

Inaugural Audit Committee Conference 2011

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Audit Committees and Shareholder Value

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Governance Context

- Investors place a premium on governance which ranges from 11% in the McKinsey 1996 study.
- Premia for governance seem to vary by territory and general sophistication of regulatory environment:
 - Asia : 20 -27%
 - Europe and US: 18 – 22%
 - Latin America : 21 -28%
- Premia increase when there are QUALITATIVE improvements in
 - Transparency and overall disclosure
 - Shareholder rights
 - Effective Board Committees especially audit committee
 - Competencies of directors
- To the contrary, investors punish share prices by around 9% for disclosing financial restatements but impose a larger penalty for failing to quantify a misstatement
- Latest body of research into governance and focus by regulators has been very focused on audit committees as one of the key drivers of governance effectiveness and shareholder value creation
- Series of scandals which affect investor perceptions of companies have been due to audit failure, accounting misstatements, lack of adequate attention to key risks facing corporations, poor compliance culture

Why audit committees should matter to investors

- The key value add of the audit committee are to ensure that there is adequate disclosure of financial and non-financial issues that affect investor perception of a company.
- Audit committee should assess and address risks from a shareholder perspective
- Investors expect audit committees to communicate financial information in a way that enables investors to fairly assess an entity's future earnings
- Adequate disclosure helps
- Investors manage unpleasant surprises
- Better assess sustainability of earnings
- Better assess the earnings generation capacity of an enterprise
- Obtain a more informed view of qualitative aspects that may affect prospective financial information
- Reliable financial information is an important input into determining cost of capital
- Disclosure is shown to result in lower cost of capital

What sort of shareholder value destruction have we witnessed?

- Financial restatements/mistatements
- Regulatory fines
- Competition Commission
- SARS Tax Penalties
- Environmental

Requirement for audit committees to enhance shareholder value

- Focus on 3 sorts of risks:
 - Financial
 - Operational
 - Reputational
- Enforcement of a Compliance culture
- Stronger focus on interrogation of qualitative aspects of key drivers of shareholder value

What qualities of audit committees are associated with shareholder value creation

- Regulators and legislators have prescribed that audit committee should be:
- Largely independent of management
- Have financial expertise
- Dominate the composition of the audit committee

What does empirical research tell us about audit committees?

Accounting/financial expertise and accounting misstatements

- Audit committees with a clear mandate for oversight and monitoring of financial reporting, a high proportion of outside members who are not managers and with a financial/accounting expert are significantly less likely to have high levels of earnings “management” (Carcello, Hollingsworth, Kline, Neal (2006) – Audit Committee Financial Experts)
- Firms with more effective board and audit committees produce more accurate financial forecasts, are more likely to voluntarily update market participants and elicit more favourable market responses. (I. Karamanor and N. Vafeas – The Association Between Corporate Boards, Audit Committees and Management Earnings Forecasts)
- General conclusion is that investors have more confidence in good news forecasts that undergo the scrutiny of an effective audit committee ((I. Karamanor and N. Vafeas – The Association Between Corporate Boards, Audit Committees and Management Earnings Forecasts)

Financial Expertise and the Confidence of Investors

- US research done by De Fond, Hann and Hu (2005) – Does the Market Value Financial Expertise on Audit Committees of Boards of Directors.
- South Korea research done by Choi, Han and Lee – Audit Committees, Corporate Governance and Shareholder Wealth – Evidence from South Korea)
- General findings were:
- General positive reaction by investors to appointment of accounting experts into audit committees
- No reaction to appointment of non-accounting financial experts
- Investors are more concerned with accuracy of financial information and interpret appointment of accounting experts as more likely to result in improvement in the reliability of accounting information
- Investor reaction is even stronger when the overall governance of the enterprise is already strong
- Conclusion: Markets reward enterprises that appoint financial and accounting experts to their audit committees

How do investors view gender representation within audit committees?

- Gender representation in all aspects of corporate life is a matter of serious consideration.
- Part of criticism of failures of audit committees is that they also lack gender representation
- Research by Huang, Yan and Fornaro – Market Reactions to Audit Committee Director's Gender
- Findings are:
 - Female representation on audit committee reduces inherent risk of financial misstatements due to women directors :
 - Tend to be better prepared for board meetings
 - Are less likely to engage or tolerate unethical behaviour
 - Are generally risk averse
 - Have a better perception of unethical conduct
- Conclusion: Consideration has to be given making a special effort to getting gender diversity into audit committees

What now?

- Investors are paying particular attention to the quality of financial information that they use to assess shareholder value
- Inclusion of audit committee members who are financially and accounting literate improve the quality of financial reporting
- Effective audit committees contribute to shareholder value by ensuring that reporting earnings are real and persistent (high quality) which allows investors to assign an appropriate multiple
- Shareholder value has been largely undermined by the lack of enforcement of a compliance and ethical culture
- The diversity of audit committees can aid in improving the quality of financial information
- Audit committees can enhance shareholder value better when the overall board governance process is strong

What information helps in assessing shareholder value

- Choice of accounting standards
- Comprehensiveness of financial information
- Quality of non-financial information
- Evidence of problematic relationships with key non-financial stakeholders and regulators
- Timeliness of filing of financial statements with regulatory bodies
- Attention to societal and environment concerns

- The responsible investment thesis is largely focused on the belief that ESG analysis will enhance the understanding of a company's competitive risks and opportunities, value potential and future performance.



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