THE LINK BETWEEN AUDIT COMMITTEES AND CORPORATE GOVERNANCE QUALITY A NORMATIVE AND EMPIRICAL OVERVIEW FOR THE US- AND GERMAN CAPITAL MARKET

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Abstract

Audit committees are a main instrument to increase corporate governance for US- and German listed corporations. The following analysis gives a normative and empirical overview of possible links between audit committees and corporate governance variables (capital costs and market reactions, earnings management and external management reporting, management fraud and external audit). In this context the job specification of audit committee members (independent financial experts) will be focused.

Keywords: audit committees, corporate governance research, financial expertise, board independence

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1. Introduction

A profound international competition between corporate governance and corporations constitutions systems has been going on since the middle of the last century (La Porta et al. (2002), p. 1147). A basic categorization has been made with regard to the ratio between in- and external corporate governance as well as to the management and supervising structure of publicly owned firms (one tier and two tier system). Amongst others, a partial convergence of both constitutional models indicates a high acceptance of audit committees in both systems of corporation's constitutions. However, the committee's competences are different in the one and two tier system as well as the main motives of their implementation. Within the two tier system, the audit committee has been implemented to support and relieve the supervisory board in preparing various tasks. In addition the committee is expected to strengthen corporate governance as a consequence of the high number of supervisory board members. Moreover, the appointment of financial experts as audit committee members is to counteract the lack of respective knowledge in the supervisory board. In contrast, the one tier system is by trend forcing a stronger personal separation between executive and non-executive directors in the board. In addition, major importance is placed on the independence of the committee members in the one tier system which is usually symptomatic for the separation of functions within the two tier system. As with the example of audit committees, it becomes clear that both models try to use the advantages of the respective constitutional systems. However, a general superiority of one system cannot be concluded.

The aim of the present analysis is to provide an overview of empirical survey results with regard to the acceptance of audit committees on the capital market and the influence of audit committees on corporate governance. Major attention is paid to a statistically proven relation between certain corporate governance variables and the implementation of audit committees, especially with regard to the independence and financial expertise of its members. The German stock corporation law will be used as an example to demonstrate the importance of audit committees within the two tier system. Similarly, the US-American capital market with its particular regulations of the stock exchange commission will be used for the one tier system.

2. Normative Analysis

2.1 Germany (two tier system)

2.1.1 Implementation

The discussion regarding the implementation of audit committees to enhance corporate governance grew more intense with the "control and transparency law" in 1998 (see Schmitz (2003), p. 179). Amongst others, the empirical survey of Coenenberg/Reinhart/Schmitz (1997) supports this relatively young movement deriving from a scientific economic source. The majority of the management board members of the 100 top German corporations in question were not aware of the necessity to implement audit committees in 1995. In contrast, the survey of Quick/Hoeller/Koprivica (2008) was able to prove an implementation quota of 100% for the DAX30 and 86% for the MDAX. Hence, the present survey results suggest that the majority of the listed stock corporations in the German prime standard have implemented audit committees to strengthen corporate governance.

In contrast to the USA, the German stock corporation law and commercial law have not yet stipulated a general, legally binding obligation for the implementation of audit committees. In fact, the decision to implement audit committees is subject to the autonomy of the supervisory board in terms of § 107 III 1 AktG. This voting right has already been part of the stock corporation law of 1937 and was reinforced by further reform act. The national legislator on purpose did not include the obligation to implement audit committees in order to guarantee highest flexibility with regard to the corporation's management. However, the demand for due diligence of the supervisory board accounting for an appropriate organisation of its activities, will lead to the implementation of audit committees with rising number of board members. Without audit committees, the necessary intensity of the supervision is no longer ensured. Consequently, the corporations voting right to implement audit committees becomes redundant with rising number of supervisory board members. Accordingly, this fact gives reasons for the recommendation in the German Corporate Governance Code (GCGC). According to this recommendation, the implementation of qualified audit committees should depend on the specific circumstances of the company as well as its numbers of members. Since its introduction, the GCGC explicitly advises the implementation of audit committees. In case the supervisory board is composed of only 3 to 6 members, the prevailing opinion allows for an abandonment of the implementation of audit committees. In this case, no explanation according to § 161 AktG is required, since such small supervisory board usually would not relate to the implementation of an audit committee.

The audit committee has been explicitly mentioned for the first time within the context of the commercial and stock corporation law since 2009. However, a general obligation to implement audit committees is still missing. In principle, only capital market oriented stock corporations in terms of § 264d HGB that do not have a supervisory board with the respective job specifications, are obligated to implement audit committees with at least one independent financial expert. Since all tasks of the audit committee may also be fulfilled by the plenum of the supervisory board, all stock corporations that are legally forced to implement supervisory boards still hold a voting right concerning the implementation of audit committees. Hence, the national legislator relies on the empirically proven high quota in complying with the GCGC.

2.1.2 Job specification

The matter of independence is implemented in the German stock corporation law in § 105 I 1 AktG. Thus, a member of the audit committee is not allowed to be an active management board member or permanent deputy, authorized officer or a general agent authorized for the entire corporations management at the same time. In addition and according to the prohibition of crosswise intersection, a member of the audit committee is not allowed to be a legal representative of a dependent company or of another corporation that engages a management board member of the corporation in question in the supervisory board. These regulations are common practice in the German two tier system. Therefore, the audit committee needs to evolve from the supervisory board and its members are not allowed to fulfil any managerial functions. In accordance with § 264d HGB, capital market oriented stock corporations need to appoint at least one independent member in the supervisory board or audit committee. However, this is the only article with regard to the term "independence" so far. In fact, the recommendation of the EU-commission of the 15th of February 2005 can be classified as a general guidance. A cooling off period of 2 years for former management board members to become supervisory board members of listed stock corporations is advised in 2009. An exception is granted, if shareholders holding more than 25% of the voting rights of the corporation are in favour of the nomination.

In addition to the stock corporation law standards, the GCGC recommends that supervisory board and hence audit committees should be composed of an adequate number of independent members. Thus, a member is independent if he has no commercial or personal relation to the corporation or its management that accounts for a conflict of interests. Furthermore, the GCGC advises a nomination of no more than two former management board members for the supervisory board. Moreover, the GCGC suggests that the present supervisory board chairman should not take the chair of the audit committee. However, the chairman of the audit committee should be independent. The cooling off period of two years for former management members to become audit committees chairman should be strictly adhered to. A missing compliance with the before mentioned code suggestions will not account for a justification with regard to the conformity declaration, since the compliance statement only relates to recommendations.

In addition to the independency, the job specification of the audit committee emphasises on the financial expertise of its members. In terms of § 100 I AktG, no specialist knowledge is mentioned explicitly. However, "a minimum level of common, economic, organisational and judicial knowledge, necessary for understanding and appropriately judging on all regular business transactions unassisted is demanded (BGH (1982), p. 991). Nonetheless, financial expertise is not mentioned explicitly. At least one member of the audit committee is expected to have the necessary expert knowledge with regard to accounting or auditing (financial expert). Yet, no comment is made on whether and in how far the audit committee chair is to be involved in this part.

Similarly, he GCGC only recommends that the audit committee should be composed of some members that are able to fulfil all tasks with the required knowledge, skills and professional experience at all times. Though, the GCGC provides a detailed job description of the audit committee's chairman. According to this, the audit committees chairman is expected to have special knowledge and experience with regard to the application of accounting standards and internal control procedures. Consequently, the GCGC expects the chairman to be a financial expert, whereas the national legislator only demands for compliance with the legal minimum requirements.

2.2 USA (one tier system)

2.2.1 Implementation

The implementation of audit committees on the US American capital market was first recommended in 1939/1949 by the Securities and Exchange Commission (SEC) and the New York Stock Exchange (NYSE). Since corporations did not put this recommendation into effect in the following years, the American Institute of Certified Public Accountants (AICPA) (1967) renewed and enhanced the recommendations of the SEC. Within this context, the composition of audit committee members and their tasks were discussed for the first time. A liability law case (US District Court for the Southern Disctrict of New York (1968)) led to a vote for an obligatory disclosure in the proxy statement with regard to the implementation of audit committee and its members by the SEC (1974). In addition to the name of the members, the disclosure of the number of meetings and their main tasks and responsibilities became obligatory with the 01st of July 1978. Since that time, it became mandatory for all listed corporations at the NYSE to implement an independent audit committee. This was stipulated by the SEC (1978). The American Stock Exchange (AMEX) followed in 1980 and the National Association of Securities Dealers Automated Quotations (NASDAQ) in 2001. In 1987, the results of the National Commission on Fraudulent Financial Reporting became public, also emphasising the importance of audit committees regarding the corporation's supervision. Within this context, the national commission recommended the implementation of audit committees for all publicly owned firms. The "Blue Ribbon Report" went along with this after a couple of years in 1999. The Sarbanes Oxley Act stipulated an implicit obligation for the implementation of audit committees as permanent committees of the board of directors for all corporations listed at a US stock exchange. In addition, the job specification of the audit committee's members was described in detail. Opposed to German stock corporation law, the corporations in question do not have an option with regard to the implementation of audit committees.

2.2.2 Job Specification

According to the Sarbanes Oxley Act, all members of the audit committee have to be financially and personally independent of the corporation's management (Section 301). The term independent is applicable only if no direct or indirect corporate or affiliate payment is collected by an audit committee member. The regulations of the Sarbanes Oxley Act are of exterritorial nature. Hence, the rules of financial independence would only hardly be applicable in countries with internal employee participation (e.g. German corporations that are secondary listed at a US American stock exchange). The co-determination of the supervisory board would be dependent in terms of their salary. In order to preserve the exterritorial effect, the SEC is expecting only managing employees to comply with the rules of financial independence (see Altmeppen (2004), p. 401).

Depending on the stock exchange listing, supplementary regulations of the NYSE, respective the NASDAQ may apply in addition to the ones of the SEC. According to Section 303 of the Sarbanes Oxley Act, a listing at the NYSE requires the independence of all audit committee members. Thus, an audit committee member is independent if he is not an employee of the (affiliated) corporation currently or has been for the past three years. In addition his direct relatives are not part of the management and have not been for the past three years (NYSE (2004)). With regard to the audit committee member's independence, the NASDAQ demands for an enhancement of the greater SEC criteria. Thus, demanding that an audit committee member has not participated in the preparation of the annual financial statements as a governing body within the last three years. The Sarbanes Oxley Act does not provide for such cooling off periods after termination of employment. However, as already described above, the German stock corporation law generally arranges for a cooling off period of two years for former management board members to become supervisory board members.

In addition to the requirements of independence, the Sarbanes Oxley Act is demanding for at least one financial expert within the audit committee. Initially, the SEC was interested in stipulating that this person ought to be an expert in terms of accounting. However, in the end they refrained from doing so. In addition to accounting, it is hence acceptable if the expert has knowledge of other finance areas. An exception to this rule may apply if it has been briefly described why no financial expert was appointed as an audit committee member. In general, this is not often the case in order to maintain a good reputation (see Altmeppen (2004), p. 397). The requirement to appoint at least one financial expert is consistent with the amendments of the German stock corporation law. Though in contrast to the German legislator, the SEC is specifying the financial expert qualification in detail. Thus the financial expert is expected to have good knowledge with regard to the preparation of annual financial statement and accounting standards. In addition, he must have the relevant skills to generally judge on the application of accounting policies with regard to estimation, amortization and the setting up of accruals. Furthermore, he needs to be experienced in the preparation, assessment, analysis and evaluation of financial statements which are comparable in scope and complexity to the registered corporation’s financial statement. Moreover, he is expected to be experienced in actively supervising people that are assigned to the previously described tasks (Section 401 and 407 of the Sarbanes Oxley Act). Such requirements correspond to the job specifications of accountants, finance directors, accounting directors or similar profession. The Sarbanes Oxley Act does not comment on the qualification of other audit committee members.

In case a corporation is listed at the NYSE, at least one member of the audit committee needs to be experienced in finance and accounting management (NYSE (2004), Section 307). This is consistent with the minimum requirement of one financial expert according to the Sarbanes Oxley Act. Furthermore, all members need to prove basic knowledge in finance and accounting or are required to be financially literate after a reasonable time. Hence, the NYSE requirements are more demanding than the ones of the Sarbanes Oxley Act with regard to the professional qualification of the audit committee members.

In case a corporation is listed at the NASDAQ, all audit committee members are expected to understand and comprehend the respective corporation’s financial statements at the time of their nomination. The regulation with regard to the financial expertise is comparable to the one of the NYSE. In accordance with the regulations of the NYSE, at least one audit committee member is to be experienced in finance and accounting (financial expert). Thus, a professional qualification with regard to accounting or any other comparable experience or basic background knowledge is expected (NASDAQ (2006), Section 4350).

3. Empirical relevance of audit committees

3.1 Capital costs and market reactions

Since no multivariate empirical studies concerning the impact of audit committees on corporate governance are available for the German capital market, US American studies have been used primary. The following explanation provide an overview of current research. According to Ashbaugh/Collins/LaFond (2004), the number of independent audit committee members is related to lower costs of capital. Anderson/Mansi/Reeb (2003) empirically proved that audit committees with independent members imply lower interest on debt. In contrast, the results of Bhagat/Black (1999) suggest a lower corporate performance in case the majority of the audit committee members are independent. Similarly, this holds true for the analysis of Klein (1998). Likewise, no statistical significance exists regarding the number of non-executive directors and the enhancement of corporate performance.

In addition, the study of DeFond/Hann/Hu (2005) was addressing the question whether the existence of an accounting expert or a member with any other financial expertise had an influence on the amount of accumulated abnormal return on investment. The results of this study provided a statistical significant positive evidence for an accounting expert. The studies of Wild (1994);(1996) found a significant positive increase of accumulated abnormal accruals, e.g. stock price fluctuation on the statement results.

The empirical results suggest that the implementation of independent and financially literate audit committees provides and increases confidence on the capital market. Hence, the demonstrated attempts of the standard setter regarding the job specifications of audit committee members (independence and financial expertise) are legitimated from an economic point of view for the US American one tier system.

3.2 Earnings management and external management reporting

An offensive earnings management is sanctioned by the capital market with regard to balance sheet analysis. Hence, a conservative performance is approved. The earnings management performance is measured by means of abnormal accruals. By supervising managing directors, the audit committee is due to provide incentives for the reduction of earnings management.

According to Ebrahim (2007), a significant negative correlation exists between the number of independent audit committee members and the accounting policy, measured by means of abnormal accruals. Xie/Davidson/DaDalt (2001) analysed the financial expertise of audit committee members. They were able to prove a significant evidence for a negative influence of investment banking members and non-excutive directors on the amount of corporations accounting policy, measured by means of discretionary (disproportional) accruals.

Bédard/Chtourou/Courteau (2004) verified a significant negative influence on the accounting policy, in case at least one audit committee member had the respective financial expertise. A corresponding relation applies to audit committees with solely non-executive directors without substantial corporate integration, provided that the corporate addressees have detailed knowledge of the audit committee's job specification. According to the research of Yang/Krishnan (2005), a significant positive relation exists between the share property of the audit committee members and the amount of non-discretionary operative accruals. Further studies of Klein (2002) provide evidence for a significant negative correlation between the audit committee's independence and accounting policy in case the audit committee not solely, but by majority consists of non-executive directors. The respective relation is measured by means of the absolute value of adjusted abnormal accruals.

Other areas of research seek to addresses the impact of audit committees on the occurrence of subsequent accounting adjustment. Reactive adjustment leads to negative market reactions. From a capital market point of view, they are caused by (intentional) misinterpretations of the corporate management. According to the empirical results of Abbott/Parker/Peters (2004), the frequency of occurrence of subsequent adjustment of the annual financial statement may be reduced significantly by audit committees solely consisting of independent members and/or the existence of at least one financial expert.

Furthermore, accounting policy is directly influencing quality and quantity of the external management reporting. Hence, by pooling financial expertise the audit committee fulfils an advisory function to the managing directors. The joint effort is to provide the capital market with the best available management reporting. The survey of Karamanou/Vafeas (2005) proves a significant positive correlation between financial expertise in the audit committee and the frequency, e.g. quality of the management's performance forecast. The results differentiate in how far the corporation responds to negative forecasts ("bad news") and how well they are documented. In addition, attention has been paid to the conformity of corporation information with the analyst's opinion. However, according to the survey of Peasnell/Pope/Young (2005), no direct relation exists between the implementation of audit committees and the corporation's accounting policy.

3.3 Management fraud

In addition to the impact on accounting policy, empirical corporate governance research is addressing possible consequences of audit committees on the existence and prevention of management fraud. Here, the occurrence of fraud is associated with an intentional erratic behaviour of the management and results from information asymmetries between the corporation's management and the capital market. The continuous supervision of the management by the audit committee seeks to increase the likelihood of revealing fraud. In addition, it is likely that the implementation of audit committees may impede the occurrence of accounting fraud pre-emptively and avoid falsification of the balance sheet by means of due diligence.

In case the submitted financial statement documents are rejected by the SEC in the context of enforcement, negative publicity and damage to the corporation's reputation will be the consequences. According to Abbott/Park/Parker (2000), audit committees without continuous employees, holding a meeting for at least twice a year, might be able to alleviate the rejection of the SEC. A corresponding significant negative influence can be verified for audit committees without employees or managing directors having substantial relations to the corporation or its management. These findings are consistent with the research of Krishnan (2005). Hence, an independent and financially literate audit committee reduces the risk of internal control-system failure. However, the corporation is obliged to report on the weakness in case of a change of the auditor. The survey of McMullen (1996) reveals a significant negative correlation between the existence of audit committees and the sanctions of the SEC. Farber (2005) empirically proves that accounting fraud usually occurs more often in corporations with audit committees consisting of only few non-managing directors. According to Beasley et al. (2000), the likelihood of management fraud diminishes with the implementation of audit committees that solely consist of independent members. The sole existence of audit committees leads to a corresponding significant negative influence. The research of Uzun/Szewczyk/Varma (2004) corresponds with the mentioned empirical findings. Thus, the occurrence of fraud is negatively correlated with the existence of audit committees, respectively positively correlated with audit committees consisting of dependent, non-executive directors. These results are supplemented by the research of McMullen/Raghunandan (1996). By trend, corporations with no financial statement fraud have audit committees solely consisting of non-managing directors, i. e. independent audit committees nominating at least one financial expert (e. g. auditor).

3.4 External audit

Amongst others, US-American surveys emphasise on the relation between audit committees and external audit. In addition to the supervision of management and accounting, this activity aims at supervising the external auditor. By continuous monitoring of the auditor's qualification, the audit committee is able to enhance the quality of corporate governance. Amongst others, the relation between compensation of audit and non-audit activities provides a basis for judging on the independence of the external auditor. According to the prevailing opinion, an increase in compensation of audit (non-audit) activities leads to an increase (decrease) in the auditor's independence ceteris paribus. By trend, non-audit activities such as consulting promote the annual auditor's dependence on the management. In addition, they imply the risk of financial side transfers, leading to an inferior audit quality. Hence, the auditor might be willing to grant a concession with regard to the certification of the financial statement, he might not be granting in case he had no consulting mandate.

Carcello/Hermanson/Neal (2002) provided evidence for a significant positive relation between audit committees solely or by majority consisting of independent members and the amount of compensation for audit activities of the auditor. According to Abbott et al. (2003a), a completely independent audit committee with respective financial expertise has a positive influence on audit fee. Another survey of Abbott et al. (2003b) concludes that audit committees with solely independent members, holding a meeting at least four times a year might reduce the ratio for the compensation of the non-audit activities, since they might endanger auditor independence. Consequently, this implies a significant positive relation between the independence of audit committee members and auditor independence. However, the results of Vafeas/Waegelein (2007) are opposed to the aforementioned findings. Their results suggest a significant positive relation between the requirement of appointing at least one managing director or person being a member of an audit committee of another Fortune 500 corporation, into the audit committee and the amount of the audit fee.

Auditor independence serves as a substitute for the audit quality. Within an international framework, it is measured not only by means of the auditor's fee but of the size of the audit company. According to the basic description of the audit theory of DeAngelo (1981), auditor independence and hence audit quality increases with the appointment of international awarded and top-selling audit firms in comparison with other audit and trust companies. Empirical surveys have been addressing possible relations between the implementation of audit committees and the nomination of the annual auditor. If an independent audit committee is responsible for the nomination of the auditor and thus might generate an adequate audit quality in favour of the shareholders, counterproductive intervention of the management are less likely.

The empirical survey of Eichenseher/Shields (1985) already verifies that corporations tend to implement audit committees in case a new auditor needs to be appointed and one of the eight top-selling audit companies is involved. Additional empirically proven relations between audit committees and the external audit refer to the independence of the audit committee members and the likelihood of a cancellation of the auditor's contract. According to Lee/Mande/Ortmann (2004), a significant negative relation exists between a solely independent audit committee and the cancellation, e. g. resignation of the audit mandate. The research of Knapp (1987) suggests a significant positive influence of the existence of audit committees on the appointment of one of the eight top-selling companies, the economic situation of the corporation in question and the likelihood of the board supporting the annual auditor in case a conflict between auditor and management arises.

The majority of the US-American empirical research could verify a positive influence of audit committees on the quality of external annual audit resulting from the normative approach of the legislator. Until the end of the 90s of the 20th Century empirical research was emphasising only on the existence of audit committees. Later, with the introduction of the Sarbanes Oxley Act, the job specification of the audit committee became more important in terms of empirical research. Attention needs to be paid to the trend that only a cumulative existence of independence and financial expertise leads to significant positive impacts on the amount of the audit fee. The surveys often comply with the normative status quo of the Sarbanes Oxley Act, e.

g. all members of the audit committee are independent and at least one member is a financial expert.

4. Conclusion

Audit committees are of great importance in order to strengthen corporate governance within the Anglo-American one tier system and the German two tier system. The comparative normative analysis suggests that the audit committee is representative for the alternating convergence of the one and two tier systems. With regard to the one tier system, the independent audit committee serves as a monitoring instrument for the managing directors of the board of directors. With regard to the two tier system, the audit committee is responsible for preparing the plenum's decision. And with the nomination of at least one financial expert it is ought to counteract the increase of professionalism within the supervisory board. The ideas of the European commission regarding the job specification of audit committees have been realised in Germany. As a result, independence and financial expertise are of equal importance. This is due to the fact that the EU member states use one and tier systems, therefore demanding the equality of both requirements.

Overall, the requirements for the implementation and job specification of audit committees are more restrictive in the US-American one tier system. They ought to impede a potential self-assessment of the board of directors. An objective supervision of financial accounting and executive directors is not feasible with dependent audit committee members. Hence, the subject of the member's independence is of major importance within the one tier system. In contrast, the two tier system is characterised by a vast separation between managing and supervising tasks. As a result, the requirements for audit committee members are described in detail and more restrictive in the USA. However, the independence of audit committee members might be impaired as well in the two tier system. The requirements of the German law (at least one independent member in the audit committee) might not be sufficient if a member accepts an additional position in the supervisory board of another corporation of the same industry. This would lead to an increase in risk of conflicts of interests of audit committee members. Though, with the implementation of audit committees the German two tier system aims at a professional execution of the supervisory board's tasks by a purposive preparation of the plenum's decision.

The normative concretion has been analysed along with empirical findings of the international corporate governance research concerning audit committees. Yet, the present empirical results of capital market surveys are primarily based on the US American one tier system. With regard to the rising importance of audit committees in the two tier system, further studies are needed. Emphasise should be placed on the question whether and in how far the implementation of audit committees, including respective job specification has an actual influence on the improvement of corporate governance. With regard to the one tier system, empirical results suggest a correlation between the implementation and job specification of audit committees and several corporate governance indicators. Many surveys conclude a significant positive correlation between the nomination of financial experts and independent members in the audit committee and the aforementioned corporate governance variables.

Hence, further studies should address the question whether and in how far the improvement of corporate performance within the one tier system by the appointment of independent and financial literate audit committee members can be adopted to the German two tier system. Yet, it needs to be considered that the competencies of the German audit committee cannot be compared to the US-American as a result of the separation between the corporation's management and supervision. By trend, the majority of the respective studies suggest that the US American capital market has more confidence in corporations with independent and financially literate audit committee members. Thus, the certification of an increase in corporate governance quality might become more realistic. Again, this fact should lead to an increase in research on audit committees within the German two tier system.

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