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Effects of Appointment and Reporting Structure on Audit Committee Members’ Judgment

by

Veer Singh Varma

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A Major thesis submitted in fulfillment of the requirements for the degree of Master of Arts in Accounting and Financial Management

January, 2006

Research Supervisor:

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The University of the South Pacific
Suva, Fiji Islands

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Declaration of Originality

I, Veer Singh Varma, declare that this thesis is my own work and that, to the best of my knowledge, it contains no material previously published, or substantially overlapping with material submitted for the award of any other degree at any institution, except where due acknowledgement is made in the text.

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Veer Singh Varma                         Author
I, the researcher (Veer Singh Varma of the University of the South Pacific, Fiji) wish to acknowledge those people and corporations who greatly helped me in successful completion of this research study for the fulfillment of the requirements of the degree of Master of Arts in Accounting and Financial Management.

In particular, I would like to extend special thanks to my research supervisor, Dr. Arvind Patel, (Associate Professor in Accounting and Financial Management, University of the South Pacific, Fiji). Being the research supervisor, he provided invaluable assistance and support in completing this research. Fruitful discussions and arguments with him on issues essential to this research were enormously beneficial and relevant in writing this thesis.

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I am indebted to the respective boards of directors of the participant group from listed companies, private sector corporations and ex-board of directors in Fiji and abroad, who took out their precious time and completed the questionnaires within the given time frame. This shows the enthusiasm of such directors for the academic community. In addition, the management and the company secretaries deserve appreciation for their comments and for providing accessibility to the company’s boards of directors.

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Finally, I would like to express sincere gratitude to my parents for providing me strength, time and encouragement to complete this thesis.
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 of audit committees as a governance mechanism and as a sub-committee of the board of directors by bringing together arguments associated with their appointment and reporting structure in the context of the agency theory approach.

This study uses a hypothetical case to examine the perceptions of the board of directors and audit committee members from the large private sector corporations in Fiji and abroad about corporate governance practices relating to the judgment of audit committee members in the auditor-management dispute situations. This study uses agency theory to determine the relationship between the audit committees’ structure and their judgment. Two potential variable of audit committee structure is identified, the appointment and the reporting variable. These variables are then tested based on the accounting policy disagreement between the auditor and the management. Both variables were perceived to have some influence on the judgment of the audit committee members on the auditor – management dispute case. However, some interesting differences were found between the perceptions of the audit committee members appointed by (and reporting to) the board of directors and those audit committee members appointed by (and reporting to) the Independent oversight board, suggesting that appointment and reporting structure could impair audit committee independence. Four separate treatment samples are compared concurrently to determine the variances between these groups. Results of the experiment show significant differences for the two hypotheses (H1 & H2) and insignificant
differences for the interaction effects. In particular, the experimental result support the proposition that an audit committee appointed by the board of directors will support the management in auditor – management dispute situations, while an audit committee appointed by the Independent oversight board supports the auditor in such dispute cases (H1). Similarly, the experimental result support the proposition that an audit committee reporting to the Board of directors will support the management in auditor - management dispute situations, while an audit committee reporting to the Independent oversight board supports the auditor in such dispute cases (H2). Therefore, from an agency theory perspective, experimental results support the association between the appointment and reporting variables on one hand and the judgment of the audit committee members on the other. That is, these results provide evidence that appointment and reporting variables are significant in explaining the judgment of the audit committees in corporate governance process even in the presence of other company specific variables that could affect the judgment of the audit committee members. For instance these variables include the participants’ financial accounting knowledge, financial statements analysis knowledge and the level of auditing knowledge. These variables were controlled in this research.

Hence, this study proposes the need for audit committees as a means of avoiding future corporate collapses and other revelations of alleged fraud and corporate malfeasance locally. The 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 the corporate governance arena. These results have important implications for regulators, professional accounting bodies and various stock exchanges in different countries, as they attempt to establish and to enhance their audit committees as part of their future corporate governance policy. Setting up of audit committees came about in direct response to demands like improving financial reporting and public accountability. Ultimately, this research focused on the need for greater audit committee independence in corporate governance process, and the significant effect of appointment and reporting structure on the audit committee judgment in auditor – management dispute situations.

**Key words:** Agency Theory, Audit Committee Appointment, Reporting and Independence, Financial Reporting Reliability and Corporate Governance.
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Explanations of Terms and Abbreviations used in this Study

AAER Association for the Advancement of Educational Research
AARF Australian Accounting Research Foundation
AASC Accounting and Auditing Standards Committee
ADB Asian Development Bank
AICD Australian Institute of Company Directors
AICPA American Institute of Certified Public Accountants
ANOVA ANalysis Of VAriance
APB Auditing Practices Board
APL Air Pacific Limited
ASCPA Australian Society of Certified Practising Accountants
ATH Amalgamated Telecom Holdings Limited
AUDKNOW AUDit KNOWledge
BAT British American Tobacco Limited
BCA Business Council of Australia
BOD Boards of Directors
BRC Blue Ribbon Committee
CA Chartered Accountant
CAPA Confederation of Asian and Pacific Accountants
CEO Chief Executive Officer
CEPS Centre for European Policy Studies
CFO Chief Financial Officer
CGA Certified General Accountants
CGSR Centre for Global Security Research
CICA Canadian Institute of Chartered Accountants
CMA Certified Management Accountants
CMDA Capital Markets Development Authority
CPA Certified Practicing Accountant
DIFFICULT DIFFICULTy in making judgment
EC European Commission
FASKNOW Financial Accounting KNOWledge
FAS Fiji Accounting Standards
FASB Financial Accounting Standards Board
FHL Fijian Holdings Limited
FIA Fiji Institute of Accountants
FSA Fiji Standards on Auditing
GAAP Generally Accepted Accounting Principles
GAAS Generally Accepted Accounting Standards
GAO General Accounting Office
HKSA Hong Kong Society of Accountants
IAPS International Auditing Practice Statements
IAS International Accounting Standards
IASC International Accounting Standards Committee
ICAEW Institute of Chartered Accountants in England and Wales
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<td>UNDP</td>
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CHAPTER ONE

INTRODUCTION
1.0 Introduction

1.1 Background to the Research

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 abroad and locally, in particular, the listed public companies in Fiji’.

The term “governance” is a very versatile one. It is used in a 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 needs of political science with regard to state governance and from the needs of economics with regard to corporate governance. For example, the World Bank (1991:1) regarded governance as the manner in which power is exercised in the management of a country’s economic and social resources for development. Also the Commission on Global Governance (UNDP, 1997:3) suggested that governance is concerned with accountability, transparency, equitability and predictability.

Governance is about regulating relationships in complex systems (Tricker, 1978, 1984; Power, 1997) and it is ‘concerned with the processes by which corporate entities are governed; that is with the exercise of power over the direction of the enterprise, the supervision and control of executive actions’ (Tricker, 1984, p.8).

‘Governance’ corresponds to the post-modern form of economic and political organizations, for example, according to the political scientist Roderick Rhodes (1997), the concept of governance 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 on the latter meaning, the concept of “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 the performance of the companies are determined. Corporate governance depends on the nature and characteristics of the ownership structure and the capital structure of the business, and its purpose is to achieve a responsible, value-oriented management and control of companies. 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 the many branches of corporate governance, the 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 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, Parker and Peters, 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 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. There 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. As Keasey and Wright (1993, p.291) note:

The framework of corporate governance within the UK, and generally within the Anglo-American model, which relies heavily on self-regulation and market based sanctions, has been seen as suffering from a number of weaknesses which render accountability more problematic. In particular there have been concerns over: the spread of creative accounting, the spectacular increases in unexpected business failures; the apparent ease of unscrupulous directors in expropriating other stakeholders’ funds; the very limited role of auditors; the apparently weak link between executive compensation and company performance . . . These concerns have brought corporate accountability and governance to the top of the policy agenda . . . The report of the Cadbury Committee has been one response to these issues.

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.

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 notorious accounting failures have pointed out the need for substantive improvements in these components, a situation in which, perhaps, the academic accounting community can through commentary and scientific-based research
that provide direction for change, play a role in stimulating change aimed at enhancing market efficiency.

As part of the academic contribution in this area, this study uses scientific based research to propose the effect of 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 through the concern for audit committee independence and how the effect of appointment and reporting mechanisms could affect the underlying quality and integrity of the financial reporting process. This study uses the agency theory model to formulate the following research problem and research hypotheses.

1.2 Research Problem and Research Hypothesis

1.2.1 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

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 comprised and moreover, how it should function. Similarly not much guidance is given on audit committees’ role, composition and structure. The rising expectations and increased liability, which have motivated considerable inquiry in the accounting literature (DeZoort, 1998), have heightened the concern about audit committee effectiveness.

The numerous studies related to audit committee effectiveness includes Maultz and Neumann (1970, 1977); Robertson and Deakin (1977); Grinaker et al. (1978); Birkett (1980); Reinstein (1980); Braiotta (1986); Castellano et al. (1989); Spangler and Braiotta (1990); Abdolmohammadi and Levy (1992); McMullen (1992); Kalbers and Fogarty (1993); Lee and Stone (1996) and DeZoort (1998), while some studies have focused on effectiveness and specifically, differences in member experience, independence and knowledge ((Arthur Anderson, 1998; BRC, 1999; GAO, 1991, 1996; KPMG, 1999; MacDonald Commission, 1987; NACD, 2000; NCFFR, 1987; and Sommer, 1991).

In addition, good corporate governance promotes agency relationships of accountability among the primary corporate participants, to enhance corporate performance, and it holds management accountable to the board and the board accountable to the shareholders. In this paradigm, the board is in place to ensure that management is working to enhance corporate economic value in the best interests of the corporation and its shareholders. The audit committee’s role flows directly from the board oversight function.
However, audit committee independence within corporate governance is a crucial area where research has been limited. The present 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 without addressing the need to find alternative structural mechanisms for audit committees that can ensure their greater independence within the corporate governance framework.

The recent spectacular increase 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 raised 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 companies reporting with approximately $101 billion in revenues in 2000. It filed a bankruptcy with the 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 and business failures, and the potential costs of ineffective audit committee oversight, such as the legal exposures (Verschoor, 1990a, 1990b).
As such, for the purpose of this study, audit committees are regarded as part of corporate governance process, offering independent advice and expertise on matters such as internal controls and management fraud and providing an interface with the independent auditors and the internal auditors in the corporations. These committees also have a major oversight role in the financial reporting process, because their ability to link various groups involved in the financial reporting process improves the quality of the financial statements and disclosures (Imhoff, 2003). Audit committees have become a major means for companies to monitor the reliability of the financial reporting process (McMullen, 1996) and these committees were designed to add to the quality and integrity of the management’s financial reports.

The audit committees are regarded as an external governance device and there is a focus in this line of research on the structure and functioning of the boards of directors and the audit committees of such boards (Rosenstein & Wyatt, 1990; Shleifer & Vishny, 1997). Based on this authority, the corporate boards charge audit committees with the responsibility for the oversight of the financial reporting and auditing processes (Public Oversight Board [POB], 1993; Treadway Commission, 1987; Wolnizer, 1995). Therefore, this study argues that changing the appointment and reporting structure of the audit committees affects the independence of audit committees within the corporate governance practices of the corporations. In particular, this study focuses on the effect of appointment and reporting structure of audit committees and argues that an Independent oversight board as opposed to board of directors should appoint audit committees 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 a 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 an 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 would alternative appointment and reporting structures of audit committees within the corporate governance framework of corporations affect the audit committee members’ judgment in auditor - management disagreements?**

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 public confidence in the mechanism (Lublin and MacDonald, 1998; Verschoor, 1990a, 1990b). The 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).

This research problem has been chosen as the major area of this study, particularly because of its increasing dimension and widespread public interest globally due to huge corporate failures in some of the large international corporations. As noted, the recent saga of corporate failures and the dramatic collapse of Enron, Worldcom, AOL Time Warner, Boeing, HIH, Computer Associates, Xerox, Tyco, IBM and Cendant in the international arena and of the National Bank of Fiji locally, provides continuing evidence of weaknesses of corporate governance at all levels including the senior management, boards of directors, audit committees, external auditors, financial regulators and the
accounting and auditing profession. Such turmoil in foreign markets has pointed out the need for substantive improvements in the area of accounting and auditing within the corporate governance framework of the corporations and has further compounded pressures on our financial reporting process.

The research problem primarily focuses on the research activity and the literature search and is mostly confined to the private sector corporations in Fiji and abroad. These entities basically include the listed public companies (all the 16 companies listed on the South Pacific Stock Exchange as at 2004), large private sector corporations operating in Fiji and abroad. The Fiji economy has been chosen for the major focus of this research activity since this is the place where the researcher and the supervisor live, so it will be easy to gain access to collect relevant data and to analyze these data in a limited time frame. Access to corporations will be an added advantage to carry forward for this type of research.

In due consideration of the research problem and its urgency, the following section formulates the research hypotheses based on the extant literature and the agency theory model.

1.2.2 Research Hypotheses

To solve the research problem, in part, 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 the 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.

The concept of corporate governance within the agency theory is focused primarily on designing contractual mechanisms to control self-interested managerial behavior. Jensen and Meckling (1976) describe an agency relationship as arising where there is a contract under which one party (the principal) engages another party (the agent) to perform some service on the principal’s behalf. Under the contract the principal delegates some decision-making authority to the agent (Godfrey et al., 2000).
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. That is, an agency relationship among shareholders and management necessitates the implementation of costly contracts, compensation plans and monitoring schemes of the boards and the audit committees and as such, the audit committees will work towards the interest of the agent (management via board) to fully achieve the benefits of their position. Also, numerous studies have conceptualised the adoption and operation of audit committees for reducing agency costs (Zaman, 2002) as part of their corporate governance mechanism. Agency theory postulates that the interests of the principals and the agents may not be aligned and that monitoring of managers is a method of reducing agency costs (Jensen and Meckling, 1976). In previous research, monitoring is conducted via corporate governance information systems (Eisenhardt, 1989), and the external audit being a monitoring device (Watts and Zimmerman, 1983). Both managers and stakeholders have incentives to encourage such monitoring (Fama and Jensen, 1983).

Therefore, based on the above arguments, this study extends the literature by examining whether a relationship does exist between the appointment and reporting structure of audit committees and the judgments made by the audit committees in an auditor-management disagreement over an accounting policy choice which has direct implications for the quality of financial reports (such as Knapp, 1987; DeZoort and Salterio, 2001). Additionally, this study is motivated to provide empirical findings to facilitate evaluation of the question of substitution of governance mechanisms with respect to the demand for the quality of the financial reporting process and to extend the prior research of audit committee structure within the corporate governance practices of the corporations.

**Appointment of Audit Committee**

The hypotheses are derived from the point of view of the issue of auditor - management dispute (as used by Knapp, 1987 and DeZoort and Salterio, 2001), which is becoming an increasingly constructive way to make audit judgments when there is a dispute between these two parties. After looking at the dispute, the audit committee member will be
inclined to form an independent opinion on the judgment of who is correct or whom to support. As part of the audit committee role, when a dispute reaches the audit committee, the audit committee members’ position will be affected by who have appointed them.

In particular, when a dispute reaches the audit committee, members who are appointed by the board of directors are more likely to be biased towards management (DeZoort and Salterio, 2001) because the board is the upper level management and the audit committee members may have incentives for stock options and compensation, since the board of directors will have the power to appoint, compensate and terminate these audit committee members. As such, this study posits that audit committee members appointed by the board may be biased towards management and thus, more likely to support the management’s position.

Conversely, this research states the proposed alternative structure of the audit committees with the corporate governance framework of the corporations. It is based on the notion that today corporate boards, managers, auditors, audit committees and accounting standard setters are all presumably working together to create a financial reporting process of unparalleled integrity (Imhoff, 2003) and greater ‘transparency’ for financial statements stems from greater recognition and disclosure requirements of generally accepted accounting principles (GAAP), as well as more frequent and timely reporting requirements in the financial reporting process. To overcome the biasness in the financial reporting process, this study examines the audit committee as a governance device, that can be used to achieve greater transparency and accountability in the financial reporting process, and this can be successfully achieved by changing the appointment structure of these audit committees.

Based on this notion, and believing that the independence of the audit committees may be compromised when they are appointed by the board and therefore, this study proposes that the appointment structure of audit committees be changed from the hands of boards of directors to the power of independent oversight board in the respective countries.
This study, however, argues that the proposal of the Sarbanes - Oxley Act (2002) fall short of meeting the expected requirements of independence. The appointment in the new proposal is still retained with the board of directors. Boardroom politics is a very complex environment and most of the corporate failures have been attributed to boardroom politics and board members failing in their duties. In order that a high degree of independence can be achieved, the independent oversight board rather than the board of directors should execute appointment of the audit committees. To support this proposition (H1), the following hypothesis is stated and will be tested in this research.

These arguments then lead us formally to the following hypothesis:

**H1:** An audit committee that is appointed by the Board of directors is more likely to support the management in case of any auditor - management dispute situation compared to an audit committee appointed by the Independent oversight board.

**Reporting by Audit Committee**

These hypotheses are also derived from the point of view of the issue of auditor - management dispute (as used by Knapp, 1987 and DeZoort and Salterio, 2001). After looking at the dispute, the audit committee member will be inclined to make an Independent opinion on the judgment of who is correct or whom to support. As part of the audit committee role, when a dispute reaches the audit committee, the audit committee members’ position will be affected by whom they are reporting to. In particular, when a dispute reaches the audit committee, members who are reporting to the board of directors are more likely to be biased towards management (DeZoort and Salterio, 2001) because the board is the upper level management and the audit committee members may have incentives for stock options and compensation since the board of directors will have the power to appoint, compensate and terminate these audit committee members. As such, this study posits that audit committee members reporting to the board of directors may be biased towards management and thus, more likely to support the management’s position.
Conversely, based on the second proposition, when a dispute reaches the audit committee, members reporting to an Independent oversight board 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 reporting via an Independent oversight board, 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 neither are they part of the management. Supporting auditors will mean that they are more concerned towards the quality of the financial reports presented to them and, are more likely to be taking the “substance” approach to support the auditor (DeZoort and Salterio, 2001). This will reduce the likelihood of fraud and error in the financial statements, thereby improving the quality of the financial reporting process (FSA 11, Para, 2, 3).

One of the important mechanisms of corporate governance is that an audit committee should be reporting back to this Independent oversight board based on the committees’ deliberations. This alternative structure will, perhaps, enhance audit committee independence since the independent audit committee will not be constrained or be self-interested to support the management and/or board of directors position. They will be more inclined to make decisions that are independent and unbiased. Therefore, within the agency theory model, audit committees need to report to an Independent oversight board since these committees are contracted with the company to provide an independent oversight function on the financial statements, which then adds credibility to the financial reports and thereby improves the financial reporting process.

These arguments then lead us formally to the following hypothesis:

**H2:** An audit committee that is reporting to the Board of directors is more likely to support the management in case of any auditor - management dispute situation compared to an audit committee reporting to the Independent oversight board.
1.3 Justification for the Research

Interest in the audit committees as part of overall corporate governance has increased dramatically in recent years and has been the subject of considerable attention in many countries (see CICA, 1981; NCFFR, 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 the US, the 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 the US, Canada and Singapore but is voluntary in the UK and Australia [CGSR.9/1000(Aca), 2000].

Early recommendations for audit committees made in the US (NCFFR, 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 the Fiji economy to establish audit committees and make them mandatory for the listed public companies for their own benefit in future.

What are notable are the extent of the audit committees’ 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 the US and Thailand. In the UK, Australia, New Zealand and South Africa, companies listed on the stock exchange are required to state in their annual report whether they have an audit committee. In some countries such as France, Hong Kong, Japan and the Netherlands, audit committees are recommended as a best practice (Morse and Keegan, 1999).
The Treadway Commission (NCFFR, 1987, p.183) emphasised the key role that the audit committee should play with regard to monitoring the integrity of the financial statements, noting that ‘an informed and vigilant audit committee represents one of the most effective influences for minimising fraudulent financial reporting. Countering this support for audit committees is the criticism that a lack of clearly defined responsibilities and insufficient authority has severely hampered audit committee effectiveness (Wallace, 1985; Knapp, 1987). One of the most important factors that determine the effectiveness of audit committees has been the ability of the audit committee members to remain independent in executing their tasks.

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). Recent evidence suggests that strong corporate governance including an independent audit committee has the potential to increase audit efficiency and effectiveness (Cohen and Hanno, 2000). Such effect of sound governance practices on the quality of financial reporting have recently received attention from many researchers, particularly in the US (McMullen, 1996; Beasley, 1996; Beasley et al., 2000; Abbott et al., 2000). These studies mainly focus on the relationship between the audit committees and fraudulent financial reporting, with results generally supporting a negative relation between an active audit committee and the likelihood of a company being cited for fraudulent reporting.

While these results provide evidence from a strong sophisticated capital market environment2 very little research has been conducted in countries3 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

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2 Such as stock markets in the US, for example, New York Stock Exchange. (the world’s largest capital market).
3 Such as developing countries (for instance, Fiji as one of the South Pacific countries).
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, the 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 additional motivation for research in this area.

Also research into these areas will eventually help to control the local cases such as the case of the National Bank of Fiji’s (NBF)\(^3\) collapse. The government-owned NBF nearly collapsed in the mid-1990s. The subsequent government bailout, although inevitable in political terms, cost the economy dearly. The NBF’s collapse was largely due to poor supervision and poor corporate governance in the public sector.

Furthermore, with regard 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 Fiji economy has misused $12 million in what we commonly referred to 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 ‘scams’ of this type and how audit committees might benefit the stakeholders in terms of providing a transparent audit reporting process.

\(^3\) NBF was Fiji’s own national bank, which was bankrupt and liquidated its services in 1990. It is now operated by Colonial Group of Companies Ltd., under the name of Colonial National Bank. Changes took place in the structure of the management, board of directors and shareholders.
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 have 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 the Fiji Islands) where there is more potential for corporations to adopt to reforms in the corporate structure. However, even in the developed world, the role of the audit committee in corporate governance is relatively new. Therefore, this study seeks to contribute to our understanding of the value and potential of the audit committees’ as a governance mechanism by bringing together arguments associated with their adoption, appointment and reporting structure, with evidence of their impact in practice. In this study, an effective audit committee is believed to be one that is independent in its oversight function and thereby provides an accurate judgment in the auditor - management disagreements, hence, improving its effectiveness and enhancing the quality of the financial reporting process. Therefore, to
achieve audit committee independence, the appointment and reporting structure needs to be changed from the present board of directors to the Independent oversight board.

Finally, this study addresses the scarcity of research in the field of auditing by exploring governance issues relating to the quality of financial reporting, in particular, the effect of appointment and reporting variables on the audit committee members’ judgment. Much research has been done on the audit committee’s role, composition, power, knowledge, experience and meetings but none of these studies has researched into the alternative appointment and reporting structure of audit committees. Also little research has focused on quantitative approaches to solving research problems in this area, particularly the use of agency theory in reducing agency costs of audit committees in corporate governance. Therefore, the following section discusses the methodology and the research methods used in this study.

### 1.4 Methodology

A survey will be used as a data collection technique to gather information from the respondents. The data will be collected through structured questionnaires with attached experimental cases. This method is widely used in social science, which has three major forms: descriptive, explanatory and attitude survey. This research will use the attitude survey technique to measure audit committee members’ judgments. Participants will be asked to rank their responses on a scale that will measure their attitudes. The Likert method of attitude survey (7-point scale) will be used in this research. There are several considerations when deciding to adopt a quantitative research methodology in this thesis. This is because it is more reliable, objective and it provides internal and external validity to a study. Survey and experimental instruments will be used to collect the relevant data required for this research. An experimental study will be carried out to collect the data and analyse the result for this research. An experiment is defined by Kerlinger, 1973, quoted in Trotman, 1996, p.6) as ‘a scientific investigation in which an investigator manipulates and controls one or more independent variables and observes the dependent variable or variables for variation concomitant to the manipulation of the independent
variables’. Case experiment is regarded as the most common method of examining judgments in auditing (Trotman, 1996). This research will utilise the field experiment, which is defined as ‘a research study in a realistic situation in which one or more independent variables are manipulated by the experimenter under as carefully controlled conditions as the situation will permit’ (Kerlinger, 1973, quoted in Trotman, 1996, p. 7). The use of factorial design is considered to be appropriate to hypothesise and test the interactions by enabling the researcher to examine the interactive effects of independent variables on the dependent variable.

The testing for significant statistical differences in a factorial design is normally conducted using Univariate Analysis of Variance (Univariate ANOVA). A ‘2 x 2’ ANOVA will be used to test these hypotheses. ‘Appointment’ and ‘Reporting’ are between - subjects factors with two levels (Board of directors and Independent oversight board). The ‘Board of directors’ and ‘Independent oversight board’ are within - subjects factors with two levels (appointment and reporting). The dependent variable is the ‘judgment of the respondents’, which thereby affects the quality of the financial reporting process. An ANOVA for a ‘2 x 2’ factorial design requires that each independent variable be analysed separately and then the interaction between these variables be analysed.

Contrarily, qualitative research technique such as case study is not used in this research, for three important reasons. First, there is a difficulty for drawing boundaries around the subject matter of the case study. The holistic ideal of studying all aspects of a social system is clearly unattainable. Secondly, social systems are not natural phenomena, they cannot be understood independently of human beings and the researcher cannot be regarded as a neutral independent observer that is there is no objectivity (Hoepfl, 1997). This emphasises the problem of researcher biasness. The third difficulty is the ethics of the researcher’s relationship with his/her subjects based on confidentiality of the information. A subject may not be prepared to reveal his/her views or opinions if the researcher is to feed back this information to others in the organisation. This undermines the validity of evidence in the research and for these reasons a qualitative methodology seems unsuitable for this research.
1.5 Outline of the Thesis

The following paragraphs describe and outline the structure of the relevant chapters in the thesis. The structure and style of this thesis is more based on Perry’s (1994) “five chapter structure” model. Chapter one is the introductory chapter, chapter two reviews the literature and states the research question and the hypotheses, chapter 3 is based on methodology of data collection, chapter 4 provides analysis of data collected, and the final chapter 5 discusses the contribution to the body of knowledge. These chapters are based on Perry’s (1994) “five chapter structure”. This “five chapter structure” can be used to effectively present a masters’ thesis (Perry, 1994).

1.6 Definitions

Definitions adopted by researchers are often not uniform, so key controversial terms are defined in this section to establish positions taken in this thesis.

Firstly, the term “governance” means different things to different people. It is useful, therefore, for this thesis to clarify, at the very outset, the sense in which it understands the word. Among the many definitions of “governance” that exist, the one that appears the most appropriate from the viewpoint of this thesis is “the manner in which power is exercised in the management of a country’s economic and social resources for development”\(^4\). Corporate governance is a universal concept having variety of definitions and measures. However, for the purpose of this study, the focus will be on the accountability and the quality of the financial reporting process, which thereby, depends on the effectiveness of the audit committees. Therefore, the thesis adopts the following definition. “Corporate governance” may be 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, p.301)

An “audit committee” is defined as “a committee of non-executive directors responsible for overseeing external financial reporting” (Gill et al., 2001). This thesis takes a similar stand. Also, the concept of corporate governance within agency theory is focused primarily on designing contractual mechanisms to control self-interested managerial behavior. Jensen and Meckling (1976) describe an “agency relationship” as one arising where there is a contract under which one party (the principal) engages another party (the agent) to perform some service on the principal’s behalf. Under the contract the principal delegates some decision-making authority to the agent (Godfrey, et al., 2000).

A “financial report audit” may be defined as “an audit that enables an auditor to express an opinion as to whether the financial report is prepared, in all material respects, in accordance with an identified financial reporting framework” (Gill et al., 2001). The term “errors” as defined in SAS No.53 (AICPA 1988a), refers to unintentional misstatements of amounts or disclosures in the financial statements. The term “irregularities” refers to intentional misstatements or omission of amounts or disclosures in the financial statements. In SAS No. 54 (AICPA 1988b), the term “illegal acts” refers to violations of laws or government regulations perpetrated by an entity or its management or employees, acting on the entity’s behalf. The above arguments, thus, lead us to the following assumptions and limitations of this study.

1.7 Limitations and Key Assumptions

1.7.1 Limitations

The major limitation of this study is that the design will ask participants, most of whom are the ‘board of directors’, to role-play as a member of an audit committee and it is therefore possible that they did not respond as audit committee members. This may cause plausibility in interpreting the results of this study. 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 and abroad. 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 thesis could also be due to a number of factors, including the possibility that the experimental case issue did not create enough of a need for incorporating the appointment and reporting structure of audit committees to make a difference in members’ responses. In addition, higher levels of accounting knowledge may also lead to a greater diversity of opinions among more knowledgeable members, resulting in no clear directional support for the auditor or the management.

1.7.2 Key Assumption

The key assumption is that most of the participants (such as the board of directors) will be required to role play their structural role, that is assuming that they have been appointed by (and reporting to) the board of directors and/or by the Independent oversight board. To answer the research questions, each category of participants will be asked to assume their role and structure. For instance, the first set of participants will be asked to assume that they are outside, non-executive directors of the corporations’ Board for past two years and they have been duly appointed by the Board of directors (Board) as one of the three independents to serve on the Board’s audit committee. Their appointment, termination, remuneration and compensation, all depends on this Board. The assumptions for remaining participants are also based on the above context.

The major reason for asking participants to role-play as members of an audit committee is because there are very few (11%) audit committees in the private sector and listed corporations in Fiji. Concentrating only on these fewer audit committees wouldn’t have formed the sample size if only audit committee members are taken as participants and it would have been impossible to collect data. Role-playing was designed to add realism to the experiment and encourage participants to take the tasks more seriously. To help ensure that respondents focused on their respective roles as audit committee members, a separate covering letter was used for each group. The letter to the board of directors will stress that this research is concerned with issues that audit committees (and thereby the Board) considered important for strong corporate governance.
1.8 Conclusion

This chapter has laid the foundations for this study. It outlined the broad field of study charting the depth and breadth of the existing body of knowledge and then leads us into the focus of the research problem, outlining the research area and setting boundaries for its generalisability. It then introduced, in brief, the research hypotheses since thorough review will be provided in chapter two. Then the research was justified on several important theoretical and practical grounds, emphasising the neglect of the research problem and methodologies and discussing the usefulness of potential applications of the research’s findings. An introductory overview of the methodology was placed in the next section, describing the research methods in general terms and including a description of the statistical processes and the justification of the quantitative methodology used in this study. It then outlined the coverage for the future sections and chapters of this research followed by the definitions to be adopted for the purpose of this study and the key and controversial terms were defined to establish positions in this research. Finally, the limitations were stated and justifications for the limitations were provided followed by the key assumptions to be considered and adopted for the purpose of adding validity and realism to this study. On these foundations, this study can proceed further with a detailed description of the research from chapters’ two to five.
CHAPTER TWO

LITERATURE REVIEW
2.0 Literature Review

2.1 Introduction

The concept of “governance” can be discussed in two contexts: state and corporate. Both contexts embrace action by judicial bodies such as the national courts and tribunals and actions by executive bodies and assemblies such as national parliaments. Keasey and Wright (1993) identified governance as a system by which organizations are governed and controlled. They argued that governance is concerned with the performance of the organizations in relation to its institutional ownership based on its internal control and the management audit, the board structures and its audit committees. The board of directors, representing all the shareholders, will be responsible for the governance (Hee-Joon, 2002).

Sound governance by the boards of directors is recognized to influence the quality of financial reporting, which in turn has an important impact on investor confidence (Levitt, 1998 and 2000a). So the strong governance should reduce the adverse effects of earnings management as well as reduce the likelihood of misstatements arising from fraud and errors (Beasley, 1996; Dechow et al., 1996; McMullen, 1996).

However, there has been considerable debate in recent times concerning the need for strong corporate governance (McConomy and Bujaki, 2000), with countries around the world drawing up guidelines and codes of practice to strengthen governance (Cadbury, 1997). For companies, good corporate governance means securing access to broader-based, cheaper capital. For investors, a commitment to good corporate governance means enhanced shareholder value. For both, good corporate governance equals good practice of doing business.

Globalization of corporate governance mechanisms is one of the most significant developments of past two decades and innovations in corporate governance mechanisms such as audit committees are linked to such globalization mechanisms in this area of
corporate governance. Numerous research publications in professional and academic journals have been devoted to advocating their global prominence and explaining their adoption in different countries while examining various effects associated with their operation (such examples include Keasey et al., 1997; and Chew, 1997). Considerable attention has been given to audit committees as one of the mechanisms of corporate governance (see NCFFR, 1987; CICA, 1981; AARF, 1997; BCA, 1991; Cadbury, 1992, CEPS, 1995; EC, 1996; Porter and Gendal, 1998; and Morse and Keegan, 1999).

Accompanying their globalization, expanded roles for audit committees have been advocated and stipulated by various regulatory and professional bodies and various rules have been adopted concerning their operation (see for example AICPA, 1999; APB, 2000; Blue Ribbon Committee, 1999; KPMG, 1999a; ISB, 1999; POB, 2000; SEC, 2000 and for analysis of recent audit committee regulations see KPMG, 2000).

Following their widespread promotion by professional bodies and accounting firms, audit committees are now a statutory requirement or recommended best practice in many countries. Not surprisingly researchers have devoted considerable time and energy in explaining their adoption and effects (see for example Chew, 1997), and a body of literature has developed over the last decade.

Therefore, the following sections will explore the parent disciplines and classification models of corporate governance and the role of auditing, the existing literature on the immediate disciplines of audit committees, their structure and roles that affect this effectiveness in the financial reporting process. The literature review is then used to develop the analytical models, the research questions and the research hypotheses of this study. The final section provides a general overview and concluding remarks based on the existing body of knowledge and the new contribution of this study to the existing body of knowledge.
2.2 Parent Disciplines and Classification Models

The parent discipline in this research includes the discussion of the concept of corporate governance as one of the currently used concepts in contemporary social science and the role of auditing in corporate governance. The following section reviews some research and has investigated the relationship between corporate governance and auditing.

2.2.1 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). 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). Another view of corporate governance is drawn from the management literature. This relates to the resource dependence perspective (Byod, 1990; Pfeffer & Salancik, 1978). Under this perspective, the management is viewed as relying on the board of directors for access to scarce information and other resources that they will need to look after the operations of the company (Byod, 1990; Pfeffer & Salancik, 1978).

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5 SFS – is the Securities and Financial Services Council of US, which looks into the financial affairs of corporations. It aims to promote good governance as a key to improving economic efficiency.
The management will also need help from the board in determining the strategic direction of the company (Williamson, 1999). Therefore, unlike the agency theory perspective where the primary role of the board of directors was based on monitoring, under the resource dependence perspective, the primary role of the board of directors shifts from being a monitor to acting collaboratively with managers to set policies and strategies of the corporations (Baker & Owsen, 2001).

A third view of corporate governance focuses on managerial hegemony (Galbraith, 1967; Wolfson, 1984; Kosnick, 1987). This perspective views corporate governance as an unavoidable annoyance in contrast to the agency and resource dependence perspectives. This perspective views the corporate governance mechanism as being ineffective at monitoring and as largely symbolic in terms of oversight of management (Baker and Owsen, 2001). For example, senior management may select friends and colleagues to be the members of the board, rather than choosing independently minded directors (Patton and Baker, 1987). Wolfson (1984) regards the board members as passive participants in the governance process and they are dependent on the company’s management for information about the firm and its industry. Therefore, based on this hegemonic perspective, the board’s functions are limited to ratifying management’s actions, satisfying regulatory requirements and increasing senior management’s compensation (Core et al., 1999).

However, all these views of corporate governance involve only two groups, the management and the board of directors of the corporations. Shareholders are not included in these views, as Baker and Owsen (2001) mentioned that it is presumably for the benefit of the shareholders that corporate governance takes place. Also absent from these theories are the other stakeholders, independent regulatory bodies, the auditors and the society, which are not mentioned as playing a vital role in corporate governance.

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 Wyat, 1990). Efforts to reform corporate governance have been
prevalent in four areas: 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 put forth through best practices proposals rather than legal requirements (Cadbury Committee, 1992; Turnbull, 1997; The Turnbull 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 on 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 Report. 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.

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6 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.
2.2.2 Prior Research in the Role of Auditing and Corporate Governance

Relatively, there has been little research dealing with the relationship between the role of auditing and corporate governance. The research that has been done tend to focus on how corporate governance affects auditing, rather than how auditing affects corporate governance. It should also be noted that the previous research dealing with the relationship between auditing and corporate governance assumes that the goal of both corporate governance and auditing is to enhance the interests of the shareholders (Baker and Owsen, 2001).

Further, recent debates (Sutton and Arnold, 1998) demonstrate that the role of auditing in corporate governance has been a subject of discussion in critical accounting research for some time and the issues surrounding the debate have not been resolved (Freedman, 1998; Roberts, 1998; Defeo and Falk, 1998; Gray, 1998; Lee, 1998; Shaoul, 1998). These issues focused on whether auditing is useful for decision making, particularly for the investors, whether any form of auditing can be effective without strong standards of reporting and the issue of the role of auditing in corporate governance. The currently accepted understanding of the role of auditing in corporate governance is that audits assist investor decision making (Baker and Owsen, 2001). However, auditing may be more appropriately described as assisting top management to run corporations and it does not necessarily provide useful information for decision making to the investors (Elliot, 1994).

In particular, the external auditor has also played an important role in improving the credibility of the financial information (Mautz and Sharaf, 1961; Wallace, 1980). For example, the UK Cadbury Report states that: “the annual audit is one of the cornerstones of corporate governance” (1992, para 5.1), yet the governance literature has generally only recently begun to consider the association between the external audit quality as a governance device, and internal corporate governance mechanisms (for example, Anderson et al., 1993; and Jubb, 2000).
This historical relationship between the managers, auditors and shareholders of the limited liability companies under British company laws is shown in Figure 2.1.

![Figure 2.1](image)

*Based on Watts and Zimmerman (1983); Napier (1997); and Baker & Owsen (2001).

Traditionally, the financial reporting system was prepared using the historical costs based on the objectivity and verifiability of the transactions. But questions were raised whether historical cost data could provide enough relevant and quality information to help make sound and timely investment decisions (Imhoff, 2003).

Considering the past, the 18th century industrial revolution stimulated the formation of the capital markets and the separation of owners and managers. With this separation came the potential for opportunistic management behaviour which created a market for the independent auditors, voluntarily hired by some companies to provide a way to check on the management’s performance with the owners’ resources? Napier (1997) indicated that the historical understanding of the relationship between managers, auditors and shareholders of limited liability companies under the British company laws was that all of these parties were members of the same company (Baker and Owsen, 2002) (see Figure 2.1). The whole company consisted of managers, shareholders and part-time auditors.
Then during the 19th century, limited liability companies began to emerge as the principal form of business organization, and the separation of ownership and management became increasingly distinct. It also became evident that the shareholders were not able to obtain a clear understanding of the financial condition of the companies in which they invested. The British company laws continued to view managers and shareholders as being members of the same company and as such, auditing became one of the apparent mechanisms to review and state that the financial condition of the business was true and fair, as reported. So when the US market crashed in 1929, it became evident that it was due, in part, to the lack of meaningful reporting requirements to protect investors and creditors (Willet, 1968, pp.208 - 214). Hence, company laws in the later part of 19th century and the first part of the 20th century required specific forms of financial reports (i.e. at first, balance sheet, and later income statement) and mandated that these reports be scrutinized by auditors who were neither shareholders nor managers (Napier, 1997). The Securities and Exchange Commission (SEC) was given the responsibility for establishing financial reporting standards and began issuing standards in 1937. They also required all publicly traded corporations to have an independent audit each year. The independent auditors would attest to the fairness of the management’s financial reports to the shareholders would note any deviations from Generally Accepted Accounting Principles (GAAP) and would perform their audits in accordance with the established auditing practices and procedures. In essence, external auditing came to play an important role in both the British and American systems of corporate governance.

In addition, auditor’s reports are primarily for the benefit of investors and creditors in making investment and credit decisions (FASB, 1978) and are based on conformity of financial reports with financial accounting standards. However, standards for social and environmental accounting, which are often of interest to wider group of stakeholders and society generally, are not well defined and social and environmental audits are not well developed (Gray, 1998; Owen, et al., 2001; Roberts, 1998). Moreover, neither critical accounting nor mainstream accounting research have till today, conceived of auditing as controlling corporate behaviour (Baker and Owsen, 2001). As such, neither of these viewpoints suggests that auditing might actually control corporations.
Effects of Other Factors Causing Failures in International Companies

In the ‘Critical Perspectives on Accounting’ Issue (April 1998), a number of authors debated the idea of applying the principles of the US Government's Single Audit Act to corporate financial statements (Sutton & Arnold, 1998). Some researchers (Freedman, 1998; Roberts, 1998) supported this idea and while others (Defeo & Falk, 1998; Gray, 1998; Lee, 1998; Shaoul, 1998) strongly criticized this idea. The debate demonstrated that the role of auditing in corporate governance has been a subject of discussion in critical accounting research for some time, and that the issues surrounding this debate have not been resolved.

For example, there is the question of whether auditing is useful for decision making. Also, there is the question of whether any form of auditing can be effective without strong standards. In addition, there is the question of the role of auditing in corporate governance. The currently accepted understanding of the role of auditing in corporate governance is that audits assist investors in decision making. Neither critical accounting nor mainstream accounting researches have conceived auditing as controlling corporate behavior. Mainstream accountants argue that increasing the independence of auditors and audit committees would enhance the credibility of audited financial statements for the benefit of shareholders (Cohen et al., 2000).

In recent years, 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). Efforts to reform corporate governance have emerged in some areas such as the organisation structure and the role of audit committees. Also, the recent high profile cases of financial statement fraud such as Enron, Cendant and K-Mart have severely damaged the reputation of the accounting profession. The corporate governance issues of Enron have received very serious questions-strengthening the board of directors and their audit committees and to remove conflicts of interest with the auditors. Enron is one of the world’s leading electricity, natural gas and communications company with approx. $101billion in revenues in 2000.
It filed a bankruptcy with United States Department of Justice, Securities & Exchange Commission on February 2nd, 2002.

Similarly, with regard to Cendant, this New York City marketer of real estate and travel services has had its share of accounting troubles. An accounting fraud at CUC International, which merged with HFS Inc. in 1997 to create Cendant caused a collapse in Cendant’s stock price. Also K-mart with 2100 stores and Ames with 280 stores were in bankruptcy due to poor management. The collapse of K-mart in the US has left a vast retail hole that even Wal-mart and Target cannot fill. As such, these examples shows that there are other factors that could lead to bad governance and corporate failures.

Moreover, these frauds demonstrate failures of corporate governance at all levels including senior management, board of directors, the audit committee, the auditors and the financial regulators. These 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. While this study realizes that such a wide range of topics may fall within the interest of the corporate governance and auditing special interest groups, given the broad remit of corporate governance, this is inevitable. It is therefore intended that this study will work very closely with the auditing issues under the umbrella of corporate governance- the focus of which will be the critical role of the independent audit committees within the reporting entities in Fiji.

While it may be possible to improve the effectiveness of corporate audit committees, management is responsible not only for the accuracy of financial statements, but also for the system of internal controls. Any changes to make audit committees more effective should include comparable changes to management’s responsibilities to improve the effectiveness of management reporting. A requirement to report on the adequacy and effectiveness of the system of internal control would be one way of highlighting management’s responsibilities for reporting accurate financial information.
2.3 Immediate Discipline, Analytical Models and the Research Questions and Hypotheses

The corporate governance debate has changed dramatically, moving from the fundamental arguments over its relevance, to the practical discussion of how to transform the concept from a good idea on paper to a reality in practice (BRC, 1999). One of the issues that has taken on increasing importance in the search for good governance is how best to harness the oversight process to achieve more fully the goal of quality corporate financial reporting. This important search then leads us immediately to the audit committee of the board of directors – the entity at the core of the corporate financial reporting process (Baker and Owsen, 2001). Therefore, this section will illustrate the immediate discipline of this research based on prior research on audit committees, the currently accepted role of audit committees in the financial reporting process, the factors affecting audit committee effectiveness, the analytical models, the agency theory perspective, the relationship between corporate governance, financial reporting and the incentives for audit committees, and the research problem and hypotheses.

2.3.1 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, development has heightened the importance of accounting and auditing standards. New statutes have prompted more attention to auditing practices and new rules for audit committees (Phillips, 1996). The task of the committee regularly comprises (Frankfurt, 2000, p.6):
• 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:

Audit committees are considered by some to be ‘creatures of the company’s management rather than watchdogs over shareholders’ interests’ (Wechsler, 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 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 [NCFFR, 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 have previously supported the adoption of audit committees (for further details see BCA, 1991; CEPS, 1995; CICA, 1981; Cohen Commission, 1978; Colbert, 1989; English, 1994; Colegroe, 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 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 placed on the alternative appointment and reporting structure of audit committees and its effect on the financial reporting process.

Furthermore, corporate boards charge audit committees with the responsibility for oversight of the financial reporting and auditing process (POB, 1993; Treadway Commission, 1987; and Wolnizer, 1995). For instance, Verschoor (1990a, 1990b) measured the actual and potential cost of ineffective audit committee oversight and concluded that lack of audit committee oversight can contribute to corporate failures and may diminish public confidence in the mechanism (also see Lublin and MacDonald, 1998).

A number of researchers have identified many different factors that affect audit committees and their effectiveness in the financial reporting process and as such, a significant body of literature concerning corporate governance has evolved over the past two decades guiding audit committees in their composition, structure and responsibilities. For instance, the Blue Ribbon Committee (1999) on Improving the Effectiveness of Corporate Audit Committees has made ten recommendations to the major securities markets and the Securities and Exchange Commission, which include audit committee member relationships, independence, financial literacy and expertise, audit committee charter, its disclosure and compliance, accountability, outside auditors, quality of accounting principles, audit committee letter in annual reports and interim financial
review. Cohen and Hanno (2000) suggested that strong corporate governance including an independent audit committee has 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).

Research has also been done on international concerns about audit committee effectiveness and specifically, difference in member experience, independence and knowledge (Arthur Anderson, 1998; BRC, 1999; GAO, 1991, 1996; KPMG, 1999; MacDonald Commission, 1987; NACD, 2000; NCFFR, 1987; and Sommer, 1991). Audit committees are required to be composed completely of independent directors (BRC, 1999; DeZoort and Salterio, 2001; MacDonald Commission, 1987; NACD, 2000; and Treadway Commission, 1987). Also, Vicknair (1993) provides a detailed discussion of director independence.

Prior studies (for example, Mautz and Neumann, 1970, 1977; Robertson and Deakin, 1977; Grinaker et al., 1978; Feinstein, 1980; Birkett, 1980; Bratia, 1986; Castellano et al., 1989; Spangler and Bratia, 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; NCFFR, 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).

In addition, there were studies which examines the 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
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).


Also, researchers found that financial reporting and audit knowledge differences affect member judgments (Bonner and Lewis, 1990; and Libby and Tan, 1994) and all members need to be financially literate for the audit committee to work effectively (BRC, 1999; NACD, 2000). Moreover, two recent studies examine the association between the presence of gray directors on audit committees and issues related to the external auditor (Carcello and Neal, 1999; Abbott and Parker, 2000).

Furthermore, Kalbers and Fogarty (1993) proposed that audit committee effectiveness is perceived as a function of the types and extent of audit committee power. Effectiveness consisted of three domains of oversight (financial reporting, external auditors and internal controls). Further, Raghunandan et al., (2001) examined the association between the audit committee composition and the activities of the audit committee as they relate to internal auditing. Their findings provided empirical support for BRC’s recommendations related to audit committee composition.
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).

2.3.2 Agency Theory Perspective of Corporate Governance

An 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 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 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 to remain 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 by 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 study 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.

2.3.3 Corporate Governance, Financial Reporting and Audit Committee Incentives

Previous studies have examined the association between the presence of an audit committee and the absence of financial reporting problems (DeFond and Jiambalvo, 1991; McMullen, 1996; Dechow et al., 1996; Beasley, 1996). 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. So while the financial reporting process is providing 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). These are the 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.

The recent examples are the latest corporate collapses globally such as AOL Time Warner, Worldcom, Boeing, Computer Associates, Xerox, Enron, Tyco, and IBM. This may not be over yet so what path should we follow to improve the governance process in general and accounting and auditing in particular? (Imhoff, 2003). Based on the prerogatives of these issues and concerns, the following section identifies the major research problem to be addressed for the purpose of this research study.
2.3.4 Development of Research Problem

Reading the popular press since the turn of the century leaves one wondering how the corporate disasters of today could have happened given our system of governance, the transparency from our financial reporting requirements and the development of audit technology in response to the hard lessons of the past. What is it that is not working in practice? (Imhoff, 2003). As the 20th century unfolded and we entered into the new millennium, the audit industry prospered and gained respect but their development was not without setbacks. From time to time weaknesses in auditing within corporate governance were highlighted by widely publicized cases of management fraud, corruption and corporate failures and by the end of 1970s both accounting and auditing were under attack for failing to satisfy the needs of the investors and the creditors.

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. 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). Thus, effective boards and audit committees constrain earnings management activities. According to BRC (1999, p.22) “several recent studies have produced a correlation between audit committee independence and the two desirable outcomes: a higher degree of active oversight and a lower incidence of financial statement fraud”. Further, they should enhance the effectiveness of both internal and external auditors (Simnett et al., 1993).

Despite continuous development and refinements, as we entered into the 21st century, a new wave of high-profile business scandals ensued. Auditing failures have taken down
one of the largest CPA firms in the world\(^7\), and it may not be over yet. Accounting and auditing were often cited for failing to prevent these problems. With the proliferation of auditing scandals since the turn of the century, the corporate disasters of today have severely hampered our system of corporate governance, transparency from our financial reporting system, accountability in reporting and the development of audit technology.

One important area identified as troublesome was the dual role that CPA firms played as both independent auditors and as management consultants to some of their client firms. External auditors normally conduct a substantial amount of non-audit work for the company, arguing that they are in the best position to do so. While many research studies indicate that non-audit service consultancy is not an issue that impacts on external auditor independence, several large corporate failures have been attributed to external auditors’ failure to remain independent while earning a substantial amount of non-audit income from these firms (for example, Enron, HIH and Worlcom) (Ball et al., 2002). These firms were providing audit and non-audit services to their clients, which is still a debatable issue in the field of auditing today. This switch from audit to non-audit services, in turn, created concern about the underlying integrity, independence and quality of the financial reporting process.

Normally made up of outside directors, the audit committee was designed to add to the quality and integrity of management’s financial reports. Corporate boards of directors whose responsibilities were to meet with and oversee the managers of the entity and look out for the interests of the owners also made sure managers received appropriate compensation for their efforts. Many boards established special ‘compensation committees’ to see to it that incentive plans properly rewarded managers for their efforts to maximize shareholder wealth (Imhoff, 2003).

Audit committees came into existence, primarily to solve the disputes between the management and the external auditors. These audit committees act as a ‘mediator’ or a ‘negotiator’ between the management and the external auditors, thereby working to solve

\(^7\) This is Arthur Anderson & Co., the firm that had to close down its audit services due to professional negligence with Enron case.
their conflicts and disagreements on matters pertaining to the credibility of the financial reporting process.

However, one of the major areas identified as troublesome within the independence debate is the independence of audit committees within the corporate governance framework. The board of directors nominates audit committees and they report to the board of directors, so the audit committees’ incentives, remuneration, compensations and bonuses all are based on the board of directors’ opinion. This is in line with the reality that corporate board members are not really nominated by the shareholders and it is the chief executive officer who has major influence on the membership of corporate boards.

For example, a recent study documented that 55% of the firms surveyed reported the current chief executive officers, who are also the chairman of the board, played the dominant role in appointing members of the board and committee chairs (Korn/Ferry International’s ‘Annual Board of Directors Study’, 2000). Also, the chairman of the board was either the current or the former chief executive officer of the company and they are the most influential person in nominating new board members, and in controlling the agenda of all that goes on at board meetings (Imhoff, 2003). As such, the chief executives nominate people to serve on their own oversight board, particularly the audit committees of these boards. To increase their wealth, the board members are frequently compensated with stock options and these options provide incentives to the board members who will require their sub-committees (such as audit committees) to be in favour of the management in cases of any auditor - management disagreements.

However, Cohen et al. (2000) report that a number of audit practitioners involved in exploratory interviews expressed concern over the effectiveness of audit committees, with some partners suggesting that audit committees are not powerful enough to resolve conflicts with management. It is generally argued that, for an audit committee to be effective, a majority if not all members should be independent (Cadbury, 1992) and they should have an understanding of accounting, auditing and control issues (Cohen et al., 2000; Goodwin and Seow, 2000; Hughes, 1999; Lear, 1998).
Governance experts say that the audit committee’s lack of independence makes it less inclined to question management. This will severely compromise the independence of the audit committee members in the corporations. This lack of independence is a major difficulty with the currently accepted model (as shown in figure 2.2), which is yet to be solved. Also, audit committee independence is still an issue that is not clearly identified in the various stock exchange proposals.

Based on the above problem, this study, however, believes that the independence of the audit committees may be compromised when the board and when they report to the same board appoint the audit committees. This is because in cases of auditor - management disagreements, these audit committees normally tend to support the management. In other words being biased towards the management is believed to compromise their independence. The audit committee members will have incentives to do so and this will have an adverse effect on the quality of the financial reporting process since there may be likelihood of errors, fraud or misstatements in the financial reports of the corporations and eventually, such irregularities will severely hamper the quality of the financial reporting process; in some cases, indeed, these scandals can actually lead to the failure of such corporations.

Such debates about corporate governance among mainstream researchers have been essentially reduced to questions concerning how best to protect the interests of shareholders. Shareholders become increasingly concerned about how much of their wealth is being shared with top management (Colvin, 2001). They may begin to look for mechanisms that make top executives more accountable to shareholders and perhaps to society generally. Some observers of corporate governance argue that it would be best to have truly independent board members chosen from a knowledgeable group of people, with representation from public interests groups and employee interests.

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As such, this research proposes to discuss the issue of audit committee more in-depth and recommends alternative structural positions for the audit committees to be more independent in their judgment, thereby enhancing the quality of the financial reporting process given the structure of corporate governance in the corporations. In particular, this study posits to find out the effects of changing the appointment and reporting structure of audit committees and to determine its implications in the quality of the financial reporting process. Therefore, the following research problem has been identified from the outset of the existing literature:

How would alternative appointment and reporting structures of audit committees within the corporate governance framework of corporations affect the audit committee members’ judgment in auditor - management disagreements?

Extensive research in this area is needed because of the actual fraud and business failures and the potential for legal costs of ineffective audit committee oversight (Verschoor, 1990a, 1990b). Furthermore, the findings of this research are expected to be consistent with the idea that audit committees, because of their ability to link various groups involved in the financial reporting process, improve the quality of financial statements and disclosures. Moreover, in 1997 the AARF issued its “Audit Committees: Best Practice” guide to assist companies in setting up audit committees. The guide makes the following statement about the usefulness of an audit committee “an audit committee is unique in that it provides a forum where directors, management and auditors can deal together with issues relating to the management of risk and with financial reporting obligations” (AARF, 1997).

Similarly, there should be a truly independent audit committee whose members cannot be chosen by the board of directors and whose compensation does the Independent oversight board set. A similar approach has been adopted by the Cadbury Committee (1992) and the Turnbull Report (1999) which states that there should be truly independent auditors who cannot be chosen by the management and whose compensation does the independent
board set. These approaches have supporters in the investment community, the one force that may be able to overcome the power of corporate management.

Nevertheless, shareholders may be fearful that public interest members and employee representatives will introduce substantial costs and introduce members with little or no loyalty to shareholder interests. Shareholders may prefer working with boards picked by CEOs, whom they can, theoretically, remove to working with directors who might reduce shareholder’s return on investment. Adding outsiders may be viewed as unlikely in the current climate.

Thus, this research problem will be examined more precisely in the research hypotheses section in the next part of this chapter.

2.3.5 Development of Research Hypotheses

General overview

To investigate the research problem, various alternative proposal needs to be designed and implemented and the research hypotheses will be developed to acquire relevant information on the alternative proposals for appointment and reporting structure of audit committees within the corporate governance framework of corporations. Therefore, the objective of this research is to test for the association between the appointment and reporting structure of the audit committee and the judgment they make in auditor-management dispute cases.

The issues such as auditor independence and conflict resolution led to the formation of various other corporate governance mechanisms such as the alternative roles of audit committees. McMullen (1996) considered audit committees as a monitoring mechanism that links the various groups involved in the financial reporting process in order to improve the quality of the financial reporting process. Countering this support for the audit committee is the criticism that a lack of clearly defined responsibility and
insufficient authority has severely hampered audit committee effectiveness (Wallace, 1985; Knapp, 1987). 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).

This study has considered taking up the audit committee independence issue in greater depth and will look closely at the appointment and reporting structure of audit committees as an alternative mechanism within the corporate governance structure of corporations. Presumably, the underlying reason for this emphasis lies in concerns over the integrity of the financial reporting process and research has identified that sound governance is recognized to influence the quality of financial reporting, which in turn has a vital impact on investor confidence (Levitt, 1998 and 2000a).

Hence, this study extends the literature by examining whether a relationship does exist between the appointment and reporting structure of audit committees and the judgments made by the audit committees in an auditor - management disagreement over an accounting policy choice, which has direct implications on the quality of financial reports (DeZoort and Salterio, 2001). Additionally, this study is motivated to provide empirical findings to facilitate evaluation of the question of substitution of governance mechanisms with respect to the demand for the audit quality and to extend the prior research of audit committee structure within the corporate governance practices of corporations. Two important variables (appointment and reporting) are separately discussed hereafter.

**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. For example, this is certainly true for Fiji Islands: 75% of the
listed public companies on the South Pacific Stock Exchange have CEOs on board, and many private sector companies in Fiji also have the CEOs as the majority shareholder.

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 favour of the management. This is in line with the view of the agency theory relationship. This clearly provides a strong incentive 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.

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 that has been suggested is the appointment of the audit committee by Independent oversight board. Appointment of audit committee by Independent oversight board is expected to provide greater degree of independence for the audit committee and therefore, it is expected that audit committee will be able to display greater level of objectivity in any auditor-management dispute.
Supportively, the empirical literature does provide some arguments in favour of this prediction. 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 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 (FSA 11, Para, 2, 3).

Conversely, within the US financial reporting environment, there has been a growing trend to provide managers with incentives to manage earnings, and most cash bonus plans as well as most stock option plans or stock award plans are based on accounting results (Bloedorn and Chigos, 1991; Ittner et al., 1997). The quantity of options made available to managers and directors in any given year is frequently based on current accounting performance measures. This has made the financial statements the focal point of management’s wealth maximization strategy. So while the financial reporting process is providing investors and creditors with GAAP and GAAS based reports on the entity’s performance, it is also impacting the current and future wealth position of its managers and board members (Imhoff, 2003).

Thus, incentives for a strategic game can easily develop in this environment. The game: managers try to mask their wealth-enhancing activities and/or their managerial failures by manipulating financial reports, often to conceal bad news and to perpetuate these window dressing activities. For example, Enron is among the many growth companies that resorted to bad accounting in order to maintain rapid growth in sales and earnings. Andersen was there to help Fastow create the vehicles for dressing up the financials. The role of these financial wizards is to develop financial schemes to help managers look as though they are performing beyond the expectations of the shareholders.
As such, this section of the study introduces arguments that have been advanced to promote the case for an alternative appointment structure of audit committees of the private sector corporate enterprises, in order to set out a structure of the main aspects of corporate governance where they may be expected to have an impact. Subsequent sections will then evaluate the evidence of this alternative. The arguments on the areas where this alternative appointment structure may have potential benefits on the corporate financial reporting process are taken mainly from what may be termed as the advocative literature on expected benefits of the existence of audit committees, which covers a broad range of largely professional publications promoting their adoption, and includes reports by accountancy bodies, professional institutes, and official and governmental committees.

Arguments associated with the promotion of audit committees emphasise their potential contribution to, for example, the relationships between directors, investors and auditors, and the discharge of accountability and directors’ execution of their responsibilities (Zaman, 2002). The following quotations illustrate these beliefs in the value of audit committees (as stated in Zaman, 2002):

There is no doubt that audit committees can play a major role in bringing about greater accountability by companies and in restoring confidence in financial reporting [Lindsell, 1992, quoted in Zaman, 2002, p. 5].

Audit committees can] help directors meet their statutory and fiduciary responsibilities, especially as regards accounting records, annual accounts and the audit [Collier, 1992, quoted in Zaman, 2002, p. 6].

An audit committee is unique in that it provides a forum where directors, management and auditors can deal together with issues relating to the management of risk and with financial reporting obligations [AARF, 1997, quoted in Zaman, 2002, p. 6].

These extracts, which are echoed in the text of many reports, suggest that audit committees influence the balance of power in accountability and audit relationships (Zaman, 2002). Although audit committees are voluntarily formed in some countries (as in the case of Fiji), it can indicate something about the motivation associated with audit
committees in governance structures and the organizational circumstances in which accountability benefits are most strongly perceived.

Many audit committees comment upon and approve choice of accounting policies and they can be expected to influence a company’s approach to financial reporting, levels of disclosure and adherence to standard practice. Over many years, the advocative literature has included various claims about the potential contribution of audit committees to improving financial reporting (see for example, Williams, 1977; Baruch, 1980; Marsh and Powell, 1989; APB, 1994; and ICAEW, 1997). While an effective audit committee is crucial to providing reliable financial reports, the board of directors also plays an important role. The overall perception is that the performance of audit committees stems directly from the practices of the entire board of directors. If a board is functioning properly as an active entity separate from management, the audit committee can build effective principles for oversight and monitoring of the financial reporting process. This is supported by the Blue Ribbon Committee (1999, p.6) which states that the “performance of audit committees must be founded in the practices and attitudes of the entire board of directors”. In addition, the POB (1994, p.3) also ‘urges the board of directors to play an active role in the financial reporting process’.

However, top management’s influence over the board composition seems contrary to effective corporate governance. If the corporate board oversees management on behalf of the shareholders, then why does management sit in such a position of importance on the board of directors? Why does the CEO nominate people to serve on their own oversight board? Adding to problems of board independence is the fact that the board members are frequently compensated with stock options. Options provide incentives not to face up to setbacks in a firm’s performance. What kind of incentives do options create for corporate boards? How can corporate boards make the audit committees advocate for transparency and full disclosure in financial reporting. This is the reality of corporate governance in the US today, and it provides the opportunity for major problems with the system of checks and balances (Imhoff, 2003). There is some evidence that companies with strong
CEOs have a higher probability of placing insiders and interested directors on audit committees than those with relatively weaker CEOs (Klein, 1998).

As such, this study argues that various proposals fall short of meeting the expected requirements of independence of audit committees, which leads to the lack of independence of the audit committee members in their judgment in auditor-management disagreements. This study believes that the appointment structure in the new proposals should be changed to reflect a more transparent, accountable, independent and higher quality financial reporting process. This is because boardroom politics is a very complex environment and most of the corporate failures have been attributed to this where the board members are failing in their duties.

Therefore, to remain independent, audit committees should be appointed by an Independent oversight board. This alternative arrangement will ensure that audit committees achieve a high degree of independence, since their judgment will not be biased towards the management, rather they will ensure the interests of the shareholders generally. This is in view of the agency theory. Comparatively, one of the most important factors determining 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.

In particular, when a dispute reaches the audit committee, audit committee members appointed by an Independent oversight board 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 independent oversight board, 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. This will reduce the likelihood of fraud and error in the financial statements, thereby improving the quality of the financial reporting process (FSA 11, Para, 2, 3). As such, specifically, this study hypothesizes that audit committees appointed by the Independent oversight board are more likely to support the auditor than are audit committees appointed by the board of directors, who are believed to support the management in such a dispute case, particularly in a context where the auditor advocates a position based on economic substance.

These arguments then lead us formally to the following hypothesis:

**H1:** An audit committee that is appointed by the Board of directors is more likely to support the management in case of any auditor - management dispute situation compared to an audit committee appointed by the Independent oversight board.

**Reporting by Audit Committee**

In this proposition, audit committees find themselves working side-by-side with the managers of the corporations they oversee. They 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 for their ‘independent’ oversight services.

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 board’s independence from management and these corporate boards will make the audit committees advocate for management’s position in the financial reporting process. This is the reality of corporate governance in the US today, and it provides the opportunity for major problems with their system of checks and balances (Imhoff, 2003).
In the current structure of audit committees, 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 to which they are reporting. This has made the board the focal point of audit committees’ compensation and remuneration strategy, so while the financial reporting process is providing 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 thereby the board members and audit committees. In this way, audit committees try to mask their wealth-enhancing activities and/or their biased judgments leading to managerial failures by supporting the management in the manipulation of the financial reports.

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 Independent oversight board. 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 dispute cases.

An analytical model is developed to show the currently accepted role of auditing in corporate governance as shown in Figure 2.2. This model incorporates the first proposition (Hypothesis 1) and shows that appointment and reporting via the board of directors is an acceptable line of communication in the current corporate governance structure.
Figure 2.2 shows that currently, the board of directors appoints the audit committees 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 oversee. 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 the 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 provide 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. Professional accountants designated or licensed by the state must audit these reports. 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, 2001). This is the current understanding of the role of audit committees in corporate governance.

Conversely, the existing situation of corporate governance is typical of our general mess of mismanagement. This background clearly demonstrates that the days of lax corporate governance are numbered and the corporate culture has to change. The companies have to change and opt for stringent and transparent corporate governance if they wish to survive and thrive in future. They are likely to be subjected to accountability which is shaping up both the in-guise of regulatory framework, stock exchange listing requirement and general public demand.

To support this proposition, mainstream accountants argue that increasing the independence of auditors and audit committees would enhance the credibility of audited financial statements for the benefit of shareholders (Cohen et al., 2000). This is perhaps the most important fact that has attracted a lot of attention in the current corporate governance reform programs. For example, in the US, the Sarbanes-Oxley Act (2002) and NYSE Corporate governance rules now require that all the members of the audit committee be independent members, independence being as defined in their respective documents.

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9 The documents referred to here are the BRC recommendations, Sabane - Oxley Act (2002) and NYSE CG Rules
The issue of ‘independence’ has received the attention not only of the profession but also regulators and stock exchanges around the world. Levitt’s (1998 and 2000a) criticisms of the failure of the auditing profession in the US to curb excessive earnings management, together with the SEC’s attempts to regulate audit independence, have been well publicized. As a result there has been a concerted effort to devise ways of enhancing independence (SEC, 2000; Independence Standards Board, 2000).

However, this 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 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 US (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.

Therefore, this research has proposed to examine the perceptions of audit committees concerning the impact of certain governance mechanisms on their oversight role, prevention and detection of control weaknesses, financial statement errors and fraud. While this provides only an indirect measure of the independence of the audit committees and the effectiveness of these mechanisms, it is regarded that in any corporate governance regime, audit committees should have considerable influence over the accountability and integrity of the financial reporting process. Therefore, identifying the alternative structure of the audit committees should enhance our understanding of the importance of corporate governance mechanisms.
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 presently accepted model of the role of auditing in corporate governance is deficient in such areas as independence and conflict resolution. It recommended the establishment of a strong internal audit function and the appointment of a Chief Internal Auditor, who would report to the Supervisory Board (as in Germany or The Netherlands) or an audit committee of the Board of Directors composed entirely of non-executive directors (as in the United Kingdom, Australia and the United States).

The external auditors would co-operate with, and assess the work of, internal auditors, and they would opine independently on the management’s assertions concerning their responsibilities. The reliability of these opinions would depend to a large extent on the strength of the Supervisory Board and the independence of the audit committee (Baker and Owsen, 2001).

To overcome the difficulties of the currently accepted model of auditing in corporate governance, this study enables investigation into the effectiveness of an alternative reporting structure of audit committees within the corporate governance framework of the corporations that mandates a sound level of corporate governance in terms of improving the quality of the financial reporting process.

Therefore, this study intends to find out the effect of changing the reporting structure of the audit committee within the corporate governance practices of corporations on the quality of the financial reporting process. Recent evidence also suggests that strong corporate governance including an independent audit committee has the potential to increase audit efficiency and effectiveness (Cohen and Hanno, 2000).

This study proposes that audit committees will be more independent and effective when they are reporting to the Independent oversight board which then reports to the shareholders directly, rather than reporting indirectly via the board of directors. This is in
line with the agency theory view of the role of audit committees within the corporate governance structure of the corporations.

To reinforce this proposition, the agency theory relationship could be used to illustrate the significance of this proposition. This theory of agency can be used to design efficient governance mechanisms, ones that boards can use to provide efficient governance of the firm via monitoring and ratification of managerial decisions and the framework can be used to supply structural and behavioural interventions designed to make boards better agents for the shareholders.

The agency theory could also be used by shareholder groups to design effective contractual structures that bind the boards and their sub-committees to their mandate and by audit committees themselves to understand the ways in which top managers and boards can bind them to their mandate, as well as to look into ways in which they could function more effectively, as in cases of auditor - management dispute situations.

In particular, when a dispute reaches the audit committee, audit committee members reporting to the Independent oversight board, 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 reporting via the Independent oversight board, 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 are more concerned towards the quality of the financial reports presented to them and more likely they will be taking the ‘substance’ approach to support the auditor. This will reduce the likelihood of fraud and error in the financial statements, thereby improving the quality of the financial reporting process (FSA 11, Para, 2, 3).

As such, specifically, this study hypothesizes that audit committees reporting to the Independent oversight board will be more likely to support the auditor than will an audit
committee reporting to the board of directors, who will support the management in such
dispute cases, particularly in a context where the auditor advocates a position based on
economic substance.

These arguments then lead us formally to the following hypothesis:

**H2:** An audit committee that is reporting to the Board of directors is more likely
to support the management in case of any auditor - management dispute
situation compared to an audit committee reporting to the Independent
oversight board.

### 2.4 Conclusion

Corporate governance and auditing are chosen as the major area of this study particularly
because of the increasing dimension and widespread public interest globally due to huge
corporate failures in some of the large international corporations. For example, 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, provide continuing evidence of
weaknesses of corporate governance at all levels including the senior management,
boards of directors, audit committees, external auditors, financial regulators and the
accounting and auditing profession. Such turmoil in foreign markets has 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 corporations.

Theories regarding boards of directors, prior empirical research and various
recommendations suggest that some characteristics such as size, independence, directors’
motivation and competence of the board have an influence on the quality of the financial
reports as measured by the level of earnings management. The impetus for companies to
form effective audit committees is that ultimately the market will be the judge of whether
the board and the audit committee’s charter and performance are adequate. However,
independence and competence will not result in effectiveness unless the committee is
active (Chotourou et al., 2001).

The suggestions implicit in many studies in this literature could go a long way toward
enhancing the independence and competence of the corporate boards of directors and
audit committee, and representing shareholders’ interests more effectively. Recommended changes would enhance the ability of corporate boards to govern
corporations in the interests of shareholders and for the audit committees to be
independent. The two issues of prominence related to governance that have been
addressed in this study are: that management has too much influence over the
composition and conduct of corporate boards; and the corporate board members are not
competent and/or independent enough to prevent opportunistic management behaviour at
the expense of shareholders. As Imhoff (2003, p.123) suggests, ‘something more must be
done to enable corporate boards to fulfill their responsibilities as powerful and
knowledgeable shareholder advocates’. Therefore, this study intends to suggest
alternative changes in the appointment and reporting structure of audit committees in
auditing, accounting, and corporate governance and it supports Imhoff’s (2003) view by
proposing such alternatives to enhance the financial reporting process. Three critical
aspects underpin the framework developed in this study: (1) the view of audit committees
as a corporate governance mechanism, (2) a consideration of the structural context in
which audit committees operate in the corporate governance framework and (3) the issue
of quality of the financial reporting process based on audit committees’ oversight role.

Given the predominance of the factors affecting the effectiveness of audit committees in
the extant literature, this study represents an initial effort at developing an alternative
framework for appointment and reporting structure of audit committees in corporate
governance. This study, therefore, seeks to contribute to the literature on corporate
governance by providing a theoretical framework for conceptualising innovation and
effects of changing the appointment and reporting structure of audit committees. It is not
the intention to develop an all-embracing theoretical framework, but rather to develop a conceptual, analytical tool that may be useful for explaining the adoption and operation of a governance mechanism such as audit committees and the effects of their alternative appointment and reporting structure on the audit committee members’ judgment as part of the corporate governance practice.

Finally, notwithstanding the fact that we face serious problems today in accounting, auditing and corporate governance that have undermined the quality and integrity of financial reporting process, accounting and auditing are only components of the broader system of corporate governance and cannot be fixed in any lasting way without substantive changes in the overall governance process. Today corporate boards, managers, auditors, audit committees and accounting standard setters are presumably all working together to create a financial reporting process of unparalleled integrity (Imhoff, 2003). Greater ‘transparency’ for financial statements stems from greater recognition and disclosure requirements of generally accepted accounting principles, as well as more frequent and timely reporting requirements. Therefore, responsible parties need to act more responsibly (Imhoff, 2003).

Based on the above argument, within agency theory the concept of corporate governance is focused primarily on designing contractual mechanisms to control self-interested behaviour. Central to the agency theory perspective is that those performing the monitoring function (the boards of directors) should be independent from those being monitored (the management). However, within this view, the board is viewed as relying on the management for improving the profitability and performance of the corporation as well as helping the board in determining the oversight function. Thus, the primary role of the board of directors and its audit committee shifts from being a monitor, as in the agency perspective, to acting collaboratively with the management to perform the committees’ oversight function.

As such, corporate governance mechanisms are viewed as being ineffective at monitoring and largely symbolic in terms of oversight function. This poses a dilemma for the board
and its audit committee in that they are part of the management and also if they are to increase the profitability and performance of the corporation they need to obtain the cooperation of the management and be biased towards the management in any dispute cases, thereby compromising their independence. Such disagreements may lead to misapplication of accounting policies, which could severely hamper the quality of the financial reporting process and will be treated as a “fraud or error” in the financial information (FSA 11, Para, 2, 3). Such type of ‘fraud or errors’ can lead to corporate scams and mismanagement in the corporations and in some cases these scandals can actually lead to the failure of such corporations. Chapter three discusses the methodology and research methods adopted in this study.
CHAPTER THREE

METHODOLOGY
3.0 Methodology

3.1 Introduction

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 whether the appointment and reporting structures 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 a survey instrument and experimental analysis have 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.

3.2 Justification of the Methodology Used in this Research

3.2.1 Basis for the Use of a Quantitative Methodology

This study has adopted a quantitative research methodology because it is more reliable and objective, and it provides internal and external validity to this research. For instance, survey and experimental instruments, which are the most objective instruments, will be used to collect the relevant data required for this study. This research adopts an experimental study to be carried out to collect the data and analyse the result. Experimental case is regarded as the most common method of examining judgments in auditing (Trotman, 1996) and because of this proposition, this research utilises a field experiment to be investigated.

The experimental analysis of this research is based on a “2 x 2” factorial research design method, which has several important advantages. For instance, factorial designs are useful in resolving contradictions in the literature by controlling confounding variables and building them into the design (Trotman, 1996). It allows the researcher to examine the interactive effects of independent variables on the dependent variable and it
hypothesizes and tests the interactions between them. Also, using factorial design we needed fewer subjects and it is more economical in terms of subjects required than conducting two separate experiment since the respondents’ time is a scarce commodity. In addition, using factorial design can increase the external validity of this type of research (Trotman, 1996).

Research techniques based on qualitative methods such as case study are not used in this research, for the following important reasons. Firstly, there is a problem of researcher bias since social systems are not natural phenomena and they cannot be understood independently of human beings: the researcher cannot be regarded as a neutral independent observer, so there is no objectivity. The second difficulty is based on the confidentiality of the information and the ethics of the researcher’s relationship with his/her subjects because a subject may not be prepared to reveal his/her views or opinions if the researcher is to feed back this information to others in the organization. Thirdly, there is a difficulty for drawing boundaries around the subject matter of the case study since the holistic ideal of studying all aspects of a social system is clearly unattainable. Therefore, for these reasons a qualitative methodology seems unsuitable for this research since it prevents the validity of evidence in these types of research.

However, the relative value of qualitative and quantitative inquiry has been long debated by researchers (Patton, 1990). Each of these research techniques represents a fundamentally different inquiry and in different paradigm and the researcher actions are based on the underlying assumptions of each paradigm (Hoepfl, 1997). For instance, logical positivism, or quantitative research, uses experimental methods and qualitative measures to test hypothetical generalizations whereas the phenomenological inquiry or qualitative research uses a naturalistic approach that seeks to understand phenomena in context-specific settings. Therefore, this research will utilize the quantitative research techniques to seek association, causal determination, prediction, and generalization of findings between the appointment and reporting structure of audit committees and their judgments, thereby its effects on the quality of the financial reporting process in corporate governance.
3.3 Research methods

3.3.1 Research Design

Kerlinger (1973) (quoted in Trotman, 1996, p. 9) defines a research design as “the flow, structure and strategy of investigation conceived so as to obtain answers to research questions and to control variance”. As such, this research design has two basic purposes: to provide answers to research questions and to control error variance. The research design is developed to allow the researcher to answer the research questions as validly, objectively, accurately and economically as possible (Trotman, 1996, p. 9). The research questions are normally expressed in terms of the hypotheses and these hypotheses are derived from a theory. As in this research, the hypotheses developed are based on the agency theory framework. Therefore, experiments are designed to test theories and to examine the effect of independent variables on the dependent variable; a ‘2 x 2’ factorial design is used in this research.

A ‘2 x 2’ Factorial Design

The ‘2 x 2’ factorial design used for the purpose of this research design involves the simultaneous examination of two independent variables (appointment and reporting) to determine the effect of each on the dependent variable (judgment of audit committee members). This research tests for the effect of two independent variables namely ‘appointment’ and ‘reporting’ variables on the judgment of the audit committee members (dependent variable), thereby on the quality of the financial reporting process, which makes up a ‘2 x 2’ factorial design. The two independent variables are manipulated each across two levels. These two independent variables are completely crossed; meaning the two possible combinations of the two variables will be represented giving four different cells. These four treatments will be based on the main effects of the hypotheses (cells 1-4).
However, it is also expected that there will be interaction effects. The subjects would then be randomly allocated to one of the four treatments (cells 1-4). This is a *between subjects* design as subjects receive only one treatment. Figure 3.1 displays the research design.

**Figure 3.1: A 2x2 Factorial Design**

<table>
<thead>
<tr>
<th>Audit Committee Reporting to</th>
<th>Board of Directors</th>
<th>Independent Oversight Board</th>
</tr>
</thead>
<tbody>
<tr>
<td>Audit Committee Appointed by</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Board of Directors</td>
<td>Cell 1</td>
<td>Cell 2</td>
</tr>
<tr>
<td>Independent Oversight Board</td>
<td>Cell 3</td>
<td>Cell 4</td>
</tr>
</tbody>
</table>

**Dependent and Independent variables**

The basis of any experimental design is that one or more independent variables are to be manipulated and the effect on the dependent variable is to be observed. As stated, independent variables are the variables manipulated by the researcher and the observed variable is the dependent variable. The effect of the manipulations of the independent variables is examined on the dependent variable. Other rival hypotheses that could explain the association between the independent and the dependent variables are ruled out to maximise *the internal validity* of this research. In particular, the importance of randomly assigning subjects to treatment groups is emphasised as the most appropriate method of maximising internal validity (Trotman, 1996).

**Dependent variable**

The ‘*judgment*’ of the participants is the dependent variable in this scenario. 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 the Likert scale, which in turn depends on the ‘appointment’ and ‘reporting structure’ of the audit committee members. This will have an effect on the effectiveness of audit committees in providing good corporate governance and reliable accountability reports to the stakeholders. The quality of financial reports is being measured by looking at the judgments of the participants, that is, those participants supporting the auditors will be adding more reliability in the financial reporting process as opposed to those supporting the management whose financial reports may be biased and less reliable. The judgment of the audit committee is illustrated on a 7 - point Likert scale ranging from -3 to 3.

**Independent variables**

The two independent variables, which are manipulated for the purpose of this study, are as follows:

1. *Appointment* of the audit committee by *either* the Board of directors *or* the Independent oversight board (H1).
2. *Reporting* by the audit committee to *either* the Board of directors *or* the Independent oversight board (H2).

**Control Variables**

As with any experimental design, the number of variables that we can examine is constrained by many interacting factors such as the model complexity, the length of the research instrument and the likely response rate. Likewise, there will be certain confounding variables that need to be controlled or held constant across the experiment. To reduce the effects of these confounding variables, this study is conducted in a controlled experimental setting so as to allow this research to remove many of these confounding factors that make the audit committee judgment very complex. This will add comparative advantage to this research experiment as Libby and Luft (1993) state that,
the experimentalist’s comparative advantage lies in the ability to abstract and control other potentially influential variables.

In this study, such control variables include the participants’ assessment of the case (questions 2-4); which includes the level of knowledge based on financial accounting, financial statement analysis, and auditing knowledge. Controlling these variables would allow this research to test the effects of the conditions (i.e. alternative appointment and reporting variables) that do not yet exist in practice (Trotman, 1996) since other variables will be held constant. These control techniques will be used to maximise the internal validity of this research.

**Manipulation Variables**

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 (questions 5-8).

**Demographic Information**

Participants were also asked to indicate about their demographic information on their work and corporate governance experience (questions 9 and 10); age and gender (question 11); and the level of education (question 12).
3.3.2 Experimental Task

Case on Auditor-Management Dispute

The purpose of this study is to determine whether alternative appointment and reporting structure of audit committees affect the audit committee member’s judgments and thereby the reliability and the quality of the financial reporting process. To date, only two published studies have examined the response of audit committee members to disputes between the auditors and the management. Firstly, 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. Secondly, 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) indicated 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 participants for their opinion. The judgment of the respondents is hypothesized to be based on the ‘appointment’ and ‘reporting’ structure of the audit committees. This selection of the case is based on a review of the relevant literature and the results of the earlier surveys (in particular, Dezoort and Salterio, 2001) relating to the effectiveness of audit committees in terms of enhancing the quality of the financial reporting process. The case will be of a non-routine in nature as would be expected of any dispute between the auditors and the management that reaches the audit committee.

The audit committee members will be required to make their judgment on auditor-management dispute case between the external auditor and the management of the
corporations. The dispute case will be neutral as can be expected from any auditor - management disagreement which involves the revenue recognition policies of an electronics goods retailer. The case designed for this research experiment is based on the experimental research case of Dezoort and Salterio (2001), which seemed to be very realistic and most relevant in the context of this study. It involves the revenue recognition policies of E-Man Technology Incorporation (Inc.), an electronics goods retailer 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. The full description of the case is provided in Appendix A.

**Pilot Testing**

The research materials included an accounting policy dispute task, knowledge and ability tests questionnaire and demographics. The experimental task was created with the assistance of the working paper of Dezoort and Salterio (2001). The task was pre-tested on 16 accounting academics at University of the South Pacific (Fiji Islands) 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.
3.3.3 Research Instruments

Survey

A common quantitative data collection technique is a survey that would be used to gather information from the respondents in this research. Three major forms of surveys are widely used in social science: descriptive, explanatory and attitude surveys. For the purpose of this research, an attitude survey technique will be utilised to measure audit committee members’ judgments. Audit committee members’ will be told to rank their responses on a scale, which will measure their attitudes, that is, the Likert method of attitude survey will be used for the purpose of this study. The standard set of questionnaires would be the most important way to collect survey data for this research.

Also, an experimental case is prepared to collect the data, on the basis of four treatments: (1) an audit committee is appointed by the Board of directors and it reports to the Board of directors, (2) an audit committee is appointed by the Independent oversight board and it reports to the Independent oversight board, (3) an audit committee is appointed by the Board of directors and it reports to the Independent oversight board, and (4) an audit committee is appointed by the Independent oversight board and it reports to the Board of directors. Each assumption will have numerous descriptive statements.

The research instrument comprises of five parts. Part one includes an instruction sheet, part two includes one hypothetical case, part three includes the knowledge tests such as the test on financial accounting knowledge, test on financial statement analysis knowledge, and test on the audit knowledge of the participants. These three control variables are rated from low knowledge (-3) to high knowledge (3) with the mid-point as uncertain (0). Part four includes some ability tests such as the test on the level of understanding (no understanding ‘-3’ to total understanding ‘3’), test on reality of the case (very unrealistic ‘-3’ to very realistic ‘3’), test on its importance (very unimportant ‘-3’ to very important ‘3’) and test on the difficulty of the case (very easy ‘-3’ to very difficult ‘3’ with the mid-point as uncertain (0).
Part five includes some biographical questions (such as the respondents’ work experience, corporate governance experience, age, gender, and professional qualification). The instrument was pre-tested in a *pilot survey* using accounting academics with business and auditing experience at the University of the South Pacific, Laucala Campus, and Suva, in the Fiji Islands. After completion of the pilot study, the final instrument was modified on the basis of the feedback received from these respondents. Participants in the main research survey are mostly based on the boards of directors of the private sector corporate enterprises (including listed public companies and large private sector companies in Fiji and abroad) and ex-board of directors’ members in Fiji based private sector corporate enterprises.

**Participants**

The adoption of audit committees in Fiji is voluntary and given the fact that there is only a handful of corporations that have established audit committees, it is very difficult to gather the data on the audit committee members’ responses alone. As such, given the difficulty in accessing audit committee members, the *boards of directors* from these companies were chosen as the participants of this research irrespective of whether they are audit committee members. These boards of directors are from 28 different companies (see the listing in Tables 3.1 and 3.2), former boards of directors and boards of directors from abroad, with varying levels of technical knowledge and skills in accounting, financial management and auditing. A similar approach has been used by DeZoort and Salterio (2001) who have used students as the research participants in their pilot survey and they pre-tested their initial set of research questions on different groups of accounting students at various levels and faculty with different levels of accounting and auditing knowledge.

Given their difficulty in accessing audit committee members, they pre-tested the questions with over 30 subjects who they expected to vary greatly in knowledge among audit committee members. They also tested their final set of questions on 12 MBA students with significant work experience. They used this test to evaluate whether
students’ responses varied in accordance with differences in auditing background. There results showed that the test scores were lower (higher) consistent with lower (higher) auditing backgrounds. This relationship provides evidence of construct validity that is the test measures variations in audit knowledge consistent with what it should measure based on subject background (Cronbach, 1970).

In addition, as this research proposes to test changes in the existing appointment and reporting structure of audit committees, it would not be relevant to use the existing audit committee members in the dispute case since these members are already appointed by the board of directors and they report to the board of directors, so their opinion may be biased towards the management. As such, the boards of directors seem to be the appropriate category chosen to be used in this research to add internal validity to the results.

The validity would have been questioned had this research chosen the existing audit committees as participants to make their judgments on proposed alternatives. As such, it would have been difficult to compare the results if the present audit committee members were asked to assume their role in different structural situations, which may actually affect the biasness of their decision. Therefore, this research presumed that taking one set of participants (i.e. the board of directors) and then getting their views based on different sets of assumptions makes it more valid and constructive for research like this where alternatives are tested. As such, this approach is used in this study to improve construct validity.

**Sample Size and Sample Frame**

The ultimate purpose of this research is to determine whether changing the appointment and reporting structure of the audit committees will affect their judgments and thereby the quality and reliability of the financial reporting process. A sample of reporting entities (such as listed companies and large private sector companies) was contacted from the Capital Markets Development Authority (CMDA) in Fiji to participate in this research.
Along with these, ex-board directors were identified from the Registrar of Companies to further strengthen the sample size. Also some of the current board members from overseas companies were contacted through the internet via email to increase the sample size further. A *stratified sample* is used, which is based on the pre-determined characteristics of the population (these characteristics are identified in the research design section). This type of sample is particularly useful for surveys where there is a control group that does not have a given characteristic (Hoepfl, 1997). Therefore the treatment samples will adequately include the boards of directors with the consequences of interest, of the 16 listed companies on the South Pacific Stock Exchange (SPSE), 12 other large private sector companies in Fiji and the former boards of directors of these companies in Fiji and some of the boards of directors from overseas companies.

The sampling approach selected for this study involves identifying a population, which will comprise all the board of directors of these 28 companies. The total sample size includes 600 participants – 150 participants chosen for each treatment group. Each participant is approached via mail and email. The sample frame includes all the ‘boards of directors’ (including listed companies, ex-board members and boards of directors abroad) of which some of them may already be an audit committee member.

The research instrument was sent out to the boards of directors of the 16 listed companies on the South Pacific Stock Exchange in Fiji, 12 private sector companies in Fiji, the ex-board of directors from private sector companies in Fiji and the boards of directors from abroad giving a grand total of 600 members of the board of directors. The list of the members of the board of directors from the listed companies on South Pacific Stock Exchange in Fiji is presented in Table 3.1.
<table>
<thead>
<tr>
<th>Listed public companies</th>
<th>No. of BODs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amalgamated Telecom Holdings Ltd</td>
<td>8</td>
</tr>
<tr>
<td>Atlantic &amp; Pacific Packaging Co. Ltd</td>
<td>4</td>
</tr>
<tr>
<td>Carlton Brewery (Fiji) Ltd</td>
<td>6</td>
</tr>
<tr>
<td>Communications (Fiji) Ltd</td>
<td>6</td>
</tr>
<tr>
<td>Fiji Care Insurance Ltd</td>
<td>5</td>
</tr>
<tr>
<td>Fiji Sugar Corporation Ltd</td>
<td>9</td>
</tr>
<tr>
<td>Fiji Television Ltd</td>
<td>7</td>
</tr>
<tr>
<td>Flour Mills of Fiji Ltd</td>
<td>5</td>
</tr>
<tr>
<td>Fijian Holdings Ltd</td>
<td>9</td>
</tr>
<tr>
<td>Kontiki Growth Fund Ltd</td>
<td>6</td>
</tr>
<tr>
<td>Pacific Green Industries (Fiji) Ltd</td>
<td>5</td>
</tr>
<tr>
<td>R. B. Patel Group Ltd</td>
<td>8</td>
</tr>
<tr>
<td>South Pacific Distilleries Ltd</td>
<td>5</td>
</tr>
<tr>
<td>The Rice Company of Fiji Ltd</td>
<td>3</td>
</tr>
<tr>
<td>Toyota Tsusho (South Sea) Ltd</td>
<td>6</td>
</tr>
<tr>
<td>Vishal Bharteeya Company Ltd</td>
<td>5</td>
</tr>
</tbody>
</table>

**Total**                                           **97**

(Source: Respective Annual Reports - 2004)
Similarly, the list of the members of the board of directors from the private sector companies in Fiji is presented in Table 3.2 and the grand total number of participants is illustrated in Table 3.3.

**Table 3.2: List of Participants – Private Sector Companies (Fiji) (2004)**

<table>
<thead>
<tr>
<th>Private sector companies</th>
<th>No. of BODs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Telecom Fiji Limited</td>
<td>7</td>
</tr>
<tr>
<td>Vodafone Fiji Limited</td>
<td>8</td>
</tr>
<tr>
<td>Fiji Directories Limited</td>
<td>3</td>
</tr>
<tr>
<td>Internet Services Fiji Limited</td>
<td>5</td>
</tr>
<tr>
<td>TransTel Limited</td>
<td>4</td>
</tr>
<tr>
<td>Xceed Pasifika Limited</td>
<td>3</td>
</tr>
<tr>
<td>Air Pacific Limited</td>
<td>9</td>
</tr>
<tr>
<td>Courts Homecentres (Fiji) Limited</td>
<td>4</td>
</tr>
<tr>
<td>British American Tobacco</td>
<td>11</td>
</tr>
<tr>
<td>Credit Corporation (Fiji) Limited</td>
<td>7</td>
</tr>
<tr>
<td>Fijian Holdings Trust Mgt. Limited</td>
<td>6</td>
</tr>
<tr>
<td>Fiji Times Limited</td>
<td>4</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>71</strong></td>
</tr>
</tbody>
</table>

(Source: Respective Annual Reports - 2004)

**Table 3.3: List of Participants – Totals**

<table>
<thead>
<tr>
<th>Participant category</th>
<th>No. of BODs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ex-boards of directors</td>
<td>232</td>
</tr>
<tr>
<td>BODs from abroad</td>
<td>200</td>
</tr>
<tr>
<td>BODs from Listed Public Companies</td>
<td>97</td>
</tr>
<tr>
<td>BODs from Private Sector Companies</td>
<td>71</td>
</tr>
<tr>
<td>Grand Total of Participants</td>
<td>600</td>
</tr>
</tbody>
</table>
3.3.4 Research Procedures

To answer the research question and the hypotheses, the participants (the boards of directors) are asked to role-play as ‘audit committee members’ on an audit committee focused on the quality of the financial reporting process and critical issues in corporate governance. The design was used because it simulates the typical approach taken by governments when addressing important issues pertaining to the business community (such as the Singapore Government in the study of Goodwin and Seow, 2002). Thus, asking participants to role-play as members of an audit committee was designed to add realism to the experiment and encourage participants to take the tasks more seriously. While it could be argued that the participants were not receiving the cases as audit committee members per se but rather as boards of directors, the study was framed to capture their views as audit committee members in particular and audit committee generally.

To help ensure that participants will focus on their respective roles as audit committee members, a separate covering letter is used for each group. This letter to the boards of directors stresses the concern for this research with issues that audit committees considered important for strong corporate governance. Furthermore, it can be argued that, even though role-playing (Goodwin and Seow, 2002), participants’ views would have been formulated from their individual experiences as being part of the board of directors of their companies.

This research uses one hypothetical case with four different sets of assumptions to be given to the participants in each category. Since this a between-subjects design where the subjects receive only one treatment, the same case will be based on four sets of assumptions: (1) where the participants are asked to role play as audit committee members who are appointed by the board of directors and they report to the Board of directors; (2) where the participants are asked to role play as audit committee members who are appointed by the Independent oversight board and they report to the Independent oversight board; (3) where the participants are asked to role play as audit committee
members who are appointed by the Board of directors and who are required to report to the Independent oversight board; and (4) where the participants are asked to role play as audit committee members who are appointed by the Independent oversight board and who are required to report to the Independent oversight board.

Participants are asked to read the case and respond to a series of questions. Based on the assumptions in the case, two variables were manipulated in a ‘2x2’ between-subjects design. This resulted in four treatments of the case. The dispute in the experimental case is referred to the board of directors, role-playing as members of the audit committee for its opinion (Dezort and Salterio, 2001). The boards of directors have to refer to the case and provide an opinion from their judgment of whose position they would support in the dispute. The participants will have to respond on a 7 point Likert scale (-3 to –1 = tend to support the management’s position, 0 = uncertain, 1 to 3 = tend to support the auditor’s position). These categories are best illustrated on the 7-point Likert scale as shown below:

<table>
<thead>
<tr>
<th>Management</th>
<th>Uncertain</th>
<th>Auditor</th>
</tr>
</thead>
<tbody>
<tr>
<td>-3</td>
<td>-2</td>
<td>-1</td>
</tr>
<tr>
<td>Certain</td>
<td>Highly Probable</td>
<td>Probable</td>
</tr>
<tr>
<td></td>
<td>Uncertain</td>
<td>Probable</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Highly Probable</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Certain</td>
</tr>
</tbody>
</table>

Tend to support management’s position  Tend to support the auditor’s position

Participants are informed that there is no reason to doubt the integrity of the other board members, auditors and the management team, and that they did not know them personally. They are also told that they had no direct knowledge of the company’s control system but had no reason to believe that there were any unusual weaknesses in controls (Goodwin and Seow, 2002). This scenario was designed to portray a fairly neutral picture.
of a company with no noticeable weaknesses in corporate governance other than with respect to the variables being manipulated. The participants are generally informed that they have to assume that the Board of directors and the Independent oversight board have appointed them and they have to report back to these boards respectively. Their appointment, termination, compensation, review and performance, all are based on the discretion of the boards. Hence, after collecting the relevant data, an experimental analysis would be carried out to test the four hypotheses as stated.

3.3.5 Data Analysis

Statistical Technique

This study will use a statistical technique to analyze the data. This technique would be used to conduct statistical data analysis, including descriptive statistics such as plots, frequencies, charts and lists, as well as sophisticated inferential and univariate statistical procedures and Univariate Analysis of Variance (Univariate ANOVA). This technique is particularly common for survey based research. However, if there are differences between these treatment groups, and if the mean difference is significant, then this research expects the hypothesis to be accepted. This will show up as a significant ‘F’ statistic in a Univariate ANOVA. The findings of the study would highlight the validity of the hypothesis to be tested using Univariate ANOVA.

The results were analysed by using a 2 x 2 Univariate Analysis of Variance (Univariate ANOVA) model. A Univariate ANOVA statistical technique was used to test for significant statistical differences in a factorial design based on responses due to different sets of assumptions. To test these hypotheses a ‘2 x 2’ ANOVA was used where ‘appointment’ and ‘reporting’ is a between subjects’ factor with two levels: the Board of directors and the Independent oversight board. The dependent variable is the ‘judgment’ of the participants.
Control Variable Test

A Univariate ANOVA for a ‘2 x 2’ factorial design requires that each independent variable is analysed separately and then the interaction between these variables analysed, so this method involves the calculation of a between-group variance. If the between group variances are statistically different, then there are no group differences other than those resulting by chance. Thus, the fixed factor will be the ‘Appointment’ and ‘Reporting’ variable and the control variables will be the level of ‘Financial Accounting Knowledge (FAKNOW), the level of ‘Financial Statements Analysis Knowledge (FSAKNOW), and the level of audit knowledge (AUDKNOW).

Manipulation Test

A manipulation test was conducted to determine the appropriateness of the case. These variables included the level of ‘understanding’ of the case (UNDERSTANDING), how ‘realistic’ was the case (REALISTIC), how ‘important’ were the case (IMPORTANCE) and the level of ‘difficulty’ of the case (DIFFICULTY).

3.4 Conclusion

Chapter three described the major methodology and research methods that were to be used to collect the data for testing the hypotheses in the next chapter. This chapter was based on the data collection methods and the use of quantitative research methodology in the area of auditing, audit committees and corporate governance. This chapter provided justification for the methodology in terms of the research problem and the literature review and summarized the unit of analysis, sources of data, population, the sampling frame and the sample size to be adopted in the research. It also emphasized the research instruments and the research procedures to be used to collect data, including the measurement of the dependent variable, details of pilot studies and explicit concern for internal and external validity of the research (as in Yin, 1989, p.41 and Parkhe, 1993, p.260-261).
This chapter discussed the administration of the research instruments and procedures (for example, when, where, and who) so that the research is considered to be reliable. Then the research was justified on several important theoretical and practical grounds, emphasizing the neglect of the research problem and discussing the usefulness of application of the research’s findings. Further, this chapter justified the limitations of the research methodology such as the practical limitations of the participants who would be ‘role playing’ as the audit committee members. Also, the sampling frame or sample size of the questionnaire in this survey research is clarified and justified.

In addition, this chapter controlled the confounding variables in the research design that might have an influence on the results of the research and properly justified the impact of these variables for statistical analyses. This chapter also ensured that all critical processes and procedures have been followed in conducting this research. The penultimate section of this chapter covered the ethical considerations of the research including the research grant issues. Finally, this chapter laid the audit trail for this study (Perry, 1994). On these trails, this study could proceed to the results and analysis section in the next chapter (Chapter four).
CHAPTER FOUR

ANALYSIS OF DATA
4.0 Analysis of Data

4.1 Introduction

This chapter provides a detailed analysis of the data collected for this study. The task was piloted with the students and staff of the department of accounting at University of the South Pacific, Suva, Fiji Islands. The staff reviewed several drafts of the materials and all thought the case was realistic. They also agreed that the case was non-routine as would be expected of any dispute between auditors and management that reaches the audit committee. The case involved the revenue recognition policy and an in-house extended warranty of an electronics good retailer. After considering the case information, the board of directors, as participants and role-playing as audit committee members, were asked whose position they would support in the dispute. The participants responded on a 7-point scale (-3 = tend to support management’s position, 0 = uncertain, 3 = tend to support the auditor’s position).

The first part of this chapter provides a detailed report on the subjects such as the participants and the number of respondents in this study. It states the way questionnaires were distributed and how responses were received. It provides the percentages of the responses received compared to the total participants. The next part of this section discusses the use of statistical techniques and provides the descriptive data and means about the subjects including the results for Univariate ANOVA for each groups. It then provides the patterns of data for research question and research hypotheses followed by hypothesis testing.

4.2 Subjects

4.2.1 Participants and Respondents

Given the fact that there are only few companies in Fiji having audit committees (3 of 28; 10.7% according to our sample companies) and the difficulty in accessing audit
committee members abroad, 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. Therefore, participants in this research were members of the boards of directors of the private and listed companies in Fiji in 2004, the past directors in Fiji and the boards of directors abroad. The listed companies were chosen as part of the reporting entities for this research because it comprises the companies from different industries such as telecommunications, packaging, breweries and distilleries, communications, insurance, agriculture and primary industries, manufacturing, holding companies, retailers and car dealers. The boards of directors were identified from the past and present annual reports.

The sample size included all the listed companies on the South Pacific Stock Exchange in Fiji (16 companies as at 2004) and some selected private companies operating on a large scale in Fiji (12 companies which are not listed), the ex-board members from local companies basically identified from the previous annual reports, and the boards of directors from overseas companies basically identified through the internet search engines, in particular the Google Fiji. The total number of board of directors was 600.

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 ‘Post Fiji’ envelope for their quick response. All groupings and treatments were randomly allocated. In case of the hand-delivered questionnaires to the company secretaries, as a formality, the company secretaries had to make note of all correspondence received and therefore, they had to deliver these questionnaires to the board of directors together with other board papers in the board meeting. All the boards of directors were asked to return the filled questionnaire in the prepaid envelope as soon as possible. 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 (refer to Appendix A for more explanation).

4.2.2 Response Rate

The completed questionnaires were returned in the postage paid envelopes and some in the company envelopes within 2 to 4 months directly to the researcher’s mailbox. Of the possible 600 boards of directors, usable questionnaires were received from 199 participants, producing an overall response rate of 33.17%. This response varied somewhat among the overseas directors, ex-directors and the companies surveyed. The responses received for each treatment were 52 responses for treatment 1, 46 responses for treatment 2, 48 responses for treatment 3 and 53 responses for treatment 4 were received in a total of 150 individual sets distributed (response rate clusters between 30-35% in each treatment).

This response rate compares favorably to previous research involving these types of subjects. For example, Mautz and Neumann (1970, 1977) had total response rates of 21% and 22% respectively. Robertson and Deakin (1977) had a response rate of 23.5% from audit committee members. Birkett (1980) had rates of 18% for audit committee members and 35.6% for external auditors. Castellano et al., (1989) had a response rate of 34.7% for audit committee members. DeZoort and Salterio (2001) had a response rate of 20% from the audit committee members. Goodwin and Seow (2002) received the response rate of 18%, which was comparable to other studies involving directors in Singapore (Goodwin and Seow, 2000) and also in the US (Hermanson, 2000).

Kalbers and Fogarty (1993) reported that response rates for mailed audit committee questionnaires generally cluster between 20-25%. Therefore, the response rate in this research is considered highly acceptable given the length of the research instrument and the nature of the participant pool. In the audit committee literature, rates of responses
have varied considerably but for statistical purposes, response rate needs to be uniformly distributed. The great majority of respondents were males (82%) and more than 91% were over the age of 40. Approximately 20% of the respondents indicated that they held more than one directorship and 60% of them were members of an audit committee. The total members of the audit committee for these 28 companies were 20 and 18 of them were among the respondents who were actually on the audit committee.

4.3 Statistical Technique

Statistical technique is used to analyze the data. Statistical techniques are part of data management and analysis and it provides many advantages for this purpose. Amongst its features are modules for statistical data analysis, including descriptive statistics such as plots, frequencies, charts and lists, as well as sophisticated inferential and multivariate statistical procedures like Univariate Analysis of Variance (Univariate ANOVA). It is particularly well-suited to survey research (Trotman, 1996).

This study used a Univariate Analysis of Variance to test for differences among the four treatments: (1) an audit committee appointed by the board of directors and reporting to the board of directors; (2) an audit committee appointed by the Independent oversight board and reporting to the Independent oversight board; (3) an audit committee appointed by the Board of directors and reporting to the Independent oversight board; and (4) an audit committee appointed by the Independent oversight board and reporting to the Board of directors. A ‘2 x 2’ factorial design produced four sets of cases to test the study’s hypotheses in an effort to minimize completion time demands. Along with these four treatments, interaction effects are also expected.

4.3.1 Manipulation Test (Analysis of Questions 5 – 8)

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. Tables 4.1 provide the descriptive statistics of the manipulation test.
The results in Table 4.1 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).

4.3.2 Demographic Information (Analysis of Questions 9 – 12):

Table 4.2 presents the demographic information of the respondents’:

Table 4.2  Respondents’ Demographic Information

<table>
<thead>
<tr>
<th>Demographic Information</th>
<th>% of Respondents ( n = 199 )</th>
</tr>
</thead>
<tbody>
<tr>
<td>Work experience</td>
<td>78</td>
</tr>
<tr>
<td>Corporate governance exp</td>
<td>22</td>
</tr>
<tr>
<td>More than 1 yr. of exp</td>
<td>81</td>
</tr>
<tr>
<td>Audit committee member exp</td>
<td>12</td>
</tr>
<tr>
<td>Age (35-55)</td>
<td>91</td>
</tr>
<tr>
<td>Males on board</td>
<td>87</td>
</tr>
<tr>
<td>Females on board</td>
<td>13</td>
</tr>
<tr>
<td>Professional education</td>
<td>79</td>
</tr>
<tr>
<td>Undergraduate/masters</td>
<td>9</td>
</tr>
<tr>
<td>Size (value of assets)</td>
<td>$70m-$200m</td>
</tr>
</tbody>
</table>
Work experience

Based on the work experience, most of the respondents (78%) seem to be either the president of a corporation, a senior executive officer, or a former senior civil servant. This indicates that the respondents had work experience being public trustee of having extensive board-level experience.

Corporate governance, audit committee and number of years experience

Only 22% of the respondents held corporate governance experiences in more than one corporation while most of them (81%) had more than 1 year of experience as a board member in different organizations. Therefore, the results indicate that corporate governance experience didn’t have substantial effect on the audit committee members’ judgment. Also only 18 (out of 199) respondents had served as an audit committee member. The longer the board of director and/or management has been with the company, the more knowledgeable they will become concerning the accounting policy choices and the financial reporting knowledge. Most boards of directors had 1-2 years of experience so the results indicate that the number of years of experience didn’t have any effect on the audit committee members’ judgment in the auditor-management dispute situation.

Size of the company

Generally, the sizes (assets values) of these companies cluster between $70m and $200m. In addition, size has been used in the past as a proxy for the strength of a company’s internal controls (see Kinney and McDaniel, 1989; DeFond and Jiambalvo, 1991) while other researchers (Watts and Zimmerman, 1978, 1990) have indicated that size may proxy for political costs because large companies are more politically visible and may be more concerned with financial reporting process. In this research, the natural logarithm of the value of total assets is used to measure the size of the corporation (refer to Table 4.3). The management of these corporations can create an environment that encourages
maintaining an effective accounting system and control procedures and in either case, size may affect the integrity of the financial reporting system.

**Gender, age and educational status**

In addition, most of the respondents (91%) were aged between 35 and 55 years, more of them being males (87%) than females (13%). The educational status of these respondents was mostly a professional designation and training certificates (79%) with few having undergraduate and master’s degrees (9%). Therefore, gender, age and educational differences did not affect the overall findings since most of the respondents were in similar positions or status. This is similar to findings stated by DeZoort and Salterio (2001) that used an analysis of variance to test for differences in responses due to experience, age and gender. Their tests indicated that biographical differences had no significant impact on the results of this type of study.

### 4.4 Analysis of Results

This study investigates the effects of the appointment and reporting structures on the audit committees’ judgment in an auditor – management dispute situation. A Univariate Analysis of Variance was conducted to test the results. 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 4.3 and Table 4.4 display the descriptive statistics and the Univariate analysis of variance respectively.
The results in Table 4.3 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 Independent oversight board and reporting to the Independent oversight board (mean = 1.3043) compared to the
audit committee appointed by the Board of directors and reporting to the board of directors (mean = 0.4808). Therefore the mean difference is higher for an audit committee appointed by (and reporting to) the Independent oversight board compared to the audit committee appointed by (and reporting to) the board of directors.

The results in Table 4.4 indicates that the appointment and reporting variables have a significant impact on the respondents’ perceptions regarding their judgments on the auditor-management dispute situation. The research question is explored using Univariate Analysis of Variance (Univariate ANOVA) supported by Analysis of Variance (ANOVA) where appropriate. The Univariate ANOVA using a single construct score (calculated by totaling the scores for the dependent variables) reveals that the two manipulated variables are both significant (appointment @ p = 0.000 and reporting @ p = 0.003).

The result in Table 4.4 shows the sum of squares, degrees of freedom (df) and mean square for the simple linear regression model (corrected model) with intercept and error. Here, note that the P-value = 0.000 is the area under the F-curve to the right of the computed F = 6.804 for the model. The test of between-subjects effects shows that P-value < 0.05, (i.e. p-value = 0.000 and 0.003 respectively as given in Table 4.4 so there is compelling evidence that the means are significantly different. Moreover, because R Squared = 0.082, about 8.2% of observed variation in the Judgment variable can be explained by such a linear model.

There are no significant interaction effects between the appointment and reporting variables on the judgment of the audit committees. The Univariate ANOVA test indicates that the mean responses for the directors do not differ significantly based on their appointment and reporting structure concurrently. Therefore, Univariate ANOVA reveals insignificant differences between the appointment and reporting variables. The interaction between the two variables is not significant (p = 0.235). These findings further support the need for univariate analysis on each of the dependent variables to determine which variables are driving the results. As none of the higher interactions are significant, details of these effects have not been provided.
Finally, the control variables, financial accounting knowledge (FAKNOW), financial statement analysis knowledge (FSAKNOW), and the auditing knowledge (AUDKNOW) have no significant impact on the results.

Therefore, the first hypothesis (H1) predicted that an audit committee that is appointed by the board of directors (mean = 0.4808) will support the management in case of any auditor - management dispute situation other than an audit committee which is appointed by the Independent oversight board (mean = 1.3043) will support the auditor in such cases. The results of the hypothesis supported this prediction. The second hypothesis (H2) predicted that an audit committee that is reporting to the Board of directors (mean = 0.4808) will support the management in management – auditor dispute cases other than an audit committee reporting to the Independent oversight board (mean = 1.3043) will support the auditor in case of any management-auditor dispute situation. Hence, the results of this hypothesis supported this prediction.

**Appointment vs Reporting Variable**

The Univariate ANOVA in Table 4.4 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). Figure 4.1 displays the estimated marginal means of the two variables (appointment and reporting) manipulated at two levels (board of directors vs independent oversight board).
4.5 Conclusion

The results of this study suggest that, generally, the value of an audit committee arises particularly when an accounting disagreement occurs between the management and the auditor and there is a possibility of opinion shopping on the management’s part (McMullen, 1996). The results provide support for the two hypotheses \( H1 \) & \( H2 \) tested. The judgments of the audit committee members were more consistent with the judgments expected based on their appointment and reporting structure. A Univariate ANOVA provided evidence of significant interaction effects for appointment and reporting variables at 5% level of significance.

Based on the findings, therefore, it indicates that an audit committee tends to only support the party which appoints them (as in case of \( H1 \)) and to whom they have to report to (as
in case of \(H2\)). This indicates that the two variables: appointment and reporting are significant in explaining audit committee judgments in auditor – management dispute cases. When it comes to appointment and reporting concurrently to different parties then it is quite unclear as to whom will the audit committee support: the management or the auditor. This was obvious in the results where there were no significant interaction effects.

In addition, the overall observation from the auditor-management dispute indicates that an audit committee appointed by the board of directors (\(H1\)) and an audit committee reporting to this board of directors (\(H2\)), supported the management while an audit committee appointed by the Independent oversight board (\(H1\)) and an audit committee reporting to this Independent oversight board (\(H2\)), supported the auditor. Hence, in total, 70% of the audit committee members indicated support for the management in treatment 1 (i.e. less than uncertain ‘0’) and 70% of the audit committee members indicated support for the auditor in treatment 2 (i.e. greater than uncertain ‘0’). This overall support level is consistent with the results reported in (Knapp, 1987 and DeZoort and Salterio, 2001).

The results from this study can be compared with the results from prior research using structured cases. Cross-study comparisons provide evidence about the validity of the research results in the present study and a larger basis for comparing the audit committee member results. In particular, comparative analysis facilitates an evaluation of the use of board of directors as a criterion group proxy. Study comparability is tempered by differences between this study and previous studies.

Finally, the results indicated that the appointment and reporting structure, that is, appointment of the audit committees by the board of directors and the Independent oversight board and audit committees reporting to the board of directors and the Independent oversight board, made a difference in the audit committee members’ judgments. Tests of Univariate analysis revealed that in the four cases where differences were found, the audit committee appointed by (and reporting to) the same group (cases 1 and 2), variables were more critical of the structural system.
Collectively, this study provides some initial empirical support for concerns about audit committee structure and raises the importance of appointment and reporting variables as part of the corporate governance process in terms of affecting the judgment of the audit committees’ in case of auditor – management dispute situation. The next chapter discusses the conclusions and implications of this study.
CHAPTER FIVE

CONCLUSIONS

AND

IMPLICATIONS
5.0 Conclusions and Implications

5.1 Introduction

Globalization of audit committees as a common mechanism of corporate governance is one of the most prominent developments in accounting and over the last decade, accounting firms and professional bodies have developed a body of literature promoting and explaining the adoption of audit committees as part of the corporate governance process.

Today, we are facing serious problems in accounting, auditing and corporate governance that have undermined the quality and integrity of the financial reporting process. These accounting and auditing practices are only components of the broader system of corporate governance and can not be fixed in any lasting way without substantive changes in the overall governance process. We cannot shirk by simply blaming corporate disasters and accounting failures on the last few big CPA firms, the FASB, or the POB and we should not stand by and wait for the new requirements from the Sarbanes-Oxley Act to reveal their obvious flaws (Imhoff, 2003). For instance, one of these flaws, according to this study, relates to the independence of audit committees in the corporate governance process.

This research suggests alternative changes in the appointment and reporting structure of audit committees as a mechanism of corporate governance in enhancing the quality of the financial reporting process. It is time to act considerably and to find solutions to such corporate scandals that devastate the economic well being of the nation. As such, this study proposes to change the appointment and reporting structure of audit committees in corporate governance so as to control the fraudulent activities and to achieve improvements in the financial reporting process. However, the proposals stated in this study could be intentionally controversial and may further stimulate arguments and debate internationally in this field of research.
This study seeks 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 and the evidence of the impact of this changing structure of audit committees on the quality of the financial reporting process. The results in this study suggest that companies with audit committees appointed by (and reporting to) the Independent oversight board will support the auditor in management - auditor dispute cases, thereby being independent and enhancing the quality of the financial reporting process. The findings of this study are consistent with the idea that audit committees, because of their ability to link various groups involved in the financial reporting process, improve the quality of financial statements and disclosures (McMullen, 1996). However, research has been limited in this area of audit committees and corporate governance and prior research, in particular, has not involved the issue of audit committee independence via alternative appointment and reporting structure of audit committees and its effect on the financial reporting process.

Therefore, this study adds to the extant literature on the role of audit committees in corporate governance and broadens the knowledge on the need for independent audit committees in corporate governance practices of private sector corporate enterprises to achieve a quality financial reporting process. This research is conducted in a developing country – the Fiji Islands - where there is lack of knowledge and research in this area and where there is a need for such audit committees to control unscrupulous behaviour. No prior research has focused on this issue locally and even internationally, and therefore, this research adds to the body of knowledge about uncharted territories of the role of audit committees in corporate governance. As such, this research might be helpful for accounting policymakers and regulatory bodies to look at the issue more in-depth and help to form future corporate governance policies leading to the formation of independent audit committees, both locally (Fiji) and internationally.
5.2 Conclusions about Research Hypotheses

The following sub-sections state the findings for each research hypothesis and offers explanations within the context of this and prior research. It provides agreements and disagreements with previous research and justifies the reasons for such disagreements. One of the major disagreements is due to the geographical differences since this study has used mostly participants in the Fiji Islands and only a few from abroad, while some of the prominent research has focused on the data collected from developed countries. However, some of the disagreements stated do suggest that the research is making a contribution to the knowledge and might add to the body of literature. Therefore, each research hypothesis is discussed in detail in the following sub-sections with its reference from prior research.

5.2.1 Conclusion about Research Hypothesis One (H1)

The first hypothesis predicted that an audit committee appointed by the board of directors would make a judgment in favour of the management in an auditor - management dispute case compared to an audit committee appointed by an Independent oversight board. The results of a series of Univariate ANOVA provided support for H1 (see Table 4.4). The first hypothesis assert that appointment of the audit committee by the board of directors is more likely to support the management in dispute with the auditor and as the results reported in Table 4.4 indicated that the univariate differences between appointment by board of directors and judgment towards support for the management is statistically significant, and thereby H1 is accepted.

This follows from the agency theory approach where the agent (audit committee) needs to act on behalf of the principal (board of directors as representatives of shareholders) in the dissemination of accountability processes in the corporate governance system. As Napier (1997) indicated that the historical understanding of the relationship between managers, auditors and shareholders of limited liability companies under the British
company laws was that all of these parties were members of the same company (Baker and Owsen, 2002) (see Figure 2.1).

Conversely, the first hypothesis also predicted that an audit committee appointed by the Independent oversight board would make a judgment in favour of the auditor in an management - auditor dispute case. The result of a series of Univariate ANOVA provided support for this assertion (see Table 4.4). Hence, the appointment of an audit committee by the Independent oversight board is more likely to support the auditor in dispute with the management and as the results reported in Table 4.4 indicated, the univariate differences between appointment by Independent oversight board and support for the auditor is statistically significant, and thereby, H1 is accepted.

Therefore, the results of this hypothesis supports the proposition that an audit committee appointed by the Board of directors is more likely to support the management in auditor – management dispute cases compared to an audit committee appointed by the Independent oversight board who is more likely to support the auditor in such dispute cases, therefore we accept H1.

5.2.2 Conclusion about Research Hypothesis Two (H2)

The second hypothesis predicted that an audit committee reporting to the board of directors would make a judgment in favour of the management in auditor - management dispute case compared to an audit committee reporting to an Independent oversight board. The results of a series of Univariate ANOVA provided support for H2 (see Table 4.4. The second hypothesis assert that reporting by an audit committee to the board of directors is more likely to support the management in dispute with the auditor and as the results reported in Table 4.4 indicated, the univariate differences between reporting to the board of directors and support for the management is statistically significant, and thereby H2 is accepted.

Conversely, the second hypothesis also predicted that an audit committee reporting to the Independent oversight board would make judgment in favour of the auditor in
management - auditor dispute case. The result of a series of Univariate ANOVA provided support for this assertion (see Table 4.4). Hence, the reporting of an audit committee by the Independent oversight board is more likely to support the auditor in dispute with the management and as the results reported in Table 4.4 indicated the univariate differences between reporting to Independent oversight board and support for the auditor is statistically significant, and thereby, H2 is accepted.

Therefore, the results of this hypothesis supports the proposition that an audit committee reporting to the Board of directors is more likely to support the management in auditor – management dispute cases compared to an audit committee reporting to the Independent oversight board who is more likely to support the auditor in such dispute cases, therefore we accept H2.

These hypotheses, based on the findings, therefore, indicates that an audit committee tends to only support the party which appoints them and to whom they have to report to and when it comes to appointment and reporting by different parties then it is quite unclear as to whom the audit committee will support: the management or the auditor. This is in line with the agency theory view of the role of audit committees in corporate governance.

5.3 Conclusions about the Research Problem

This section explores the implications of the research for furthering understanding of the research problem by incorporating the qualitative findings about the research problem. It clearly develops the contribution of the research to the body of knowledge and discusses the conclusions based on the findings and the research results with the discussion of the role of audit committees in corporate governance and the generally, and the independence of audit committees specifically.
5.3.1 Implications for Furthering Understanding of Research Problem

Auditor independence

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).

Another source of evidence on the contribution of audit committees to auditor independence is their behaviour in situations where there is a dispute between the external auditor and the executive management. Confidentiality limits the research potential in this area, but limited numbers of questionnaire and experimental test results are available. In an early experimental survey, Knapp (1987) examined factors affecting audit committee support for auditors, rather than management, in audit disputes. The results suggested that audit committee members, on average, tended to support the auditors, rather than management, in the conflict scenarios where the dispute involved objective technical standards and the auditee was in a weak financial position.

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, practising auditors state that their discussions with audit committees or boards never affect the type of audit report issued (Cohen et al., 1999).

**Effects on Financial Reporting**

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).
5.3.2 Qualitative Findings

From a methodological perspective, the additional item results provided an informative extension of traditional policy capturing approaches. Providing participants opportunities to demonstrate technical knowledge that supplemented traditional parameters like judgments and analyses strengthened the overall results of this study. In particular, audit committee members’ abilities to identify and communicate relevant oversight questions beyond those provided by others are an important component of overall committee effectiveness. The findings also reveal a number of differences resulting from their appointment and reporting structure. Significant differences were found between the judgments of audit committee appointed by the board of directors (and reporting to the same board) and those appointed by an Independent oversight board (and reporting to the same board). These results highlight the need for researchers, interest groups and policymakers to identify correctly the appointment and reporting structure of audit committees within the corporate governance framework of corporations, so as to improve the quality of the financial reporting process.

5.4 Research Contributions

5.4.1 Practical Contributions

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 the number of private evidences process and public sector advocates (see Birkett, 1986 for a detailed historical overview of efforts to encourage audit committee formation from the 1930s to the 1960s) and 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). One key to increasing public confidence in financial statements
is more direct involvement by independent agencies outside the corporation in the company’s auditing process and the integrity of the reported financial information. Future research to establish actual rather than perceived effects, unintended as well as anticipated consequences, and the organizational and institutional context in which particular effects are encountered, would provide a more systematic and robust basis for discerning the value of audit committees and contribute to public policy debates about their role in corporate governance (Zaman, 2002).

This study’s proposal 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) 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, as well as improve the reliability of the financial reporting process.

Collectively, this study provides some initial empirical evidence addressing a primary area of concern related to the audit committee structure. In particular, the results support suggestions that the appointment and reporting structure of audit committees can make a difference in audit committee member oversight, thereby affecting the quality of the financial reporting process. The results of this study related to judgment and additional items listed stand contrary to suggestions of changing the composition of audit committees, when appointment and reporting structure needs to be looked at first, and provides some limited support for concern that ‘judgment by audit committee members may be constrained by their appointment and reporting structure’. If audit committee members lack appropriate appointment and reporting structure in corporate governance to perform their oversight function such as solving the dispute in auditor - client disagreements, then their ability to govern corporate activity and facilitate corporate accountability in those areas may differ markedly if they are members who have been
appointed by the board of directors only, which in fact is dominated by the chairman of the board who also happens to be the CEO of the company. There is also some evidence that companies with strong CEOs have a higher probability of placing insiders and interested directors on audit committees than those with relatively weaker CEOs (Klein, 1998).

With this in mind, the existence of appointment and reporting structure in this study and the possibility of effects in other oversight areas highlights the importance of careful identification of prospective audit committee members, appointment of members and their reporting. In particular empirical results 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. The findings of this study also suggest that considerations of independent board legislation and regulation, both actual and proposed, should be tempered with assessments of the need for an Independent oversight board.

Survey evidence from auditors and directors in Singapore, where audit committees are mandatory, reported that although the existence of a strong audit committee is perceived as enhancing the effectiveness of an external audit and helping the company prevent and detect errors in the financial statements, there was some doubt among respondents about whether a strong audit committee would help the company to prevent and detect control weaknesses and fraud (Goodwin and Seow, 2000). Some evidence is also available that the more independent the audit committee from executive management, the more active its approach to internal audit (Scarborough, et al., 1998).

To this end, some researchers attribute the US accounting failures to a deficiency in US GAAP: since accounting-related problems are more common in the US than other countries, they argue, it must be the accounting rules that are at fault. However, this may be totally inappropriate because US GAAP represents the most comprehensive set of financial statement requirements in the world, generating greater transparency in financial reporting than in any other country. In other words, as Leuz et al., (2003) stated,
it is likely that so many of the financial reporting problems have been uncovered in the US because of the greater transparency in U.S. GAAP. Accounting rules require implementation by managers and review by auditors seeking to disclose the economics of a transaction. Managers and auditors who are no longer acting in the interest of shareholders can always circumvent both bright-line rules and principles-based rules (Imhoff, 2003).

Within the US financial reporting environment, managers have increasingly been provided with incentives to manage earnings and most cash bonus plans as well, as most stock option plans or stock award plans are based on accounting results (Bloedorn and Chingos, 1991; Ittner et al., 1997). Normally the quantity of options made available to managers and directors in any given year is based on current accounting performance measures.

Recent studies have reported that independent and active audit committees are associated with a decreased likelihood of both fraud and non-fraudulent earnings misstatements (Abbott, Park and Parker, 2000; Abbott, Park and Peters, 2000). Similarly, income-increasing accounting has been found to be constrained by independent audit committees and by public disclosure of audit committees’ responsibility for monitoring financial reports (Parker, 2000). Among companies subject to SEC AAERs, Beasley et al. (2000) found that fraud firms have fewer audit committees, less independent audit committees and fewer audit committee meetings. Zaman (2002) advocated that both audit committee meetings (a measure of audit committee activity) and the independence of audit committee members have consistently been found to be associated with a lower likelihood of problems in financial reporting quality.

This result of this study is in line with the previous studies that have examined the association between the presence of an audit committee and the absence of financial reporting problems (DeFond and Jiambalvo, 1991; McMullen, 1996; Dechow, et al., 1996; Beasley, 1996). 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).

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.

Prior research 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). Thus, effective boards and audit committees constrain earnings management activities. According to BRC (1999, p.22) “several recent studies have produced a correlation between audit committee independence and the two desirable outcomes: a higher degree of active oversight and a lower incidence of financial statement fraud”. Further, they should enhance the effectiveness of both internal and external auditors (Simnett et al., 1993). Further evidence is now being reported that audit committee characteristics are important in explaining, inter alia, cross-sectional differences in financial reporting quality (Wright, 1996; Klein 2000; Abbott, Park and Parker, 2000; Abbott, Parker and Peters, 2000; Parker, 2000.

Ultimately, understanding audit committee member judgments is, in itself, a large and important task, whose importance is magnified by the current pressure to increase the quantitative and qualitative scope of audit committees’ oversight responsibilities magnifies the task’s importance. This study provides an initial attempt to evaluate whether appointment and reporting structure affect audit committee member judgment in one important oversight area for audit committees, which is acting as a mediator in the
management – auditor dispute situations. 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 effectiveness in the financial oversight process within the corporate governance structures of corporations.

Using these results, arguments over ‘what difference audit committees make in practice’ (Zaman, 2002) could be partly solved if the audit committees are made completely independent and their concern centres on improving the quality of the financial reporting process so that future corporate collapses could be avoided. The existence of an audit committee as a governance mechanism also results in better corporate performance or wealth effects for investors. As Zaman (2002, p. 7) states, “management and governance structures are intended to lead to improved control and better management practices, and this in turn could be associated with positive improvements in performance on behalf of investors”. Such research would help both practitioners and policymakers to determine ways to enhance audit committee independence and improve the reliability of financial reporting.

5.4.2 Theoretical Contribution

Agency theory view

The agency theory view of corporate governance assumes that managers act from self-interest, which 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 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 both to be independent from the management and 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 whom 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). Much of the research to date has been developed around theories of existence of audit committees but this research has given greater attention to possible theories of operation.

Prior studies have identified the independence of the audit committee members (for example, Abbott et al., 2000; Beasley et al., 2000; Parker, 2000; and Windram and Song, 2000). For instance, the Blue Ribbon Committee (1999) on ‘Improving the Effectiveness of Corporate Audit Committees’ has made ten recommendations to the major securities markets and the Securities and Exchange Commission, including audit committee member relationships, independence, financial literacy and expertise of members.

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 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 (FSA 11, Para, 2, 3).
In the absence of objective criteria, members appointed by the board of directors and reporting to this board of directors are more likely to make sub-optimal decisions in primary oversight domains (for example, accounting, auditing and corporate ethics) because they may lack the technical knowledge needed, fail to understand the wide range of existing and potential problems, possess inadequate problem-solving skills or lack the requisite degree of independence. Lindsell (1992, p.104) suggested:

Audit committees are only as good as their members: they will help to enhance standards of corporate governance only if they are made up of truly independent non-executive directors with the experience, the skill and the commitment to: challenge knowledgeably, incisively and fearlessly the actions and judgments of management as they relate to the financial reporting process, monitor actively management’s commitment to the maintenance of an effective system of internal control, support the auditors by encouraging them to discuss their findings and views freely; and act independently and objectively in helping to resolve differences of view between auditors and management.

Thus, to support this proposition, a similar situation arises in the political process within the organizations, where the task of the audit committee members and those interacting with them is to develop explanations, rationalizations and legitimization for the desired activities and choices, which may frequently be resolved through their structural position. The framework for alternative structure of audit committees thus recognizes the appointment and reporting structure in the audit committee process and explains two types of structural alternatives – appointment and reporting – that can be used for analyzing the audit committee process and judgments in the financial reporting process.

**New Analytical Model**

The results of the hypotheses support the proposition that to achieve more independence of audit committees in corporate governance process, a changing the structure of audit committees is required. The model shown in Figure 5.1 (refer to figure 2.2 for comparison) predicts that the independence of the audit committees will greatly enhance the role the audit committee plays in corporate governance in terms of enhancing the quality of the financial reporting process. As mainstream accountants argue, 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).

Figure 5.1: New Role of Audit Committees in Corporate Governance

Figure 5.1: New Role of Audit Committees in Corporate Governance

Source: Adopted and modified from McInnes (1993); Schilder (1996); Baker and Owsen (2001).

Keys:

- Represents the new links, as proposed, compared to the current model in Figure 2.2
- Represents the additional Independent Oversight Board to be included as part of the proposed model, compared to the current model in Figure 2.2.
As the model in Figure 5.1 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 look at the procedures of how the external auditors are being appointed by the audit committees of the corporations. This structure is in line with the findings of this research, which indicate that audit committee members tend to support the party that appoints them and to whom they have to report. As in this case, there will be unbiased judgments leading to the quality financial reporting process.

If an audit committee is 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 makes sense only 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,
Likewise, in order to achieve a high degree of independence, this research believes that the Independent oversight board other than the board of directors should execute appointment and reporting structure of the audit committees.

**Effects of Principal-Agency Relationship in Dispute Situations**

Although the Sarbanes-Oxley Act of 2002 included a number of provisions intended to address auditor independence, their substantive impact will be modest. In addition to the new oversight board, the act addresses both audit staff rotation and non-audit services. Rotation could significantly improve the overall quality of an audit and enhance the quality of the financial reporting process (Imhoff, 2003). Rotation should also offer stronger incentives for the CPA to stand up to the managers of the client-firm in any accounting dispute. Currently auditors may be reluctant to force accounting adjustments on management of client-firms due to reasons such as fear of losing the entire engagement and lack of a bright-line accounting rule that could be used to require management to change their accounting treatment. With rotation every few years, CPAs will be more inclined to act independently and require adjustments to management’s financial reports for inappropriate accounting treatments. This likelihood will be enhanced knowing that another CPA firms will be right behind them, forming an independent view on whether the treatment is appropriate. Also CPAs could be more inclined to use their professional judgment even without a bright-line rule to refute management’s treatment of a transaction (Imhoff, 2003). However, the Act does not state about the appointment and reporting structure of audit committees which could be of significant importance in the area of corporate governance.

**5.4.3 Implications for Policy and Policymakers**

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 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 US
(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 and its independence of management. It must have adequate
information to make informed judgments and it must be able to act effectively 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).
Concerns about the effectiveness of audit committees in overcoming weaknesses in corporate governance (Lee, 2001) have also been expressed by the regulators. 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 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.

Audit committees have been recommended by a wide range of professional firms, accountancy bodies and regulatory committees who have 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 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. At the present time, however, 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 Turnbull Report (1999) and OECD Principles of Corporate Governance (1999) are steps in the right direction (Baker and Owsen, 2001). Unfortunately, each of these proposals concentrates 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). From a methodological perspective, the results provided an informative extension of traditional policy capturing approaches. These results highlight the need for researchers, interest groups and policymakers to identify correctly the appointment and reporting structure of audit committees relevant to their concerns. As such, the following paragraphs discuss the implications for the society generally.

5.4.4 Implications for the Accounting and Auditing Profession

This research has implications for regulators and various stock exchanges, as they attempt to formulate future corporate governance policies. The results are 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), the Institute of Internal Auditors (IIA), the South Pacific Stock Exchange (SPSE), the Capital Markets Development Authority (CMDA) and the Companies Act (1983).

Many official organisations and bodies have proposed an important role for the audit committees in the improvement of the financial reporting and control (Kalbers and Fogarty, 1993). Their findings suggest that policy makers external to the corporations
comprehend the complexities of overseeing the overseers. Similar implications are expected from this research.

5.4.5 Implications for 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.

Prior studies (McMullen, 1996) indicate that audit committees are associated with fewer shareholder lawsuits alleging fraud, fewer quarterly earning restatements, fewer SEC enforcement actions, fewer illegal acts and fewer instances of auditor turnover when there is an auditor - client accounting disagreement.

The capacity of the institutional environment is also important for the development of sound corporate governance because it helps determine the impact achieved by the economic policies adopted by the government. In this context, the quality of governance is important in the countries concerned (such as Fiji in this study) and the ability of the governments to implement effectively the policies they have chosen. Hence, ‘getting policies right’ may not, by itself, be sufficient for successful development, if standards of governance are poor (ADB, 2002). It is for this reason that improving governance, or sound development management, is a vital concern for all governments. Therefore, good governance is required to ensure that these policies have their desired effect.
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).

5.4.6 Implications for Fijian Economy

In spite of its size, Fiji plays an important role in setting standards of corporate governance in the South Pacific region. Not only was it one of the first countries to legislate listed public companies under South Pacific Stock Exchange (SPSE) but as part of the government-led drive to become the dominant regional financial investment center, there has been considerable emphasis on the need for sound corporate governance. The Fijian economy has two major sectors, public sector and private sector. Being a developing country, Fiji is mostly dependent on the offshore investment in the private sector including multinationals and listed companies. Currently, there are only 16 listed companies in Fiji and only one of these companies has an audit committee to report to the shareholders in a wider context (this is applicable to ATH). This audit committee is named as ‘Due Diligence Committee’, which has been re-constituted as the ‘Audit and Finance Committee’. This committee is responsible for both, audit and finance matters.

Regarding the public sector, it has started to establish audit committees as part of their current restructure under the ‘Finance Management Act’. This had been a call from many years, in particular, after the collapse of National Bank of Fiji (NBF) in the mid-1990s. NBF was the government-owned National Bank of Fiji. This has been a major historical corporate collapse in the public sector in Fiji; The NBF’s collapse was largely due to poor supervision and poor corporate governance in the public sector.
Usefulness of 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 (Hong Kong Society of Accountants). 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).

Given these responsibilities of audit committees, McMullen (1996) suggested the following financial reporting consequences that should be associated with the audit committee in place at a company: (1) less incidence of intentional or unintentional inappropriate accounting measurements, (2) less incidence of intentional or unintentional inadequate accounting disclosures and (3) less incidence of management fraud and illegal acts. The results of their study indicated that audit committees are associated with fewer shareholder lawsuits alleging fraud, fewer quarterly earning restatements, fewer SEC enforcement actions, fewer illegal acts and fewer instances of auditor turnover when there is an auditor-client accounting disagreement.

These results suggest that companies with errors, irregularities and other indicators of unreliable financial reporting are less likely to have audit committees. Furthermore, the findings are consistent with the idea that audit committees, because of their ability to link various groups involved in the financial reporting process, improve the quality of financial statements and disclosures.

Concerns about the effectiveness of audit committees in overcoming weaknesses in corporate governance (Lee, 2001) have been expressed by regulators, as is evident, for example, in recent speeches by SEC Chief Accountant, Lynn Turner (2001a, 2001b). Some have argued that the adoption of audit committees may be primarily symbolic.
(Kalbers and Fogarty, 1998), that although audit committees fulfill the form of regulation in reality they often lack sufficient substance (Cohen et al., 1999) and there is need to evaluate more closely the possibility that the benefits associated with audit committees are more rhetorical than substantive (DeZoort, 1997, p.225). The incidence of corporate failures involving fraud, poor accounting, inadequate internal control and apparently ineffective monitoring by audit committees accentuate these concerns (Lee and Stone, 1997, p.100).

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 financial reporting and public accountability. In the U.S., the role of an audit committee has been subjected to consistent review/studies. Studies have been conducted with focus on making their role more effective and elevating their status to grapple with critical questions likes full disclosure, financial reporting integrity, improving corporate governance and accountability.

**Relevance of Audit Committees in Fiji**

This section of the study introduces arguments that have been advanced to promote the case for adoption of audit committees by corporations and, in particular, listed companies in Fiji, in order to set out a structure of the main aspects of corporate governance where they may be expected to have an impact. The arguments on the areas where audit committees have potential benefits or effects are taken mainly from what may be termed the ‘advocative literature’ on audit committees, which covers a broad range of largely professional publications promoting their adoption, and includes reports by accountancy bodies, professional institutes and official and governmental committees.

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.

Therefore, the benefits of an effective functioning audit committee have been identified by best practice companies. For these companies, the quality of financial reporting has improved and a climate of discipline and control greatly reduces the opportunity for fraud. Independent director judgment has been brought to bear on assessing internal control matters that are of material interest to shareholders. Also clear channels of communication could be established with external auditors. In the process, the internal audit function could also be strengthened with greater independence from management. And, in the end, proper disclosure and transparency increases public confidence in the credibility and objectivity of financial statements and of boards.
**Strength of an Audit Committee**

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.

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). Thus, effective boards and audit committees constrain earnings management activities. According to Blue Ribbon Committee (1999, p.22) “several recent studies have produced a correlation between audit committee independence and the two desirable outcomes: a higher degree of active oversight and a lower incidence of financial statement fraud”. If we accept the assertion that independence is associated with a better oversight, we expect that audit committee independence will be associated with lower levels of earnings management.

Further, they should enhance the effectiveness of both internal and external auditors (Simnett et al., 1993). However, Cohen et al. (2000) report that a number of audit practitioners involved in exploratory interviews expressed concern over the effectiveness of audit committees, with some partners suggesting that audit committees are nor powerful enough to resolve conflicts with management. It is generally argued that, for an audit committee to be effective, a majority if not all members should be independent (Cadbury, 1992) and they should have an understanding of accounting, auditing and control issues (Cohen et al., 2000; Goodwin and Seow, 2000; Hughes, 1999; Lear, 1998).

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).

This research intends to strengthen the corporate and financial governance standards in auditing and improve the overall efficiency of listed companies and private enterprises in the real and financial sectors. This will be achieved by strengthening the regulatory framework for better auditing standards and practices for audit committees in corporate governance. Generally, the roles of the audit committees and standards maintained by accounting professions are absolutely vital in entrenching sound corporate governance in the corporate sector. There is a growing interest in the effects of corporate governance on the choice of auditors and audit committees both in the private and the public sector. The role of the auditor in entrenching corporate governance is important.

Thus, this study while examining the role of audit committees in corporate governance will be able to develop knowledge and understanding of the main theoretical perspectives and frameworks of corporate governance, integrating regulatory, international, ethical, environmental and social dimensions of the role of audit committees in corporate governance. Hence, the major usefulness of this study is that it proposes an establishment of an independent audit committee for listed companies and private sector corporations in the Fijian economy by achieving benefits in terms of effective communication and audit reporting to the major shareholders in the economy. In a world of increasingly prominent cross borders flows of workers, capital, and ideas, it is unsurprising that financial
reporting practices and auditing have required a global perspective. The general scrutiny imposed on auditing practice implies its significance in the flow of trade, and as these flows have increasingly global reaches accounting practice and standards affect worldwide economic and social well being. Big global companies have become so complex that insiders are often the only people who truly understand them. It requires independent and rigorous oversight on the part of independent board to reveal any irregularity. Yet, many audit committees do not exercise the diligent oversight. Governance experts say that the audit committee’s lack of independence made it less inclined to question management (Hussain, 2002).

In today’s global business environment, there is increasing focus on organizational behaviour. For example, regarding how the boards of directors discharge their duties and regarding the integrity of information reported to shareholders and the investing public. Given this, and to enhance Fiji’s position as a potential regional financial hub, Fiji has to establish standards comparable with corporate governance principles and practices in the United States, Britain and Australia. And as a result, Fiji has to establish audit committees, which should be made mandatory committee required by law, at least in listed companies. Such calls could be supported by the recent interest in corporate governance which has pushed audit committees further into the spotlight, for instance, in case of Singapore, which has an effective audit committee crucial in enhancing the corporate governance practices of a company (Wallace, 2001).

Finally, it is a hope that this study will facilitate the setting up of international collaboration to approach the auditing issues in corporate governance, in particular setting up of audit committees in listed companies and other large private sector corporations in Fiji. The appointment and reporting structure of the audit committees needs to be directed by the Independent oversight board. 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 financial reporting and public accountability. This subject has acquired a completely new dimension and wider interest and we can no longer avoid it.
5.5 Recommendations

5.5.1 Recommended Changes to Corporate Boards

Imhoff (2003) strongly argued that the influence of top management over the composition of the corporate board seems contrary to effective corporate governance, because if the corporate board oversees management on behalf of the shareholders, then why does management sit in such a position of importance on the board of directors? Why does the CEO nominate people to serve on his or her own oversight board? Adding to problems of board independence is the fact that the corporate board members are frequently compensated with stock options. Options provide incentives not to face up to setbacks in a firm’s performance. What kind of incentives do options create for corporate boards? How can such corporate boards make the audit committees advocate for transparency and full disclosure in financial reporting? This is the reality of corporate governance in the US today, and it provides the opportunity for major problems with the system of checks and balances (Imhoff, 2003).

One key to increasing public confidence in financial statements is to have more direct involvement of boards of directors in the auditing process and the integrity of the reported financial information. The proposed initiative in this study should take the lead at improving our governance system. In particular, prohibiting the board of directors from appointing audit committee members themselves; and as Imhoff (2003) has proposed these suggestions to SEC such as, prohibiting the CEO or any other past or current top manager of the corporation from acting as the chairman of the corporate boards from being involved in any way in the nomination of directors or from being responsible for setting the board’s agenda and meeting requirements; prohibiting all outside directors from holding stock options in any entity whose board of directors are a member; and make these board members consist of outside directors who have not been employed or had significant business relationships with the corporation or its top executives.
These suggestions would enhance the independence and competence of corporate boards of directors and represent shareholders’ interests more effectively. Also corporate managers should be called upon to report to the board of directors whenever necessary, but corporate managers do not need to – indeed, should not - chair the board, control the agenda of board meetings, or guide the nomination of new board members. These are all activities that independent outside directors should manage. These changes would enhance the ability of corporate boards to govern corporations in the interests of shareholders. It will address issues related to governance: management has too much influence over the composition and conduct of corporate boards and corporate board members are not competent and/or independent enough to prevent opportunistic management behaviour at the expense of shareholders (Imhoff, 2003).

Shareholders will need to exercise more control over CEOs, to reexamine their relationships with top managers and to urge legislators to change the legal regulation of corporations to provide for adequate independent oversight mechanisms and the ability to control corporations and the managers who lead them. Therefore, suggested improvements in corporate governance such as the Cadbury Committee Report (1992), The Turnbull Report (1999) and the OECD Principles of Corporate Governance (1999) are steps in the right direction. Some of these proposals could be embodied in partial form in various countries’ corporations’ laws. For instance, as recommended in the ICAS document, two-tier boards of directors, comprising a supervisory board and a managing board, are mandated under the company laws of several countries including Germany and The Netherlands. Realigning the focus of the audit committees towards the interests of a wide range of stakeholders, combined with the suggested changes from the ICAS document, may be the way forward towards strengthening the role of audit committees in corporate governance.

As Imhoff (2003) has proposed a continuing education requirement for all outside corporate board members, a similar approach could be mandated to audit committees, to help the members keep abreast of the rapidly changing nature of business since we are in a knowledge revolution where the best practices in business are in a continuous state of
change. Too few senior business leaders make the time to keep abreast of current developments in finance, financial reporting, governance and changing demographic trends in business and industry. For example, a recent *Economist* (2002) article discusses CEOs who claimed to have not understood the accounting problems at their companies.

Audit committees should be called on to report to the board of directors whenever necessary but audit committees do not need to be appointed by this board. Similarly, corporate managers should be called on to report to the board of directors whenever necessary, but corporate managers do not need to chair the corporate board, control the agenda of board meetings, or guide the nomination of new board members. These are all activities that independent outside directors should manage (Imhoff, 2003).

### 5.5.2 Establishment of Independent Oversight Board

There is a strong need for the establishment of an Independent Oversight Board. According to the requirements of the Sarbanes - Oxley Act (2002), the new Public Company Accounting Oversight Board (PCAOB) has 5 members and has been appointed by the SEC. It is funded by publicly traded companies. However, it is unclear how this board will differ from the POB in any substantive way and it remains to be seen whether a 5 - member board can effectively oversee all accounting in public companies, when the SEC has failed to do so (Imhoff, 2003).

This commentary attempts to make the case that governance problems are, in fact, the weakest link in addressing the problems related to accounting quality and the integrity of today’s financial reporting system. In addressing problems that have been largely blamed on accounting quality and auditing, we must first address the weaknesses of corporate governance. These governance problems can be addressed with insightful leadership from professional bodies such as PCAOB. More explanations are provided in the following sections (Sec.) extracted from the Sarbanes - Oxley Act (2002).
Sec. 101 Public Company Accounting Oversight Board (PCAOB)

This PCAOB is established to oversee the audit of public companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest 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 Board shall be a body corporate, operate as a non-profit corporation. The Board shall register public accounting firms that prepare audit reports for issuers; establish or adopt, by rule, auditing, quality control, ethics, independence and other standards relating to the preparation of audit reports for issuers; conduct inspections of registered public accounting firms; conduct investigations and disciplinary proceedings concerning and impose appropriate sanctions; perform such other duties or functions as the Board determines are necessary or appropriate to promote high professional standards among and improve the quality of audit services offered by registered public accounting firms or otherwise to carry out this Act in order to protect investors or to further the public interest; enforce compliance with this act, the rules of the Board, professional standards and the securities laws relating to the preparation and issuance of the audit reports and the obligations and liabilities of the accountants; and to set the budget and manage the operations of the Board and the staff of the Board (H.R.3763-6/7).

In addition, the Board shall have 5 members, appointed from among prominent individuals of integrity and reputation who have a demonstrated commitment to the interests of investors and the public, and an understanding of the responsibilities for and nature of the financial disclosures required of issuers under the securities laws and the obligations of accountants with respect to the preparation and issuance of audit reports with respect to such disclosures. Two members of the Board shall be certified public accountants, provided that if 1 of 2 members is the chairperson, he or she may not have been a practicing certified public accountant for at least 5 years prior to his or her appointment to the Board. Each member of the Board shall serve on a full-time basis and may not, concurrent with service on the Board, be employed by any other person or engage in any other professional or business activity. No member of the Board may share
in any of the profits of, or receive payments from a public accounting firm, other than fixed continuing payments (H.R.3763-7).

**Sec.101 (E) (4) Appointment of Board Members**

The Commission shall appoint the chairperson and other initial members of the Board, and shall designate a term of service for each. A vacancy on the Board shall not affect the powers of the Board but shall be filled in the same manner as provided for appointments. The term of service of each Board member shall be 5 years and until a successor is appointed except that the terms of the office of the initial Board members (other than the chairperson) shall expire in annual increments, 1 on each of the first 4 anniversaries of the initial date of appointment; and any Board member appointed to fill a vacancy occurring before the expiration of the term for which the predecessor was appointed shall be appointed only for the remainder of that term. No person may serve as a member of the Board, or as the chairperson of the Board, for more than 2 terms, whether or not such terms of service are consecutive. A member of the Board may be removed by the Commission from office for good cause shown before the expiration of the term of that member (H.R.3763-8).

**Sec. 301 Public Company Audit Committees**

The audit committee of each issuer, 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 (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or related work, and each such registered public accounting firm shall report directly to the audit committee. Each member of the audit committee of the issuer shall be a member of the board of directors of the issuer, and shall otherwise be independent. In order to be considered to be independent, a member of the audit committee of an issuer 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 issuer; or be an affiliated person of the issuer or any other subsidiary thereof.

Each audit committee shall establish procedures for the receipt, retention and treatment of complaints received by the issuer regarding accounting, internal accounting controls or auditing matters and the confidential anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters. Each audit committee shall have the authority to engage independent counsel and other advisers, as it determines necessary to carry out its duties. Each issuer shall provide for appropriate funding as determined by the audit committee in its capacity as a committee of the board of directors for payment of compensation to the registered public accounting firms employed by the issuer for the purpose of rendering or issuing an audit report and to any advisers employed by the audit committee (H.R.3763-32/33).

5.5.3 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.

Mandating a continuing education requirement would also help directors keep abreast of the rapidly changing nature of the business. We are in a knowledge revolution where the
best practices in business are in a continuous state of change. Senior leaders should make the time to keep abreast of current developments in finance, financial reporting, governance and changing demographic trends in business and industry. A recent Economist (2002) article discusses that CFOs of today are much less competent in accounting issues than prior generations of CFOs due to their background.

Debates among mainstream researchers about corporate governance 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 Turnbull 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, but by the Independent oversight board which also sets the compensation rate. 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 the 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 shareholders’ return on investment. Shareholders need to exercise more control over CEOs; to reexamine their relationships with top managers; and 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).
5.6 Limitations of the Research Study

A discussion of the results of this study should be made in the context of this study’s unique limitations. Therefore the following are the limitations of this study.

5.6.1 Participant Weakness

A major limitation of this study is that the research design asked most of the participants to *role-play* as members of an audit committee and it is therefore possible that they did not respond as members of the audit committee so it is possible that their responses lack some authenticity. As previously discussed, this is even more likely in the Fiji context where there are only few audit committees in the private sector corporate enterprises. However, as any bias resulting from role-playing would presumably work against finding significant differences between boards of directors, a possibility remains that the design did not fully capture the true extent of the differences between the four treatment groups.

The use of *board of directors* as the criterion group should be considered in the context of the task domain selected for this study. It is important not to over - generalize the results because boards of directors are probably not an appropriate benchmark for all audit committee oversight tasks. In addition, although board of directors training and experience related to audit make them seem an appropriate criterion group, it is important to remember that potential biases and perceptual dilemmas can affect audit committee members’ judgment.

It is however, difficult to draw general conclusions from these survey studies since the observed effects can be due to the fact that the subjects’ attention was drawn specifically to the existence of an audit committee, or otherwise, and may not represent normal decision processes in practice. Extant audit committee studies are often based on large samples, utilizing publicly available and or questionnaire data and rarely attempt to reflect the reality of audit committee operation and effects. A similar approach has been
used in this research; however, the effects of audit committees cannot be adequately investigated using solely questionnaire surveys and analysis of databases (Zaman, 2002).

Studies of this kind, which show variances between different levels of appointment and reporting structure and the quality of financial reporting, cannot detect a true causal relationship. In addition, it is very difficult to detect when the audit committee was established, relative to the changes in the appointment and reporting structure, using hypothetical data. While the results of this study are consistent with causality, it is possible that another variable not included in this study, such as the corporate operating environment, causes both the changes in the appointment and reporting structure and more reliable financial reporting. For example, the management of some companies may consider financial reporting more important than the management of other companies and, thus, develop better controls including the establishment of an audit committee.

5.6.2 Weaknesses on Characteristics of Audit Committee

Furthermore, this study examines the impact of changes in the appointment and reporting structure of audit committees and its effect on the financial reporting process, it does not consider any of the attributes or characteristics of audit committees that contribute to improving the quality and credibility of the financial reporting process.

What is not resolved by the studies on reporting quality is whether the improvements in financial reporting are specifically due to the existence of audit committees or a product of other corporate characteristics? A particularly interesting finding relating to this is that the presence of audit committees does not significantly affect the likelihood of fraud (Beasley, 1996). Therefore, general evidence on the link between audit committee presence and more recently, characteristics, and financial reporting quality raises some important questions. Similarly, although the research on board composition suggests that audit committees, as a sub-committee of the board, may fulfill a useful role, they do not provide direct evidence of audit committee effect on corporate performance (Zaman, 2002).
Moreover, extant research provides very little understanding of the processes through which governance structures affect financial reporting quality and corporate performance. While there is some evidence of a correlation between financial reporting characteristics and governance arrangements, however, further research is necessary to establish issues relating to the processes and impact unique to audit committees. It is also important to establish whether the effects on financial reporting and corporate performance are simply due to the mix of insiders and outsiders on the board or whether particular governance structures such as audit committees really make a difference (Zaman, 2002).

Furthermore, it is important to be clear whether particular benefits or effects are due to the existence of appointment and reporting structure or if they are a result of other features of corporate governance. Positive findings on this issue could imply that audit committees, being a subcommittee of the board, but being independent (appointed by the Independent oversight board and reporting to the Independent oversight board) might lead to improvements in the financial reporting process. However, results of this nature are consistent with the proposition that audit committees do perform an important role in corporate governance and serve the interests of shareholders.

In addition, this study is limited to the extent that other elements of audit committee member expertise (for example, knowledge and ability) and judgment performance (such as stability and hypothesis generation) are not captured. For example, the effects of accounting and auditing knowledge on members’ considerations of auditor-management disagreements represent an important area for future research. This study examined judgments at the individual level, even though audit committees are supposed to function as groups. The results of this study should not be used to make inferences about group interaction and the process loss or gain that may occur in audit committee meetings.

Some have cast doubt on the ability of audit committees to improve auditor independence, arguing that ‘in respect of financial reporting matters, we now have audit committees forming opinions of (accounting) opinions rather than opinions based on
dated financial facts (Zaman, 2002). Given this, the claim that audit committees enhance the technical quality of financial statements is nonsense’ (Wolnizer, 1995, p.63).

Rosentein and Wyatt (1990) provided evidence that outside directors are viewed as likely to act in the interests of shareholders. However, this research contemplates that if there is an outside Independent oversight board which appoints (and to whom the audit committee reports) audit committees would be more independent.

5.6.3 Experiment Weakness

There are a number of other limitations, which should be borne in mind when interpreting the findings of this study. Some of the non-significant results relating to the appointment and reporting structure of the audit committees may stem from the fact that, even in the weak condition, the audit committee still met the minimum criteria set down in the legislative and listing requirements of countries. As a result the manipulation of this variable may not have been strong enough. In addition, the small sample size may have led to insignificant interaction effects between the variables tested. On the other hand, multiple testing of the dependent variables may have resulted in some significant findings being reported purely by chance. There is also a risk of non-response bias, although tests suggest that this is likely to be minimal.

The experiment was not undertaken in a controlled environment and this could have resulted in demand effects from participants either guessing the manipulations or comparing instruments with peers. Some respondents may have not taken the study seriously or may not have completed the instrument themselves. It is hoped that this problem would be minimized by the fact that participants are professionals whom we assume would act with integrity. As participation in this study involved effort and time, the most obvious outcome if a person did not take the study seriously would be a non-response.
5.6.4 Respondent Weakness

Further, the respondents may not be a representative of their respective groups and there may also be cultural characteristics associated with directors in Fiji that limit the generalisability of the results to other jurisdictions. Hence, it is possible that differences in perceptions resulting from appointment and reporting structure were not adequately captured in this study.

5.6.5 Company Specific Variables

Finally, the results of this study apply only to companies with errors and irregularities and those companies having top level of management in their boards. One may not be able to generalize these findings to companies with fully independent audit committee members as part of their corporate governance structure. The results should be interpreted with careful considerations of the notable demographic area chosen (such as most participants were from ‘Fiji Islands’ in this study). Although tests for age and gender effects indicated no significant problems, the possibility exists that the differences in age and gender could explain some of the results. It is important not to overgeneralise the results because boards of directors are probably not an appropriate benchmark for all audit committee oversight tasks.

These limitations then provide us with some opportunities and implications for further research as covered in the next section.
5.7 Implications for Further Research

Despite these limitations, the results provide support for the two hypotheses, indicating that appointment and reporting structure of audit committees makes a difference in audit committee member judgment on an accounting policy dispute task. Of primary importance, audit committee members appointed by board of directors and reporting to the board of directors made the accounting policy dispute judgment more like those in favour of management than those appointed by the Independent oversight board and reporting to the Independent oversight board made judgments in favour of the auditors.

However, the nature of judgment differences in this study certainly warrants further consideration. For example, it is interesting to note that audit committee members appointed by the Independent oversight board and reporting to the Independent oversight board tended to be far more critical in their assessments than were other groups. If audit committee members appointed by an Independent oversight board and reporting to this Independent oversight board tend to be more critical or cautious in their approach to a problem, they may in fact be effective contributors to the overall audit committee effort. Future research should continue to investigate whether and when appointment and reporting leads to cautiousness in oversight and how such as result affects audit committee effectiveness and efficiency. Additional work in the area is also needed to evaluate whether this type of finding is task specific or common across the diverse range of audit committee duties.

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 hypotheses warrants further research. Audit committees do not operate in a vacuum and their operation and effects cannot be adequately examined without regard to the organizational context in which they function and power relationships that 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. Audit committee effects need to be examined in the context in which they operate so that due account can be taken of the relational dynamics in and around the audit committee, and the interaction of the audit committee with other internal structures of the entity. It should also be recognized that the personalities of the audit committee members, particularly that of the audit committee chair, and the underlying corporate culture are important factors affecting the operation and effects of audit committees (Zaman, 2002). Other features such as the character and operations of audit committees may be fruitful areas for research into the conditions under which the anticipated benefits of audit committees can be realized.

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 utilize 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. This study has argued that the appointment and reporting structure of audit committees has been predominantly examined from an agency perspective. Notwithstanding the volume of academic research, understanding of audit
committee structure in corporate governance has been largely limited due to the myopic adoption of agency perspective and quantitative methods. As an alternative to the agency perspective, future research should seek to develop a framework for conceptualising corporate governance mechanisms, such as audit committees. The framework should focus attention on the role of the power relationships conditioning audit committees’ institutional and technical environment. Therefore, an alternative framework for conceptualizing audit committee appointment and reporting structure should be drawn upon institutional and power perspectives.

The intentional or unintentional omission of variables from the experimental testing might have affected not only the presence of the appointment and reporting variable but also the quality of financial reporting. Future research should be concerned with finding ways to operationalize factors such as the organizational environment and the influence of the audit committee chairperson with respect to audit committee effectiveness.

As such, this study has highlighted many opportunities for future research. The impact of respondents’ experience on their perceptions could be explored more fully. Studies could also examine other variables that were not tested in this study, for example, external auditors offering management advisory services. Further investigation into the effectiveness of the appointment and reporting structure of audit committees is needed in order to explain some of the inconclusive results of this study.

Finally, a more in-depth investigation of the variables in the 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.
5.8 Conclusion of the Research Study

In the introduction to this study, 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 appointment and reporting variable has a significant effect on the judgment of the audit committees. In addition, the findings revealed that an audit committee appointed by the Board of directors and reporting to the Board of directors is more likely to support management in auditor-management dispute cases compared to an audit committee appointed by the Independent oversight board and reporting to the Independent oversight board which will support the auditor in such dispute cases. The findings also revealed that an audit committee appointed by and reporting to the Independent oversight board has less variations in their results thus, indicating that they provide an accurate and independent judgment leading to improvements in the financial reporting process compared to an audit committee appointed by and reporting to the Board of directors.

However, there were no significant interaction effects. The empirical research related to audit committee processes such as the interaction between audit committees, management, and 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.

By examining the views of the board of directors who are heavily involved with corporate governance in Fiji, this study has provided insights into the perceived effectiveness of certain corporate governance mechanisms in enhancing both financial reporting and audit quality. This research has contributed to the literature by focusing on mechanisms where prior research has been scarce or where research findings have been mixed. The results of the study have implications for the regulators and others who are
concerned with establishing guidelines and listing rules pertaining to corporate governance, especially in developing capital markets.

A strong audit committee was found to have a significant impact on audit effectiveness, on errors in financial statements and on the detection of management fraud (Goodwin and Seow, 2002). It appears that more emphasis may need to be placed in legislating companies to establish their audit committees and to ensure that a strictly enforced code of conduct and audit committee charter is in place. However, different perceptions of audit committee members and directors should be borne in mind when making recommendations. As this study has indicated, the preferred governance mechanisms may reflect a different emphasis on control issues, with audit committees favouring mechanisms that would reduce the risk of fraudulent financial reporting and directors favouring mechanisms that enable them to monitor and control more directly the behaviour of management and employees.

Even in the developed world, the role of audit committees 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 fulfil this kind of expectation for lack of expertise in the field of financial management, which has been growing in complexity.

Studies have been conducted with a focus on making their role more effective and elevating their status to grapple with critical questions likes full disclosure, financial reporting integrity, improving corporate governance and accountability. The boards of directors in most companies may not have the time in possess the expertise to ensure reliability and integrity of financial reporting for public, therefore, what they need to do is to set up an independent audit committee to discharge their responsibility.

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 be part of the audit function both internal and the external to be an effective arm of the corporate governance. Another precondition 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. In addition, Price Waterhouse (1997) (quoted in Zaman, 2002, p.7) asserts that:

Increasingly, companies will be expected to demonstrate good governance in order to access the world’s capital markets. The fact that a company has an audit committee may boost investor confidence in its governance practice.

However, existence does not constitute effectiveness, and the mere formation of an audit committee does not mean that boards of directors actually rely on audit committees to enhance their monitoring ability (Menon and Williams, 1994). Other factors such as audit committee composition and the frequency of audit committee meetings have been used as potential indicators of audit committee impact in practice. It is also argued that an audit committee enhances the independence of the auditor from management, which in turn can be important in protecting the auditor from allegations of inadequate auditing associated with business failure or fraud (Mautz and Neumann, 1970).

Therefore, responsible parties need to act more responsibly. The SEC is ultimately the responsible authority for oversight of the world capital markets, the financial reporting process and the enforcement of the current standards and rules pertaining to them in the international arena. Although audit committee effectiveness has been examined in many ways, researchers, practitioners, and policymakers argue that the construct is multidimensional. In particular, the extant literature involving audit committee effectiveness examines a variety of dimensions such as independence, diligence, committee size, the number of committee meetings, the length of meetings, conformity with prescribed standards and management cooperation.
In addition, the results reported for this study mostly apply to companies without audit committees so that these companies may take into consideration the proposed appointment and reporting structure of audit committees to minimize errors and irregularities that may not be detected or reported otherwise. However, one may not be able to generalize these findings to companies with audit committees and/or companies with errors or irregularities.

Collectively, this study provides some initial empirical evidence addressing a primary area of concern related to the audit committee structure. In particular, the results support suggestions that improving the appointment and reporting structure of audit committees can make a difference in the financial statements and thereby, improve the financial reporting process. The results related to judgment provide some limited support for concern that ‘judgment by audit committee members may be constrained by their education and experience’ (Wolnizer, 1995, p.22). With this in mind, the findings also suggest that considerations of audit committee structure, both actual and the proposed should be tempered with assessments of the specific type of audit committee needed. 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 support 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.

Ultimately, these findings supplement anecdotal thought and survey-based research in the area of independence of audit committees in corporate governance. In particular, this study showed that the appointment and reporting structure of audit committees have a significant effect on their judgment in the auditor – management dispute situation.
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APPENDIX A
A Research Questionnaire – Treatment 1

Audit Committee Members and Financial Reporting Oversight

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General Instructions

- The questionnaires asked below and the responses I will get will be treated as strictly confidential.
- Please answer the attached questions in the order they are asked.
- Do not change any answer once you’ve written it, otherwise it will become null and void.
- Please answer on your own, without discussing the questions with anyone.
- There will be space at the end for you to provide any clarifications you would like to make to your answers.
- You may refer to other source materials you consider helpful in answering the questions.

Table of Contents

1. Case – E-Man Technology Inc. accounting policy choice and the audit committee
2. Demographic information

Thank you in advance for completing this questionnaire.
1. Case – E-Man Technology Inc. accounting policy choice and the audit committee

E-Man Technology Inc.

Background

E-Man Technology Incorporation is an electronics retailer that sells and services stereos, radios, televisions, and computers. This case focuses on a dispute between E-Man’s management and the external auditors about the timing of revenue recognition and associated expenses under a new pricing policy for combined extended warranty/product sales. As a member of the E-Man audit committee you have been informed that this issue will be discussed at the next audit committee meeting.

E-Man operates in a very competitive market and has worked hard over the years to develop a competitive advantage. In a recent move to distinguish itself from the competition, the company started selling all electronic products with an in-house extended warranty (beyond the manufacturer’s warranty) at prices slightly above the product prices offered by competitors. Previously, E-Man sold an extended warranty on a commission basis from a third party vendor who assumed all warranty related costs. Sales of this third party extended warranty were high with more than 50% of customers buying the extended warranty. Under the new sales plan, E-Man now sells both product and its own extended warranty as one transaction to every customer.

In previous years, E-man had recognized revenue from the product sales when the retail customer purchased the merchandise. E-Man also immediately recognized as revenue its commission on any extended warranty sale. These policies have been followed consistently for the five years that the company has been publicly traded. When E-Man started including an extended warranty with the product sale this year, the company continued to immediately recognize all revenue. To match expenses with revenue, the company recorded the amount of estimated warranty expense that would be incurred over the life of the extended warranty. See Exhibit 1, column A for selected financial data prepared following this revenue recognition policy.

The Chief Financial Officer of E-Man believes that this accounting policy is appropriate because it meets the matching principle as all costs are matched with the revenues they generate. Further, he believes it is consistent with the previous policy that recognized all product revenue and warranty revenue at the time of sale.

The Auditor’s Position

The company’s long time auditors have objected to the company’s accounting policy. The auditors argue that the company is selling two different products, the electronic equipment and the extended warranty, for one price. They argue that the price must be separated between the two products and appropriate revenue recognition policies must be developed for each product’s revenue. In particular, the auditors are concerned that the accounting policy is not appropriate when it comes to recording the extended warranty
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Based on the auditors’ analysis of the authoritative literature, they feel that the company is taking an inappropriately aggressive approach to revenue recognition with respect to recognizing extended warranty revenue. The auditors propose that the warranty revenue be separated from the product sales revenue and that the warranty revenue be deferred and recognized into income over the extended warranty contract period. Such a change would result in a significant (and material) deferral of revenue and associated expenses in the current year. Exhibit 1, column B shows the net effects of the auditor’s proposed changes on selected financial statement amounts. In summary, E-Man’s liabilities would increase and net income would decrease.

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The Chief Financial Officer (CFO) argues strongly that the auditor’s proposed revenue recognition policy would be misleading to the readers of the financial statements. In particular, the CFO argued that the company already has received the cash, can estimate what warranty expenses will be on average and therefore, can reasonably estimate the profit on the extended warranty contract. He contends that the auditor’s proposed accounting policy would delay the recognition in the financial statements of a significant change in the company’s marketing strategy. In addition, the auditor’s proposed policy would result in a breach of a long-term debt covenant concerning the debt to equity ratio.
The effects of this covenant breach on the operations of E-Man cannot be ascertained in advance.

The auditors have completed their audit in all other respects but cannot reach agreement with company management on the revenue recognition policy issue. As a member of the audit committee, you are now considering your position with respect to this disagreement.

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**E-man Technology Inc.**
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<thead>
<tr>
<th></th>
<th>Column A</th>
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</tr>
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<tbody>
<tr>
<td><strong>Current revenue recognition policy</strong> ($000’s)</td>
<td></td>
<td></td>
</tr>
<tr>
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</tr>
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<td>112,300.00</td>
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</tr>
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<td></td>
<td></td>
</tr>
<tr>
<td>EPS ($ per share)</td>
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<td>0.23</td>
</tr>
<tr>
<td><strong>Operating ratio</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debt to equity</td>
<td>0.73</td>
<td>0.75</td>
</tr>
</tbody>
</table>
Questions

Considering Your Position

Assuming that, at present, you are one of the boards of directors of E-Man Technology Incorporations’ Board and you have been duly appointed by the Board of directors (Board) as one of the three audit committee members to serve on the Boards audit committee. You are also required to report to the Board of directors based on all proceedings and deliberations of the audit committee.

You may not, other than in your capacity as a member of the audit committee, the board of directors or any other board committee accept any consulting, advisory or other compensatory fee from the company or be an affiliated person of the company.

Along with your appointment and termination, the board of directors will evaluate your performance. Assume the case is neutral as can be expected from any dispute between the auditor and the management.

Question 1:

Based on the above information, whose position will you support at the audit committee meeting? Please respond on the following 7-point scale by placing a circle (○) on the numbers. Numbers -1 to -3 denotes that you will support the management’s position while numbers 1 to 3 denotes that you will support the auditors’ position in the dispute. The ascending order of numbers denotes the extent to which you will support the management and the auditors. Zero (0) will mean that you are uncertain to make decision as to whom to support.

<table>
<thead>
<tr>
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<tr>
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</tr>
<tr>
<td>Certain</td>
<td>Highly Probable</td>
<td>Probable</td>
</tr>
</tbody>
</table>

Tend to support management’s position  Tend to support the auditor’s position
Please rate your knowledge/ability, in the context of your peers, for questions 2 to 4 on the following 7-point scale by placing a circle (○) on the numbers.

**Question 2**

What level of financial accounting knowledge, that is, about how business activities are represented in financial statements do you consider in your position.

Low knowledge                      High Knowledge

<p>| |</p>
<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td>○</td>
</tr>
<tr>
<td></td>
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<tr>
<td>-3  -2  -1  0  1  2  3</td>
</tr>
<tr>
<td>Certain Highly Probable Probable Uncertain Probable Highly Probable Certain</td>
</tr>
</tbody>
</table>

**Question 3**

What level of financial statement analysis knowledge, that is, knowledge needed to analyze and interpret information contained in financial statements is needed for the case presented.

Low knowledge                      High Knowledge

<p>| |</p>
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<thead>
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<th></th>
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</thead>
<tbody>
<tr>
<td>○</td>
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<tr>
<td></td>
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<td>-3  -2  -1  0  1  2  3</td>
</tr>
<tr>
<td>Certain Highly Probable Probable Uncertain Probable Highly Probable Certain</td>
</tr>
</tbody>
</table>

**Question 4**

What level of auditing knowledge, that is, knowledge about the auditor’s responsibilities, the types of audit reports issued, and the audit report’s meaning is required in the case presented.

Low knowledge                      High Knowledge

<p>| |</p>
<table>
<thead>
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<tbody>
<tr>
<td>○</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>-3  -2  -1  0  1  2  3</td>
</tr>
<tr>
<td>Certain Highly Probable Probable Uncertain Probable Highly Probable Certain</td>
</tr>
</tbody>
</table>

175
Please respond to questions 5 to 8 on the following 7-point scale by placing a circle (〇) on the numbers. Zero (0) denotes where you are not sure of the response, -1 to -3 denotes negative response and 1 to 3 denotes a positive response to the particular aspect.

**Question 5:**
To what extent did you understand this case?

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<thead>
<tr>
<th></th>
<th>Tend to have no understanding</th>
<th>Tend to totally understand</th>
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<td>Highly Probable</td>
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<td>Certain</td>
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</table>

**Question 6:**
How realistic was this case?

<table>
<thead>
<tr>
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<th>Very unrealistic</th>
<th>Very realistic</th>
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<tr>
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**Question 7:**
How important was the case to you for you to be able to justify the position you took in this case?

<table>
<thead>
<tr>
<th></th>
<th>Very Unimportant</th>
<th>Very Important</th>
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</thead>
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<tr>
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</tbody>
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Question 8:

How difficult was it to make your judgment in this case?

<table>
<thead>
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<th>2</th>
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<td>Uncertain</td>
<td>Probable</td>
<td>Highly Probable</td>
<td>Certain</td>
</tr>
</tbody>
</table>

Demographic information

Question 9:

Work experience: please check (in terms of ‘yes’ or ‘no’) all that apply to you.

President of a corporation
Senior executive of a corporation
Former holder of public office at provincial/federal level
Former senior civil servant
Former auditor

If so, how long since you last were an auditor? _____ years

Other: ________________________________

Question 10:

Corporate governance experience: please check all that apply to you.

a. Number of boards of directors you serve on currently. _____
b. Number of boards of directors you are an independent member. _____
c. Total number of years that you have been a board of directors’ member. _____
d. Number of audit committees you serve on currently. _____
e. Total number of years that you have been an audit committee member. _____
f. Have you ever served on an audit committee of a company for which
you were also a member of senior management? Yes____ No___
g. Approximate total assets of the largest company for which you are an independent director. $__________

**Question 11:**

Please indicate the following by writing in the box:

**AGE:**

**GENDER:**

**Question 12:**

Please tick (✓) all that apply to you.

**EDUCATION:**

☐ Undergraduate degree(s) in ____________________________

☐ Graduate Bachelors degree(s) in ____________________________

☐ Masters degree in ____________________________

☐ PhD in ____________________________

☐ Professional designation in accounting (e.g., CA, CMA, CGA, CPA, etc.), Specify the designation and the country obtained from ____________________________

☐ Any other, Please specify ____________________________

Thank you very much for your assistance with this research.
A Research Questionnaire – Treatment 2

Audit Committee Members and Financial Reporting Oversight

Researcher: Veer Singh Varma, Department of Accounting & Financial Management, University of the South Pacific, Suva, Fiji Islands. Email: varma_v@usp.ac.fj

General Instructions

- The questionnaires asked below and the responses I will get will be treated as strictly as confidential.
- Please answer the attached questions in the order they are asked.
- Do not change any answer once you’ve written it, otherwise it will become null and void.
- Please answer on your own, without discussing the questions with anyone.
- There will be space at the end for you to provide any clarifications you would like to make to your answers.
- You may refer to other source materials you consider helpful in answering the questions.

Table of Contents

1. Case – E-Man Technology Inc. accounting policy choice and the audit committee

2. Demographic information

Thank you in advance for completing this questionnaire.
1. Case – E-Man Technology Inc. accounting policy choice and the audit committee

E-Man Technology Inc.

Background

E-Man Technology Incorporation is an electronics retailer that sells and services stereos, radios, televisions, and computers. This case focuses on a dispute between E-Man’s management and the external auditors about the timing of revenue recognition and associated expenses under a new pricing policy for combined extended warranty/product sales. As a member of the E-Man audit committee you have been informed that this issue will be discussed at the next audit committee meeting.

E-Man operates in a very competitive market and has worked hard over the years to develop a competitive advantage. In a recent move to distinguish itself from the competition, the company started selling all electronic products with an in-house extended warranty (beyond the manufacturer’s warranty) at prices slightly above the product prices offered by competitors. Previously, E-Man sold an extended warranty on a commission basis from a third party vendor who assumed all warranty related costs. Sales of this third party extended warranty were high with more than 50% of customers buying the extended warranty. Under the new sales plan, E-Man now sells both product and its own extended warranty as one transaction to every customer.

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The Chief Financial Officer of E-Man believes that this accounting policy is appropriate because it meets the matching principle as all costs are matched with the revenues they generate. Further, he believes it is consistent with the previous policy that recognized all product revenue and warranty revenue at the time of sale.

The Auditor’s Position

The company’s long time auditors have objected to the company’s accounting policy. The auditors argue that the company is selling two different products, the electronic equipment and the extended warranty, for one price. They argue that the price must be separated between the two products and appropriate revenue recognition policies must be developed for each product’s revenue. In particular, the auditors are concerned that the accounting policy is not appropriate when it comes to recording the extended warranty.
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Management’s Reaction

The Chief Financial Officer (CFO) argues strongly that the auditor’s proposed revenue recognition policy would be misleading to the readers of the financial statements. In particular, the CFO argued that the company already has received the cash, can estimate what warranty expenses will be on average and therefore, can reasonably estimate the profit on the extended warranty contract. He contends that the auditor’s proposed accounting policy would delay the recognition in the financial statements of a significant change in the company’s marketing strategy. In addition, the auditor’s proposed policy would result in a breach of a long-term debt covenant concerning the debt to equity ratio.
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Management | Uncertain | Auditor
---|---|---
-3 | -2 | -1 | 0 | 1 | 2 | 3
| Certain | Highly Probable | Probable | Uncertain | Probable | Highly Probable | Certain

Tend to support management’s position

Tend to support the auditor’s position
Please rate your knowledge/ability, in the context of your peers, for questions 2 to 4 on the following 7-point scale by placing a circle (Ο) on the numbers.

**Question 2**

What level of financial accounting knowledge, that is, about how business activities are represented in financial statements do you consider in your position.

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<thead>
<tr>
<th>Low knowledge</th>
<th>High Knowledge</th>
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<tbody>
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**Question 5:**

To what extent did you understand this case?

Tend to have no understanding Tend to totally understand

<table>
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<th>-3</th>
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<th>0</th>
<th>1</th>
<th>2</th>
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</table>

**Question 6:**

How realistic was this case?

Very unrealistic Very realistic

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<td>Uncertain</td>
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<td>Certain</td>
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</table>

**Question 7:**

How important was the case to you for you to be able to justify the position you took in this case?

Very Unimportant Very Important

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<tr>
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<td>Probable</td>
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**Question 8:**

How **difficult** was it to make your judgment in this case?

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**Demographic information**

**Question 9:**

Work experience: please check (in terms of ‘yes’ or ‘no’) all that apply to you.

- President of a corporation  
- Senior executive of a corporation  
- Former holder of public office at provincial/federal level  
- Former senior civil servant  
- Former auditor  

  If so, how long since you last were an auditor? _____ years

Other: ____________________________________________

**Question 10:**

Corporate governance experience: please check all that apply to you.

  a. Number of boards of directors you serve on currently. _____
  b. Number of boards of directors you are an independent member. _____
  c. Total number of years that you have been a board of directors’ member. _____
  d. Number of audit committees you serve on currently. _____
  e. Total number of years that you have been an audit committee member. _____
f. Have you ever served on an audit committee of a company for which you were also a member of senior management?  Yes___  No___
g. Approximate total assets of the largest company for which you are an independent director.  $__________

Question 11:
Please indicate the following by writing in the box:

AGE:  
GENDER:  

Question 12:
Please tick (✓) all that apply to you.

EDUCATION:

☐ Undergraduate degree(s) in ________________________________
☐ Graduate Bachelors degree(s) in____________________________
☐ Masters degree in ________________________________
☐ PhD in ________________________________
☐ Professional designation in accounting (e.g., CA, CMA, CGA, CPA, etc.), Specify the designation and the country obtained from ________________________________
☐ Any other, Please specify ________________________________

Thank you very much for your assistance with this research.
A Research Questionnaire – Treatment 3

Audit Committee Members and Financial Reporting Oversight

Researcher: Veer Singh Varma, Department of Accounting & Financial Management, University of the South Pacific, Suva, Fiji Islands. Email: varma_v@usp.ac.fj

General Instructions

- The questionnaires asked below and the responses I will get will be treated as strictly as confidential.
- Please answer the attached questions in the order they are asked.
- Do not change any answer once you’ve written it, otherwise it will become null and void.
- Please answer on your own, without discussing the questions with anyone.
- There will be space at the end for you to provide any clarifications you would like to make to your answers.
- You may refer to other source materials you consider helpful in answering the questions.

Table of Contents

1. Case – E-Man Technology Inc. accounting policy choice and the audit committee
2. Demographic information

Thank you in advance for completing this questionnaire.
1. Case – E-Man Technology Inc. accounting policy choice and the audit committee

E-Man Technology Inc.

Background

E-Man Technology Incorporation is an electronics retailer that sells and services stereos, radios, televisions, and computers. This case focuses on a dispute between E-Man’s management and the external auditors about the timing of revenue recognition and associated expenses under a new pricing policy for combined extended warranty/product sales. As a member of the E-Man audit committee you have been informed that this issue will be discussed at the next audit committee meeting.

E-Man operates in a very competitive market and has worked hard over the years to develop a competitive advantage. In a recent move to distinguish itself from the competition, the company started selling all electronic products with an in-house extended warranty (beyond the manufacturer’s warranty) at prices slightly above the product prices offered by competitors. Previously, E-Man sold an extended warranty on a commission basis from a third party vendor who assumed all warranty related costs. Sales of this third party extended warranty were high with more than 50% of customers buying the extended warranty. Under the new sales plan, E-Man now sells both product and its own extended warranty as one transaction to every customer.

In previous years, E-man had recognized revenue from the product sales when the retail customer purchased the merchandise. E-Man also immediately recognized as revenue its commission on any extended warranty sale. These policies have been followed consistently for the five years that the company has been publicly traded. When E-Man started including an extended warranty with the product sale this year, the company continued to immediately recognize all revenue. To match expenses with revenue, the company recorded the amount of estimated warranty expense that would be incurred over the life of the extended warranty. See Exhibit 1, column A for selected financial data prepared following this revenue recognition policy.

The Chief Financial Officer of E-Man believes that this accounting policy is appropriate because it meets the matching principle as all costs are matched with the revenues they generate. Further, he believes it is consistent with the previous policy that recognized all product revenue and warranty revenue at the time of sale.

The Auditor’s Position

The company’s long time auditors have objected to the company’s accounting policy. The auditors argue that the company is selling two different products, the electronic equipment and the extended warranty, for one price. They argue that the price must be separated between the two products and appropriate revenue recognition policies must be developed for each product’s revenue. In particular, the auditors are concerned that the accounting policy is not appropriate when it comes to recording the extended warranty
revenue at the time the product is sold. The auditors point to Fiji Institute of Accountants, “Fiji Accounting Standard 18 – Revenue”, Handbook, Vol. 1, Para. 22 (the primary source of written generally accepted accounting policies, GAAP, in Fiji) which states “Revenue is recognized only when it is probable that the economic benefits associated with the transaction will flow to the enterprise”. FAS 18, Para.26 also states that “when the outcome of the transaction involving the rendering of services cannot be estimated reliably, revenue should be recognized only to the extent of the expenses recognized that are recoverable”. The FIA Handbook, however, does not address the issue of combined product/extended warranty sales or even accounting for the sale of extended warranties.

Thus, auditors have examined CICA Handbook and US GAAP for this issue. The CICA Handbook Section 3400.13 (GAAP in Canada) states “Revenue from service transactions and long term contracts is usually recognized when the service or contract activity is performed.” The auditors argue that the extended warranty revenue should be deferred to future periods so that it can be matched with the future warranty expenses. However, the CICA Handbook does not specifically address this issue and thus the auditors have examined US GAAP for this issue.

US GAAP also does not directly address the issue of combined product/extended warranties sales. However, FASB Technical Bulletin 90-1, “Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts” does address the issue of how to record separately priced (from the product sale) extended warranty contracts. This bulletin stated that revenue from extended warranty contracts “should be deferred and recognized over the period of the contract” usually on a straight-line basis.

Based on the auditors’ analysis of the authoritative literature, they feel that the company is taking an inappropriately aggressive approach to revenue recognition with respect to recognizing extended warranty revenue. The auditors propose that the warranty revenue be separated from the product sales revenue and that the warranty revenue be deferred and recognized into income over the extended warranty contract period. Such a change would result in a significant (and material) deferral of revenue and associated expenses in the current year. Exhibit 1, column B shows the net effects of the auditor’s proposed changes on selected financial statement amounts. In summary, E-Man’s liabilities would increase and net income would decrease.

Management’s Reaction

The Chief Financial Officer (CFO) argues strongly that the auditor’s proposed revenue recognition policy would be misleading to the readers of the financial statements. In particular, the CFO argued that the company already has received the cash, can estimate what warranty expenses will be on average and therefore, can reasonably estimate the profit on the extended warranty contract. He contends that the auditor’s proposed accounting policy would delay the recognition in the financial statements of a significant change in the company’s marketing strategy. In addition, the auditor’s proposed policy would result in a breach of a long-term debt covenant concerning the debt to equity ratio.
The effects of this covenant breach on the operations of E-Man cannot be ascertained in advance.

The auditors have completed their audit in all other respects but cannot reach agreement with company management on the revenue recognition policy issue. As a member of the audit committee, you are now considering your position with respect to this disagreement.

### Exhibit 1
E-man Technology Inc.
Selected Financial Data

<table>
<thead>
<tr>
<th></th>
<th>Column A</th>
<th>Column B</th>
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<tbody>
<tr>
<td><strong>Current revenue</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>recognition policy</td>
<td>($000’s)</td>
<td>Effects of auditor’s proposed</td>
</tr>
<tr>
<td>($000’s)</td>
<td></td>
<td>revenue recognition policy</td>
</tr>
<tr>
<td>Revenue</td>
<td>$58,796.00</td>
<td>$54,500.00</td>
</tr>
<tr>
<td>Net income</td>
<td>2,924.80</td>
<td>1,820.00</td>
</tr>
<tr>
<td><strong>Balance sheet</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total assets</td>
<td>149,490.40</td>
<td>149,490.40</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>109,164.80</td>
<td>112,300.00</td>
</tr>
<tr>
<td>Shareholders’ equity</td>
<td>40,325.60</td>
<td>37,190.40</td>
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<tr>
<td><strong>Earnings per share</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EPS ($ per share)</td>
<td>0.37</td>
<td>0.23</td>
</tr>
<tr>
<td><strong>Operating ratio</strong></td>
<td></td>
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</tr>
<tr>
<td>Debt to equity</td>
<td>0.73</td>
<td>0.75</td>
</tr>
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</table>
Questions

Considering Your Position

Assuming that, at present, you are one of the boards of directors of E-Man Technology Incorporations’ Board and you have been duly appointed by the Board of directors (Board) as one of the three audit committee members to serve on the Boards audit committee. You are required to report to the Independent oversight board based on all proceedings and deliberations of the audit committee.

You may not, other than in your capacity as a member of the audit committee, the board of directors or any other board committee accept any consulting, advisory or other compensatory fee from the company or be an affiliated person of the company

Assume the case is neutral as can be expected from any dispute between the auditor and the management.

Question 1:

Based on the above information, whose position will you support at the audit committee meeting? Please respond on the following 7-point scale by placing a circle (○) on the numbers. Numbers -1 to -3 denotes that you will support the management’s position while numbers 1 to 3 denotes that you will support the auditors’ position in the dispute. The ascending order of numbers denotes the extent to which you will support the management and the auditors. Zero (0) will mean that you are uncertain to make decision as to whom to support.

<table>
<thead>
<tr>
<th>Management</th>
<th>Uncertain</th>
<th>Auditor</th>
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<tr>
<td>-3</td>
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<tr>
<td>Certain</td>
<td>Highly Probable</td>
<td>Probable</td>
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</table>

Tend to support management’s position

Tend to support the auditor’s position
Please rate your knowledge/ability, in the context of your peers, for questions 2 to 4 on the following 7-point scale by placing a circle (〇) on the numbers.

**Question 2**

What level of financial accounting knowledge, that is, about how business activities are represented in financial statements do you consider in your position.

<table>
<thead>
<tr>
<th>Low knowledge</th>
<th>High Knowledge</th>
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<tr>
<td>-3</td>
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<td>-1</td>
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Certain   Highly Probable     Probable     Uncertain     Probable     Highly Probable     Certain

**Question 3**

What level of financial statement analysis knowledge, that is, knowledge needed to analyze and interpret information contained in financial statements is needed for the case presented.

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<tr>
<th>Low knowledge</th>
<th>High Knowledge</th>
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Certain   Highly Probable     Probable     Uncertain     Probable     Highly Probable     Certain

**Question 4**

What level of auditing knowledge, that is, knowledge about the auditor’s responsibilities, the types of audit reports issued, and the audit report’s meaning is required in the case presented.

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<th>Low knowledge</th>
<th>High Knowledge</th>
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Certain   Highly Probable     Probable     Uncertain     Probable     Highly Probable     Certain
Please respond to questions 5 to 8 on the following 7-point scale by placing a circle (○) on the numbers. Zero (0) denotes where you are not sure of the response, -1 to -3 denotes negative response and 1 to 3 denotes a positive response to the particular aspect.

**Question 5:**
To what extent did you understand this case?

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<td>Tend to have no understanding</td>
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**Question 6:**
How realistic was this case?

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**Question 7:**
How important was the case to you for you to be able to justify the position you took in this case?

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**Question 8:**

How difficult was it to make your judgment in this case?

Very Easy  Very Difficult

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<td>Probable</td>
<td>Highly Probable</td>
<td>Certain</td>
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**Demographic information**

**Question 9:**

Work experience: please check (in terms of ‘yes’ or ‘no’) all that apply to you.

- President of a corporation  
- Senior executive of a corporation  
- Former holder of public office at provincial/federal level  
- Former senior civil servant  
- Former auditor  
  
  If so, how long since you last were an auditor? _____ years  

Other: ________________________________

**Question 10:**

Corporate governance experience: please check all that apply to you.

a. Number of boards of directors you serve on currently.  

b. Number of boards of directors you are an independent member.  

c. Total number of years that you have been a board of directors’ member.  

d. Number of audit committees you serve on currently.  

e. Total number of years that you have been an audit committee member.  
f. Have you ever served on an audit committee of a company for which you were also a member of senior management? Yes___ No___
g. Approximate total assets of the largest company for which you are an independent director. $__________

**Question 11:**
Please indicate the following by writing in the box:

**AGE:**

**GENDER:**

**Question 12:**
Please tick (✓) all that apply to you.

**EDUCATION:**

- [ ] Undergraduate degree(s) in __________________________________________
- [ ] Graduate Bachelors degree(s) in_______________________________________
- [ ] Masters degree in __________________________________________________
- [ ] PhD in _____________________________________________________________
- [ ] Professional designation in accounting (e.g., CA, CMA, CGA, CPA, etc.), Specify the designation and the country obtained from _____________________________

- [ ] Any other, Please specify ____________________________________________

Thank you very much for your assistance with this research.
A Research Questionnaire – Treatment 4

Audit Committee Members and Financial Reporting Oversight

Researcher: Veer Singh Varma, Department of Accounting & Financial Management, University of the South Pacific, Suva, Fiji Islands. Email: varma_v@usp.ac.fj

General Instructions

- The questionnaires asked below and the responses I will get will be treated as strictly as confidential.
- Please answer the attached questions in the order they are asked.
- Do not change any answer once you’ve written it, otherwise it will become null and void.
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2. Demographic information

Thank you in advance for completing this questionnaire.
1. Case – E-Man Technology Inc. accounting policy choice and the audit committee

E-Man Technology Inc.

Background

E-Man Technology Incorporation is an electronics retailer that sells and services stereos, radios, televisions, and computers. This case focuses on a dispute between E-Man’s management and the external auditors about the timing of revenue recognition and associated expenses under a new pricing policy for combined extended warranty/product sales. As a member of the E-Man audit committee you have been informed that this issue will be discussed at the next audit committee meeting.

E-Man operates in a very competitive market and has worked hard over the years to develop a competitive advantage. In a recent move to distinguish itself from the competition, the company started selling all electronic products with an in-house extended warranty (beyond the manufacturer’s warranty) at prices slightly above the product prices offered by competitors. Previously, E-Man sold an extended warranty on a commission basis from a third party vendor who assumed all warranty related costs. Sales of this third party extended warranty were high with more than 50% of customers buying the extended warranty. Under the new sales plan, E-Man now sells both product and its own extended warranty as one transaction to every customer.

In previous years, E-man had recognized revenue from the product sales when the merchandise was purchased by the retail customer. E-Man also immediately recognized as revenue its commission on any extended warranty sale. These policies have been followed consistently for the five years that the company has been publicly traded. When E-Man started including an extended warranty with the product sale this year, the company continued to immediately recognize all revenue. To match expenses with revenue, the company recorded the amount of estimated warranty expense that would be incurred over the life of the extended warranty. See Exhibit 1, column A for selected financial data prepared following this revenue recognition policy.

The Chief Financial Officer of E-Man believes that this accounting policy is appropriate because it meets the matching principle as all costs are matched with the revenues they generate. Further, he believes it is consistent with the previous policy that recognized all product revenue and warranty revenue at the time of sale.

The Auditor’s Position

The company’s long time auditors have objected to the company’s accounting policy. The auditors argue that the company is selling two different products, the electronic equipment and the extended warranty, for one price. They argue that the price must be separated between the two products and appropriate revenue recognition policies must be developed for each product’s revenue. In particular, the auditors are concerned that the accounting policy is not appropriate when it comes to recording the extended warranty.
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Based on the auditors’ analysis of the authoritative literature, they feel that the company is taking an inappropriately aggressive approach to revenue recognition with respect to recognizing extended warranty revenue. The auditors propose that the warranty revenue be separated from the product sales revenue and that the warranty revenue be deferred and recognized into income over the extended warranty contract period. Such a change would result in a significant (and material) deferral of revenue and associated expenses in the current year. Exhibit 1, column B shows the net effects of the auditor’s proposed changes on selected financial statement amounts. In summary, E-Man’s liabilities would increase and net income would decrease.

Management’s Reaction

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The effects of this covenant breach on the operations of E-Man cannot be ascertained in advance.

The auditors have completed their audit in all other respects but cannot reach agreement with company management on the revenue recognition policy issue. As a member of the audit committee, you are now considering your position with respect to this disagreement.

### Exhibit 1
E-man Technology Inc.
Selected Financial Data

<table>
<thead>
<tr>
<th></th>
<th>Column A</th>
<th>Column B</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Income statement</strong></td>
<td><strong>Current revenue recognition policy ($000’s )</strong></td>
<td><strong>Effects of auditor’s proposed revenue recognition policy ($000’s )</strong></td>
</tr>
<tr>
<td>Revenue</td>
<td>$58,796.00</td>
<td>$54,500.00</td>
</tr>
<tr>
<td>Net income</td>
<td>2,924.80</td>
<td>1,820.00</td>
</tr>
<tr>
<td><strong>Balance sheet</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total assets</td>
<td>149,490.40</td>
<td>149,490.40</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>109,164.80</td>
<td>112,300.00</td>
</tr>
<tr>
<td>Shareholders’ equity</td>
<td>40,325.60</td>
<td>37,190.40</td>
</tr>
<tr>
<td><strong>Earnings per share</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EPS ($ per share)</td>
<td>0.37</td>
<td>0.23</td>
</tr>
<tr>
<td><strong>Operating ratio</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debt to equity</td>
<td>0.73</td>
<td>0.75</td>
</tr>
</tbody>
</table>
Questions

Considering Your Position

Assuming that, at present, you are one of the boards of directors of E-Man Technology Incorporations’ Board and you have been duly appointed by the Independent oversight board (Boards) as one of the three audit committee members to serve on the Boards audit committee. You are required to report to the Board of directors based on all proceedings and deliberations of the audit committee.

You may not, other than in your capacity as a member of the audit committee, the board of directors or any other board committee accept any consulting, advisory or other compensatory fee from the company or be an affiliated person of the company

Assume the case is neutral as can be expected from any dispute between the auditor and the management.

Question 1:

Based on the above information, whose position will you support at the audit committee meeting? Please respond on the following 7-point scale by placing a circle (〇) on the numbers. Numbers -1 to -3 denotes that you will support the management’s position while numbers 1 to 3 denotes that you will support the auditors’ position in the dispute. The ascending order of numbers denotes the extent to which you will support the management and the auditors. Zero (0) will mean that you are uncertain to make decision as to whom to support.

<table>
<thead>
<tr>
<th>Management</th>
<th>Uncertain</th>
<th>Auditor</th>
</tr>
</thead>
<tbody>
<tr>
<td>-3</td>
<td>-2</td>
<td>-1</td>
</tr>
<tr>
<td>Certain</td>
<td>Highly Probable</td>
<td>Probable</td>
</tr>
</tbody>
</table>

Tend to support management’s position

Tend to support the auditor’s position
Please rate your knowledge/ability, in the context of your peers, for questions 2 to 4 on the following 7-point scale by placing a circle (〇) on the numbers.

**Question 2**

What level of financial accounting knowledge, that is, about how business activities are represented in financial statements do you consider in your position.

<table>
<thead>
<tr>
<th>Low knowledge</th>
<th>High Knowledge</th>
</tr>
</thead>
<tbody>
<tr>
<td>-3</td>
<td>-2</td>
</tr>
<tr>
<td>Certain</td>
<td>Highly Probable</td>
</tr>
</tbody>
</table>

**Question 3**

What level of financial statement analysis knowledge, that is, knowledge needed to analyze and interpret information contained in financial statements is needed for the case presented.

<table>
<thead>
<tr>
<th>Low knowledge</th>
<th>High Knowledge</th>
</tr>
</thead>
<tbody>
<tr>
<td>-3</td>
<td>-2</td>
</tr>
<tr>
<td>Certain</td>
<td>Highly Probable</td>
</tr>
</tbody>
</table>

**Question 4**

What level of auditing knowledge, that is, knowledge about the auditor’s responsibilities, the types of audit reports issued, and the audit report’s meaning is required in the case presented.

<table>
<thead>
<tr>
<th>Low knowledge</th>
<th>High Knowledge</th>
</tr>
</thead>
<tbody>
<tr>
<td>-3</td>
<td>-2</td>
</tr>
<tr>
<td>Certain</td>
<td>Highly Probable</td>
</tr>
</tbody>
</table>
Question 5:

To what extent did you understand this case?

Tend to have no understanding  
Tend to totally understand

| -3 | -2 | -1 | 0 | 1 | 2 | 3 |

| Certain | Highly Probable | Probable | Uncertain | Probable | Highly Probable | Certain |

Question 6:

How realistic was this case?

Very unrealistic  
Very realistic

| -3 | -2 | -1 | 0 | 1 | 2 | 3 |

| Certain | Highly Probable | Probable | Uncertain | Probable | Highly Probable | Certain |

Question 7:

How important was the case to you for you to be able to justify the position you took in this case?

Very Unimportant  
Very Important

| -3 | -2 | -1 | 0 | 1 | 2 | 3 |

| Certain | Highly Probable | Probable | Uncertain | Probable | Highly Probable | Certain |
**Question 8:**

How difficult was it to make your judgment in this case?

<table>
<thead>
<tr>
<th>Very Easy</th>
<th>Very Difficult</th>
</tr>
</thead>
<tbody>
<tr>
<td>-3</td>
<td>2</td>
</tr>
<tr>
<td>-2</td>
<td>3</td>
</tr>
<tr>
<td>-1</td>
<td>Certain</td>
</tr>
<tr>
<td>0</td>
<td>Highly Probable</td>
</tr>
<tr>
<td>1</td>
<td>Probable</td>
</tr>
<tr>
<td>2</td>
<td>Uncertain</td>
</tr>
<tr>
<td>3</td>
<td>Probable</td>
</tr>
<tr>
<td></td>
<td>Highly Probable</td>
</tr>
<tr>
<td></td>
<td>Certain</td>
</tr>
</tbody>
</table>

**Demographic information**

**Question 9:**

Work experience: please check (in terms of ‘yes’ or ‘no’) all that apply to you.

- President of a corporation  
- Senior executive of a corporation  
- Former holder of public office at provincial/federal level  
- Former senior civil servant  
- Former auditor  
  - If so, how long since you last were an auditor? _____ years  
- Other: ________________________________

**Question 10:**

Corporate governance experience: please check all that apply to you.

a. Number of boards of directors you serve on currently. _____

b. Number of boards of directors you are an independent member. _____

c. Total number of years that you have been a board of directors’ member. _____

d. Number of audit committees you serve on currently. _____

e. Total number of years that you have been an audit committee member. _____
f. Have you ever served on an audit committee of a company for which you were also a member of senior management?   Yes___   No___

g. Approximate total assets of the largest company for which you are an independent director.   $__________

**Question 11:**

Please indicate the following by writing in the box:

**AGE:**


**GENDER:**


**Question 12:**

Please tick (✓) all that apply to you.

**EDUCATION:**

☐ Undergraduate degree(s) in ____________________________________________

☐ Graduate Bachelors degree(s) in_________________________________________

☐ Masters degree in ____________________________________________________

☐ PhD in _____________________________________________________________

☐ Professional designation in accounting (e.g., CA, CMA, CGA, CPA, etc.), Specify the designation and the country obtained from _____________________________

☐ Any other, Please specify ____________________________________________

Thank you very much for your assistance with this research.