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CORPORATE GOVERNANCE AND FINANCIAL REPORTING

EDITED BY

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MAJOR WORK

INTRODUCTION

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INTRODUCTION: CORPORATE GOVERNANCE AND FINANCIAL REPORTING

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1. Introduction to the collection

The topic of corporate governance is the subject of a burgeoning literature. Accordingly it is impossible to summarise an entire field in a book of readings. For this reason, I have focused this selection of readings on the financial reporting aspects of corporate governance, which marries two of my research interests. Given the speed of change in the area of corporate governance, generally-speaking the volume of readings is skewed towards more recent publications. However, some seminal material is included from which a considerable amount of corporate governance empirical research was derived, especially Jensen and Meckling (1976), Fama & Jensen (1983) and Jensen (1993). Denis (2001) suggests that the groundswell for research on corporate governance by financial economists stated with Jensen and Meckling's (1976) paper on the theory of the firm and featuring agency theory.

1.1 Focus of major work

This is a focussed interdisciplinary compilation of readings which brings together corporate governance and financial reporting, and issues of accountability. It does not comprise a broad coverage of all corporate governance issues. Instead, it takes a narrower perspective, concentrating only on those corporate governance mechanisms influencing financial reporting and accountability.

1.2 Approach to paper selection

The papers selected comprise a mixture of theoretical and review articles and original empirical research. The empirical papers primarily consider financial reporting aspects of corporate governance. Financial reporting itself is the focus of much of these papers. However, other governance mechanisms relevant to financial reporting are also considered, especially the role of audit committees, of internal audit, of risk management and the role of external audit. Papers are selected from as wide a variety of journals, and as many non-US journals, as possible.

1.3 Summary of each volume

The major work has three volumes. Volume 1: *Theoretical Context and Overview of Corporate Governance* starts with some key papers on the theoretical origins of corporate governance. This is followed by a selection of overview papers, to give readers a broad understanding of corporate governance generally, and of corporate governance research in particular.

The accounting and financial reporting aspects are taken up in Volume 2: *Corporate Governance and Financial Reporting*. In Volume 3: *Mechanisms of Governance relevant to Financial Reporting* four mechanisms of governance relevant to financial reporting are given particular attention – audit committees, internal audit, risk management and external audit. The papers are summarised in Table 1 by type of paper (theoretical, review, discursive and empirical). Table 2 analyses the empirical papers by reference to the research questions addressed, including variables tested in the research.

The major work concludes with some considerations of governance and accountability.

VOLUME 1: *THEORETICAL CONTEXT AND OVERVIEW OF CORPORATE GOVERNANCE*

2. Corporate governance theories

One theory, agency theory, dominates corporate governance research. This is particularly the case in research on corporate governance and financial reporting. Other theoretical perspectives include: stewardship theory, stakeholder theory, resource dependence theory, signalling theory, class hegemony theory, managerial hegemony theory, contracting theory and transaction cost economics. Some authors point to the absence of appropriate formal theories (Denis 2001: 202; Hermalin and Weisbach 2001: 1). Pesqueux (2005) is an interesting alternative to the agency theory perspective, and in effect is a critique of the agency approach. Huse (2005) discusses many agency theory alternatives, and calls for greater theoretical pluralism in researching board processes and dynamics.

2.1 Theoretical premise of the papers

One of the most cited papers, and arguably the originator of the burgeoning research literature in corporate governance, is Jensen and Meckling (1976). In this paper, they put forward a theory of the firm based on the ownership structure of firms. Their theory explains the conflicting objectives of individual participants in firms.

Jensen and Meckling (1976: 308) define an agency relationship as:

> "…a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent. If both parties to the relationship are utility maximizers, there is good reason to believe that the agent does not always act in the best interests of the principal."

In the context of firms, the primary principal is the owner of the firm, i.e., shareholders. Agents are the managers in firms to whom day-to-day management is delegated by shareholders. They assume both shareholders and managers are rational and wish to maximize their respective utility (i.e., maximise their personal benefits) from their association with the firm. Benefits in the case of shareholders are firm profits and firm value. Benefits in the case of managers include perquisites such as salary, bonuses and other forms of remuneration. It is not possible for shareholders and managers to maximize their utility at the same time. If shareholders maximise their benefits it may be at the expense of managers, and vice versa. Shareholders can limit divergence of their benefits and those of management by putting in place incentives to align shareholders' and managers' interests, and by monitoring the activities of managers to limit their opportunities at utility maximization at the expense of shareholders.

Thus, there are costs arising from the separation of ownership (outside shareholders) and control (day-to-day management of the firm). These costs are referred to as agency costs. Jensen and Meckling (1976) argue that as the amount of outside equity increases agency costs will increase. They assert that, as managers' ownership share falls, outside shareholders have increased incentives to expend resources to monitor managers' behaviour.

Notwithstanding the agency costs inherent in the corporate form, Jensen and Meckling observe that the corporation has so far survived any alternative form for doing business. They pick up this theme in Fama and Jensen (1983) which attempts to explain the survival of organizations where there is separation of ownership and control. In public companies (what they refer to as open corporations), external monitoring by the stock market, monitoring by the takeover market, and especially monitoring by expert corporate boards of directors are suggested as devices which control agency problems in corporations, leading to their survival.

Jensen (1993) considers competitive economic changes and failures of monitoring mechanisms such as takeovers and corporate internal control systems. He identifies four control forces moderating sub-optimal managerial decisions: (i) capital markets, (ii) legal/political/regulatory systems, (iii) product and market factors, and (iv) internal control systems headed by the board of directors. He suggests that problems with boards involve issues with board culture, information problems, boards minimizing downside risks rather than maximizing value, lack of management and board member equity holdings, oversized boards, duality of the roles of chairman and Chief Executive Officer (CEO) and lack of shareholder activism.

Hart (1995) provides a theoretical framework for corporate governance. The paper considers one of the first major reports in a wave of reforms to corporate governance regulations – The Cadbury Report (1992) in the UK. The first part of the paper discusses incomplete contracts as being essential to corporate governance and the resulting agency problems. He then proceeds to summarise the main mechanisms for controlling management in public companies, viz. board of directors, proxy contests (to replace underperforming directors on boards), large shareholders, hostile takeover bids and finally financial structure. He concludes by favouring the principles-based, comply-or-explain best practice approach of the Cadbury Report over statutory rule changes.

Hermalin and Weisbach (2001) point out that there has been relatively little theorising about boards of directors, notwithstanding that they have been subject to a great deal of empirical research.

3. Introduction to corporate governance and financial reporting

The word 'governance' originates from the Latin word 'to steer'. An equivalent term is 'to direct'. Boards are often described as having three roles: strategy, monitoring and provision of service and wise counsel. The primary role of a board is strategy, i.e., to direct the firm – which leads to the terms 'directors' and 'boards of directors'. In practice, some would argue that boards spend too much time on the second role – monitoring management, and not enough time directing.

3.1 Corporate governance definitions

Shleifer and Vishny (1997: 737) define corporate governance as the process that "*deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment*". Denis (2001) and Denis and McConnell (2003) expand on this definition:

> " Corporate governance encompasses the set of institutional and market mechanisms that induce self-interested managers (and controllers) to maximise the value of the residual cash flows of the firm on behalf of its shareholders (the owners)." (Denis 2001: 192)

> " …the set of mechanisms – both institutional and market-based - that induce the self-interested controllers of a company (those that made the decisions on how the company will be operated) to make decisions that maximise the value of the company to its owners (the suppliers of capital)" (Denis and McConnell 2003: 1)

Many authors add "*effectiveness*" as a criterion relevant to good governance (e.g., Jensen 1993; Hart 1995; Denis 2001; Denis and McConnell 2003).

Short, Keasey, Wright and Hull (1993:291) include accountability as a sub-set of governance in their definition:

> "Corporate governance concerns the structures and processes associated with production, decision-making, control and so on within an organisation. Accountability, which is a sub-set of governance, involves the monitoring, evaluation and control of organisational agents to ensure that they behave in the interests of shareholders and other stakeholders."

3.2 Corporate governance mechanisms

Corporate structure has a major disadvantage arising from the separation of capital providers (shareholders) and capital users (management). How do entrepreneurs, shareholders and managers minimise the loss of value that results from the separation of ownership and control? Corporate governance mechanisms have evolved that help

reduce – but never completely eliminate – the costs associated with the separation of ownership and control (Denis, 2001). They act as a check on managerial self-serving behaviour. Efficiency is enhanced when this gap is bridged, as long as the cost of bridging it does not exceed the benefit of so doing.

Shleifer and Vishney (1997) provide a useful overview of corporate governance, and in some respects set the scene for this collection of readings. Having considered agency theory and raising of finance by firms, the paper discusses governance mechanisms including legal protection, ownership by large investors (ownership concentration) and takeovers. Denis (2001) further develops the discussion of corporate governance mechanisms. Following Jensen (1993), they distinguish between legal and regulatory mechanisms, internal control mechanisms, external control mechanisms and product market competition (referred to earlier in this introduction in discussing Jensen and Meckling, 1976). Arising from the complex set of interrelationships between corporate governance mechanisms, Denis (2001) points out that there is no single set of mechanisms optimal for a firm. Short, Keasey, Wright and Hull (1993) discuss ways in which mechanisms are complementary and may be substituted.

Focussing on research in countries other than the US, Denis and McConnell (2003) pick up this theme of corporate governance mechanisms, distinguishing between internal and external mechanisms. They examine two internal mechanisms, boards of directors and ownership structure; and two external mechanisms: takeovers and the legal system.

3.2.1 Governance mechanisms external to company operations

External governance mechanisms, which are activated when internal mechanisms do not work, include (Denis and McConnell, 2003):

- The legal system
- Market for corporate control

The legal system

While the legal system is a fundamentally important corporate governance mechanism, Jensen (1993) argues that it is too blunt an instrument to handle the problem of wasteful managerial behaviour effectively.

The key differentiation in different legal systems is the extent to which the law protect investors' rights, and the extent to which the laws are enforced. Recent international corporate governance research has identified systematic cross-country differences in the extent to which countries offer legal protection to minority shareholders (Denis 2001). Systematic cross-country differences have been found in ownership concentration, capital market development, the value of voting rights, the use of external finance and dividend policies. These differences are related to the degree to which investors are legally protected from expropriation by managers and controlling shareholders.

The level of legal protection offered is in inverse proportion to ownership concentration. Countries with highest legal protection (such as the US and the UK) have the widest shareholder dispersion. Conversely, ownership concentration is highest in countries offering least protection for minority investors. Only legal systems that provide significant protection for minority shareholders can develop active equity markets. It is not clear whether it is the regulations themselves (law on the books), or the differences in enforcement of regulations (law in practice), that differentiates legal systems. However, common law systems seem to outperform civil law systems in providing superior protection to minority shareholders. Economies with a common law system and strong protection of minority shareholders have more dispersed shareholdings. Strong legal protection encourages investors to become minority shareholders. Thus, law does matter and regulation can somehow promote economic efficiency than can reliance solely on financial contracting.

A further development of the research on majority and minority shareholders is the extraction of private benefits (where benefits obtained are disproportionately higher than the proportion of shares owned) by shareholders who (in various complex ways) can control companies. Such investors obtain control rights in excess of their cash

flow rights (Shleifer and Vishney 1997; Denis 2001; Denis and McConnell 2003). There are two ways in which this is done:

- Tunnelling, whereby assets and profits are transferred out of firms for the benefit of controlling shareholders
- Choosing corporate managers (e.g., employing less well-performing family members instead of professional mangers)

Francis, Kharana and Pereira (2003) investigate the relationship between an external mechanism of governance, the investor protection qualities of a country's legal system, on an internal mechanism of governance, accounting and auditing. This paper is discussed further on.

Market for corporate control

The central role of contracts and market transactions in agency theory extends beyond the internal workings of the firm, to include external market-based forces such as takeovers. Such external forces help ensure efficiency of internal forces. Poorly performing firms are more likely to be takeover targets. Inefficient contracting will be penalised by the market and the risk of these penalties promotes self-correcting behaviour. Thus, takeovers should create value in total – The combined value of the target and bidder should increase as a result of the takeover. However, there is a negative side to takeovers. Takeovers can create additional conflicts of interest between managers and shareholders. While shareholders of target firms gain (on average) as a result of takeover, shareholders in bidding firms loose out by paying too much for the target. In some cases, the takeover premium exceeds the additional value created by the combination, causing the value of the bidder's shares to fall. Managers who are interested in maximising the size of their business empires can waste corporate resources by overpaying for acquisitions rather than returning cash to shareholders (Denis, 2001; Denis and McConnell, 2003).

3.2.2 Governance mechanisms internal to company operations

Agency theorists suggest that internal control mechanisms play an important role in aligning the interests of managers and owners. Internal governance mechanisms are

the first line of protection of shareholders. The more effective these internal control mechanisms, the more likely managers are to pursue shareholder wealth generation.

Internal governance mechanisms include (Denis, 2001; Denis and McConnell 2003):

- Effectively structured boards (with particular emphasis on director independence)
- Compensation contracts designed to align managers' and shareholders' interests
- Concentrated ownership holdings (including institutional shareholders) that lead to active monitoring of managers
- Debt structures

The internal mechanisms considered by Short, Keasey, Wright and Hull (1993) include board structure, directors' remuneration, directors' ownership, institutional shareholders, auditors, auditing and accounting information.

3.2.3 Boards of directors

Arguably the single most important corporate governance mechanism is the board of directors. For example, when things go wrong in companies, the first port of call for the media and others to blame is the board. As mentioned earlier, boards have three key roles: (1) Strategy – the process by which directors shape the direction, future, vision, values of an organisation; (2) Monitoring and oversight of management; and (3) Service role – to support management, especially the CEO, assist in the acquisition of scarce resources and to generally bring benefits to the company. Most research on corporate governance and financial reporting focuses on the second monitoring and oversight role. The strategic role of boards, and the service roles directors bring to boards are confined to the management literature and do not feature much in accounting research.

Boards are composed of three types of directors. Executive directors manage the organisation on a day-to-day basis. It is considered best practice to have some executive directors on a board. Usually, the managing director/CEO is a board member, as is the chief financial officer. The presence of executive directors on boards ensures that the onerous legal responsibilities are shared between both executive and non-executive directors. A risk for non-executive directors on boards is

that management know (or should know) everything about the operations of the entity. However, the non-executives only know as much as management is willing to tell them about the organisation. As such, management is the gatekeepers in terms of provision of information to the board. Having members of the senior management team on the board, such as the CEO and finance director, is considered helpful in exchange of information between management and the board.

In addition to executive directors, boards also include non-executive outside directors, who do not work in the organisation on a day-to-day basis, and who are generally only present in the organisation for board or committee meetings, or other board-related activities. The category of non-executive directors is further refined into what are called "grey" or affiliated directors and independent non-executive directors. Grey or affiliated directors are those that have relationships with the organisation that could compromise their independence. Examples of such relationships include being a former employee, holding a large proportion of shares in the organisation, receiving additional remuneration beyond directors' fees, having a material business relationship, etc. Regulators are increasingly requiring non-executive directors to be classified between independent and grey directors. For example, New York Stock Exchange Rule 303A.02 sets out five "bright line" tests for director independence. The UK's Combined Code on Corporate Governance sets out seven independence criteria for distinguishing between independent and grey non-executive directors.

In the UK, it is considered best practice to separate the roles of chairman of the board and the CEO, so that no one individual has unfettered power of decision. Views on the importance of this issue are less strong in the US. In assessing the governance of organisations, CEO duality (holding both positions of chairman and CEO) is relevant in evaluating the extent to which an individual is a dominant personality in relation to the affairs of the company.

Boards of directors generally have a number of committees to assist them in carrying out some key duties. Generally speaking, three committees are standard: The audit committee to oversee financial matters and risk management; the nominations committee for selecting new board members; and the remuneration committee for overseeing management compensation issues.

3.2.4 Compensation contracts

Agency theory has been mentioned earlier. The owners of large public companies (i.e., the shareholders) generally do not manage day-to-day operations, which is the responsibility of managers. There is a risk that instead of working for the owners/shareholders, managers will look after their own personal interests. Compensation contracts are governance mechanisms to align the interests of shareholders and managers. Thus, managerial compensation will comprise a mixture of salary, bonus, shares and stock options. The thinking is that if managers hold shares, they will have the same interest as shareholders in enhancing share value to their own personal benefit (and, inter alia, to the benefit of the shareholders). Stock options provide managers with the option at a specified future date to buy shares in the company at a price specified in the option contract. If the share price increases beyond the option price, executives will be "in-the-money", as the options will have a value being the difference between the option price and the higher market price of the shares. Executives will only have to pay the option price to buy shares in the company, whereas the general public would have to pay the prevailing market price for the same shares. Thus, stock options motivate managers to enhance shareholder value by working to increase the share price as much beyond the option price as possible.

Highly incentivised compensation contracts are not considered necessary or appropriate for non-executive directors, who are generally paid a flat fee for board membership, possibly with additional flat fees for committee membership. Non-executive directors are encouraged to put some of their personal assets on the line by buying shares in the company. In so doing, they demonstrate confidence in the company, and they align their own personal interests with those of the shareholders. It is not considered best practice for non-executives to be paid in the form of stock options, although this may be the only means of remuneration to attract non-executive expertise to cash-strapped, highly risky start-ups.

In order to understand why stock options are not appropriate for non-executive directors, clarity is required around the question - To whom do directors owe their duty? This is an area of confusion in the literature. A range of possibilities exist from

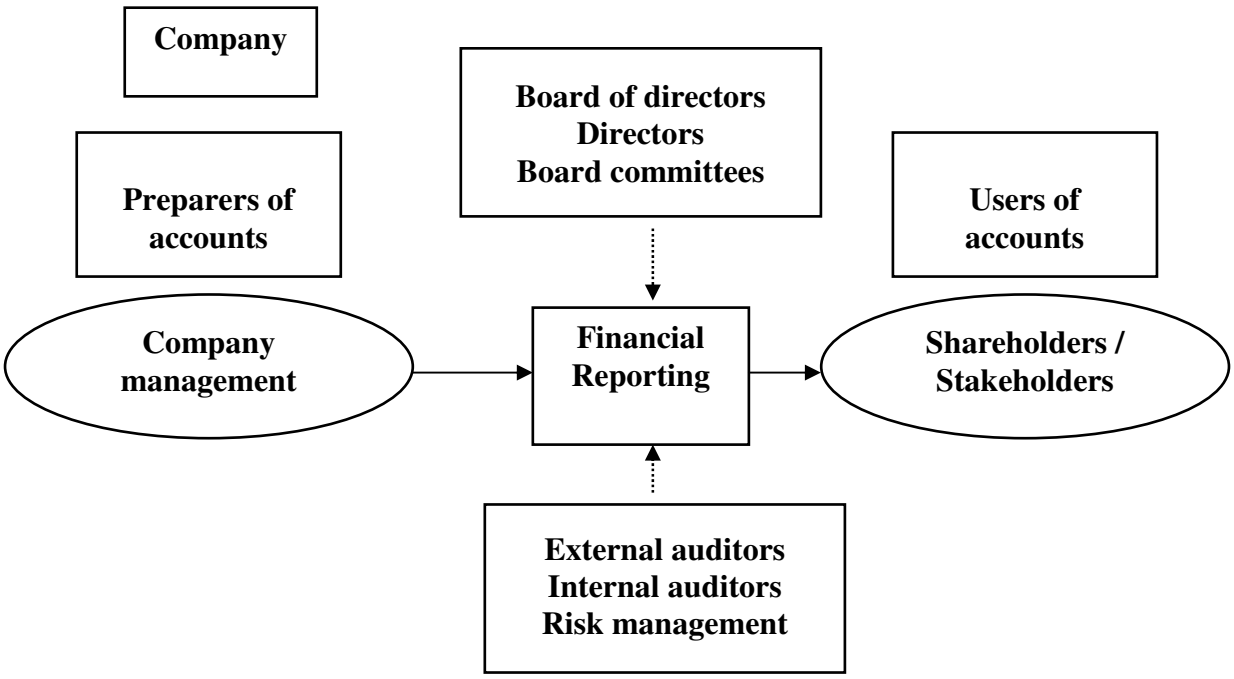
duty to the company, to shareholders collectively, to shareholders only, and/or to shareholders and wider stakeholders.

Strictly speaking in UK law, directors owe their duty to the company, not to the shareholders. However, in the US the duty tends to be expressed as a duty to shareholders collectively (but this very much depends on individual circumstances). In most cases, this difference has no consequences in practice. However, in extreme cases (Enron comes to mind here), where directors focus on shareholders/shareholder value (in modern markets this is often an excessively short term perspective), they may compromise the very survival of the company through misplacing their duty to shareholders instead of to the company (or to shareholders as a collective group). Thus, duty to company implies a longer-term perspective and a requirement for prudence in ensuring the survival of the company.

3.2.5 Concentrated ownership

The existence of concentrated ownership (sometimes referred to as large blockholders) is an important mechanism of governance. Concentrated ownership can arise in a number of ways. For example, founders of companies that list on a stock exchange are likely to retain a significant proportion of the company. Such founders may also hold key senior roles in the organisation. High levels of managerial share ownership are beneficial in aligning the interests of managers and shareholders, but run the risk of managerial entrenchment, especially of managers hold significant amount of shares. Large shareholders may also be represented on the board of directors. Such large blockholders, often with board representation, are considered advantageous in corporate governance terms in being both willing and able to monitor managers. Finally, institutional shareholders who may control large proportions of companies, can have advantageous monitoring roles to the benefit of corporate governance of the organisation.

Figure 1: Corporate Governance and Financial Reporting



3.2.6 Financial reporting as a mechanism of governance

Outside shareholders know very little about their company. Senior management knows (or should know) everything about the company. This information gap is often referred to as information asymmetry. There is information asymmetry between outside shareholders and inside managers. Financial reporting is a mechanism to bridge that gap.

But shareholders are still left with a concern. How do they know that the account of the organisation provided to shareholders by management is accurate? Two groups are appointed to provide some assurances to shareholders on this point. They are the directors on the one hand, and the external auditors on the other hand. This is illustrated in Figure 1. Directors and auditors are appointed by shareholders at shareholder meetings to look after shareholder interests. So what precisely are the respective responsibilities of directors and auditors? Directors are responsible for preparing accounts that show a true and fair view. External auditors are responsible for auditing the accounts and for providing an opinion on whether the accounts show a true and fair view.

3.2.7 Mechanisms of governance relevant to financial reporting

As already discussed, a key internal mechanism of governance is the board of directors. More detailed consideration of this mechanism reveals subsidiary mechanisms of the board that protect the integrity of financial reporting to shareholders by management. In this respect, four subsidiary mechanisms are important: (i) the audit committee of the board, (ii) the internal audit function, (iii) risk management in the organisation and (iv) external auditing.

3.3 Other insights on corporate governance

Hermalin and Weisbach (2001) review prior research on boards of directors, providing an overview of the operation of boards. The paper is a useful introduction into the interface between the board of directors and financial reporting, with a much broader focus than merely financial reporting which is not specifically addressed. The most common stream of research on boards of directors attempts to answer the question whether effective boards leads to enhanced firm performance. Hermalin and Weisbach (2001) review findings relating (i) board composition and (ii) board size to

firm performance. They also look at boards' influence on CEO turnover and takeovers. They also examine influences on board composition and board dynamic. Their paper concludes by considering the operation of boards in specific industries.

While also an overview paper, Short, Keasey, Wright and Hull (1993) consider auditors, auditing and accounting information which is identified as a crucial aspect of the corporate governance system. They acknowledge the information asymmetry problem between management and the board, and outside providers of finance. They suggest that corporate governance mechanisms may interact and compliment each other and that they must be considered together rather than individually. They also caution against firms focussing excessively on corporate governance and control systems to the detriment of performance and profitability.

Pesqueux (2005) takes a critical perspective, suggesting that corporate governance provides the illusion of democracy for shareholders but is in fact a mask to protect the interest of an elite group. Accounting systems, and auditing firms, serve merely to legitimise corporate governance systems.

Baker and Wallage (2000) do some crystal ball gazing and attempt to predict developments in corporate financial reporting given electronic systems of communication. They conclude that financial reporting, and the need for audited financial statements, will remain an essential component of effective corporate governance.

3.4 Failures of governance in a financial reporting context

Many world-renowned governance failures involved fraudulent financial reporting. Brennan (2003) considers the reasons for failures of governance related to financial reporting. She identifies limitations of auditing and of accounting that have led to problems. Safeguards to prevent such problems, such as audit committees, internal audit and external audit are then discussed, as are the role of analysts. Possible reasons for the failure of these safeguards are considered.

One of the most interesting aspects of corporate governance is the human interactions involved among, *inter alia*, managers, directors, shareholders and auditors. In

instances of corporate governance failure, the personal behaviours of some or all of these key players has been found wanting. Staubus (2005) examines financial reporting failures from an ethical point of view. Ethical failures of management, auditors, academics and standard setters are considered.

As mentioned earlier, most corporate governance research is based on economic models which assume rationality. Marnet (2007) takes a different approach in considering psychological and behavioural issues, particularly in relation to those charged with oversight of managers, such as directors and auditors. He questions the wisdom of responding to corporate governance failures with new legislation, because such a response assumes that the failure has arisen from deliberate fraud. Instead he suggests that subconscious bias, particularly on the part of gatekeepers such as directors and auditors, is more likely to have contributed to the failure, which subconscious bias cannot be remedied by new legislation. He urges that the effect of human psychology on judgement, choice and behaviour be increasingly considered in relation to corporate governance.

VOLUME 2: *CORPORATE GOVERNANCE AND FINANCIAL REPORTING*

4. Mechanisms addressed in this collection

The overview papers cited above take a broad perspective on corporate governance. The second volume of readings is much narrower, focussing on the role of the board of directors in financial reporting. Though not identified as such in earlier readings, financial reporting by managers to shareholders and other stakeholders is a corporate governance mechanism. This process is overseen by the board of directors, often through its audit committee. Two additional mechanisms (also not mentioned to any great degree in earlier papers) are internal audit and external audit.

4.1 Financial reporting

Cohen, Krishnamurthy and Wright (2004) review the relationships between financial reporting quality and corporate governance mechanisms. As such, their review article goes to the heart of this collection of readings. Figure 1 in their paper shows the interrelationships between financial reporting quality, management and boards of directors, audit committees, internal audit and external audit. The influence of

regulations (legislators, the courts, stock exchanges), financial analysts and shareholders is also acknowledged.

4.1.1 Transparency and disclosure

The collection includes six papers on the influence of corporate governance on corporate disclosures/transparency. Two of the papers examine this issue at the level of country (Francis, Khurana and Pereira 2003; Bushman, Piotroski and Smith 2004). The remaining papers are firm-level disclosure studies (Forker 1992; Bushman, Chen, Engel and Smith 2004; Beekes and Brown 2006; Cheng and Courteney 2006). The governance variables predicted to influence disclosure and transparency vary from external mechanisms in the form of legal systems for the country-level studies, to internal governance mechanisms relating to the board of directors, its committees, its independence, share ownership by directors and managers, ownership concentration among large shareholders and the quality of auditors.

One of the first studies to examine the influence of corporate governance on disclosure / corporate transparency was Forker (1992). Only one item of disclosure was considered, albeit a sensitive one: disclosure of share options. Nine governance variables were tested (see Table 2). Forker found that disclosure quality was lower where firms had a dominant personality (combined role of chairman/CEO), and where the administrative costs of disclosure were greatest. Only a weak association was found between corporate governance monitoring devices such a non-executive directors and existence of an audit committee and disclosure quality.

Whereas Forker (1992) studied disclosure at the firm level, Francis, Khurana and Pereira (2003) is based on a study of 49 countries. They test the influence of country on accounting disclosure and auditing quality. Countries are distinguished by their investor protection legal framework. Accounting disclosure was measured by country by taking at least three annual reports from each of 49 countries in the study, and by computing a disclosure index depending on the inclusion or omission of 90 disclosure items. Another measure of the quality of accounting is an accrual index which captures the degree to which the accounting system deviates from a cash measure of performance (a proxy measure for earnings management). They find that countries

with stronger investor protection have greater transparency through public financial disclosure. Such countries also have higher quality auditing.

Bushman, Piotroski and Smith (2004) also conduct a country-orientated study on corporate transparency. They define (p. 207) transparency as the "…availability of firm-specific information to those outside publicly traded firms". They group transparency measures into three categories:
(1) The corporate reporting regime (e.g. measures of disclosure intensity, disclosure timeliness, audit quality, intensity of governance disclosures [identity, remuneration and shareholdings of officers and directors, and identity and shareholdings of major shareholders]);
(2) The intensity of private information acquisition (e.g. analyst following, prevalence of pooled investment schemes, insider trading activities); and
(3) Information dissemination (e.g. extent of media penetration).

In this way, comprehensive, country-level measures of corporate transparency based on multiple information mechanisms are developed. They distinguish between financial transparency – intensity and timeliness of financial disclosures and their interpretation and dissemination by analysts and the media – and governance transparency – the intensity of governance disclosures used by outside investors to hold officers and directors to account. They find that governance disclosures are higher in common law counties with efficient judiciary, while financial disclosures are higher in countries with less state interference in the economy.

Bushman, Chen, Engel and Smith (2004) examine the influence of lower transparency on corporate governance systems or mechanisms in US quoted firms. They define transparency differently to Bushman, Piotroski and Smith (2004), as the clarity of activities and performance of the firm to outsiders. Bushman, Piotroski and Smith (2004) is a country-level study, whereas Bushman, Chen, Engel and Smith (2004) is a firm-level study.

Low transparency is proxied in two ways: Firstly, where the relationship between reported earnings and share prices is low, i.e. low earnings timeliness; Secondly, where this is high firm complexity as indicated by multiple geographical or class of

business segments. Low transparency is associated with higher governance standards as indicated by higher ownership concentration, larger directors' and executives' equity-based incentives and outside directors' reputations (average number of other boards on which director sits).

Beekes and Brown (2006) study the effect of corporate governance on the informativeness of disclosures of 250 Australian firms. They use six indicators of informativeness: (i) the frequency of price sensitive announcements; (ii) firm analyst followings; (iii) accuracy (iv) bias and (v) disagreement in analysts' forecasts and (vi) speed with which the share price reflects value relevant information. Corporate governance quality is a score based on information about the board, its committees (especially the independence of the committees), meeting frequency and related party disclosures in the annual report. They confirm their thesis that better governed firms make more informed disclosures. Specifically such firms disclose more price sensitive information, have higher analyst following, more accurate/less biased consensus analysts' forecasts and earnings are more timely.

Cheng and Courtenay (2006) examine the association between level of voluntary disclosure of firms listed on the Singapore stock exchange and governance variables, including proportion of independent directors, board size and the nature of the regulatory regime. They found a significant and positive association between independence of the board of directors and voluntary disclosure. They also found an interaction between board monitoring and regulatory regime confirming Denis and McConnell's (2003) suggestion of an interrelationship between internal and external governance mechanisms.

4.1.2 Earnings management

The collection includes six papers on earnings management. These papers assume that financial statements with high abnormal accruals, which is a proxy for earnings management, are poorer quality. It should be noted, and as mentioned earlier, Marnet (2007) critiques prior earnings management research, particularly the difficulty in measuring earnings management.

Klein (2002) tests whether the independence of audit committees is related to earnings management. She also considers other board of director characteristics such as proportion of outside directors and existence of majority independent board. She finds that earnings management behaviour is negatively associated with independent audit committees/boards. Lowering of independence on audit committees/boards is associated with increasing earnings management behaviour.

Xie Davidson and DaDalt (2003) find that board of directors composition and audit committee composition are related to the likelihood that firms will engage in earnings management. Members with corporate or financial backgrounds are important in this finding, as are frequency of meetings. Koh (2003) finds that earnings management in Australian firms is reduced with long term institutional shareholders and is increased with lower institutional ownership levels which are more common with transient, short-term institutional holdings. Mitra and Cready (2003) conduct a similar study but include firm size and richness of information environment as well as institutional holdings.

Davidson, Goodwin-Stewart and Kent (2005) also study earnings management and their paper is discussed future in connection with the role of internal audit.

4.1.3 Fraud/earnings restatements

Two papers are included which examine the relationship between corporate governance and fraud/accounting scandals. Beasley (1996) selected 75 US quoted companies which the Securities and Exchange Commission and/or the *Wall Street Journal* had found to have been subject to financial statement fraud. A matched sample of no-fraud firms was selected, based on firm size, industry, national stock exchange and time period. Governance variables include proportion of outside directors, percentage shares owned by inside directors, number of years tenure of the CEO, dual chairman/CEO and percentage shares owned by blockholders. A number of additional control variables were included in the model. The proportion of outside directors was found to be lower for fraud firms, while existence of an audit committee does not significantly affect the likelihood of financial statement fraud.

Instead of focussing on financial statement fraud, Agrawal and Chadha (2005) consider the influence of corporate governance on the probability of firms having to restate their earnings. They adopted a similar methodology to Beasley (1996) in that they selected a sample of 159 US quoted firms that had to restate earnings, and matched those with a sample of firms that did not restate earnings. Matching was based on size and industry. Governance variables considered in the paper include independence of boards and of audit committees, the presence of financial expertise on boards and on audit committees, auditor independence, CEO dominance, large blockholders and auditor quality. The presence of directors with financial expertise on audit committees was found to be strongly related to likelihood of restatements which was significantly lower in such cases. Restatement was significantly more likely when the CEO was part of the founding family of the firm. Governance variables not found to be relevant were independence of boards and audit committees and independence of auditors as indicated by provision of nonaudit services.

4.1.4 Cost of debt

Anderson, Mansi and Reeb (2004) examine the influence of corporate governance on cost of debt. Creditors are concerned with the reliability and validity of accounting numbers to assess the health and viability of firms to which they have lent monies. Strong governance should lead to higher quality financial reports, which in turn should lead to lower cost of debt finance. They test whether cost of debt is related to the proportion of independent board directors, to board size, to audit committee independence, board share ownership, financial expertise on the audit committee and audit committee meeting frequency. Board and audit committee independence were found to be associated with lower cost of debt, as were larger boards and audit committees. Audit committee meeting frequency was also associated with lower cost of debt.

VOLUME 3: *MECHANISMS OF GOVERNANCE RELEVANT TO FINANCIAL REPORTING*

The third volume of readings concerns governance mechanisms specifically relevant to financial reporting, in particular audit committees, internal audit function, risk management and external auditors.

4.2 Audit committees

Audit committees are committees of the main board of directors. Board committees (audit committees and other committees of boards) do not take decisions. They are merely advisory, advising the main board on issues such as adoption of the annual financial statements, the effectiveness of the system of internal control and risk management, effectiveness of the internal audit function and issues concerning the external auditors. Thus, while the main board might delegate to the audit committee the in-depth oversight of financial reporting and auditing issues, the main board cannot delegate its responsibility for these matters. In law, all directors, executive and non-executive, those on the audit committee and not members of the audit committee, broadly-speaking carry the same legal duties and responsibilities for these matters.

One of the key advisory roles of the audit committee is to advise the main board whether it should adopt the annual financial statements. Existence of an audit committee provides a group of directors with the opportunity to delve into issues around financial reporting in more detail than permitted during the time available at main board meetings. Those appointed by the chairman of the board to sit on the audit committee are likely to be the most financially literate of the main board members. Thus, the audit committee is a mechanism that allows for financial experts to focus on financial matters.

Audit committees were first recommended by the New York Stock Exchange in 1977. Since then, other regulatory bodies have made similar recommendations, and it is now accepted best practice for boards to establish audit committees comprising a minimum of three independent non-executive directors. Members of management should not be members of the audit committee, although they (especially the finance staff) are expected to attend audit committee meetings. This is to facilitate private discussions between the audit committee and the external auditors and internal auditors in the absence of management.

More recently, notwithstanding the existence of audit committees, the many accounting scandals in the US and elsewhere have pointed to their ineffectiveness in

some circumstances. As a result, an additional best practice requirement of audit committees has been to have at least one financial expert on the audit committee.

Bradbury (1990) investigates the characteristics of firms that form audit committees on a voluntary basis. He examines three categories of explanation. Firms with high agency costs arising from the separation of owners and managers are expected to be more likely to form audit committees. Audit committee formation may also be influenced by the board of directors. Finally, external auditors may recommend the formation of audit committees. Bradbury does not find agency or external auditor explanations to support voluntary audit committee formation. However, he does find a relation between his measures for outside directors on the board, and for monitoring incentives of board directors, to explain audit committee formation.

In another study of voluntary formation of audit committees, Menon and Williams (1994) test Bradbury's (1990) assertion that the formation of audit committees may be for the purpose of appearances only. They look for evidence that firms actually rely on audit committees. Two indicators are examined by way of evidence: the frequency of audit committee meetings and composition of audit committees. They consider that audit committees with inside directors cannot be effective monitors of management. Confirming their suspicion that audit committees were more cosmetic than real, they found 38% of audit committees met one or less times per annum. They also found that 12% had managers on the audit committee. However, as the proportion of outside directors on the board increases, the committees met more often and were less likely to have executives on the committee.

In a similar study to Menon and Williams (1994), Collier and Gregory (1999) study voluntary formation of audit committees by UK companies. They consider both the length of meetings, as well as their frequency, in assessing audit committee activity. They found the existence of audit committees to be influenced by big-six auditors and by the agency-related variable, leverage. They also found that audit committee activity was less where the roles of chairman and CEO were combined and where there were executives on the audit committee.

Research on audit committees questions whether audit committees make a difference to financial reporting. Are audit committee important to the financial reporting process? One of the first studies examining the influence of audit committees on financial reporting quality is Beasley (1996) referred to earlier. In relation to financial statement fraud, he found no significant difference between fraud and no-fraud firms and the existence of an audit committee.

Carcello and Neal (2000) test the relationship between the independence of the audit committee – as evidenced by the proportion of audit committee members that are affiliated non-executive directors rather than being fully independent non-executive directors – and external auditor going concern audit reports. The sample comprised publicly quoted companies with audit committees that were experiencing financial distress. They find that auditors are significantly less likely to issue going concern audit reports the higher the proportion of affiliated directors on the audit committee. They conclude that when it comes to composition of audit committees, independence is important and makes a difference.

Further support for the importance of the independence of audit committees is provided by DeZoort and Salterio (2001). Using an experimental approach, the reaction of independent directors in a dispute between management and auditors is assessed. Variables tested include experience of independent directors, audit reporting knowledge, financial reporting knowledge and audit committee members who are concurrently managers in other companies. Experienced independent directors and those with knowledge of audit reporting are more likely to side with the auditors, while independent directors who are concurrently managers are more likely to side with management in a dispute between auditors and managers. Financial reporting knowledge was not found to be a significant variable.

Klein (2002), referred to earlier in the earnings management section, finds an inverse relation between earnings management and the independence of audit committees.

4.3 Internal audit

One of the key responsibilities of boards of directors is an effective system of internal controls and risk management. A key source of information on the operation of the

system of internal controls is the internal audit function. One of the key responsibilities of audit committees is to monitor and review the effectiveness of the internal audit function. Gramling, Maletta and Schneiderand (2005) provide an overview of the role of internal audit in a corporate governance context. In a survey of internal auditors, Raghunandan, Read & Rama (2001) examine the interaction between audit committee composition and the internal audit function. Internal auditors report experiencing a more meaningful engagement with audit committees composed of independent directors and where there is financial expertise represented on the audit committee. Meetings are longer, internal audit plans and reports are reviewed by the committee, and internal auditors have private access to the audit committee in the absence of management. Gendron and Bédard (2006) explore the dynamic between audit committee members, external auditors, management and internal audit. In 22 interviews, including three internal auditors, they find that internal audit plays a central role in the effectiveness of audit committees, and in developing accountability relationships between management and audit committees.

Using case study methodology, Turley and Zaman (2007) examine the interaction between audit committees and internal audit. The head of internal audit in that paper describes his role as giving comfort to the board that risks are being managed. It is clear from the paper that internal audit is primarily involved with internal control matters. Internal auditors tend to focus their work on ensuring an effective system of internal controls, and generally do not have a direct role in relation to financial reporting. However, there is evidence in the paper that internal audit can also play a role in relation to financial reporting issues, although that role is not formalised (the case in point being the allocation of expenditure between capital and revenue).

Davidson, Goodwin-Stewart and Kent (2005) do not find voluntary establishment of an internal audit function to be associated with lower earnings management. They implicitly acknowledge the limited role of internal audit in financial reporting by stating that an internal audit function would ensure that internal controls are adequate, but that this is not really relevant as earnings management generally overrides internal controls in place. In any event, even if a relationship between internal audit and earnings management had been found, identifying causality is a problem. Do well-governed firms voluntarily establish internal audit functions and are well-governed

firms less likely to engage in earnings management? Is it well-governed firms, rather than voluntary internal audit functions, that reduce the level of earnings management?

4.4 Risk management

Companies are a legal construct that encourages entrepreneurs to take risks in pursuing enterprising activities for the benefit of society. Shareholders are insulated from the effects of risk-taking going wrong, by the limited liability protection provided through the legal construct of companies. As companies are vehicles to encourage risk-taking, prudent management of risks is a key challenge for company management. Spira and Page (2003) examine the effect of changes in the management of risk arising from the Turnbull Report in the UK on the internal audit function. In an empirical study, Goodwin-Stewart and Kent (2006) examine factors associated with internal audit, including factors relating to risk management. They find a strong association between the voluntary establishment of an internal audit function, and a company's commitment to risk management, proxied by the existence of a risk management committee comprising directors and managers and by the appointment of a designated risk manager. Causality is not clear in this paper. Goodwin-Stewart and Kent (2006) expect to find a link between the use of internal audit and a company's commitment to risk management. However, rather than commitment to risk management driving internal audit, it is possible that the existence of internal audit and commitment to risk management are both reflections of a company's corporate governance standards.

4.5 External audit

While shareholders can place some reliance on the board of directors to ensure quality financial reports, there is a second, more expert level of assurance available to shareholders in the form of external auditors. Many studies of corporate governance and financial reporting include variables on aspects of the external audit function. The most common measure is auditor quality which is usually proxied by a binary or dummy variable for big 6/5/4 auditors and other audit practices. Firms audited by big-6/5/4 practices are expected to provide better quality financial statements (Forker 1992; Agrawal and Chadha 2005; Davidson, Goodwin-Stewart and Kent 2005). Studies of audit committee effectiveness predict that higher quality auditors will lead to more effective audit committees (although causality and the direction of this

relationship is open to debate) (Bradbury 1990; Menon and Williams 1994; Collier and Gregory 1999). Collier and Gregory (1999) also predict that qualified audit reports will lead to more effective audit committees, although they do not provide an explanation to justify the inclusion of this control variable.

Following recent high profile audit failures, Agrawal and Chadha (2005) use a more sophisticated measure – auditor independence. This is the size or proportion of non-audit fees compared with total fees paid to the external auditors.

In their country-level study, Francis, Khurana and Pereira (2003) measure quality of auditing as the total audit fees of the top ten auditing practices as a proportion of gross national product. Another country-level measure of audit quality is the percentage share of big five auditing practices.

Most papers cited above examine the influence of external auditors on financial reporting or audit committee effectiveness. Two papers in the collection take the opposite direction of causality, by examining the influence of corporate governance on the behaviour of external auditors. Cohen and Hanno (2000) consider auditor client-acceptance judgments whereas Cohen, Krishnamoorthy and Wright (2002) look at auditor planning decisions. Auditors are predicted to be more likely to accept clients with strong governance. In a study based on interviews with auditors, Cohen, Krishnamoorthy and Wright (2002) find that management and not the board or audit committee are the primary drivers of corporate governance.

5. Empirical papers in the collection

Of the 46 papers in this collection, summarised in Table 1, 28 can be categorised as empirical papers – that is they are based on data collected for the purpose of research, rather than being theoretical papers, reviews of prior research of discursive papers. Reflecting US dominance in accounting research, most of the papers take a quantitative, regression analysis approach. The small number of qualitative papers provides an interesting contrast to the quantitative research.

5.1 Issues / questions for research

All empirical research should have a clear issue to be addressed by the research. This may be expressed as a research question, or more precisely in the form of a hypothesis. Often implicit in hypotheses are a dependent variable(s) and independent variables proposed to explain changes in the dependent variable. A summary of the issues addressed in the empirical papers in this collection is provided in Table 2.

As has been touched upon earlier, the direction of causality between corporate governance and financial reporting is not clear. Most studies address the question: Does good corporate governance generate higher quality financial reports? (i.e., is the quality of financial reports a function of good governance?). The direction of causality is that corporate governance influences financial reporting. Good governance is also hypothesised to influence the quality of external and internal audits.

An alternative approach to causality is taken in Bushman, Chen, Engel and Smith (2004). They posit that if financial reporting is weak and less transparent, other governance mechanisms will have to be stronger to compensate for poor financial reporting. Thus, the direction of causality is that financial reporting is predicted to influence various other corporate governance mechanisms.

Table 1: Classification of papers in volume of readings, by methodology

(1) Theory papers
Jensen & Meckling (1976)
Fama & Jensen (1983)
Jensen (1993)
Hart (1995)

(2) Review articles
Corporate governance generally
Shliefer & Vishney (1997)
Denis (2001)
Denis & McConnell (2003)
Hermalin and Weisbach (2001)
Cohen, Krishnamurthy and Wright (2004)
Gramling, Maletta and Schneiderand (2005)

Corporate governance and accounting
Short, Keasey, Wright & Hull (1999)
Pesqueux (2005)
Baker & Wallage (2000)

(3) Discursive papers
Financial reporting failures
Brennan (2003)
Staubus (2005)
Marnet (2007)

Internal audit
Spira & Page (2003)

Accountability
Huse (2005)

(3) Empirical papers
Regression analysis
Forker (1992)
Francis, Khurana and Pereira (2003)
Bushman, Piotroski & Smith (2004)
Bushman, Chen, Engel & Smith (2004)
Beekes and Brown (2006)
Cheng & Courtenay (2006)
Klein (2002)
Xie, Davidson & DaDalt (2003)
Koh (2003)
Mitra & Cready (2005)
Beasley (1996)
Agrawal & Chadha (2005)
Anderson, Mansi & Reeb (2004)
Bradbury (1990)
Menon & Williams (1994)
Carcello & Neal (2000)
Carcello & Neal (2003)
Karamanou & Vafeas (2005)
Davidson, Goodwin-Stewart and Ken (2005)

Interviews
Gendron and Bédard (2006)
Cohen, Krishnamoorthy and Wright (2002)
Goddard (2005)

Case study
Turley & Zaman (2007)
Goodwin-Stewart and Kent (2006)

Survey
Collier and Gregory (1999)

Questionnaire
Raghunandan, Read & Rama (2001)

Laboratory experiment
DeZoort & Salterio (2001)
Cohen & Hanno (2000)

Table 2: Summary research questions addressed in corporate governance and financial reporting empirical studies

Study	
Financial reporting and governance	
Forker (1992)	Disclosure quality = f (Proportion of options held by directors; Firm size; Proportion of non-executive directors, Existence of an audit committee, Duality of role of chairman and CEO; Proportion of equity held by directors; Auditor quality; Value of share options held by directors; Proportion of options outstanding)
Francis, Khurana and Pereira (2003)	Higher quality accounting and auditing = f (Strong / weak investor protection) Development of financial markets = f (Higher quality accounting and auditing)
Bushman, Piotroski and Smith (2004)	Financial transparency & Governance transparency = f (Country's legal / judicial regime; Country's political regime)
Bushman, Chen, Engel and Smith (2004)	(i) Board structure, (ii) Equity-based incentives of outside shareholders, (iii) Equity-based incentives of inside and outside directors, (iv) Executive compensation plans = f (Earnings timeliness; Organisational complexity; Growth opportunities; Performance history; CEO tenure; CEO founder; No. years firm public)
Beekes and Brown (2005)	Earnings informativeness, Earnings timeliness = f (Corporate governance quality, measured by firm rankings in a published survey)
Cheng & Courtenay (2006)	Voluntary disclosure = f (Proportion independent non-executive directors, Board size, Regulatory regime, Inside blockholder, Firm size, Leverage, Government ownership, Duality)
Earnings management	
Klein (2002)	Earnings management = f (Majority outside directors, Proportion outside directors, Audit committee composed solely of outsiders, Audit committee composed of majority of outsiders, Outside blockholder member of audit committee, Equity holdings of CEO, Market value over book value of firm, Change in net income in period, Consecutive years of negative earnings, Debt, Firm size)
Xie, Davidson & DaDalt (2003)	Earnings management = f (Board composition (CEO duality; proportion of inside directors; types of director), Board structure (Board size; Audit committee; Executive committee), Other board considerations (No. board meetings; Percentage blockholder votes)
Koh (2003)	Earnings management = f (institutional ownership)
Mitra and Cready (2005)	The higher the level of institutional investor shareholdings, the lower the level of abnormal accruals The relationship between institutional investor shareholdings and the level of abnormal accruals is different for S&P 500 and non-S&P 500 firms

Table 2: Summary research questions addressed in corporate governance and financial reporting empirical studies

Study	
Fraud/earnings restatements	
Beasley (1996)	Fraud = f (Proportion of outside directors, Proportion of independent directors, Audit committees)
Agrawal and Chadha (2005)	Earnings restatements = f (board independence, audit committee independence, independent directors with financial expertise; auditor independence , independent director blockholders, CEO influence on board, Auditor quality)
Cost of debt	
Anderson, Mansi and Reeb (2004)	Cost of debt = f (Board independence, Board size, Audit committee independence, Audit committee size, Board equity holdings, Audit committee financial expertise, Audit committee meeting frequency)
Audit committees	
Bradbury (1990)	Audit committee = f (Outside directors, Leverage, Assets-in-place, Large intercorporate stockholdings, directors' equity ownership, Auditor quality, Board size)
Menon and Williams (1994)	Audit committee activity = f (Management equity holdings, Leverage, Firm size, Audit quality, Proportion of outside directors) Management membership on audit committee = f (Management equity holdings, Leverage, Firm size, Audit quality, Proportion of outside directors)
Collier and Gregory (1999)	Audit committee activity = f (Proportion of shares held by directors, Leverage, Firm size, Auditor quality, Proportion of non-executives directors, Board size, CEO duality, Number of shareholders, Ratio book value to market value, Growth in sales revenue, Qualification of audit report)
Carcello and Neal (2000)	Going concern modified audit report = f (Proportion affiliated directors, Debt default, Going concern report in prior year, Firm size, Client's financial distress, Stage of development of client)
DeZoort & Salterio (2001)	Audit committee member judgements = f (Director experience, Executive director positions held, Financial reporting knowledge, Audit reporting knowledge)
Carcello and Neal (2003)	Auditor dismissal = f (Proportion affiliated directors, Governance expertise of audit committee members, Financial expertise of audit committee members, Equity holdings of audit committee members, Going concern opinion, Firm size, Auditor industry share, Auditor tenure, Financial condition of firm, Change in top management)

Table 2: Summary research questions addressed in corporate governance and financial reporting empirical studies

Study	
Karamanous & Vafeas (2005)	Disclosure, accuracy, credibility of management earnings forecasts = f (Proportion of outside directors, Board size, Board meetings, Insider ownership, Institutional ownership, Proportion of outside directors on audit committee, Proportion of audit committee members with financial expertise, Audit committee size, Audit committee meetings, Bad news, Forecast dispersion, Analyst following, High tech industry, Total assets)
Gendron and Bédard (2005)	Audit committee effectiveness = f (Background of audit committee members, Features of meetings, Interpretations of meetings, Interpretations of informal practices, Post-Enron environment)
Turley and Zaman (2007)	Audit committee effectiveness = f (Formal processes, Informal processes, Power relationships)
Internal audit	
Raghunandan, Read & Rama (2001)	Audit committee interaction with internal auditor = f (Completely independent audit committee with financial expertise)
Davidson, Goodwin-Stewart and Kent (2005)	Earnings management = f (Board independence, CEO duality, Effective audit committee, Presence of internal audit function, Auditor quality)
Risk management	
Goodwin-Stewart and Kent (2006)	Existence of internal audit function = f (Separate risk management committee, Designated risk manager, Finance industry, Higher proportion of receivables and inventory, Firm size, Complexity of firm structure, Independent board chair, Proportion of independent directors, Existence of audit committee, Effectiveness of audit committee
External audit	
Cohen and Hanno (2000)	Auditor client-acceptance judgments, Auditor substantive testing judgments, = f (Corporate governance, Management control)
Cohen, Krishnamoorthy and Wright (2002)	Auditor's planning of audit and assessment of client risk = f (Corporate structure, Corporate governance, Audit committee)
Accountabilty	
Goddard (2005)	Relationships between accounting, governance and accountability. Theory of interrelationships of governance and accountability with accounting practices in local government organisations.

5.2 Data sources

Many US papers use computerised data sources. Such data sources are not readily available outside the US. Non-US researchers are more likely to obtain empirical data from alternative data sources such as interviews (Gendron and Bédard 2006; Cohen, Krishnamoorthy and Wright 2002; Goddard, 2005), case studies (Turley and Zaman 2007; Goodwin-Stewart and Kent 2006), surveys (Collier and Gregory 1999), questionnaires (Raghunandan, Read and Rama 2001) and laboratory experiments (DeZoort and Salterio 2001; Cohen and Hanno 2000).

5.3 Dependent variables

The dependent variables in the empirical papers are primarily various constructions of financial reporting including disclosure quality, accounting/auditing quality, transparency, earnings management (including level of abnormal accruals), earnings informativeness, earnings timeliness, fraud and cost of debt. Sometimes the dependent variable is a corporate governance variable such as voluntary formation of an audit committee, audit committee activity, audit committee effectiveness, voluntary formation of an internal audit function and external auditor judgments.

5.4 Independent governance variables

The corporate governance variables tested can be categorised into two groups: board of director variables and other governance variables. The board of director variables include: Proportion of inside executive director/outside non-executive grey directors/ outside independent non-executive directors; Proportion of equity held by directors; Duality of the role of chairman and chief executive; Existence of an audit committee; Board size; and Number of board meetings.

Other governance variables include: Options held by directors (proportion, value, outstanding); Proportion of inside blockholders; Proportion of outside blockholders/institutional shareholdings.

The above variables are at the firm-level. As has already been mentioned, some studies are country-level studies. Francis, Khurana and Pereira (2003) distinguish countries with strong and weak investor protection. They also differentiate countries based on the development of their financial markets. Bushman, Piotroski and Smith

(2004) consider the impact on transparency of countries' legal / judicial regimes and political regimes.

5.5 Independent control variables

The most common control variable is Firm size. Others include Leverage, Ratio of book value to market value, Growth, Debt, Auditor type. Choice of control variables depends on the dependent variable being researched.

6. Future research

Corporate governance research is in its infancy, and there are no shortages of interesting topics and avenues of inquiry in this field. Some suggestions follow.

6.1 New theoretical approaches

No single theory to date fully explains corporate governance mechanisms, and multiple theories are necessary to take account of the many mechanisms and structures relevant to effective governance systems. Some authors suggest that a multi-theoretic approach is necessary to understand the many mechanisms and structures that may enhance the way in which organisations are structured and function. Huse (2005) recommends that researchers expand beyond rational theoretical models such as agency theory, and considering models from group and cognitive psychology in understanding board decision making.

6.2 Organisational and institutional contexts

New organisational and institutional contexts provide opportunities for research. Corporate governance design should take account of context and actors. Huse (2005) calls for a greater consideration in future research of the dynamics between resources, context and design parameters. He defines a corporation as a set of relationships and resources. Corporate resources are important contextual factors to consider. Other contextual factors include national, geographical and cultural differences, industry, ownership dispersion and types, lifecycle variations (e.g. corporate crises) and CEO tenure, attributes and background. Raghunandan, Read & Rama (2001) and Goodwin-Steward and Kent (2006) have also suggested research in other jurisdictions. The impact of organisational changes and events such as corporate wrongdoings on

corporate governance (in particular audit committees) is recommended for study by Turley and Zaman (2007).

6.3 New methodological approaches

Huse (2005) advocates more behavioural research. Turley and Zaman (2007) observe that governance outcomes are significantly influenced by informal processes and power relationships which are largely unexplored in prior research. These are best studied using more qualitative research methods including in-depth interviews, case studies, field studies. Huse (2005) calls for more 'board life stories' and interviews with directors, while cautioning that such qualitative research needs to be conducted with great rigor.

6.4 Interactions among variables

Dimensions such as formal processes, informal processes, power relationships and organisational context interact with one another in producing governance outcomes (Turley and Zaman 2007). It is difficult to isolate the effect of one from the other. Interaction between variables considered singly in prior research is a potentially fruitful avenue for further research. For example, Cohen and Hanno (2000) recommend the study of the interaction between corporate governance and management control philosophy. Goodwin-Steward and Kent (2006) point to the complex interactions between audit committees, external audit and internal audit. In this respect, Raghunandan, Read and Rama (2001) recommend studying the nature of the relationship between audit committees and internal audit, including personality, attitude and character brought to the relationship by audit committee members. They also wonder at the extent to which communication with the external auditor may substitute for that with the internal auditor.

7. Concluding comment

Corporate governance is a relatively new concept in business. Research on corporate governance is also at an early stage of development. Policy makers and regulators have few research findings on which to base their decisions. Much corporate governance research follows rather than leads regulatory change. Researchers ask questions after the event. Did the regulatory change result in improved governance and added value for the firm? Researchers should search for opportunities to lead

regulation, providing regulators with insights into the costs and benefits of regulatory change.

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