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Do audit committees reduce the agency costs of ownership structure?☆

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ABSTRACT

We investigate the agency costs of corporate ownership structure and the role of audit committees in mitigating their effect. Using China as a laboratory, where audit committees are voluntary, we study the demand for and value relevance of audit committees conditional on the various agency costs of corporate ownership. Audit committees complement existing internal governance systems by reducing the agency conflicts embedded in ownership structure. They are always value relevant, the magnitude of which depends upon the level and complexity of the ownership lattice. Audit committees substitute for inefficient external regulatory environments, particularly where weak legal institutions predominate. Our results are robust to firm size, investment level and financial leverage.

1. Introduction

Since Jensen and Meckling's (1976) discussion of the implicit and explicit contracts between owners and managers, research has improved our understanding of the agency costs relating to the separation of ownership and control. However, it is documented in a global context that the diffused shareholdings underlying Jensen and Meckling (1976) are not the norm in most countries. Instead, concentrated, pyramid, and state[1]

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[1] In this paper, the terms, 'state' and 'government' are used interchangeably.

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ownership structures are far more common (La Porta et al., 1999; Claessens et al., 2002; Fan et al, 2011; Huyghebaert and Wang, 2012; Duchin and Sosyura, 2012; Boubakri et al., 2013).

In this paper, we investigate whether audit committees offset any negative valuation effects from having specific shareholder structures, such as state shareholders or pyramid holdings. Financial reporting quality is at the very foundation of good governance and a central mechanism for reducing a firm's agency costs. Literature has also shown that audit committees enhance managerial accountability and are an effective component of corporate governance. Since audit committees provide better quality assurance, their usefulness should increase in response to the level of inherent agency problems within a firm.[2]

Whereas in most developed markets, audit committees are necessary for stock exchange listing, in China they are optional. By examining the determinants of audit committee formation and analyzing the moderating impact of ownership structure, we are able to disentangle the agency cost of controlling ownership (state versus private, pyramid versus direct shareholdings) and its effect on corporate value. In this regard, we employ a comprehensive sample of Chinese firms immediately following government-instigated corporate reforms during which audit committees were formally encouraged but not obligatory.

Our core empirical analysis presents evidence that privately-owned companies are more likely to have an audit committee when the cash flow rights of the controlling owner are at either extreme of the ownership distribution. This is in contrast to state-owned firms where the presence of an audit committee is invariant to the level of the state shareholder's cash flow rights. We also document that audit committees are value relevant, particularly in firms with severe agency relationships. Keeping the source of ownership constant, audit committees are more likely to be found in companies that have stronger levels of corporate governance, such as when there are more non-executive directors, more frequent board meetings, and a larger board. We also find that they are associated with firms where the chairman and chief executive role is combined. At the firm level, audit committees appear to complement other forms of good corporate governance. However, we find that audit committees are more common in weak legal environments and appear to substitute for a lack of resilient external governance structures.

2. Regulatory environment and literature review

In order to improve the quality of listed companies and establish a modern corporate governance culture in China, the Chinese Security Regulation Commission (CSRC) and the National Economic and Trade Commission (NETC) have issued a number of regulations and guidelines on corporate governance. The most important document is the "Code for Corporate Governance of Listed Companies" issued by the CSRC and the NETC in January 2001.

A major component of the Code is the recommendation that committees for strategy, audit, remuneration, and nomination be formed. Unlike other countries, the formation of board sub-committees, such as the audit committee, is not obligatory but encouraged. It is not uncommon to see company directors on their own audit committee. However, the majority of audit committee members should be independent and at least one individual should have financial expertise.

2.1. Ownership structure in China

The objectives and performance of corporate managers will, naturally, be influenced by the objectives of shareholders. For example, socio-political agendas will be an important driver of managerial behavior in firms with state-shareholders, whether they relate to a capping of profits, a targeted investment strategy or positive employment practices. In addition, state shareholders are unlikely to have specialized knowledge of a firm's operations, allowing managers some scope in pursuing their personal objectives. Executive turnover and bonuses also tend to be less in firms with state shareholdings (Boycko et al., 1996; Dewenter and

[2] There is a large body of research, theoretical and empirical, that considers how audit committees contribute to the internal corporate governance process and improve financial reporting quality. Recent examples include Defond et al. (2005), Karamanou and Vafeas (2005), Krishnan (2005), Vafeas (2005), Gaynor, et al. (2006), Abbott, et al. (2007), Chen and Zhou (2007), Lennox and Park (2007), Archambeault et al. (2008), Krishnan and Visvanathan (2008), Beasley et al. (2009), Goh (2009), Hoitash, et al. (2009), Magilke, et al. (2009), Naiker and Sharma (2009), Caskey, et al. (2010), Engel et al. (2010), Ghosh et al. (2010), and Price et al. (2011).