

Governance Characteristics and Role Effectiveness of Audit Committees

Abstract

How do the collective qualities of independence, competence and diligence of Audit Committee (AC) members impact on the effectiveness of ACs in performing their roles? Two primary roles of an AC are assessed in this study. They are the roles of vetting the integrity of external annual financial statements (using the incidence and severity of financial restatements as an effectiveness measure) and monitoring external auditor independence (using a non-audit to audit service fees as the effectiveness measure). Previous studies have not drawn these AC characteristics together in a comprehensive model as done in this study. Using secondary data from Australian listed companies over the years 2004 to 2009, the results reveal that stronger AC independence and competence, but not diligence, is significantly related to a lower incidence and severity of financial restatements (i.e. to a lower integrity of financial statements). However, greater AC diligence, but not independence or competence, is significantly related to lower non-audit fee ratio (i.e., to higher external auditor independence). Consideration is given to implications of the results for the composition and functioning of ACs.

Keywords: Audit Committee effectiveness, audit committee characteristics, corporate governance, financial restatements, auditor independence, non-audit fees.

1. Introduction

Determining whether an Audit Committee (AC) is an effective sub-committee of a Board of Directors is a principal issue in good corporate governance. An AC represents a governance mechanism that needs to function effectively in order to limit potential agency conflict problems arising from the separation of corporate ownership and control (Abbott and Parker 2000; Jensen and Meckling 1976). Under the traditional view of good corporate governance – where the focus is on the interests of shareholders, the equitable treatment of shareholders and disclosure and transparency by management – monitoring roles by the Board, its committees and Independent Auditor are central. Such monitoring roles are a means of ensuring proper accountability, probity and openness in the conduct of a corporation's business (ASX 2010b).

The notion of AC effectiveness can be benchmarked against the widely recognized roles of an AC. An AC is considered to have three principal monitoring roles: monitoring of external financial statements, monitoring of external auditors, and monitoring of internal controls (Kalbers and Fogarty 1993; ASX 2010a). This study benchmarks AC effectiveness against aspects of two of these roles, namely, vetting/maintaining the integrity of company external financial reports and monitoring/maintaining external auditor independence.

The membership of an AC, particularly different characteristics of its members, has been viewed as a determinant of an AC's effectiveness (Kalbers and Fogarty 1993; DeZoort 1998; Lindsell 1992). According to DeZoort and Salterio (2001), the effectiveness of an AC is likely to be affected by its members' collective characteristics of being qualified and well informed, with a majority of independent members who meet frequently and have the authority to protect stakeholder interests through their diligent oversight efforts.

This study is motivated to fill a gap in the literature on AC effectiveness and its determinants, and also to provide findings that can have practical implications for the formation and functioning of ACs. Previous corporate governance literature has been limited in modelling the effectiveness of ACs. Most prior studies have addressed partial aspects in their design of AC effectiveness and its determinants, as will be outlined in the next section. This study seeks to fill a gap in the literature by integrating these prior studies into a more comprehensive empirical design of the governance characteristics and role effectiveness of ACs. From a practical viewpoint, an improved understanding of how ACs can be more effective is important to boards, shareholders, and regulators because there is a significant agency cost and benefit in operating an AC. Even though the ineffectiveness of ACs does not necessarily imply financial monitoring failure, when ACs do fail various stakeholders suffer (Sommer 1991). Hence, the findings of this study can have practical implications for an evaluation of whether, and in what circumstances, current governance structures of ACs are effective in relation to the monitoring of the corporation's financial reports and external auditing.

The specific objectives of this study are:

1. To analyse the governance characteristics of ACs, in terms of the members' collective independence (proportion of members declared to be independent), competence (financial and relevant industry expertise) and diligence (size and meeting frequency of the AC);
2. To explain the extent to which ACs' governance characteristics impact on their role of vetting the integrity of the external financial statements (as proxied by the incidence of financial restatements);

3. To explain the extent to which ACs' governance characteristics impact on their role of monitoring external auditor independence (as proxied by the non-audit to audit service fee ratio).

Conclusions will be drawn from the findings about the set of governance characteristics of ACs that renders them more effective in fulfilling their roles in particular corporate and regulatory circumstances.

2. Literature Review and Hypotheses Development

In this section, literature is reviewed on elements of AC effectiveness and AC governance characteristics, respectively. Within this review, arguments and prior evidence are used to generate a set of testable hypotheses.

2.1 AC Effectiveness

The literature addressing AC effectiveness is extensive and conflicting; however this literature has identified several factors that impact on the effectiveness of an AC. These factors include composition (mainly in terms of independence), authority/ power, resources, diligence (as reflected in committee size, number of meeting, length of meetings), financial expertise and industry expertise (DeZoort 1998; Kalbers and Fogarty 1993; DeZoort et al. 2002; Abbott et al. 2004; Carcello et al. 2002; Beasley 1996). Other literature in ACs identifies the principal goals of an AC as maintaining external auditor independence (Carcello and Neal 2000; Eilifsen and Messier 2000; Knapp 1987) and protecting investors by vetting the integrity of the financial reports (McDaniel et al. 2002; DeZoort et al. 2002; Palmer 1977).

The literature in AC effectiveness uses different proxies to determine the effectiveness of ACs in their monitoring roles. Five proxies for AC effectiveness are found in the literature. First, Abbott et al. (2003a) conceive AC effectiveness as an ability to maintain external auditor independence. The AC ability to maintain external auditor independence whether in appearance or fact is measured by ratio of non-audit to audit service fees. Second, Carcello et al. (2002) assess the effectiveness of AC as an ability to promote shareholder interests by purchasing higher quality audit services, where the quality of the audit service is represented in the audit fee. Third, Abbott et al. (2004) and Aier et al. (2005) evaluate AC effectiveness as ability to maintain the integrity of the financial statements, as proxied by the extent of prior-period restatements of financial statements. Fourth, Farber (2005) and Beasley (1996) also assess the effectiveness of AC as an ability to maintain the integrity of financial statements, which they proxy by fraud disclosures. Fifth, Klien (2002) similarly views AC

effectiveness as an ability to vet the financial statements; however he uses abnormal accruals as a proxy for effectiveness.

2.1.1 Monitoring External Auditor Independence

The effectiveness of an AC in undertaking its role of monitoring external auditor independence is considered important because independent auditors are more likely to discover and report a breach in the external financial statements (DeAngelo 1981; DeFond et al. 2002). The complexity of the relationship between the auditor and the audit client is intensified when non-audit services are added to the responsibility of the auditor, particularly when non-audit services generate approximately 50% of revenues earned by the large audit firms (Levitt 2000). Non-audit service fees are considered to potentially impair external auditor independence, as they increase the economic bond between the audit client and the external auditor, which may make the external audit firm economically dependent on the audit client. That is, non-audit fees are expected to reduce the willingness of external auditors to challenge executive management and more likely to acquiesce to executive management pressure (Levitt 2000; DeAngelo 1981; Frankel et al. 2002; Kinney et al. 2004). However, non-audit service fees are also thought to improve the quality of the audit through information spill-over, as financial reporting problems are considered to be caused by external auditors lacking client specific knowledge (Abbott et al. 2003a; Frankel et al. 2002; Stanley and DeZoort 2007; DeFond et al. 2002; Kinney et al. 2004). Moreover, external auditors may have incentives to maintain their own independence unrelated to the level of non-audit fee. These incentives can include maintain professional reputation and facing institutional pressures from peers (DeFond et al. 2002 ;Raghunandan et al. 2003).

Nevertheless, there is evidence that relatively higher non-audit fees result in biased or error-prone financial reporting that is purported to be a consequence of impaired external auditor independence. For example, Frankel et al. (2002) find a positive relationship between non-audit fees and earnings management; Kinney et al. (2004) find a positive relationship between non-audit fees and financial restatements. Therefore, while the fact of whether an external auditor remains independent is not directly observable, the proportion of non-audit fees paid by a client firm is considered a satisfactory proxy for external auditor independence (Abbott et al. 2003a).

2.1.2 Vetting the Integrity of Financial Statements

The effectiveness of an AC in undertaking its role of vetting the integrity of the company's financial reporting can be represented by the incidence and severity of occurrence of restatements in annual financial statements (Abbott et al. 2004; Aier et al. 2005). Stanley and DeZoort (2007, p.133) state that "restatements due to error or fraud are defacto reporting failures ... because the originally

released information was not free from material misstatements". The nature of restatements can be due to prior period errors or accounting policy changes, as explained in the financial reporting standard, AASB 108, paragraph 5 as follows:

"Prior period errors are omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that: (a) was available when financial statements for those periods were authorised for issue; and (b) could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements" (AASB 2010, p.11).

"Accounting policies are the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements" (AASB 2010, p.10).

Companies experiencing financial restatements in form of prior period errors (i.e., errors, misstatements or misuse of otherwise reliable information) can be regarded as having an ineffective AC in their monitoring role over vetting the integrity of the external financial statements. Alternatively, restatements due to accounting policies may arise from choice of an unacceptable revenue recognition or asset measurement base that result in material misstatements in financial statements. This, again, can be regarded as an ineffective AC vetting of financial statements. Of lesser severity would be restatements due to failure to adopt, in a timely manner, a change in accounting policies required by newly released or revised accounting standards.

2.2 AC Governance Characteristics

The literature on the determinants of AC effectiveness identifies four key governance characteristics of ACs: (1) coerciveness, (2) independence, (3) competence and (4) diligence. Coerciveness is considered to be a function of AC responsibility, influence and legitimate power (DeZoort et al. 2002; Kalbers and Fogarty 1993). Turley and Zaman's (2007) findings suggest that an AC's authority to influence the decisions of its assigned responsibilities will moderate its effectiveness, even if the AC members are independent, competent and diligent. In this study, suitable data for a measure of the AC's coerciveness or exercise of authority could not be obtained. The absence of this AC characteristic is a limitation of this study.

2.2.1 AC Independence

Director independence can be considered a precedent concept in the context of good corporate governance practice. Independent directors are considered to be better equipped to maintain the

integrity of the external financial statements as they do not have personal or economic ties with executive management and are regarded as professional referees whose role is to oversee and monitor the company's executive management (Bradbury 1990). Therefore ACs with independent directors can be regarded as better equipped to maintain the integrity of company financial statements (Klien 2002; Vera-Munoz 2005). Recommendation 4.2 of the ASX's *Corporate Governance Principles and Recommendations* (ASX CGPRs) states that an "audit committee should be structured so that it ... consists of a majority of independent directors" (ASX 2010a, p.28).

Abbott et al. (2003b) and Carcello et al. (2002) find that the more independent ACs demand a higher quality audit service, where audit fees are considered to represent the quality of the audit. Abbott and Parker (2000)'s findings suggest that more independent AC's are more likely to select an industry specialist as an external auditor; industry specialists are considered to provide a superior audit service, where the integrity of the external financial statements are better maintained by such services. Abbott et al. (2003a) find that more independent ACs have lower non-audit service fees, where these are considered to impair external auditor independence.

Abbott et al. (2004), Beasley (1996), and Farber (2005) find that more independent boards are less likely to experience a restatement in their financial statements, where restatements as an indicator of a failure to maintain the integrity of external financial statements. Furthermore, DeZoort and Salterio (2001) find that independent directors are more likely to support external auditors over executive management in external auditor-management conflict situations.

The literature reveals that the extent of AC independence has been studied as a determinant of external auditor selection, non-audit service fee disclosures, level of audit fees, non-fraud versus fraud firms, and earnings management. The literature in director independence has identified AC independence as a principal element of an effective AC. Following the literature an AC effectiveness ratio is identified, the 'independence ratio'. This ratio measures the percentage of committee members who are independent based on committee size. An effective committee should have an independence ratio above 50 percent, based on ASX CGPRs that an AC should consist of a majority of independent members. In this study, in the area of the role effectiveness of an AC's characteristic of independence; the following hypotheses are generated:

H1: The greater the independence of AC members, the lower the incidence and severity of financial statement restatements (i.e., effectiveness in the role of vetting financial statements).

H2: The greater the independence of AC members, the lower the non-audit service fee ratio (i.e., effectiveness in the role of maintaining external auditor independence).

2.2 AC Competence

Financially competent ACs can be considered to have a superior ability to monitor the integrity of the external financial statements. Moreover Peecher (2002) states that AC members with industry sophistication may compensate for their shortcomings in financial sophistication. DeZoort (1998) suggests that ACs with members with financial and industry sophistication follow cognitive heuristics similar to the external auditors in decision making, and that industry sophistication positively impacts AC oversight judgments. DeZoort and Salterio (2001) find that members who have financial and industry sophistication are more likely to support the external auditor in external auditor-management conflict situations. Coates et al. (2007) finds that more expert ACs attract superior stock market returns. Carcello et al. (2002) and Abbott et al.'s (2003b) findings suggest that AC members with financial and industry expertise are more likely to demand higher quality audits. The quality of audit service provided is deemed to be represented in the audit fee.

The financial competency of AC members is analysed in several prior studies. Abbott et al. (2004), Aier et al. (2005), and Farber (2005) find that companies that experience restatements in their external financial statements, had ACs with lower financial competency. Carcello and Neal (2003) verify that the financial literacy of an AC does indeed proxy for the effective monitoring over maintaining external auditor independence and vetting the integrity of the external annual financial statements. McDaniel et al. (2002) concluded that financial literacy (viewed as second-hand accounting knowledge) is primary in maintaining the integrity of the external financial statements, however financial expertise (viewed as first-hand accounting experience) cannot be justified. Recommendation 4.2 of ASX CGPRs states an "audit committee should include members who are all financially literate....able to read and understand financial statements" (ASX 2010a, p.29).

Turning to the concept of industry sophistication of AC members, there is little evidence of the effectiveness of this attribute in prior studies. Since industry sophistication is viewed as compensating for financial expertise, and ASX CGPRs expect all AC members to be financially literate (not necessarily expert), an industry-sophisticated AC should have at least a third of its members with industry expertise according to Carcello et al. (2002). Therefore, in the area of financial competency, coupled with industry competency, it is expected that ACs will be more effective in their monitoring roles.

Based on the above literature, the following hypotheses are specified:

H3: The greater the financial and industry competency of AC members, the lower the incidence and severity of restatements (i.e., effectiveness in the role of vetting financial statements).

H4: The greater the financial and industry competency of AC members, the lower the non-audit service fee ratio (i.e., effectiveness in the role of maintaining external auditor independence).

2.3 AC Diligence

Diligence is considered a process factor which is required for effective AC operations (DeZoort et al. 2002; Kalbers and Fogarty 1993). Diligence refers to the desire of AC members' to carry out their monitoring roles and "includes factors such as the number of board meetings and the behavior of individual... [which includes] preparation before meetings, attentiveness and participation... (and) post-meeting follow-up. (But) the factor that is publicly observable is the number of board meetings" (Carcello et al. 2002, p.371). The literature identifies the meeting frequency of boards as an indirect signal for board diligence (Menon and Williams 1994; Abbott et al. 2004; Conger et al. 1998; Carcello *et al.* 2002; Farber 2005). Conger et al. (1998) suggest that an increase in board meetings may improve the effectiveness of the board. Abbott et al. (2004) and DeZoort et al. (2002) suggest that committee size can proxy for AC diligence.

Prior studies have established that AC diligence (AC meeting frequency and size as proxies) is a significant factor in the context of AC effectiveness. Abbott and Parker's (2000) findings suggest that ACs that meet at least twice a year are more likely to select an industry specialist as an external auditor. Industry specialists are considered to provide a greater quality audit service; such services are considered to enhance the integrity of the external financial statements. Abbott et al. (2003a) find that ACs that meet at least four times a year have a lower non-audit fee ratio. Abbott et al. (2003b) and Carcello et al. (2002) find that ACs that meet at least four times a year have higher audit fees, where audit service fees represent the quality of the audit. Abbott et al. (2004) find that ACs composed of less than three members are more likely to experience a financial restatement; however they find that meeting frequency is negatively related to the probability of financial restatements.

Drawing on these prior studies, the following hypotheses are generated:

H5: The greater the diligence of ACs in terms of their meeting frequency and size, the lower the incidence and severity of restatements (i.e., effectiveness in the role of vetting financial statements).

H6: The greater the diligence of ACs in terms of their meeting frequency and size, the lower the non-audit service fee ratio (i.e., effectiveness in the role of maintaining external auditor independence).

3. Methods

3.1 Sample

The sampling scheme was first to identify ASX listed companies that had recorded a restatement (prior period adjustment) in the notes to their annual financial statements in any year during the period 2004 to 2009. Working in descending order from the largest listed companies down, 60 companies were found. The year of restatement and the immediately prior year for these restatement companies were sampled. Then these restatement companies were matched with a sample of non-restatement companies in terms of company size and year. The final sample consisted of 180 cases. The source of data collected from these companies was their annual financial statements (available from *Connect4 Annual Reports* database, and on-line ASX data. The sample is stratified into those reporting a financial restatement and those that do not.

3.2 Variables and their measurement

The dependent variables are the effectiveness proxies for monitoring/maintaining external auditor independence and vetting/maintaining the integrity of the external annual financial reports. First, the non-audit service fees ratio (NONAUDFEES) is measured as the percentage of the external audit firm's non-audit service fees (e.g., taxation and management consulting services) to audit service fees charged to the company (Frankel et al. 2002; Ashbaugh et al. 2003; DeFond et al. 2002). Some studies have simply taken the natural log of non-audit service fees (Abbott et al. 2003b; Carcello et al. 2002; DeFond et al. 2002). However in this study the ratio measure is used because it provides a sufficient scaling for company size.

Second, the incidence and severity of restatements in financial statements (RESTATEMENT) is measured in this study on a 3-point scale: no restatement, low severity restatement (e.g., correction of accounting policy applications, errors of estimates), and high severity restatements (e.g., detection of material omissions or fraud).

The explanatory variables for this study are proxy measures of AC governance characteristics: AC independence, competence and diligence. First, AC independence is measured as the percentage of committee members who formally declared they meet ASX independence criteria relative to the committee size. For example, for an AC with three members, two of which are independent would have an ACINDEP of 67 percent ($2/3 * 100$ rounded to nearest whole percentage).

Second, the AC competency construct is measured based on a taxonomy adopted from Coates et al. (2007). Details of this taxonomy are as follows:

Financial Sophistication

6 = CFO, CPA, CA, or PHD or Prof. of finance or accounting.

5 = previously worked for big four auditors (Deloitte, KPMG, Ernst & Young and PwC) or former CFO, CPA, CA.

4 = Finance or accounting related accounting experience.

3 = Finance or accounting related undergraduate or honours degree.

2 = Other business qualification or law background.

1 = Other qualification.

0 = Unknown Background.

Industry Sophistication

2 = Prior work experience in company's operating industry or at least 10 years' experience in current company.

1 = Prior work experience in another industry.

0 = Unknown Background.

Using this scoring taxonomy, financial sophistication of an AC is calculated by adding the total financial sophistication of each AC member and dividing by the total possible financial sophistication, multiplied by 100. Alternatively, the industry sophistication of an AC is measured as the proportion of industry-experienced members against committee size; an industry-sophisticated AC will had 50 percent of members with relevant experience. Refer to table 1 for an illustrated example of the competency ratios of a 3 member AC.

Table 1 AC competency of company X Ltd

Member	Financial Sophistication	Score	Industry Sophistication	Score
A	4/6		2/2	
B	5/6		½	
C	6/6		½	
	15/18 *100	83%	4/6*100	67%

Ratios are round to nearest whole percentage

Third, AC diligence is measured on the basis of frequency of meetings and size of membership of the AC during the year. Data on number of meeting for the relevant year and number of members on the AC is extracted from annual reports of sampled companies. The multiple of these two numbers represents AC meeting time accumulated across all committee members, so is a proxy for AC diligence.

To test the construct validity of both AC competency and AC diligence, a factor analysis was performed on the items in their respective measure. That is, the four individual data items of financial sophistication, industry sophistication, meeting frequency and committee size were factor analysed to determine if they loaded onto two factors as expected. Results given in table 2, in the rotated component matrix, confirm a correct loading onto two factors.

Table 2 Factor analysis of items in AC competency and AC diligence

Total Variance Explained				Rotated Component Matrix		
Component	Initial Eigenvalues				Component	
	Total	% of Variance	Cumulative %		1	2
1	1.324	33.094	33.094	Fin.Soph	.004	.784
2	1.211	30.287	63.381	Indus.Soph	.028	-.734
3	.820	20.490	83.870	Meet. Freq	.819	.176
4	.645	16.130	100.000	Size of AC	.795	-.212

Several control variables have been considered that may impact on the hypothesised relationships. These variables are: (1) whether there has been a switch of external auditor made by the company in the year following a restatement, (2) the form of operation of the AC in terms of its relationship with the Board of Directors, (3) whether the company in a top 300 ASX company (mandatorily required to have a separate AC, or not), (4) the industry of the company, and (5) the size of the company (in total assets). on the basis of eligibility to attend BOD meetings.

In terms of the second control variable above, the structural form than AC takes relative to the Board of Directors (BOD) is categorized as follows:

DIRMIN = Minority of AC members are active directors on the BOD.

DIRMAJ = Majority of members are active directors on the BOD.

DIRFULL = The full BOD is the AC membership; there is a separately designated AC.

BODONLY = No established AC; BOD takes AC responsibility.

3.3 Research Design

Two regression models to test the six hypotheses in this study are:

$$\text{RESTATEMENT}_i = \beta_0 + \beta_1 (\text{ACINDEP})_i + \beta_2 (\text{COMPET})_i + \beta_3 (\text{DILIGENT})_i + \beta_4 (\text{ACFORM})_i + \beta_5 (\text{EXAUDSWITCH})_i + \beta_6 (\text{INDUS})_i + \beta_7 (\text{COSIZE})_i + e_i \dots (1)$$

$$\text{NONAUDFEES}_i = \beta_0 + \beta_1 (\text{ACINDEP})_i + \beta_2 (\text{COMPET})_i + \beta_3 (\text{DILIGENT})_i + \beta_4 (\text{ACFORM})_i + \beta_5 (\text{EXAUDSWITCH})_i + \beta_6 (\text{INDUS})_i + \beta_7 (\text{COSIZE})_i + e_i \dots (2)$$

Where:

RESTATEMENT = coded 3 if high severity restatement, 2 if low severity restatement, 1 if non-restating.

NONAUDFEES = NAS fees / total audit fees (NAS + audit);

ACINDEP = percentage of independent AC members;

COMPET = mean (FINSOPH,INDUSOPH);

DILIGENT = mean (MEET,ACSIZE);

ACFORM = coded 1 if DIRMIN, 2 if DIRMAJ, 3 if DIRFULL, 4 if BODONLY;

EXAUDSWITCH = coded 1 if restating company has change their external auditor in the year following the restatement, 0 otherwise;

INDUS = the company operating industry, coded 1 if diversified financials, 2 if materials, 3 if other industry;

COSIZE = the natural log of total assets.

4. Results and Discussion

4.1 Descriptive Statistics

Table 3 provides a profile of the companies and ACs in the sample in terms of frequency details about the industry composition of the paired companies, the structural form of the ACs, and regulatory categories of the companies as S&P/ASX 300 or not. These frequencies are compared for the restatement and non-restatement company groups, and the non-audit fee ratio of low (<16%) and high (>16) company groups. Note that the industry distribution of the non-restatement sample group is proportionally similar to the restating sample group, although the non-restating group is twice as large as the restating group because it is sampled over two years. The comparison of restating and non-restating companies shows little difference between the structural form of ACs, or the AC regulatory categories of companies. Table 3 also shows little difference between the higher and lower non-audit fee companies (i.e., higher and lower external auditor independence) in terms of their AC's form or regulatory category.

Table 3 Descriptive Statistics

	Restating Sample		Non-Restating Sample		NONAUDFEES <16		NONAUDFEES >16	
	Freq.	Percentage	Freq.	Percentage	Freq.	Percentage	Freq.	Percentage

Industry	Diversified	8	13.3	16	13.3	11	12.1	13	14.6
	Financials								
	Materials	11	18.3	22	18.3	19	20.9	14	15.7
	Other	41	68.3	82	68.3	61	67.0	62	69.7
	Total	60	100%	120	100%	91	100%	89	100%
AC Form	DIRMIN	0	0.0	3	2.5	2	2.2	1	1.1
	DIRMAJ	50	83.3	104	86.7	75	82.4	79	88.8
	DIRFULL	2	3.3	4	3.3	2	2.2	4	4.5
	BODONLY	8	13.3	9	7.5	12	13.2	5	5.6
	Total	60	100%	120	100%	91	100%	89	100%
ASX List	ASX/300	9	15.0	21	17.5	77	84.6	73	82.0
	Non-ASX/300	51	85.0	99	82.5	14	15.4	16	18.0
	Total	60	100%	120	100%	91	100%	89	100%

Table 4 reveals some significant relationships between AC form and AC characteristics of independence and diligence, as reflected in the Chi-square in Panel B. First, those companies with a majority of directors on their AC will have an AC with greater independence, whereas those with no separate AC but the BOD fulfils the roles of AC will have lower independence. Second, when the form of AC is to have a majority of full set of directors serving on the AC, the diligence of the AC will be higher. In summary, the main result from Table 4 is that AC's with a majority of directors in their members will have stronger characteristics of independence and diligence, but no difference in competence.

Table 4 Cross tabulation of AC form to AC characteristics

Panel A Crosstab											
		ACINDEP			COMPET*			DILIGENT			
		Other -wise	INDEP > 50%	Total	0	1	Total	.00	.50	1.00	Total
AC Form	DIRMIN	1	2	3	1	2	3	0	1	2	3
		33.3	66.7	100%	33.3	66.7	100%	.0	33.3	66.7	100%
	DIRMAJ	36	118	154	68	75	143	32	63	59	154
		23.4	76.6	100%	47.6	52.4	100%	20.8	40.9	38.3	100%
	DIRFUL L	3	3	6	2	3	5	0	2	4	6
		50.0	50.0	100%	40.0	60.0	100%	.0	33.3	66.7	100%
	BODON LY	13	4	17	13	4	17	0	3	14	17
		76.5	23.5	100%	76.5	23.5	100%	.0	17.6	82.4	100%
Total		53	127	180	84	84	168	32	69	79	180
		29.4	70.6	100%	50.0	50.0	100%	17.8	38.3	43.9	100%
Panel B Pearson Chi-Square Tests											
Value		22.068			5.641			15.512			
Sig.		.000			.130			.017			

* In preparing the COMPET variable for the crosstab, it was made dichotomous based on its median value (69.50).

4.2 Regression Results for the Role of Vetting Financial Statements (RESTATEMENTS)

This section presents the results of multiple regressions analysis to test hypotheses 1, 3, and 5. These hypotheses concern the effectiveness of ACs in vetting the integrity of financial statements before they are published. Panel A of Table 5 presents the regression model summary. While the model has modest explanatory power (Adj.R Square = .129), it has significance. Multicollinearity is not of concern as indicated by the VIF and Tolerance statistics. However, some autocorrelation is present as indicated by the Durbin-Watson score of .465. Given these model weaknesses, the results in Panel B provide tests of H1, H3 and H5.

The characteristic of AC independence is significantly inversely related to RESTATEMENT. That is, the lower the AC's independence, the higher the incidence and severity of restatements. Therefore, H1 is supported. The characteristic of AC competency is also significantly inversely related to RESTATEMENT – lower AC competency leads to higher restatement incidence and severity. H3 is supported. In contrast, the characteristic of diligence is not significant. H5 is rejected. The conclusion is that ACs with higher independence and competence will be more effective in vetting financial statements, but higher AC diligence does not have an impact.

Table 5 Financial Restatements and AC Characteristics (H1, H3, and H5)^b

Panel A: Model Summary							
R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson	F	Sig	
.404 ^a	.163	.129	.501	.465	4.799	.000 ^a	
Panel B: Regression Coefficients							
	Unstandardized Coefficients		Standardized Coefficients	T	Sig.	Collinearity Statistics	
	B	Std. Error	Beta			Tolerance	VIF
(Constant)	2.088	.604		3.456	.001		
ACINDEP	-.004	.002	-.179	-2.077	.039	.654	1.529
COMPET	-.011	.004	-.206	-2.748	.007	.864	1.158
DILIGENT	-.002	.119	-.002	-.019	.985	.712	1.404
ACFORM	.015	.078	.017	.192	.848	.592	1.690
EXAUDSWITCH	-.467	.102	-.329	-4.598	.000	.947	1.056
INDUS	-.062	.059	-.083	-1.051	.295	.789	1.268
COSIZE	.028	.025	.107	1.133	.259	.546	1.830

a. Predictors: (Constant), ACINDEP, COMPET, DILIGENT, ACFORM, EXAUDSWITCH, INDUS, logAssets
b. Dependent Variable: RESTATEMENT

Further, Table 5 reveals a negative and statistically significant relationship between external auditor change (EXAUDSWITCH) and financial restatements in the year immediately following the restatement. The inference is that the decision by a BOD to switch the company's external auditor

following a financial restatement is made when the AC is exposed as being less independent and/or competent.

4.3 Regression Results for the Role of Monitoring the External Auditor (NONAUDITFEES)

This section presents the multiple regressions analysis relating to the AC's role of monitoring the quality of the external auditor in order to test hypotheses 2, 4, and 6. Panel A of Table 6 presents the model summary. This model has reasonable explanatory power (Adj.R-Sq = .213), and is low in both autocorrelation (Durbin-Watson = 2.074) and multicollinearity (tolerance not below .5 and VIF not above 2). of the multiple regression, which investigates AC effectiveness in maintaining external auditor independence and AC corporate governance characteristics. Results in Panel B of Table 6 present the regression coefficients that provide the test of H2, H4 and H6.

Table 6 Non-audit Service Fee Ratio and AC Characteristics (H2, H4, and H6)^b

Panel A: Model Summary							
R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson	F	Sig	
.316 ^a	.247	.213	22.069	2.074	1.205	.002 ^a	
Panel B: Regression Coefficients							
	Unstandardized Coefficients		Standardized Coefficients	T	Sig.	Collinearity Statistics	
	B	Std. Error	Beta			Tolerance	VIF
(Constant)	-22.280	26.625		-.837	.404		
ACINDEP	-.046	.076	-.055	-.601	.549	.654	1.529
COMPET	.028	.178	.012	.155	.877	.864	1.158
DILIGENT	-10.346	5.264	-.173	-1.965	.051	.712	1.404
ACFORM	1.211	3.444	.034	.352	.725	.592	1.690
EXAUDSWITCH	-2.849	4.477	-.049	-.636	.525	.947	1.056
INDUS	.817	2.583	.027	.316	.752	.789	1.268
COSIZE	2.583	1.107	.235	2.333	.021	.546	1.830
a. Predictors: (Constant), ACINDEP, COMPET, DILIGENT, ACFORM, EXAUDSWITCH, INDUS, logAssets							
b. Dependent Variable: NONAUDFEES							

Results reveal that the only attribute of AC members that significantly impacts on the effectiveness of ACs in their role of monitoring external auditor independence the attribute of diligence. When AC diligence is high, there is a significantly lower ratio of non-audit to audit fees of the external auditor (Beta = -.173, sig. = .051). The phenomenon underlying this result could be that AC's with greater diligence (more meetings and members) would be better placed to make demands for higher quality external audits based on securing a higher company budget for audit service fees. Such higher audit service fees would tend to force the non-audit fee ratio down. The result supports H6.

On the other hand, ACINDEP and COMPET are attributes that do not significantly impact on the AC's role of monitoring the external auditor's independence. H2 and H4 are not supported.

The variables COMPET and DILIGENT comprise of sub-dimensions. A further regression was run in which the sub-dimensions of financial-sophistication and industry-sophistication were substituted for COMPET and meeting frequency and committee size were substituted for DILIGENT. A summary of the finding from these regression results is given in table 7.

Table 7 Regression Results Summary

Variable	AC Governance Characteristic						
	Independence	Competency			Diligence		
	ACINDEP	COMPET	FinSoph	IndusSop	DILIGENT	Meetfreq	ACsize
Hypothesis	H1,H2	H3,H4			H5,H6		
RESTATEMENT	- Sig.*	- Sig.*	- Sig.*	- Sig.*	ns.*	ns.	ns.
NONAUDFEES	ns.*	ns.	ns.	ns.*	- Sig.*	- Sig.*	ns.

Note: Sig.* = Significant result and expected direction
 Sig.= Significant result but unexpected direction
 ns.*= Not significant however expected direction
 ns.= Not supported

5. Conclusions

This study analyzed archival evidence on the incidence and severity of financial restatements and the extent of non-audit to audit service fees of the external auditor to examine whether the role effectiveness of an AC is driven by the AC's governance characteristics of independence, competency and diligence.

In discussing the summary of results in table 7, an overall conclusion is that the collective members of AC's require all three attributes of independence, competency and diligence in order to effectively fulfil multiple roles. However, to be effective in a particular role, only some attributes are important. Thus, the role of effectively vetting financial statements is shown in table 7 to be dependent on having an AC comprising a higher proportion of independent members. This result re-enforces prior studies by Abbott et al. (2004), Beasley (1996), and Farber (2005) who find that more independent boards are less likely to experience a restatement in their financial statements. Further, effectiveness in vetting financial statements is shown in table 7 to be driven by a higher level of AC competency in terms of both financial-sophistication and industry-experience. This result lends support to findings by Abbott et al. (2004), Aier et al. (2005), and Farber (2005) that companies experiencing restatements in their external financial statements have ACs with lower financial competency. Carcello and Neal (2003) verify that the financial literacy of an AC positively relates to

the severity of external annual financial restatements. However, this study adds new evidence of the significance of the level of AC's industry-sophistication as a factor reducing restatements.

Turning to the role of effectively maintaining external auditor's independence, table 7 finds that only AC diligence based on meeting frequency has a significant impact. The finding by Abbott et al. (2003a) that companies with more independent ACs have more independent external auditors is not supported in this study. Nor does this study support the finding by Carcello and Neal (2003) that the AC's financial literacy significantly relates to maintaining external auditor independence. However, the finding in table 7 that AC diligence in terms of meeting frequency has a significant relationship with external auditor independence provides support to Abbott et al.'s (2003a) finding that ACs that meet at least four times a year have a lower non-audit fee ratio.

Overall, the findings in this study have implications for corporate governance practices in terms of the composition and functioning of ACs in Australia. First, for the purpose of more effectively carrying out the role of vetting the integrity of financial statements to be published, the composition of an AC requires close attention to maintaining a majority of members who are independent of executive management and who have financial expertise and/or relevant industry experience. Second, for the purpose of more effectively maintaining the quality of the external auditor (in terms of their independence), the functioning of an AC should ensure a strong degree of diligence involving a frequency of meetings above a minimum of four per year.

This study has limitations. First, the major AC role of monitoring the company's internal audit function is not integrated into the model in this study. The AC's responsibility for effective oversight of internal auditing could impact on the dynamics of AC membership. Second, the specific proxy measures used to represent the broader concepts of effectiveness of the AC in its roles of vetting financial statements and maintaining the external auditor's independence are likely to have deficiencies in their construct validity. Third, the AC members' collective characteristics of independence, competency and diligence are likely to be constructed from several behavioural and organisational factors that are not reflected in the proxy measures such as members' formal qualifications or committee meeting frequency used in this study.

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