

AUDIT COMMITTEE EFFECTIVENESS: A SYNTHESIS OF THE AUDIT COMMITTEE LITERATURE

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Abstract

The purpose of this paper is to add a meaningful critique to the existing audit committee (AC) literature by providing (i) a critical analysis of the AC literature grounded on agency theory; (ii) a discussion of the emerging new theories of AC, which investigate the people serving on and working with ACs, and (iii) a description of the relationship between these two groups of literature. A number of qualitative AC studies have provided new insights by investigating the actual people serving on and working with audit committees. This review paper summarizes these findings and provides a comparative evaluation with the agency theory-based AC research. This review documents, among others, that the attributes of ACs, as measured by the quantitative literature, have hardly been reflected by qualitative investigation, whereas qualitative analysis of the data contributed by people who have actual experience of ACs questions the fundamental propositions, not only of why ACs exist, but also how they function. This paper provides a cross-examination of the afore-mentioned two paradigms of literature on AC effectiveness and invites corporate scholars to reflect on the differences between the two groups of AC studies.

Keywords: Audit Committee Effectiveness, Agency Theory, Corporate Governance, Social Phenomenon

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1 Introduction

Audit committees (hereafter ACs) play an important role in ensuring the credibility of financial reporting. Mainstream theorization of ACs rests on the foundation of the agency problem, which arises from conflicts between corporate owners and professional managers. Because modern corporations are run by professional managers (agents), but are owned by diverse investors (principals) who do not take part in the operation of the business, an information asymmetry problem exists between the two groups (Jensen & Meckling, 1976). This asymmetric information problem makes the principals suspicious of the agents' behaviour and generates the demand for corporate governance mechanisms with the expectation of aligning the interests between these two groups as closely as possible (Fama & Jensen, 1983; Shleifer & Vishny, 1997). The academic literature is replete with studies on the board of directors as the primary governance mechanism (Hermalin & Weisbach, 1998, 2003; Adams et al. 2010). In order to function effectively, boards consist of different sub-committees, of which the AC is one. ACs oversee the audit scope and the adequacy of the independent public accountant's audit plans and results, review and monitor the annual and quarterly financial statements and other financial reports, and monitor the internal accounting controls.

Although a sizable volume of academic research on various aspects of ACs exists, a major challenge facing researchers is to develop a theory explaining why ACs exist. DeFond and Francis (2005) and

Bédard and Géndron (2010) both express concerns about the lack of theories explaining the existence of ACs. The mainstream agency theory explanation for AC effectiveness has been questioned, especially in the light of the massive corporate collapses in recent years¹. Agency theory hypothesizes that an effective AC will improve financial reporting quality by reducing the information asymmetry between managers and external shareholders. Kalbers and Fogarty (1998) question the assumption that ACs actually reduce this information asymmetry (i.e. that ACs are effective in carrying out their responsibilities).

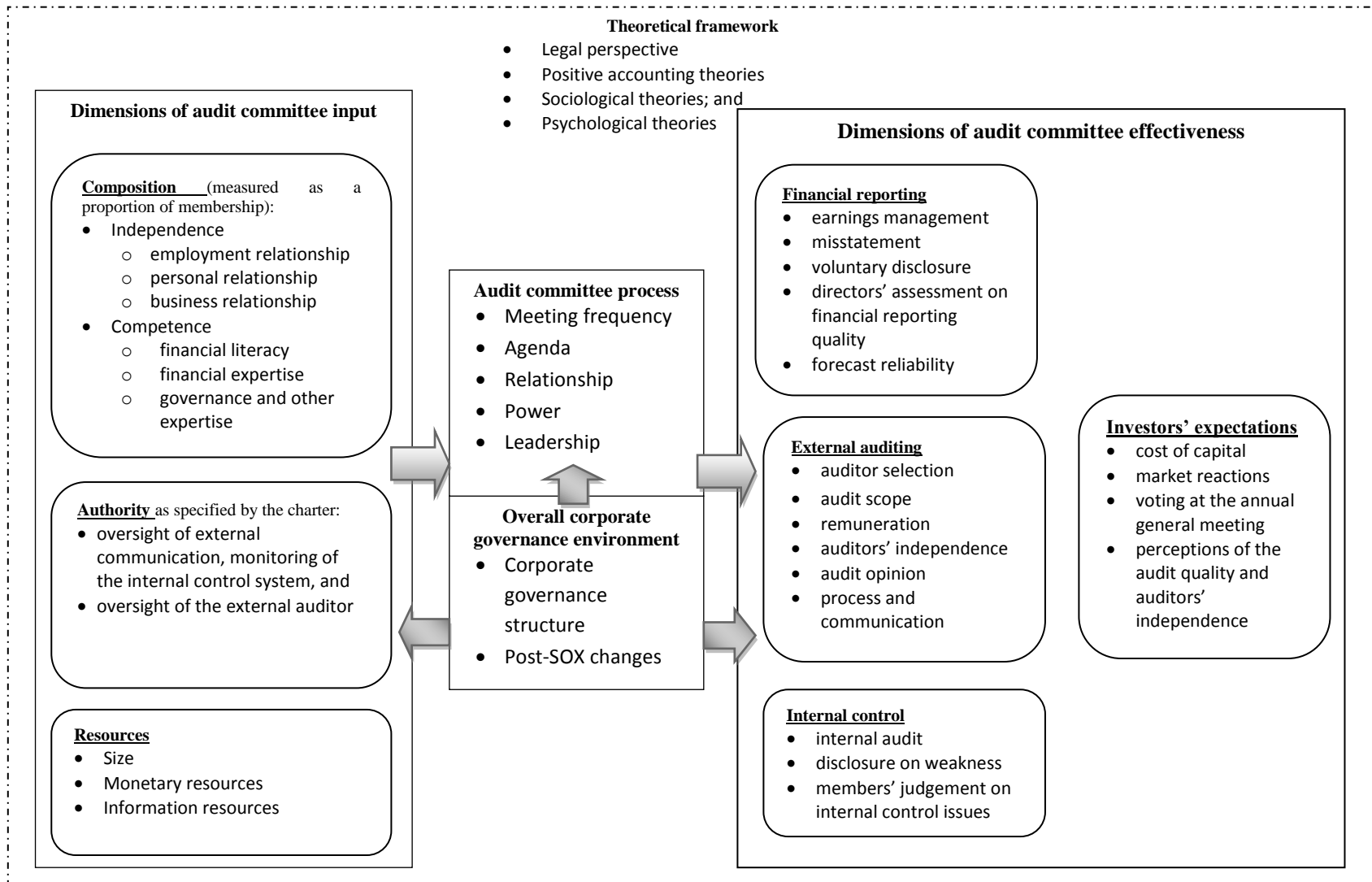
The large volume of AC literature has also produced an impressive number of literature reviews on ACs. A study by DeZoort et al. (2002) is the first systematic review of AC literature focusing on the factors contributing to AC effectiveness from an agency theory perspective. DeZoort et al (2002) assert that an effective AC could protect stakeholders' interests by ensuring reliable financial reporting, effective internal control and high quality risk management, identifying these as output measures of AC effectiveness. In contrast to DeZoort et al (2002), who focus on the factors contributing to AC effectiveness, Turley and Zaman (2004) synthesize the research on the impact of AC outputs on corporate governance. They develop a framework to organise the AC empirical research, categorising the effects of ACs in terms of (a) the expectations that led to their establishment and (b) the corporate governance effects, represented by the audit function, financial reporting quality and firm performance. Bédard and Géndron (2010) have provided the most up-to-date AC literature review, requesting future researchers to adopt different theoretical, methodological and geographical points of view, rather than focusing solely on a positive accounting theory approach. Bédard and Géndron (2010) extend the DeZoort et al (2002) framework by incorporating process and output components of the AC inputs. These inputs affect the internal control, financial reporting and external audit functions and ultimately have an impact on investors' perceptions about AC effectiveness. Figure 1 presents a comprehensive AC research framework integrating these three important reviews.

The purpose of this paper is to add a meaningful critique to the existing AC literature by providing (i) an analysis of the AC literature grounded on agency theory; (ii) a discussion of the emerging new theories of ACs, which investigate the people serving on and working with ACs, and (iii) a description of the relationship between these two groups of literature. Several important conclusions can be drawn from this review. First, this review argues that, although the agency theory-based empirical literature has identified and accumulated a comprehensive set of measures for AC attributes, process and outputs, the effectiveness of ACs has not been conclusively proven.

Second, the review documents the diverse insights into real world ACs provided by the qualitative AC literature. In recent years, a growing number of these studies have investigated the actual people who have had experience of working in ACs (Spira 1998, 2002; Géndron & Bédard, 2006; Turly & Zaman, 2007; Wu et al., 2010). This paper will discuss and consider these alternative AC research studies, which are based on sociological theories, for investigating and explaining AC dynamism. This stream of research studies provides further opportunities for the corporate governance research community to consider whether the AC mechanism - a social phenomenon in nature - has been understood fully.

¹The AC as a corporate governance mechanism has been regarded as a reaction to the shockwaves from the corporate failures which were caused by fraudulent financial reporting (Spira 1998, 2002). Although discussion about and research on ACs has proliferated since the mid-1990s, the historical evolution of ACs dates back to 1938, following the United States (US) Supreme Court's decision in the Securities and Exchange Commission (hereafter SEC) vs McKesson and Robbins Inc. case on fraudulent financial reporting (Markham, 2005). In 1970, the SEC recommended that all listed companies should establish ACs comprising independent directors. According to Birkett (1986), the increased adoption of ACs in USA corporations in the 1970s was the result of joint promotional efforts by the Congress, the SEC and the accounting and legal professions. In the 1990s, earnings management and creative accounting practices, considered to be a threat to market integrity, proliferated and required a strong corporate governance culture to constrain such behaviour (Harrast & Mason-Olsen, 2007). A number of research projects sponsored by practitioners or government bodies were accordingly published, with the Blue Ribbon Committee (BRC) (1999) in the US receiving significant attention.

Figure 1. Schematic representation of the AC research framework developed by integrating the frameworks in DeZoort *et al.* (2002), Turley and Zaman (2004), and Bédard and Gendron (2010)



A third conclusion of this review details the extent to which the empirical archival and qualitative AC literature has provided contradictory evidence about the effectiveness of ACs. The attributes of ACs, as measured by the archival empirical literature, have hardly been reflected by qualitative investigation, whereas qualitative analysis of the data contributed by people who have actual experience of ACs questions the fundamental propositions, not only of why ACs exist, but also how they function. This paper provides a cross-examination of the afore-mentioned two paradigms of literature on AC effectiveness and invites corporate scholars to reflect on the differences between the two groups of AC studies. It is hoped that future research will focus on building robust theoretical foundations for ACs as social phenomena, as well as developing comprehensive, effective measures that will contribute to the soundness of corporate governance.

The paper proceeds as follows. In the next section, the archival AC research examining AC determinants and composition with respect to AC effectiveness is reviewed. As Bédard and Géndron (2010) conduct a comprehensive, updated, archival AC literature review, this paper reviews only the archival studies that are not included in their synthesis. Section 3 of the paper reviews the qualitative AC research studies. Section 4 compares and contrasts the two streams of AC research and provides some directions for future research. Section 5 concludes the paper.

2 Empirical AC literature

A large volume of archival empirical research has been conducted to explain voluntary AC formation and the association between AC characteristics and financial reporting outcomes.

2.1 Determinants of AC formation

Why do ACs exist? The answer to this seemingly obvious question has not been grounded on a rigorous theoretical foundation. DeFond and Francis (2005) expressed this concern as follows: “A potential stumbling block in understanding how audit committees impact governance is that there are no theories that explain why boards of directors exist in the first place much less why audit committees exist. The absence of theoretical guidance presents obvious problems in investigating questions about audit committees’ effectiveness” (p.17).

This is aptly illustrated in a recent study by Baxter and Cotter (2009), who investigate the impact of AC formation on earnings quality in Australia. They do not provide any theoretical framework for the likely effect of the former on earnings quality, but instead provide a very general statement that, “Tests will allow a direct assessment of whether the voluntary formation of an audit committee is followed by an increase in earnings quality” (p. 270).

According to Turley and Zaman (2004), the formation of ACs is usually an attempt to reduce agency costs. The variables hypothesized to support such a proposition are therefore mainly agency cost proxies, such as firm size, leverage and ownership structure (Dey, 2008; Rainsbury et al., 2008). Firm size has been found to be positively associated with AC existence (Piot, 2004; Iyer & Watkins, 2008), independence (Vermeer et al., 2006; Dey, 2008), the number of AC members with financial expertise (Carcello et al., 2006; Dey 2008) and meeting frequency (Méndez & García, 2007; Raghunandan & Rama, 2007; Dey 2008). Fama and Jensen (1983) suggest that agency conflicts become more severe as firm size increases and that greater control of managerial actions is therefore required. With respect to another agency cost variable, leverage, it is argued that as agency conflicts intensify with the increasing level of debt, debtholders may require better governance mechanisms in place to safeguard their interests (Jensen & Meckling, 1976). The leverage hypothesis, however, has only been weakly supported (Dey, 2008; Rainsbury et al, 2008). Ownership structure and AC composition has been studied internationally because of the variations in firm ownership structure worldwide. Piot (2004) finds that the level of management shareholding was negatively associated with both the establishment and independence of ACs in French listed firms. In Hong Kong, family shareholding positively affects the formation of ACs (Chau and Leung, 2006) but significantly reduces the monitoring effectiveness of such ACs with respect to earnings management (Jaggi and Leung 2007). AC composition has been found to be associated with firms’ industrial contexts, in particular their level of litigation risk. Firms with high litigation risk tend to emphasise more formal corporate governance settings, including ACs (Ashbaugh-Skaife et al., 2006; Carcello et al., 2006; Raghunandan & Rama, 2007; Emmerich et al., 2006). Piot (2004) provides evidence

that France, which has a generally less litigious environment than either the UK or the USA, required less independent ACs.

Since the AC is a sub-committee of the main board, it is natural to consider whether the composition of the board of directors influences the formation of the AC (Cotter & Silvester, 2003; Piot, 2004; Chau & Leung, 2006; Ruiz-Barbadillo et al., 2007; Iyer & Watkins, 2008 and Rainsbury et al., 2008). The results of these studies show that board size and independence are positively associated with AC existence and independence. Cotter and Silvester (2003) interpret this as meaning that when boards of directors adopt an AC structure, much of the monitoring responsibility of the board is expected to be borne by the independent AC members.

When observing AC establishment, some propositions regarding an AC's nature can be discussed (Tsui et al., 2006). First, the AC as a sub-committee of the board of directors carries out its functions through board delegation. AC members are therefore obliged to understand and represent the board's expectations and to report to the board about the outcome of its delegation. Little research has been done about this interaction between the AC and the board. Second, the agency problem, ownership structure and litigious/industrial risks are key issues of corporate governance. To perform their role in corporate governance effectively, AC members need to interpret their delegated duties according to their specific organisational setting; such interpretation involves the exercise of both subjective and professional judgement. Little has been documented in agency research about how AC members reflectively interpret their roles, their attributes and their efforts in relation to their particular organisations. Third, the incorporation of alternative theories to explain AC formation could address concerns regarding the lack of satisfactory theories for explaining AC formation.

Kalbers and Fogerty (1998) argue that a single theory like agency theory is insufficient to explain the demand for ACs. They suggest that their "...findings of some significant correlations between agency variables and internal institutional forms of power also yield the potential for combining agency and institutional premises to better explain activities within organizations" (p. 144). In contrast to agency theory, institutional theory offers a sociological approach that portrays ACs as a 'symbolic display of conformity and social accountability', with the real work being accomplished by an internal operating process. Corporate governance structures "fulfill ritualistic roles that help legitimize the interactions among the various actors within the corporate governance mosaic" (Cohen et al. 2008, p. 187). This theory predicts that ACs will become more similar over time, either due to coercive (regulatory) and/or mimetic influences (DiMaggio & Powell, 1983). This begs the question as to whether this reflects a tendency towards conforming to a standardized form of AC behavior, or an in-substance improvement of the AC's effectiveness and thereby a firm's corporate governance.

2.2 AC composition and AC effectiveness

A competent, committed, independent, and tough-minded audit committee has been described as "one of the most reliable guardians of the public interest" (Levitt 2000, 5). Two important characteristics of AC membership qualifications that have received significant research attentions are AC independence and their competencies. With respect to members' competencies, Section 407 of the SOX requires the SEC to adopt rules mandating that the ACs of public firms include at least one member who is a financial expert, or disclose reasons for not adopting this requirement.

2.2.1 AC members' expertise

To qualify as a financial expert, the SOX requires a director to have five attributes, namely (i) an understanding of Generally Accepted Accounting Principles (GAAP) and financial statements; (ii) the ability to assess the general application of such principles in connection with accounting for estimates, accruals and reserves; (iii) experience preparing, auditing, analysing or evaluating the registrant's financial statements, or experience actively supervising one or more persons engaged in such activities; (iv) an understanding of internal controls and the procedures for financial reporting; and (v) an understanding of AC functions. While the SOX proposes a narrow definition of financial expertise, the SEC adopts a broader definition of financial expertise, whereby an AC member can be deemed to be a financial expert if the member has either accounting, finance or supervisory expertise.

Given the lack of consensus on what precisely constitutes AC members' expertise, it is not surprising that contradictory evidence about the impact of AC expertise has been reported in the literature. On one hand, AC financial expertise tends to enhance the diligence of the committee and the quality of reporting and auditing (Abbott et al., 2003; Bédard et al., 2004). On the other hand, financially sophisticated directors can be aggressive and risk-taking and may therefore act in a manner contrary to the expectation that they will oversee the financial reporting process in order to protect shareholders' interests (DeZoort et al., 2003). Bédard and Géndron (2010) review 39 studies about the association between financial expertise and AC effectiveness. These studies adopted a more restrictive view of financial expertise and constrain expertise to directors who are auditors, professional accountants, CFOs, accounting academics, investment advisors, and bankers. They found that 22 (13) of the 39 studies reported a significant (insignificant) positive association between expertise and AC effectiveness respectively. Studies that adopt a broader definition of financial expertise (n=16) provide much more inconclusive evidence (an equal number of positive and non-significant studies). The evidence suggests that the association between AC effectiveness and AC financial expertise is contingent on the way financial expertise is defined.

It is believed that having more financial experts on the AC increases earnings' quality (Abbott et al., 2003; Bédard et al., 2004; Baxter & Cotter, 2009; Krishnan & Visvanathan, 2008), reduces the probability of restatements (Marciukaityte & Varma, 2008; Abbott et al., 2004; Cohen et al., 2010) and increases the probability of more timely remediation of internal control weaknesses (Goh, 2009). Dhaliwal et al. (2010) found that AC accounting expertise is positively associated with financial reporting quality as proxied by accruals' quality². They report further that this association is stronger for accounting experts who (a) are independent of the firm, (b) hold low levels of multiple directorships and (c) have a lower tenure in their firms. Rainsbury et al., (2009), however, do not find any relationship between the Audit Committee Best Practice (ACBP) code in New Zealand and financial reporting quality. Furthermore, Baxter and Cotter (2009) actually find some evidence of a higher level of discretionary accruals (DACCR) in firms with a greater proportion of qualified accountants on their ACs, which is contrary to the agency theory hypothesis.

A major shortcoming of the AC financial expertise and financial reporting quality studies relates to the endogenous nature of this relationship. For example, it is not unusual to think of a scenario in which financially literate people are more likely to sit on ACs for firms with better reporting qualities. In this case, financial experts in the AC may be appointed as a signaling mechanism to assure stakeholders that their company's existing financial reporting systems pass the due diligence test required by the AC financial experts. Therefore, an already existing higher reporting quality regime may attract financially expert AC members giving rise to a reverse causation problem (Engel, 2005).

AC financial expertise is also expected to enhance audit quality, but the research results are mixed. AC financial expertise is found to be associated with higher audit fees (Abbott et al., 2003; Goodwin-Stewart & Kent, 2006), but is unrelated to the decision to employ industry specialist auditors (Chen et al., 2005). Additionally, the likelihood of an auditor resignation and the shareholders' vote on auditor's ratification are not associated with AC financial expertise (Lee et al., 2004; Raghunandan & Rama, 2003). Naiker and Sharma (2009) explore the rationale for the SEC mandating a three year "cooling-period" before a former audit partner can become an AC member of the client firm. This "revolving-door" appointment policy has given rise to significant concern about the financial reporting quality of client firms. Naiker and Sharma (2009), however, fail to find any evidence to support this concern.

In summary, the AC composition literature constructed on agency theory has provided some evidence of an association between members' expertise and AC effectiveness. However, a shortcoming of this theory with respect to AC members' competence is that agency theory considers an AC to be a viable monitoring mechanism, without considering the power element in the AC selection process. Managerial hegemony theory, on the other hand, presumes that the AC is controlled by management and is established for symbolic, rather than substantive, oversight of financial reporting (Beasley et al. 2009). Lisic et al. (2011) consider this perspective and examine the effect of AC financial expertise on earnings restatements in relation to CEO power. The authors report that when CEO power is sufficiently strong, even an AC with

²Accruals improve the informativeness of earnings by smoothing out transitory fluctuations in cash flows. The use of accruals quality relies upon the fact that accruals are estimates of future cash flows and earnings will be more representative of future cash flows when there is lower estimation error embedded in the accruals process (Dechow and Dichev, 2002).

a financial expert fails to perform its monitoring role. Carcello et al., (forthcoming) examine the relationship between CEO involvement in board selection and financial statement restatements. The authors provide some evidence that CEO involvement in the board selection process eliminates the benefits of an AC staffed by members who possess financial expertise and who are also independent. Additionally, the negative market reaction to earnings restatement is weakened by the presence of an independent AC, but only when the CEO does not personally select the board members (which is consistent with managerial hegemony theory). These findings again call for a broadening of the AC theoretical landscape beyond only agency theory.

2.2.2 AC members' independence

Members' independence is generally defined as the absence of relationship with the company that may interfere with the exercise of their independence from management and the company (BRC, 1999). Such independence may be impaired because of the presence of employment relationship, personal relationship and/or business relationship. Independent audit committees serve as superior monitors of the financial reporting process (Klein, 2002) but there has been disagreement about the ideal proportion of independent directors for an AC. Research has tried to ascertain the impact of different proportions of AC independence on financial reporting quality but the results have been very mixed. Davidson et al. (2005), Klein (2002), and Ghosh et al. (2010) find no association between AC independence and earnings management but Bédard et al. (2004), report that fully independent AC members constrain aggressive earnings management. A recent study by Bronson et al., (2009) provide indirect evidence of the benefit of having an independent AC by documenting that such a committee may help ensure that an audit firm issues a going-concern opinion to financially distressed firms. Furthermore, the authors document that independent ACs inhibit auditor dismissal following the issuance of a going-concern opinion for financially distressed firms. The inconsistent results derived from agency theory-based AC independence studies are not surprising, since "the simple tallying of the affiliations of individual board members provides insufficient information to assess whether or not that board is active and independent" (MacAvoy & Millstein, 2004, 37-38). A completely independent board could still be siding with management, particularly in scenarios where CEOs are involved in the board member selection process (Carcello et al., 2011).

2.2.2 AC members' tenure and multi-directorships

The average tenure of AC members has recently been introduced as a new variable into the AC literature. Yang and Krishnan (2005) and Liu and Sun (2010) find that the average length of tenure of AC members was associated with higher financial reporting quality. Increased tenure allows AC members to acquire the procedural knowledge required for monitoring purposes. Furthermore, long-tenure directors may have a good reputation, which has been developed over time, and can be safeguarded by ongoing strong monitoring. On the other hand, those who oppose increased tenure argue that concern may arise about AC members developing a friendly relationship with management because of their long tenure. Also, it is becoming increasingly difficult for long-tenure directors to keep pace with changes caused by increasingly complex business operations, whereas new directors can bring fresh ideas and critical thinking to the board or the AC (Yang and Krishnan, 2005; Liu & Sun, 2010).

Related to length of tenure is the phenomenon of directors holding multiple directorships in several organisations, which has become increasingly common in recent years. There has been intense debate about whether multi-directorships is an indication of the good reputation of directors, or a signal of directors being over-committed (Pritchard et al., 2003). On the one hand, AC members' multi-directorships contribute to better financial reporting quality (Vafeas, 2005; Yang & Krishnan, 2005). On the other hand, busy directors are less likely to accept auditors' suggested adjustments (Hunton & Rose, 2008), or are more likely to leave the firm when earnings management or poor performance are disclosed (Dewally & Peck, 2010).

2.3 AC corporate governance impacts

Provision of timely and credible disclosures is critical for the functioning of an efficient capital market. Such disclosures are likely to reduce the information asymmetry problem between managers and shareholders (Healy & Palepu, 2001). The impact of ACs on firms' disclosure practices has enjoyed considerable attention in the literature. The existence of an AC is positively correlated with the level of

voluntary corporate governance disclosures (Chau & Leung, 2006; Barako et al., 2006), disclosure of interim financial information (Chen et al., 2007), forward-looking information (O'Sullivan et al. 2008), internet disclosures (Kelton & Yang, 2008) and a higher level of disclosure about the impact of adopting International Financial Reporting Standards (IFRSs) in Australia (Kent & Stewart, 2008).

On the other hand, AC characteristics are unrelated to information precision, as measured by management earnings forecast accuracy. Karamanou and Vafeas (2005) find that forecast accuracy increases with an increase in board independence, but decreases with AC independence. Bédard et al. (2008) examine the impact of audit quality on management earnings forecast accuracy using IPO sample in Canada. They classify ACs as independent and competent if more than 50% of its members are independent and at least one has financial expertise. They do not find any systematic relationship between AC quality and forecast accuracy. One plausible reason for this finding may be attributed to the difficulties associated with predicting earnings at the time of an IPO and hence the forecast error may be due more to factors related to firm operations and characteristics than to its governance structure. Using analyst forecast accuracy as the information precision variable, Byard et al., (2006) find results similar to that of Bedard et al. (2008).

Market reaction is an indication of the assessment of firms' corporate governance, as perceived by the shareholders. Several studies have found that securities markets react positively to the announcement of the appointment of AC members with financial expertise (Davidson et al., 2004; DeFond et al., 2005; Farber, 2005). Chan and Li (2008) find that the independence of an AC leads to higher firm value, but only when a majority of independent directors serve on the board. Brown and Caylor (2006), on the other hand, find no association between AC composition and firm value³.

To sum up, most of the existing research on ACs has been based on large samples, selected from archival data or obtained from surveys, but has rarely investigated what has happened within ACs. Several areas can be identified as gaps within the existing body of knowledge. For example, the empirical research has associated the determinants of AC establishment and composition with the characteristics of their boards, the agency conflicts, leverage levels and litigious risks. Little, however, is known about how ACs interact with their boards. Furthermore, little has been documented about how AC members reflectively interpret their roles, their attributes and their efforts in relating to their particular organisations. In particular, how do AC members interpret the word 'independence' in the context of their specific committees and what expertise or attributes assist AC members to fulfil their duties?

2.4 Implications of the archival AC literature and future research opportunities

The archival research, although providing many insights, suffers from a number of serious limitations, including the uncritical acceptance of agency theory as the dominant theory for explaining AC effectiveness. Agency theory-based academic research on ACs fails to provide convincing evidence about the effect of AC effectiveness on the provision of quality financial information (Brown & Caylor, 2006; Larcker et al. 2007; Romano, 2005)⁴.

On methodological grounds too, considerable measurement error exists with respect to the variables used in the archival research. For example, a popular measure of financial reporting quality is the degree of earnings management, proxied by abnormal accruals. However, the reliability of the abnormal accruals' models used in the literature is questionable (Dechow et al., 2003). A specific problem with using abnormal accruals as a proxy for opportunistic earnings management is that managers could also use DACCR as an efficient contracting device to provide credible signals to the marketplace about the future growth prospects of their organizations. The earnings management-based accounting literature, however, generally assumes opportunistic motives for using abnormal accruals. Furthermore, managers could manipulate accounting information by using a combination of accruals' management, real activities' manipulation (Roychowdhury, 2006) and classification shifting mechanisms (McVay, 2006).

³Brown and Caylor (2006), for example, construct a composite governance index based on 52 variables and find a positive association between this composite index and firm value.

⁴Larcker et al. (2007) find that a comprehensive set of different governance measures explains only 0.6% to 5.1% of the cross-sectional variation of their dependent variables (e.g., abnormal accruals, Tobin's Q, accounting restatements). They attribute the failure to find any consistent relationship between corporate governance measures and organizational performance to the difficulty in generating reliable and valid measures for the corporate governance construct.

Since the passage of the SOX 2002, research on ACs has also expanded geographically, from the US and the UK, to other share markets, for example, Australia (Carson 2002), Hong Kong (Chau & Leung 2006) and New Zealand (Rainsbury et al., 2008). In the latter countries, the mandatory requirements for establishing ACs are less rigid than those in the US and the UK. There have also been studies on ACs in European share markets, for example, Melis (2005) in Italy, Piot (2004) in France, Knechel and Willekens (2006) in Belgium and Osma and Noguer (2007) in Spain. These studies have not only shed light on ACs operating in European jurisdictions in contrast to the Anglo-American environment, but have also enriched the discussion about ACs in different institutional backgrounds (Collier & Zaman, 2005). For example, ACs in Europe consist of both independent and executive directors, in contrast to the USA, where all AC members must be independent. The rationale for the European situation is that the representatives of controlling shareholders and employees, who, in Europe, are typically members of the board of directors, or a supervisory board, are not independent, but cannot be excluded from participating in the roles played by the AC (Willekens et al., 2004).

Establishing ACs has become a matter of compliance for listed companies; assessing the effectiveness of ACs on certain security markets is therefore primarily an assessment of the effectiveness of the regulations and/or the guidelines governing AC issues. This assessment could be expanded if future empirical research were to focus on the effect of AC regulations and guidelines, by establishing a set of consistent and comprehensive AC compliance indicators and applying such indicators to compare (i) the corporate governance implications before and after therelated regulations or guidelines took effect within a specific share market and (ii) the corporate governance implications between different cultures, examining different financial reporting practices or different legal systems within a social and historical context. The first research avenue not only assesses the effectiveness of AC regulations and guidelines, but also reflects on the development of AC mechanisms in society, whereas the second research direction may be of value in understanding the circumstances under which AC mechanisms operate effectively in different environments. Both of these research directions require a thorough scrutiny of and triangulation between the theoretical frameworks that have been used to underpin AC empirical studies, namely, agency theory, which underpins the AC mechanisms per se, and institutional theory, which explains the compliance with AC regulations.

3 AC qualitative research studies

The existing empirical literature fails to address the process by which an AC functions. There has therefore been an increase in qualitative research studies, constructed on sociological theories, which attempt to unveil the intricacies of real-world AC functioning. This section of the paper provides an overview of these qualitative research studies, which have contributed to a reconsideration of the expectations of ACs by a wide range of corporate governance stakeholders.

3.1 Spira (1998; 2002) - investigating ACs through actor-network theory

Spira (1998; 2002) outline the evolution of ACs within the broad context of corporate governance developments internationally. Based on a scrutiny of the cause and effect relationships of several events of different corporate governance regimes, such as the setting up of the Cadbury Committee (1992) and the increasing popularity of ACs in public companies, she argued that the establishment and activities of ACs was the outcome of power relationships arising from actor networking⁵. She concludes that AC meetings and the questioning process usually demonstrated in ACs' daily activities were 'ceremonial' and 'play an important part in offering comfort and reassurance to investors and lenders' (Spira, 1998, p.1).

Spira's (1998; 2002) studies focused on the role of rituals in AC meetings, examining the extent to which AC effectiveness was embedded in the routine activities during the meeting, the asking of questions and meeting with auditors privately. Spira (1998) interviewed AC members of UK listed companies. Based on her investigation of the AC operations, Spira (1998; 2002) argues that the expectations implicit in establishing independent ACs to improve financial reporting as well as audit qualities were 'unproven',

⁵ Actor-network theory ('ANT') provides explanations of how networks overcome resistance and internalise a desired outcome (Callon, 1983). Such a process is regarded as 'translation' (Spira, 1998, p.58). In the process of translation, non-human actors, for example, in the AC context, the Cadbury Committee Report (1992), or the AC charter of individual companies, play an important role, in addition to human actors. This is regarded as the 'punctuation' effect (Spira, 1998, 58).

but that ACs do assist companies to present an image about the quality of their statutory audit and financial reporting. Therefore, AC formal activities, i.e. AC meetings, were primarily ceremonial. In addition to providing an insight into AC processes, Spira's (1998) study has contributed to the theoretical development of AC research methodology.

3.2 Géndron and Bédard (2006)-the constitution of AC effectiveness

According to Géndron and Bédard (2006), neither the existing empirical nor qualitative research into AC effectiveness has focused on the meaning of the word 'effectiveness'. They argue firstly that the meaning of AC effectiveness is internally constructed, rather than objectively measured and that secondly, its meaning varies according to different contexts (Géndron & Bédard, 2006). Therefore, their focus is on the process that constitutes the meaning of AC effectiveness. The theoretical framework adopted by Géndron and Bédard (2006) was drawn largely from Schütz's (1967) social constructivist approach. Géndron and Bédard (2006) justify using this theoretical foundation for their investigation by referring to the actors' reflectivity and the role this plays in the process of constructing meanings for particular social phenomena. Therefore, AC members and other parties (for example, internal auditors, external auditors and executives) who attended AC meetings 'ascribed meaning to the committee's effectiveness' (Géndron & Bédard, 2006, p. 215).

Based on twenty-two interviews with AC meeting attendees from three Canadian listed companies, Géndron and Bédard (2006) find that the constructionist process of AC meeting attendees involves 'two layers of meaning, the symbolic and the substantive' (p. 215). Their research highlights the problems of defining AC effectiveness in some concrete manner as AC members'

"...configurations of meaning regarding AC effectiveness are constructed through four categories of processes, those being: the background of AC members; ceremonial features of AC meetings; reflective interpretations of substantive practices and activities taking place during AC meetings, as well as reflective understandings of informal practices taking place outside meetings. Every attendee's configuration of meaning consists of a more or less heterogeneous set of emotions regarding the committee's areas of involvement-emotions that vary from confidence to hopefulness to anxiety" (p. 212).

In contrast to Spira (1998; 2002), Géndron and Bédard (2006) went beyond the rituals within the meetings, to include informal processes outside AC meetings. To a certain extent, the research results of Géndron and Bédard (2006) about the meaning of 'AC effectiveness' also provide insight into how real-world AC members and the people who work with them interpret the diligence of ACs. Géndron and Bédard (2006) expand the insight into AC diligence beyond meeting frequency, which had been almost the only diligence measure adopted by the AC empirical research to date.

3.3 Beasley et al., (2009) -the AC oversight process

Beasley et al (2009) interview forty-two active AC members to enrich their understanding of the role ACs play as effective monitors of management (an agency theory-based proposition), as opposed to the institutional theory view of ACs as being purely symbolic and ceremonial. Five specific AC process areas were identified and used as the themes during the interview sessions. These were (i) acceptance and continuance of due diligence processes; (ii) selection of AC nominees; (iii) AC meeting processes; (iv) AC oversight of the financial reporting process; and (v) oversight of the internal and external audit processes. The authors report that:

Many audit committee members strive to provide effective monitoring of financial reporting and seek to avoid serving on ceremonial audit committees. However, within six specific audit committee process areas we find evidence of both substantive monitoring and ceremonial action, such that neither agency theory nor institutional theory fully explains our results (Beasley et al. 2009, 66).

The Beasley et al (2009) study provide valuable insights into ACs in US companies, but, being exploratory in nature, the research design was not based on any particular qualitative research framework. Most of the interview questions asked by Beasley et al (2009) were opinion-based, investigating the general processes of ACs. Thus, the contribution of their research findings was of a more empirical, than

theoretical nature, unlike the other qualitative research studies using sociological paradigms that were specifically interested in the ‘unexpected’ incidents and relationships within ACs.

3.4. Wu et al., (2010) – the intentional orientation of AC members

Wu et al., (2010) interview twenty-one AC members in New Zealand listed companies in order to understand the intentional processes of AC members in performing their daily tasks. Following a phenomenological approach, the study argues that performing AC duties is an intended process⁶. The findings challenge several public expectations of ACs, including the notion of ‘independence’. The study also highlights the potential benefit for corporate governance stakeholders in considering the individuality of AC members within the context of their organisation in promoting corporate governance best practice.

Wu et al., (2010) argue that AC members’ intentional justifications of their roles in the committees contribute to the effectiveness of the ACs. The interviewees revealed that they performed their AC duties according to one of two possible intentional orientations; some interviewees tended to perform their role according to their assessment of the characteristics of good directorship, whereas others tended to perform their role to conform to public expectations of ACs. In some cases, these two orientations were not mutually-exclusive, but overlapped. These two different categories of AC members may form an intentional, but friendly, rivalry in the board rooms of New Zealand listed companies. The two groups of directors may not necessarily agree with each other’s intentional orientations, but they recognise each other’s value. It is also noteworthy that neither group accepts extra accountability for serving on the AC; rather, they contend that it is the board of directors as a whole which should be held accountable for the firm.

3.5 Summary of the qualitative AC research and future research opportunities

As mentioned previously, this paper argues that the AC, which is a social phenomenon, as well as a device for corporate governance, has not yet been fully understood. Qualitative AC research studies have contributed to the existing body of knowledge about ACs in many ways; for example, Spira (1998; 2002) reveal an ‘inconvenient truth’, namely that the AC mechanism per se could be viewed as an outcome of regulatory bargaining between regulators, investors and practitioners, regardless of whether the effectiveness of ACs has been proven. Géndron and Bédard (2006) suggest that the meaning of AC effectiveness is comprehensive and diverse, and lies in the interactions between AC members and other AC meeting participants during and outside AC meetings. Wu et al., (2010) argue that because AC members make sense of their ACs in different - even opposing - ways, the effectiveness of ACs cannot be assessed consistently. Both Wu et al., (2010) and Turley and Zaman (2007) find that real world ACs are pervasively influential and aim to bring changes to their organisations, in contrast to the pervasive notion of ‘independence’, which requires ACs to be distant from executive power. These qualitative investigations into ACs, however, still focus only on the AC members. This paper invites corporate governance academics to include a broader range of subjects, like directors who are not AC members, corporate executives, audit practitioners and institutional investors. This may require abandoning the AC’s input-process-output research model and rather investigating AC effectiveness through the lenses of participants who are not AC members. Such research will provide an opportunity to understand and document independent expectation formation and assessment of AC performance.

The qualitative studies have enriched the theoretical foundation and methodological construction of the existing body of knowledge of ACs. The archival research, grounded on agency theory, assumes that people are rational and that their behaviours are therefore predictable (i.e. measurable). In contrast to this, the qualitative research employs actor-network theory and constructionist and phenomenological approaches to explore real-world ACs. These sociological theories posit that people are diverse and that their behaviours are contextual and contingent on numerous factors. As these different approaches have generated different conclusions, this paper calls for the academic community to employ other sociological

⁶The primary principle underlying phenomenology is that any given social phenomenon is intended by the people who live through it. Such an intentional orientation is abstracted by processes of making sense. It is important that the ‘intentionality’ in phenomenology should not be interpreted as ‘purposeful’; rather, intentionality specifies a process of consciously making sense of a past experience, as opposed to justifying the purpose of anticipated events (Sokolowski, 2000). Such sense-making experience is obtained by documenting the accounts of the person who lived through the phenomenon.

theories to further enrich the understanding of the people, the behaviours and the events (for example, an economic recession, or the adoption of IFRS) associated with ACs. Grounded theories may also be used to extend the existing qualitative research towards a measurable theoretical framework.

4 Cross-examination of the empirical and qualitative AC research results

This section of the paper provides a cross-examination of the quantitative and qualitative AC research to reemphasise that, although ACs have become common practice for listed companies, there are still several unsolved issues regarding AC effectiveness. First, it has been generally established by the empirical research that the determinants of AC establishment and composition are associated with firm characteristics which represent agency cost proxies. Spira (1998; 2002), however, argue that firms willingly bear the costs of establishing ACs to avoid harsher corporate governance regulations being imposed on them. Wu et al., (2010) reveal that, even in real-world ACs, there were some members who believed in the mechanism of an AC, while others doubted that an AC was anything more than a mere formality, adding nothing new to the existing tasks performed by directors.

Second, empirical research has provided some evidence that an AC should have independent and competent members (i.e. members with financial accounting expertise) in order to provide assurance for financial reporting and audit quality, as well as to maintain market confidence. However, Wu et al., (2010) did not find that real-world AC members had any concern about their independent status; they also reported that AC members may even seek to influence management, effectively undermining their supposed independent status. Wu et al. (2010) find that a broad range of experiences and skills assisted AC members to perform their roles, with only a limited group of 'specialised' AC members justifying their roles on the basis of their accounting background. Their findings derived from interviews with AC members in New Zealand. To what extent this will be generalised across jurisdictions is not obvious.

Third, as stated by DeZoort et al (2002), the diligence of ACs has been measured in empirical studies only in terms of AC meeting frequency. Géndron and Bédard (2006), however, suggest that the meaning of AC effectiveness is internally generated, reflecting members' questioning skills used both during and outside AC meetings and comprises a wide range of emotions, ranging from confidence to anxiety.

Finally, it is generally accepted by the empirical research that an effective AC should enhance corporate governance (DeZoort et al, 2002). The previously identified AC corporate governance impacts, namely financial reporting qualities, audit qualities, disclosure practices, internal control and internal audit cannot, however, necessarily be regarded as a comprehensive list of the corporate governance impacts of ACs. Given that the empirical research results are inconsistent and inconclusive, this begs the question as to what corporate governance impacts an effective AC should have. Wu et al. (2010) reveal that AC members perceive their performance to be concluded when they provide the board of directors with good recommendations according to the board's delegated duties and responsibilities.

This paper contends that the empirical and qualitative research findings regarding AC committee effectiveness are contradictory, rather than complementary, to each other. Although the AC literature has been dominated by quantitative studies, qualitative research has shaken the fundamental assumptions underlying the AC mechanism. This paper therefore calls for triangulation in further AC research studies. According to Altrichter et al., (2008) triangulation can assist researchers to achieve a more balanced picture of the situation under investigation. Future research may focus on triangulating between different data, different theories and different methodologies to reconcile the differences in the extant AC literature.

5 Conclusions

This paper, following the lead of DeZoort et al (2002), Turley and Zaman (2007) and other AC research studies, has reviewed the existing body of knowledge addressing AC effectiveness, in an attempt to understand how and why an AC can be effective. The review is based on the two streams of AC research literature, namely, empirical archival and qualitative, focusing mainly on discussing the theorising of AC existence and functions.

Firstly, the research findings of the existing empirical AC research, constructed predominantly on agency theory, are summarised. Thus far, however, there has been no concrete evidence provided about whether

an AC can significantly reduce information asymmetry, which is the core of the agency problem, even after ACs have become widely established in listed companies all over the world. The criticism of agency theory as the main foundation for AC research has been shared by many scholars. Institutional scholars argue that ACs will become similar over time, either by compliance with regulation and/or by imitating best practice (DiMaggio and Powell, 1983). It is questionable, however, whether a tendency towards 'standardised ACs' is of benefit to the soundness of corporate governance.

The paper then reviewed the emerging qualitative literature, which aims to theorise ACs as social phenomena, acted by real people. This stream of literature has provided diverse insights into ACs in different countries and revealed other possibilities for theorising why ACs exist and how they can be effective. Reading the quantitative and qualitative literature alongside each other, we argue that the AC as an area of research has not yet been fully understood; therefore further theorizing attempts should be encouraged. Perhaps the time has come for the academic community, as well as for regulators, investors, practitioners and other corporate governance stakeholders to sit back, reflect and reconsider the expectations of, and reliance on, ACs.

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