

## THE ROLE OF EXTERNAL AUDIT ON COMPANY PERFORMANCE IN DEVELOPED ECONOMIES

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**Abstract:** *The financial statements of a company are important factors in the decision-making process of investors, because financial statements not only highlight the current position of the company but also its future performance. From this point of view, the audit has a very important role, as an inefficient audit committee implies that companies have insecure financial statements, therefore investor do not have confidence required to understand and evaluate in a timely manner the current position of the company. To test the impact of audit practices on the performance of new companies, we used a series of OLS estimates on a sample of the most developed countries in the Eurozone: Germany, France, and Italy. After analyzing the impact of audit practices on the profitability of listed companies in France, Germany and Italy, our results show that ensuring the independence of the audit committee has a positive effect on the profitability of the company calculated as the rate of return on assets, but the effect is reduced from the perspective of return on equity. Our results indicate that in the case of developed companies, the independence of audit committees has a positive impact on the overall performance of the company, even if it is lower. Therefore, investors and decision makers must consider establishing and ensuring the independence of external audit to ensure the premises for increasing the performance of companies.*

**Keywords:** *determinants of firm performance, developed economies, external audit, independence of external audit*

**JEL Classification:** *G32, G34*

### Introduction

The financial situations of a company present significant elements for investors in decision-making, by highlighting the current position of the financial perspective of the company but also the performance afterwards. From this point of view, the audit has a very important role, and an inefficient audit committee can be reflected in those companies that present uncertain financial situations, that do not present confidence and that do not report in a timely manner the current position of the company (Khamsi Che Abdul Hamid et al., 2014). The quality of the audit directly affects the different decisions of the users of the audited financial statements in that the auditors are responsible for ensuring the quality of financial reporting because of professional auditing standards (DeFond and Zhang, 2014).

Thus, we believe that ensuring the quality of the audit by ensuring the independence of internal auditors also contributes to increase the performance of companies and improving the quality of financial reporting.

Information on the characteristics of a company's internal audit committee is extremely useful for investors, regulators and other users of financial situations in order to make the understanding and detection of the criteria associated with a report more efficiently especially in a competitive corporate environment (Khamsi Che Abdul Hamid et al., 2015). This information can help to incentivize investors to make companies voluntarily create effective control mechanisms to ensure the quality of financial reporting. As the main role of internal auditing in the company is to verify the conformity of financial situations with the company's activity itself and to streamline the communication mechanisms between the board of directors, the executive committee and other committees with external auditors, we consider that maintain an independent internal audit committee which exercises its powers objectively, particularly with regard to the examination of the company's financial problems, participates in ensuring the quality of superior financial reporting and as a result, to the financial situation of residence. In addition, financial statements which present unclear elements and are not published in a timely manner may suggest an ineffective internal audit because an independent internal audit with an adequate level of financial knowledge contributes to the improvement of the financial quality (Khamsi Che Abdul Hamid et al., 2015).

### **Literature review**

Internal audit is an important governance mechanism within a company that aims to protect investors' rights by reducing the asymmetry of information and ensuring the provision of information about the company. Financial situations are documents that may suggest the effectiveness or inefficiency of the audit in a company through their accuracy, credibility, and reliability. Internal audit is a particularly important component within a company in its impact on the reliability of financial reporting (Anderson et al., 2004; Chan and Li, 2011).

The financial situations of a company must cumulatively meet criteria such as: to be issued in a timely manner, to have accuracy, to be credible and reliable because these criteria are very important in detecting possible distortions or even fraud. From this point of view, internal audit through the function of ensuring the compliance of a company's financial report has an important role to play in ensuring that the quality criteria of financial situations are met. Thus, we believe that ensuring the effectiveness of the audit committee by ensuring the independence of the members of the committee contributes to ensuring the quality of the financial situation. The independence characteristic of the audit committee is a basic feature of internal audit, which in the literature is often associated with the effectiveness of the audit committee (Abbott and Park, 2000). In this context, there are studies in the literature that associate the independence of the audit committee with the efficiency of the detection of fraudulent reporting (Cornejo et al., 2019) and the detection of errors, omissions and misreporting in financial situations (Abbott and Park, 2000).

Independent members of the audit committee have the role of protecting financial reporting more effectively, studies show that an independent audit committee contributes to the improvement of the management monitoring mechanism (Aldamen et al., 2012).

Recent studies show that internal audit has a particular impact on the quality of financial reporting. For example, Alzeban, (2020), looked at the implications of corporate governance traits, including internal audit features on his independence and his expertise on the quality of financial reporting on a sample of 386 companies in the UK, France, Italy and Spain over a period between 2015 and 2017 using linear regression (OLS). The results of the study showed that the most important influence on the quality of financial reporting in corporate governance characteristics is the composition of internal audit. Thus, an independent internal audit composed of members with expertise has a positive and significant direct impact on the quality of financial reporting. In this context, it was found that the independence and expertise of the audit committee represent valuable control mechanisms for the company that lead to the improvement of the quality of financial reporting. Basically, the results of the study place the independence and expertise of the audit committee as the main influencing factors of the quality of financial reporting.

Oroud, (2019), analyzed the implications of the audit committee's characteristics on the performance of 55 companies, expressed by Jordan's rate of return on equity (ROE), using a sample of 255 observations over a period between 2013 and 2017 using the fixed effects date panel OLS method. The results suggested that the independence of the audit committee has a positive and significant impact on the rate of return on equity (ROE).

Saha et al., (2018) analyzed the implications of corporate governance characteristics including internal audit on company performance expressed through ROA, ROE and TobinQ. They used a sample of 81 companies listed over a period between 2013 and 2017. Their results showed that the independence of the internal audit committee has a positive and statistically significant effect on the company's performance calculated through the ROA and TobinQ and a positive but statistically insignificant impact on the ROE.

Yameen et al., (2019) analyzed the implications of corporate governance networks including audit ones such as the independence of internal audit on the performance of firms calculated through ROA, ROE and TobinQ using the multiple OLS linear regression model. Their sample was composed of panel data on 39 Indian companies listed on the stock exchange over a period between 2013 and 2018. Their results showed that the independence of the internal audit committee has positive and statistically significant effects on the performance of the model companies calculated through the ROA. Al-Najjar, (2011), analyses the committee's internal audit determinants using a sample of 70 UK companies over a period between 2003 and 2008. The results of the study show that large companies are more advanced in monitoring and do not ask for an independent internal audit committee. Also, companies that have high cash flows indicate the need to set up an independent audit committee. Thus, the liquidity of a firm is inversely proportional to the independence of the internal audit.

Bunget et al., (2020), analyzed the link between board structure, audit and corporate performance, the latter being expressed by ROA and ROE. Using a sample of 226 registrations representing companies listed mainly from Romania and Greece for a period between 2016 and 2018. As a metrology they used the Ordinary Least Square linear regression model of OLS. Their results showed that the independence of the audit committee contributes to improving the performance expressed by the ROA, the coefficient having a positive and statistically significant impact. As regards the performance variable expressed by the ROE, their results suggested that the independence of the audit committee

has a positive and statistically significant impact, but significance is not present in all the models generated.

In the context of the literature analysis, we find that the independence of the internal audit contributes to a better performance, respectively improves the quality of financial reporting, thus, we use two hypotheses to carry out our empirical analysis:

*H.1. The independence of the audit committee has a positive impact on the company's performance expressed through the ROA;*

*H.2. The independence of the audit committee has a positive impact on the company's performance expressed through the ROE.*

## Data and Methodology

### Data

To carry out the empirical study, we used data from the financial statements of listed companies in Italy, Germany, and France. The data used was collected from the Thomson Reuters Eikon database. Companies are defined as large companies, listed on private sector less so in the financial sector and financial services. Also excluded from the situation were funds for the co-financing of the model and the results. The data used from our sample is for a period of 10 years, respectively the years 2010-2019. As regards the of the variables used, a brief description of them can be found in Table No. 1. as follows.

As we can see from the table, as dependent variables we have chosen the two profitability variables the rate of return on assets (ROA) and the rate of return on equity (ROE) in accordance with the studies carried out in this field such as (Alzeban, 2019; Bahaa Hussein Mohammed et al., 2019; Oroud, 2019). The independent variables in the table called control variables consider indicators of the financial situation of companies and are in number of variables. These include the indebtedness the company's share of total assets, borrowers, the current rate and the rapid rate as well as a company's stocks in agreement with (Alzeban, 2019; Oroud, 2019; Ashari and Krismiaj, 2019).

**Table 1. Description of the variables used in the model**

Variable	Description
Dependent Variables	
ROA	Rate of return on assets, calculated as the ratio between EBIDA and total assets
ROE	Rate of return on equity calculated as the ratio of EBIDA to total equity
Control variables	
Indebtedness	Indebtedness, calculated as the ratio of total liabilities to total assets
QUICKRATIO	The rapid rate calculated as the ratio between the assets of the company from which we deduct the inventory and the liabilities of the company.
RataLiq	Current rate represented by the ratio of current assets to current liabilities
Stocks	The stocks that the company has
LnDebitori	Debtors, calculated as a natural logarithm from debtors
Size	The size of the company, relative to the natural logarithm of the total assets
Specific audit variable	

Variable	Description
dummyAI2_n	Dummy variable, denoted by 1 if there is an independent audit committee/department and 0 if not.

Source: The Authors

Our variable of interest is represented by a dummy variable, denoted by 1 in the situation in which the firm register an independent audit department or committee and 0 in the situation where the firm has an audit department or committee but is not independent. In this context, we processed the variable according to the logical reasoning that the audit department or committee with the members over 50% independence was allocated to the dummy variable the value 1 and what was less than 50% independent members was considered as dummy value 0.

As regards the descriptive statistics of the variables used in the model, this is shown in Table No. 2. as follows:

**Table 2. Descriptive statistics of initial variables**

Variabile	Obs.	Mean	Std.Dev.	Min.	Max.
ROA	12214	0.2446	54.4534	-596.78	5241.96
ROE	11718	-7.5646	153.776	-6755.37	1820.17
Size	12656	12.1380	2.5691	0.6931	20.7120
QUICKRATIO	11633	2.9408	48.6296	0	4605.3
LnDebitori	10750	10.2216	3.0679	0	18.6211
Stocks	12439	14970.8	748809.3	0	1.22e+07
RataLiq	11694	0.4026	0.8754	0.0001	51.5897
Indebtedness	11622	0.2898	0.9809	9.81e-06	54.375
dummyAI2_n	2960	0.6628	0.4728	0	1

Source: Own processing

We can see from 2. there are extreme values of variables that can cause risks of estimation and invalidate the model. In this context, to eliminate the outliers, we have achieved winsorized the data which involves setting the identified extreme values (outliers) to the 1% and 99% percentiles, respectively. In this context, using this practice often found in the literature (Duru et. al, 2016; Yameen et al., 2019), we have produced the descriptive statistics of the processed dataset, revealed in Table No.3. as follows.

**Table 3. Descriptive statistics after winzsorizing**

Variabile	Obs.	Mean	Std.Dev.	Min.	Max.
ROA	12214	-0.2032	16.9482	-90.47	30.5
ROE	11718	-1.9517	43.4707	-260.43	78
Size	12656	12.1436	2.5200	6.5652	18.5190
QUICKRATIO	11633	1.6273	2.1541	0.14	16.38
LnDebitori	10750	10.2289	3.0169	2.7080	16.9315
Stocks	12439	112835.2	359609.9	81	2525000
RataLiq	11694	0.3676	0.2187	0.0223	1.2952
Indebtedness	11622	0.2556	0.1976	0.0002	1.0254
dummyAI2_n	2960	0.6628	0.4728	0	1

Source: Own processing

As can be seen, because of winsorization, the extreme values have been reduced, our variables having smaller variations. In this context, we note that the variation of the ROA is between -90.47 and 30.5, the ROE having a variation between -260.43 and 78. The model used in our analysis is a panel model, which has a relatively small time period of 10 years (n=10) and a relatively large number of registers (N>500). As we can see from the table with the descriptive statistics only 408 companies, present data on the audit committee out of the total of 12439. In this context, our opponent is also due to the lack of audit data, it has been restricted from 1244 companies to 408 companies. In order to carry out our analysis we have generated table no. 4. the correlation matrix.

**Table 4. Correlation matrix**

Variables	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
(1) ROA	1.000								
(2) ROE	0.636	1.000							
(3) Size	0.308	0.271	1.000						
(4) QUICKRATIO	-0.048	-0.022	-0.251	1.000					
(5) LnDebitori	0.231	0.210	0.566	-0.230	1.000				
(6) Stocks	0.068	0.067	0.527	-0.095	0.493	1.000			
(7) RataLiq	-0.201	-0.173	-0.112	-0.419	-0.150	-0.055	1.000		
(8) Indebtedness	-0.135	-0.095	0.090	-0.222	0.377	0.051	0.215	1.000	
(9) dummyAI2_n	0.404	0.476	0.515	-0.283	0.518	0.375	-0.199	0.063	1.000

Source: Own processing

## Methodology

The method used for analysis is the method the linear regression OLS- Ordinary Least Square with cross-sectional fixed effects, the most used method in the literature (Alzeban, 2019; Oroud, 2019; Yameen et al, 2019; Bunget et al., 2020). As far a sour data set is concerned, a peculiarity of the analyses on the impact of the audit on the performance of companies is the emergence of the endogenous country (Wang and Shailer, 2015; Cărauşu, 2016). In this context, to avoid the occurrence of endogenous risk, we chose to use the estimates with robust standard errors grouped at company level in agreement with (Petersen, 2009). These types of estimates are preferred because they are considered estimates that combat endogenous risk and the risk of heteroskedasticity.

In order to determine the equation of general linear regression, X is determined by two major variables as follows:

$$VD(ROA, ROE)_{i,c,t} = \beta_1 VIAI_{i,c,t} + \beta_2 VINC_{i,c,t} + \alpha_i + \varepsilon_{i,t} \quad (1)$$

Where:

$VD_{i,c,t}$  represent the dependent variables represented by roa and roe at the company level and in the country c at time t;

$VIAI_{i,c,t}$ . Represents our dummy variable on independent auditing denoted by 1 if the company i in country t registers an independent audit department or committee at the time t and zero otherwise.

$VINC_{i,c,t}$  represent the company-specific control variables, i.e. the indicators in the company's financial statements and in the country c at time t;

$\alpha_i$  represent the specific constant of the company;

$\epsilon_{i,t}$  represent idiosyncratic errors;  
 i represent the company;  
 that I represent the country;  
 t represent tthe period of time, in our case 2010-2019.

In order to identify the estimation method with fixed effects or the one with random effects, related to our and the emanation, which would most appropriately respond to the data set used, we chose to perform the Hausman test (1978), a test that indicates the most appropriate variant to use between fixed cross-sec model or the random effect model. The results of the Hausman test for both the ROA dependent variable and the ROE dependent variable are shown in Table no. 5. as follows:

**Table 5. Hausman test**

Variabile	$\chi^2(5) = (b-B)'[(V \ b-V \ B)^{-1}](b-B)$	Prob> $\chi^2$
ROA	56.14	0.0000
ROE	123.65	0.0000

Source: Own processing

After performing the Hausman test, we found that the cross-sectional fixed effects model is the most appropriate model to use for our dataset. This is explained by our results expressed in Table 5. Thus, in the case of our model, the results emphasize that the individual effects are correlated with regressors (Prob> $\chi^2$  less than 0.05) which indicates the use of the fixed effects model, the one with random effects being problematic.

### Empirical results

When testing the effects of audit practices, by highlighting the effectiveness of the audit and revealing the financial situations in the companies in the top countries of the European Union, we have chosen a sample of companies from the first largest economies reported the most developed countries of the European Union, in particular in the Euro area, namely Germany, France and Italy, which are among the top countries in the European Union according to the size of gross domestic product according to Eurostat 2019. Because we want to test the implications of audit practices on the most relevant performance indicators detached from the financial situations of listed companies, we have used an OLS fixed effects panel model, which is the most use model in the literature on similar databases and similar testing. This method was used on a sequence between 2446 and 2537 observations over a period of 10 years (2010-2019). The performance indicators extracted from the financial statements are represented by the two rates of return of a company, namely the rate of return on assets (abbreviation ROA) and the rate of return on equity (ROE abbreviation).

Thus, our analysis is aimed at testing the audit practices and revealing the financial situation of companies in the three most important countries in the Euro Zone, namely France, Germany and Italy after the gross domestic product according to Eurostat 2019, in the context of the modern economy. Our results are shown in table no. 6 respectively no. 7. which provides a picture of the impact of audit practices by ensuring its independence, a basic principle in international auditing standards on the performance of listed companies

in the main countries in the European Union. Following the analysis of the impact of audit practices on the performance of listed companies in France, Germany and Italy, our results show that ensuring the independence of the audit committee leads to a positive and statistically significant influence on performance the company is calculated as the rate of return on assets.

Table 6. Results of estimates of the impact of the independent audit on the rate of return on assets (ROA)

Fixed-effects (within) regression	Number of obs =	2537				
Group variable: comp	Number of groups =	408				
R-sq: within = 0.0889	Obs per group: min =	1				
between = 0.3378	avg =	6.2				
overall = 0.2907	max =	10				
corr(u_i, Xb) = 0.0017	F(7,407) =	5.98				
	Prob > F =	0.0000				
	(Std. Err. adjusted for 408 clusters in comp)					
Robust						
ROA	Coef.	Std. Err.	t	P> t	[95% Conf. Interval]	
Size	3.058879	1.207697	2.53	0.012	0.6847764	5.432981
QUICKRATIO	0.4743817	0.382387	1.24	0.215	-2.773184	1.226082
LnDebitori	-0.5727917	0.4094441	-1.40	0.163	-1.377681	0.2320975
Stocks	-2.81e-06	1.10e-06	-2.56	0.011	-4.96e-06	-6.48e-07
RataLiq	-10.05939	6.475701	-1.55	0.121	-22.78939	2.670605
Indebtedness	-7.840326	4.275392	-1.83	0.067	-16.24493	0.5642817
dummyAI2_n	5.629514	3.355136	1.68	0.094	-0.9660458	12.22507
cons	-35.19538	15.06161	-2.34	0.020	-64.80365	-5.587118
	sigma_u	13.651754				
	sigma_e	7.4772822				
	rho	0.7692351	(fraction of variance due to u_i)			

Source: Author's Estimates

The variable coefficient dummiAI\_n is positive at 5,629 and statistically significant with a value  $p < 0.1$ . In this context, our hypothesis H.1. The independence of the audit committee has a positive impact on the company's performance expressed through the ROA is accepted.

Ensuring the independence of the members of the internal audit committee is a solution to improve the profitability of a company expressed through the ROA, being in line with the literature in the field (Alzeban, 2019; Saha et al., 2018; Yameen et al, 2019).

The results of our estimates suggest that on average the companies that have secured an internal audit committee present an economic return expressed by the rate of return on assets higher by 5,629 at the expense of those that did not secure their independence of the audit committee.

Table 7. Results of estimates of the impact of the independent audit on the rate of return on equity (ROE)

Fixed-effects (within) regression	Number of obs =	2446
Group variable: comp	Number of groups =	401
R-sq: within = 0.2532	Obs per group: min =	1
between = 0.3818	avg =	6.1
overall = 0.3052	max =	10

corr(u<sub>i</sub>, X<sub>b</sub>) = -0.5313      F(7,400) = 13.99  
 Prob > F = 0.0000  
 (Std. Err. adjusted for 401 clusters in comp)

Robust

ROE	Coef.	Std. Err.	t	P> t	[95% Conf. Interval]	
Size	13.94163	3.85671	3.61	0.000	6.359678	21.52359
QUICKRATIO	-0.8047939	0.9871499	-0.82	0.415	-2.745444	1.135856
LnDebitori	-0.1186817	1.480034	-0.08	0.936	-3.028298	2.790935
Stocks	-0.0000122	5.27e-06	-2.32	0.021	-0.0000226	-1.86e-06
RataLiq	-111.2392	20.13559	-5.52	0.000	-150.824	-71.65441
Indebtness	-111.0449	19.80429	-5.61	0.000	-149.9784	-72.11141
dummiAI2_n	10.68649	11.69088	0.91	0.361	-12.29675	33.66973
cons	-138.2361	47.51605	-2.91	0.004	-231.6485	-44.82371

sigma\_u | 38.848352  
 sigma\_e | 23.689405  
 rho | .7289448 (fraction of variance due to u<sub>i</sub>)

Source: Author's Estimates

In this context, we believe that the independence of the audit committee contributes to making the detection of fraudulent reporting more effective (Owens-Jackson et al, 2009), the detection of errors, omissions and misreporting in financial situations (Abbott and Park, 2000; Siagian and Tresnaningsih, 2011). Thus, independent internal audit members are able to protect financial reporting more effectively and contribute to improving the management monitoring mechanism in agreement with (Alzeban, 2019; Aldamen et al., 2012). Following the analysis of the impact of audit practices on the performance of listed companies in France, Germany and Italy, our results show that ensuring the independence of the audit committee exerts a positive and insignificant influence statistically on the performance of the company expressed by the rate of return on equity. Our results are in line with (Saha et al., 2018) where the independence of the internal audit committee has a positive but statistically insignificant association with the company's profitability, as measured by the rate of return on equity (ROE).

The variable coefficient dummiAI<sub>n</sub> is positive at 10,686 but not statistically significant having a p>0.1 value. In this context, our hypothesis H.2. The independence of the audit committee has a positive impact on the company's performance expressed through the ROE cannot be accepted at the level of this performance indicator. We take the view that ensuring the independence of the internal audit committee has a small role to play in listed companies in France, Italy and Germany, as it does not have a direct and statistically significant impact on the rate of return on equity. One possible factor is the lack of integration in our analysis in addition to the independence of the audit and audit variables on the work and expertise of the audit committee. The independence and expertise of the audit committee used together as audit variables in analyses within the specialized works are valuable control mechanisms for the company that lead to the improvement of the quality of financial reporting (Alzeban, 2019; Zalata et al., 2018, Tanyi and Smith, 2015). In this context, to retest the results obtained as the data will be available, we will consider the use of several variables related to the composition of the internal audit committee such as: expertise, size, frequency of meetings of the audit committee.

Although we cannot explain our results from the point of view of statistical significance, from an economic point of view we find that since the coefficient of the variable  $dummiAI_n$  is positive it is consistent with the studies in the literature. (Oroud, 2019; Saha et al., 2018) in that an independent audit department presents a contribution to a firm's higher performance, a performance calculated as the rate of return on equity.

## **Conclusion**

The financial statements of a company are important factors in the decision-making process of investors because financial statements not only highlight the current position of the company but also its future performance. From this point of view, the audit has a very important role, as an inefficient audit committee implies that companies have insecure financial statements, therefore investor do not have confidence required to understand and evaluate in a timely manner the current position of the company. To test the impact of audit practices on the performance of new companies, we used a series of OLS estimates on a sample of the most developed countries in the Eurozone: Germany, France, and Italy for the period 2009-2019. After analyzing the impact of audit practices on the profitability of listed companies in France, Germany and Italy, our results show that ensuring the independence of the audit committee has a positive effect on the profitability of the company calculated as the rate of return on assets, but the effect is reduced from the perspective of return on equity. Our results indicate that in the case of developed companies, the independence of audit committees has a positive impact on the overall performance of the company, even if it is lower. Therefore, investors and decision makers must consider establishing and ensuring the independence of external audit to ensure the premises for increasing the performance of companies.

In terms of quantitative data, our study is limited to three countries in the top countries in the European Union according to the size of gross domestic product due to the lack of access to data. We believe that a first future direction of research can be expressed by the expansion of the sample to more countries in the European Union as it ensures the availability of accessing more data. Also, in our analysis we considered only companies listed on the stock exchange and excluded companies with a financial profile. In this context, another direction of research is aimed at including in the analysis, as the data will be available to us and of unlisted companies as well as those in the financial sector. Regarding our variable of interest, due to the lack of access to the data, only the independence of the audit committee was considered from the defining elements of the audit committee's effectiveness. A future direction of research, as available to access the data, aims to include in the analysis other elements such as the expertise of the members of the audit board, the frequency of meetings of the audit board and its size. We thus find that our analysis opens new horizons regarding the quantification of the implications of internal audit practices and the relevance of the financial statements at European Union level.

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