AN EXAMINATION OF THE QUALITY OF AUDIT COMMITTEE DISCLOSURES OF AUSTRALIA'S LEADING CORPORATIONS

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ABSTRACT

In order to extend the work done in the area of audit committees and corporate governance, this study will examine the profile of the audit committee and its efficacy in performing its function. This investigation will examine the correlation between the numbers of directors on the audit committee with formal financial qualifications against the quality of disclosure of financial reporting and external audit oversight functions. The results of the study show a positive correlation and that an increase in number of formally financially qualified directors improves the quality of the disclosure of the financial reporting and audit oversight functions.

INTRODUCTION

With Australian regulatory changes requiring entities listed on the Australian Stock Exchange (ASX) to have an audit committee, their role in corporate governance research is gaining a renewed popularity. Recommendations that the committee is structured so as to ensure that there is effective oversight of an entity's financial reporting and external audit environment means that at least one member has financial expertise. This paper seeks to further an understanding of the role of the audit committee in ensuring good corporate governance by examining the link between the number of directors with financial expertise on the audit committee and the level and quality of disclosures of audit committee roles, responsibilities and processes. There has been little research into the value of the audit committee as much of the work of committees is done in private with no direct public accountability (Spira, 2003). As a sub-set of the Board, the audit committee outputs are reports and recommendations to the Board and are not publicly disclosed. The question this paper poses therefore is how does one assess the effectiveness of the audit committee as a key governance mechanism? The authors believe that this could be answered by the nature and extent of the disclosures of the responsibilities and processes of the audit committees. Although, Carcello *et al*. (2002) suggest that some audit committees choose to limit their disclosures due to cost or potential legal liability issues, it is their belief, that full and fair disclosure to capital markets is advantageous.

In spite of the requirement for listed entities to have an audit committee, there is little guidance as to what they should do and how their accountability should be discharged. Some guidance may be found in industry (see for example, Ernst and Young, 2002). Buchalter and Yokomoto (2003) also summarize the responsibilities of the audit committee to include such matters such as monitoring and overseeing the financial reporting process and overseeing the external audit function. This paper examines the disclosures on audit committees in an attempt to answer the question posed as to how to assess the effectiveness of the audit committee as a key governance mechanism. As these disclosures are typically contained within the corporate governance statements of the entities listed on the ASX, an examination of the disclosures on audit committee activities will be undertaken and a rating for the level and quality of disclosures will be assigned. Recommendations from regulatory bodies and business practice shows that best practice in this area is for at least one member of the committee to be a "financial expert", thus assuming a link between financial expertise and financial reporting oversight (McDaniel *et al.*, 2002).

THE STUDY AND RESEARCH METHODOLOGY

The research question in this study is to gauge the extent to which the number of directors in the audit committee with formal financial qualifications will influence the quality of the disclosures about the financial reporting and the oversight of the external auditor. The research question that will be tested is *whether increasing the number of financially qualified directors on the audit committee improves the disclosures regarding the process of financial reporting and external audit oversight.*

In the analysis, the number of directors with formal financial qualifications will act as the independent variable while the disclosures about the financial reporting and external auditors' oversight function will be the dependent variables. In developing the criteria by which to assess the financial qualifications of the directors, the authors drew on the definitions from the various authorities and decided on the following definition for such a director: *a financially qualified director must have an undergraduate qualification in accounting, commerce, finance or economics, or be a member of either of the two professional accounting bodies.* Although this is similar to ASX recommendations, it is a tighter criterion to that imposed for an "audit committee financial expert" by the overseas regulatory bodies. As part of the identification process for which companies to sample, consideration was given primarily to companies listed on the ASX, as they are reporting entities with easily accessible data and these companies are likely to have a large group of stakeholders denoting a wider accountability. The expectation is also that these companies will be at the forefront in best corporate governance practice. In sourcing the data for this study, reliance was placed on general-purpose financial reports specifically for information and disclosures relating to the audit committee. As the requirement for an audit committee is only newly implemented, the expectation is that the disclosures about processes are likely to be varied in quality and content (for background see Richardson, Barut and Foreman, 2004). The relevant data was collected using the listed entity's published financial statements from the Connect4 Database, where the key documents referenced were the *Corporate Governance Statements*, and the *Directors' Profiles*. The data used in this paper is sourced from a sample representing the top 150 entities listed on the ASX based on market capitalization at close of business on 3rd July 2003. The annual reports for the sampled top 150 listed entities (useable data 120) were sourced for the 2002 year (2003 company data was incomplete) and the information regarding the audit committee's financial report oversight function and the auditor oversight function was collected. These disclosures were ranked using a scoring system based on a range of 0 (zero) to 3. A rating of zero was given for no disclosure or vague and minimal disclosure, and a maximum of three was given for more comprehensive and outstanding information which gave a full and clear account of the audit committee processes.

ANALYSIS AND FINDINGS

As a test of the associations specified in the hypotheses, correlation analysis was used for the study. Correlation analysis was used to determine the strength of the relationship between the independent variable and the dependent variables for all the models. The numerical descriptive measure of correlation is provided by the Pearson product moment coefficient of correlation, *r,* which measures the strength of the linear relationship between the two variables (McClave *et al.,* 2001). Table 1 shows the correlation results and indicates that for the majority of the entities the number of directors with formal financial qualifications does bear a relationship to the level of all disclosures. Once the number of financially qualified directors on the audit committee increases to more than two, the results show a positive correlation for all aspects of disclosure.

TABLE 1: RESULTS FROM THE CORRELATION ANALYSIS			
Dependent Variable	***Independent variable: Formal Financial Qualifications of Directors***		
	Entities with zero Fin.Qual.Dir (N=22)	**Entities with one or two Fin.Qual.Dir (N = 83)**	**Entities with 3 or more Fin.Qual.Dir (N = 15)**
All disclosure	N/A	-0.04075	0.41828
Fin report O/S	N/A	-0.05896	0.21129
Ext Audit O/S	N/A	-0.01767	0.57143

The results of the study support the hypothesis that an overall positive relationship would exist between the financial expertise of directors and the oversight functions of the audit committees. Indeed as the model was changed to allow for an increase in the number of financially qualified directors, the results become more attractive and there was marked improvement in the quality of audit committee disclosure with regard to the process of financial reporting and external audit oversight. Thus the number of financially qualified directors on the audit committee does impact on the disclosures about the financial oversight function. The results would suggest that as the numbers of such directors increases, the level of disclosures increases, thereby supporting the changes to corporate governance mechanisms calling for financially qualified directors on audit committees. Even so, the results in Table 1, would imply that there needs to be at least three directors on the audit committee who are financially qualified to make a difference to the quality of the output.

Even given the strong correlation presented in Table 1, the expectation that formal financial qualifications would prove a boon for an audit committee member should not be seen as the only criterion to be taken into consideration when looking at suitability for audit committee membership. Other items would include common sense, wide experience, independence, good judgment and an understanding of the role of the audit committee, thus detailed knowledge of financial reporting standards may not be as important (Jones *et al*., 2001).

DISCUSSION AND IMPLICATIONS

This paper is an exploratory study of the oversight functions of an audit committee in light of corporate collapses and changes to listing requirements. We provide evidence that disclosures about the audit committee oversight function are related to the number of directors with formal financial qualifications on the audit committee. As the audit committee is required to discuss and evaluate the company's financial reporting and to oversee the external auditor functions, the results suggest that the inclusion on the committee of directors with formal financial qualifications is likely to add to the disclosures reported by the company and the explanations given. Further work could be done to address the varied results achieved when the numbers of formally qualified directors increase. The major limitation of this study was the reliance on publicly available data, which was appropriate for a study on the quality of disclosure but inadequate to assess the ultimate effectiveness of the committee.

REFERENCES

Contact authors for full reference list.