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Audit committees' independence and the information content of earnings announcements in Western Europe

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ABSTRACT

We examine whether the percentage of independent members sitting on the audit committee, in different institutional settings, impacts the market reaction (measured by the abnormal stock returns variance and the abnormal trading volume) to earnings announcements. For our sample composed of more than 7'600 earnings announcements made by European firms from 15 countries between 2006 and 2014, we find that the market reactions to earnings announcements are significantly larger when the audit committee is more independent in countries with weak institutional setting. Our results generally hold after controlling for numerous methodological issues. We conclude that more independent audit committees are substitutes for weak institutions to increase the credibility of earnings announcements. Our results should be of great interest for European regulators who recently introduced new requirements for public firms regarding audit committees' independence.

1. Introduction

Prior research on investor reactions to earnings announcements has shown that the institutional setting significantly influences the information content of these announcements (e.g. DeFond, Hung, & Trezevant, 2007). However, this literature does not consider the role of firm-specific governance mechanisms and the role they play in enhancing earnings credibility. We posit that governance mechanisms such as independent audit committees have a significant influence on earnings credibility and that this relationship varies across institutional settings. Specifically, we show that audit committees play an especially important role in enhancing earnings credibility in countries with weaker accounting standard enforcement, or weaker legal protection of investors. As such we are the first to investigate the joint effect of firm-level governance mechanisms, such as the audit committee, and the institutional context on earnings credibility.

The European setting provides a unique opportunity to investigate investor perception of audit committee effectiveness in various institutional contexts. Since 2006, European public-interest entities¹ must establish an audit committee that includes at least one independent member (European Commission, 2006). Some companies, however, have voluntarily decided to hire 100% of independent members on the audit committee, which ultimately results in large disparities in the composition of European audit committees. Such variance does not exist anymore in the US, because the Sarbanes-Oxley Act obliges public firms to appoint 100% of independent members in the audit committee. In 2014, the European legislation was amended. The European commission decided

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¹ Those entities are defined as “entities governed by the law of a Member State whose transferable securities are admitted to trading on a regulated market of any Member State.” <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:2006L0043:20080321:EN:PDF>.

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that at least half (50%) of the members sitting on the audit committee must be independent. This new regulation, which entered into force in 2016, does not affect our study that covers the period 2006–2014.

This study focuses on investor reactions to annual earnings announcements, which crucially depends on the credibility of the earnings. Indeed, investors must believe that earnings reflect the true performance of the company, which is notably the case when managers (or insiders) have not managed earnings (Dechow, Ge, & Schrand, 2010; Healy & Wahlen, 1999; Leuz, Nanda, & Wysocki, 2003). Since the credibility of earnings is not directly observable, investors may try to assess it by focusing on some observable factors. First, institutional characteristics may improve the credibility of earnings, such as the legal protection of investors (Ball, Kothari, & Robin, 2000; Leuz et al., 2003). Second, various firm-specific characteristics may also improve the credibility of earnings, especially audit committees composed of independent members (Bédard & Gendron, 2010; DeFond & Zhang, 2014). However, it is likely that these two factors are related. Indeed, in weak institutional contexts, managers have more incentives to distort financial information to acquire private benefits (Leuz et al., 2003; Pevzner, Xie, & Xin, 2015). In such contexts, investors may rely on firm-specific substitutes, such as the audit committee, to assess the credibility of earnings. The role of the audit committee might, however, also be enhanced in a context where institutions are stronger and enable this committee to fulfil its duties in a more efficient way. Such effect is found by Becher and Frye (2011), who show that more efficient governance practices are related to stronger regulation. Consequently, audit committee effectiveness and institutional strength might complement each other in reinforcing investor confidence in reported earnings, or they might act as substitutes. This article specifically studies the role played by audit committees in enhancing earnings credibility in different institutional settings, by focusing on the impact of the audit committee's independence on the market reaction to earnings announcements in Europe.

Several studies have already shown that financial markets reaction to earnings announcements differ across countries. DeFond et al. (2007) find that annual earnings announcements are more informative in countries with higher earnings quality and stronger investor protection. Landsman, Maydew, and Thornock (2012) examine whether the information content of earnings announcements increases in countries following mandatory IFRS adoption. They show that the information content increased in countries that mandated adoption of IFRS compared to countries that maintained domestic accounting standards. However, the effect of mandatory IFRS adoption also depends on the strength of legal enforcement in the adopting country. Finally, Pevzner et al. (2015) investigate the effect of societal trust on investor reactions to corporate earnings announcements. They find that investors reactions to earnings announcements are significantly higher in more trusting countries, but the positive effect of societal trust on investors reactions is more pronounced when a country's investor protection is weaker, suggesting that trust acts as a substitute for formal institutions.

These studies emphasize the role of institutions to explain the market reaction to earnings announcements. Therefore, such country-level studies provide little information about the role of firm-specific mechanisms that increase the credibility of earnings and, therefore, may also explain the market reaction in a given institutional context. In particular, these studies do not consider the role of audit committees, which are likely to affect managers' financial reporting choices and, therefore, may increase earnings credibility through two main channels (Bédard & Gendron, 2010; DeFond & Zhang, 2014). First, these committees are responsible for the selection of external auditors, the validation of their workload and the negotiation of audit fees. Second, audit committees also oversee the internal control of the firm.

Various studies show that the effectiveness of the audit committee depends on its composition. More specifically, the independence of such committees' members seems to play a crucial role when considering the quality of financial reporting. Indeed, more independent committees are associated to lower abnormal accruals (Bédard, Chtourou, & Courteau, 2004; Carcello & Neal, 2003; Klein, 2002; Koh, Laplante, & Tong, 2007; Peasnell, Pope, & Young, 2005) and fewer restatements (Abbott, Park, & Parker, 2000; Beasley, Carcello, Hermanson, & Lapides, 2000; Pucheta-Martínez & De Fuentes, 2007). Since most studies focus on the US market, which is characterized by specific institutions (e.g. strong investors' legal protection), it is not clear whether independent audit committees are also efficient mechanisms in countries with different institutional contexts.

To the best of our knowledge, no study has yet analysed the role of independent audit committees in different institutional settings. The academic literature has focused on the role of external auditors, especially the role of Big Four auditors. For instance, Francis and Wang (2008) find that earnings quality increases for firms with Big Four auditors when a country's investor protection regime gives stronger protection to investors. Fung et al. (2016) show that auditors are more likely to issue modified opinions to their economically important clients and this association is stronger in countries with stronger legal regimes. Choi and Wong (2007) show that Big Five auditors play a more important role in countries with weak institutions compared to countries with strong ones. Finally, Choi, Kim, Liu, and Simunic (2008) develop a model in which national legal environments play a crucial role in determining auditor effort and audit fees. Their empirical study supports this prediction. Overall, the role of external auditors seems affected by the institutional environment, but it is not totally clear how these two mechanisms are associated. One potential reason might lie in the fact that these studies do not take into account internal control. In that case, the analysis of independent audit committees is particularly interesting since they oversee internal control and external control.

To analyse the impact of the independence of audit committees on the market reaction to earnings announcements in different institutional contexts, we built a sample comprising 7656 earnings announcements by 1420 listed companies in 15 European countries. We find that the proportion of independent members sitting on the audit committee is positively and significantly associated with the market reaction to earnings announcements, which is measured with abnormal stock returns variance and abnormal trading volumes. In addition, the institutional context proxied by the Brown, Preiato, and Tarca (2014) audit and enforcement index is also positively associated with the market reaction. However, the interaction between the proportion of independent members in the audit committee and the institutional context is negatively related to the market's reaction to earnings announcements. Thus, the independence of the audit committee has a stronger impact on investors' reaction to earnings announcements in countries with weaker institutional contexts. This result leads us to conclude that the audit committee's independence and the institutional context are substitutes.

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