

THE IMPACT OF AUDIT COMMITTEE APPOINTMENT AND REPORTING ARRANGEMENTS ON AUDIT COMMITTEES' INDEPENDENCE

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Abstract *This study investigates impact of audit committee appointment and reporting arrangements on audit committees' independence in resolving auditor-management disputes. Corporate governance is one of the critical issues in business today. Corporate governance practice provides the structure through which the objectives of the company are set, the means of attaining those objectives are met and monitoring the performance of the companies is determined. Amongst the many branches of corporate governance, the financial reporting system is one which closely relates to the concept of corporate governance and accountability. 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 et al., 2000; Abbott et al., 2000). In order to gain confidence in the organizations around the world, corporations must provide users with relevant, reliable and timely information in order to enhance the quality and integrity of the financial reporting process. (Imhoff, 2003).*

The role of auditing in the corporate governance structure is essential in the flow of 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 a role emerged during the early 20th century when shareholders appointed representatives such as the board of directors, who serve 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.

Keywords: *Audit Committee, Corporate Governance, Auditor-Management Dispute*

INTRODUCTION

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.

Agency Theory Perspective of Corporate Governance

An agency theory approach to conceptualizing 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 that 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 conceptualized the adoption and operation of audit committees for reducing agency costs (Zaman, 2002) as part of their corporate governance mechanism.

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). Drawing upon the agency theory model, this study provides an alternative framework

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for conceptualizing 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. For example, the appointment and reporting structures of audit committees can differ and are always intrinsic to that context.

More recently, Beasley et al., (1999, 2000) analysed SEC enforcement actions, finding that companies with fraud were less likely to have audit committees having solely outside directors. McMullen (1996) investigated the consequences associated with audit committees. His test supported the association that presence of an audit committee will enhance more reliable financial reporting (i.e. absence of errors, irregularities and illegal acts).

Within the financial reporting environment, audit committees are provided with incentives to oversee financial reports if they are independent members from outside the board. As such, their compensation may be based on the board that has appointed them. This has made the board the focal point of audit committee's remuneration and compensation strategy. With regard to this, audit committees are considered by some to be the 'creatures of the company's management rather than watchdogs over shareholders' interests' (Weschler, 1989, p.132). While the financial reporting process provides investors and creditors with generally accepted accounting principles and generally accepted accounting standards based reports on the entity's performance, it is also impacting the current and future wealth position of its managers (and board members and thereby audit committees). Audit committees try to mask their wealth-enhancing activities and/or their managerial failures by manipulating financial reports (Imhoff, 2003).

What investors and creditors do observe all too often lately are instances where it appears the auditors and/or the audit committees were not effective (Imhoff, 2003). There are cases of fraud, material errors or misstatements, material omissions, restatement of multiple prior years' earnings because of accounting oversights or improprieties, or maybe just aggressive accounting called to the attention of the Securities and Exchange Commission. There are many recent examples of corporate collapses globally such as AOL Time Warner, Worldcom, Boeing, Computer Associates, Xerox, Enron, Tyco, and IBM, Lehman Bros and Satyam.

Research Hypothesis

A great deal of debate has been focused on the details of corporate governance (Forker & Green, 2000; O'Sullivan, 2000; Shleifer and 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 are not specific in their stipulation of how an effective

audit committee should be structured and moreover, how it should function. The rising expectations and increased liability have motivated considerable inquiry in the accounting literature (DeZoort, 1998) and have heightened the concern about audit committee independence. However, audit committee independence within corporate governance is a crucial area where research has been limited. The present study is motivated by 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 without addressing the need to strengthen structural mechanisms for audit committees' such as appointment and reporting arrangements which will ensure their greater independence within the corporate governance framework.

The audit committees are regarded as an external governance device and there is a focus in research on the structure and functioning of the boards of directors and the audit committees of such boards (Rosenstein & Wyatt, 1990; Shleifer & Vishny, 1997). The corporate boards charge audit committees with the responsibility for the oversight of the financial reporting and auditing processes (Public Oversight Board, 1993; Treadway Commission, 1987; Wolnizer, 1995). Under this arrangement the audit committees are appointed by and their report to the corporate board. Given that the compensation of audit committees is also governed by the corporate board, it is doubtful whether audit committees can operate completely independently of the corporate board. Hence an important research question is the impact of alternative appointment and reporting arrangements of audit committees on audit committee independence in resolving auditor - management disputes?

Appointment of Audit Committee

This proposition is based on the argument that audit committees are currently appointed by the board of directors and often we see that the composition of the board of directors includes at least one of the executives from the senior management. Recently, we have noticed the growing number of the management executives as part of the board composition and even in some cases the CEOs are the chairman of the board, which they think itself is independent.

In other words, corporate boards are not really nominated by the shareholders, because it is the chief executive officer (CEO), who significantly influences the membership of corporate boards. For example, the 2000 Korn/Ferry International's 'Annual Board of Directors Study' (Korn/Ferry International, 2000) documented that 55% of the firms surveyed reported that the current chief executive officer, who was also the chairman of the board, played the dominant role in appointing members of the board and committee chairs. Also, it is not unusual for the chairman of the board to be either the current or the former CEO of the firm, to be the most influential person in nominating new board members, and to control the agenda of all that goes on at board meetings (Imhoff, 2003). In this way, the CEOs nominate people to serve on their own oversight board – the audit committee. At times the CEOs even chair the audit committees or are part of these committees and they will look for their own interests as opposed to the interests of the corporation. The current practice is that the board appoints the audit committee and these board members are frequently compensated with stock options and these options provide incentives to the board members and they will require their sub-committees to be in favor of the board *vis-a-vis* the management. This is in line with the view of the agency theory relationship. This clearly provides strong incentives for the audit committee to work with and as part of the board and the top management, thereby compromising their independence and deteriorating the quality of the financial reporting process.

According to the arguments in '*Auditing into the Twenty-first Century*', a document prepared by the Institute of Chartered Accountants in Scotland (ICAS); (McInnes, 1993), the present accepted model of the role of auditing in corporate governance is deficient in such areas as independence and conflict resolution.

Based on the above mechanisms, agency theory (Jensen and Meckling, 1976; Fama and Jensen, 1983) postulates that the opinion of the audit committee will be largely affected by the 'principal - agent' relationship. An alternative to board appointed audit committees, is the appointment by shareholders which is expected to provide greater degree of independence for the audit committee in terms of audit committee judgments in conflict resolutions. Westphal and Zajac (1997, 1995) and Zajac and Westphal (1996) find some empirical support for this argument. They 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, board appointed, audit committee members are less likely to appreciate the auditor's "substance over - form" position in such disputes.

These arguments then lead to the following hypothesis:

H1: An audit committee which is appointed by the board of directors is more likely to support the management in any auditor - management dispute case compared to an audit committee appointed by the shareholders.

To support this proposition, when a dispute reaches the audit committee, audit committee members appointed by shareholders will be more likely to understand and sympathise with the risk the auditor is taking in confronting management (Chow and Rice, 1982; Dhaliwal et al., 1993). With appointment *via* the shareholders, the audit committee members are more likely to appreciate situations where auditors have carefully considered their position because the members are not dependent on management and/or board of directors. Supporting auditors will mean that they will show more concern towards the quality of the financial reports presented to them and it is more likely they will be taking the 'substance' approach to support the auditor.

Reporting by Audit Committees

Similar to the appointment hypothesis, in this proposition audit committees find themselves working side-by-side with the managers of the corporations they oversee because audit committees report to the board in terms of management actions. Audit committees consider management to be the paying client for all oversight services and at the same time the focal point of their investigations and oversight responsibilities. These audit committees will then make their decisions based on the management's perspective, since they have incentives not to face up to setbacks in a firm's performance. This will adversely affect the audit committee independence, thereby affecting board's independence from management and these corporate boards will make the audit committees advocate for management's position in the financial reporting process.

Based on these mechanisms, the agency theory (Jensen and Meckling, 1976; Fama and Jensen, 1983) postulates that the opinion of the audit committee will be largely affected by the 'principal - agent' relationship. The audit committee will act differently if it is reporting to the board of directors as opposed to the shareholders. As such, agency theory has been used to derive hypotheses regarding where one would expect to find audit committees as a means of reducing these agency costs. Such agency relationship among management and the shareholders allow the implementation of compensation plans, their monitoring schemes and costly contracts of the boards and the audit committees and as such, the audit committees will work towards the interest of the agent, that is the management (*via* the board) to achieve fully the benefits of their position in terms of supporting the management in any auditor-management dispute cases. These arguments then lead us formally to the following hypothesis:

H2: An audit committee which is reporting to the board of directors is more likely to support the management in any auditor - management dispute case compared to an audit committee reporting to the shareholders.

METHOD

A '2 x 2' factorial between subjects design is used to investigate the research hypothesis. The two independent variables are appointment and reporting. The two independent variables are manipulated across two levels, that is, either as board or shareholder appointment (APPT) and as board or shareholder reporting (REP). The 'judgment' of the participants is the dependent variable, that is, the judgment to support or oppose external auditors in a management conflict (JUDGMENT).

Participants are asked to respond to the first question concerning the extent of their support to either the management or the auditor. The support for either the management or the auditor then becomes the judgment of the audit committee member. The 'judgment', which is the dependent variable is measured in terms of the chosen opinion of the participants on a 7-point Likert scale ranging from -3 to 3.

Control variables in this research include the participants' assessment of the case; which includes the level of knowledge based on financial accounting, financial statement analysis, and auditing knowledge.

Manipulation variables are conducted to determine the appropriateness of the case. Participants were asked to indicate on a Likert scale on how well they understood the case; how realistic was the case and how important was the case and how difficult was the case. These manipulation variables include factors such as understanding, realistic, importance, and difficulty of the case. Participants were also asked to indicate about their demographic information of their work and corporate governance experience; age and gender; and the level of education.

Experimental Case on Auditor-Management Dispute

The research materials included an accounting policy dispute task, knowledge and ability tests questionnaire and demographics. The experimental task was adopted from the case utilized by Dezoort and Salterio (2001). The task was pre-tested on 16 accounting academics with significant work experience. As an additional precaution, a post-experimental questionnaire (Uecker et al., 1981) is included in the study to gather the respondents' biographical data.

To date, only two published studies have examined the response of audit committee members to disputes between

the auditors and the management. First, Knapp (1987) conducted an experiment and found that audit committee members who were active managers of publicly traded companies were more likely to support the auditors in auditor - management disputes than were audit committee members who were not active managers. Second, Dezoort and Salterio (2001) investigated whether audit committee members' corporate governance experience and financial-reporting and audit knowledge affects their judgments in auditor-corporate management conflict situations. Their results (Dezoort and Salterio, 2001) indicate that greater independent director experience and greater audit knowledge was associated with higher audit committee member support for an auditor who advocated a 'substance - over form' approach in dispute with the client management. This research utilizes a similar type of experiment where a dispute case was given to the audit committee members for their opinion who were required to make their judgment on auditor-management dispute case between the external auditor and the management of the corporations. The dispute case was neutral as can be expected from any auditor - management disagreement which involves the revenue recognition policies of an electronics goods retailer, E-Man Technology Incorporation (Inc.), who has changed from selling all of its products with an optimal third-party vendor's extended warranty to selling an in-house extended warranty as part of the normal purchase price of the product. The revenue stream changed from being a commission from a third-party warranty vendor, who took full responsibility for servicing the warranty, to revenue being received implicitly as part of the product price with the client accepting full responsibility for servicing the warranty. Despite the change in the type of the revenue stream, management wanted to continue to recognize all warranty revenue when the product was sold. However, the auditors in the case objected to the management's accounting policy choice because they believed it did not reflect the substance of the transaction stream and specifically, the auditors believed that there were *de facto* separate streams of revenue from the product and the warranty, and that warranty revenue was not realized at the time of the sale. If auditors change this accounting policy then the net income will materially decrease, which will result in change to the debt-to-equity ratio, leading to the client's violation of a debt covenant.

ANALYSIS and RESULTS

This study utilized the board of directors to *role-play* as audit committee members and to respond to the questions as if they are the *real* audit committee members. The sample size included 600 board of directors. A total of 600 questionnaires with 150 questionnaires for each treatment were distributed randomly. Of these, 168 questionnaires were hand-delivered

to the 28 company secretaries, 232 questionnaires were mailed to ex-board members in Fiji and 200 questionnaires were mailed to the board of directors abroad, with attached prepaid envelope for their quick response. All groupings and treatments were randomly allocated. The questionnaire presented included a three-part instrument in the following order: the accounting policies dispute case, the knowledge and ability tests and the experience and demographic questionnaire (DeZoort and Salterio, 2001). A covering letter was attached with the main questionnaire indicating that the participants' responses would be anonymous and will be held confidential. They also had to answer the questions in the order of presentation without any changes and discussions with anyone. Of the possible 600 questionnaires, 199 usable questionnaires were received from the participants, producing an overall response rate of 33.17%. This response rate compares favorably to previous research involving these types of subjects as Kalbers and Fogarty (1993) reported that response rates for mailed audit committee questionnaires generally cluster between 20-25%.

A test of manipulation was conducted to determine the ease of understanding, the degree of realistic, and the importance of the case situation and the difficulty level of the experimental task. TABLE 1 provides the descriptive statistics of the manipulation test.

Table 1: Manipulation Test of the case: Descriptive Statistics (n = 199)

	Mean	Std. Deviation
UNDERSTANDING	1.2362	.77817
REALISTIC	1.3518	1.10412
IMPORTANCE	1.7236	1.04881
DIFFICULTY	1.2211	1.30707

The results in TABLE 1 indicate that participants tend to understand the case (mean = 1.2362), that the case was realistic (mean = 1.3518), the case was important (mean = 1.7236) and also the case was a bit difficult (mean = 1.2211). TABLE 2 presents several demographic information of the respondent's.

A Univariate Analysis of Variance was conducted to the dependent variable, that is, the judgment of audit committees to support or oppose the auditor in a management-auditor dispute (JUDGMENT). Several control variables were included to reduce the impact of possible confounding effects. These variables were the level of financial accounting knowledge (FAKNOW), the level of financial statement analysis knowledge (FSAKNOW) and the level of auditing knowledge (AUDKNOW). TABLE 3 displays these descriptive statistics.

Table 2: Respondents Demographic Information (n = 199)

Demographic Information	% of Respondents
Work experience in years	93
Corporate governance exp in years	88
More than 1 yr. of exp	81
Audit committee member exp in years	62
Age (35-55)	91
Males	87
Females	13
Professional education	79
Undergraduate/masters	42
Size (value of assets) of organizations participants involved with.	\$70m-\$200m

Table 3: Descriptive Statistics of Dependent Variable: Judgment

Appointment (APPT)	Reporting (REP)	Mean	Std. Deviation	N
Board of directors	Board of directors	-.4808	1.90449	52
	Shareholders	.0208	1.98387	48
	Total	-.2400	1.94946	100
Shareholders	Board of directors	.2075	2.36447	53
	Shareholders	1.3043	1.61754	46
	Total	.7172	2.11429	99
Total	Board of directors	-.1333	2.16647	105
	Shareholders	.6489	1.91602	94
	Total	.2362	2.08397	199

Table 4: Analysis of the type of Appointment and Reporting on Audit Committee Judgment in Resolving Management-Auditor Dispute

Source	Mean Square	F	Sig.
Corrected Model	15.715	3.941	.001*
Intercept	1.385	.347	.556
FAKNOW	6.673	1.673	.197
FSAKNOW	2.792	.700	.404
AUDKNOW	4.515	1.132	.289
APPT	51.427	12.897	.000*
REP	35.067	8.794	.003*
APPT * REP	5.655	1.418	.235
Error	3.988		
Total			
Corrected Total			

FAKNOW – Financial Accounting Knowledge

FSAKNOW – Financial Statements Analysis Knowledge

AUDKNOW – Audit Knowledge

APPT- APPOINTMENT

REP- REPORTING

The results in TABLE 3 indicate numerical descriptive measures including the mean and standard deviation for all the respondents based on the dispute case. It shows that the mean responses are higher for audit committee appointed by the shareholders and reporting to the shareholders (mean = 1.3043) compared to the audit committee appointed by the board of directors and reporting to the board of directors (mean = 0.4808). TABLE 4 displays the Univariate Analysis of Variance of the dependent variable (JUDGMENT).

The results in TABLE 4 indicates that the appointment (APPT) and reporting (REP) variables have a significant impact on the respondents' perceptions regarding their judgments on the auditor-management dispute situation. The Univariate analysis using a single construct score (calculated by totaling the scores for the dependent variables) reveals that the APPT ($p = 0.000$) and REP ($p = 0.003$) are both significant. The analysis indicates no significant interaction effects between the appointment and reporting variables on the judgment of the audit committees. That is, the judgments for the participant's do not differ significantly based on their appointment and reporting structure concurrently.

The control variables, financial accounting knowledge (FAKNOW), financial statement analysis knowledge (FSAKNOW), and the auditing knowledge (AUDKNOW) have no significant impact on the results.

In summary, the results show support for H1 and H2, that is an audit committee appointed by the board of directors (mean = 0.4808) will support the management in case of any auditor - management dispute situation compared to an audit committee which is appointed by the shareholders (mean = 1.3043). Support is also found for H2, that is, an audit committee reporting to the board of directors (mean = 0.4808) will support the management in management - auditor dispute compared to an audit committee reporting to the shareholders (mean = 1.3043).

Appointment and Reporting Variables

The Univariate analysis in TABLE 4 revealed insignificant interaction effect between the appointment and reporting variables. The interaction between the two variables is not significant ($p = 0.235$) at the corresponding 95% confidence interval for mean (5% significance level or $p < 0.05$).

Summary and Conclusions

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.

This study investigated the impact of appointment and reporting structures of audit committees in resolving management-auditor disputes and found support that these are important variables to consider for audit committee independence.

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 US 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 system generally.

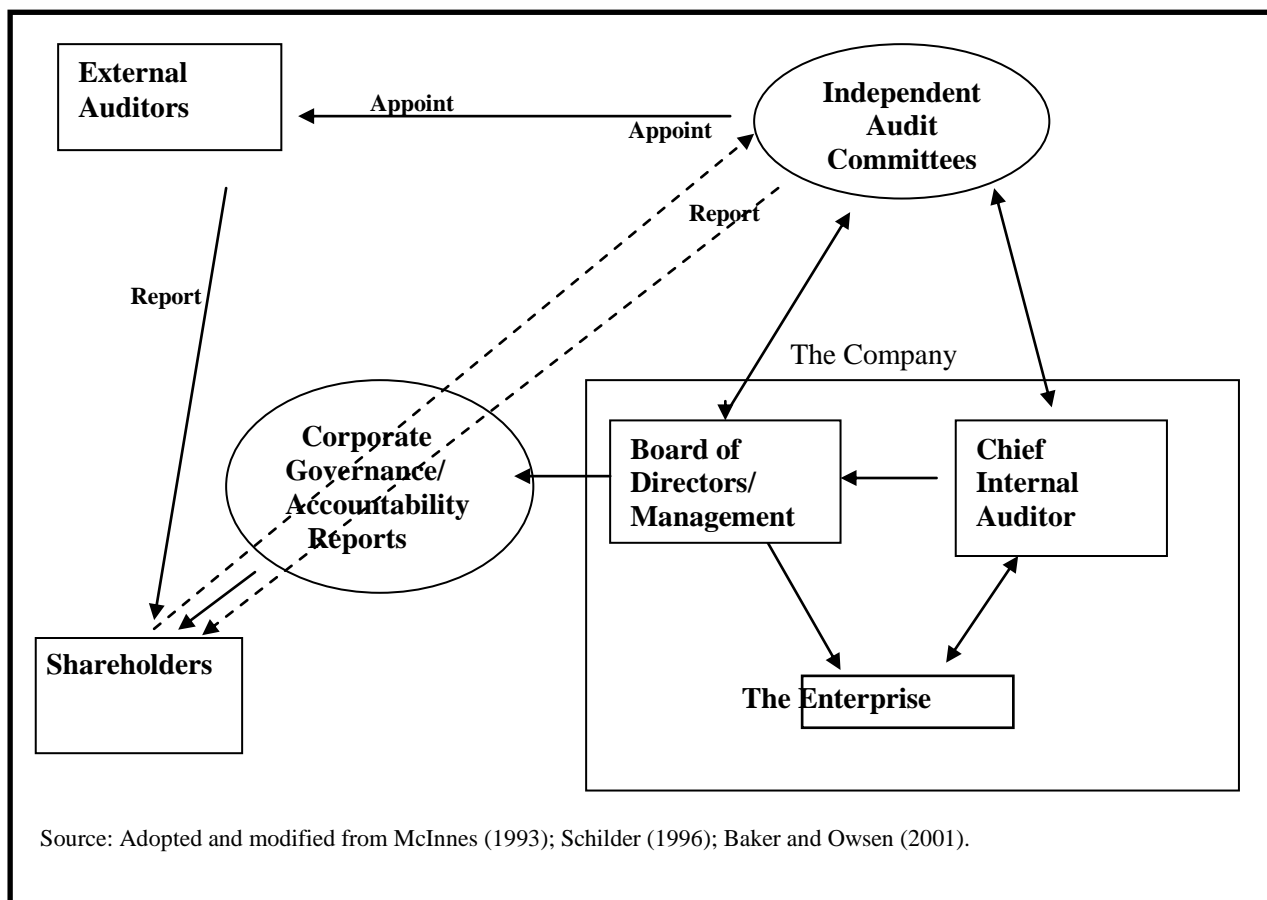
The findings of this research has important implications for audit committee practice and financial reporting process (for example, Herdman and Neary, 1988; Kolton, 1988; Bull and Sharp, 1989; Marsh and Powell, 1989). The results of this research would help both practitioners and policymakers in determining ways to enhance audit committee independence, as well as improve the reliability of the financial reporting process. Empirical results from this research are consistent with prescriptions suggesting that audit committee formation should include consideration of the appointment and reporting structure for existing and potential audit committee members. Survey evidence from auditors and directors in Singapore, where audit committees are mandatory, reported that the more independent the audit committee from executive management, the more active its approach to internal audit (Scarborough, et al., 1998).

Additionally, the empirical literature does provide some arguments in favour of the 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* the 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. The agency theory approach, therefore conceptualises the impact of audit committee members judgment in financial reporting quality (Zaman, 2002).

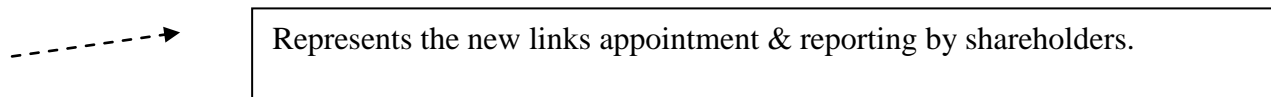
The results of this study support the proposition that to achieve more independence of audit committees in corporate governance process, changing the structure of audit committees is required. The model shown in Figure 1 presents an alternate audit committee structural arrangement that the results of this study indicate will enhance the independence of the audit committees.

This research has a number of implications for the regulatory bodies, policymakers, the accounting and auditing profession and the society generally. It suggests policymakers, corporate boards, and the academic researchers ought to give the issue more in-depth so as to consider beyond the possible tendencies of the audit committee to be a ‘rubber stamping’ mechanism or simply an arm of management (DeZoort and Salterio, 2001, p.44).

Figure 1: New Role of Audit Committees in Corporate Governance



Keys:



The existence of an effective audit committee also benefits the external auditor. As part of their oversight function, audit committees ask questions of both auditors and 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 company management. The audit committee can be a vehicle for maintaining balance in the relationship between management and the external auditor (Cohen Commission, 1978, p.106). The findings supplement anecdotal, thought and survey-based research in the area of audit committee members' appointment and reporting structure and suggest the need for further empirical research in the area to facilitate audit committee independence in the financial oversight process within the corporate governance structures of corporations.

There are several limitations of this study. First, the participants who were requested to role play as members of the audit committee indicating a possibility that their responses lacked authenticity. Second, the manipulation of the independent variables may not be strong enough, since the participants would be focusing on the minimum legislative requirements of audit committee duties and responsibilities. Finally, the experiment was not undertaken in a controlled environment therefore increasing the demand effects on participants.

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