

Family Ownership and Earnings Informativeness: Role of Audit Committees

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1. Introduction and Motivation

Concentrated ownership among Indian family firms creates incentives for promoters (usually the founding members) to not share timely information with external stakeholders leading to information asymmetry. Over the last decade, Securities and Exchange Board of India (SEBI) has legislated corporate governance provisions through clause 49 of the Listing Agreement which all the listed Indian firms are obliged to follow. These provisions intend to protect external minority shareholders and resolve the issue of information asymmetry. Earnings informativeness (disclosures) provides relevant information to the investors and enables them to take informed investment decisions. This research paper empirically examines the relationship between earnings and market returns in the post-governance regulation era (sample period 2006-2012) and investigates the impact of audit committees on this relationship, especially for family firms.

The SEBI provisions focus on establishing audit committees and improving the quality of information disclosures to all the stakeholders. These reforms are expected to improve earnings informativeness and resolve the issue of poor quality of reported earnings. Recent corporate failures (e.g. the Satyam fiasco in India) raise significant questions about the quality and the role of audit committees. These unexplored issues have motivated this paper which investigates the role of audit committees in the relationship between family ownership and earnings informativeness.

Given the governance environment with independent audit committees to oversee the reporting practices of the firms, this research study examines:

- Earnings informativeness in India through the correlation between earnings of the firm and its stock returns

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Note : SEBI Listing Obligations And Disclosure Requirements Regulations, 2015 was not in effect when this paper was written.

- Impact of ownership structure on earnings informativeness
- Association between audit committee characteristics and earnings informativeness
- Impact of audit quality attributes on earnings informativeness

The findings of this study can provide useful insights to regulators in general, and SEBI in particular, who are striving to improve the quality of information disclosures, transparency, and corporate governance through a series of reforms.

About 70% of the listed firms in India are family controlled. The earnings informativeness of family owned firms determine to a large extent the quality of governance at the country level. Indian family firms appoint family members and friends to top managerial positions to retain the control apart from cross shareholdings (Manos et al., 2012). Many family owned firms are conglomerate groups having diversified into many sectors (e.g. Reliance, TATA, etc). The group affiliated firms not only have family capital, but they also access and source large amounts of external capital by leveraging the reputation of the group (Claessens et al., 2000). The groups can also create their virtual (internal) capital markets, by pooling and reallocating funds among group companies themselves (Bertrand et al., 2002). These features are expected to cause lower informativeness among family firms. However, the age old family run companies are now gearing up to compete with the upcoming MNCs and first generation professionally run companies (Loadh et al., 2014). This corporate transformation motivated the present study to investigate the level of earnings informativeness across firms with concentrated family ownership, in comparison to the widely held firms.

2. Sample Firms

The sample for our study comprises 368 Indian firms--all representing publicly traded non-banking firms included in the CNX S&P 500 Index in India. The yearly data of 368 Indian firms over a period of 6 years (2006-12) results in 2208 (368 x 6) firm-year observations. Informativeness of accounting earnings has been measured based on the relation between earnings and cumulative abnormal stock returns (CAR).

3. Data and Variables

Earnings informativeness refers to the quality of financial reporting which aids the analysts in arriving at the right prediction and helps the investors in making an informed decision about a company. Earnings informativeness is measured by the

correlation between stock returns and operating earnings. If earnings disclosures are genuine, the correlation between earnings and stock returns would be high.

Four audit committee characteristics--representing size (Zaman et al., 2011), independence (Woidtke and Yeh, 2013), number of meetings held and director attendance (Lin and Hwang, 2010)--were taken as proxies to assess the impact of audit committees on earnings informativeness.

To control for the effects of firm specific factors, leverage (firm's debt-to-equity ratio), total assets and Tobin's Q (ratio of market to book value of shares) were treated as control variables in our study that would influence the relationship between earnings informativeness and stock returns.¹⁹ All these factors by themselves are capable of influencing the relationship that we are studying and hence, they need to be controlled for our study to be meaningful. For example, higher Tobin's Q indicates higher expected earnings growth and stronger earnings-return relationship (Fan and Wang, 2002).

4. Empirical Results and Implications

a. Sample Statistics

The average accounting earnings were found to be around 9.5% with the standard deviation of around 30%. Family holdings on an average were 45%, whereas outside owners were holding on an average 35% of firms' capital. On an average, 87% of audit committee members were found to be independent and 4 audit committee meetings were convened in a year. Audit committee members attended 83% of committee meetings. Firms engaged auditors not only for statutory audit but also for consulting services. Average annual audit fees paid by the firms were around Rs. 5 million, whereas the consultation fees paid was around Rs. 2 million. Relative to the non-family firms, family firms paid higher average fees for audit services, but lower average fees for non-audit services. Only 32 % of family firms engaged a Big 4 audit firm as an auditor.²⁰ These observations support the opinions that family firms hold on to their long term auditors based on their relationship and it is not popular to engage the Big 4 audit firms in India.

19 A control variable refers to the element that is not changed throughout a study, because its unchanging state allows the relationship between the other variables being tested to be better understood.

20 Big 4 audit firms are the four largest international accountancy firms offering audit, tax, consulting, advisory, corporate finance, legal services etc. They handle the vast majority of audits for publicly traded companies as well as many private companies.

b. Ownership Structure and Earnings Informativeness

Family ownership stake is a reliable metric to determine control of founding family. A shareholding between 15% and 25% is generally considered as the yardstick for family control in the Indian context. Audit committee regulations and SEBI requirements for corporate disclosures did not contribute to improved earnings informativeness among firms with family control. The shareholding percentage of the domestic financial institutions and retail public has been considered as outside ownership. Outside ownership had statistically significant positive association on informativeness indicating desirability of dispersed ownership among such firms.

c. Audit Committee Characteristics and Earnings Informativeness

Well-structured audit committees are expected to reduce opportunistic earnings management and improve earning informativeness. Audit committee independence is critical, particularly in India with concentrated family ownership, where value-reducing related party transactions are perceived to be higher (Sarkar, 2013).

The audit committee size is found to have positive association with earnings informativeness. However it is found statistically significant only in widely held firms. The percentage of independent directors was lower in the firms with higher family ownership. Audit committee independence had significant positive relationship on earnings informativeness. The impact of the number of meetings and percentage attendance in audit committee meetings were examined to identify the tangible benefits from audit committees as against reported grievances of their being a costly affair. Both the variables had positive association with earnings informativeness.

On the whole, the results support the view that the regulations relating to the structure and functioning of audit committees that are aimed at raising the committees' independence indeed strengthen earnings informativeness but do not go so far as to remedy the negative relationship between family holdings and earnings–return relationship. This indicates that audit committees as of now are yet to meet performance expectations about improving earnings informativeness.

d. Auditor Engagement and Earnings Informativeness

Audit fee has a positive association with earnings informativeness. This result indicates that audit committees would pay higher fees and set higher quality expectations on auditors. Consultation fees paid for non-audit services had significant negative association with earnings quality. This supports the regulators' view that engaging auditors for non-audit work creates conflict of interest and limits their independence.

Audit by Big 4 firms had a positive but insignificant relationship on earnings informativeness. The results confirm that engaging the Big 4 is not pervasive in India. Significant social and cultural differences between India and the West explain the multiple reasons for this trend. In India, family firms engage auditors based on personal relationships and do not change or rotate them. Indian firms which engage Big 4 for professional compulsions, still retain their existing auditors as joint auditors. Big 4 engagement requires payment of higher audit fees, including the premium associated with the brand. Domestic family firms that do not have exposure to international capital or product markets, do not believe that such audit premium results in any additional benefits. The result indicates that auditor reputation does not matter or affect the quality of the reported earnings.

5. Concluding Remarks

Quality disclosures of accounting earnings are essential for the well-functioning of capital markets. According to the study, accounting earnings exhibit a significant positive relationship with stock returns which indicates that investors find accounting earnings value-relevant. Positive earnings-returns relationship also indicates the benefits of regulator's efforts, both to strengthen governance quality and to develop capital markets. Such improvement contributes to the development of informationally efficient capital markets, which is vital for an emerging economy like India. However, family firms continue to exhibit lower earnings quality when compared with widely held firms. The results also provide evidence that regulations (relating to structure and functioning of audit committees) aimed at boosting independence of audit committees do ensure reliable financial reporting and provide quality information relevant for investors in capital markets.