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Can Anglo-Saxon audit committee scheme improve earnings quality in non-Anglo-Saxon environments?

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A B S T R A C T

Inspired by the debate about globally uniform governance standards on setting up an Anglo-Saxon model of audit committee, this study investigates whether firms adopting audit committee system vis-à-vis a local governance scheme can improve earnings quality. We exploit a unique setting in Japan where firms are allowed to switch to the audit committee from the statutory auditor board under the conventional two-tier structure. We find that improvements in earnings quality cannot be achieved by merely adopting the audit committee but are reaped by firms that converge to the audit committee with substance. Our results indicate that many Japanese firms may adopt audit committee as a fashionable "label" without embracing shareholder primacy.

1. Introduction

This study is motivated by the recent trend toward adoption of the Anglo-Saxon corporate governance system with an audit committee (AC) in the board of directors (Tafara, 2006; Vanasco, 1994), and the debate over whether one corporate governance system can fit all institutional environments. Recent studies have called for research on examining the relation between AC and earnings quality in countries that do not follow the Anglo-Saxon governance model (e.g., Carcello et al., 2011). Bédard and Gendron (2010) indicated that there is scant knowledge on the effectiveness of importing the AC scheme in countries which do not follow the Anglo-Saxon model.

The common view of corporate governance has traditionally respected the institutional background of each country and the individual governance system for each country. However, in recent years, a global standard for corporate governance has been advocated by the Organization for Economic Cooperation and Development (OECD). The idea is that, within a global economy, a global standard can best facilitate international investments, and leveling diverse playing fields can reduce the cost of capital for multinational firms. However, some concerns have been raised with regard to the appropriateness of the Anglo-Saxon governance model in other countries where legal traditions, enforcement standards, investor protections and ownership structures are clearly different from those of the U.S. or the U.K. Dallas and Scott (2006) asserted that "no one

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system of corporate governance is the benchmark for all companies in all jurisdictions and no system of governance is without its own vulnerabilities." Due to the call for global convergence of corporate governance by the OECD, some non-Anglo-Saxon countries might merely be following the trend or the fashion in choosing the audit committee approach (Abrahamson, 1991; DiMaggio and Powell, 1983;). Functional convergence in corporate governance is unlikely to be achieved simply by harmonizing the forms of corporate governance alone. The convergence of form can be attained easily by importing a common governance scheme, but convergence in the effectiveness of monitoring – convergence of function – is highly dependent on whether the exotic scheme corresponds to domestic institutional characteristics.

In this study, we investigate whether importing the Anglo-Saxon-type audit committee in Japan can lead to a convergence of function, in addition to a convergence of form, such that earnings quality improves among Japanese firms that switched to the audit committee scheme. We take advantage of a unique setting in Japan where companies from April 2003 were allowed to choose either (1) the Anglo-Saxon board scheme with an audit committee (AC) for the oversight of financial reporting or (2) the conventional two-tier board structure, in which statutory auditors monitor the board of directors and attempt to ensure the accuracy of financial reports. There are many difficulties in operationalizing global convergence with this AC scheme in Japan (Bebchuk and Roe, 1999; Guillen, 2000; Gilson, 2004). Unlike those in Anglo-Saxon countries, corporations in Japan are managed for a range of stakeholders other than shareholders, including employees, banks, suppliers and business partners. Some might argue that the strong economy during the post-war period in Japan and the competitiveness of Japanese lean production are linked to conventional corporate governance in which main bank system enables the promise of lifetime employment by shielding managers and employees from shareholder demands (Aoki and Okuno, 1996; Porter, 1992). However, in response to prolonged slow growth in the 1990s and the 2000s and under pressure from foreign investors, Japan's Commercial Code has been revised many times to move from a stakeholder-oriented management approach toward a shareholder-oriented style of management (Hashimoto, 2002). The objective is to promote the shareholders to a status and position that is higher than that of other stakeholders so that shareholder value is the dominant concern. In addition, one may expect the members of an audit committee that embraces shareholder primacy to be better at safeguarding earnings quality than statutory auditors under a two-tier board structure. Prior literature also finds that an audit committee can ensure that managers act in the interests of outside shareholders and firms, and improve the quality of their financial statements in the U.S. and U.K. (Klein, 2002; Peasnell et al., 2005).

To test whether the Anglo-Saxon AC can function well in Japan, we benchmark earnings quality of the firms that adopt audit committees against earnings quality of the other firms that have not switched to audit committees during the sample period. We use two methods of earnings management to proxy earnings quality. Following prior literature (Klein, 2002), we first employ a modified cross-sectional Jones model to measure accrual-based earnings management (Dechow et al., 1995) and examine the association between estimated discretionary accruals and the type of governance scheme that the firm chooses. Second, as Herrmann et al. (2003) found that Japanese firms tend to sell fixed assets and securities to meet management forecasts, we follow their approach and see if firms choosing audit committees have a lower tendency to manage forecast errors by selling investments. After controlling for self-selection, we do not find evidence that the adoption of audit committees can improve earnings quality.

Institutional theory suggests that firms may adopt the AC only symbolically, resulting in convergence of form (Abrahamson, 1991; Cohen et al., 2004; DiMaggio and Powell, 1983). In contrast, firms may adopt the AC seriously, leading to convergence of function with a high quality AC as represented by high proportion of outside directors, having the chair of the AC being an outsider, and including financial experts and diligent directors in the AC (e.g., Agrawal and Chadha, 2005; DeZoort et al., 2002; Klein, 2002). We therefore examine whether convergence of form or convergence of function can affect the effectiveness of adopting the AC. We construct one composite measure to aggregate the dimensions of AC quality and split the sample into two groups: a substantive group if the composite score is above the median and a symbolic group if the score is equal to or below the median. We find that substantive adopters experience an increase in earnings quality but we find no improvements for the symbolic group. The results suggest that where AC adoption is symbolic – more a matter of convergence of form than of convergence of function (Gilson, 2004) – the AC does not lead to improved earnings quality.

We contribute to the literature by providing evidence that corporate governance schemes need to be matched against the institutional features of a given country, and that incentives play an important role in reshaping a stakeholder-centered scheme into a shareholder-centered one. Our findings are in line with prior literature (Ball et al., 2000; Cohen et al., 2004) indicating that firms' reporting incentives are different and only firms adopting the AC with substance can improve earnings quality. We also contribute to the literature on global convergence of corporate governance and to the debate about whether the Anglo-Saxon-type audit committee is a scheme that can fit all countries as a means of enhancing monitoring power (Dallas and Scott, 2006; Gilson, 2004).

2. Institutional background and hypothesis development

2.1. Statutory auditor board (SAB) and the audit committee (AC)

Unlike countries that mandate the adoption of the AC scheme (e.g., Australia, Canada, Mexico and Singapore), Japan employs a voluntary approach and allows firms to choose between the AC scheme and the SAB scheme that Japanese firms have conventionally adopted. The conventional