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Accounting and Auditing as Mechanism of Corporate Governance Review of Literature

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Abstract : *The corporate governance and its relationship with corporate board and audit committee have been under scrutiny in this review of literature. As research studies in this area are abundant, after a thorough investigation of a number of studies, twelve studies were selected for the analysis, which were published in or after 2003. However, from these studies only the issues related to corporate board and audit committee were picked. The discussions are focused on the implications of the findings of these studies. While identifying the relationship between corporate governance, corporate board, and audit committee, a number of future study opportunities have been pointed out as well.*

Keywords: *Corporate Governance; Corporate Board; Audit Committee*

Introduction

Researchers have long studied the relationship between good corporate governance and good accounting outcomes. The investigation started with the studies of Beasley and Dechow et al. (1996). These two studies spurred other researchers to follow their footsteps and even move the researches to different dimensions. Later, introduction of Sarbanes-Oxley Act passed in the U.S. House of Representatives in 2002, has widened the horizon of research for the researchers. Investigation of Pre-SOX and post-SOX relationship between governance characteristics and accounting and auditing outcomes got acceleration. A thorough analysis of recently published researches may give an overall picture of the situation. Keeping this in mind, this research was designed to get a clear understanding of the relationship between the corporate board and audit committee issues.

Method

The method used in this research is a very simple one. Twelve recent studies were selected for analysis after a careful examination of few recently published research articles. Only the researches published in and after 2003 were selected. From the finding and analysis sections of these studies, relationship between corporate governance and corporate board and audit committee was separated and analyzed.

Governance and Accounting Outcomes

Recent studies linking corporate governance and accounting outcomes are abundant. Most of these studies have focused their studies on a few characteristics, such as accounting conservatism, fraudulent financial reporting, earnings management or accruals quality, restatements etc.

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Fraudulent Financial Reporting

Among the recent studies used for the purpose of this research, only three have found some relationship between fraudulent financial reporting and governance characteristics. So, the more general finding of the researches is that there is no direct relationship between governance quality and fraudulent activities. However, the three researches that have found a relationship between these two aspects have not found similar relationships. The relationships are different in magnitude. The study of Fich & Shivdasani (2007), found a positive relationship between fraud and governance. The study actually identified a few governance variables, which have close relationship with fraudulent activities. If a company has a weak governance or a very large management board or if the members of the management board are very busy or if the members of the board are not independent or if it becomes difficult for the board members to sit together or if board members are not financial experts or if there is a CEO duality issue, there is a positive probability of a fraudulent activity. The study identified a few instances of fraudulent activities. A company was sued for fraudulent financial activity, which indicated the presence of a corrupt director. High index number showed weak governance in some companies as well. Another study by Zhao & Chen (2008) found a negative relationship between allegations of fraudulent financial reporting and the presence of a staggered board or the independence of a board. At the same time, the study found a positive relationship between allegations of fraudulent financial reporting and the issue whether the CEO presides over the meetings of the board. The study of Beasley et al. (2010) performed univariate tests and found relationship between fraudulent financial reporting and some management trends. The study compared between no-fraud firms and fraud firms and found that fraud firms have more inside directors on the board and audit committee than no-fraud firms. The average period of the directors of fraud firms are much less than that of no-fraud firms. In most of the cases the fraud firms do not have any audit committee and when they have an audit committee, the committee comprises less than three members. However, the study suggested further study to identify the practical significance of the differences mentioned.

Restatements

Two of the studies that were selected for this research focus on the relationship between governance and restatements. They examined the process of selecting directors and the role of the CEO in the process. The effect of the presence of industry experts in the audit committee was also scrutinized. The earlier studies of Abbott et al. (2004) and Agrawal & Chadha (2005), found a negative relationship between restatements and independence of the audit committee and financial expertise. But a recent study of Carcello et al. (2011) found no intelligible relationship between restatements and independence of the audit committee or financial expertise. The study found that if the CEO is involved in selecting the directors of audit committee, the audit committee generally fails to be strong in its activities. The study also identified that when the audit committee is independent and the CEO is not involved in the selection process of directors of audit committee, the reactions of the stock market to the restatement announcements tend to be less negative. Cohen et al. (2010a) identified a very strong negative relationship between audit committee industry expertise and restatements. The more specific industry knowledge the audit committee has, the more negative relationship exists. When the audit committee industry expertise is combined with either audit committee financial expertise or auditor industry specialization, the risk of restatements becomes lower. A study worth mentioning here is the study of Larcker et al. (2007). It examined the relationship between accounting outcomes and a number of governance characteristics. The study used principal component analysis and it started the examination with 39 governance criteria. After the analysis the study identified 14 governance variables, which have relationships with accounting restatements. However, the relationships are not very strong.

Earnings Management/Accruals Quality

Earnings management issues have been investigated by a large number of studies. For the purpose of this study only a few recently published studies were selected which focused on the relationship between governance quality and earnings management. The study of Larcker et al. (2007) has already been mentioned which identified 14 governance criteria, which have some sort of relationships with different accounting outcomes. The relationships are not always straightforward. Rather, these 14 governance dimensions have a mixed relationship with unnatural accruals. Some of the criteria even have unexpected signs. Bowen et al. (2008) identified that there is a negative relationship between accounting discretion and the quality of corporate governance. Earnings management shapes the company's future performance. There are some evidences that prove that there is a positive relationship between accounting discretion and future performance of the company. The results of the study suggest that the shareholders benefit from the earnings management used for improving poor corporate governance, though expenditure may seem to lead to loss. The study of Zhao & Chen (2008) found a negative relationship between completely surprising accruals and the presence of a staggered board and also the audit committee with a block holder on it. The negative relationship between a staggered board and earnings management is not always consistent in the sense that weak governance and poor financial reporting quality are closely associated with each other. The study of Naiker & Sharma (2009) identified that the performance-adjusted discretionary accruals are negatively related with experience of audit committee member as an audit partner. The study of Dhaliwal et al. (2010) found a clearly positive relationship between the accruals quality and the presence of accounting expertise on the audit committee. The relationship is easily understood when the accounting expert is independent in giving his opinion, when he does not hold a lot of positions in some other boards of some other companies and when his tenure as an expert on the audit committee is short. However, the positive relationship between the above mentioned aspects becomes even stronger when both accounting expertise and finance expertise are on the board.

Accounting Conservatism

Beekes et al. (2004) identified the relationship between accounting conservatism and corporate governance. Other studies based this particular study to investigate similar relationship. There is a positive relationship between accounting conservatism and the quality of governance. According to the study of Ahmed & Duellman (2007) the percentage of the presence of inside director on the board is negatively related to many procedures of accounting conservatism. On the other hand, the ownership of outside directors is positively related to accounting conservatism. The study of Chung & Wynn (2008) investigated the relationship between the liability coverage of directors and officers and accounting conservatism. If litigation risk is higher, the study found, the greater coverage leads to reduce accounting conservatism. The study of Krishnan (2008) found that in the audit committee if there is accounting expertise and no non-accounting financial expertise greater accounting conservatism results. However, the overall corporate governance has to be strong.

Governance and Auditing Outcomes

Auditor Selections, Change, and Ratification

Recent studies have found that companies that have better/stronger governance tend to select highly skillful external auditors and try to keep them for long time. For instance, the study of Lee et al (2004) found a negative relationship between auditor resignations and the independence of audit committee and board and financial expertise of audit committee. The audit committees that are independent try to find even more skilled successor auditors. The study of Chen & Zhou (2007) examined the issue of auditor change and its relationship with the failure of Andersen. Companies having more independent audit committees and financial expert on the audit committees terminated their relationship with Andersen immediately. The companies having more independent boards with larger audit committees and the companies that hold more audit committee meetings tend to select an auditor related to Big 4. The study of Lennox & Park (2007) found that independent audit committees generally promote auditor independence. They do not normally want to select an audit firm where the members have some sort of affiliation to their own companies. According to the finding of the study of Bronson et al. (2009) when a going concern opinion is issued there is a negative relationship between dismissing the auditor and completely independent audit committees. The role of audit committee quality, where the audit committee has selected the auditor, in the ratification of the auditor by shareholders has also been researched. The study of Hermanson (2009) found that there is a positive relationship between shareholder votes and the presence of financial expertise on the audit committee. When there is more financial expertise on audit committee, the shareholders have more confidence in the auditor who was selected through voting.

Auditor Risk Assessment, Audit Planning, and Audit Opinions

The relationship between corporate governance and a few issues related to audit (audit opinion, audit planning, auditor risk assessment, etc.) has been studied by a few studies. The findings of these studies suggest that the characteristics of governance have a significant influence over audit planning and auditors' risk assessment. At the same time the quality of the governance has a close tie with the audit opinions. The study of Cohen (2007b) found that if the role of the board is strong it could affect audit planning decisions and control risk assessments. The study found these results basing on an investigation with managers and audit partners. If the role of the board is weak, higher-control risk assessments and higher audit budgets are the results. The study found a negative relationship between auditors' risk assessments and the existence of the audit committee and the frequency of meetings of the audit committee. The study of Sharma (2008) conducted an experiment on Big 4 auditors in Singapore. The study found that if there were strong client corporate governance, it would lead to a few results. For example, it will be more acceptable to the clients; it will lower the assessments of control environmental risk; it will rely more on client controls; it will reduce substantive testing and it will increase interim testing. There are some studies, which have examined the relationship between governance characteristics and internal auditors' decisions. The study of Asare (2008) found that in some cases the quality of audit committee influences the fraud risk assessments of internal auditors. However, the study found that the judgments on audit scope are not hampered. The study of Bronson (2009) found that an independent audit committee is positively related to a going-concern opinion, which is issued to a financially distressed company. However, in the audit committee the presence of only one non-independent member is unacceptable.

Audit Fees

Following the suggestion by Hay et al. (2006), researchers have been continuously examining the relationship between the characteristics of corporate governance and audit fees. The study of Carcello et al. (2002) identified that strong governance may lead to an increase of demand for auditing which means it may increase the fees of auditing. Additionally or otherwise, it may reduce auditors' assessments of risks, which means it may reduce audit fees. Recent studies, especially, related to the presence of financial expertise on the audit committee, have come up with mixed results. The study of Krishnan (2009) found a negative relationship between the presence of accounting expertise on the audit committee and audit fees. But the study pointed out that this is true for the companies, which have strong governance. Some issues like the size of the board, frequency of board meetings, meetings of audit committee, CEO duality etc. may increase audit fees. When the risk of earnings management is low, the relationship between the presence of accounting expertise on the audit committee and audit fees is negative. When the risk of earnings management is high the audit committee with accounting expert may want to carry out more extensive auditing. The study of Gul (2010) identified a negative relationship between audit fees and director stock ownership. At the same time, the study identified a positive relationship between audit fees and less "democratic" boards, meeting of board and the presence of financial expertise on the audit committee. In case of stronger board, the presence of financial expertise on audit committee remains consistent.

Non-audit Fees

How board and audit committees influence non-audit fees has been investigated by a number of recent studies. The study of Gul & Goodwin (2010) carried out an experiment with some experienced directors who work as members of audit committees. The study also evaluated the use of external auditors in allowable non-audit services. The study found that when audit quality increases, the members of audit committee want to employ the auditor for non-audit services as well. Nevertheless, when the fees of the auditors are publicly disclosed, the members of audit committee are not interested to employ the auditor for non-audit services. Even if there is a chance of the improvement of audit quality, in this case, they are not likely to employ the auditor for non-audit services. The relationship between corporate governance and the purchase of tax services, in the earlier researches, is mixed. The study of Bédard & Paquette (2009) identified that the presence of accounting expert on audit committee and the member of boards served by that accounting expert are negatively related to the employment of that accounting expert for providing tax services. However, the study of Lassila (2010) identified a positive relationship between the employment of an auditor for providing tax service and corporate governance strength. The study considered a number of characteristics for corporate governance strength such as the structure of board size, independence of the board, size of the audit committee, independence of the audit committee, rights of the shareholders, institutional ownership etc.

Internal Audit Function

The internal audit function has been studied by a number of research studies. Among these studies three have investigated internal audit budgets and all of these studies found relationship of internal audit budgets and some governance characteristics. The study identified that if audit committee reviews the budget, the overall internal audit budget becomes higher. The study of Barua (2010) found a positive relationship between internal audit budget and frequency of meetings of audit committee and a negative relationship between internal audit budget and the presence of audit expert on the audit committee and the duration of the members of audit committee. The study of Abbott (2010) found that when the audit committee scrutinizes internal audit, the focus of internal audit on internal control related activities increases. The study of Abbott (2007) examined the outsourcing of routine and non-routine internal audit activities of pre-SOX period. The finding of that study suggests that "effective" audit committees entertain less outsourcing of regular internal audit activities from external auditor. The effectiveness was measured basing on independence, meetings and expertise. These routine activities could, however, hamper the independence of the auditor. The non-routine activities or outsourcing to other audit firms do not fall under the above mentioned situation.

Summary

Summary of Research on Accounting Outcomes

Recent studies have investigated different variables relating to governance quality and accounting outcomes. These studies used dependent variable like accounting conservatism and independent variables like the involvement of the CEO in the selection process of directors, staggered board, industry expertise of audit committee, accounting expertise of audit committee etc. generally, the studies have found positive relationships between good governance criteria and good accounting outcomes. The characteristics of governance, which are considered good, also lead to good accounting outcomes. Among the studies we used for this purpose, Larcker (2007) carried out the most extensive analysis. Using principal component analysis, the study analyzed a large number of governance characteristics and accounting outcomes. There are still scope for the researchers to carry out detail studies using numerous corporate governance characteristics and principal component analysis.

Summary of Research on Auditing Outcomes

The recent researches on governance and auditing outcomes have focused on four major areas: (1) selection of auditors and their retention, (2) influences of governance characteristics on the assessments of risk and planning decisions, (3) audit and non-audit fees and some conflicting issues of governance and (4) relation between internal audit budgets and governance characteristics.

Conclusion

During the last 15 years researchers have long studied on the relationship between corporate governance and accounting and auditing outcomes. The research reviewed above provides many great insights into the corporate governance literature in accounting and auditing. In this paper, I go over the main points (relationship between corporate governance and corporate board and audit committee was separated and analyzed) and integrate the findings to date. At the same time, I also propose few suggestions for future research.

Scope of Future Study

Though studies in the areas of corporate governance, corporate board and audit committee are ample, still there are scopes for the researchers for further studies. From the review of literature, a number of cases have been identified where there should need more investigation. The role of investors in shaping the governance is the first area, which should be investigated more. The identification of the characteristics of effective governance is the second area, which should be studied by the researchers in future. The third area, which should come under further investigation, is the influence of the whistleblowers in making the governance more effective. The roles of members of board and committees other than the audit committee should also be investigated thoroughly.

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