

Research Article

CORPORATE GOVERNANCE MECHANISMS AND PRODUCT DIVERSIFICATION: THE INFLUENCE OF AUDIT COMMITTEE CHARACTERISTICS AND INTERNAL AUDIT QUALITY

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ABSTRACT

This study aims to investigate the effect of audit committee characteristics and the company's internal control system on product diversification in companies listed on the Tehran Stock Exchange. For this purpose, five hypotheses were formulated to investigate the issue, and data from 130 member companies of the Stock Exchange were analyzed for the period between 2012 and 2018. The research regression model was examined and tested using panel data with a fixed-effects approach. The results showed that among the audit committee characteristics, audit committee financial expertise and audit committee independence have a significant positive effect on product diversification, due to increased monitoring, transparency, and appropriate disclosure. However, audit committee size does not have a significant effect on product diversification. Also, the results confirm that among the characteristics of the company's internal control system, the presence of weaknesses mentioned in the audit report has a significant negative effect on product diversification. On the other hand, regarding the ratio of internal audit department employees to the total number of employees in the business unit, the results indicate that it has no significant effect on product diversification.

INTRODUCTION

The issue of diversification in the company's business activities has been widely considered in recent financial management literature. Many companies worldwide are moving towards growth and expanding the scope of their business activities. Perhaps one reason is to respond to the diversity of customer needs. Managers try to meet customers' multifaceted needs to make them more loyal to their company (Tehrani et al., 2008). The vulnerability of specialized companies to rapid, unexpected environmental changes has led diversification to be considered an essential basis for ensuring the growth and survival of companies in the global competitive arena since the late twentieth century.

Today, few can ignore the importance of audit committees. An effective audit committee is considered a determining factor in a company's governance pillars, from which we can make the best use of its existence. Audit committee members work with the board of directors, which is responsible for protecting shareholders' interests, and monitor the quality and suitability of financial statements, accounting, auditing, internal controls, and the reporting process. Communication between internal auditors, audit committees, and the board of directors increases the flow of useful, effective, and informative information. The committee helps investors make informed decisions and increases accountability to shareholders. The establishment of an audit committee has greatly contributed to the proper relationship among the board of directors, independent auditors, and the company's internal auditors. The members of this committee cooperate with the board of directors, which is responsible for protecting shareholders' interests, and monitor the quality and suitability of financial statements, the optimal implementation of the audit process, internal controls, and the financial reporting process.

By establishing communication between the independent auditors, the audit committee, and the board of directors, the quality of the company's financial reporting will also improve. (Daghani and Ahmad Khanbeigi, 2017) Internal audit plays a fundamental and supporting role in managing internal control for the board of directors. From a management perspective, internal audit has all the responsibilities that indicate the desired role of internal controls (Adele, 2013). The role of internal audit for the audit committee has traditionally been a behind-the-scenes player that helps audit committees carry out their duties and acts as a watchdog for management to perform its duties (Rahimian and Tavakolnia, 2012). The role of internal audit is to support the business unit in achieving its goals, systematically evaluate methods and procedures, and ensure organizational control. Internal audit is the audit of an organization by itself or by an independent auditor. (Chang et al., 2019).

Sullivan (2020). However, although the relationship between internal audit, the audit committee, and product diversification has always been of interest, there is still no clear understanding of the pattern of these relationships. In general, in the present study, diversification is considered to create innovation because companies add new activities, even if these activities are not new to the market. Many studies show that audit committee characteristics affect internal audit (e.g., Adele and Maysa, 2013; Abbott, Parker, and Petters, 2010; Barua, Rama, and Sharma, 2010) and internal audit budget is specifically related to the number of audit committee meetings, which indicates that the audit committee consistently supports internal audit, which leads to a higher internal audit budget (Barua et al., 2010). In fact, the interaction between audit committees and internal auditors is considered as one of the

most important strengthening factors for governance and is supported by some aspects such as regular meetings between audit committees and internal auditors, The lines of communication between them, the review of the internal auditor's work report by the audit committees, and the control of their appointment and dismissal are measured (Abdelfattah Sartawe, 2016). The main objective of this study is to investigate the effect of audit committee characteristics and internal audit quality on product diversification in companies listed on the Tehran Stock Exchange.

THEORETICAL BASIS OF RESEARCH

Diversification

Diversity is the extent to which institutions are simultaneously engaged in different business activities (Nowlando, 2019). One of the basic principles for achieving development in companies is diversification of activities. Diversification in a company actually means selecting new activities and, in the process of producing or providing new goods and services to members and the market. In other words, diversification of activities occurs when a company provides new goods or services to its subsidiaries or introduces new products or services to the market within its current activities.

Audit Committee

The audit committee is a committee consisting of board members, which is usually formed in Iran from three to five non-executive directors, that is, neither the company's executive director nor employed by the company, to guarantee and increase the interests of shareholders and act as a control mechanism to reduce information asymmetry between shareholders and other stakeholders (Tavangar et al., 2018; Heyrani, 2019).

Internal Audit

Internal audit is one of the pillars of today's organizations. Internal auditors, as representatives of managers, while identifying problems and shortcomings in executive methods and evaluating internal controls, also provide appropriate suggestions for the optimal use of available resources and truly appear as management consultants. Many managers still view internal audit traditionally and do not recognize its role and importance in the organization, even though many changes have occurred in internal audit's functions and organizational role. Internal audit, like other parts of the organization, must act effectively to support the organization's goals and help create added value. Each part of the organization needs characteristics that align with its operating environment for effectiveness and efficiency. Internal auditors and managers of different parts of the organization must be carefully aware of each other's duties, functions, and mutual interests. Internal auditors must act in accordance with professional standards and always strive to maintain their relative independence and impartiality. The scope of activities, methods, and duties of internal audit within the organization, and how it is reported, must be clearly defined, and competent individuals and groups must continually evaluate internal audit's performance (Hassan Zadeh et al., 2016).

RESEARCH BACKGROUND

Jamei, Jafari (2020) examines the relationship between audit and accounting expertise and knowledge of audit committee members and the implementation of internal audit recommendations, and concludes that, according to theoretical foundations, this increase in audit committee expertise and knowledge leads to a better understanding of auditors' judgments, more effective monitoring of accounting and financial reporting procedures, and an increase in the company's added value and market value.

Heyrani and Ebrahimi (2019) studied the effect of audit committee characteristics on the effectiveness of internal controls over operations and compliance, and their results indicate that audit committee characteristics can reduce internal control weaknesses and compliance control weaknesses. However, reports of internal control violations in operations have no significant relationship with audit committee characteristics.

Sullivan et al. (2020) examined the effect of audit committee expertise on audit quality using evidence from UK audit costs. The findings show that companies whose audit committees have accounting and financial expertise have a positive, significant impact on the quality of auditing and financial reporting.

Ling (2018) concluded in a study on audit committees that their formation reduces information asymmetry by providing fair and informative financial reports.

Nowlando et al. (2019) conducted a study to examine the informational benefits of CEO attendance at audit committee meetings. The findings show that CEO attendance at audit committee meetings is positively and significantly associated with increased information sharing between company management and audit committees.

Method

The present study is applied in purpose and correlational in its descriptive method. The statistical population of this study includes all companies listed on the Stock Exchange for the period from 2012 to the end of 2018. The quality of information and ease of access to financial statements and other information are the most important reasons for choosing this statistical population.

Given the nature of the research and the existence of some inconsistencies among the companies listed on the Stock Exchange, the systematic exclusion sampling method (purposive) was used. Since all companies listed on the Stock Exchange are the statistical population of this research, we select samples from the statistical population that have the following characteristics: Companies must continue to operate during the period under study. The statistical sample includes manufacturing and industrial companies. Companies whose fiscal year ends at the end of March.

Research models

A regression model was used to test the hypothesis:

$$Product_{i,t} = \beta_0 + \beta_1 ICQR_{i,t} + \beta_2 ICQE_{i,t} + \beta_3 size_{i,t} + \beta_4 Liquid_{i,t} + \beta_5 Loss_{i,t} + \beta_6 Age_{i,t} + \beta_7 MBV_{i,t} + \beta_8 CFO_{i,t} + \beta_9 LEV_{i,t} + \beta_{10} ROA_{i,t} + \varepsilon_{i,t}$$

$$Product_{i,t} = \beta_0 + \beta_1 ACEXP_{i,t} + \beta_2 ACIND_{i,t} + \beta_3 ACSIZE_{i,t} + \beta_4 size_{i,t} + \beta_5 Liquid_{i,t} + \beta_6 Loss_{i,t} + \beta_7 Age_{i,t} + \beta_8 MBV_{i,t} + \beta_9 CFO_{i,t} + \beta_{10} LEV_{i,t} + \beta_{11} ROA_{i,t} + \varepsilon_{i,t}$$

Research variables

The variables in the present study are divided into three groups: independent, dependent, and control.

Independent variables

According to the research hypotheses in this study, the independent variables are as follows:

1. The presence of weaknesses mentioned in the audit report ($ICQR_{i,t}$): If there is a weakness in internal control in the audit report, it accepts the number 1 and otherwise accepts the number zero.
2. The ratio of the number of internal audit staff to the total staff ($ICQE_{i,t}$): Equal to the number of internal audit department staff divided by the total staff of the business unit.
3. Financial expertise of the audit committee ($ACEXP_{i,t}$): Equal to the percentage of members with financial expertise in the audit committee (Zhu and Niu, 2019). According to Article 6 of the Charter of the Audit Committee, financial expertise of members is defined as a university degree or a domestic or internationally recognized professional degree in finance (accounting, auditing, financial management, economics, other management disciplines with a financial or economic orientation), along with the ability to analyze and present financial reports and internal controls governing financial reporting.
4. Audit Committee Independence ($ACIND_{i,t}$): It is equal to the percentage of independent members in the audit committee (Maki et al., 2019). An independent member is defined as a member who does not have any direct or indirect relationship or interest that affects their independent decision-making, causes them to favor the interests of an individual or a specific group of shareholders or other stakeholders, or causes them to fail to observe the same interests of shareholders.
5. Audit Committee Size: ($ACSize_{i,t}$) It is equal to the number of members present in the audit committee (Lari Dasht-Bayaz et al., 2016). According to paragraph one of Article 5 of the committee charter, the audit committee is composed of three to five members selected and appointed by the board of directors.

Dependent Variable

The product diversification variable is considered the dependent variable in this study.

1. Product diversification ($Product_{i,t}$): It is equal to the number of products of the business unit, and this variable is extracted from the explanatory notes accompanying the financial statements of the companies (Jamei and Jafari, 2020).

Control variables

Given that this study examines the effect of ownership structure on the behavior of dividend policies of companies listed on the Tehran Stock Exchange, the control variables used in this study are as follows:

1. Company size (SIZE): equal to the natural logarithm of the company's total assets (Chenhal and Morris, 2018)
2. Company liquidity (Liquid): equal to the ratio of cash and cash equivalents to the company's total assets (Andrew et al., 2018)
3. Loss: (Loss) is a dummy variable that is one if the company has a loss in the current year and zero otherwise
4. Financial leverage (LEV): equal to the ratio of total liabilities to total assets of the company.
5. Company age (Age): equal to the natural logarithm of the company's age from the date of establishment (Metan Zain et al., 2006).
6. Market value to book value (MBV): It is defined as the ratio of the market value of equity to the book value of the company's equity.
7. Operating cash flow (CFO): It is equal to the company's operating cash flow and is adjusted by the company's total assets.
8. Return on assets (ROA): It is equal to the ratio of net profit to total assets of the company (Souri et al., 2019)

To test statistical hypotheses and analyze data, mixed regression is used. Statistical analysis of the data was also carried out using Excel and IViews version 8.

Research hypotheses

Hypothesis 1: The presence of a weakness mentioned in the audit report has a significant effect on product diversification.

Hypothesis 2: The ratio of the number of internal audit department employees to the total number of business unit employees has a significant effect on product diversification.

Hypothesis 3: The financial expertise of the audit committee has a significant effect on product diversification.

Hypothesis 4: Independence of the Audit Committee has a significant effect on product diversification.

Hypothesis 5: Audit committee size has a significant effect on product diversification.

FINDINGS

As shown in Table 1, the descriptive statistics for the research variables are presented.

Table 1: Descriptive statistics of model variables

Variable	Mean	Median	SD	Max.	Min.
Product diversification	7.504	7	1.589	30	2
Ratio of internal audit staff to total staff	0.018	0.019	0.010	0.046	0.001
Financial expertise of the audit committee	0.811	1	0.258	1	0.333
Independence of the audit committee	0.731	0.666	0.172	1	0.333
Audit committee size	3.936	3	0.998	5	3
Company size	6.118	6.041	0.691	8.414	4.415
Firm liquidity	0.041	0.025	0.043	0.208	0.002
Firm age	1.561	1.602	0.157	1.826	1.041
Ratio of market value to book value	1.847	1.562	0.835	6.374	1.005
Ratio of operating cash flow to total assets	0.120	0.106	0.126	0.451	-0.232
Financial leverage	0.601	0.612	0.199	0.987	0.104
Return on assets	0.098	0.082	0.135	0.454	-0.339
Descriptive statistics of dichotomous variables					
Variable	Mean	Median	SD	Max.	Min.
Existence of weakness mentioned in the audit report	0.493	0	0.500	1	0
Company loss-making	0.132	0	0.339	1	0

According to the descriptive statistics (Table 1) of the research variables and the closeness of the mean and median in most of the variables, it can be stated that all variables have a proper distribution. The company's liquidity ratio averages about 4 percent, indicating a significant liquidity problem in Iranian companies, given the volume of debt. In addition, the return on assets variable averages approximately 10 percent, indicating that the listed companies did not earn a proportionate return, given the inflation rate over the last decade. This could be due to the sanctions conditions.

Table 2: Results of the reliability test of variables using the Eviews software

Variables	Levine, Lin, and Cho test statistic	Error Level
Product diversification	-31.359	0.000
Ratio of internal audit staff to total staff	-30.259	0.000
Financial expertise of the audit committee	-22.021	0.000
Independence of the audit committee	-23.491	0.000
Audit committee size	-3.848	0.000
Company size	-31.043	0.000
Firm liquidity	-37.557	0.000
Firm age	-136.91	0.000
Ratio of market value to book value	-33.132	0.000
Ratio of operating cash flow to total assets	-23.212	0.000
Financial leverage	-13.059	0.000
Return on assets	-32.135	0.000

As shown in Table 2, the research variables are stable at the 99% confidence level. Therefore, the parameters can be estimated without concern about spuriousness.

Table 3. Results of the *F*- Limer test for the research models*

Model under study	Stat	Error Level	Accepted Method
First research model	6.025	0.000	Fixed Effects Method
Second research model	6.003	0.000	Fixed Effects Method

* Source: Research findings

Given the statistics and error levels of the Chow test for the research models, the fixed-effects model is preferred. It is also necessary to perform the Hausman test to choose between the fixed-effects panel data model and the random-effects panel data model. (Table 3).

Table 4: Results of the Hausman test for the research models

Model under study	Stat	Error Level	Accepted Method
First research model	48.851	0.000	Fixed Effects Method
Second research model	45.084	0.000	Fixed Effects Method

As shown in Table 4, the results indicate that the fixed-effects model is the preferred method for the research models. Therefore, the research model (1) was estimated as follows, using the preferred method.

Table 5: Estimation results of the first research model*

Variable	Variable coefficient	Standard deviation	T stat	Error Level
Intercept	0.615	1.686	0.365	0.715
Existence of weakness mentioned in the audit report	-0.209	0.084	-2.473	0.013
Ratio of the number of internal audit staff to total staff	11.892	11.748	-1.012	0.311
Company size	0.813	0.252	3.222	0.001
Company liquidity	1.048	0.937	1.118	0.263
Company loss-making	-0.114	0.108	-1.058	0.290
Company age	4.041	1.519	2.660	0.008
Ratio of market value to book value	0.129	0.32	3.968	0.000
Ratio of operating cash flow to total assets	-0.196	0.283	-0.693	0.488
Financial leverage	-0.748	0.316	-2.365	0.018
Return on assets	0.219	0.465	0.473	0.636
Coefficient of determination	0.640			
Adjusted coefficient of determination	0.575			
Durbington-Watson statistic	2.314			
F statistic	9.860			
Probability of the F statistic	0.000			

* Source: Research findings

According to the results in Table 5, and given the F-statistic (9.860) and its p-value (0.000), it can be concluded that, at a 99 percent confidence level, the research model is highly significant overall. Also, considering the adjusted coefficient of determination for the model, which is 57%. In addition, considering the value of the Durbin-Watson statistic, which is equal to 2.314, it can be claimed that there is no first-order autocorrelation between the residuals of the model. Also, the results show that among the control variables, only company size, company age, the market-to-book ratio, and financial leverage have a significant effect on product diversification.

Table 6. Estimation results of the second research model

Variable	Variable coefficient	Standard deviation	T stat	Error Level
Intercept	0.906	1.817	0.498	0.618
Financial expertise of the audit committee	2.087	0.590	3.536	0.000
Independence of the audit committee	1.472	0.733	2.006	0.045
Audit committee size	-0.047	0.053	-0.886	0.375
Company size	0.783	0.260	0.704	0.481
Company liquidity	1.168	0.943	1.237	0.216
Company loss-making	-0.056	0.111	-0.511	0.609
Company age	3.612	1.550	2.330	0.020
Market value to book value ratio	-0.146	0.034	-4.294	0.000
Operating cash flow to total assets ratio	-0.166	0.296	-0.561	0.574
Financial leverage	-0.707	0.333	-2.125	0.033
Return on assets	0.196	0.465	0.422	0.672
Coefficient of determination	0.628			
Adjusted coefficient of determination	0.561			
Durin-Watson statistic	2.302			
F statistic	9.299			
Probability of the F statistic	0.000			

* Source: Research findings

According to the results in Table 6, and given the F-statistic (9.299) and its p-value (0.000), it can be concluded that, at a 99 percent confidence level, the research model is highly significant. Also, given the model's adjusted coefficient of determination of 56 percent, the independent and control variables explain more than 56 percent of the changes in the dependent variable. In addition, considering the value of the Durbin-Watson statistic, which is equal to 2.302, it can be claimed that there is no first-order autocorrelation between the residuals of the model. Also, the results show that among the control variables, only company age, the market-to-book ratio, and financial leverage have a significant effect on product diversification. According to the tables presented, the results of testing the research hypotheses are presented in Table 7.

Table 7: Results of confirmation or rejection of research hypotheses

Hypothesis number	Hypothesis text	The result of the hypothesis at the 95% confidence level is
First	The presence of a weakness mentioned in the audit report has a significant effect on product diversification.	Confirmed
Second	The ratio of internal audit department employees to the total number of employees in the business unit has a significant effect on product diversification.	Rejected
Third	The audit committee's financial expertise has a significant effect on product diversification.	Confirmed
Fourth	The independence of the audit committee significantly affects product diversification.	Confirmed
Fifth	The size of the audit committee has a significant effect on product diversification.	Rejected

CONCLUSION

The first hypothesis examines the effect of the presence of weaknesses identified in the audit report on product diversification among companies listed on the Tehran Stock Exchange. According to the model estimation results, the coefficient for the variable indicating the existence of weaknesses mentioned in the audit report is -0.209, with an error level of 0.013. Therefore, given the negative coefficient and significance level of this variable, it can be concluded that the weaknesses mentioned in the audit report have a significant negative effect (at the 5 percent error level) on product diversification. According to the theoretical foundations, companies with weaknesses identified in the audit report are likely to have lower levels of internal control, and their supervisory mechanisms are therefore unnecessary. As a result, companies with weaker supervision tend to have less product diversification. It should also be noted that Al-Shaer et al., in their research in 2017, addressed the importance of audit reports and stated that the existence of the weakness mentioned in the audit report affects the quality of information disclosure and financial reporting and the quality of the audit committee, so the result of testing the first hypothesis is consistent with the results of the aforementioned research.

The second hypothesis examines the effect of the ratio of internal audit department employees to the total number of employees in the business unit on product diversification in companies listed on the Tehran Stock Exchange. According to the model estimation results, the coefficient for the ratio of internal audit department employees to the total number of employees in the business unit is 11.892, with an error level of 0.311. Therefore, given the positive coefficient and the variable's significance level, it can be concluded that the ratio of internal audit department employees to the total number of employees in the business unit has a non-significant positive effect (at the 5 percent error level) on product diversification. The results

of this hypothesis test are consistent with the research of Dadashi et al. (2018), and these researchers also state, based on their research results, that the ratio of the number of internal audit department employees to the total number of employees of an institution does not have a significant effect on financial statements and diversification.

The third hypothesis examines the effect of audit committee financial expertise on product diversification in companies listed on the Tehran Stock Exchange. According to the model estimation results, the coefficient for the audit committee financial expertise variable is 2.087, and its error level is 0.000. Therefore, given the positive coefficient and significance level, it can be concluded that audit committee financial expertise has a significant positive effect (at the 5 percent error level) on product diversification. According to theoretical foundations, there is an argument that companies with a more specialized audit committee have more transparency and more precise planning, and these companies try to properly disclose and manage all the risks that the company faces, so it is expected that with higher transparency and supervision, we will see an increase in product diversification. Therefore, considering the significance level, the third hypothesis of the study is confirmed at the 5% error level. The audit committee's financial expertise has always been of interest to researchers. Several studies have examined the effect of this feature, including the research of "Sullivan et al." in 2020 and "Jamei and Jafari" in 2020, both of which announced in their results that the financial expertise of the audit committee has a positive and significant effect on increasing added value and market value, as well as increasing the quality of auditing and financial reporting.

The third hypothesis examines the effect of audit committee independence on product diversification in companies listed on the Tehran Stock Exchange. According to the model estimation results, the coefficient for the audit committee independence variable is 1.472, with a standard error of 0.045. Therefore, given the positive coefficient and significance level, it can be concluded that audit committee independence has a significant positive effect (at the 5 percent error level) on product diversification. According to the theoretical foundations, companies with more independent audit committees have higher levels of monitoring and transparency. These companies aim to disclose all the risks they face properly, so it is expected that, with higher levels of monitoring and transparency, we will witness an increase in product diversification. Therefore, considering the significance level, the fourth hypothesis of the research is confirmed at the 5 percent error level. In 2017, "Alzbon and Savan" highlighted the independence of audit committee members as an important factor in implementing internal audit recommendations and stated that the internal audit department's recommendations affect managers' decision-making. Since managers make decisions based on financial reports and statements about the diversification of their products, the results of the aforementioned research are consistent with those of the fourth hypothesis test.

The fourth hypothesis examines the effect of audit committee size on product diversification in companies listed on the Tehran Stock Exchange. According to the model estimation results, the coefficient for the audit committee size variable is -0.047, with a p-value of 0.375. Therefore, given the negative coefficient and the variable's significance level, it can be concluded that the audit committee size has a non-significant negative effect (at the 5 percent error level) on product diversification. According to theoretical foundations, companies with larger audit committees exhibit greater transparency and more accurate reporting due to greater oversight, and they strive to disclose all the risks they face properly. Therefore, it is expected that larger audit committee sizes will increase product diversification through higher transparency. In 2018, Baharam Moghaddam and Jokar conducted a study. They found that the

size of the audit committee does not moderate or affect investors' preferences in the capital market and, in fact, is not an influential factor. According to the results of the fifth hypothesis test, the results of the aforementioned researchers do not correspond to the theoretical foundations.

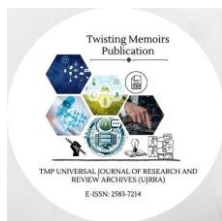
In addition, according to the study's results, investors are advised to pay attention to the level of product diversification across all reports, including the board of directors' activity report, when evaluating companies and making investment decisions. According to the results of the study, which showed that product diversification is affected by the level of transparency and specific information of the company, investors and creditors are advised to pay attention to the level of product diversification in making investments and financing because product diversification increases the company's competitiveness by reducing the risk of being eliminated by competitors and protects the interests of investors and creditors.

Discussion of restrictions on access to data on the audit committee's characteristics and the company's internal control system that have been disclosed since 2012.

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