

Corporate Governance in the Post-Sarbanes-Oxley Era: Auditors' Experiences*

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1. Introduction

In the aftermath of major accounting scandals such as Enron and World-Com and an alarming number of earnings restatements (Palmrose and Scholz 2004; Agrawal and Chadha 2005), there were calls for major reforms in the responsibilities and oversight of management, external auditing, and corporate governance (in particular, the audit committee and board of directors). These calls culminated in the enactment of the Sarbanes-Oxley Act in 2002 (hereafter referred to as SOX).

The primary purpose of the current study is to capture the experiences of auditors in their interactions with the audit committee, board, and internal auditors in the post-SOX environment. In particular, we focus on how such interactions affect the audit process (e.g., risk assessments and resolution of contentious accounting issues) and the audit environment (e.g., appointment and termination of auditors). In addition, as a secondary objective we examine if auditors' experiences with the current governance structure are in line with an effective monitoring approach (Beasley, Carcello, Hermanson, and Neal 2009) or whether the reforms are merely symbolic (Cohen, Krishnamoorthy, and Wright 2008; Powell 1991).

Based on interviews with 36 external auditors (11 seniors, 12 managers, and 13 partners) prior to the passage of SOX, Cohen, Krishnamoorthy, and Wright (hereafter referred to as CKW) (2002) captured auditors' experiences with respect to corporate governance and the audit process. They report that auditors generally found audit committees to be ineffective in monitoring the financial reporting process. Given the dramatic changes in the

* Accepted by Michel Magnan. We want to thank the participants for being generous with their valuable time and expertise. We would like to acknowledge the comments of participants at the 2007 Alternative Perspectives on Accounting Research Conference held in Québec City, the 2007 International Symposium on Auditing Research in Shanghai, the 2008 Midyear Auditing Meeting of the American Accounting Association in Austin, TX, and workshops at Arizona State University (West), Boston College, Iowa State University, University of Western Ontario and the University of Wisconsin at Madison. We also thank the anonymous reviewers and the editor, Michel Magnan, for many valuable comments and suggestions.

responsibilities of management, the board, the audit committee, and auditors mandated by SOX and related regulation, it is important to examine whether auditor experiences have changed significantly in the post-SOX era. We also extend CKW by looking at contemporary issues stemming from various provisions of SOX such as the substantive role that audit committees are expected to play in the appointment and termination of the auditors. Finally, when relevant, we compare the experiences of auditors with those of audit committee members as reported by Beasley et al. 2009 based on their interview study of audit committee members.

To address these issues, similar to CKW 2002, we conducted semi-structured interviews with 30 experienced audit partners and managers from three of the Big 4 firms. We find that auditors report that the corporate governance environment has improved considerably in the post-SOX era with audit committees that are substantially more active, diligent, knowledgeable, and powerful. However, in some instances governance appears to be symbolic. For example, management continues to be seen as a major corporate governance actor and, contrary to the intent of SOX, often the driving force behind auditor appointments and terminations. Further, some auditors report that audit committees play a passive role in helping resolve disagreements with management.

The remainder of this paper is divided into five sections. The next section provides a review of relevant studies followed by the identification of the overarching research question. The two sections that follow provide a description of the method and present the research findings. The final two sections contain an analysis, interpretation, and contribution of the findings of the study vis-à-vis agency and institutional theories as well as CKW 2002, with the last section devoted to a summary and discussion of the major findings and their implications for practice and future research.

2. Relevant research and research question

Effectiveness of corporate governance with respect to financial reporting

Prior research provides evidence that strong corporate governance, as measured primarily using archival data, is associated with improved financial reporting quality in terms of a lower incidence of fraud (McMullen 1996; Abbott, Park, and Parker 2000; Beasley, Carcello, Hermanson, and Lapides 2000; Farber 2005), fewer restatements (Abbott, Parker, and Peters 2004), and lower levels of earnings management (Klein 2002; Xie, Davidson, and DaDalt 2003; Bédard, Chtourou, and Courteau 2004). The current study extends prior research on this important issue in three ways. First, in a review of the literature, DeFond and Francis (2005) note that existing research indicates that greater financial expertise and more frequent audit committee meetings are associated with improved reporting. However, there is no evidence on the effectiveness of some of the requirements of SOX as viewed from the experiences of auditors, the focus of the current study.

Second, in a response to DeFond and Francis 2005, Carcello (2005) notes that financial expertise for the audit committee is defined very broadly by the Securities and Exchange Commission. Thus, there is need for research on how diversity of expertise can potentially influence audit committee effectiveness. Further, there is little evidence on other potentially important dimensions such as audit committee power and diligence. The current study investigates these issues.

Third, the findings of two recent studies provide further motivation for the research. DeZoort, Hermanson, and Houston (2008) report that audit committee support is significantly greater in the post-SOX period, and this finding is driven by members who are Certified Public Accountants. Further, participants indicate they believe audit committees have greater expertise, are more conservative, and more concerned with reporting accuracy after SOX, and they perceive that audit committees have greater power in resolving disputed matters. Thus, there is strong initial evidence that the findings of research in corporate governance conducted prior to the enactment of SOX may need to be revisited in light of the changes in environmental and institutional forces in the post-SOX regime.

Based on an interview of audit committee members, Beasley et al. (2009) find that, in the post-SOX era, audit committee members perceive that they take an active role in monitoring the financial reporting process. Further, audit committee members perceive that presently audit committees have the requisite financial expertise, meet frequently and for long time periods, and ask probing questions of management. However, there is also evidence of the audit committee performing ceremonial roles.

The research cited above generally suggests an improved corporate governance environment after the enactment of SOX in promoting sound financial reporting and in improving corporate governance. However, the current research extends our knowledge of the post-SOX environment because we examine the experiences of the auditor. This is important as the nature and strength of corporate governance is expected to impact the audit process (e.g., risk assessments and extent of audit tests), because professional standards dictate that the audit should be tailored to the risk of misstatements (American Institute of Certified Public Accountants 1984). Further, the audit committee is responsible for overseeing the quality of financial reporting and the audit and hence is expected to affect the audit process and audit quality, including ensuring proper resolution of auditor–client disputes (SOX 2002).

Auditors' experiences with corporate governance

Despite the potential conceptual link of the impact of corporate governance on the audit process, there is limited empirical evidence to date documenting this link. Early work on this issue was conducted by Cohen and Hanno 2000, who find that management control philosophy and governance structure (audit committee and board) affected auditors' preplanning (client

acceptance, business risk judgments) and planning judgments (extent and timing of tests). Bédard and Johnstone (2004), using archival data, find a significant effect of earnings manipulation risk on planned audit effort and billing rates and the effect is greater for clients that have heightened corporate governance risk, while Ng and Tan (2003) find that the effect of the availability of authoritative guidance on the resolution of a proposed audit adjustment is higher in the absence of an effective audit committee than in its presence.

CKW interview study

As noted, CKW (2002) is the only prior study that directly captures auditor experiences concerning their interactions with audit committees and boards of directors and the resulting effect on the audit process. CKW found that auditors' experiences indicated audit committees to be lacking the expertise, power, and skepticism that would make them effective. In effect, auditors frequently found audit committees to play a passive and ritualistic role. In all, CKW found that auditors' experiences prior to SOX suggested a corporate governance environment that lacked meaningful substance.

Contributions of the current study and overarching research question

Because of the significant expanded responsibilities required by SOX and an environment of heightened concerns for financial reporting quality, the current study examines whether and to what extent auditors' experiences with corporate governance parties, particularly the audit committee, have changed since CKW 2002 in the post-SOX environment. Further, we provide corroborating evidence of auditors' experiences to compare to those reported by audit committee members (DeZoort et al. 2008; Beasley et al. 2009) on issues such as audit committee expertise, power, and involvement in resolving disputes. Finally, we extend the CKW study by providing evidence on important regulatory requirements of SOX such as chief executive officer (CEO) and chief financial officer (CFO) certification of the financial reports. In all, we investigate the following overarching research question:

RESEARCH QUESTION: *How have auditors' experiences with corporate governance parties changed in the post-SOX era?*

3. Method

We employed a semi-structured interview approach to address the research question. An interview approach allows us to gain insights into the "black box" of the audit process and the interactions between auditors and other corporate governance parties (Gendron, Bédard, and Gosselin 2004; Gendron and Bédard 2006; Beasley et al. 2009). We asked contact people from the office of each of the Big 4 firms in a large Northeastern city in the United States to solicit the voluntary participation of audit managers and

partners. As a result of this call, 11 managers and 19 partners from three of the Big 4 firms agreed to participate in our study. The interviews were conducted in 2006.¹

Table 1 provides demographic data about the sample. As indicated in panel A, managers (partners) had an average of 9 (18.5) years of auditing experience, with an average 66 (76) percent of their last 5 years' experience with public company clients. With the exception of one partner, all participants had worked with public clients but not all the experiences they discussed related completely to public companies. Participants were free to note any substantial differences between public and nonpublic clients. Some questions specifically focus on provisions of SOX and thus are only applicable to public companies.

Panel B provides a summary of industry specialization of participants. The panel shows that the sample is representative of a broad spectrum of industries that is reflective of the practice base of the participating audit firms, with the largest percentage of auditors focused on financial services.²

The interviews were structured around 19 questions.³ When constructing the questionnaire, we carefully reviewed the following sources to identify significant issues for interview questions: the questionnaire in CKW 2002, literature on recent legislative and regulatory reforms (e.g., SOX), academic accounting research, and professional literature including recent changes in auditing standards (e.g., audit of internal controls). We did not interview audit seniors for this study because findings from CKW indicated that seniors have limited exposure to corporate governance and knowledge of how this impacts the audit process.⁴

In order to ensure external and internal validity of the questions, two audit partners and several academic researchers (not associated with this study) independently evaluated the questions for clarity, completeness, and relevance. The interviews were conducted by at least one member of the research team at the offices of the audit firm with each interview taking approximately 45 minutes to one hour. Interview questions were emailed to the participants in advance with an explicit instruction that participants should refrain from discussing the questions or their response with their

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1. Because the impact of the financial reporting reforms resulting from SOX and regulatory agencies (e.g., the stock exchanges) are expected to be pervasive across all of the Big 4 firms, we do not expect any differences in responses across firms. Our review of the transcripts from the interviews confirms this expectation.
 2. Given that the largest percentage of participants indicated the financial services industry as their specialization, we compared the qualitative responses of these participants with the responses of all other participants. Based on this analysis, we did not find evidence to support the notion that the financial services industry is in some way different from other industries in terms of the impact of SOX.
 3. A copy of the instrument is available from the authors upon request.
 4. Accordingly, all comparisons in this paper to the results in CKW 2002 include responses from managers and partners only and exclude responses from seniors.

TABLE 1
Demographic data

	Audit Managers* n = 10	Audit Partners* n = 18	Total* n = 28
Panel A: Years of auditing experience (percentage of last five years of experience with public company clients)			
Mean	9.0 (66)	18.5 (76)	15.1 (73)
Median	8.0 (65)	18.5 (80)	14.5 (75)
Range	5–20 (40–100)	10–30 (0–100)	5–30 (0–100)

Note:

* Data was unavailable for one partner and one manager.

Industry	# of audit managers and partners	Percent
Panel B: Industry specialization		
Financial services, including mutual funds and banks	11	24
Consumer products/business	10	22
Retail	7	15
Manufacturing	5	11
Healthcare	4	9
High-tech	3	6
Other (utilities, real estate, public sector, and services)	6	13
Total	46*	100

Note:

This total exceeds the number of participants (30) because some participants reported specialization in more than one industry.

colleagues. Participants were informed that the objective of the study was to obtain *their experiences* with audit clients, and hence there are no right or wrong answers to the questions. Further, as is customary in such studies, participants were informed that their responses would be held in strict confidence. Consistent with CKW 2002 and Hirst and Koonce 1996, when auditors' responses indicated that we pursue them in order to gain a more complete understanding we did so before returning to the interview questionnaire. With permission, interviews were audiotaped to ensure completeness and accuracy. Tapes were later transcribed by research assistants. As described more fully in the next section, a coding scheme for each question was developed. All interviews were then coded by two members of the

research team with an average initial intercoder agreement of 88 percent, indicating a high level of coding reliability. The researchers attempted to reconcile all disagreements, with remaining unresolved disagreements reconciled by a third member of the research team.

4. Results⁵

Tables 2 and 3 provide results from the analysis of coded responses. Responses to open-ended questions (e.g., What is your definition of corporate governance?) are coded as 1 (0) if the indicated response was (was not) identified by the respondent. Responses to a closed-ended question (e.g., Do discussions with audit committee impact audit risk assessment?) are coded as 1 (yes), 0 (no), or NA (not available). A response was coded as NA if the question was not asked or if the participant did not respond to the question. Responses coded as NA were excluded from the computation of percentages.

Definition of corporate governance

Despite the importance placed on corporate governance in academia and practice in recent years, there is still no universally accepted definition of corporate governance, and there is even greater divergence of views on what is considered “good governance”. CKW (2002) found that auditors placed management in the forefront of corporate governance. Given the dramatic changes of SOX with respect to the financial oversight responsibilities of the board and the audit committee, auditors’ views on what constitutes “corporate governance” may have changed since the CKW study. Consistent with CKW, we did not offer participants a definition of governance, but rather asked them to provide us with their definition.

Table 2 (panel A) summarizes the parties included in the participants’ definition of corporate governance. The definitions predominately focused on the management (67 percent) and the board (67 percent). Noting the importance of the board in achieving effective governance, a partner stated that a board is a “buffer between the management and shareholders”. However, another partner stated:

5. In the course of our analysis, we did not find any apparent substantive differences in the qualitative (verbal) responses of managers versus partners. With respect to differences in the coded (quantitative) responses included in Tables 2 and 3, there were a few responses that were different between managers and partners although these differences were not pervasive across all questions or across all responses within a question/topic. Importantly, the usable sample size with respect to managers was predominately in single digits, making statistical tests of differences in responses between managers and partners infeasible. Accordingly, the results reported in Tables 2 and 3 combine the responses of managers and partners.

TABLE 2
Definition and role of corporate governance

Open-ended (OE) or Closed-ended (CE) Question		Total	
Panel A: Definition of corporate governance¹			
OE		n	%
Stakeholders and other governance mechanisms included in the definition			
	Management	20	67
	Board	20	67
	Control environment/corp. culture	18	60
	Audit committee	10	33
	Control activities	9	30
	Other	2	7
Panel B: Auditor appointment and termination			
OE	<i>Who has most influence on hiring/firing auditor?¹</i>		
	Management (CEO, CFO)	29	97
	Audit committee	28	93
	Board of directors	2	7
	Stockholders	0	0
CE	<i>Mean percentage influence on hiring/firing auditor²</i>		
	Audit committee	41	
	Management (CEO, CFO)	53	
	Board of directors	5	
	Stockholders	1	
	Other	0	
Panel C: Audit process			
CE	<i>Nature and extent of the use of corporate governance information in the following audit phases changed in the last five years?²</i>		
	Planning phase (audit scope)	28	97
	Field-testing	17	59
	Manager or partner review	16	57

(The table is continued on the next page.)

TABLE 2 (Continued)

Open-ended (OE) or Closed-ended (CE) Question		Total	
CE	<i>Does the role and importance of corporate governance vary across engagements?</i> ²		
	Varies based on risk profile of the engagement	18	69
	Varies based on the nature of the industry	11	46

Notes:

1. Responses to OE questions (e.g., What is your definition of corporate governance?) are coded as 1 (0) if the indicated response was (was not) identified by the respondent. The percentage reflects the total number of participants indicating the response out of a total of 30 participants. For example, in panel A, 20 (10) out of 30 participants identified (did not identify) "management" in their definition of corporate governance, resulting in a 67 percent score.
2. Responses to CE questions (e.g., Has the nature and extent of the use of corporate governance information in the following audit phases changed in the last five years?) are coded as 1 (yes), 0 (no), or NA (not available). A response was coded as NA if the question was not asked or if the participant did not respond to the question. Responses coded as NA were excluded from the computation of percentages. For example, in panel C, 17 (12) auditors indicated that the nature and extent of the use of corporate governance information in the field-testing phase has changed (not changed) in the last five years, with one auditor classified as NA, resulting in a computation of 59 percent (17 out of 29) indicated in the table.

At the end of the day, it is really management that is going to make things work or not work. I mean the audit committee or board certainly can over time do a lot to affect them, but I really do think it is [up to] management to do the right thing or not.

Emphasizing the role of the CEO, another partner noted:

What that CEO does on a day-in and day-out basis sends a much stronger message to everyone in the organization than what is written on an ethics policy, or the corporate governance website or anything like that.

Thus, consistent with CKW 2002, management continues to be viewed by auditors as an important part of the corporate governance mosaic.

TABLE 3

Interaction with the audit committee, board, and internal auditors

Open-ended (OE) or Closed-ended (CE) Question		Total	
		n	%
Panel A: Interaction with the audit committee			
CE	<i>Frequency of meetings</i> ²		
	Mean* number of meetings per year	6.4	
OE	<i>What issues are typically discussed in audit committee meetings?</i> ¹		
	Accounting/auditing issues	20	67
	Audit plan	14	47
	Results of audit	13	43
	SAS 61 and other mandated items	10	33
	Accounting personnel	8	27
	Audit risk	7	23
	Disagreements with management	5	17
	Internal control & control environment	5	17
	Compliance-related Issues	4	13
	Audit fees	4	13
	Auditor independence	3	10
	Earnings releases, MD&A, etc.	2	7
	Other	13	43
CE	<i>Do discussions with audit committee impact the following?</i> ²		
	Audit risk assessment	16	53
	Audit program planning	15	56
	Resolution of contentious issues	14	52
	Type of audit report	4	16
CE	<i>Does the audit committee play a role with respect to internal controls?</i> ²	23	88
OE	<i>Changes in the last five yrs with respect to interactions with the audit committee</i> ¹		
	Lots of questions...anything they need to know?	11	37
	Upfront planning	4	13
	Focus on audit risk	3	10
	Whistleblower program	2	7
	Other	16	53
CE	<i>Whistleblowing and audit committee</i> ²		
	Whistleblowing policy exercised by client employee?	14	56

(The table is continued on the next page.)

TABLE 3 (Continued)

Open-ended (OE) or Closed-ended (CE) Question		Total	
	Is audit committee effective in overseeing fraud whistleblowing?	20	87
Panel B: Financial expertise and power of the audit committee			
		n	%
CE	<i>Audit committee financial expertise²</i>		
	Does audit committee have sufficient financial expertise?	25	93
	Does audit committee financial expertise vary by industry, size, or other factors?	12	75
	Is the difference between the most and the least qualified audit committee member significant?	18	86
CE	<i>Audit committee power²</i>		
	Does the audit committee have sufficient power to confront management?	23	96
	Does audit committee power vary by industry, size, or other factors?	9	75
CE	<i>Change in the last five years with respect to audit committee's effectiveness in monitoring the financial reporting process?²</i>	23	96
Panel C: Interaction with the board and subcommittees			
CE	<i>Change in the last five years with respect to board's effectiveness in monitoring the financial reporting process?²</i>	11	50
CE	<i>Consider the composition and work of committees other than the audit committee?²</i>	23	82
OE	Specific committees considered: ¹		
	Compensation	13	43
	Governance	3	10
Panel D: Interaction with internal auditors and management			
CE	<i>Role of internal auditors changed in the last five years?²</i>	20	83
CE	<i>Nature and extent of reliance on internal audit work changed over the last five years?²</i>	22	85

(The table is continued on the next page.)

TABLE 3 (Continued)

Open-ended (OE) or Closed-ended (CE) Question		Total	
CE	<i>Has SOX CEO/CFO certification requirement impacted:²</i>		
	Integrity of financial reporting?	15	68
	The audit process?	4	20

Notes:

- * For participants who provided a range for the number of meetings, the midpoint of the range was used for the purpose of computing the mean number of meetings.
- 1. Responses to OE questions (e.g., What issues are typically discussed in audit committee meetings?) are coded as 1 (0) if the indicated response was (was not) identified by the respondent. The percentage reflects the total number of participants indicating the response out of a total of 30 participants. For example, in panel A, 20 (10) out of 30 participants identified (did not identify) “Accounting/Auditing Issues”, resulting in a 67 percent score.
- 2. Responses to CE questions (e.g., Was whistleblowing policy exercised by client employee?) are coded as 1 (yes), 0 (no), or NA (not available). A response was coded as NA if the question was not asked or if the participant did not respond to the question. Responses coded as NA were excluded from the computation of percentages. For example, in panel A, 14 (11) auditors indicated that whistleblowing policy was (was not) exercised by client employee, with five auditors classified as NA, resulting in a computation of 56 percent (14 out of 25) indicated in the table.

Sixty percent of the auditors identified the control environment/corporate culture in their definition of governance. This is consistent with the notion of governance espoused both in academic literature and in practice where the monitoring role of the board and the overall control environment and corporate culture are emphasized as fundamental to achieving effective governance. Finally, only 33 percent and 30 percent of the participants, respectively, included the audit committee and control activities in their definition of corporate governance. Thus, the findings suggest that the majority of our participants viewed corporate governance in the broader terms of management, the board as a whole, and the overall environment as opposed to the specific role of the audit committee and the control activities. One potential reason that the audit committee was mentioned by relatively few respondents in their definition of corporate governance may be that it is viewed as a subcommittee of the larger board.

Auditor appointment and termination

To strengthen the independence of auditors, SOX gives the audit committee the authority to appoint and dismiss the external auditor and to determine the audit fee. Despite this requirement, evidence from a survey of audit committee members and other executives suggests that CFOs continue to have the greatest influence over auditor retention (KPMG 2004). Further, Gendron and Bédard (2006) argue that governance cannot be thought of simply in terms of the input and output measures of different regulatory requirements. For example, they illustrate that audit committees, at times, may not play that decisive a role in the decision to continue with the existing auditor.

Auditors were asked to share their experiences on who *actually* has the most *influence* in the appointment and dismissal of auditors in a public company. They were also informed that the *actual influence* refers to the substance of the decision to hire and fire auditors, and not necessarily to what is required under SOX. In order to further understand the extent of this influence, auditors were also asked to specify the percentage of influence that they believe the following stakeholders have with respect to the decision to hire and fire auditors: audit committee, management (CEO, CFO), board of directors, stockholders, and others. Management and the audit committee were identified, respectively, by 97 percent and 93 percent of the participants (Table 2, panel B). Further, the mean percentage of actual influence assigned to the management was 53 percent while that assigned to the audit committee was 41 percent. For example, noting that management is still a dominant player with respect to decisions regarding audit services, one manager stated:

I would say without a doubt, management. Clearly the law stipulates that it is the responsibility of the audit committee. We acknowledge that readily in our engagement letters so that it's clear from a contractual standpoint that we understand that and presumably the audit committee understands that but I would say point of fact that the group of individuals who hold the most influence over the appointment decision and retention would be management.

A partner noted:

But I will say over the last several years what is interesting is that CEOs are much more involved in this process than before. I think CEOs always kind of figured that's the CFO's prerogative but I think they have had a lot of issues with the firms over the last several years. I think CEOs are starting to realize [that] the audit firm can have a significant impact in my business.

Interestingly, the influence of management in auditor appointment and dismissal decisions appears to increase when the CEO is dominant on the board. One partner noted, “where the CEO is also chair then there is more influence [by] management”.

Corporate governance and the audit process

We asked participants if the nature and extent of the use of corporate governance in the various phases of the audit process (planning, field-testing, and review) has changed over the last five years. We also asked auditors to comment on whether the role and importance of corporate governance varies across engagements and, if so, whether auditors seek and utilize information relating to corporate governance based on the risk profile of the engagement and the nature of the industry in which the client operates.

With respect to the planning and field-testing phases, 97 percent and 59 percent of the auditors, respectively, indicated that these phases of the audit process have changed in the last five years with respect to the use of corporate governance information (Table 2, panel C). Similarly, 57 percent indicated that the last five years has seen a significant change with respect to manager or partner review as it relates to the use of corporate governance information. Although we did not ask whether the change was an increase or decrease in the use of governance information, responses indicate that the change has resulted in an increase in the use of governance information. For example, one manager stated the following:

I think in the planning phase we obviously consider [corporate governance] a lot more than we did before. . . . If we think that there’s a good corporate governance then the extent to which we will do the field work will be lessened and the extent to which the manager and partner will review the work papers is also reduced, and [when] we think that there’s not enough corporate governance, sometimes that kicks it into a riskier category for us and there’s a lot more review.

Similarly, a partner noted that,

because of the increased focus on governance and more documentation on what’s going on, we absolutely incorporate more of the company’s governance and thought process in our planning phase.

There was a divergence of views on whether the role and importance of corporate governance varies across engagements. Most participants noted that corporate governance is important in every engagement, but some noted that this varies. Specifically, 69 percent and 46 percent of the auditors, respectively, noted that the role and importance of corporate governance differs based on the risk profile of the engagement and the nature of

the client's industry. With respect to the importance of corporate governance based on the risk profile, one partner noted:

But I do think that the risk profile definitely plays into it. If you have a company that has not been in complex transactions, things are pretty much going along [and] they are not under a lot of pressure from Wall Street, corporate governance may not be of [as much] importance as a higher risk type of company or a company that is in a different industry where there is a lot of risk and [there are] complex transactions.

Noting the importance of the industry, one partner stated:

First [if] a company [is] in an industry that's not matured, that's growing, that's doing its own acquisitions and growing double-digits, [it is good to have] a good audit committee that can step up to management and say slow down you are overreaching your capabilities here.

Interaction with the audit committee

SOX places significantly greater responsibilities on the audit committee to oversee financial reporting, the audit process, and internal controls. With such SOX requirements, companies are expected to have enhanced the quality of audit committees, including greater audit committee independence, financial expertise, and the power to confront management. This is corroborated by Gendron et al. 2004, who found that audit committee members ask diligent questions to establish their perceived effectiveness. An important issue is whether there has been a significant change in the post-SOX era from the largely negative experiences of auditors with audit committees as reported in CKW 2002.

Table 3 tabulates auditors' interactions with the audit committee, the board, and internal auditors. CKW (2002) found that auditors typically met only two to three times a year with the audit committee. In comparison, we found that in the post-SOX era the activity has expanded to an average of over six meetings a year.

With respect to the issues discussed at audit committee meetings, 67 percent of the respondents indicated that they discussed accounting and auditing issues; 47 percent and 43 percent indicated that they discussed the audit plan and results of the audit respectively; 33 percent discussed *SAS No. 61* and other mandated items, and 27 percent and 23 percent, respectively, discussed the quality of the accounting personnel employed by the client and audit risk (Table 3, panel A). As an illustration of the importance placed on discussing accounting and auditing issues, one manager remarked:

Key communications with audit committee are the judgments in the financial statements, the estimates, [and] the quality of earnings. Those are three of the key things that I communicate every quarter to my audit committee and usually what you will do is we will have a sheet of bullet points, here are the findings, focusing on those three key points.

We also asked respondents about the impact of the interactions with the audit committee on various phases of the audit process; 53 percent and 56 percent of the respondents indicated the discussions affected audit risk assessment and program planning process. One partner noted:

If we are in dialogue with an audit committee throughout the year or throughout the audit process and we don't get a comfortable feeling that the audit committee is taking it seriously that obviously impacts our risk assessment.

Surprisingly, these percentages are lower than that found in CKW 2002 — 80 percent and 81 percent, respectively, for audit risk assessment and program planning. Perhaps this difference is caused by the weaker audit committees that were common in the pre-SOX environment, which may have unilaterally resulted in very high-risk assessments. For example, if, as a result of the discussions with the audit committee, they are perceived to be a rubber stamp for management, then the control risk of the client will be evaluated as higher.

About half of the respondents indicated that discussions with the audit committee helped resolve contentious issues with management. A partner noted:

In the course of the discussions with the audit committee we were reporting on adjustments not recorded and the audit committee chairman said, I don't think so, I think we should record known errors [and] departures from GAAP. So we want you to go back and record that adjustment and we don't care if it takes two days to run it all the way through the financials and so forth. We think you should do it.

However, other partners indicated audit committees are not sufficiently engaged in helping resolve disagreements between the auditor and the management. One partner mentioned:

I think most committees have an expectation that it's our job and management's job to work out what the issues are to make determination on what's appropriate. That they will be brought the results as opposed to needing to be referees of fights.

Some responses suggest that the audit committees normally expect disputes to be resolved before they come to them. These results are similar to the findings of Gendron and Bédard 2006.

Another interesting comment made by a partner referred to how management today is more reluctant to bring matters to the audit committee to persuade them of the virtue of their position. The partner stated:

They [audit committees] usually do not get involved in resolving contentious accounting issues, that's usually resolved with the management and then brought to the committee with the resolution and maybe the various alternatives that were discussed. One thing I will point out though is that management is much less willing to take an item to the audit committee today.

This sentiment could be attributable to management being afraid of being consistently turned down and looking too aggressive in managing earnings.

With the requirement of SOX 404 that auditors evaluate the controls of a company, the next question examined the role of the audit committee in connection with controls. Eighty-eight percent of the respondents indicated that the audit committee plays an important role in providing an oversight function over controls. For example, one partner stated:

So they [audit committee] had a significant impact in terms of one, the overall control environment . . . and two, their role in making sure that (the requirements of) 404 (were accomplished) and that it got done right.

This is confirmed by another partner's remarks:

I think the role of the audit committee is ensuring that management has done what they need to do to maintain [an] effective internal control environment and to challenge management as to whether [the internal control environment] really is effective or not.

Thus, it appears that SOX 404 has clearly had a positive influence on the audit committee's role in overseeing controls.

In the prior study, CKW (2002) found that, by and large, meetings with the audit committee were passive, with auditors merely reporting results of the planning and final stages of the audit. In contrast, 37 percent of the auditors indicate that the audit committee members ask a lot of questions and the meetings in general are currently seen as more give and take. A number of respondents gave examples of how the interactions have changed in the past five years in terms of the types of questions the audit committee asks. For example, one partner stated:

Audit committees challenge management. . . they ask questions of management whereas in the old days it was much more focused on the auditors. So it is very even. Audit committees are much more serious today than they used to be . . . It's a completely different view than it was pre-Sarbanes. And that to me is the biggest benefit of the entire Sarbanes-Oxley Act.

As part of SOX, protection is supposed to be provided to whistleblowers who file allegations about fraud and other financial matters with the audit committee. Fifty-six percent of the respondents indicated that they were aware of instances where the client's whistleblower policy was exercised by an employee, and 87 percent of the respondents noted that the audit committee provided effective oversight over the whistleblowing process. However, some respondents indicated that nothing of substance has been brought to the whistleblowing hotline. One partner stated:

Sarbanes-Oxley would tell you that if there have been no reports to a whistleblower hotline that might be a big hint that the control environment is weak. Many of my clients would say it's indicative that there's a strong control environment because no one has anything to report. So who knows?

Expertise and power of the audit committee

One of the striking findings of CKW 2002 was that auditors' experiences indicated audit committees lacked both the expertise and the power to play an effective oversight role over management. Further, even though audit committee members were seen as appropriately independent according to existing regulations, their independence did not translate into actions. However, with the passage of SOX, there appears to be greater emphasis on increasing the knowledge base and independence of the audit committee. In the Beasley et al. 2009 study, 81 percent of audit committee members noted they were appointed because of either their accounting or industry background.

In the current study, 93 percent of the auditors reported that the audit committee had sufficient expertise, and 96 percent note that audit committee members have sufficient power to confront management with respect to the financial reporting process (Table 3, panel B). As an example of the change in the power dynamics, one managing partner of a large office remarked on an interaction between the audit committee and management:

Now that was an example of power being used by [an] audit committee, that pre-Sarbanes, management would have said this is the way it's going to be, like it or not. So audit committees wield a lot of influence

today on management. I think management is a little bit back on their heels versus being very aggressive.

However, it must be noted that at least some respondents perceived that when the client was doing well, then management had greater power. One partner noted:

I do think that companies that have a strong CEO and the company is performing very well then there's typically a balance of power that is shifted towards management.

In a further probing of expertise, 86 percent of the respondents mentioned that there was a significant difference in the financial expertise between the most and least qualified members of the committee. Three-quarters of the respondents indicated that audit committee power and expertise varied by industry, size, or other factors which might suggest that there is a better matching of the financial sophistication of the audit committees with the financial complexity of the companies within which they are serving. One partner noted:

I think the smaller the company the more likelihood that you are going to have this big variance between the expert and the least expert on the committee. I think the gap will be closer in a bigger company, a bigger public company. But I don't think there are many companies, even the big ones, that have three financial experts on their audit committee that would qualify as a financial expert.

Finally, having some cross-section of expertise was viewed favorably by respondents. For example, one partner touted the virtue of diversity in the background of audit committee members, stating:

Within the company, yes, there can be a wide range of financial savviness of the audit committee members, but in a good audit committee not everyone has to be financially savvy. I have some audit committee members where, I got some attorneys that are on the audit committee that aren't really financially savvy but boy do they ask some great questions.

The final question on this topic examined changes in the last five years with respect to audit committees' effectiveness in monitoring the financial reporting process. In contrast to the findings reported in CKW 2002, 96 percent of the respondents in the current study indicated that audit committees have become more effective in monitoring the financial reporting process. In response to the change in the audit committee's willingness to confront management, a regional director of the audit practice remarked:

Yes, yes, yes over and over again. They're very active, very proactive and the questions just don't come to the auditors anymore, they come to management.

Interaction with the board and other subcommittees of the board

Besides the change in auditors' interactions with the audit committee we were also interested in the auditors' interaction with the board and other subcommittees of the board. CKW (2002) found almost no interaction with the board, and consideration of other committees of the board was not identified. Although auditor interaction with the board is still limited, half of those responding perceived that the board as a whole has become more effective with respect to monitoring the financial reporting process. However, other committees such as the nominations and compensation committee also play significant roles in appointing qualified members to the board and audit committee as well as establishing management incentives that affect the potential for earnings management and taking excessive business risks (Beasley 1996; Klein 2002; Xie et al. 2003). Prior research has stressed the importance of executive and CEO compensation on disclosure (e.g., Craighead, Magnan, and Thorne 2004) and financial reporting decisions. Excessive managerial compensation has received much adverse press which has resulted in changes in the disclosures for executive compensation (SEC 2006). Accordingly, it is not surprising that, besides the audit committee, the committee which received the most scrutiny by auditors is the compensation committee.

Forty-three percent of the auditors indicated that they consider the composition and work of the compensation committee when conducting an audit. One manager noted:

The compensation committee [we] definitely consider because they're setting the salaries and bonuses, the bonus structures. So that's a key control that we consider . . . when we're looking at the audit because you're always concerned what the drivers are for the bonuses.

Interaction with the internal auditors

The internal audit function is seen as a potentially strong component of the corporate governance mosaic especially since the passage of SOX (Cohen, Krishnamoorthy, and Wright 2004; Committee of Sponsoring Organizations 2004; Felix, Gramling, and Maletta 2005). Internal auditors are also expected to play a significant role in ensuring compliance with the SOX mandate requiring management to assess the strength of internal controls over financial reporting. Thus, we examine auditor experiences in the post-SOX environment in working with internal auditors. Eighty-three percent of the respondents indicated that the role of the

internal audit function has changed over the past five years and 85 percent indicating that the nature and extent of reliance on internal audit work has increased considerably. One partner, while discussing his firm's reliance on the internal audit function, stated:

So there's been a big increase in terms of the work and our use of their [internal audit] work to satisfy our 404 obligations. It's been a big change. It's required a lot more coordination between us and them [internal audit] and a lot more evaluation of their competency and making sure really that they know what they're doing.

This is reinforced by the comments of another manager who remarked:

And now the internal auditors really spend, in my experience, probably 90 percent of their time doing something 404-related, whether it's documenting the processes, documenting controls, doing the actual testing for the company. So that's been a huge change.

The impact of management certification and other issues

One key element of SOX is the certification of the financial statements by top management (Section 302). The rationale for the provision is that the very act of certification increases the accountability of management. However, there is debate about whether, in fact, certification impacts management's behavior in promoting sound financial reporting (Nyberg 2003). In an experiment, Mayhew and Murphy (2003) find that certification alone does not reduce misreporting except when public certification and social persuasion (completion of an ethics seminar) are combined. In this study, approximately 68 percent of the respondents indicated that the requirement has had a positive impact on the integrity of the financial reports but only a minority (20 percent) believed that the requirement ultimately had an effect on the audit process.

To illustrate how auditors indicate that the certification has placed the onus for the quality of financial reporting squarely on management, one partner stated:

I think it's made a very big impact. It was very easy for people to say well I wasn't involved in that, I didn't know anything about that. That's poor leadership and poor management. I think that certification requires them to be involved and most people take that requirement very seriously.

Although only a minority of respondents reported that management certification affected the audit process, there were some exceptions. It appears that, at least for some companies, management and the CFO are

trying to avoid questionable accounting issues. One partner said about his clients:

CFOs are, I believe, particularly in larger companies, closer to the numbers now than they were before. They want to understand what the issues are. They don't want to have unrecorded adjustments on their score sheet as it were, on the summary of adjustments because they know they are going to get picked at from the audit committee. So I think it has brought the CFOs closer to the audit process than they used to be in the past, and that again is really good.

Finally, we asked participants if they wanted to add anything else on the subject of corporate governance. The majority who did respond brought up the issue of ethics. One partner discussed how he resigned from an engagement because he perceived that there were ethical problems with one of his clients. Discussing the resignation, the partner stated:

Evaluating integrity, just over a gut instinct like that. . . . I just said something smells here, it stinks, so we resigned and in the process of resigning what was amazing was everyone in management was trying to cover their butts that it wasn't them and the things they told us were unbelievable.

5. Analysis, interpretation, and contribution

Relevant theoretical perspectives

Based on the results reported in the prior section, we examine if auditors' experiences with the current governance structure and the reforms set out by SOX are in line with an effective monitoring approach (an agency theory perspective; Beasley et al. 2009) or if they are merely symbolic, which provides evidence consistent with institutional theory (Cohen et al. 2008; Powell 1991). In addition, where appropriate, we delineate the incremental contribution of this study vis-à-vis CKW 2002 and other recent studies that have examined the role of governance in the audit environment in the post-SOX era.

In a recent review, Cohen et al. (2008) suggest that two theories are of particular importance to audit researchers in understanding the role of governance in the audit process: agency theory and institutional theory.⁶ In the

6. Cohen et al. (2008) also discuss the managerial hegemony perspective (i.e., the board is under the control of management and is basically not acting with the shareholders' interest in mind) as well as the resource dependence perspective (i.e., the board is designed to help further the strategic objectives of the firm). A recent interview study of audit committee members by Beasley et al. 2009 confirms that agency and institutional theories are the most relevant theories for enhancing our understanding of the role of governance in the audit process, because the audit is focused on financial reporting and internal controls and not as heavily on operational and strategic issues.

agency framework (Fama and Jensen 1983; Baysinger and Hoskisson 1990; Bathala and Rao 1995), contractual mechanisms, including corporate governance, are designed to monitor management's behavior. The agency perspective implies that governance entails a strong monitoring function with particular importance placed on the fact that the monitors are independent of management. On the other hand, institutional theory suggests that many structures and interactions within organizations fulfill symbolic and ritualistic purposes (Powell 1991). The institutional theory perspective implies that governance entails a ceremonial role, including structures and processes that are as important for their symbolism ("form") as opposed to substantive purposes ("substance"). For instance, an audit committee may consist of all independent members (symbolic) but in fact fail to vigorously challenge management over financial reporting quality issues (substantive).

In order to understand how well agency theory and institutional theory map into the results from our interviews, we have adapted a process from that outlined in St-Onge, Magnan, Thorne, and Raymond 2001, in which we enrich the findings by providing an analysis and interpretation of the major results to provide insights on the incremental contribution of this study above and beyond what has been documented in prior studies. In particular, Table 4 provides a comparison of the primary findings of CKW pre-SOX to the results of the current study post-SOX.

Definition of corporate governance

In their definition of governance, audit partners and managers articulated notions of both agency and institutional theories. The findings indicate that auditors often emphasize the role of management in providing a definition of governance. This suggests that, despite SOX, management often has a very strong influence, which may in some instances supersede that of the board and the audit committee. One potential additional explanation for this result may be that management also oversees other employees, thus acting in a monitoring role.

As indicated in Table 4, the emphasis on management in auditors' definition of corporate governance was equal to that of the board post-SOX but decreased from CKW 2002. While this decline in the emphasis on management in their definition of corporate governance may be viewed as positive by some observers, others may argue that the inclusion of senior management by a majority of the respondents is a reflection of their continued influence in the governance process in the post-SOX era and is inconsistent with the spirit of SOX. Although the influence of management in governance is examined indirectly in prior studies via examination of the independence of the board, this study provides a more direct assessment of the impact of management from the auditors' vantage point.

There was also a slight decline in the percentage of respondents who identified the board in their definition of corporate governance. Seventy-five percent of the participants in CKW 2002 identified the board in their

TABLE 4
Corporate governance and the audit process, pre- and post-SOX

Issue	Pre-SOX (CKW 2002)	Post-SOX (Current study)
Definition of corporate governance	Greater focus on senior management than the board. Secondary importance to the audit committee (AC). Not asked.	Equal emphasis on senior management and the board.
Appointment and termination of external auditors		Management has greater influence than the audit committee or the board in decisions relating to hiring/firing auditor.
Use of corporate governance info in the audit process	Very high in the audit planning phase; moderate in the field-testing phase; and low in the manager/partner review phase.	Very high in the audit planning phase; moderate in the field-testing phase and manager/partner review phase.
Importance of corporate governance based on client's risk profile and industry	Almost all (majority) respondents considered client's risk profile (industry).	Majority (minority) of respondents consider client's risk profile (industry).
Frequency of meetings with the AC	2-3 times a year.	Over six times a year.

(The table is continued on the next page.)

TABLE 4 (Continued)

Issue	Pre-SOX (CKW 2002)	Post-SOX (Current study)
Primary issues discussed at AC meetings	Audit plan; and results of the audit.	Audit plan; results of the audit; accounting/auditing issues; and <i>SAS No. 61</i> and mandated issues.
Impact of interactions with AC on phases of the audit process	Audit risk assessment; Audit program planning.	Audit risk assessment; Audit program planning; and resolution of contentious issues.
Role of AC in establishing and maintaining controls	Not asked.	A significant majority of respondents indicate that AC has a significant role.
Whistleblowing and AC	Not asked.	A significant majority of respondents indicate that AC is effective with respect to overseeing the whistleblowing process.
AC financial expertise	AC members lacked the expertise to perform their jobs effectively.	AC members have sufficient financial expertise; AC financial expertise varies by industry, size, and other factors; and significant variance across AC members with respect to financial expertise.
AC power to confront management	AC lacked sufficient power.	AC has sufficient power, but this power varies by industry, size, etc.

(The table is continued on the next page.)

TABLE 4 (Continued)

Issue	Pre-SOX (CKW 2002)	Post-SOX (Current study)
AC effectiveness in monitoring with respect to financial reporting	AC perceived to be typically passive, ineffective, and asking perfunctory questions.	AC perceived to be proactive, have a higher level of effectiveness, and asking probing and difficult questions.
Interaction with the entire board	Rarely met with the board.	Limited interaction with the board.
Committees of the board	Not asked.	Increased focus on the compensation committee.
Interaction with internal auditors	Internal audit function not emphasized.	Increased reliance on the internal audit function.
Impact of SOX certification requirements on integrity of the financial reporting process and the audit process	Not asked.	Positive impact on the financial reporting process but little or no impact on the audit process.

definition, while 67 percent did so in the current study. While this decline is not as significant as that observed with respect to management, it appears to be a surprising finding, given the increased emphasis on independent boards in the post-SOX era.

Auditor appointment and termination

Prior literature suggests that audit committees play a more passive, ceremonial role that is consistent with institutional theory, rather than the monitoring-focused role implicit in agency theory (CKW 2002). Therefore, an important issue is whether in the post-SOX period auditors still have experiences consistent with management having the primary influence in maintaining a relationship with the auditor, or whether SOX has fundamentally affected the audit committee's power in hiring/firing the auditor.

CKW (2002) did not explicitly address the audit committee's role in auditor appointment and termination. As indicated in Table 4, auditors in the current study indicate that management has a greater influence than the audit committee with respect to decisions about hiring/firing auditors. An analysis of participant responses revealed that several managers and partners expressed a view consistent with institutional theory. Interestingly, the influence of management in auditor appointment and dismissal decisions appears to increase when the CEO plays a dominant role on the board. Collectively, these results indicate that, despite the legislative and regulatory reforms, in substance management continues to play a critical role in decisions with respect to the hiring and firing of auditors.

While the influence of management was echoed by many participants, some auditors reflected the view that decisions with respect to engaging audit services is a collaborative process that involves both management and the audit committee. Though this view is not entirely consistent with the predictions of agency theory, it does imply a greater role for the audit committee in the auditor appointment and termination process than what is implied by the purely symbolic role espoused by institutional theory.

Although prior literature has focused on the association between independence of the audit committee and financial reporting quality (e.g., Abbott et al. 2004), the *de facto* role of the audit committee in auditor appointment and dismissal decisions from the standpoint of auditors has not been examined extensively in the literature. Beasley et al. (2009) find that audit committees are active in selecting the new engagement partner at the time of partner rotation. Nonetheless, our findings regarding the significant role of management in auditor appointment and dismissal supports the notion that the post-SOX reforms relating to audit committee's ultimate authority to hire and fire auditors may also be partly "form" as well as "substance".

Corporate governance and the audit process

From an agency theory perspective, a stronger corporate governance structure should lead to more effective monitoring of controls and the control environment, potentially resulting in lower assessments of control risk and perhaps less substantive audit work. The responses appear to be consistent with an agency view, whereby auditors are incorporating governance information in the audit process in the post-SOX environment.

As summarized in Table 4, the use of corporate governance information in the audit process in the Post-SOX period continues to be very high in the audit planning phase and moderate in the field-testing phase. However, there appears to be increased emphasis on corporate governance in the manager/partner review phase of the audit process in the post-SOX era, as compared with pre-SOX.

Both in the pre-SOX and the post-SOX periods, auditors emphasized the importance of corporate governance based on the risk profile of the engagement. These observations are also consistent with Cohen, Krishnamoorthy, and Wright 2007, who report that auditors' control risk assessments were higher when the board was considered weak with respect to its agency or resource dependence roles, than when the board was stronger on these dimensions.⁷ Further, their results indicate that when the board was stronger on both agency and resource dependence dimensions, control risk assessments were the lowest and auditors decreased planned audit effort, while audit effort increased when boards were weak on either or both of these dimensions. Further, while a majority of respondents indicated that the importance of corporate governance to the audit process varies based on industry in the pre-SOX study, the importance of industry was indicated by a minority of participants in the current study. This change may be indicative of the notion that corporate governance in the post-SOX period is important to the audit process and the client's control environment, regardless of the industry in which the client belongs.

Interaction with the audit committee

A number of participants reported that the increased interaction with the audit committee resulting from SOX and related regulation has resulted in a greater focus by the audit committee on matters related to the audit process, providing support for the effectiveness of the monitoring function predicted by agency theory. Auditor responses suggest that there is a significant shift from the results reported in CKW 2002 where auditors characterized their meetings with the audit committee as passive. In that respect, the pre-SOX environment seemed to be more reflective of a symbolic role played by the audit committee and consistent with institutional theory.

7. Resource dependence entails support from governance parties such as the board in helping to establish corporate strategies and obtaining needed resources.

Most of the participants in the current study noted that the audit committee is taking a more proactive role with respect to overseeing audit risk assessment and related audit planning decisions. Indeed, it appears that this shift from a more symbolic role of the audit committee in the pre-SOX era to one that is more substantive with respect to the audit committee's involvement with monitoring external audit-related issues is consistent with both the prescriptions of agency theory as well as the intent of SOX. Although prior studies have examined the role of corporate governance in audit planning decisions (e.g., Bédard & Johnstone 2004; Cohen et al. 2007), to our knowledge this is one of the few studies that directly contributes to our understanding of whether external auditors' risk assessment and program planning decisions have been affected in the post-SOX era as a result of auditors' interactions with the client's audit committee.

As summarized in Table 4, one of the significant changes from pre-SOX to the post-SOX period relates to the frequency of auditor meetings with the audit committee. With respect to the primary issues discussed at the meetings with the audit committee, pre-SOX, CKW (2002) found that, by and large, meetings with the audit committee were passive, with auditors merely reporting the results of the planning and final stages of the audit. In contrast, post-SOX the meetings are characterized by our respondents as more give and take. In addition, there is a greater discussion of accounting/auditing issues, *SAS No. 61*, and other mandated issues. These changes are reflective of a greater monitoring role assumed by the audit committee post-SOX and are consistent with the tenets of agency theory. Audit committees see their role more as a watchdog and seem to take their duties and responsibilities more seriously than in the past.

Expertise and power of the audit committee

The responses to our interviews suggest a change in the power dynamic and an increase in the monitoring/agency role of the audit committee. With the exception of matters related to auditor appointment and dismissal, a review of the responses highlights how audit committees have substantively claimed power that had previously been seized by management. The findings suggest that the audit committee in the post-SOX environment has the requisite power to render effective oversight of management, while conceding some of that power when management is performing at desired levels.

Table 4 indicates that pre-SOX audit committee members lacked the requisite expertise and power to perform their jobs effectively, while it appears that post-SOX these deficiencies have been overcome, although there is significant variance across audit committee members with respect to financial expertise. Overall, it appears that the expertise and power of the audit committee has moved from an emphasis on outward appearance and symbolism in the pre-SOX era to one where substantive power and financial expertise is contributing significantly to the effective monitoring of a firm's financial reporting process. Consistent with the objectives of SOX and the

emphasis predicted by agency theory, auditors' experiences indicate that there is a significant change that has come to at least the audit committee's approach and perceived role.

The findings of this study also provide incremental insights into the sufficiency of the audit committee's financial expertise and power to fulfill its obligations to the board and the shareholders. A number of recent studies have focused on the importance of accounting versus nonaccounting financial expertise when evaluating the role and effectiveness of audit committees (e.g., Dhaliwal, Naiker, and Navissi 2006; Krishnan and Visvanathan 2008), but this is one of the very few studies that examines whether audit committees possess *sufficient* financial expertise to function effectively. Similarly, in the post-SOX era, this is one of the very few studies that investigates whether audit committees have *sufficient* power to confront management on critical issues that impact audit process and audit quality.

Interactions with internal auditors

As summarized in Table 4, pre-SOX the internal audit function was not emphasized by auditors because they believed that few internal audit departments were strong. However, post-SOX the majority of auditors believe that the stature of the internal audit function has increased, resulting in increased reliance on internal audit work. A number of respondents commented on how the internal audit function now frequently reports directly to the audit committee, which has helped strengthen the independence and reliability of the work generated by the internal audit function. As discussed earlier, the audit committee in the post-SOX era has exhibited a focus that is generally consistent with agency theory, and this focus may be contributing to the audit committee viewing the internal audit function as a key element of the corporate governance mosaic of the firm. It appears that auditors increasingly view the internal audit function as an important party in helping the audit committee monitor the quality of the financial reporting process and in ensuring that a client's control system is operating effectively. However, the notable absence of internal auditors in the definition of corporate governance (Table 2, panel A), raises questions about whether auditors view the internal audit function as a significant player in the governance mosaic in its own right or simply view it as an "assistant" carrying out the directives of the audit committee and the board.

6. Summary and discussion

As part of the corporate governance mosaic, auditors play an important role in working with other actors such as management, the audit committee, and the board of directors to ensure quality financial reporting. CKW (2002) reports auditors' experiences of this process from data gathered in 1999–2000 before SOX. CKW note that auditors consider the quality and efforts of corporate governance within the firm in their risk assessments and program planning. However, of concern, auditors indicated that audit

committees were generally found to be ineffectual. Importantly, with significant reforms since that time, particularly SOX, this study extends prior research (DeFond and Francis 2005) and CKW to determine the extent to which auditors' experiences have changed in the post-SOX era. In addition, the study explores the extent to which auditors' experiences are consistent with the expectations of agency and/or institutional theory.

The primary finding of the current study is that auditors indicate significant changes in the corporate governance environment since CKW 2002 and, importantly, since the passage of SOX. Auditors see the board and the control environment as important actors in the governance structure of a firm. Corporate governance plays an important role in influencing the audit process across engagements, with audit committees considerably more active and diligent in the post-SOX era. Audit committees are seen as having sufficient expertise and power to fulfill their responsibilities, with members playing important roles in overseeing internal controls, focusing on reporting quality, identifying risks, asking challenging questions, and overseeing the whistleblowing process. Interestingly, though, many auditors report that management continues to be the dominant player in auditor appointment and dismissal decisions, and only about half of the auditors felt audit committees play an important role in resolving auditor disputes with management.

In all, we find that auditors' experiences indicate there is a strong, positive shift post-SOX in the seriousness that audit committee members bring to their role as monitors of the quality of the financial reporting process. These results are largely congruent with the experiences of audit committee members as reported in Beasley et al. 2009 and DeZoort et al. 2008. The major differences in findings relate to the role played by the audit committee in auditor hiring and termination decisions and in the resolution of disputes. Beasley et al. (2009) do not directly address these issues. DeZoort et al. (2008) find that audit committee members are more likely to indicate support for an auditor's position in the post-SOX era as opposed to pre-SOX, while in our study approximately half of the respondents did not perceive that the audit committee was effectively involved in resolving reporting disputes. One explanation for this difference is that, in our study at least, some respondents' experiences suggested that the audit committees wanted disputes resolved before it reached them, while in the DeZoort et al. 2008 experimental study audit committees were forced to make a decision that indicated whether they would support an auditor's proposed adjustment.

Our conclusions regarding an improved corporate governance environment post-SOX, however, may appear to be inconsistent with the observations of DeFond and Francis 2005, who argue that many of the provisions of SOX are of questionable value in improving the financial reporting and auditing processes. For instance, they argue that there is a lack of evidence that self-regulation of the auditing profession was ineffectual and the

establishment of the Public Company Accounting Oversight Board was necessary, or that the banning of nonaudit services will enhance audit quality. We concur with DeFond and Francis's call for research to examine the efficacy of various provisions of SOX, and in the spirit of this call, the current study examines auditors' experiences pre- and post-SOX.

Auditors also report consideration of the activities of committees other than the audit committee, most notably the compensation committee. Reliance on internal auditors has increased in the post-SOX period, particularly in the area of internal controls where internal auditors have shifted emphasis in response to SOX Section 404. Finally, auditors indicate the CFO and CEO certification requirements of SOX have had a positive effect on the integrity of financial reporting, although little impact on the audit process itself, in that it is the auditor's responsibility to test management assertions.

In the recent study of the experiences of audit committee members, Beasley et al. (2009) report that a majority of the respondents perceived that they were chosen because of their accounting or industry background. This corroborates the experiences of the auditors in our study who perceived that audit committee members have sufficient expertise and power to fulfill their roles. Further, in both our study and the Beasley et al. 2009 study, it is noted that audit committee meetings are frequent and substantive. One potential force that may be at work is the notion of "coercive isomorphism". Cohen et al. (2008, 186) state, "Coercive isomorphism comes about as the result of external regulatory-type pressures for organizational convergence." An example of this is the mandate for independent audit committees provided by SOX. Future research can explore if there is less convergence in countries which allow more flexibility in achieving an effective corporate governance framework. For instance, in Australia, audit committee requirements are more flexible, requiring an audit committee only for the top 500 companies, and there are no requirements for all members to be independent and financially literate or that at least one member be a financial expert.

Cohen et al. (2008) argue that, in auditing, governance must be examined through a wider lens than that prescribed by agency theory. For example, they discuss the relevance of institutional theory, stating (2008, 183), "Institutional theory suggests that it is necessary to understand the substance of the interactions between different governance parties and how these parties use at times symbolic gestures and activities to maintain their form to all relevant parties." In the previous section of this paper we attempt to evaluate whether auditors' experiences with governance post-SOX are consistent with an agency theory perspective, an institutional perspective, or some combination of both. Although the CKW (2002) study did not directly address institutional theory, the findings of that study with respect to governance mechanisms appeared to be largely symbolic. For example, auditors viewed audit committees in the pre-SOX era as being passive and having little impact on financial reporting quality. This would suggest that, by and large,

prior to SOX auditors' experiences with governance mechanisms were largely inconsistent with the effective monitoring espoused by agency theory. In contrast, the results of the current study suggest that governance mechanisms appear to have become more effective, consistent with the prescriptions of agency theory. For example, auditors report that audit committees are now more active and diligent in asking questions and the internal audit function is playing a greater monitoring role. On the other hand, there are at least some elements of governance that auditors' experiences indicate are consistent with institutional theory. For example, although audit committees are directed to be in charge of the appointment and termination of auditors, management is still seen as having a major role in this process. Further, approximately half of the respondents indicate that audit committees are not effective in resolving auditor management reporting disputes.

In all, relative to the pre-SOX period (as reported in CKW 2002), there appears to be a shift in auditor experiences to one where monitoring/agency aspects of governance are emphasized in the post-SOX period. One potential explanation for this shift is that post-SOX audit committee members may perceive that there is an increased fear of legal liability associated with being on the committee that necessitates audit committee members to take their monitoring roles much more seriously. Future research may examine how the litigation regime in various countries potentially affects the role that audit committees play. Perhaps in countries where audit committee members are less fearful of litigation they may be playing a more symbolic role than they appear to be playing in the United States.

Because all public companies must comply with SOX and thus have audit committees that are independent and have a designated financial expert, "in form" audit committees may be deemed as being effective. Future research is needed to determine the extent to which auditors are able to successfully discriminate between the effectiveness of audit committees that are merely symbolic in nature and fulfill the ritual-based role suggested by institutional theory ("in form") as opposed to audit committees who take a more activist role in monitoring the financial reporting process as suggested by an agency theory approach ("in substance").

In all, this study finds a significantly stronger corporate governance environment than in the pre-SOX era. This development is a very positive one for auditors, who have gained allies such as the audit committee, the board, internal auditors, and, in many cases, management in promoting quality financial reporting and sound internal controls. The results suggest that, according to the experiences of auditors, many of the provisions of SOX appear to be "working". This finding also suggests that attempts by business lobbies to reduce the requirements of SOX may have the potential to weaken the protection of the public interest which is a cornerstone of the accounting profession.

This study reports auditors' experiences; future research is needed to corroborate the findings using alternative methods such as experimental or

archival studies. For instance, how effective are audit committees in identifying and resolving reporting problems? Also, does CFO and CEO certification improve the quality of financial reporting? Further, of concern, many auditors in this study note that audit committees continue to play a passive role in helping to resolve disputes. If this is corroborated by other studies, it is important to explore why this is the case. Perhaps some audit committee members view their role as reviewing the financial reports and the reporting process and believe that all disputes should be resolved before the reports come to the audit committee. Further, management is still seen by auditors as one of the driving forces in auditor appointments and terminations, despite SOX mandating this authority to the audit committee. Does this mitigate the intent of SOX in ensuring auditor independence? Does this impact who the auditor views as “the client”, that is, management or the audit committee? In addition, auditors continue to report limited involvement with the board or other committees than the audit committee. Why is this so and is it a problem in leveraging with other corporate governance actors?

This study is based on the reported experiences of auditors who, because of changes in audit approach and increased fees in recent years, may have a vested interest in viewing many of the reforms of SOX as being effective. Nonetheless, the interview questions are designed to focus on auditor experiences and not opinions. Further, responses, as reported, indicate a divergence of experiences and, in some cases, do not support the prescriptions of SOX (e.g., auditor appointments and terminations). Finally, to build on this research and the Beasley et al. 2009 study, there is a need to examine the experiences of audit committee chairs and other members of the audit committee and the board as a whole to probe in further depth if their experiences are different than that of auditors and how the audit process has been affected.

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