Effectiveness of Audit Committees in the Turkish Banking Sector

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Abstract

The audit committees play a significant role on oversight function of the companies' boards over their audit and financial reporting systems. U.S. Securities Exchange Commission Act; defined audit committee as an equivalent body established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and as a financial reporting processes of the issuer and audits of the financial statements of the issuer. According to Turkish Banking Law 5411 Article 24 bank should establish audit committees for the execution of the audit and monitoring functions of board of directors and should consist of minimum two members who do not have any executive duties. In Turkey the auditing committee practices in banks are monitored and supervised by Banking Regulation and Supervision Agency. In this study we examine whether the annual meeting number of audit committees have an effect over the banks financial performance in the means of loans under legal follow-up. The study is planned to include data of 3 governmental depository banks which are settled in Turkey.

Keywords: *Turkish Banking System, Audit Committes*

1. Introduction

Interest in corporate governance and audit committees has increased dramatically in recent years as a consequence of fraudulent financial reporting scandals at prominent companies especially in U.S. The audit committee increases the confidence of the investors in the credibility and objectivity of financial statements raising the efficiency of the corporate governance practice in the related company.

2. General Wiev Of Audit Commitees

The audit committee is an important vehicle in increasing the organizational status and independence of internal auditing.[1] The audit committee is expected to be an informed, prudent, and constructive overseer of the financial reporting process.[2]

The main reasoning of the establishment of the audit committee is to answer the constantly shifting defiance's of business environment and to assist the board of directors and management to deal with those challenges' said Bromark and Hoffman in their study. They also added up following challenges' as:

- "Widening concern regarding corporate ethics.
- The increasing complexity of transactions, accounting standards, and regulatory requirements.
- A cry for fair disclosure of the quality of the company's earnings and financial condition, and the resulting responsibility of management and the board for full and fair disclosure of financial results.

[1] *D. Paul Scarbrough, Dasaratha V Rama and K. Raghunandan,Audit Committee Composition and Interaction with intemai Auditing: Canadian Evidence, Journal of International Accounting,Auditing&Taxation.1998, pp. 181-194.*
[2] *John Wild,The Audit Committee and the Earnings Quality, Journal of Accounting, Auditing & Finance,p.247.*

- Globalization of markets, which has opened new opportunities, increased competition, and created an explosion of the information required to make informed decisions.
- Widespread use of information technology, including microcomputers and networks, satellite transmissions, and introduction of electronic data interchange, all of which have changed internal control methods."[3]

The audit committee responsibilities, duties or as you may wish to call as assignments are expanding and evolving in order to cope with difficulties that the companies face deailing with internal control system, the relationship between the board of directors and the auditors. It should be noted that even though the responsibilities of the audit committee set by the Sarbanes-Oxley Act, New York Stock Exchange or Nasdaq, they tend to be differentiate along with the peculiar characteristics of the companies. According to the study of Mautz et al. " Research conducted in I960 showed that only slightly over 30 percent of the Fortune 500 and equivalent companies had audit committees, that in many cases these met infrequently (some only once a year), that their most common and most important assignment was to receive the audit report from the independent auditors and that, except for a variety of other relatively unimportant duties, many audit committees did little else. In fact, the performance of even that duty by some audit committees was perfunctory."[4]

3. Literatuve Review

Audit committee effectiveness is an important issu which is focused by many academicians since years. Thus we have stated the short summaries of those studies by noting especially the findings and reflections.

Gendron et al. (2004, 153-171) have researched the audit committee effectiveness by conducting a field survey about audit committee meetings of three Canadian public corporations that are listed on the Toronto Stock Exchange in 2004. They used interviews to get information about audit committee meetings and they have resulted that during the meetings members of the audit committee especially highlighted those issues; accuracy of financial statements, appropriateness of the wording used in financial reports, effectiveness of internal control and the attribute of auditor's work.

Sori et al. (2007) have explored the perceptions of senior managers of Malaysian publicly listed companies regarding the effectiveness and authority of audit committee in 2007. They have used a questioannaire survey technique by sending 150 questioanairres to 150 companies selected from the Bursa Malaysia Berhad. As a result they have found out that majority of managers agreed upon that auditor would be more effective and independent if audit committee undertook the responsibility to appoint the auditor, determine and review the audit fees, and the external auditor's scope and duties.

In Turley and Zaman's (2007, 765-788) study they have discussed the audit committee effectiveness by using a case study about a UK company called Ashburton plc in 2007. They have gained information from those three sources; semi-structured interviews with relevant personnel, internal documents of company and annual report. They have resulted that informal networks between audit committee participants condition the impact of the audit committee and that the most significant effects of the audit company on governance outcomes occur outside the formal structures and processes.

Vafeas and Waegelein (2007, 241-255) have examined the relationship between audit committee effectiveness and executive compensation with corporate audit fees in 2007. They have used a cross-sectional approach with Fortune 500 firms of the year 2001 and three avaliable years of audit fee data of 2001 to 2003. In the end they have come up with this result that audit committee size, committee members expertise and committee member independence are positively associated to audit fee levels on the contrary CEO long-term pay and insider ownership are inversely related to audit fee levels.

Ismail et al. (2008, 21-42) have provided a research about audit committee effectiveness via associating the quality of reporting and corporate governance in the means of some audit committee characteristics as financial literacy, multiple directorship, independence of audit committee in the year 2008. They have used logistic regression analysis and gathered information of hundred and eight companies listed on the Bursa Malaysia. They have found out that only multiple directorships of audit committee members is significantly related to quality of reporting.

In Krishnanand and Visvanathan's (2009, 114-115) study, issue of audit committee effectiveness has been discussed by relating the audit fees with one of the characteristics of the audit committee effectiveness which was

[3] *Ray Bromark and Ralph Hoffman,An Audit Committee For Dynamic Times, Directors & Boards,Spring 1992. pp.51-60.*
[4] *Robert K. Mautz and Robert D. Neary, Corporate Audit Committee-Quo Vadis?,The Journal of Accountancy, October 1979,pp. 83-88.*

financial expertise of the audit committee in 2009. They have used the Standard & Poor's (S&P) 500 firms for the years 2000 through 2002 as a sample. They have resulted that the lack of a significant relationship between nonaccounting financial expertise and audit fees suggests that auditors perceive that only accounting financial expertise contributes to audit committee's effectiveness.

Spangler and Braiotta (1990,134) have surveyed the audit committee effectiveness in the means of different leadership forms of audit committee chairmen. The study was conducted in 1990 and questionnaire method was used. In order to get answers from managing partner of twenty six branch offices of a Big Eight auditing firm, seperate questioannaires were arranged for audit committee chairpersons and members, chief financial officers and chief internal auditors. As a result they have found out that correlations of transformational leadership,contingent awards and active management by exception with effectiveness were significant in the predicted positive direction, and passive management by exception was nonsignificantly related to audit committee effectiveness.

Joshi and Wakil have discussed the functioning of the audit committees in Bahrain in order to understand which companies have been following the standard recommendations and guidelines of the Blue Ribbon Committee in the year 2004. They have conducted questionnaires to gather information from thirty companies listed on the Bahrain Stock Exchange. Thus they have resulted that all banks established audit committees due to the Basel committee on banking supervision advisory, and also large size companies are more likely to establish an AC and majority of ACs are comprised of members of the board of directors that is a mixture of both independent non-executives and executives of the company.

Muniandy has studied the audit committee effectiveness in terms of relating a firm's corporate governance characteristics and audit fees in 2007. He has used multiple regression analysis in order to evaluate the data which were gathered from annual reports of four hundred forty seven Malaysian public listed companies on the main board. In the end he has concluded that the presence of CEO duality on the board, a proxy for board independence is associated with higher audit fees and that positive relation is significantly weakened when the firm has a higher proportion of independent directors on audit committee.

Dionne and Triki have researched the importance of independence and financial knowledge for the board and the audit committee in the means of investigating the impact of guidelines set for the audit committees by Sarbanes Oxley Act and the NYSE on the company's hedging policy in 2005. They have used multivariate analysis to perform regression and gathered data from prior search of themselves bearing the date of 2004. They have found out that the new requirements concerning the audit committee size and independence encourage firms to seek more hedging, whereas the requirement of a majority of unrelated directors on the board has no effect on the corporate risk management activity. Also their results suggested that the requirements on the audit committee size and independence are reasonable, although maintaining a majority of unrelated directors on the board and a director with an accounting background on the audit committee may not be necessary.

Karamanou and Vafeas have analyzed the relationship between corporate board, the characteristics of the audit committee and the accuracy of management earning forecasts in 2005. They have selected their sample from the 1995 Fortune 500 survey in order to perform logistic regression analysis. Accordingly they have resulted that better corporate governance as s result of precise management earning forecast diminishes the asymmetry between board and shareholders of the company. Also with the effective board of directors and audit committee that watches financial reporting system of company, it is feasible to maintain healthy information transition to shareholders from company.

Al-Mudhaki and Joshi have discussed the role and the functions of audit committees of Indian companies which were listed in the Bombay Stock Exchange in the year 2004. Their sample consisted of two hundred and eighty-six companies whose sales turnover was more than US$25 and they have conducted questionnaires which were comprised of two parts; in the first part there were questions concerning the characteristics of respondents' companies and in the second part questions regarding the characteristics of the audit committee. In the end they have resulted that there is a a lack of independent representation on the audit committees among Indian companies and also the frequency of audit committee meetings has an important effect on the internal control and evaluation function of a company.

Klein has examined the relationship between audit committee and board characteristics and earnings management by the firm in 2002. The initial sample of study contained all firm-years listed on the S&P 500 as of March 31, 1992 and 1993 with annual shareholder meetings between July 1, 1991 and June 30, 1993 but she has eliminated 28 firm-years for firms domiciled outside the U.S., 53 banks and 36 insurance companies because it was difficult to define accruals and abnormal accruals for financial services firms. She has performed cross-sectional analyses in order to understand the relation. As a result she has found that when either the board or the audit committee has less than a majority of independent directors.

Weir et al. have explored the effect of corporate governance on the performance of UK firms in 2001. They have used logistic regression to perform the analysis and gathered data consisting of all quoted, non-financial UK firms for which full data could be obtained covering the period 1994 and 1996 and after some necessary exclusions that left a final sample of 312 companies. Finally they have resulted that neither the independence of the committee membership not the quality of the committee members has an effect on performance.

4. Analysis of Audit Committee Effectiveness in the Means of Legal Follow Up of Loans

4.1 Research Model

This paper focuses on whether the number of meeting conducted by audit committees have an impact on the loans of Turkish governmental banks which are under legal follow-up. The model of the research is carried out as the following.

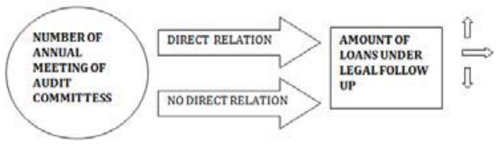

Figure 1: Model of The Research

As it is shown in the figure it is tried to find out the effect of audit committees meetings on one of the banks performance measurement indicator which is known as loans under legal follow up. At the end of this research it is aimed to find out that an increase in the number of meetings in one year directly increase or decrease the total amount of loans under legal follow up.

4.2 Method of the Research

A correlation analysis was conducted in order to find out the effect of audit committees meetings on one of the banks performance measurement tool. This research is focused only on the governmental banks located in Turkey. Because of that analyze is limited with 3 governmental banks located in Turkey. Number of population is composed of three elements. In order to take healthier results correlation analysis conducted in this research.

Within the content of this research correlation coefficient (r) is calculated which measures the strength and the direction of a linear relationship between two variables. The value of r is such that $-1 < r < +1$. The + and – signs are used for positive linear correlations and negative linear correlations, respectively.

If x and y have a strong positive linear correlation, r is close to +1. An r value of exactly +1 indicates a perfect positive fit. Positive values indicate a relationship between x and y variables such that as values for x increases, values for y also increase. If x and y have a strong negative linear correlation, r is close to -1. An r value of exactly -1 indicates a perfect negative fit. Negative values indicate a relationship between x and y such that as values for x increase, values for y decrease.If there is no linear correlation or a weak linear correlation, r is close to 0. A value near zero means that there is a random, nonlinear relationshipbetween the two variables

Name of the Bank	Number Audıt Com. Meetıng	Amount of Loans Under Legal Follow Up			
	X	Y	X^2	Y^2	XY
Ziraat Bankası	34	2.057.553	1156	4,23352E+12	69956802
Halkbank	13	1.959.646	169	3,84021E+12	25475398
Vakıfbank	37	2.724.963	1369	7,42542E+12	1,01E+08
	84	6.742.162	2694	1,54992E+13	1,96E+08

Table 1: Correlation Coefficient of Variables

$$r=\frac{\sum XY-\frac{(\sum X)(\sum Y)}{n}}{\sqrt{\left[\sum X^2-\frac{(\sum X)^2}{n}\right]\left[\sum Y^2-\frac{(\sum Y)^2}{n}\right]}}$$

$$r=\frac{1{,}96-\frac{(84)(6.742.162)}{3}}{\sqrt{\left[2694-\frac{(84)^2}{3}\right]\left[1{,}54992-\frac{(1{,}54992)^2}{3}\right]}}=0{,}05$$

As you see in the formula, correlation coefficient of two variables is equal to 0,05 which means there is a weak relationship between two variables. According to the correlation analyses 0,05 coefficient does not mean a significant affection between the number of AC meetings with the amount of loans under legal follow up.

5. Conclusion

The Audit committee refers to the governance body that is charged with oversight of the organization's audit and control functions. The main role and responsibilities of the audit committee should include: monitoring the integrity of the financial statements and any formal announcements relating to financial performance, reviewing internal financial controls and, unless there is a separate board risk committee, reviewing the company's internal control and risk management systems, monitoring and reviewing the effectiveness of the internal audit function, making recommendations to the board in relation to the appointment, re-appointment and removal of the external auditor and approve the remuneration and terms of engagement of the auditor, reviewing the auditor's independence and objectivity, developing and implementing the non-audit services policy.

In this study it is tried to examine whether the annual meeting number of audit committees have an effect over the banks financial performance in the means of loans under legal follow-up. In order to reach the result of this research a correlation analysis was conducted. As a result correlation coefficient of two variables is equal to 0,05 which means there is a weak relationship between two variables. We must underlined that audit committees are vital for banks in order to regulate their operations but meeting number of these committees don't have a significant impact on the amount of loans under legal follow up.

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