# Keep stricter audit committee standards flexible, argues new study: Study validates controversial OSC 2003 decision

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Independent, financially-literate audit committees lead to higher firm values and less diversion of resources by management, shows a new study by researchers at the University of Toronto.

But the paper, which looked at small companies that voluntarily adopted standards required of larger companies, also says it's important for regulators to stay flexible around rules requiring high-quality audit committees, particularly for smaller firms that may be hurt by expensive director compensation costs.

The study was motivated by controversy surrounding a 2003 decision by the Ontario Securities Commission (OSC). The OSC exempted smaller firms from a new policy requiring higher audit committee standards for TSX-listed securities issuers, arguing for a balance between investor protection and maintaining a competitive environment for Canadian companies.

"Our evidence is consistent with OSC's stand," said Feng Chen, a professor at the University of Toronto Mississauga and the University's Rotman School of Management who wrote the paper with Yue Li, also an accounting professor at UTM and the Rotman School. The researchers wrote that critics of voluntary standards may "underestimate the economic incentives for smaller firms to voluntarily adopt the new policy."

The researchers examined data for companies listed on the Toronto Venture Exchange, which were exempt from the policy, as well as for a group of TSX-listed companies, which were not. Out of 376 TSX Venture firms, some 101 of them had voluntarily adopted the OSC policy by 2005, something the researchers called "a pleasant surprise." The policy requires audit committees to have at least three independent and financially-literate members.

The study found that TSX Venture companies with lower compliance costs and a greater need to raise external financing were more likely to adopt the higher standards. All companies operating under the higher standards, including those that were required to, generally saw higher firm value, improved investment efficiency, and significantly lower borrowing costs.

Previous research has found that companies that have financial experts on their audit committees are less likely to restate earnings, dismiss their auditors if they receive a negative report, and are less likely to outsource routine internal auditing jobs to external auditors.

The OSC policy was developed following tougher accounting and financial rules drafted in the U.S. under the Sarbanes-Oxley Act. Critics of the OSC's decision to exempt smaller companies called it unfair and said that it was small start-ups where investors faced the biggest risks.

But the researchers' study shows that the OSC policy "is effective," says Prof. Li. "It provides the flexibility for smaller firms to assess for themselves the costs versus the benefits of stronger governance. A more strict policy on mandatory adoption probably would not work well in the Canadian context where we have a large number of firms on the venture stock exchange."

The study is forthcoming in the *Accounting Review*.

Provided by University of Toronto