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Research Note

A research note: The informational benefits of CEO attendance-by-invitation at audit committee meetings

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ABSTRACT

This study contributes to the policy debate about independent audit committees by examining the occurrence and consequences of CEO attendance-by-invitation at audit committee meetings. We investigate whether this is a way for powerful CEOs to exert their influence over audit committee matters or an informal channel for information sharing between management and audit committees. We find that CEO attendance-by-invitation at audit committee meetings is positively related to firm complexity and firm governance practices, and is associated with lower earnings opacity. These results are consistent with CEO attendance-by-invitation at audit committee meetings enhancing information sharing between firm management and audit committees. Thus, this study identifies significant benefits from allowing CEOs to act as informal advisors at audit committee meetings.

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1. Introduction

Around the world, policymakers are requiring firms to form audit committees that are independent from firm management. For example, the Sarbanes-Oxley Act in the United States and Australia's Corporate Governance Principles and Recommendations require audit committees be comprised solely of independent or non-executive directors. Similar guidance also exists in Belgium, Canada, Finland, France, Italy, Luxembourg, New Zealand, Pakistan, Russia, Singapore, South Africa, Switzerland and the United Kingdom.[1] These policies are based on the view that management involvement in audit committee matters is dominated by agency concerns, e.g. CEOs exerting their influence over audit committee outcomes to further their own self-interest. Consistent with these expectations, academic research finds that firm accounting quality is higher when audit committees are comprised of independent directors, directors without social ties to the CEO and when the CEO is not involved in the selection of audit committee members (Klein, 2002b; Bronson et al., 2009; Carcello et al., 2011; Bruynseels and Cardinaels, 2014).

Yet, audit committees also rely on information provided by firm management to perform their monitoring function and make effective decisions (Adams and Ferreira, 2007; Chen et al., 2015). By removing the formal involvement of management

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[1] See corporate governance codes available at: http://www.ecgi.org/codes/all_codes.php. Most countries have comply-or-explain codes rather than mandatory requirements.

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on audit committees, a vital channel of communication between management and audit committees is lost. The consequence is that information sharing between management and audit committee members now takes place through informal channels, such as meetings between the audit committee chairman (and other members) and firm management outside of audit committee meetings, conversations between audit committee members and firm management, and firm management being invited to informally attend audit committee meetings to present information or answer questions.

In this study, we examine the occurrence and consequences of an unexplored phenomenon – CEO attendance-by-invitation at audit committee meetings.[2] We concentrate on this phenomenon as there are indications from several countries that firms are inviting their CEOs to informally attend audit committee meetings. For example, the 2005–2014 annual reports of Australia's Fairfax Media Ltd state that their CEO attends audit and risk committee meetings "as an invitee of the committee." The 2013 annual report of Switzerland's Alpiq Holdings states that "as a rule, the Chairman, CEO, CFO, Head of Group Internal Audit and the auditors attend the meetings of the audit and risk committee." In addition, the United Kingdom's Corporate Governance Code states that "no one other than the committee chairman and members is entitled to be present at a meeting of the nomination, audit or remuneration committee, but others may attend at the invitation of the committee" (FRC, 2012, Section B.1, pg 11).

We propose two possible explanations for CEO attendance-by-invitation at audit committee meetings. The first explanation, termed *CEO power*, is based on agency theory and proposes that CEO attendance-by-invitation at audit committee meetings is another channel for CEOs to exert influence over audit committee matters. This explanation suggests that CEOs are effectively inviting themselves to audit committee meetings, allowing them to exert influence over audit committee matters and reduce the independence of the audit committee. This scenario is expected to be associated with powerful CEOs and weak firm governance practices, and result in lower quality financial reporting.

The second explanation, termed *information sharing,* proposes that audit committees invite CEOs to informally attend their meetings because they receive the benefits of enhanced information exchange about accounting-related issues with the CEO.[3] Since the financial reporting process can be complex, audit committee members can potentially benefit from CEOs providing additional information about the firm's current and future operating environment and further explanations of particular accounting treatments. This scenario is expected to be associated with high firm complexity and good firm governance practices, and result in higher quality financial reporting.[4]

Using a sample of Australian firms, which disclose formal attendance and informal attendance-by-invitation of CEOs at audit committee meetings, we find evidence consistent with the *information sharing* explanation for CEO attendance-by-invitation at audit committee meetings. Corporate governance practices (e.g. board independence and audit committee size) and firm complexity are positively related to the likelihood of CEO attendance-by-invitation at audit committee meetings. In addition, we document that CEO attendance-by-invitation at audit committee meetings is negatively related to earnings opacity, measured using the Modified Jones and Dechow-Dichev models. These results suggest that CEO attendance-by-invitation enhances the information exchange between firm management and the audit committee, resulting in higher quality financial reporting.

This paper contributes to the academic literature and the policy debate regarding independent audit committees in the following ways. Prior studies have concentrated on the agency costs of CEO involvement in audit committee matters. This study highlights the informational benefits audit committees can derive from greater information exchange with firm management. Thus, adding a positive dimension to CEO involvement in audit committee matters. Furthermore, as firms are being pushed to form independent audit committees, thereby removing the formal involvement of management, informal channels of communication are becoming more important. In this study, we highlight and investigate an informal channel of information exchange between management and the board of directors, showing that it has a significant effect on audit committee outcomes. For policymakers and practitioners, we show that significant benefits exist if firms allow their CEOs to act as informal advisors at audit committee meetings.

2. Literature review and hypothesis development

The prior literature on audit committees has been heavily based on agency theory. Agency theory argues that firm managers may exercise their own self-interest, to the detriment of shareholders (Jensen and Meckling, 1976). One way to reduce agency costs is to strengthen the effectiveness of corporate governance mechanisms, such as the board of directors, in offsetting the influence of management (Fama and Jensen, 1983). Audit committees play a specific role in the monitoring of firm management, tasked with oversight of financial reporting. An audit committee that is independent from management is expected to be more effective in overseeing the financial reporting process, particularly in combatting inappropriate earnings management distorting the true financial performance of companies (Levitt, 1998).

Following this logic, in 1999 both the NYSE and Nasdaq required companies to maintain audit committees of at least three directors, all of whom have no relationship to the company (Klein, 2002a). Klein (2002b) examines the effects of these new

[2] We would ideally like to explore other informal channels that could enhance the information exchange between audit committees and firm management, but we are limited by the availability of data.

[3] Firms may also invite CFOs to their audit committee for a similar purpose. Unfortunately, not enough data is available for CFOs in our setting. In our sample period there are only nine observations of CFOs attending audit committee meetings by invitation.

[4] If the information provided by the CEO is not useful to the audit committee then we should find no significant results in our earnings opacity tests.

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