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Managerial dominance over the board and audit committee independence in financial institutions

Abstract

The purpose of this paper is to analyze whether the degree of control exercised by management affects the independence of the audit committee over the board of directors. Four characteristics of the board are being examined; size, composition, CEO duality and management ownership. Results from a sample of 54 Lebanese banks operating in various Lebanese territories during the period 2009-2011 show that all of these banks created an audit committee between 2009-2011 and comply with Lebanese central bank regulations (BDL) to guarantee their independence from management which requires the audit committee in Lebanese banks to be including independent members. Empirical results suggest that in Lebanese banks, managers can impair the effectiveness of audit committees by the presence of inside *directors* on the board and CEO duality.

Keywords: audit committee, independence, board of directors, management ownership, corporate governance.

JEL Classification: M1, M10, M42.

Introduction

For many years, prior studies have examined the role of audit committees in a corporation (Rainsbury et al., 2009). In corporate governance mechanisms, audit committees play an important role in improving financial reporting quality (Ghafran and O'Sullivan, 2012) by monitoring the financial reporting process in an independent manner. In 2002, the world has witnessed successive crises which caused the regulators and governmental bodies to introduce new regulations in term of corporate governance. Consequently, new laws and regulations were established to improve audit committee effectiveness, such as the Sarbanes-Oxley Act (2002) and the Blue Ribbon Committee (1999). The independent audit committee has several benefits such as reducing financial reporting problems (McMullen and Raghunandan, 1996) and ensuring high quality of financial statements. Consequently, an independent audit committee may strengthen corporate governance.

Our study analyzes companies in Lebanon in Middle East context which have established an independent audit committee to strengthen corporate governance (Al Kafaji and Majdalawieh, 2012). The adoption of audit committees with the aim of enhancing corporate governance has been examined in many Middle East countries (Al Kafaji and Majdalawieh, 2012; Al-Twaijry et al., 2002). In Middle East region, audit committee was adopted recently in the majority of countries, and initiating

them has been taken as an essential part of corporate governance in companies due to local regulations. For example, the audit committee in Lebanon was an unusual, little-known entity until the issuing of Basic Circular No. 118 by the BDL (2008), which recommended that all Lebanese banks should immediately establish an audit committee with independent members.

The BDL regulations fixed the role, characteristics, and function of the audit committee in order to enhance corporate governance mechanisms in the Lebanese banking sector. First, the audit committee plays a major role in controlling the efficiency of internal auditors and evaluating the independence of external auditors. The auditor reports periodically to the audit committee which observes the audit and control system (Corten et al., 2015). Second, the audit committee must have certain characteristics, such as size (a minimum of three members), independence (totally independent), frequency of meeting (four times per fiscal year), and financial literacy of members (a minimum of one member) in order to fulfil efficiently its responsibilities. Third, the audit committee should assist the board of directors in fulfilling the supervision of regulation by controlling the internal and external auditors. The Banking Control Commission, which was established in 1967, plays an important role in monitoring and control to ensure good governance in Lebanese banks, especially concerning the independence of audit committees and other characteristics.

Lebanese banking and financial institutions have a relatively weak listing in the stock market as well as illiquid markets. Hence, corporate governance in this sector is not well developed. Therefore, insiders' equity ownership alone is sufficient to reduce agency costs in a Lebanese environment with

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poor corporate governance (Salloum et al., 2012). In other words, bank performance decreases and then increases with the percentage of outside directors on the board (Chahine and Safieddine, 2011), and current external governance mechanisms are not sufficient to provide monitoring for the Lebanese banking industry. The presence of outside directors enhances the independence and the objectivity of the board and affects positively the decisions making. This paper, therefore, examines the effects of the relationship between boards of directors and management on audit committee independence. Hence, the separation of ownership and control may allow managers to pursue their own interest to the detriment of shareholders' interests. Managers' domination, on the other hand, may prevent the board from completing their roles in management monitoring, thus leading the audit committee to become less effective by the presence of inside directors, CEO duality and management ownership.

The originality and importance of the topic is that the decision to establish audit committees was made in 2008 and was modified in 2010 in Lebanese banks.

1. Audit committee independence

The audit committee, delegated by the board of directors, has the authority to oversee the entire auditing and financial reporting process (BRC, 1999). The audit committee's role is to assure the efficiency of internal audit system, the reliability of financial statements and the independence of external auditors. In more details, it can moderate threats to auditor independence, thus protecting the quality of financial reporting and supervising internal control (Abbot et al., 2010). The search for a corporate governance mechanism which ensures high-quality financial reporting, as well as the role and function of audit committees, is still new, particularly in Middle East countries. However, it was suggested to issue further regulation with the aim of improving audit committee effectiveness and enhancing the corporate governance in some Middle East countries in this context (Al-Twaijry et al., 2002).

Our main concern is to determine the factors affecting the independence of audit committees, which should be composed of independent members. Non-executive directors, on the other hand, are considered to be an important presence in ensuring corporate accountability. The presence of independent directors in audit committees has a high level of audit coverage (Ghafran and O'Sullivan, 2012), which helps in reducing the likelihood of financial reporting problems (McMullen and Raghunandan, 1996). Moreover, large proportions of independent directors enhance management monitoring (Xie et al., 2003),

assure information objectivity, and avoid legal liability (Carcello et al., 2002).

2. Hypothesis development

According to agency theory (Jensen and Meckling, 1976), a conflict exists between shareholders and managers. Hence, agency theorists suggest that monitoring of management activities is the primary role of the board of directors, with the aim of protecting shareholders' interests (Hillman and Dalziel, 2003). The board may face significant limitations in performing their monitoring role effectively, such as limitations in their information processing and calculation capabilities (Cyert and March, 1992; Simon, 1947). These limitations force board members to selectively attend to certain issues and thereby forgo others. In other words, board members' attention, 'the noticing, encoding, interpreting, and focusing of time and effort' on a particular issue or issues is limited.

Moreover, Buchholtz et al. (2005) found that board involvement increased the level of effective conflict among top management team members, while board control decreased it. It is expected that the board should perform its duty independent of the persons they control (Ruiz-Barbadillo et al., 2007). The CEO has the incentive to "capture" the board and ensure that its job can be kept or done as expected. On the other hand, the outside directors' aim is to maintain their independence, monitor the CEO, and replace him if he performs ineffectively. In this paper, the audit committee is situated between two different incentives: the board of directors' incentive, which is to maintain the independence of the audit committee in order to perform effectively; and the management's incentive, which is to hinder the function of the audit committee by struggling to safeguard an audit committee that is less independent. Gracia-Sánchez et al. (2012) found that high level of the proxies of audit committee effectiveness for companies display the best practices in terms of their boards of directors' independence. This is clear evidence that the domination of outside directors on the board creates an independent audit committee by strengthening the presence of outside directors.

2.1. Board composition and audit committee independence. Independent members are defined as non-management or outside directors of the board (Johnson et al., 1996) and shouldn't, therefore, be aligned with management to safeguard their good reputation. For this reason, outside directors are chosen in the interest of shareholders. The board of directors mostly prefers outsiders' domination with the aim of creating effective monitoring and safeguarding the independence of the board. On the

other hand, the board of directors also contains insiders which can have the inside information and have operational knowledge and skills. Hence, the presence of inside directors, was limited because their domination leads to a lack of management monitoring, and increases agency costs (Nicholson and Kiel, 2007). Hence, the high presence of inside directors on the board can lead to an increase in conflict between shareholders and managers. Moreover, inside directors' decision-making discretion should be limited to prevent the board from becoming an instrument of management.

The audit committee should independently complete their responsibilities regarding the efficiency of internal auditing and control, the independence of external auditing, and the credibility of financial reporting. Salloum et al. (2013) suggest that Lebanese firms are less comfortable with board monitoring and rely more on the auditors due to board independence. Managers can impair the effectiveness of audit committees through the creation of management-dependent audit committees (Ruiz-Barbadillo et al., 2007). Therefore, managers are able to influence the decision-making of the board. Thus, our first hypothesis is developed:

H1: The higher the proportion of inside directors on the board, the lower the likelihood of having an independent audit committee.

2.2. CEO duality and audit committee independence. The combination of these two positions can affect the independence of the board. This structure creates a conflict of interest, because the dual CEO pursues their own self-interest to the detriment of the shareholders and stakeholders (Alvarez and Svejnova, 2005). In addition, previous researchers suggest that a chairperson can have a substantial influence on the agenda of board meetings and dominate the process of hiring, firing, and compensating of top management. This is clear evidence that CEOs can select directors in accordance with their own interests. CEO duality may give the CEOs enormous powers (Alfzalur, 2012) which can be utilized to pursue their own interests rather than the interests of shareholders (Weisbach, 1988). CEO duality may reduce the board's ability and effectiveness in monitoring management functions and activities. Their dominance leads to weak control (Messier, 2000), because the CEO has little incentive to develop control mechanisms. Therefore, a more independent audit committee provides an effective monitoring mechanism when CEO duality is present (Bliss et al., 2007). In Lebanon, CEO duality has no impact on banks' performance (Salloum et al., 2014).

Hence, CEO duality is not developed in regulations and corporate governance code in Lebanon. Thus, our second hypothesis is developed:

H2: Companies with CEO duality are less likely to have an independent audit committee.

2.3. Board size and audit committee independence.

Board size forms an important determinant of managerial dominance over board members. Ghosh et al. (2010) indicate that larger boards are more effective in the monitoring of financial reporting because the breadth of knowledge and skills is higher. A large board can lead to a greater presence of experts in terms of auditing, accounting, finance, operations, and others. However, a board which is too large is less effective, especially in decision-making and communication (Jensen, 1993). This can cause the board to lose concentration. On the other hand, Jensen (1993) suggests that large boards are less likely to function effectively. However, smaller boards improve monitoring and make it difficult for the management to control the board. Ruiz-Barbadillo et al. (2007) found that small boards limit the number of independent directors available to serve on the audit committee. In Lebanon, banks' performance is positively related to board size (Chahine and Safieddine, 2011). Hence, the board size is not mentioned in corporate governance codes in Lebanon. Thus, our third hypothesis is developed:

H3: The larger the board of directors, the lower the likelihood that it will have an independent audit committee.

2.4. Management ownership and audit committee independence.

Dalton et al. (2003) studied the central role of ownership structures in aligning the interests of owners and managers. The management entrenchment effect suggests that managers with a larger number of shareholders possess greater control over companies, and have a great scope for acting in their own private interests (Shuto and Takada, 2010). Therefore, the incentive alignment effect reveals that managers with larger shareholdings have stronger incentives to act in line with shareholders' interests (Shuto and Takada, 2010). It is also expected that management ownership could veil management actions rather than avoiding behavior detrimental to shareholders' wealth (Ruiz-Barbadillo et al., 2007). Furthermore, lower ownership concentration and having Big-Four auditors as external auditors lead to higher liquidity in the MENA region (Farooq and Seffar, 2012). In the Lebanese context, Salloum et al. (2015) found that some forms of management entrenchment existing in the banking sector and insiders' management ownership are sufficient to reduce

agency costs in a Lebanese environment with poor corporate governance. Ruiz-Barbadillo et al. (2007) confirmed that the proportion of inside directors on the board plays a highly significant role in explaining audit committee dependence. This is evident that a higher degree of management dominance limits the ability to create independent audit committees. Hence, this can affect the control by limiting the audit committees' ability to fulfil their responsibilities efficiently. In a similar way, management ownership is not mentioned in corporate governance codes in Lebanon. Finally, our fourth hypothesis is developed:

H4: The larger the management shareholding, the lower the likelihood of having an independent audit committee.

3. Methodology

3.1. Sample selection. The sample of companies for this study is drawn from the Lebanese banking sector, which is known as one of the main sectors that stimulates economic growth and strengthens monetary stability, as per the Association of Banks in Lebanon (2011). These banks, being large with a complex organizational structure, as well as being the focus of the basic circular issued by BDL, were more likely to establish audit committees. We were able to find information on 54 Lebanese banks operating in various Lebanese territories during the period 2009 to 2011, when the adoption of audit committees became a mandatory requirement in the

Lebanese banking sector. Since some banks entered and/or exited over the sample period, the panel data is unbalanced. Hence, some banks may have formed audit committees with the aim of enhancing corporate governance. This, in turn, provides us with a suitable context to analyze Lebanese companies' intentions behind the adoption of audit committees. Of the information available on Lebanese banks, 149 had created audit committees between the years 2009 and 2011, constituting the group under study.

We used information from corporate governance guidelines provided by each bank to identify those banks that created audit committees. In addition, the data on board structure including size, composition, CEO duality, management ownership, and financial data were collected from the annual reports of each examined bank. We also conducted further investigation concerning the independence of audit committees and board members by undertaking phone meetings with the banks' management.

3.2. Model specification and variables. To test the hypotheses, we examine the relation between audit committee independence and managerial dominance. Pearson correlation matrix measures the high degree of correlation between explanatory variables. The linear regression is used because dependent variable and at least one independent variable, is measured on a continuous scale. Hence, the equation developed is as follows:

$$\text{Independent audit committee} = b_1(\text{BOARDCOMP}) + b_2(\text{DUALITY}) + b_3(\text{BOARDSIZE}) + b_4(\text{MANAGOWN}) + b_5(\text{Control variables}) + \varepsilon_t$$

3.3. Dependent variables. In this study, audit committee independence forms the dependent variable. We calculate the degree of audit committee independence in Lebanese banks through the analysis of audit committee composition based on international studies. We use the percentage of non-executive members (*IAC_%NED*) on the audit committee (Xie et al., 2003; Vafeas, 2005; Ruiz-Barbadillo et al., 2007).

3.4. Independent variables. The four elements of board characteristics represent the exogenous variables and are defined as follows:

1. Board composition (*BOARDCOMP*): This variable measures the board composition in terms of the relation between inside and outside directors. This variable is calculated as the number of inside directors divided by the number of full board members (Menon and William, 1994; Staikouras et al., 2007).
2. Duality (*DUALITY*): This is a dummy variable which takes the value of one if the CEO chairs the

board, and zero otherwise (Kim et al., 2009; Bliss et al., 2011).

3. Board size (*BOARDSIZE*): This variable is the number of directors on the full board (Beasley, 1996; Williams et al., 2005; Menon and William, 1994).
4. Management ownership (*MANAGOWN*): This is the proportion of shares held by company management (Menon and William, 1994).

We expected the independent variables to be negatively related to audit committee independence, which would be a significant reflection of management dominance.

3.5. Control variables. Losses (*LOSS*): Klein (2002) suggests that firms with repeated losses are less likely to have non-executive directors on the audit committee. This variable takes the value of one if the company reported a loss in the current year or prior year, and zero otherwise.

Bank size (*BANKSIZE*): This variable aims to control for the effects of the bank size on audit committee

independence. Bank size is calculated as a natural logarithm of total assets for each year; Owens-Jackson et al. (2009) focused on the impact of firm size with independent audit committee. Delli and Gillian (2000) found that the probability of having an independent audit committee is positively related to firm size.

Block dummy (*BLOCK*): Carcello et al. (2006) suggest that the presence of blockholders may act either as substitutes for the presence of some audit committee characteristics, or as a monitoring mechanism (Klein, 2002). Hence, this dummy variable takes the value of one when an outside shareholder owns 10% or more of the shares and has a representative on the board, and zero otherwise.

Listing dummy (*LISTING*): This dummy variable takes the value of one if it represents listed banks, and zero otherwise. Hence, Piot (2004) has expected that

companies listed have higher incentives to enforce audit committee independence.

YEAR_i: This dummy measures the presence of audit committees for each year during the study. This variable takes the value of one if the audit committee adoption has taken place in year *i* (*i* = 2009, 2010, 2011), and zero otherwise.

4. Results

4.1. Descriptive statistics. Few banks formed audit committees before the issue of the BDL basic circular (see Table 1). Following the basic circular, all Lebanese banks that hadn't already done so created audit committees. The majority of audit committees were formed between 2008 and 2011, and particularly in 2008 (90.60%). This evidence shows that Lebanese banks comply with the decisions taken by the BDL.

Table 1. Descriptive statistics

Panel A: Audit committee first formation and year distribution									
Variable	Total sample	Banks adopt AC (first time)				Banks with AC			
	N	n	% Sample		n	% Sample			
2008	149	135	90.60		135	90.60			
2009	149	10	6.71		145	97.31			
2010	149	1	0.68		146	97.99			
2011	149	3	2.01		149	100.00			
Total		149	100.00						
Panel B: Audit committee composition (N = 149)									
Variable	N	Mean	Median	Mode	SD	Min	Max	Q1	Q3
Size	149	3.56	3.00	3.00	0.81	2.00	7.00	3.00	4.00
Proportion of executive members	149	0.16	0.16	0.00	0.18	0.00	0.33	0.00	0.33
Proportion of non-executive members	149	0.92	1.00	1.00	0.13	0.60	1.00	0.75	1.00
				N		n		(%)	
Totally independent AC				149		106		71.14	
Totally executive AC				149		3		2.01	
AC with majority of non-executive members				149		37		24.83	
Panel C: Board composition									
Variable	N	Mean	Median	Mode	SD	Min	Max	Q1	Q3
Board size (<i>BOARDSIZE</i>)	149	7.72	7.00	5	2.83	2	15	5	10
Variable	N	Mean	Median	Mode	SD	Min	Max	Q1	Q3
Proportion of executive members (<i>BOARDCOMP</i>)	149	0.20	0.20	0	0.14	0	0.6	0.11	0.28
CEO duality (<i>DUALITY</i>)	149	0.78	1.00	1	0.41	0	1	1	1
Variable				N		N		(%)	
Boards with amajority of insiders				149		10		6.71	
Variable				N		N		(%)	
Boards with amajority of outsiders				149		139		93.29	
Duality				149		116		77.85	
Panel D: Other variables									
Variable	N	Mean	Median	Mode	SD	Min	Max	Q1	Q3
Management ownership (<i>MANAGOWN</i>)	149	0.141	0	0	0.25	0	0.99	0	0.14
<i>BANKSIZE</i> (logarithm total assets)	149	13.94	14.05	9.29	1.88	9.29	17.58	12.49	15.23
				N		N		(%)	
Blockholders (<i>BLOCK</i>)				149		54		36.20	
Two years consecutive losses (<i>LOSSES</i>)				149		8		5.40	
Listed on stock market (<i>LISTING</i>)				149		18		12.10	
Big auditor				149		134		89.90	

The results show that 106 (71.14%) of the 149 audit committees established by Lebanese banks are totally composed of non-executive members, and 37 (24.83%) of the 149 banks are composed mainly of non-executive members. This is clear evidence that Lebanese banks understand the importance of audit committee independence. This percentage is similar to the 70.70% found by Ruiz-Barbadillo et al. (2007) for Spanish companies and the 67% argued by Cotter and Silvester (2003) for Australian companies.

In Lebanese banks, audit committees are composed of three members, on average, with 2.01% of its members as insiders, 24.83% as non-executive members, and 71.14% as totally independent. The presence of inside directors is similar to the 1.4% evidenced by Klein (2000) in US audit committees. According to these records, audit committee composition is more independent compared to the Middle East countries with voluntary audit committees adopted in their systems. In the Lebanese banking sector, the tendency of adopting audit committee independence is very high. This is due to the need for a great control mechanism in banks' operations.

High values were obtained in relation to the proportion of inside directors on the board and CEO duality. On average, the number of executive directors on the board is 0.20, and CEO duality is 0.78 (93.29%). The CEO duality is higher in Lebanon than in Jordan (21% in the service sector, Abed et al., 2012).

The average size of the board in Lebanese banks is approximately 8. This is similar to the averages of 8.8 evidenced by Menon and William (1994) in US companies, and lower than the average of 11 members in Egypt (Samaha et al., 2012). Managerial ownership in Lebanese banks is 0.141. This average is low in comparison with Middle East companies, especially in Jordan (Al Hawary, 2011).

From the perspective of control variables, 8 banks out of 149 reported losses for two consecutive years. 18 Lebanese banks out of 149 were listed either on a

foreign or on the Lebanese stock market. 88.9% of the banks have big audit firms. This implies that Lebanese banks have a good audit quality.

4.2. Pearson. The Pearson method was used to describe the correlation coefficient between audit committee composition and exogenous variables. There is a significant and negative relationship between audit committee composition from one side and board composition and CEO duality from the other since $p\text{-value} = \text{sig.} \leq 0.01$. However, the correlation between the audit committee composition with the board size and management ownership is non-significant and positive since $p\text{-value} = \text{sig.} \geq 0.1$. Table 2 below shows that a mixed correlation exists between audit committee composition and management dominance components. Hence, the results support *H1* and *H2*. This is clear evidence that audit committee composition depends on the degree of dominance exercised by managements over their boards in some cases.

In addition, this study integrates control variables to ensure that the sample is significantly related to audit composition. Pearson correlation indicates that there is a non-significant association between audit committee composition and other control variables. Therefore, the results indicate that a significant relation exists between bank size on the one side, and board composition, size, CEO duality, and management ownership on the other. This is consistent with Chahine and Safieddine (2011), and Petra (2008). Board composition has a positive significant relationship with duality and ownership as per Pearson correlation (see Table 2). This is consistent with Ruiz-Barbadillo et al. (2007). In addition, there is a significant negative association between the adoption of audit committees in 2009 and 2010 from one side and bank size on the other. However, the relation between blockholders with the board size and CEO duality is positive. There is a positive relationship between listing and board size which is supported by Ruiz-Barbadillo et al. (2007). Therefore, CEO duality is positively related to management ownership.

Table 2. Pearson correlations matrix of exogenous variables across Lebanese banks

Variables	IAC_ %NED	BANKSIZE	LOSS	BLOCK	LISTING	YEAR 2008	BOARDCOMP	BOARDSIZE	DUALITY
BANK SIZE	.026								
LOSS	-.119	-.287***							
BLOCK	-.079	-.011	-.118						
LISTING	.071	.473***	-.088	.020					
YEAR	.016	-.345***	.434***	-.099	-.119				
BOARD COMP	-.288***	.329**	.042	-.114	.160*	-.082			
BOARD SIZE	.080	.586***	-.072	.173**	.387***	-.164**	-.157*		
DUALITY	-.286***	.403***	-.082	.234***	.198**	-.105	.532***	.080	
MANAGOWN	.132	.224***	-.020	-.330***	-.159*	-.017	.505***	-.140*	.235***

Notes: *, **, and *** denote significance at $p \leq 0.1$, 0.05, and 0.01 respectively, two-sided.

IAC_%NED is the percentage of non-executive members on the audit committee (audit committee independence); *BOARDCOMP* is the number of inside directors divided by the number of full board members; *DUALITY* is a dummy variable which takes the value of one if the CEO chairs the board, and zero otherwise; *BOARDSIZE* is the number of directors on the full board; *MANAGOWN* is the proportion of shares held by bank management; *LOSS* is a variable that takes the value of one if the company reported a loss in the current year or prior year, and zero otherwise; *BANKSIZE* is calculated as a natural logarithm of total assets for each year; *BLOCK* is a dummy variable that takes the value of one when an outside shareholder owns 10% or more of the shares and has a representative on the board, and zero otherwise; *LISTING* is a dummy variable that takes the value of one if it represents listed banks, and zero otherwise; and *YEAR_i* is a variable that takes the value of one if the audit committee adoption has taken place in year *i* (*i* = 2009, 2010, 2011), and zero otherwise.

4.3. Linear regression analysis. We used linear regression analysis to estimate the relation between audit committee independence and independent variables. The independent variable was measured by the proportion of non-executive directors. Based on the regression (see Table 3), the four hypotheses show different results. Audit committee independence is significant and negatively associated with board composition and duality, which suggests that the presence of the same person serving as the CEO and chair does affect the independence of the audit committee and does affect the creation of a powerful control mechanism. These findings are consistent with Ruiz-Barbadillo et al. (2007).

Table 3. Linear regression of IAC-NED on management dominance and control variables

Variables	Predicted sign	Coefficients
CONSTANT		0.805
BOARDCOMP	–	–0.340**
DUALITY	–	–0.113**
BOARDSIZE	+	–0.006
MANAGOWN	–	–0.007
BANKSIZE	+	0.021
LOSS		–0.083
BLOCK	–	–0.020
LISTING	+	0.057
YEAR		0.027
R ²		0.160
Adjusted R ²		0.105
F-value		2.939

Notes: *, **, and *** denote significance at $p \leq 0.1$, 0.05, and 0.01 respectively, two-sided.

Board composition and CEO duality have a significant relationship with ownership as per Pearson correlation (see Table 2). This is consistent with Ruiz-Barbadillo et al. (2007) and qualified as reasonable because three variables are subrogates of management dominance. Hence, the first hypotheses *H1* and *H2* are supported. *H1* shows that there is a negative relationship between the proportion of inside directors on the board and the independence of audit committees. The presence of inside directors has a negative impact on the independence of audit committees, which hinders their responsibilities in monitoring and control. In addition, the presence of inside directors leads the board to become an instrument of management. Second, *H2* determines the negative relation between CEO duality and audit committee independence. Dual CEOs pursue their own self-interest to the detriment of the shareholders and stakeholders, which can have an impact on control and decisions. CEO duality has reduced the audit committee ability and effectiveness in providing monitoring over management functions and activities. Hence *H1* and *H2* are supported.

Audit committee independence is non-significant and positively associated with board size and management ownership (see Table 3), which suggests that the high presence of board members and high management ownership of company shares do not affect the independence of the audit committee and do not affect the creation of a powerful control mechanism. Ruiz-Barbadillo et al. (2007) accept the first finding and is not consistent with the second. First, *H3* studies the negative relation between large boards and independent audit committees. This is not supported by the results, because the large boards have the capacity to monitor the management efficiently through the audit committee by the presence of a high proportion of experts. Second, *H4* shows the negative relation between management ownership and audit committee independence. Hence, the presence of management ownership doesn't have any effect due to the right control exercised by the boards in this perspective. Hence *H3* and *H4* are not supported. Regarding control variables, there is no significant relationship between audit committee independence and control variables.

Conclusion

The BDL has emphasized the importance of the control role of audit committees within Lebanese banks. However, the empirical study does not show the importance of the benefit obtained from them. For this reason, regulators must be more concerned not only with the establishment of audit committees, but also with the effectiveness of their functions and their characteristics, particularly their independence and the members' experience. This study analyzes Lebanese banks that were obliged to establish audit

committees with respect to their independence on the one hand, and to the influence of management on the degree of independence over the board on the other.

The findings show that only a few Lebanese banks had created audit committees prior to 2009, while between 2009 and 2011, all banks adopted them. The committees of nearly 71.14% of these banks were composed totally of non-executive directors. This indicates that Lebanese banks understand the importance of corporate governance systems recommended by the BDL. Therefore, a large number of firms (24.83%) adopted audit committees with a majority of independent members. This could be due to the ownership structure in Lebanese banks. The banks' ownership is not concentrated in a major shareholders leading for a high frequency of representation on banks board of directors. Therefore, the percentage of independent members in Lebanese audit committees is higher compared to that on the board. This is a sign that Lebanese banks desire to improve the corporate governance system. The presence of non-executive directors in the audit committee is very high in comparison with Middle East countries.

The results suggest that in Lebanese banks, managers can impair the effectiveness of audit committees through the creation of management-dependent audit committees, which, in turn, affect the decisions taken by the boards. The determinants of the audit committees reflect management interests represented by board composition with respect to the number of inside directors and CEO duality. In this perspective, the management has the ability to influence audit committee effectiveness and is able to limit the control of audit committees. However, the determinants of the audit committees do not reflect management interests represented by board size and managerial ownership.

That is clear evidence that audit committee effectiveness is considered as an important determinant of good corporate governance in Lebanese

banks. These findings have positive and negative implications from policy and investor perspectives. First, the presence of insiders and CEO duality can create a negative implication for the investors where the control is risky. In other words, the insiders are allowed to pursue their own interest to the detriment of investors and other stakeholders. On the other hand, these findings allow the BDL to rethink recommendations for the characteristics of boards of directors in corporate governance systems. Second, a large board size is a very important characteristic which can affect audit committee independence. This is due to the possibility of a greater presence of experts from different fields, which can help to safeguard investors' interests.

In Lebanon and the Middle East region, regulators recommend a modification in the characteristics and functions of audit committees with the aim of enhancing their effectiveness and independence. For example, in Lebanon, a BDL circular requires audit committees in banks to include no fewer than three fully independent members. Other Middle East countries, such as Oman and UAE, are content for the majority to be non-executive members. Consequently, independence is an important audit committee characteristic fixed in the codes of corporate governance in almost all Middle East countries.

This study has several limitations. First, this paper studies only Lebanese banks. Hence, the results may not be generalized to other companies which use audit committees. Moreover, in Lebanon, there is a small number of banks (54 commercial banks), and this may affect the results. Furthermore, we use several measures to identify audit committee independence. One of these criteria is that independent directors are not one of the bank debtors (BDL, 2011). Because of banking secrecy in Lebanon, we found it difficult to identify this measure. Future researches must concentrate not only on audit committee determinants, but on the influence of independent audit committees on banks' performance.

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