

Study on the Relationship Between the Audit Committee of Ipo Firms and the First-Day Stock Earnings

Zhangying She*

Monash University, Melbourne, Victoria, 00008C, Australia

ARTICLE INFO

Article history

Received: 12 May 2020

Revised: 19 May 2020

Accepted: 9 October 2020

Published Online: 16 October 2020

Keywords:

IPO firms

Listed firms

Audit committee

Regression analysis

ABSTRACT

This paper mainly discusses the relationship between the audit committee of IPO firms and the stock returns on the first day of trading on the stock exchange. Using the sample of 21 firms that made an initial public offering in ASX between 2008 and 2010, Regression analysis was used to conclude that the existence of the audit committee of IPO firms and listed on the first day of the stock returns have no significant direct relationships. The result shows that the audit committee has no effect on the earnings of the first day of listing, and the establishment of the audit committee may not be considered before listing.

1. Introduction

With the emergence of profile financial and accounting scandals in the early 21st century, the Sarbanes-Oxley Act emphasized the importance and functions of the audit committee. Since then, the public emphasize the existence of the audit committee and scholars are interested in the impact of the audit committee on the company in different aspects (Defond and Francis, 2005). This article aims to examine whether the IPO firms' audit committee will affect the stock returns on the first day of trading on the stock exchange. The audit committee could enhance corporate governance, strengthen oversight, and ensure the quality of financial reporting, which influences stock price and returns indirectly.^[1] Although similar studies have been conducted in previous literature, the amount of literature

is not sufficient, and they choose non-Australian IPO companies as objects. Prior research is rarely involved in companies listed in the ASX. Therefore, this article uses the empirical analysis method, selects 21 ASX listed companies which become IPO during 2008-2010, and conduct the regression analysis to study the relationship between IPO firms' audit committee and stock returns on the first day of trading on the stock exchange. The result contributes to enrich the literature on audit committees and stock returns in Australia, as well as explore the influence of audit committees on stock return to provide a reference for pre-IPO companies to determine to establish audit committees or not.

2. Literature Review

There's a lot of research on audit committees and stock

*Corresponding Author:

Zhangying She,

Female,

Master degree in Monash University;

Research direction: accounting and finance;

E-mail: 314516081@qq.com.

returns. Azzoz and Khamees (2016) suggest the audit committee can be used as a factor to measure the corporate governance mechanisms. The existence of the audit committee improves the controlling and monitoring process of the company. ^[2]They select financial companies listed in the Amman Stock Exchange (ASE) for the period span 2007 to 2012 and conclude that there is a statistical relationship between stock return and the audit committee. Vander Zahn (2008) examines the relationship between different personal characteristics of the audit committee members of IPO companies and the level of first-day return. The sample of 322 Singapore IPOs listing on the Stock Exchange of Singapore (SGX) from 1997 to 2004 is utilized in regression analysis, and empirical results indicate no overwhelming association between the personality features of IPO audit committees and first-day returns. Beasley (1996) states that a functioning and independent audit committee can enhance the quality of disclosure, ensure the authenticity and reliability of financial information, and effectively reduce the probability of fraud. Haggard, Martin, & Pereira (2008) point that more disclosure and better transparency can enhance investors' trust and confidence in the company and more disclosure of information can enable investors to make more accurate assessments and make investment decisions, which contributes to the increase of stock prices. ^[3] Combined with the aforementioned literature, the existence of an audit committee has a positive effect on the quality of corporate governance and information disclosure, which influences the stock return indirectly. However, previous researches focus on various objective. There is no clear literature states that the correlation between the existence of the IPO firm's audit committee and the first-day stock returns is positive or negative.

3. Hypothesis Development

The audit committee contributes to a relatively higher level and more efficient corporate governance, improves companies control activities, and enhances the cooperation between internal and external auditors. The functioning audit committee could improve the quality of financial reports, enhance the transparency of the company, reduce the information asymmetry, and transfer more useful and credible information for investors and the public. The information users will evaluate the company and predict the future operation condition more accurately, which increases investors' confidence in the company. ^[4] Based on the efficient market hypothesis, the impacts caused by the auditor committee will increase the stock price and investors will demand a lower return, the stock return will decrease. According to the above analysis, the following hypothesis

is put forward.

Hypothesis 1: The presence of IPO firms' audit committee is negatively associated with the stock returns on the first day of trading on the stock exchange.

4. Research Method

This paper uses the empirical analysis method. Microsoft Excel is used to conduct the regression analysis. The detailed definition of variables and raw data are displayed in Tables 1 and Table 2 respectively. LNRETRUN is the dependent variable. AUDCOM the variable of interest. The BIGN, LNBSIZE and LNASSETS are the control variables. The ϵ is the error term. The regression models are designed as follows.

$$LNRETURN_i = \beta_0 + \beta_1 AUDCOM_i + \beta_2 BIGN_i + \beta_3 LNBSIZE_i + \beta_4 LNASSETS_i + \epsilon_i$$

As for the data and sample selection, this paper randomly selected 21 companies that made an initial public offering in ASX during 2008-2010, and ignore FUND and TRUST. The closing price of IPO's first day is collected from Yahoo Finance. The rest of the data comes from the IPO prospectus or disclosure documents released in the DatAnalysis premium ^[5] The raw data is exhibited in Appendix A.

Table 1. Definition of variables used in regression analysis

Abbreviation	Definition
LNRE-TURN	Natural logarithm of (1 + stock returns of an IPO firm on the first day of trading on ASX)
AUD-COM	Dummy variable set to one if an IPO firm has the presence of an audit committee and zero otherwise
BIGN	Dummy variable set to one if an IPO firm employs an external auditor from the member of BIGN and zero otherwise. The BIGN includes Ernst & Young, PricewaterhouseCoopers, KPMG and Deloitte Touche Tohmatsu.
LNBSIZE	Natural logarithm of the number of directors on the board of an IPO firm
LNAS-SETS	Natural logarithm of total assets value recognized on the proforma balance sheet of an IPO firm
I	An IPO firm

Table 2. Raw data collected from IPO prospectuses

Abbreviation	Definition
RETURN	Stock return on the first day of trading on the stock exchange of an IPO firm (infraction) = (Closing share price on the first day of trading on the stock exchange - IPO issue price)/IPO issue price)
BFSIZE	Number of directors on the board of an IPO firm disclosed in the IPO prospectus
ASSETS	Number of directors on the board of an IPO firm disclosed in the IPO prospectus

5. Results

The descriptive statistics and regressions results are displayed as Table3 and Table4.

Table 3. Descriptive statistics

	Mean	Median	Standard Deviation	Min	Max	N
LNRETURN	0.30741075	0.09531018	0.64856615	-0.21072103	2.19555652	21
AUDCOM	0.57142857	1	0.50709255	0	1	21
BIGN	0.38095238	0	0.49761335	0	1	21
LNBSIZE	1.44815950	1.38629436	0.24899847	1.09861229	1.79175947	21
LNASSETS	16.63268172	16.23046584	1.44772821	13.94443134	20.43295765	21
RETURN	0.86700711	0.1	2.309827935	-0.19	7.985	21
BSIZE	4.38095238	4	1.07126983	3	6	21
ASSETS	61155744.81	11189270	160865476.42	1137600	748033000	21

Table 3 exhibits Mean, Median, Standard Deviation Min Max, and N of each variable. The Mean of LNRETURN is 0.30741075, the Minimum and Maximum -0.21072103 and 2.19555652 respectively. The mean of AUDCOM is 58%, which suggests more than half IPO companies own the audit committee. 38% of 21 companies use BIG4 audit firms as their auditor. The range of Return is from -0.19 to 7.985. As for the board size, the average director number is 4 (rounded), the company with the least board of directors has 3 board members and the largest is 5. There is also a wide gap in total assets between companies, ranging from 1137600 to 748033000, the mean is 61155744.81.

Table 4. Regression results

	Coefficients	Standard Error	t Stat	P-value
Intercept	-0.955510312	2.265974086	-0.421677511	0.678871
LNASSETS	0.074077267	0.143488659	0.51625869	0.612735
LNBSIZE	0.224442655	0.688379095	0.326045136	0.748616
AUDCOM	-0.586442749	0.363076853	-1.615202799	0.125811
BIGN	0.107359449	0.435708662	0.246401916	0.808504
Number of observations	21			
R Square	0.157255488			
Adjusted R Square	-0.05343064			
Standard Error	0.665667341			

Table 4 exhibits the regression result. The R square is about 20%, which indicates 20% of the sample could be explained by the regression model. The coefficient of AUDCOM is -0.586442749, which reveals there is a negative relationship between LNRETURN and AUDCOM. The corresponding P-value is 0.125811, which is larger than 0.1, it states the coefficient is statistically insignificant. In conclusion, the LNRETURN is statistically insignificant

and negative with the AUDCOM, which cannot support the Hypothesis 1.

6. Conclusion

This article aims to examine whether the IPO firms' audit committee will affect the stock returns on the first day of trading on the stock exchange. Due to the statistically insignificant and negative relationship between the LNRETURN and AUDCOM, the hypothesis is not supported. We can't prove that there is a clear connection between the IPO firms' audit committee and stock returns on the first day of trading on the ASX.

7. Limitation of Study and Future Research

This article owns the following limitations.

a) The sample is too small, the regression results are easily influenced by extreme value, which leads to the inaccuracy of the regression result. Otherwise, the R square is only 20%, which means the regression model only explains about 20% of the sample, is not persuasive and lack of representativeness.

b) Only companies listed in ASX between 2008 and 2010 have been sampled. The time range is relatively short. The impact of the audit committee on the company will change over time, so the time range should be expanded and also collected samples from other stock exchange because Different stock exchanges have different conditions for listing

c) This paper only considers the existence of the audit committee, but does not set up indicators to measure the effectiveness of the audit committee. Only when the audit committee is running functioning, it can accord with our hypothetical development. This metric should be set in the future research.

References

- [1] Azzoz, A.-R. A., & Khamees, B. A. (2016). The Impact of Board of Directors and Audit Committees on Stock Return of Jordanian Financial Companies. *Dirasat: Administrative Sciences*, 43(2), 923–942. Retrieved from <http://ezproxy.lib.monash.edu.au/login?url=http://search.ebscohost.com/login.aspx?direct=true&db=bth&AN=123863686&site=e-host-live&scope=site>
- [2] Beasley, M. S. (1996). An Empirical Analysis of the Relation Between the Board of Director Composition and Financial Statement Fraud. *Accounting Review*, 71(4), 443–465. Retrieved from <http://ezproxy.lib.monash.edu.au/login?url=http://search.ebscohost.com/login.aspx?direct=true&db=b->

th&AN=9611271988&site=ehost-live&scope=site
 [3] DeFond, M. L., & Francis, J. R. (2005). Audit Research after Sarbanes-Oxley. *Auditing: A Journal of Practice & Theory*, 24(s-1), 5-30
 [4] Haggard, K. S., Martin, X., & Pereira, R. (2008). Does Voluntary Disclosure Improve Stock Price Informativeness?. *Financial Management*, 37(4), 747-768.

[5] Van der Zahn, J.-L. W. M. (2008). Educational Qualifications, Business Experience and Diversity Factors of Independent Audit Committee Members and an IPO's First-Day Returns. *ICFAI Journal of Audit Practice*, 5(2), 7-41. Retrieved from <http://ezproxy.lib.monash.edu.au/login?url=http://search.ebscohost.com/login.aspx?direct=true&db=bth&AN=31614287&site=ehost-live&scope=site>

Appendices

No	ASX CODE	LN RETURN	LN ASSETS	LN BSZE	AUDCOM	BEN	RETURN (N FRACTDN)	BSZE (NUMBER OF DIRECTORS ON THE BOARD)	ASSETS (AU\$)
1	ATC	-0.020202707	15.56563225	1.386294	0	0	-0.02	4	5,755,303
2	IAG	0.083881484	15.9044454	1.791759	0	0	0.0875	6	8,076,308
3	AAJ	-0.210721031	15.39051022	1.098612	0	0	-0.19	3	4,830,740
4	ATR	0.433080275	13.94443134	1.609438	1	0	0.542	5	1,137,600
5	AUC	-0.139262067	15.83491317	1.386294	1	0	-0.13	4	7,533,823
6	ABX	0.438254931	15.60443117	1.609438	0	0	0.55	5	5,982,991
7	CM M	0.300104592	16.34960515	1.386294	1	0	0.35	4	12,605,013
8	EFE	0.371563556	15.46591247	1.386294	1	0	0.45	4	5,209,073
9	EVS	-0.008032172	16.59246474	1.386294	1	1	-0.008	4	16,070,000
10	EPW	0.033711057	20.43295765	1.791759	1	1	0.034285714	6	748,033,000
11	FDM	0.09531018	17.37653746	1.386294	1	1	0.1	4	35,199,325
12	GCY	-0.077961541	16.23046584	1.098612	0	0	-0.075	3	11,189,270
13	HCH	0.048790164	15.91061283	1.098612	0	0	0.05	3	8,126,272
14	IRD	0.270027137	15.44448793	1.098612	0	0	0.31	3	5,098,658
15	M LD	0.371563556	18.68545443	1.609438	1	0	0.45	5	130,313,603
16	M YE	0.09531018	17.83495196	1.609438	1	1	0.1	5	55,670,000
17	PDI	2.148850993	16.12768156	1.609438	0	0	7.575	5	10,096,320
18	RFX	-0.15082289	16.98654846	1.386294	1	1	-0.14	4	23,832,207
19	RVA	0.127833372	18.11370711	1.791759	1	1	0.136363636	6	73,567,000
20	TER	2.19555652	18.26669644	1.098612	0	1	7.985	3	85,728,548
21	XAM	0.048790164	17.22386848	1.791759	1	1	0.05	6	30,215,587

Appendix A Raw Data-Set