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Audit committees, corporate governance, and shareholder wealth: Evidence from Korea

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A B S T R A C T

This paper examines the effect of audit committee appointments on shareholder wealth in Korea after the Asian financial crisis. We find that stock prices generally increase with audit committee appointments. In contrast, chaebol (business group) affiliates and firms switching audit committee membership are associated with significantly lower stock returns, probably due to the management's opportunistic behavior. However, the independence and financial literacy of the audit committee members appear to mitigate the opportunistic behavior. Therefore, our result confirms that the characteristics of the audit committee strengthen or weaken the existing corporate governance. We discuss the implications of our results obtained under Korea's unique corporate governance structure.

1. Introduction

Following the Asian financial crisis, many emerging economies have attempted to improve corporate governance to protect shareholder wealth, since poor governance has been regarded as one of the main reasons for the massive decline in shareholder value during the crisis (Johnson et al., 2000; Mitton, 2002; Lemmon and Lins, 2003; Baek et al., 2004; Nam and Nam, 2004). Many Asian governments have made efforts to reform their corporate governance by introducing a number of governance devices from developed economies. The audit committee is one of these key governance devices.

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Around the time when the Sarbanes–Oxley Act (SOX hereafter) was introduced in the U.S. to help strengthen the role of the audit committee system among others, a number of emerging countries suffering from the financial crisis (e.g., Singapore, Thailand, Malaysia, Hong Kong, and Korea) also mandated the audit committee system to help protect shareholders' wealth.

This paper investigates the effect of audit committee characteristics in Korea by examining the announcement effect of audit committee member appointments on shareholder wealth. Specifically, we study how the market reacts to important characteristics of appointed members. We examine the effect of financial expertise and member switches in particular because existing literature recognizes the importance of financial/accounting expertise of audit committee members (e.g., Davidson et al., 2004; Defond et al., 2005; Coates et al., 2007). Also, there is evidence that changes of auditors have a significant negative market impact (e.g., Fried and Schiff, 1981; Klock, 1994; Knechel et al., 2007). More importantly, we examine whether the impact of these individual characteristics of audit committee members on shareholder wealth depends on the existing governance structures such as membership of business group (e.g., chaebol affiliations), characterized by strong management control, and independence of the audit committees (e.g., Xie et al., 2003; Pomeroy and Thornton, 2008).

An effective audit committee system in the U.S. may not be as effective in an emerging market because of its unique characteristics of the audit committee, corporate governance and legal environment. Nevertheless, few studies examine the effect of the audit committee characteristics in emerging markets after their extensive mandated regulatory reforms. Our study explores unique characteristics of Korean audit committees and corporate structure – business group (known as chaebol). First, Kim (2007) emphasizes that the role of Korean audit committees is more comprehensive than that of the U.S. counterparts. Korean audit committees are expected to perform *operational* audits as well as *financial/accounting* audits, for example. Therefore, we can examine whether the documented importance of financial expertise extends to the case in which the function of audit committees is more comprehensive than *financial/accounting* audits. Second, it is believed that these regulatory changes of Securities and Exchange Act (SEA hereafter) may have targeted large industrial groups (i.e., chaebols) prominent in Korea. Given the strong control by management in chaebols, it is interesting to examine whether the market response to member appointments is dependent upon firms' chaebol affiliations.[1] The two results above observed in Korea provide important implications for the relation between the characteristics of audit committee members and firms' governance structures.

Overall, our results suggest that the corporate governance reform regarding audit committees in Korea appears to be effective in general.[2] More specifically, we find significantly positive cumulative abnormal returns (CARs) around 182 audit committee appointment announcements in Korea. Therefore, we conclude that the choice of audit committee members on average is expected to improve shareholder wealth. We show that chaebol-affiliated firms are associated with significantly lower abnormal announcement stock returns than non-chaebol firms. This suggests that the market does not value the appointment of audit committee members in chaebol firms as much as in non-chaebol ones. More importantly, we find that chaebol affiliation (relative to non-chaebol) is associated with negative market responses only when the audit committee is not independent. That is, when the audit committee is independent, the announcement effect is about the same for both chaebol and non-chaebol firms. The implication is that the market perceives independent audit committees to be equally effective regardless of chaebol affiliation.

We also find that announcement stock returns are significantly higher for the appointment of financially literate members when the company has an independent audit committee. This finding is consistent with Defond et al. (2005), who argue that firms with better governance have more positive stock price reactions to the appointment of financial experts. An interesting observation is that the impact of financial literacy in Korea is quite apparent even though 'financial literacy' is defined very broadly in our sample. This is likely due to the distinct nature of Korean audit committees in performing *operational* audits as well as *accounting* audits, which will be discussed in more detail. Furthermore,

[1] For the costs and benefits of Korean chaebols, refer to Ferris et al. (2003). Other relevant references for chaebols are Joh (2003), Lee et al. (2009), and Baek et al. (2004, 2006). For corporate governance in Asian-Pacific countries, refer to Friedman et al. (2003) and Lemmon and Lins (2003).

[2] This view is consistent with Choi et al. (2007) who document the positive effects of board independence on firm performance in Korea after the crisis. They show that firm performance measured by Tobin's Q and family holdings are negatively related.