullen, 2017).

Discussion of Correlation and Regression Results

As a construct of corporate governance, the auditing committee's independence was conceptualised as a percentage of autonomous occupants of the auditing committee of the board. Based on agency theory, it was hypothesised that a desirable linkage exists between the financial

performance of an organisation and its auditing committee's independence (H1). Correlation results (Table 4) revealed a non-significant association of financial performance with the auditing committee's independence of private limited firms in Uganda, thus not supporting hypothesis H1. Conceptually, this means that having only autonomous members on the auditing committee, as derived from agency theory, is not beneficial to the organisation's financial performance. These findings object to the views of Westerman (2018); Sikka et al. (2018), who posit that auditing committees ought to have not less than three members purely composed of NEDs.

Empirically, the present study findings coincide with the results of other research studies. For instance, Kajola (2018) studies the connection of membership of the auditing committee to the organisation's performance from 20 singled out non-financial Limited institutions in Nigeria. Furthermore, it establishes no tangible association. Caruana (2020), in addition, doesn't discover any connection of the population of objective occupants of the auditing committee as well as an institutional value. Furthermore, although Cäker (2017) recognise the role of monitoring by NEDs and their responsibility for disciplining management, they find no tangible linkage of the fraction of objective persons to the audit committee as well as the company's financial performance of an organisation. Additionally, unlike the assumptions of the theory of agency, the theory of stewardship maintains that NEDs present in the auditing committee cannot oversee managers compared to insider directors.

As a result, insufficient specialisation and insights of an institution's internal operations in accordance with the present study findings. This coheres with the views of Obaid and Azlain, (2017); Agrawal and Kroeber (2016); Moyo (2018) who posit that NEDs are in most cases irregular workers - a factor that limits their ability to advise the board and monitor management, given that they lack information concerning a firm's operations. As a result, an audit committee dominated by high levels of NEDs will result in uninformed decisions, which will negatively affect the financial performance of an organisation. This is further reinforced by Garg (2017) and Boivie et al. (2016), who assert that NEDs do not only suffer information asymmetry but are also too busy in their firms or affairs; thus, they do not bring the expected skills to the board. This hampers their ability to monitor management who are inclined to pursue selfish gains to the disadvantage of shareholders as well as the company hence negatively affecting firm financial performance. The above results, therefore, invalidate the agency theory and hypothesis H1, as earlier stated. Thus, in the perspective of privately-owned limited firms in Uganda, the independence of auditing committees are valueless to the firm's financial performance.

Conclusion and Recommendation

The study investigated and deep-rooted a null association between the financial performance board and autonomy of the auditing committee of private limited companies Uganda. This depicts that independent or outside members of the committee tend to be ceremonial as they are usually too busy with their personal affairs in their firms. It has also been confirmed that these objective members of the auditing committee suffer information inconsistencies due to their irregularity in companies. Consequently, take uninformed decisions, which negatively affect or add no value to the financial performance of an organisation.

From the preceding discussion, it is therefore recommended that auditing committees need a blend of both directors in an executive capacity as well as the non-executive capacity for efficient

monitoring of management. This points to the fact that whereas independent audit committee members bring expertise and neutrality in executing their mandate, their irregularity in organisations and information asymmetry, as stated above, can be covered by the executive members who are well versed with operations and always available in organisations. This factor stimulates their ability to understand the uncertainties faced by the firm, hence positively affecting financial performance.

Theoretical, Policy and Managerial Implications

First, the study has refuted the suggestions of agency theory, which advocates for solely independent audit committee members. It established that nonexecutive directors present in audit committees are not beneficial to the companies as they usually too busy in their firms, suffer information asymmetry, and are ceremonial- factors that affect their effective monitoring of the executive. Second, the study findings suggest crucial repercussions for practitioners as well as policy-makers in Uganda. Findings have highlighted that an audit committee with solely outsiders adds less value to the success of a business; thus, shareholders of private limited companies should always ensure a mix of executive and non-executive directors on their audit committees. Third, regulators such as Uganda Registration Services Bureau and the Capital Markets Authority should review corporate governance policies or codes to provide for an equilibrium of both executive and non-executive directors on the audit committees of private limited companies. They should also strengthen mechanisms for monitoring adherence to the established governance codes among companies in Uganda as a stimulus to their financial performance.

Study Limitations and Areas for Future Research

Current research is confined to only internal stakeholders; thus, future researchers could test a similar hypothesis, but seek opinions of both internal and external stakeholders for balanced results. The study was premised on a positivist approach. Future researchers could adopt a pragmatic paradigm to explore views that justify the quantitative results for more informed conclusions. Furthermore, the study dwelled on only the independence of the auditing committee, leaving out other auditing committees' characteristics like size, members' expertise, members' age, among others. These can be incorporated in future research for more valuable deductions.

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