

ENHANCING AUDIT COMMITTEE INDEPENDENCE IN CORPORATE GOVERNANCE: AN ALTERNATIVE VIEW OF APPOINTMENT AND REPORTING STRUCTURE

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Abstract *Globalization of audit committees as a common mechanism of corporate governance is one of the most significant developments during the last two decades in several countries (including United States, Singapore, United Kingdom, Australia and Canada). Following the recent saga of corporate failures and the dramatic collapse of Enron, Worldcom, Cendant and HIH on the international arena and National Bank of Fiji locally (Fiji Islands), it provides continuing evidence of failures of corporate governance at all levels including senior management, boards of directors, the audit committee, external auditors, financial regulators and the accounting and auditing profession. Probably, at present this is the hottest issue and it provides a watershed opportunity for this study to contribute to our understanding of the value and potential of audit committees as a governance mechanism by bringing together arguments associated with their appointment and reporting structure in the context of the agency theory approach.*

This study is based on the theme ‘audit committee independence in corporate governance’ and in particular ‘the appointment and reporting structure of audit committees affecting their independence in the corporate governance practices of private sector corporations, in particular, the listed public companies in Fiji’. The advent of these Independent audit committees in Fiji would facilitate the setting up of international collaboration approach to the globalisation of audit committees in corporate governance. This would be achieved in terms of new and improved auditing standards, and the mounting pressure from institutional investors and stakeholders would allow for greater compliance to prevent ethical and financial crisis.

Keywords *Agency Theory, Audit Committee Appointment, Reporting and Independence, Financial Reporting Reliability and Corporate Governance.*

INTRODUCTION

The term “Governance” is a very versatile one. It is used in variety of fields in different contexts, for instance, it is used in connection with several contemporary social sciences, especially political science and economics. It originates from the need of political science with regards to the state governance and from the need of economics with regards to the corporate governance. For example, the World Bank (1992:1) regarded governance as the manner in which power exercised in the management of a country’s economic and social resources for development. Also the Commission on Global Governance suggested that governance is concerned with accountability, transparency, equitability and predictability.

‘Governance’ corresponds to the post-modern form of economic and political organizations, for example, according to the political scientist Roderick Rhodes (1997), governance concept is currently used in contemporary social science with at least six different meanings: the minimal state, the new public management, good governance, social-cybernetic systems, self-organised networks and corporate

governance. However, for the purpose of this study, the focus is given on the latter meaning, the concept of “the corporate governance”.

Corporate governance is one of the critical issues in business today. Corporate governance practices provide the structure through which the objectives of the company are set, the means of attaining those objectives are met and monitoring performance the performance of the companies are determined. Corporate governance rules also promote and reinforce the confidence of the current and future shareholders, employees, business partners, lenders and the general public in national and international markets (Franfurt, 2000) and has emerged as one of the best vehicles for reducing the expectations gap (Gill et al, 2001).

Amongst its many branches, financial reporting system is one which closely relates to the concept of corporate governance and accountability, that is, one of the key aspects of good corporate governance is to improve the financial reporting process of corporations. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interest of the company and its shareholders and it should also facilitate effective

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monitoring; thereby encouraging firms to use resources more efficiently (BRC, 1999).

The effect of sound corporate governance practices on the quality of financial reporting has recently received attention from many researchers, particularly in the U.S. (McMullen, 1996; Beasley, 1996; Beasley et al., 2000; Abbott et al., 2000). So in order to gain confidence in the organisations around the world, corporations must provide users with relevant, reliable and timely information so that the quality and integrity of the financial reporting process is enhanced (Imhoff, 2003).

The role of auditing in the corporate governance structure is essential in the flow of the quality information to the market participants. However, the governance literature has only just begun to consider the role of the audit as a component governance device (Anderson et al, 1993). Such role emerged during the early 20th century when shareholders appointed representatives such as the board of directors who serves their interests in the corporations. Their responsibilities were to look out for the interests of the owners and to oversee the management of the entity. As part of their refinement process, these boards eventually added 'audit committees' as one of their sub-committees to address some of the more sensitive governance issues in these corporations. The audit committee was established to serve as a liaison between the independent auditor and the management.

Audit committees are a mechanism of corporate governance and their adoption and operation in corporate enterprises needs to be considered in the context of developments in the arena of governance. It is generally agreed that, for an audit committee to be effective, a majority if not all members should be independent (Cadbury, 1992). Since the issue of this report, there has been a growing practice for outside directors to form an audit committee of the board, with special responsibility for overseeing the financial reporting process and ensuring auditor independence. Setting up of audit committees came about in direct response to demands like improving financial reporting and public accountability.

In essence, to achieve orderly capital markets around the world, corporations must provide investors and creditors with relevant, reliable and timely information and accounting, auditing and corporate governance that these corporations operate within, are the essential components in the flow of information to capital market participants (Imhoff, 2003). However, recent accounting failures have pointed out the need for substantive improvements in these components, therefore, the academic accounting community can play a role in stimulating change aimed at enhancing market efficiency through proposals that provide direction for change.

As part of the academic contribution in this area, this study proposes an alternative appointment and reporting structure of audit committees within the corporate governance

framework by reviewing the historical development of accounting, auditing and corporate governance in an effort to identify and understand salient features of the past that have led to the current state of affairs. While addressing these issues, this study adds to the body of knowledge the concern for audit committee independence and how alternative appointment and reporting mechanisms could enhance the underlying quality and integrity of the financial reporting process. This study uses the agency theory model based on economic relationship to formulate such proposals for the research problem.

The initial findings of this study may also stimulate further debate and empirical research aimed at enhancing the future quality and integrity of the financial reporting process in corporate governance arena. This proposal might have important implications for regulators, professional accounting bodies and various stock exchanges in different countries (particularly the case of Fiji Islands), as they attempt to establish audit committees as part of their future corporate governance policy. There are concerns to improve corporate governance structures and the financial reporting system in Fiji and this study contributes to the Fijian economy by providing arguments for establishment of audit committees as a mechanism of improving the corporate governance process.

LITERATURE REVIEW

Prior Research in Corporate Governance

Corporate governance is defined by the mainstream accounting and finance literature as "the range of control mechanisms that protect and enhance the interests of shareholders of business enterprises" (Fama and Jensen, 1983). Good corporate governance is regarded as the key to improving economic efficiency, enhancing the attraction of our market and investors' confidence, as well as maintaining the stability of our financial system (SFS, 2002)¹. There is a focus in this line of research on the structure and functioning of board of directors and audit committees of such boards (Rosenstein & Wyatt, 1990; Shleifer & Vishny, 1997).

Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Establishing good director and board practices would be conducive to ensuring that directors and their boards act responsibly in the governance of their companies and be accountable to the shareholders for the resources entrusted to them (SFS, 2002).

¹ SFS – is the Securities and Financial Services Council of US, which looks into the financial affairs of the corporations. It aims to promote good governance as a key to improving economic efficiency.

Prior research in accounting, finance and management literature has presented several different views of corporate governance (Cohen et al., 2000). For instance, one of the views commonly held in accounting and finance literature is based on agency theory perspective (Bathala & Rao, 1995; Beatty & Zajac, 1994; Core et al., 1999). *Agency theory* view of corporate governance assumes that managers act from self-interest and it adversely affects the shareholders. The concept of corporate governance within the agency theory perspective is focused primarily on designing contractual mechanisms to control self-interested managerial behaviour and central to this perspective is the notion that those performing the monitoring function such as the members of the board of directors should be independent from those being monitored, that is the management. Therefore, under the agency theory perspective, the members of the board of directors need to be independent from the management and these members also need to have expertise in monitoring and control (Cohen et al., 2000).

Recently, a great deal of debate has been focused on corporate governance (Forker and Green, 2000; O'Sullivan, 2000; Shleifer and Vishny, 1997; Solomon et al., 2000; Rosenstein and Wyatt, 1990). Efforts to reform corporate governance have been prevalent in four areas such as the organization structure of the board of directors (O'Sullivan, 2000); the role of audit committees (Rosenstein and Wyatt, 1990); selection of external auditors (Cohen et al., 2000); and research based on compensation (Colvin, 2001). These suggestions to improve corporate governance have been out forth through best practices proposals rather than legal requirements (Cadbury Committee, 1992; Turnbull, 1997; The Turnball Report, 1999; OECD, 1999). Based on this prerogative, top management has often retained the ability to direct the intentions of the corporations (Baker and Owsen, 2001).

Hence, prior research in corporate governance has focused the role of directors in discharging their duties (Gill et al, 2001). Corporate best practice is demonstrated by various studies, such as the Treadway Report and the Cadbury Report². These corporate governance codes recognize the importance of management, maintaining and demonstrating a responsible attitude to control (for example, the UK Combined Code on Corporate Governance, 1999). The directors of the company assume the role of 'agents of the

company' and thus have power to execute the company business. The following section reviews some research that has investigated the relationship between the role of auditing and corporate governance.

Prior Research in the Role of Audit Committees in Corporate Governance

The audit committee is responsible for matters pertaining to the accounting and auditing for the company and the group. The committee evaluates the Auditor's reports and reports to the Supervisory board on its assessment of the comments in the audit report, particularly with regard to the future development of the group. It verifies the Management board's assumptions on the budget figures for the Group and its business segments. Other important documents issued to shareholders shall be presented before publication to the committee. By way of background, a development has heightened the importance of accounting and auditing standards. New statutes have prompted more attention to accounting and auditing practices and new rules for audit committees.

The task of the committee regularly comprises:

- The preparation of the selection of the Auditor, the determination of major auditing issues, even if exceeding the legally required points and the content of the audit, as well as the determination of the Auditor's fee.
- The preparation of the audit of the Annual and Group Accounts by the Supervisory Board, including the relevant business reports on the basis of the results of the audit and additional points raised by the Auditor
- The preparation of a report by the Management board with regard to corporate donations exceeding an amount determined by the Supervisory Board, and if applicable:
- the discussion of partial auditing results during the year (e.g. of the internal control system);
- The discussion of Interim Accounts and the results of any audits performed.

(Adopted from Frankfurt, 2000, p.6)

Audit committees are considered by some to be 'creatures of the company's management rather than watchdogs over shareholders' interests' (Weschler, 1989, p.132). critics argue that many audit committees hesitate to stop management misdeeds because they fear rocking the boat and lack access to knowledgeable lower level employees (Berton, 1995, B4).

Audit committees are expected to monitor the reliability of the company's accounting processes and compliance

² The full title of the Cadbury report is the 'report of the committee on the financial aspects of corporate governance – a small supplement to the report is subtitled 'the code of best practice'. The financial reporting council (UK), the London stock exchange and the UK accountancy bodies set up the committee in May 1991 to consider the issues of the responsibilities of the executive and non-executive directors, audit committees: the links between shareholders, boards and auditors; and other matters. The report was issued in December, 1992.

with corporate legality and ethical standards including the maintenance of preventive fraud controls (Zaman, 2002). There is also a belief that audit committees help ensure the maintenance of proper accounting records and the reliability of published financial information (ICAEW, 1997). The following extracts indicate the intended benefits of audit committees in this area (as stated in Zaman, 2002):

“The audit committee of a company’s board of directors can play a crucial role in preventing and detecting fraudulent reporting” [NCFRR, 1987, quoted in Zaman, 2002, p. 7].

“The existence of an audit committee can strengthen the position of the finance director. He has a forum in which to explain certain policies or disclosures relating to external financial statements” [Marrian, 1988, quoted in Zaman, 2002, p. 7].

“Audit committees have the potential to] improve the quality of financial reporting, by reviewing the financial statements on behalf of the board [and to] create a climate of discipline and control which will reduce the opportunity for fraud. [audit committees can also] increase public confidence in the credibility and objectivity of financial statements” (Cadbury, 1992, quoted in Zaman, 2002, p. 7).

For instance, audit committees have been recommended by a wide range of professional firms, accountancy bodies and regulatory committees who has previously supported the adoption of audit committees (for further details see BCA, 1991; CEPS, 1995; CICA, 1981; Cohen Commission, 1978; Colbert, 1989; English, 1994; Colegrove, 1976; Ernst & Whinney, 1987; ICAEW, 1997; Kollins et al., 1991; Lindsell, 1992; Mautz and Neumann, 1970 and the Sarbanes-Oxley Act, 2002). Notwithstanding the claimed virtues of audit committees and the prevalence of normative recommendations for their adoption, there remains the overriding question of what differences do they make to organizational accountability in practice. In this context, issues of interest include the effects of audit committees on the audit function, financial reporting and corporate performance. For the purpose of this study, focus is made on the alternative appointment and reporting structure of audit committees and its effect on financial reporting process.

Cohen and Hanno (2000) suggested that strong corporate governance including an independent audit committee have the potential to increase audit efficiency and effectiveness. Similarly, effectiveness of audit committee in the areas of experience and expertise has been emphasised by Price Waterhouse (1993) and Public Oversight Board (1994).

Prior studies (for example, Mautz and Neumann, 1970, 1977; Robertson and Deakin, 1977; Grinaker, et al., 1978; Reinstein, 1980; Birkett, 1980; Braiotta, 1986; Castellano et al., 1989; Spangler and Braiotta, 1990) have also identified some of the factors that affect the effectiveness of the audit

committees within the corporate governance framework of the corporations. Such as the power of audit committees (Kalbers and Fogarty, 1993), their decision-making authority, skills, knowledge, experience and independence (Knapp, 1987; McDonald Commission, 1987; NCFRR, 1987; Sommer, 1991; GAO, 1991, 1996; Lee and Stone, 1997; Arthur Andersen, 1998; DeZoort, 1998; BRC, 1999; KPMG, 1999a; NACD, 2000), experience (Robertson & Deakin, 1977; Treadway Commission, 1987; GAO, 1991; Kalbers and Fogarty, 1993; Lee and Stone, 1997), relationship with internal auditors (Treadway Commission, 1987; Institute of Internal Auditors, 1993; Beasley, 1996; McMullen, 1996; Scarbrough et al., 1998; BRC Report, 1999) competence and expertise of the audit committee members (BRC, 1999), audit committee member training (Sommer, 1991), the audit committee activity, audit committee charter, access to the information, the audit expectation gap, the number of meetings, members’ backgrounds and the independence of the audit committee members (for example, Abbott et al., 2000; Beasley et al., 2000; Parker, 2000; and Windram and Song, 2000).

In addition, Knapp (1987) investigated the general business experience of audit committee members in auditor-management disputes. Sommer (1991) highlighted training of audit committee members as another factor for effective audit committees. Olson (1999) offered some practical suggestions for making substantive improvements in the functioning of audit committees. Grinaker et al. (1978) recognised the multidimensionality of audit committee effectiveness and its related phenomena. Spangler and Braiotta (1990) took a more distinctly theoretical approach by examining several leadership qualities as elements contributing to audit committee effectiveness.

In another study, Goodwin and Seow (2002) indicated that auditors and directors perceive that the existence of an internal audit function and strict enforcement of a corporate code of conduct have a significant impact on the company’s ability to strengthen controls, prevent and detect fraud and financial statement errors and enhance audit effectiveness. However, empirical research related to audit committee processes such as the interaction between audit committees and internal auditors is in the developmental stage and previous researchers (for example, Beasley 1996; McMullen, 1996; Scarbrough et al., 1998) note that further studies are needed to provide increased understanding of audit committee processes and activities.

In drawing together evidence from a variety of these studies, it is recognised that there have been major changes in the context in which audit committees operate over time and the degree of codification of best practice and the attention given to the activities of audit committees have increased. Similarly, cultural and structural differences internationally will be likely to influence the operation of audit committees

(Turley and Zaman, 2001).

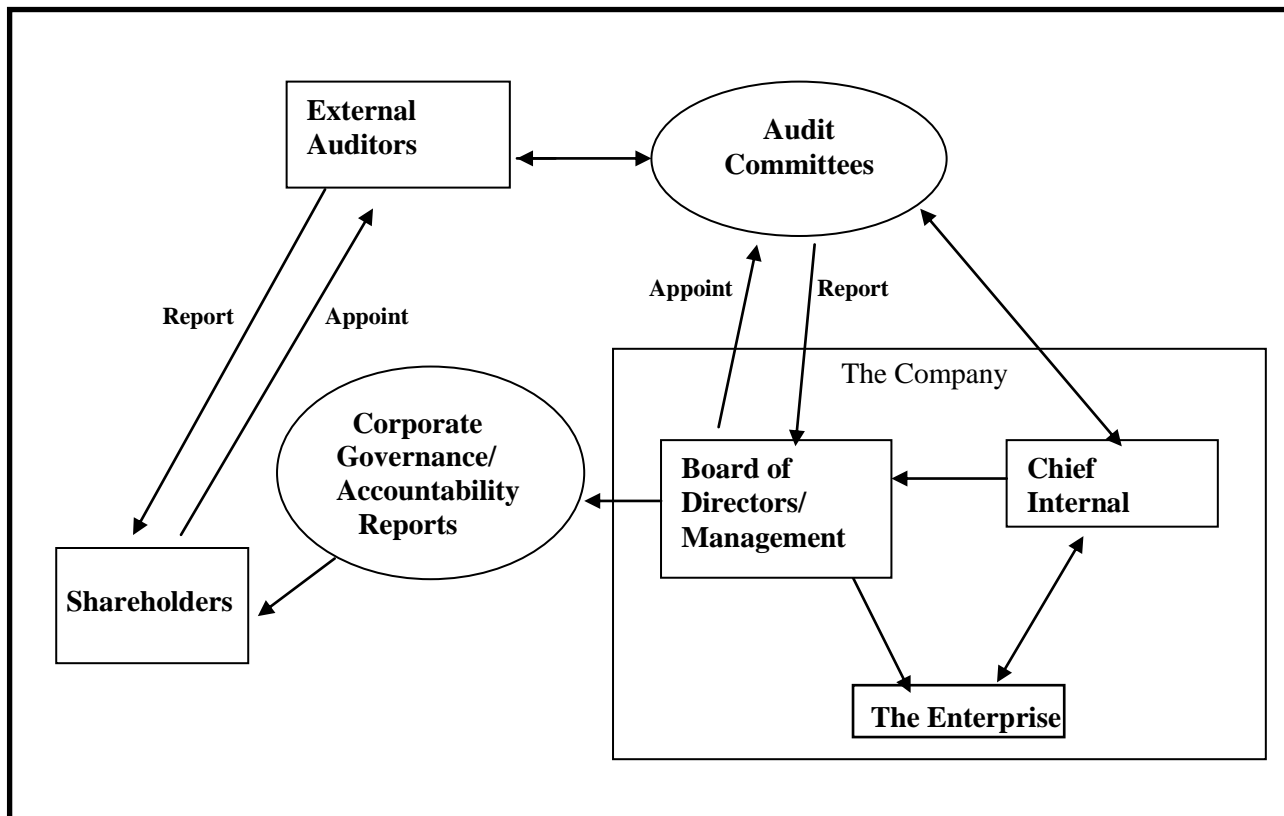
The role of auditing in the corporate governance structure is essential in the flow of the quality information to the market participants. However, the governance literature has only just begun to consider the role of the audit as a component governance device (Anderson et al, 1993). Such role emerged during the early 20th century when shareholders appointed representatives such as the board of directors who serves their interests in the corporations. Their responsibilities were to look out for the interests of the owners and to oversee the management of the entity. As part of their refinement process, these boards eventually added ‘audit committees’ as one of their sub-committees to address some of the more sensitive governance issues in these corporations. The audit committee was established to serve as a liaison between the auditor and the management. Figure 1 illustrates this concept.

Figure 1 shows that currently, the audit committees are appointed by the board of directors and they report to these boards. The major difficulty is that audit committees are subject to considerable influence by the board of directors and thereby the managers of the corporations they oversight. This is similar to Byrne (1998) and Tinker (1991) who found

that auditors are subject to considerable influence by the managers of the company they audit.

Currently, audit committees are regarded as an arm of board of directors and they have to report back to the board, which is accountable to the shareholders. Their responsibilities can be classified into three categories (Wolnizer, 1995): oversight of the financial statements, oversight of the external audit, and oversight of the internal control system including internal auditing.

The corporation and the company laws of the respective countries provided the framework for the currently accepted understanding of the role of auditing in corporate governance. Based on this understanding, the financial reports consisting primarily of financial statements prepared in accordance with certain standards, that is, those specified by law or promulgated by recognized standards setting bodies (such as the Fiji Institute of Accountants [FIA] in Fiji) are required by the law to be issued on a periodic basis to the shareholders. These reports must be audited by professional accountants designated or licensed by the state. The shareholders are not considered to be part of the company and do not have any means of directly ascertaining the validity of the financial reports provided to them by the managers (Baker and Owsen,



Based on McInnes (1993); Schilder (1996); and Baker & Owsen (2001).

Fig 1 The Current Role of Audit Committees in Corporate Governance

2001). This is the current understanding of the role of audit committees in corporate governance.

Views of Agency Theory Perspective

Agency theory approach to conceptualising corporate governance is now being used to develop models of corporate governance effects, for example the impact of audit committees on financial reporting quality (Zaman, 2002). The growing volume of research in this area generally falls into two different categories: studies which have examined the effect of audit committee presence (absence) on various measures of financial reporting quality (for example, DeFond and Jiambalvo, 1991; Beasley, 1996; Dechow et al, 1996; McMullen, 1996 and Peasnell et al, 1999); and those more concerned with testing particular audit committee characteristics, such as meetings, independence and members' backgrounds (for example, Abott, et al., 2000; Beasley et al, 2000; Parker, 2000 and Windram and Song, 2000).

Numerous studies have also conceptualised the adoption and operation of audit committees for reducing agency costs (Zaman, 2002) as part of their corporate governance mechanism. One of the most important factors that determine the effectiveness of external corporate auditing has been the ability of external auditors in remaining independent in executing their tasks. The issue of external auditor independence has been an ever-challenging problem of corporate governance. Within the agency theory model, shareholders appoint the external auditors, who are then contracted with the company to provide independent audit opinion on the financial statement.

Jensen and Meckling (1976) suggest that, because of the conflicting interests of managers and debtholders, higher leverage increases debtholders' need to monitor managers. Managers have incentives to control the agency cost of debt and can do so by providing increased monitoring through audit committees (Zaman, 2002). Evidence has been reported of a significant negative relationship between the presence of a dominant chief executive officer and audit committee activity, as indicated by frequency and duration of meetings (Collier and Gregory, 1999).

Drawing upon the agency theory model, this paper provides an alternative framework for conceptualising the structure of audit committees within the corporate governance framework. In extant audit committee research, there is very limited consideration of the structural context in which audit committees operate since corporate governance mechanisms do not operate in a vacuum and their operation and effects cannot be adequately examined without regard to the structural context and the issue of appointment and reporting relationships which is intrinsic to that context.

RESEARCH PROBLEM

Until recently, the effect of sound governance practices on the quality of the financial reporting has received attention from researchers, mostly in the US (McMullen, 1996; Beasley, 1996; Beasley, et al., 2000; Abbott et al., 2000; Goodwin and Seow, 2002). The concerns raised in these studies have been the relation between audit committees and fraudulent financial reporting. For example, Goodwin and Seow (2002) found out that the results relating to a strong audit committee are mixed, with some impact on preventing and detecting financial statement errors, detecting management fraud and enhancing audit committee effectiveness. DeZoort (1998, p.1) defined audit committee effectiveness 'as a committee's collective ability to meet its oversight objectives'. The audit committee effectiveness has been examined in many ways and the policymakers, practitioners and researchers agree that the construct is multi-dimensional involving a variety of dimensions such as independence, diligence, committee size, number of committee meetings, conformity with prescribed standards, management cooperation and audit committee member experience (Robertson and Deakin, 1977; Treadway Commission, 1987; GAO, 1991; Kalbers and Fogarty, 1993; and Lee and Stone, 1996).

A great deal of debate has been focused on the details of corporate governance (Forker & Green, 2000; O'Sullivan, 2000; Shleifer & Vishny, 1997; Solomon et al., 2000; Rosenstein & Wyatt, 1990) and efforts to reform corporate governance have emerged in some areas such as the organization structure and the role of audit committees. However, while the listing standards of some countries mandate that companies have an audit committee, these listing standards do not stipulate with much specificity how an effective audit committee should be comprised and moreover, how it should function. Similarly not much guidance is on audit committees' role, composition and structure. Concerns has also been made about audit committee effectiveness due to rising expectations and increased liability which have motivated considerable inquiry in the accounting literature (DeZoort, 1998).

However, audit committee independence within corporate governance is a crucial area where research has been limited and therefore, this study is motivated by international concerns about audit committee independence and its effectiveness in enhancing the quality and integrity of the financial reporting process. By looking at the audit literature, prior research has taken the issue of audit committee power, audit committee composition and audit committee activity more in depth but did not address the need to find alternative structural mechanisms for audit committees that can ensure their greater independence within the corporate governance framework.

Following the recent spectacular increases in unexpected business failures critically questions the independence of audit committees in the corporate governance structure of the corporations; for example, the recent high profile cases of financial statement fraud such as Enron, Cendant and K-Mart have severely damaged the reputation of the accounting and the auditing profession.

In particular, the corporate governance issues of Enron have received very serious questions on strengthening the board of directors and their audit committees. Enron was one of the world's leading electricity, natural gas and Communications Company with approx. \$101 billion in revenues in 2000. It filed a bankruptcy with United States Department of Justice, Securities & Exchange Commission on February 2nd, 2002.

Such cases also highlight inadequacies in current accounting rules and disclosures, the conflicts of interest on financial reporting such as economic links between auditors and their clients, and a culture that emphasizes strict legal compliance over full and fair disclosure in the public interest and lack of independence of the auditors, the boards and the audit committees. Therefore, research in this area is needed because of the actual costs of ineffective audit committee oversight such as huge corporate fraud, business failures and the potential costs of ineffective audit committee oversight such as the legal exposures (Verschoor, 1990a, 1990b).

As such, this study argues that changing the appointment and reporting structure of the audit committees may keep intact the independence of audit committees within the corporate governance practices of the corporations. In particular, this study proposes that audit committees should be appointed by the Independent oversight board as opposed to board of directors and these committees should also be reporting to this Independent oversight board as opposed to the board of directors.

Unfortunately, given that most companies operate under the free-market approach or would like to operate under this mechanism, this may not be possible. However, shareholders require greater transparency, accountability and more reliable financial reporting process, thereby improving corporate governance structures of corporations and controlling future corporate collapses, which will eventually benefit the shareholders and other stakeholders generally. As such, proposing this reform to bring about changes in the appointment and reporting structure of audit committees will outweigh the issue of free-market approach in today's globalised and transparent economies and the state needs to intervene to correct and improve these reforms through establishment of Independent oversight board, thereby legislating audit committees to be independent. .

Hence, based on the above issues and the outset of the existing literature, the following research problem is developed for this study:

How does alternative appointment and reporting structure of audit committees within the corporate governance framework of corporations affect their judgment in auditor-management disagreements and its impact on the quality and integrity of the financial reporting process?

Specifically, although the audit committee is only one dimension of broad-based corporate governance (*see* Cohen et al., 2000), a lack of appropriate audit committee oversight can ultimately contribute to corporate failure and diminish the public confidence in the mechanism (Lublin and MacDonald, 1998; Verschoor, 1990a, 1990b). The above research problem is based on the recent evidence that suggests that strong corporate governance, including an independent audit committee has the potential to increase audit effectiveness and efficiency by reducing the auditor's perceptions of client business risk, the auditor's control risk judgments for specific audit assertions and the amount of planned substantive testing (Cohen and Hanno, 2000).

JUSTIFICATION FOR THE RESEARCH

Interest in the audit committees as part of the overall corporate governance has increased dramatically in recent years and has been the subject of considerable attention in many countries (*see* CICA, 1981; NCFRR, 1987; BCA, 1991; Cadbury, 1992; CEPS, 1995; EC, 1996; AARF, 1997; and Porter and Gendal, 1998). The globalisation of audit committee has become a common mechanism of corporate governance and is one of the most significant developments in the area of auditing during the last two decades. In many countries including U.S., UK, Canada, Australia, and Singapore, audit committees are a feature of good corporate governance for listed companies (Canham and Soutorn, 2000). It is mandatory in US, Canada and Singapore but is voluntary in UK and Australia [CGSR.9/1000(Aca), 2000].

Early recommendations for audit committees made in U.S. (NCFRR, 1987) and Canada (CICA, 1981) have been followed by proposals for extending their use in many countries (AARF, 1997; BCA, 1991; Cadbury, 1992; CEPS, 1995; EC, 1996; Porter and Gendal, 1998 and Morse and Keegan, 1999). This research, therefore, believes that these proposals might be important and influential for Fijian economy to establish audit committees and be made mandatory for the listed public companies for their own benefit in future.

What is notable is the extent of their promotion and the subsequent adoption of the audit committees by listed companies in several countries during the last quarter century (Turley and Zaman, 2001). For example, audit committees are now required by law in Canada and Singapore and are a condition of listing on the stock exchange in U.S. and Thailand. In U.K., Australia, New Zealand and South Africa, companies listed on the stock exchange are required

to state whether they have an audit committee in their annual report. In others such as France, Hong Kong, Japan and the Netherlands, audit committees are recommended as a best practice (Morse and Keegan, 1999).

A number of studies have found that companies with an audit committee, particularly when that committee is active and independent, are less likely to experience fraud (Beasley et al., 2000; Abbott et al., 2000; McMullen, 1996) and other reporting irregularities (McMullen, 1996; McMullen and Raghunandan, 1996). Findings also suggest that audit committees are effective in reducing the incidence of earnings management that may result in misleading financial statements (Defond and Jiambalvo, 1991; Dechow et al., 1996; Peasnell et al., 2000).

While these results provide evidence from a strong sophisticated capital market environment³ very little research has been conducted in countries⁴ where capital markets are less developed and where governance mechanisms are still evolving. For instance, sound corporate governance practices are equally, if not more, important in countries that are attempting to gain credibility among the global investors. This is so in the developing countries, for example, Fiji Islands as the region attempts to gain investor confidence following the political crisis of the new millennium.

Moreover, interest in the role of audit committees in corporate governance is due to another wave of huge corporate failures and scandals such as the recent saga of corporate failures and the dramatic collapse of Enron, Worldcom, AOL Time Warner, Boeing, Computer Associates, Xerox, Tyco, IBM and Cendant on the international arena and National Bank of Fiji locally. In particular, Enron and Worldcom saga has prompted fresh calls for more stringent governance measures. This turmoil in foreign markets has even further compounded pressures on our financial reporting process and has pointed out the need for substantive improvements in the area of accounting and auditing within the corporate governance framework of the corporations. The collapse of Enron raises further controversies and arguments about the role of audit committees in corporate governance. Such calls provided added motivation for research in this area.

Furthermore, with regards to the core public sector, accountability breakdowns continue to make the news locally in Fiji. Most recently, it has been alleged that the Ministry of Agriculture, Fisheries and Forestry in the Fijian economy has misused \$12 million what we commonly hear as the 'agricultural scam'. In particular, it appears that corporate governance structures were not followed. This study further raises concern for the increasing role of audit committees in

such type of 'scams' and how audit committees might benefit the stakeholders in terms of providing a transparent audit reporting process. It also provides continuing evidence of weaknesses of corporate governance at all levels including the senior management, board of directors, audit committees, external auditors, financial regulators and the accounting and auditing profession.

Therefore, to control such unscrupulous disasters, this study takes an in-depth approach to consider structural alternatives available to the board of directors and wider stakeholders to strengthen the role of audit committees in corporate governance to avoid fraud, error and poor quality of financial reporting process and eventually poor corporate governance and failures of corporations in future.

In addition, auditing issues in corporate governance has also become crucial due to the liberalization and deregulation all over the world and the sophistication of the financial markets and the regulatory framework. We also live in a more volatile and inter-linked world where effects are instantaneous. If one company fails, it may affect other institutions and other countries. Such failures will certainly have social and economic implications such as unemployment, financial losses, bankruptcies, frauds, scandals and loss of investments in the country. Therefore, research in this area is needed because of the actual (e.g. fraud or business failure) and potential (e.g. legal exposure) costs of ineffective audit committee oversight (Verschoor, 1990a, 1990b).

As such, this study hopes to facilitate the setting up of international collaboration approach to the globalisation of audit committees in corporate governance especially in less developed and developing countries (such as the case of Fiji Islands) where there are more potential for corporations to adopt to reforms in the corporate structure. However, even in the developed world, the role of audit committee in corporate governance is relatively new.

Finally, this study addresses the scarcity of research in this field of auditing by exploring governance issues relating to the quality of financial reporting and the structure of audit committees. Much research has been done on the audit committee's role, composition, power, knowledge, experience and meetings but neither of these studies have researched into the alternative appointment and reporting structure of audit committees. Also little research has focused on the quantitative approaches to solving research problem in this area, particularly the use of agency theory in reducing agency costs of audit committees in corporate governance.

METHODOLOGY

This study is aligned towards the objective spectrum of the Morgan and Smircich (1980) framework, using a prior theoretical base. The purpose of this study is to determine

³ Such as stock markets in USA, for e.g. New York Stock Exchange. (the world's largest capital market).

⁴ Such as developing countries (for instance, Fiji as one of the South Pacific country).

whether the appointment and reporting structure of the audit committees have an effect on their judgments and thereby on the quality of the financial reporting process. As part of the research methods, quantitative techniques such as survey instrument and experimental analysis has been apprehended to be the most appropriate method to gather the necessary data and to carry out the experimental analysis based on the quantitative methodology adopted for this research. However, this study is still under progress and empirical results will not be known until the research is complete.

USEFULNESS IF THE STUDY IN FIJIAN ECONOMY

Audit committees play a critical role in the financial reporting system by overseeing and monitoring management's and the independent auditor's participation in the financial reporting processes (U.S. SEC). Their responsibilities are in four broad areas of financial reporting, internal controls, audit and responding to management needs (HKSA, 1997).

Audit committees may enhance the integrity and credibility of the financial statements by overseeing the financial reporting process, including the internal control system and the use of GAAP and overseeing the total audit process (both internal and external audit functions). Internationally, the roles of audit committees are increasing. New paradigm of research in international auditing may well require that we rethink the very nature of auditing and its functions within world order. In the last few years, this subject has also come to the forefront and the overwhelming public interest has made this subject so important to the stakeholders and the society generally. The increase in the number of committees which have been set up such as the Cadbury Committee, OECD Code, Combined Code of London Stock Exchange, the Blue Ribbon Committee in US and the Kumara Mangalam Birla Committee in India – has made this subject important to me.

Other relevant issues such as new and improved auditing standards and independence of these audit committees will greatly enhance the role audit committee plays in corporate governance. Audit committees play a key role in assisting boards to fulfill their corporate governance and oversight responsibilities. Usually neither the independent auditor nor the internal auditor is a member of the audit committee. However, both meet with the audit committee to discuss matters pertaining to the audit. Thus, irrespective of the structure of the board of directors, companies are encouraged to have an audit committee as proposed in this study.

Given such issues concerning the realization of the intended benefits from having audit committees as part of the corporate governance structure for corporations, this study evaluates the available evidence regarding the impact of audit

committees on a number of specific aspects of governance in practice. The study is restricted to the evidence on the effects of audit committees in operation and does not set out to review the entire literature on audit committees, which is rapidly expanding and encompasses many issues.

Effective audit committees enhance the credibility of annual audited financial statements and thus assist the board of directors which is charged with safeguarding and advancing the interests of shareholders (Alchian and Demsetz, 1972; Fama and Jenson, 1983). Therefore, this study intends to assist the board and the executive team of the corporations in developing appropriate corporate governance procedures to achieve organizational objectives and to ensure regulatory compliance. It seeks to help them to meet the external reporting requirements relating to audit and corporate governance. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and shareholders. It should also facilitate effective monitoring; thereby encouraging firms to use resources more efficiently (OECD, 1999). Therefore, corporate governance, which involves a set of relationships between a company's management, its board, its shareholders and other stakeholders, is one key element in improving economic efficiency and it provides the structure through which the objectives of the company are set, and to determine the means of attaining those objectives and monitoring performance.

This proposed study provides feedback from the Fijian economy about whether there is a need to establish and maintain independent audit committees within the corporate governance structures of the corporations operating in Fiji, in particular, the private companies and the listed public companies. This research seeks to further build confidence in the economy about the critical role of audit committees in improving corporate governance, which is the key to improving economic efficiency, enhancing the attraction of our market and investors' confidence, as well as maintaining the stability of our financial system (SFS, 2002). Establishing good director and board practices would also be conducive to ensuring that directors and their boards act responsibly in the governance of their companies and be accountable to shareholders for resources entrusted to them (SFS, 2002).

The literature suggests that an effective audit committee should play an important role in strengthening the financial controls of an entity (Collier, 1993; English, 1994; Vinten and Lee, 1993). A number of studies have found that companies with an audit committee, particularly when that committee is active and independent are less likely to experience fraud (Beasley et al., 2000; Abbott et al., 2000; McMullen, 1996) and other reporting irregularities (McMullen, 1996; McMullen and Raghunandan, 1996). As such, any audit committee is more effective than no audit committee.

Moreover, the committees should meet regularly (Collier, 1993; Hughes, 1999) and strong channels of communication should exist with both the external and internal auditors (Cadbury, 1992; Deloitte and Touche, 1998). Goodwin and Seow (2000) found that investors, auditors and directors all believe that a strong effective audit committee assists external auditors to perform the audit.

Price Waterhouse (1993), in a study conducted for the Institute of Internal Auditors, concluded that the single most important finding related to audit committee effectiveness was that audit committee members must thoroughly understand their responsibilities and have the knowledge and experience to meet their responsibilities effectively. The Public Oversight Board re-emphasised the importance of the Price Waterhouse report when it stated that "the effectiveness of audit committees is affected, first and foremost, by the expertise of members of audit committees in the areas of accounting and financial reporting, internal controls and auditing (POB, 1994, p.15).

DISCUSSION AND IMPLICATIONS

To partly solve the above research problem, the Sarbanes Oxley Act (2002) has been introduced to bring in the reforms in the audit committee composition and corporate governance issues. This Act proposes to establish a Public Company Accounting Oversight Board to oversee the audit of public companies that are subject to the securities laws in order to protect the interests of investors and the public in the preparation of informative, accurate and independent audit reports for companies the securities of which are sold to, and held by and for, public investors (the Sarbanes Oxley Act, 2002; Sec., 101, H.R.3763 - p.6).

According to the Act, The audit committee of each corporation in its capacity as a committee of the board of directors, shall be directly responsible for the appointment, compensation and oversight of the work of any registered public accounting firm employed by that issuer and be involved in the resolution of disagreements between management and the auditor regarding financial reporting process. Further, the Act states that each member of the audit committee of the corporation shall be a member of the board of directors of the company, and shall otherwise be independent (the Sarbanes Oxley Act, 2002; Sec., 301, H.R.3763-32/33).

The Act further states that in order to be considered independent, a member of the audit committee of the corporation may not, other than in his or her capacity as the member of the audit committee, the board of directors, or any other board committee accept any consulting, advisory or other compensatory fee from the corporation; or be an affiliated person of the corporation or any other subsidiary thereof (the Sarbanes Oxley Act, 2002; Sec., 301, H.R.3763-32/33).

However, this study argues that audit committee members are actually chosen from the board of directors or in particular the chairman of the board, who may also be a CEO of the corporation. The CEO will try his/her best to get audit committee members whom he knows and who can act in the interests of the board and/or the management. This self-interested behaviour occurs as a result of the agency cost imposed by the management to the boards or shareholders of the corporation. Therefore, audit committee members will tend to be more in favour of the management in case of any dispute between the external auditor and the management.

Implications for Furthering Understanding of Research Problem

Part of the rationale for the adoption of audit committees, both historically and in the recent past, has been linked to the issue of auditor independence. The Cohen Commission (1978) on Auditors' Responsibilities, established by AICPA, stated that the audit committee is the best vehicle for establishing and maintaining balance in the relationship between the independent auditor and management. An important research question is whether evidence can be provided that audit committees do improve auditor independence and a limited number of studies have addressed this issue. Some evidence on audit committees and auditor independence is provided by studies that have examined the impact of audit committee existence on users' perception of independence. The presence of audit committees has been found to create a perception of enhanced auditor independence and more reliable financial reporting among users of financial statements (Gwilliam and Kilcommins, 1998).

More recent similar work identified greater independent director experience and greater audit knowledge as associated with higher audit committee support for an auditor who advocated a 'substance over form' approach in a dispute with client management (DeZoort and Salterio, 2001). Given the evidence of significant disagreements between executive management, external auditors and audit committee chairs concerning the appropriate level of financial statement disclosure (Haka and Chalos, 1990), the effects of audit committees on auditor independence may be much more complex than can easily be captured in survey studies.

Audit committees were found to reduce the confrontational intensity of interactions between auditors and management by increasing the level of discussion and reducing the level of negotiation (Zaman, 2002). While in interviews, practicing auditors state that their discussions with audit committees or boards never affect the type of audit report issued (Cohen et al., 2000).

Despite the frequent assertions that audit committees are effective overseers of the financial reporting process, there

is limited substantive evidence that audit committees, as opposed to other governance characteristics, enhance the quality of financial reporting. The principal question is whether financial reporting is different in the presence of audit committees compared to their absence. Identifying signals of financial reporting quality may be difficult but can be attempted either through analysis of actual reported financial numbers, to consider whether, for example, audit committees improve companies' earnings quality, or through negative signals of problems in financial reporting, for example instances of apparent or alleged errors, fraud and irregularities. The evidence of a positive link between audit committee existence and the quality of financial reporting has been provided by analysis indicating that earnings overstatements, as indicated by prior period adjustments to correct errors in previous reports, are less likely among companies that have audit committees (DeFond and Jiambalvo, 1991) and that companies manipulating earnings are less likely to have an audit committee (Dechow et al., 1996).

Evidence has also been documented that audit committees are associated with a reduced incidence of errors and irregularities in financial statements, as identified by a number of indicators of financial reporting quality: shareholder litigation alleging fraudulent financial reporting; correction of reported quarterly earnings; SEC enforcement actions; illegal acts; and auditor turnover involving a client-auditor accounting disagreement (McMullen, 1996).

Implications for Agency Theory

Agency theory view of corporate governance assumes that managers act from self-interest and it adversely affects the shareholders. The concept of corporate governance within the agency theory perspective is focused primarily on designing contractual mechanisms to control self-interested managerial behaviour and central to this perspective is the notion that those performing the monitoring function such as the members of the board of directors should be independent from those being monitored, that is the management. Therefore, under the agency theory perspective, the members of the board of directors need to be independent from the management and these members also need to have expertise in monitoring and control (Cohen et al., 2000).

Under this concept of corporate governance, the purpose of the financial reports was to reflect the managers' stewardship of the company during their tenure in office (Watts & Zimmerman, 1983). Managers issued financial reports mostly in informal form to the shareholders, some of which were elected to audit the activities of the managers. Managers were deemed to be agents of the company as a whole. Financial reports were directed towards providing assurances regarding lack of fraud or defalcation (Watts & Zimmerman, 1983; Mills, 1990).

As such, the agency theory approach to conceptualising corporate governance is now being used to develop models of corporate governance effects, for example the impact of audit committees on financial reporting quality (Zaman, 2002).

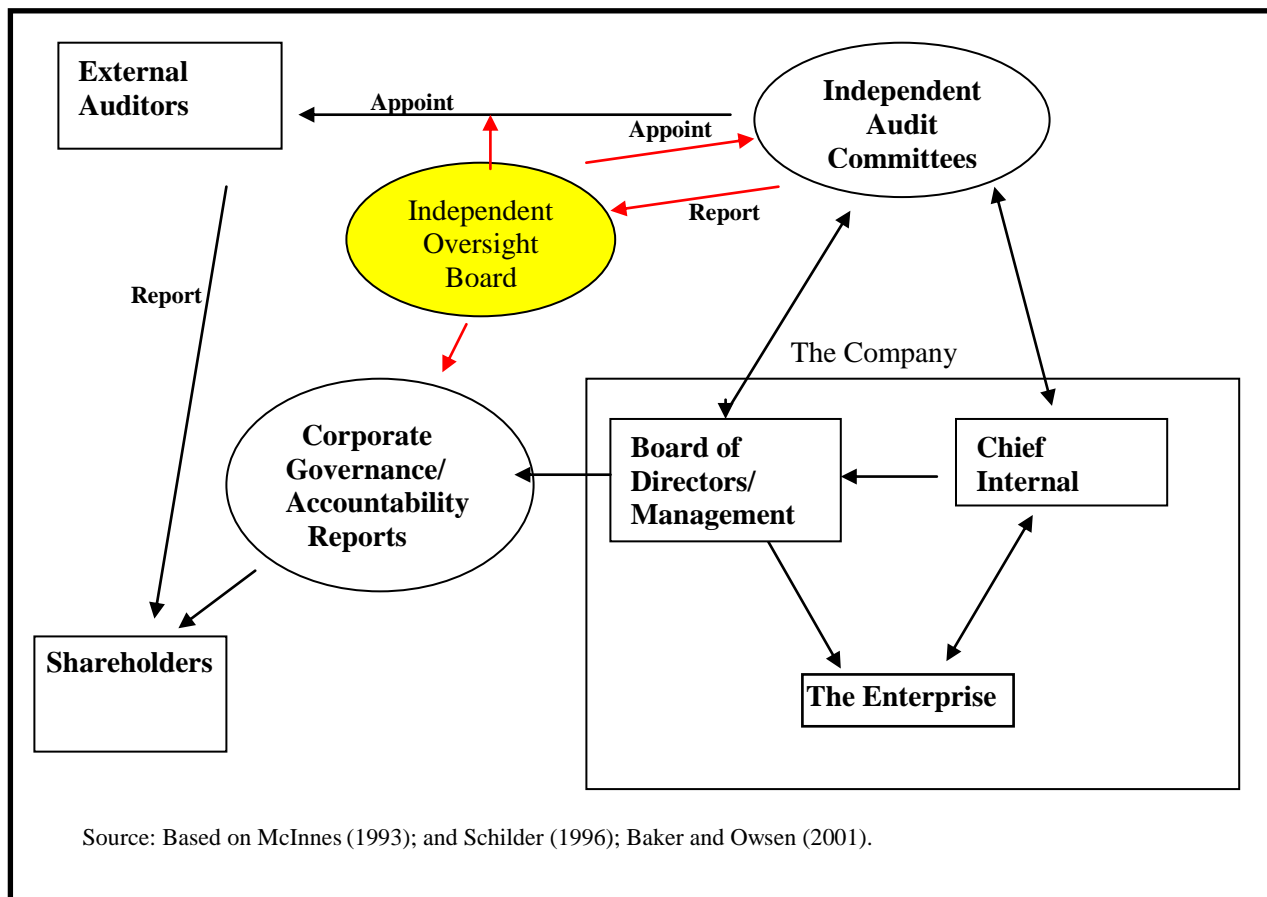
Supportively, the empirical literature does provide some arguments in favour of this agency theory view of audit committees in corporate governance. For example, Westphal and Zajac (1997, 1995) and Zajac and Westphal (1996) used a measure of concurrent management/board experience and found that corporate directors who were also senior managers tended to support other senior managers in major board-level decisions related to compensation and corporate succession. Therefore, with the appointment and reporting *via* board, audit committee members are less likely to appreciate the auditor's "substance over-form" position in such disputes resulting in misapplication of accounting policies, which will adversely affect the quality of the financial reporting process and will be considered as a "fraud or error" in the financial statements (FSA 11, Para, 2, 3).

A number of studies have found that companies with an audit committee, particularly when that committee is active and independent, are less likely to experience fraud (Beasley et al., 2000; Abbott et al., 2000; McMullen, 1996) and other reporting irregularities (McMullen, 1996; McMullen and Raghunandan, 1996). Findings also suggest that audit committees are effective in reducing the incidence of earnings management that may result in misleading financial statements (Defond and Jiambalvo, 1991; Dechow et al., 1996; Peasnell et al., 2000).

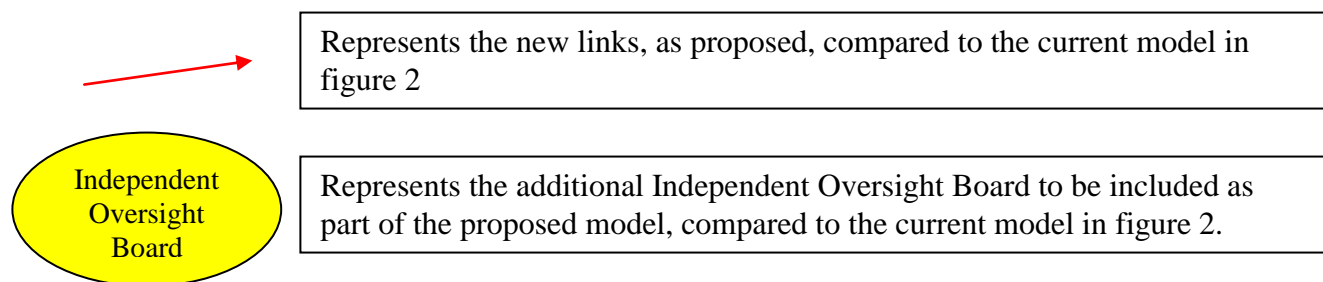
New Proposed Analytical Model

This study supports the proposition that a changing structure of audit committees is required to achieve more independence of audit committees in the corporate governance process. The model shown in figure 2 (refer to figure 1 *for comparison*) predicts that the independence of the audit committees will greatly enhance the role audit committee plays in corporate governance in terms of enhancing the quality of the financial reporting process. As mainstream accountants argue that increasing the independence of the audit committees would enhance the credibility of the audited financial statements for the benefit of the shareholders (Cohen et al., 2000).

As the model in figure 2 indicates, the new hypothesized structure of audit committees in corporate governance includes audit committee members appointed by the Independent oversight board and they report to the Independent oversight board directly, while indirectly creating links with the shareholders in terms of corporate governance and accountability reports such as the quality financial reports. Also the Independent oversight board will



Keys:



Source: Based on McInnes (1993); and Schilder (1996); Baker and Owsen (2001).

Fig 2 New Role of Audit Committees in Corporate Governance

look at the procedures of how the external auditors are being appointed by the audit committees of the corporations. This structure is in line of the findings of this research which indicates that audit committee members tend to support the party which appoints them and to whom they have to report to. As in this case, there will be unbiased judgments leading to quality financial reporting process.

If the audit committees are appointed by the board of directors and they are reporting to the board of directors then they consider themselves working side-by-side with the board and the managers of the corporations they do work

for. They consider management to be the paying client for all oversight services and at the same time the focal point of their investigations and responsibilities for board and the management. Requiring an oversight by audit committees for publicly owned companies only makes sense if the audit committee members are independent of management and/or board of directors. The pressure on audit committee members to appease managers of the corporations who are at the same time part of the board of directors who receive incentives and board compensations from the corporation/management is great.

When ambiguous accounting treatments that might be used to manage performance and/or mask failure are identified, audit committees seemed pressured to accept them unless they clearly violate GAAP. This setting encourages the audit committee to go along with the desires of management on accounting matters that may violate the spirit of GAAP but not the bright-line rules within GAAP. Too often the concern over the corporate scandals has caused audit committees not to use good professional judgment. For example, corporations' managers have often asked the board of directors to replace certain audit committee members on an engagement, implicitly because of accounting disagreements. Amazingly, boards of directors often comply with these requests (Imhoff, 2003). Likewise, in order to achieve a high degree of independence, this research believes that appointment and reporting structure of the audit committees should be executed by the Independent oversight board other than the board of directors. Figure 2 above best represents this suggested alternative.

Implications for Policy and Practice

This research has a number of implications for the regulatory bodies, policymakers, accounting and auditing profession and the society generally. It suggests policymakers, corporate boards, and the academic researchers to give the issue more in-depth analysis so as to consider the benefits of changing the appointment and reporting relationships of audit committees within the complex corporate governance structures of the corporations. Specifically, such analysis would consider possible tendencies of the audit committee to be a 'rubber stamping' mechanism or simply an arm of management (DeZoort and Salterio, 2001, p.44). Also these considerations might recognise a broad-based view of corporate governance that expands thinking beyond monitoring and control functions to include pro-active strategic contributions to the organisations (Cohen et al., 2000).

This study stresses that it is primarily the responsibility of the corporations to prevent and detect the occurrence of fraud, errors or other irregularities in the financial statements (IFAC, 1994b) which can be effectively met by putting in place a strong system of corporate governance (Bishop et al., 2000; Rabinowitz, 1996). In recognition of this, regulators and professional bodies have imposed requirements or made recommendations concerning board structure, audit committee and internal controls (Blue Ribbon Committee, 1999; Committee on Corporate Governance, 2001) but have failed to recognize the significance of alternative appointment and reporting structure of the audit committee members. The effect of sound governance practices on the quality of financial reporting has recently received attention from many researchers, particularly in the U.S. (McMullen, 1996; Beasley, 1996; Beasley et al., 2000; Abbott et al., 2000). The

main focus of these studies has been the relation between audit committees and fraudulent financial reporting.

Similarly, Baker and Owsen (2001) identified that for an audit committee to be effective, it must establish its integrity, independent of management. It must have adequate information to make informed judgments and it must be able to effectively act to correct wrongs or take other appropriate action to address specific issues. Therefore, the independence issue and the quality of the audit committee members are critical to the success of any audit committee. Other reports also mentioned that all members of the audit committee should be non-executive directors with the majority being independent of management (HKSA, 1997):

Practical Implications for Private/Public Sector Managers

The importance of audit committees as both a monitor of and a vital link in the financial reporting process is evidenced by the number of private and public sector advocates (*see Birkett, 1980 for a detailed historical overview of efforts to encourage audit committee formation from the 1930s to the 1960s*). One key to increasing public confidence in financial statements is more direct involvement by independent agencies outside the corporation in the company's auditing committees as both a monitor and a vital link in the financial reporting process is evidenced by the number of private and public sector advocates of audit committees as well as by the four 1988 AICPA expectation gap Statements on Auditing Standards (SASs) that directly acknowledge the importance of audit committees. Audit committees have been heralded as 'a large deterrent to the atmosphere that would permit financial fraud to exist' (Treadway Roundtable, 1989, p.23).

This study's proposal has important implication for audit committee practice and financial reporting process (for example, Herdman and Neary, 1988; Kolton, 1988; Bull and Sharp, 1989; Marsh and Powell, 1989) along with other proposals such as the BRC (1999) recommendations, the Sarbanes Oxley Act (2002) and NYSE Corporate Governance Rules as part of their reform programs. The public accounting profession formally views audit committees as one of several factors that constrains improper conduct by senior management (AICPA, 1999, AU316). Such research would help both practitioners and policymakers in determining ways to enhance the audit committee performance and improving the reliability of the financial reporting process.

Implications for the Accounting & Auditing Profession

This research has implications for regulators and various stock exchanges, as they attempt to formulate future

corporate governance policies. The results is expected to have implications for regulators and others who are concerned with establishing guidelines and listing rules pertaining to corporate governance, especially in developing capital markets. In Fiji, such regulators could be Fiji Institute of Accountants (FIA), Institute of Internal Auditors (IIA), South Pacific Stock Exchange (SPSE), Capital Markets Development Authority (CMDA) and the Companies Act (1983).

Implications for Regulatory Bodies and Policymakers

Concerns about the effectiveness of audit committees in overcoming weaknesses in corporate governance (Lee, 2001) have also been expressed by the regulators. As Price Waterhouse (1980, *Preface*) asserts that “it is now recognised by investors, analysts and regulators that audit committees can make an ever increasing contribution to the quality of financial reporting” and therefore, from a methodological perspective, the results may provide an informative extension of the traditional policy capturing approaches in the area of corporate governance and transparency.

Currently, much diversity exists with regard to the structure and functions of the audit committees in place at different companies. A study by the GAO (1991) indicated that many of the audit committees of the largest banks in the U.S. lacked the independence and expertise necessary to monitor bank operations effectively. An extension of this study could focus on whether there are systematic differences between the audit committees of companies with and without financial reporting problems, in terms of composition, independence and experience of audit committee members. Such research would help both practitioners and policymakers determine ways to enhance audit committee performance and improve the reliability of the financial reporting.

Audit committees have been recommended by a wide range of professional firms, accountancy bodies and regulatory committees who has previously supported the adoption of audit committees (for further details see BCA, 1991; CEPS, 1995; CICA, 1981; Cohen Commission, 1978; Colbert, 1989; English, 1994; Colegrove, 1976; Ernst & Whinney, 1987; ICAEW, 1997; Kollins et al., 1991; Lindsell, 1992; Mautz and Neumann, 1970 and the Sarbanes-Oxley Act, 2002). Notwithstanding the claimed virtues of audit committees and the prevalence of normative recommendations for their adoption, there remains the overriding question of what differences do they make to organizational accountability in practice. In this context, issues of interest include the effects of audit committees on the audit function, financial reporting and corporate performance.

The Treadway Commission (1987) recommended that the SEC require all public companies to maintain audit

committees, however, at the present time, a large segment of the over-the-counter market still does not have an audit committee requirement. Suggested improvements in corporate governance such as the Cadbury Committee Report (1992), The Turnball Report (1999) and OECD Principles of Corporate Governance (1999) are steps in the right direction (Baker and Owsen, 2001). Unfortunately, each of these proposals concentrate primarily on protecting shareholders interests, they do not pay sufficient attention to the interests of wider stakeholders and society generally. Moreover, they do not focus on the role that auditing could play in corporate governance, along the lines suggested in the ICAS document (McInnes, 1993). As such, the following paragraphs discuss the implications for the society generally.

Implications for the Society

An effective audit committee could enhance the credibility of the annual audited financial statements and thereby assist the board of directors, which is charged with safeguarding and advancing the interests of the shareholders (Alchian and Demsetz, 1972; Fama and Jenson, 1983). These audited financial statements will be used by large group of people, thereby expanding its benefit to a wider spectrum, which includes the society generally.

As part of their oversight function, audit committees ask questions of both auditors and the management and thus may reduce the risk of material errors in the financial statements by providing an information flow among the board of directors, external auditors, internal auditors and the company management (McMullen, 1996). This, eventually, will improve their ethical role in the society.

Recommended Changes to Audit Committee Appointment and Reporting Structure

Recent pre-Enron changes to improve the independence and financial awareness of audit committees of corporations were initiated by the stock exchanges, for example, the BRC on Improving the Effectiveness of Corporate Audit Committees was created in 1998 by NYSE and the NASD. The Independent oversight board has the potential to be the most influential party in the process of improving the current problems with the quality and integrity of the financial reporting system and related governance issues. However, the corporate Board needs to be aware of the market's current lack of confidence in financial reporting oversight. This ability to appoint an Independent oversight board under the Sarbanes-Oxley Act of 2002 demonstrates the building confidence in the marketplace. This kind of accounting profession response is expected to address the fundamental problems with accounting, auditing and corporate governance.

Debates about corporate governance among mainstream researchers have been essentially reduced to questions concerning how best to protect the interests of shareholders. However, as capital markets contract, shareholders may become increasingly concerned about how much of their wealth is being shared with top management (Colvin, 2001) and as a result, they may begin to look for mechanisms that make top executives more accountable to shareholders. Some observers of corporate governance argue that it would be best to have truly independent board members chosen from a knowledgeable group of people. Similarly, some (Baker and Owsen, 2001) believe that there should be truly independent auditors who cannot be chosen by the management and whose compensation is set by the Independent board (Cadbury Committee, 1992; The Turnball Report, 1999). These approaches have supporters in the investment community, the one force that may be able to overcome the power of corporate management (Baker and Owsen, 2001).

Similarly, this study argues that there should be a truly independent audit committee to oversee the financial reporting process, who cannot be chosen by the board of directors rather by the Independent oversight board and whose compensation is set by this board. There may be a need to make a case to shareholders that future earnings growth can be best assured by having more controls as described by ICAS document rather than by having board members selected by CEOs.

However, shareholders prefer working with boards picked by CEOs, who they can theoretically remove, than with directors that might reduce shareholder's return on investment. Shareholders need to exercise more control over CEOs and they need to reexamine their relationships with top managers and need to urge legislators to change the legal regulation of corporations to provide for adequate independent oversight mechanism and the ability to control corporations and the managers who lead them (Baker and Owsen, 2001).

LIMITATIONS AND IMPLICATIONS FOR FURTHER RESEARCH

The identified research problem focuses primarily on the literature review and the research activity and is applicable to those private/public sector corporations, that is, mostly the reporting entities in Fiji. As such, this research activity is mostly based on the economy of Fiji; and the findings may not be readily generalisable to outside areas. The findings of this study are still in the preliminary stages and further experimental tests are required to support the study's proposition.

Despite the limitations this study has evaluated evidence based on the incentives for audit committee members and the effects of appointment and reporting structure of audit committees within the corporate governance framework

and in the financial reporting process of corporations. Concluding observations based on the evaluation of the evidence presented on each of the hypothesis warrants further research.

Audit committees do not operate in a vacuum and their operation and effects cannot be adequately examined without regards to the *organizational context* in which they function and power relationships which are intrinsic to that context. The ways in which audit committees affect behaviour within organizations is an open and potentially interesting area for future research.

Future research on audit committees needs to make a departure from the extant preoccupation and adopt a broader perspective, drawing upon alternative theoretical frameworks and utilizing qualitative research methods. Qualitative research methods incorporating case studies and interviews provide a significant potential for researching the operations and effects of audit committees in the organizational and institutional context in which they operate. It has to be acknowledged that there are significant difficulties in conducting qualitative research, for example, in access to research sites, ensuring consistency and interpreting qualitative data. Nonetheless, such research would be expected to complement rather than replace other research approaches and methods, particularly in providing insights about the operational arrangements and interaction between audit committees and other aspects of governance.

For instance, from a theoretical perspective, there is a need to develop theories of audit committee operation rather than simply adopting *agency theory*. Future research to establish actual audit committee members to participate as the respondents would provide a more systematic and robust basis for discerning the value of audit committees in the financial reporting process and contribute to public policy debates about their role in corporate governance.

Finally, a more in-depth investigation of the variables with the help of an experimental case would be useful to determine whether there are indeed any monetary benefits from changing the appointment and reporting structure of the audit committees. Identification of the perceptions of other parties involved in corporate governance, such as investors, internal auditors and managers could also enhance our understanding of the factors that are perceived to strengthen corporate governance. Ultimately, the economic importance of the variables found to be significant in this study could be examined using actual data rather than perceptions in future research.

CONCLUSION

In the introduction of this paper, reference was made to a number of concerns about the operation of audit committees

in practice that have been expressed by practitioners, regulators and researchers. The overall conclusion from the assessment of the judgments of audit committee members towards the financial reporting quality within the corporate governance structure of the entities is that audit committees appointed by the independent oversight board and reporting to the independent oversight board will provide an accurate and independent judgment leading to improvements in the financial reporting process.

However, empirical research related to audit committee processes such as the interaction between audit committees, management, internal and external auditors is in the developmental stage and previous researchers (e.g. Beasley 1996; McMullen, 1996; Scarbrough et al., 1998) note that further studies are needed to provide increased understanding of audit committee processes and activities.

Even in the developed world, the role of audit committee in corporate governance is relatively new. Setting up of audit committees came about in direct response to demands like improving the financial reporting and public accountability. Apparently, the boards have generally failed to fulfill this kind of expectation for lack of expertise in the filed of financial management which was growing in complexity.

The independent audit committee could play a vital role in improving corporate governance culture. Indeed, this is the call of the hour. Such audit committees have to become a critical component of the management process to ensure quality financial reporting for public use. The audit committees have to become part of the audit function-both internal and the external-to be an effective arm of the corporate governance. Another pre-condition would be that they are independent and have appropriate expertise through their membership. Also they would require resources in terms of time, information access and relationship with management and the board to be able to discharge their responsibilities as envisaged by the NYSE/NASD Committee and the Sarbanes Oxley Act of 2002.

Also, understanding audit committee appointment and reporting structure is, in itself, a large and important task. The task's importance is magnified by the current pressure to increase the quantitative and qualitative scope of audit committees' oversight responsibilities. This study provides an initial attempt to evaluate whether appointment and reporting structure affects audit committee member judgment in one important oversight area for audit committees, that is, the auditor-management dispute situation. The findings of the study are still in progress but considering the preliminary findings of this study, there is a support for the presumption that audit committees would be more effective when they are directly regulated by an Independent board (such as Surveillance Board as in Australia or Public Oversight Board as in UK) rather than indirectly regulated via the board of directors. In particular, audit committees appointed by (and

reporting to) the Independent oversight board would be more unbiased in their judgments based on auditor-management dispute situations than audit committees appointed by (and reporting to) the board of directors, thereby enhancing the independence of audit committees and hence, improving the quality of the financial reporting process.

Ultimately, these findings supplement anecdotal thought and survey-based research in the area of audit committee appointment and reporting structure and suggest the need for further empirical research in the area to facilitate audit committee independence and quality of the financial reporting process.

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