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Audit Committee and Equity Return: The Case of Australian Firms[*]

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This paper examines the impact of Audit Committee (AC) meeting on the equity return in Australian firms. Data were obtained from the top 119 listed Australian firms for 1999 and 2007 and we find better equity return is influenced by the frequency of audit committee meetings. But the influences of non-executive directors are not significant in terms of influencing equity returns

Keywords: Audit Committee; Corporate Governance; Australian Stock Exchange (ASX); ROE.

JEL classification: C10, C12

1. Introduction

An audit committee is an operating committee of the board of directors charged with oversight of financial reporting and disclosure. Committee members are drawn from members of the company's board of directors, with a chairperson selected from among the committee members. Audit committee must be composed of independent outside directors with at least one qualifying as a financial expert. Audit committees are typically empowered to acquire the consulting resources and expertise deemed necessary to perform their responsibilities. In compliance to the directives of the Australian Securities and Investment Commission (ASIC) listed Australian companies have set up audit committee, remuneration committee since 1999 to ensure good corporate governance. The explicit reasons for committee formation are directly associated with the conformance role of the board (Tricker, 1994) with expectations that the committees will undertake specific tasks which will lead to improved equity performance which is measured by the return on equity (ROE) . Collier (1996) finds that 'the widespread adoption of audit committees in the UK might well reflect no more than an attempt to avoid legislative solutions to deficiencies in corporate governance' (p. 135). US researchers (Sommer, 1991; Verschoor, 1990a, b) report that the existence of an audit committee does not guarantee its effectiveness. They find that financial reporting is of problematic even where audit committees exist. Bradbury (1990) studied audit committee formation in New Zealand and provided evidence that audit committees were established to increase the credibility of annual audited financial statements. Our literature survey could not locate any study which deals with how frequencies of audit committee meetings impact the ROE. Hence, the objective of this study is to examine this issue in case of top 119 Australian companies.

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The rest of this paper is organized as follows: Section 2 contains previous studies and hypothesis development, Section 3 provides data and describes the research methodology. While Section 4 presents the analysis of the results, Section 5 the final section summaries the research on the adoption of AC regulation and recommendations and suggests opportunities for future research.

2. Literature Review and Hypothesis

Audit Committee (AC) is commonly viewed as monitoring mechanisms that enhances the audit attestation function of external financial reporting and external auditor independence by establishing a formal communication link between the board of directors, the internal monitoring system and the internal and external auditors (Bradbury 1990, Blue Ribbon Committee 1999).The primary objective of an AC is to "increase the credibility of annual financial statements, assist directors in meeting their responsibilities and enhance audit independence", Bradbury (1990:21). ACs have also been described as a mechanism for monitoring and protecting the interests of shareholders (Harrison 1987, English 1994, Menon and Williams 1994, DeZoort, Hermanson, Archambeault and Reed 2002, Gendron and Bedard 2006), while the view of Kolins, Cangemi and Tomasko (1991) is, that financial reporting is more reliable and questionable corporate practices are reduced if an AC exists. Other authors have similar views on the role of AC (see for example, Eichenseher and Shields 1985, DeZoort 1998, Carcello and Neal 2003). Responsibilities of the audit committee typically include: Overseeing the financial reporting and disclosure process, monitoring choice of accounting policies and principles, hiring, performance and independence of the external auditors, regulatory compliance, ethics, and whistleblower hotlines, monitoring the internal control process, performance of the internal audit function, discussing risk management policies and practices with management. The duties of an audit committee are typically described in a committee charter.

The formation, composition and operations of AC in Australia are governed by ASX listing rules and ASX CGC best practice recommendations. Similar to the United Kingdom reforms, Australia has predominantly adopted a ‘principles based’ approach rather than the more ‘prescriptive’ approach adopted after the collapse of Enron in the United States became the catalyst for the Public Company Reform and Investor Protection Act 2002, known as the Sarbanes-Oxley Act (hereafter SOX 2002). Instead of directly mandating audit committee regulations through the Corporations Act 2001, this has been accomplished through the ASX which has played a more active role since 2002. ASX Listing Rules are contractually binding on ASX listed companies and are enforceable under sections 793C and 1101B of the Corporations Act 2001 (Commonwealth of Australia 2001).

Vafeas (1999) found that corporate governance was related to board meeting frequency. High meeting frequency means board is more active which leads to improvements in a firm’s operating performance and profitability (Vafeas, 1999). The more frequently the board meets, the better the directors perform (Lipton and Lorsch, 1992; Conger et al., 1998). The ASX CGC (2007) defines corporate governance as “the framework of rules, relationships, systems and processes within and by which authority is exercised and controlled in corporations”. “It encompasses the mechanisms by which companies and

those in control are held to account" (ASX CGC 2007:3). "Effective corporate governance structures encourage companies to create value (through entrepreneurism, innovation, development and exploration) and provide accountability and control systems commensurate with the risks involved" ASX CGC (2007:3). In conjunction with independent, competent Boards of Directors, AC is vitally important mechanisms of good corporate governance (Chen, Moroney and Houghton 2005) and are "a more efficient mechanism than the full board for focusing the company on particular issues relevant to verifying and safeguarding the integrity of the company's financial reporting" (ASX CGC 2003:29).

Several authors (Muth and Donalson, 1998; Rechner and Dalton, 1991; Leng, 2004; Brown and Caylor, 2006) find that ROE is higher when the level of corporate governance is higher. Like its British and American counterparts, the Australian companies tend to constitute audit committee, remuneration committee to improve their financial performance. These committees may be different in terms of work load and skills. AC may need greater time commitment and specialized skills to perform their duties. It is expected that busy directors are less likely to be nominated to these committees unless they have special expertise (Jiraporn et al., 2008).

The frequency of audit committee meetings appears to be an important component contributing to audit committee effectiveness which signals diligence on behalf of the AC (DeZoort, Hermanson, Archambeault and Reed 2002; Gendron and Bedard 2006). Several studies have included the frequency of AC meetings as a proxy for diligence (Abbott, Parker, Peters and Raghunandan 2003, Abbott, Parker and Peters 2004, Song and Windram 2004). Abbott, Parker, Peters and Raghunandan (2003), found that an audit committee that meets at least four times annually was not associated with higher external audit fees. In contrast Goodwin-Stewart and Kent (2006), found that AC that meet more frequently are associated with higher audit fees. Abbott, Parker and Peters (2004), report that audit committees that meet more frequently are negatively associated with the occurrence of financial misstatement. Stewart and Munro (2007) found that the frequency of audit committee meetings and the auditor's attendance at meetings are significantly associated with a reduction in perceived audit risk. These findings suggest that when AC meets more frequently other positive benefits flow. Our hypothesis is*: better equity return is influenced by the frequency of audit committee meeting.* In order to test the above hypothesis, we examined the impact of AC on equity return in Australia.

3. Data and Methodology

Data were collected from the annual reports of the largest 119 companies in Australia, over the period 1999-2007 and they were listed in the Australian Stock Exchange (ASEX). The reasons for considering data from 1999 is that the Australian firms, in compliance to ASIC directives, instituted AC from 1999 and we want to examine this committee impact equity return. Our study considered data until 2007 since later period data were not available. We studied 119 Australian firms which nearly constitute optimum sample size as recommended by DeVaus (1996) who considered 122 as optimal sample size. Linear regression analysis is extensively used for this study. The dependent variables used for the regression analysis is return on equity (ROE) which is the net income after tax divided by total equity. It measures how well a company

performed in terms of rewarding the shareholders in terms of improved ROE. Investors usually look for companies with returns on equity that are high and growing. Though Heggestad (1979) recommended the return on assets (ROA), Weiss (1974) finds equity as more appropriate than other alternative measures since it corresponds most closely to what owners seek to maximize. Thus, the asset variable and its corresponding financial ratio (ROA) are excluded from the regression analysis. The independent variable that influence firm's financial performance is considered for this study is NOACM (number of audit committee meetings). Since non-executive directors constitute 97% of the total board members in Australia, we considered influence of non-executive directors (NONED) as independent variables which may also influence equity performance

4. Data Analysis and Result

4.1 Descriptive Measure of the Variables

Descriptive statistics of the data are shown in Table 1. Clearly, all variables have distinct statistical properties. The ROE ranges from -4% to 100%, with a mean of 8.36% which is larger than the median of 7.34% indicating that the ROE in the samples appear to be right skewed. NOACM has a mean of over 4.46 with a range of 2 to 15. The proportion of NONED ranges from 1 to 14, with a mean of around 6.44%. It can be seen that NOACM has standard deviation of 2.18 and which is lowest than others.

Table 1 Descriptive measure of the variables ROE, NONED, NOACM

Name	Mean	St. Dev	0.25Quariles	0.5Quariles	0.75Quariles	Minimum	Maximum
ROE	8.36	7.16	6.27	7.34	16.26	-4	100
NONED	6.44	2.12	4.06	5.65	12.53	1	14
NOACM	4.46	2.18	2.81	3.92	8.67	2	15

Based on 458 observations of data available

4.2 Correlation Matrix of the Variables

In the following tables we present Pearson's correlation and Spearman's rank correlation since it measures linear dependence between two variables and is widely used as a measure of the strength of linear dependence between two variables. Pearson correlation coefficient was the only measure used to estimate the dependence structure in the tails of the distribution. This measure captures only the linear relationship between the variables. On the other hand, the rank correlation coefficient is less sensitive to outliers than the Pearson correlation. Table 2.1 and Table 2.2 present the simple pair-wise correlation matrix between different variables.

Table 2a Simple Pair-wise Correlation Matrix between Different Variables

	ROE	NONED	NOACM
ROE	1		
NONED	0.0848*	1	
NOACM	0.1403**	0.3110**	1

* $p < 0.05$ (one-tailed), ** $p < 0.01$ (one-tailed).

Table 2b Simple Pair-wise Spearman Rank Correlation Matrix between Different Variables

	ROE	NONED	NOACM
ROE	1		
NONED	0.1736**	1	
NOACM	0.3045**	0.3105**	1

* $p < 0.05$ (one-tailed), ** $p < 0.01$ (one-tailed).

Pearson correlation and the rank correlation of different variables were estimated. It is evident from the above that rank correlations are robust to outliers. We observe that there is no significant difference between these variables. The pair-wise correlations between independent variables indicate absence of significant multicollinearity.

4.3 Regression Model:

We conduct the following regression model:

$$ROE = \beta_0 + \beta_1 NONED + \beta_2 NOACM + \varepsilon$$

Table 3 OLS estimates of the parameters along with other statistics of the models

Variable Name	Estimated coefficients	Standard error	T-Ratio	P-Value	VIF
CONSTANT	1.5377	1.163	1.323	0.187	
NOACM	0.4502	0.1105	4.072	0.000	1.26
NONED	0.0768	0.0406	1.8916	0.2671	1.21

Table 3 shows the regression model summary. The results of the overall model are significant with P-value<0000. Regression results for the model indicate that the model was statistically reliable in distinguishing among the independent variables included in this study (based on the conventional tests (R^2=0.4642, adjusted R^2=0.4487, F- and t-values). The model appears to have highly significant fit which means that the model in general has very good fitting performance. To postulate the model we used collinearity diagnostic to check the presence of multicollinearity. According to Dielman (2001), any individual VIF larger than 10 indicates that multicollinearity may contain misleading estimates of the regression coefficients. In our case we found that all the independent variables have VIF less than 1.3 indicating there is no significant multicollinearity between the independent variables.

4.4 Discussion and conclusion:

The results of the estimation of the model with the performance measures are displayed in Table 3. It appears that frequency of audit committee meeting (NOACM) influence equity return in the Australian firms. Also form the regression result it is found that the variable is statistically significant with (P-value<0000) holding all the other independent variables constant. We find that the coefficient of NONED is positive and insignificant (P-value < 0.2671). This finding indicates that higher proportion of NONEDs on the board

committee does not influence the equity return in the Australian firms. Furthermore, result shows that value of R^2 is 0.4642 which indicates that 46.42% of the variations in ROE that can be explained by linear regression model and the remaining 53.58% are unexplained random noise. This suggests that meeting frequency of AC positively related to improved equity return for the Australian firms. However, we do not claim that our findings can be applied to every given data set in every market conditions. We have not considered other variables such risk committee and remuneration committee which may affect equity return.

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