

The Effects of Audit Committee's Characteristics on the Accuracy of Profit Forecasting

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Abstract: This study aims to know the effects of the audit committee's characteristics (financial experience, independence, size) on the accuracy of forecasting profits. To achieve this goal, data related to companies listed on the Tehran Stock Exchange (TSE) for the years 2012 to 2015 were extracted and the research hypotheses were tested using a regression model. The results of the research showed that there is a positive effect between the independence and size of the audit committee with the accuracy of forecasting the profits. In contrast, no significant effect was observed between the financial experience of the audit committee and the accuracy of forecasting profits. Overall, the results of this research shows that an audit committee can influence the quality of financial reports by improving the accuracy of earnings forecasting. This study contributes to help the boards of directors of companies in Iran to know the extent of the impact and effectiveness of the audit committee in forecasting profits, which could be reflected on investors in making the appropriate investment decision in Iran's capital markets.

Keywords: financial experience of the audit committee, independence of the audit committee, size of the audit committee, accurate forecasting of profits.

Introduction

Corporate governance mechanisms contribute to the quality of the information disclosed by the companies, including information regarding forecasting of profits (Sabzalivor, Qitasi and Rahmati, 1391). After the financial turmoil and scandals in major international companies, the audit committee has gained great importance as one of the main mechanisms of corporate governance and the role it can play in increasing the accuracy and transparency of financial information that can be disclosed by companies (Fakhari, 2017). Which led to the international financial exchanges asking companies to found audit committees because of the benefits that they can provide to multiple parties such as the board of directors and other stakeholders, and this is what the financial market authorities have followed in emerging countries.

Accounting profit is one of the most important financial indicators that users depend in making decisions. In the past two decades, the interest of investors and others has increased in the quality of profits, and

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many studies have searched for mechanisms that contribute to the quality and forecasting of profits. In the capital markets, advertising is considered one of the most important ways for many investors to access company information, especially with regard to the disclosure of the expected earnings per share. The more accurate the management's earnings forecast, the better the financial reporting process for its users. (FEE, 2013)

One of the primary functions of audit committees is to oversee the financial reporting process, observe managers' tendencies to manipulate profits, and ensure the fairness and quality of financial statements. Therefore, financial market shareholders and regulators are increasingly focusing on the role of the audit committee in responsibility and transparency (Vafeas, 2005; Zaluki & Wan, 2010). Habib et al, 2016

They found that the audit committee affects the accuracy of forecasting the profits of management in the new companies entering the stock market and there are many studies that dealt with the characteristics of the audit committee and its effectiveness in many aspects such as limiting the earning management and improving the quality of financial reports and the quality of profits have shown the effectiveness of the audit committee on the quality of financial reports. (Krishnan et al, 2011 ;Abbott & Parker, 2000 (DeFond et al ,2005 : Sun et al ,2014 :

Due to the recent emergence of audit committees in emerging countries such as Iran, no further research has been conducted on the impact of audit committee characteristics in improving the quality of financial reports by improving the accuracy of the forecasting of management profits. Therefore, the main purpose of this research is to study the effects of audit committee characteristics on the accuracy of forecasting management profits in companies listed on the (TSE).The characteristics of the audit committee studied in this study include financial experience, independence and size.

1. Theoretical framework and previous studies

Audit Committee and the accuracy of management profit forecasting

Many stock markets and accounting institutions in many countries have been interested in defining the rules governing the formation of audit committees and the conditions to be qualified by their members due to their importance in helping the management to carry out the tasks assigned to it efficiently and effectively. The audit committee plays an important role in overseeing the financial reporting process and providing advices to the company's management (Ammer et al, 2017). In addition, these roles and conditions help to improve the quality of institutional decision-making in various ways, therefore, we observe that the quality of financial reports are high in companies with effective audit committees (Wafias, 2005; Krishnan & Viswanathan, 2008). The audit committee can be defined as a committee emanating from the company's board of directors and its membership is limited to non-executive members who have experience in the field of auditing and accounting. In Iran, the audit committee consists of three to five members, most of them are independent and have experience in the financial and accounting field and in accordance with the audit committee charter, the purpose of establishing the audit committee is to assist in obtaining reasonable assurance of the following: (1) The effectiveness of management to manage risks and internal control, (2) the integrity of financial reports, (3) the effectiveness of the internal audit, (4) the independence and effectiveness of the external auditor (5) the commitment to laws, regulations and instructions. (The Securities and Exchange Organization, 2011).

Profit is considered one of the factors affecting economic decisions and one of the most important accounting issues that received great attention after the series of financial collapses that occurred in many developed countries (Haessler ,2020). We can define the quality of profits as the level at which management options for accounting estimates affect the declared profit and the degree to which manager's benefit from the permissible flexibility (Duru & Tsitinidis, 2013). It was also defined as the extent to

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which the profits announced by the company are expressed in the real profits of the company, by being free of probability figures and exaggerations (Schipper & Vincent, 2003). Transparent disclosure of financial information reduces agency problems by reducing information asymmetries between management and stakeholders. Conversely, non-disclosure of financial information often misleads shareholders (Klein, 2002). There are many factors that lead to a decrease in the quality of profits, such as earning managing, increasing the percentage of receivables therein, and the management's judgment and estimates when choosing accounting alternatives (Sosnowski et al, 2019). Therefore, many studies have tended to search for mechanisms that help improve the quality of profits, forming one of the reliable pillars on which many relevant parties rely to make decisions. In this field, many scientific researches indicated that the characteristics of the audit committee and its role in monitoring the procedures for preparing financial reports and the requirements imposed by legislation and the laws of the state and the stock exchange and the appropriateness of accounting principles applied in companies (Krishnan & Visvanathan, 2008; Srinivasan, 2005). Lee & etal (2018) they found that companies with effective boards and audit committees contribute to providing more accurate profit forecasts. Therefore, in this study, we focus on the characteristics of the audit committee that affect the forecasting of profits.

1.2. Characteristics of the audit committee and the accuracy of earnings forecasts

One of the most important roles that the audit committee plays is supervising the procedures for preparing financial reports and their integrity, in addition to supervising the internal audit and external audit procedures, and this in turn reflects the extent of their effectiveness in many aspects such as improving the quality of financial reports, improving the quality and accuracy of the expected profits and to achieve the objectives of this research have been studied. The following characteristics of the audit committee:

1.2.1. Financial experience of the audit committee

The complexity of corporate capital structures and financial tools and the application of accounting standards drive the need for members of the audit committee to have the necessary accounting and financial knowledge and experience, and this experience may arise from the exercise of previous jobs in the financial and accounting fields or be the result of obtaining a specific certificate and based on Paragraph 1 of Article 5 For the Audit Committee Bulletin, most audit committee members should have financial experience. According to paragraph 6 of Article 6, members' financial experience can be defined as a university or professional degree (local or international) accredited in accounting, auditing, financial management, economics or other fields related to the financial or economic aspect in addition to the ability to analyze financial statements and controls. The Interior Controlling Financial Reporting (The Stock Exchange and Securities Organization, 2011). The financial experience of the audit committee is an important and influential factor in increasing the quality of financial reports (Al-Rassas & Kamardin, 2015). And raise its effectiveness (BRC, 1998). Dhaliwal et al (2010), Baxter & Cotter (2009), Nelson & Devi (2013) they found that the financial experience of the audit committee is linked to a decrease in earning management and an increase in the quality of financial reports. Krishnan, (2005); Archambeault et al (2008) they found that the audit committee's financial experience is inversely related to internal control weaknesses. Oradi et al, (2016) and Amer et al, (2014) they showed that there is a direct relationship between the audit committee's financial experience and the company's performance. Karamanou & Vafeas (2005) also concluded that the audit committee's financial expertise has a positive and important relationship with the accuracy of management's earnings expectations. Based on the results of previous studies regarding this axis, the first hypothesis of the research can be formulated as follows:

The first hypothesis: There is a positive and statistically significant relationship between the audit committee's financial experience and the accuracy of management's forecast of profits.

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1.2.2. Independence of the audit committee

Independence is one of the important conditions that must be met by members of the audit committee, according to Paragraph 1 of Article 1 of the Audit Committee Bulletin, an independent member can be defined as: A member who has no direct or indirect relationship or interest that affects his decision, or makes him biased for the interests of a specific individual or group of shareholders or other stakeholders, or causes the interests of shareholders to be ignored (Securities and Exchange Organization, 1391). Audit committees should be composed of non-executive members in order for them to have complete independence from the management of the company and thus they can make decisions and express their opinions independently (Cadbury Committee, 1992). Lin et al (2006) also stated that an audit committee with the largest number of independent members can monitor management more effectively and reduce fraudulent reporting further, there will be less interference by management. Akeel et al (2012) study found that there is a direct inverse relationship between audit committee independence and company performance. Saleh et al (2007) found that there is an inverse and statistically significant relationship between the independence of the audit committee and the earning management. The study of Oradi et al (2016) and Arslan et al (2014) also concluded that the independence of the audit committee is directly related to the performance of the company. Zaluki & Wan (2010) also indicate that the independence of the audit committee is linked to more accurate management's forecast of earnings. Based on the aforementioned presentation of previous studies regarding this axis, the second hypothesis of the research was formulated as follows:

The second hypothesis: There is a positive relationship of statistical significance between the independence of the audit committee and the accuracy of management's forecast of profits.

1.2.3. The size of the audit committee

The audit committee needs a sufficient number of members to enable it to carry out its responsibilities and achieve its objectives. According to Paragraph 1 of Article 5 of the Bulletin of the Audit Committee, the Audit Committee consists of 3 to 5 members with the election and appointment of the Board of Directors (Stock Exchange and Securities Organization, 1391). The composition of audit committee members is an indication of the existence of effective and efficient committees (Menon, & Williams 1994). The study by Raghunandan et al (2001) concluded that increasing the size of the audit committee will increase the number of its meetings and thus increase the control and performance of the audit committee. Abdullah et al (2014) showed that there is a positive and statistically significant relationship between the size of the audit committee and the company's performance. The results of the study by Yank and Krishnan (2005) and Beasley et al. (2009), concluded that there is an inverse relationship between the size of the audit committee and the earning management. Karamanou & Vafeas (2005) also confirmed that there is a positive and statistically significant relationship between the size of the audit committee and the accuracy of management's forecast of profits. Based on the results of previous studies regarding this axis, the third hypothesis of the research was formulated as follows:

The third hypothesis: There is a positive statistically significant relationship between the size of the audit committee and the accuracy of management's forecast of profits.

3. Research Methodology.

This research is a relational research, and in terms of methodology, it is considered almost experimental, but for its nature and objectives, it is an applied research. The research sample was restricted to all companies listed on the (TSE) that existed from the beginning of fiscal year 1391 until the end of fiscal year 1394 and had the following characteristics.

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1. The audit committee was formed in accordance with the internal control instructions of the (TSE) for the year 1391.
2. The financial year for the companies ends on December 31, for the possibility of comparison between the financial years.
3. The companies' activities and the fiscal year did not change during the years from (1391) to (1394).
4. Banks, financial and investment institutions, and insurance companies have been excluded, due to the nature of their specific activities. The relationship between the factors studied in this study may differ for these institutions and may not be generalizable to others.
5. Data of sample companies are available and there is no interruption in trading.

Despite these limitations, the sample consisted of 130 companies (432 years-companies) observations. In order to collect the sources for the research, libraries and the actual data of the companies were relied upon, while different sources were relied upon to obtain the actual data of the companies listed on the (TSE), including the information website of the (TSE) and the (Rahvardnovin) program for collecting financial statement data for companies listed on the (TSE), and to analyze the data, the statistical program (Stata) was used.

3.1. Measurement model

To measure the relationship between the audit committee's characteristics and the accuracy of management's earnings forecasts, the following measurement model is used:

$$|EFEE_{it}| = \alpha_0 + \alpha_1 AC_EXP_{it} + \alpha_2 AC_IND_{it} + \alpha_3 AC_SIZE_{it} + \alpha_4 SIZE_{it} + \alpha_5 LEV_{it} + \alpha_6 GROWTH_{it} + \alpha_7 B_IND_{it} + \alpha_8 B_SIZE_{it} + \alpha_9 AGE_{it} + \varepsilon_{it}$$

3.2. Measuring variables

3.2.1 Dependent variable

Accuracy of management's earnings forecasts (EFEE_{it}): In this research, the Mnif model (2009) was used to measure the amounts of error to predict earnings per share, as follows:

$$|EFE| = |ER - EF| / |EF|$$

In the above equation we have:

EFE = Error magnitudes of profit following per share of company i in year t

ER = Realistic net profit per share of company i in year t

EF = Management's expected net profit of company i in year t

In the above relationship, both the forecast profits and the actual profits are considered in the form of net profit after deducting tax. Since the actual profit may be less and its use in the denominator of the discount will inflate the relationship, thus, the forecast profit is used in the denominator of the discount. The greater the |EFE|, will lower the accuracy of the profits, and vice versa. This measurement model was used by (Mahdavi et al, 2013).

3.2.2. Independent variable

Financial Experience of the Audit Committee (AC_EXP_{it}): Depends on the percentage of members with financial experience to the audit committee, which is calculated by dividing the members with

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financial experience in the committee on the number of members (according to the definition of financial experience and knowledge on a theoretical basis).

on the number of current members of the board of directors. The study of **Audit Committee Independence (AC_INDit)**: Depends on the percentage of independent members of the audit committee, which is calculated by dividing the independent members of the committee by the number of its members (according to the definition of independence in the theoretical foundations of research).

Audit Committee Size (AC_Sizeit): It indicates the number of members of the Audit Committee, which in Iran consists of 3 to 5 people.

3.2.3. Control variables

Company size (SIZEit): the natural logarithm of total company assets. Sabzalipour, (2012) showed that large firms have a higher accuracy in forecasting profits than small firms.

The company's financial leverage (LEVit): The total company's liabilities are divided by the company's total assets. The study by Jenn et al. (2007) found that the greater the financial leverage of the companies, the less accurate is the profit forecasts.

Growth of the company (GROWTHit): The sales of the current year are subtracted from the sales of the last year, and are divided by the sales of the last year. The result of the study Jaggi et al (2006) concluded that there is an inverse relationship and statistically significant between the growth of the company and the accuracy of profit forecasts.

Board Independence (B_INDit): Proportion of non-executive board members.

Board size (B_SIZEit): Depends Karamanou & Vafeas (2005) found that the higher the percentage of non-executive members in the board, the more accurate the forecast of management profits.

Age of the company (AGEit): Depends on the natural logarithm of the number of years since the company was founded. Whereas, the longer the life of the company, the greater the accuracy and quality of its expected profits. This is because forecasting profits are more difficult for emerging companies than for companies that have a long and reliable history of profit (Mnif, 2009; Mahdavi et al, 2013).

4. Results

4.1. Descriptive analysis

In this paragraph, the descriptive results of the variables study are presented including the weighted mean, standard deviation, maximum and minimum.

Table No. (1), descriptive analysis of the research variables

Var.	weighted mean	median	S.D	max	min
EFE	0/559	0/440	0/556	5/200	0/010
AC_EXPit	0/860	1	0/189	1	0
AC_INDit	0/717	0/670	0/145	1	0
AC_Sizeit	3/175	3	0/563	5	3
SIZEit	14/366	14/120	1/377	18/740	10/670
LEVit	0/548	0/560	0/213	1/210	0/010
GROWTHit	0/234	0/150	0/643	4/890	-0/960
B_INDit	0/639	0/600	0/127	0/850	0/200
B_SIZEit	5/071	5	0/329	7	5
AGEit	3/534	3/625	0/414	4/170	2/300

Based on the data of Table No. (1), we noted that the average Error magnitudes to forecast management's profits is equal to 0.559. With regard to the characteristics of the audit committee, about 86% of the audit committee members have financial knowledge and experience and 72% are independent members. Also, the average size of the audit committee is 3,175. This indicates that most of the audit committees in companies consist of 3 members. Also, the results presented in the above table indicate that the size of the company, the financial leverage and the growth of the company were 14,366, 0.548 and 0.234 respectively. There are about 64% of independent (non-executive) board members, and the average number of board members is 5,071. Also, the Natural logarithm of the company's lifetime, on average, is 3,534. It must be noted that if the number of observations is more than 30 observations, they have a normal distribution according to the state of the central hyphen (Crane, 2011) .It should also be noted that before processing the data, Parker's, (2014) method was used to determine random observations. In this method, instead of deleting the old data, it is edited and replaced with percentage values of 1 and 99 (Plato, 2016).

4.2. Results of research hypothesis tests

In the studies where the data is complex and to determine whether using the (panel data) method in estimating the used model would be appropriate or not, the F-Limer test was used and whether the panel method was used to determine either of the two methods (fixed effects). (Or random effects) to make the estimation of the model more appropriate, the hausman test is used. Also, in this study, to detect the heterogeneity of the variance and the auto-regression in the Disruption Components of the used model, the test was used (The Modified Wald Test and the Weldridge Test, respectively, and Table (2) shows the test results

Table (2) shows the results of (F-Limer, (hausman test), (wald test) and (Weldridge)).

test	Observation	Statistic Value	D.F	Sig.
F-Limer	432	7/77	129 , 293	0/000
hausman test	432	30/50	9	0/000
wald test m.	432	+05e3/1	130	0/000
Weldridge	432	21/308	1 , 118	0/000

Through the data of Table No. (2), we observation that the significance of (F-Limer) test is equal to (0,000) at a level less than (0.05), so the null hypothesis H_0 at the level of 95% is rejected and this indicates that the use of the (panel) method is necessary. In addition, it can be noted that the significant results of the hausman test were at (0,000), so the H_0 hypothesis at the 95% level is rejected and the alternative hypothesis H_1 is acceptable. Therefore, the fixed effects method must be used when using the aforementioned measurement model. As for the significant results of the modified wald test, it was at (0,000). This indicates that there is a heterogeneity of variance in the components of the disruption in the used model. Finally, the significance level of (Weldridge) test is equal to (0,000). This indicates the existence of an automatic serial correlation in the disturbance components in the used model. Based on the above results and for the purpose of eliminating the heterogeneity of variance and automatic sequential correlation in the final estimates of the measurement model, the generalized Ordinary Least Squares (OLS) method is used. In Table No. (3) We display the results of the model's estimates related to the research hypotheses.

Table No. (2), Results of research hypothesis tests**

$$EFEE_{it} = \alpha_0 + \alpha_1 AC_EXP_{it} + \alpha_2 AC_IND_{it} + \alpha_3 AC_SIZE_{it} + \alpha_4 SIZE_{it} + \alpha_5 LEV_{it} + \alpha_6 GROWTH_{it} + \alpha_7 B_IND_{it} + \alpha_8 B_SIZE_{it} + \alpha_9 AGE_{it} + \varepsilon_{it}$$

Var.	Coefficient	S.D	Value Z	P.(Z)	VIF
Constant value	0/769	0/204	3/76	0/000	---
AC_EXPit	-0/068	0/050	-1/36	0/173	1/119
AC_INDit	-0/190	0/056	-3/35	0/001	1/096
AC_Sizeit	-0/098	0/016	-5/95	0/000	1/074
SIZEit	0/013	0/006	1/93	0/054	1/091
LEVit	-0/063	0/050	-1/25	0/211	1/079
GROWTHit	-0/064	0/016	-3/86	0/000	1/026
B_INDit	-0/168	0/053	-3/17	0/002	1/121
B_SIZEit	-0/036	0/025	-1/45	0/148	1/132
AGEit	0/117	0/023	4/96	0/000	1/035
^x (value of wald test)			89/49		
The statistical significance of the (wald) test			0/000		

** The above table is from the researcher's work using (STATA)

The results of Table No. (3) Show that the significant statistical value of the statistical tests indicates that there is no statistically significant relationship between the financial experience of the audit committee and the error with the accuracy of management's forecast of profits. Accordingly, the first research hypothesis was rejected. The results of Table (3) also indicate the existence of an inverse and statistically significant relationship between the size of the audit committee and the error with the accuracy of management's expectations of profits. As mentioned earlier, profit forecasting error is inversely related to profit forecasting accuracy. Based on this, it can be said that the independence of the audit committee and the size of the audit committee have a positive and statistically significant relationship with the accuracy of management's forecast of profits. On this basis, it becomes evident to us to accept the second and third hypothesis. The results of Table No. (3) Also show that the size and age of the company have a statistically significant relationship with the accuracy of the management's forecast of profits, a positive relationship. These results show that as the size and age of the company increases, the accuracy of management's earnings forecasts decreases and with the increase in company growth and board independence, management profits have higher accuracy. The results of the table also show that there is no relationship between financial leverage and board size with management's accuracy of earnings forecast.

5. Conclusion

The main topic in this study was to verify the relationship between audit committee characteristics and the accuracy of earnings forecast. In theoretically, the relationship between the audit committee and the accuracy of the management's profit forecasting in various studies is indicated that the audit committee as one of the important elements of corporate governance can affect the accuracy of the forecasting of management's profits. The question that arises here is whether the audit committees in Iranian companies with studied characteristics (financial experience, independence and size) affect the accuracy of forecasting management profits or not. The answer of this question reflects the main purpose of this study.

The results of the first hypothesis test of the research did not show a statistically significant relationship between the audit committee’s financial experience and the accuracy of the management’s profit forecast, which indicates the rejection of the above hypothesis. The result of this hypothesis contradicts the findings of Carmenon and Waves (2005). In the second hypothesis of the research, it was tested the experience of a relationship between the independence of the audit committee and the accuracy of forecasting the profits of the management, and the test results showed there was a positive and significant relationship, which indicates the acceptance of the above hypothesis. The result of this hypothesis was consistent with that of Zelluki and Van (2010). The results of the third hypothesis tests indicated that there was a significant relationship between the size of the audit committee and the accuracy of the management’s profit forecast, which indicates acceptance of the above hypothesis. The result of this hypothesis was consistent with those of Carmannon and Wafis (2005). In general, the results of this study show that the audit committee as one of the main mechanisms of corporate governance can be associated with increasing the quality of financial reports by improving the accuracy of management's profit forecasting.

6. Recommendations

According to the results of the research, it is proposed that the corporate board of directors forming an audit committee and, appointing independent persons in this committee and increasing the number of the members of the audit committee as much as possible. In addition improving the quality of financial reports, to help the company to achieve better earnings forecast. On the other hand, due to the recent establishment of the audit committee in Iran, very little researches have been conducted in this field. Therefore, it is suggested that research should be conducted on the impact of the characteristics of the audit committee on the quality of internal control, the quality of the audit and the reservation.

7. Limitation

One of the limitations of the research is non-disclosure of the number of audit committee meetings in the search time frame. On the other hand, since 2012, companies listed on the Tehran Stock Exchange have been asked to publish information related to the audit committee on the (Cadaf) website, but some companies did not disclose these information during the research period. As a result, a number of companies and company year notes have been removed due to lack of information.

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