AN EXPERIMENTAL ANALYSIS OF THE FACTORS IMPACTING AUDIT COMMITTEE MEMBERS' JUDGMENTS AND DECISIONS

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DEDICATION

This dissertation is dedicated first and foremost to my family. To my husband Mark for his encouragement and support, and to my children Ellie and Joshua, for all the times that they heard the words "I have to study", and understood. I would also like to dedicate this to my dissertation chair, Jim Groff, and my committee members, Dorothy Flannagan, Elaine Sanders and Pamela Smith without whom this would not have been possible.

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by

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Two experiments were conducted to explore the impact of various pressures/incentives on the decisions made by audit committee members. The first experiment examined whether simultaneously imposed pressures related to form of audit committee member compensation (stock options versus cash) and risk of Public Company Accounting Oversight Board (PCAOB) inspection (likely or unlikely) cause audit committee members to make qualitatively different decisions when solving financial reporting disputes between management and the external auditors. Specifically, it was hypothesized that individuals receiving primarily option compensation would show greater support for management than those receiving cash and that those individuals with a high likelihood of inspection by the PCAOB would show greater support for the auditors than those with a low likelihood of inspection. A model was also proposed that predicted that likelihood of PCAOB inspection would moderate the effect of form of compensation on the side taken in these disputes. Participants were Executive MBA students from two large U.S. universities. Significant main effects were found for both form of compensation and likelihood of PCAOB inspection and the hypothesized interaction was also supported. The second experiment examined whether audit committee members' decisions are influenced to a greater degree by the financial expert on the committee whose occupational background is similar to their own. Participants were 30 actual audit committee members.

Regression results indicated a significant positive association between the occupational background of the participants and the relative weight given to the opinion of the financial expert with a similar background.

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The second experiment examined whether audit committee members' decisions are influenced to a greater degree by the financial expert on the committee whose occupational background is similar to their own. A regression model was run in order to test whether there was a significant positive association between the subject's occupational background and the relative weight given to the opinion of the financial expert with a similar background.

These studies add to the existing literature by examining in an experimental setting the impact of form of compensation, as well as some of the *unintended* consequences of SOX, on audit committee members' decisions.

II. LITERATURE REVIEW

2.0 Overview

Initially, this section provides a history of audit committees, as well as an overview of the regulatory changes in recent years that have impacted both audit committee responsibilities and composition. In addition, a review of the relevant research related to audit committee dispute resolution is presented. Next, the impact of various pressures and incentives on audit committee member judgments and decisions is discussed. Specifically, this section reviews the pertinent literature related to Public Company Oversight Board (PCAOB) inspections, form of compensation and various group/individual characteristics that may impact decision making.

2.1 Overview of Literature Related to Audit Committees

History of Audit Committees

Regulators have long been concerned with ways in which to improve the financial reporting process. Boards of directors were created as a way of protecting the interests of shareholders due to the conflict that arises from the separation of corporate management and ownership. Agency theory suggests that this may be necessary because management may not always act in the best interests of the owners (Fama 1980, Fama and Jensen 1983). In 1940, the SEC recommended that audit committees comprised of non-officer board members be established in order to help mitigate some of the potential conflicts that agency relationships create.

In response to requests for a stronger audit committee, the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD) co-sponsored a Blue Ribbon Committee on Improving the Effectiveness of Audit Committees (BRC, 1999). The BRC made a series of recommendations that can be classified into three categories. The first relate to improving audit committee member independence and qualifications. The second category proposes disclosure by the audit committee of their responsibilities and how they were discharged. The final category recommends expanded communication between the audit committee and the external auditors.

The NYSE and the NASD adopted rules related to all three categories of recommendations made by the BRC (1999). However, the guidelines for implementing these rules were somewhat different between the exchanges. The NYSE, in most instances, left more discretion in the board of director's hands to set specific operational guidelines for implementing the rules adopted. In addition, in direct response to the recommendations made by the BRC (1999) regarding expanded communication between the audit committee and the external auditors, the AICPA issued Statement on Accounting Standards No. 90, Audit Committee Communications, which amends SAS No. 61 and SAS No. 71. SAS No. 90 requires an auditor of SEC clients to discuss with the audit committee, the auditor's judgments about the quality, not just the acceptability, of the company's accounting principles and underlying estimates in its financial statements.

However, these additional rules were not deemed to be enough after the highly publicized financial reporting failures of companies such as Enron, Worldcom and Xerox, all of whom were subject to the new standards. As a result, the U.S. Congress passed the Sarbanes-Oxley Act (SOX) of 2002, which amends the Securities Exchange Act of 1934. This Act, among other things, reinforced the need for the audit committee to accept an expanded role in the oversight process and supported the call for mandated rules related to independence and financial expertise. In addition, both the NYSE and the NASD proposed more stringent corporate governance rules for listed firms.

Audit Committee Financial Experts

Since the initial call for the establishment of audit committees by the SEC, regulators have continued to refine and expand both the requirements related to the composition of the committee and the role it should play in the corporate governance process. As mentioned above, one of the areas that has received recent attention by both regulators and the stock exchanges is the issue of financial expertise. The increasingly complex nature of the underlying transactions and accounting policies that comprise financial statements, along with the increased demands placed on audit committee members to take a more active role in assessing the quality of these policies and transactions (SAS 90) highlights the need for financial expertise on the audit committee. The BRC (1999) recommended that companies should "have an audit committee comprised of a minimum of three directors, each of whom is financially literate or becomes financially literate within a reasonable period after his or her appointment to the audit committee, and further that at least one member of the audit committee have accounting or related financial management expertise." Expertise was defined by the BRC (1999) as "past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a CEO or other senior officer with financial oversight responsibilities."

The NASD adopted these recommendations almost in their entirety (Rule 4350 (d) (2a)). While the NYSE adopted the substance of the recommendations, they allowed the Board to exercise discretion in setting expertise requirements (Section 303.01 (B) (2c)).

In addition, Section 407 of SOX also incorporated requirements related to financial expertise. Under the rules implemented by the SEC (Item 401 (h)(2) of Regulation S-K), a company is required to disclose that its board of directors has determined that the company either has at least one audit committee financial expert serving on its audit committee, or does not have an audit committee financial expert serving on its committee. If a company does not have a financial expert, they must explain why they do not. If a company does have a financial expert, they must disclose the expert's name.

The final SEC rules (Item 401 (h) (2) of Regulation S-K) define an audit committee financial expert as a person who has all of the following attributes:

- An understanding of generally accepted accounting principles and financial statements;
- The ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves;
- Experience preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the registrant's financial statements, or experience actively supervising one or more persons engaged in such activities;
- An understanding of internal controls and procedures for financial reporting; and
- An understanding of audit committee functions.

Under the final rules, a person must have acquired such attributes through any one or more of the following:

(1) Education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor or experience in one or more positions that involve the performance of similar functions;

(2) Experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions;

(3) Experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements; or

(4) Other relevant experience.

Characteristics of Audit Committee Financial Experts

Williams (2005) performed a study in which she examined the characteristics of audit committee members post SOX by examining the proxy statements from 489 firms (370 were from large (S&P 500) firms and 119 were from smaller (assets less than $400 million) firms. The data shows that approximately 98 percent of the firms sampled had at least one financial expert. In addition, 46 percent of large firms designated multiple financial experts (only 12.8 percent of smaller firms do so).

In addition to the above financial expert characteristics, Williams (2005) also discovered some interesting findings regarding the professional experience of the audit committee financial expert. Almost half of the financial experts of the large firms sampled have held the positions of Chief Executive Officer and/or Chairman of the Board of other firms, while smaller firms have a significantly greater number of their financial experts who have held the position of President or Chief Financial Officer.

Carcello et al (2006) also examined the financial expert disclosures of 100 sample companies from each of four different groups: Fortune 500 companies, companies traded on the NYSE, Nasdaq's NMS and Nasdaq's NDQ. Their findings indicate that 30 percent of the companies in their sample have increased the number of experts on their audit committees since the passage of SOX. Specifically, they found that the 50 percent of the Fortune 500 companies sampled and 34 percent of NYSE companies disclose that they have multiple experts (approximately 14 percent of Nasdaq companies disclose they have multiple experts). The authors suggest that these numbers may be understated due to the fact that the SEC does not require a company to disclose whether they have multiple experts. In terms of professional background, similar to Williams (2005), the authors note that the "the clear modal background of an ACFE is top management (defined as CEO, President, COO or chairman of the board)".

Audit Committee's Role in Evaluating Accounting Estimate Quality

SAS No. 90 requires an auditor of Securities and Exchange Commission (SEC) clients to discuss with audit committees the auditor's judgments about the quality, not just the acceptability, of the company's accounting principles and underlying estimates in its financial statements.

Audit Committee's Role in Solving Auditor/Management Disputes

The audit committee is required to be notified when there are disputes between management and the external auditors (SAS No. 61, *Communication with Audit Committees*, AICPA, 1988b; SAS No. 89, *Audit Adjustments*, AICPA, 1999a). The Sarbanes-Oxley Act (2002) takes the audit committee's responsibility a step further by specifically charging the audit committee with the resolution of financial reporting disagreements.

Prior Research on Audit Committees and Dispute Resolution

Numerous researchers have examined the role audit committees play in the financial reporting process. Typically, these studies have examined the factors that impact the willingness of audit committees to support the auditor in disputes with management regarding the booking of audit adjustments. Knapp (1987) was the first to experimentally examine the role that audit committees play in the resolution of auditor/management disputes. His findings suggest that audit committee members are more likely to support the auditor when the issue in dispute is supported by objective, rather than subjective technical standards and when the company is in relatively poor financial condition. Knapp's (1987) findings also suggest that audit committee members who were currently also employed as corporate managers were more supportive of the auditors than were subjects who were retired business executives or individuals with a non-business background.

DeZoort and Salterio (2001) expand upon Knapp (1987), by examining in more detail the manner in which individual audit committee member characteristics impact their decisions in auditor/management disputes. Specifically, the authors examine the impact of audit committee member independence and financial knowledge. The authors found that more independent board member experience and higher audit-reporting knowledge were associated with greater support for the auditor in the auditor/management dispute. Contrary to Knapp (1987), their results also suggest that concurrent board/management membership is associated with greater support for management in the auditor/management dispute. Financial-reporting knowledge was not found to impact audit committee member judgment.

DeZoort et al. (2003a) provided additional insight into the factors that may impact audit committee member willingness to support auditors in auditor/management disputes. This study examined the effect of materiality justification and accounting precision on audit committee members' decisions. The results in this experiment suggest that audit committee members will show stronger support for the auditor when the auditors provide both quantitative and consequences-oriented justification (impact on earnings trend). They also found that CPAs and audit committee members who were more experienced (as measured by the number of audit committees on which the respondent currently serves) tended to side with the auditors and propose that the adjustment be recorded.

DeZoort et al. (2003b) performed an additional experiment in which they examined the impact of financial-report timing, EPS proximity to analyst forecast and external auditor argument consistency on audit committee member support for a proposed audit adjustment. The authors found that audit committee members were more likely to support the recording of audit adjustments when the audit is at year-end, unadjusted EPS is above rather than below forecast, and when the auditor consistently argues for adjustment. Surprisingly and in contrast to DeZoort et al. (2003a), the authors found that CPAs were less likely to argue for adjustment. Written explanations suggest that the CPAs either viewed the proposed adjustment as being immaterial (3% of pre-tax income) or they felt the amount was too subjective to be recorded.

2.2 Public Company Accounting Oversight Board

The passage of the Sarbanes-Oxley Act (2002) also resulted in the establishment of the Public Company Accounting Oversight Board (PCAOB). The PCAOB is charged with conducting public company inspections of registered audit firms. This task was previously carried out through the use of peer reviews, in which firms who were members of the SEC Practice Section would review the audits of one another. An audit firm is subject to annual reviews if they audit more than 100 SEC registrants, firms with fewer than 100 SEC registrants are subject to reviews by the PCAOB every three years.

According to the PCAOB, Board inspections are designed to identify and address weaknesses and deficiencies related to how a firm conducts audits. Audit engagements are selected based upon the Board's criteria and the audit firm is not allowed an opportunity to limit or influence the selection process. After an engagement is selected the Board chooses certain high-risk areas of the audit engagement to review. Part of the review process includes interviewing substantially all audit committee chairpersons of the companies they select for inspection and also encompasses a review of the communications between the public accounting firms and the audit committees. If it should come to the Board's attention that an issuer's financial statements appear not to present fairly, in a material respect, the financial position, results of operations, or cash flows of the issuer in conformity with GAAP, the Board reports the information to the SEC, which has jurisdiction to determine the proper accounting treatment in the issuer's financial statements. This may result in the company in question having to restate their financial statements. In addition, the results of the PCAOB's audits are publicly disclosed.

2.3 Impact of Stock Option Compensation on Financial Reporting

The potential incentives created by providing option-based pay to management have been well documented. Including stock options as part of overall compensation packages was seen as a way to more closely align the interests of management and shareholders by creating an incentive for managers to make operating and investing decisions that maximize shareholder wealth (Jensen and Meckling 1976). While there is evidence that option based pay does in some instances reduce the level of agency issues between management and shareholders (See Bryan 2000 for a review of literature), there is a growing body of research that suggests that option-based pay may also create incentives for management to act in an opportunistic manner.

Yermack's (1997) findings suggest that the timing of CEO stock option awards coincides with favorable movements in company stock prices, suggesting that CEOs receive stock option awards shortly before favorable corporate news. Aboody and Krasznik (2000), found evidence that suggests that CEOs make opportunistic voluntary disclosure decisions that maximize their stock option compensation. The results of a paper by Chauvin and Shenoy (2001) show an abnormal decrease in stock prices during a 10-day period immediately preceding the grant date of stock options.

Baker, Collins and Reitenga (2003) investigate the possibility that as opposed to managing either option award dates or disclosure dates, companies may be managing earnings to maximize option value. Specifically, they examine whether the use of stock options, relative to other forms of pay, is associated with the opportunistic use of discretionary accruals in reported earnings. Their findings suggest that relatively high option compensation is associated with income-decreasing discretionary accrual choices in the periods leading up to award dates, which would result in lowering the exercise price of the options. In addition, Cheng and Warfield (2005) examined the relationship between equity incentives and earnings management and found that managers with high equity incentives are more likely to engage in earnings management to increase the value of their shares. Burns and Kedia (2006) examined some characteristics of firms that announced restatements to their financial statements. They found that the sensitivity of a CEO's option portfolio to stock price was significantly and positively associated with the propensity to misreport.

2.4 Impact of Leadership on Group Decision Making

Kameda et al (1997) examined the extent to which individual members influence others in a group based upon the amount of information that they possessed as compared to other group members. A group member was considered to be "cognitively central" to the group if there was a great deal of overlap between the information held by that member and other members of the group. Interestingly, a majority of the time the group chose the preference of the cognitively central member, even when the individual held the minority view. The authors assert that other group members perceive the cognitively central member to possess expertise on "focal domain knowledge" and were therefore likely to accept their judgment.

In addition, research examining the impact of stress and group decision making (Kruglanski et al. 2002, 1993) has found that stressful conditions (as measured by time constraints, complexity of task, etc.), create a greater need for "closure" by individuals within a group. This need manifests itself in terms of a greater need among members for uniformity of opinion. The authors argue that this uniformity may be achieved by stronger attempts to influence individuals whose opinion deviates and/or a greater willingness to yield one's own opinion. In addition, this stress tends to induce a greater centralization of power by one or more key leaders of the group (De Grada et al. 1999).

2.5 Role Identity Salience

Identity is defined by Stryker (2000) as "parts of self composed of the meanings that persons attach to the multiple roles they typically play in highly differentiated contemporary societies". The beginnings of identity theory can be traced back to Mead (1934). In his writings he characterized "self" as being comprised of both a social structure and personality. Mead asserted that "Society shapes self shapes social behavior". Identity theory was introduced as a way to organize, structure and ultimately test the concepts of "society" and "self" and predict relationships between the two. In initial attempts at conceptualizing Mead's assertions, "social behavior" was replaced by "role choice behavior" and the crucial question on researchers' minds was: Given situations in which there exist behavioral options aligned with two (or more) sets of role expectations attached to two (or more) positions in networks of social relationships, why do persons choose one particular course of action? (Stryker 1968, 1980). Researchers attempting to unravel this question tend to view the self as a structure of roles (Turner 1978), identities (Stryker 1980) or role-identities (McCall and Simmons 1978). The hierarchical structuring or salience of these role-identities by an individual will ultimately determine behavior choices because role-identities that are identified as being at the top of the list are considered to be most representative of self.

III. EXPERIMENTS

The first chapter of this research is an experimental analysis that employs a hypothetical audit case in which simultaneously imposed pressures related to form of audit committee member compensation (stock options versus cash) and risk of Public Company Accounting Oversight Board (PCAOB) inspection (likely or unlikely) are examined in order to determine whether they cause audit committee members to make qualitatively different decisions when solving financial reporting disputes between management and the external auditors.

The second chapter is an experimental analysis examining the unintended impact on audit committee dispute resolution of the provisions in the Sarbanes-Oxley Act related to financial expertise. A hypothetical audit case is used to examine whether audit committee members' decisions are influenced to a greater degree by the financial expert on the committee whose occupational background is similar to their own. Specifically, the case examines whether audit committee members will change their initial decision in a hypothetical dispute between management and the external auditors when they are given additional information regarding the opinions of the financial experts.

CHAPTER 1: THE IMPACT OF COMPETING PRESSURES/INCENTIVES ON AUDIT COMMITTEE MEMBER RESOLUTION OF MANAGEMENT/AUDITOR DISPUTES

I. INTRODUCTION

The increased demands on audit committee members as a result of both intensified shareholder scrutiny and additional regulatory burdens have made the search for factors that may impact the effectiveness of the audit committee in fulfilling its governance responsibilities an increasing priority. Audit committees have been under increasing pressure to strengthen their oversight process. Regulations related to improving the overall effectiveness of the audit committee process have been passed in recent years by the New York Stock Exchange (NYSE), the National Association of Securities Dealers (NASD), the American Institute of Certified Public Accountants (AICPA) (Statement of Accounting Standards No. 90) and most recently the U.S. Congress (Sarbanes-Oxley Act of 2002). Clearly, ways in which to improve the audit committee governance process are seen as a high priority by many participants in the regulatory process.

The purpose of this paper is to examine some of the fundamental conflicting incentives/pressures faced by audit committee members when attempting to effectively fulfill their governance responsibilities. Specifically, this paper examines whether simultaneously imposed pressures related to form of audit committee member compensation (stock options versus cash) and risk of Public Company Accounting Oversight Board (PCAOB) inspection cause audit committee members to make qualitatively different decisions when solving financial reporting disputes between management and the external auditors. Understanding which of these conflicting pressures "wins" when the audit committee is faced with settling financial reporting disagreements between management and the external auditors is critical because of the direct impact that the resolution of these financial issues has on the financial statements.

An agency theory framework can be used to examine some of the incentive alignment issues that may exist as a result of compensation contracts. In an agency theory framework, the principal is the owner of the firm and the agent is the manager hired by the owner to manage the firm in her best interests. The owner is presumed to write compensation contracts for the managers that maximize the value of the firm to the owners. In a real world setting, the owners are represented by the Board of Directors and the manager is represented by the CEO and other managers of the firm. The theoretical case for the incentives of the manager to engage in suboptimal and/or opportunistic behavior is well documented (Jensen and Meckling 1976; Watts and Zimmerman 1978, 1979; Fama 1980; Fama and Jensen 1983). A large body of empirical evidence also exists that supports these theoretical arguments (Healy 1985; Press and Weintrop 1990; Jones 1991; Burgstahler and Dichev 1997; Han and Wang 1998; Barton 2001; Dichev and Skinner 2002). This is particularly true when the manager's compensation contract is tied to stock prices through stock options (Yermack 1997; Aboody and Kraszník 2000; Chauvin and Shenoy 2001; Baker, Collins and Reitenga 2003; Cheng and Warfield 2005; Burns and Kedia 2006).

As evidenced by the large body of laws and regulations governing the composition of Boards of Directors, the conflict that arises when managers hold membership on the Board of Directors is well recognized. This conflict would be particularly acute if internal members were able to dominate the audit committee and thus strengthen management's influence in cases where there is a disagreement between the external auditor and management. The independence requirements imposed on audit committee members by the Sarbanes-Oxley Act (SOX) are designed to help alleviate this problem. However, the problem still exists if directors receive compensation in the form of stock options. In effect, using options as director compensation has potentially broadened the “agency relationship umbrella” to include not only management but directors as well. The implications of misaligned loyalties on the part of audit committee members can be substantial, given that they are charged with oversight of the financial reporting process.

Competing pressures to mitigate the potential for opportunistic behavior on the part of audit committee members due to receipt of options do exist. Potential sanctions from perceived ineffective director performance could be litigation costs, and/or damage to reputation and loss of standing in the business community. This is particularly true for highly visible directors, such as audit committee members, who have direct oversight responsibility of the financial reporting process. A vehicle by which some of these sanctions may be realized is the Public Company Accounting Oversight Board (PCAOB). The PCAOB is charged with conducting public company inspections of registered audit firms. Part of the PCAOB’s inspection process includes interviewing substantially all audit committee chairpersons of the companies they select for inspection, and also encompasses a review of the communication between the public accounting firms and the audit committee. Depending upon the severity of the PCAOB’s findings, violations may be reported to the SEC. The SEC may require a company to restate its financial statements. In addition, all significant findings by the PCAOB are publicly disclosed. The reputation impact, as well as the potential litigation risk for audit committee members who are associated with companies whose financial statements are restated, would seem to act as a significant deterrent to potential opportunistic financial reporting decisions by audit committee members.

Audit committee members receiving primarily option compensation were hypothesized to show greater support for management in financial reporting disputes than those receiving cash. In addition, audit committee members facing a high likelihood of inspection by the PCAOB were hypothesized to show greater support for the auditors than those with a low likelihood of inspection. A model was also proposed that predicted that likelihood of PCAOB inspection would moderate the effect of form of compensation on the side taken in these disputes. Significant main effects were found for both form of compensation and likelihood of PCAOB inspection and the hypothesized interaction was also supported.

The results of this study suggest that while option compensation may in fact create misaligned loyalties on the part of audit committee members these loyalties can be realigned through the use of mechanisms put in place to improve the entire corporate governance process, namely PCAOB inspections.

II. BACKGROUND AND HYPOTHESES DEVELOPMENT

2.0 Background

The ultimate goal of both regulators and shareholders is the preparation of high-quality, transparent financial statements. The audit committee has a responsibility to ensure to the best of their ability that this goal is achieved. Obtaining the clearest understanding possible of the factors that contribute to an audit committee successfully achieving this goal is of paramount interest to all stakeholders in the financial reporting process.

Prior research examining the role of audit committees in disputes between management and the external auditors has focused on the type of financial issue being resolved, corporate financial factors, the position of the external auditor and the level of independence and knowledge of the audit committee member. The results of these studies would seem to suggest that the disposition of management/external auditor disputes varies greatly depending upon the type of dispute in question, the timing of the disagreement, and the individual characteristics of the audit committee members attempting to settle the dispute. These results highlight the need for additional research in this area in order to more fully explore the complexities inherent in the corporate governance process.

Research incorporating form of compensation and newly enacted provisions of SOX related to audit committee financial expertise has yet to be explored in a behavioral setting.

2.1 Recent Changes

In 2002, the U.S. Congress passed the Sarbanes-Oxley Act which amends the Securities Exchange Act of 1934. This Act, among other things, reinforced the need for the audit committee to accept an expanded role in the oversight process. The audit committee is required to be notified when there are disputes between management and the external auditors (SAS No.

61, *Communication with Audit Committees*, AICPA, 1988b; SAS No. 89, *Audit Adjustments*, AICPA, 1999a). SOX takes the audit committee's responsibility a step further by specifically charging the audit committee with the resolution of financial reporting disagreements.

In addition, SAS No. 90 requires an auditor of Securities and Exchange Commission (SEC) clients to discuss with audit committees the auditor's judgments about the quality, not just the acceptability, of the company's accounting principles and underlying estimates in its financial statements. Some of the recent financial failures have been the result of the aggressive use (misuse) of acceptable accounting policies. Therefore, the responsibility of the audit committee to make an assessment of the quality as well as the acceptability of the company's accounting policies and estimates has the potential to have large implications on the actual financial statements issued by management.

2.2 Director Compensation

Following a growing trend, International Business Machines Corporation (IBM) announced in December of 2006 that they will no longer grant outside directors options (Lublin and Bulkeley 2006). Peter Gleason, COO of the National Association of Corporate Directors (NACD) expressed the view that eliminating options as a form of director compensation reduces controversy because any potential for manipulation just goes away. Stock options are worthless unless a stock price rises, thereby creating an incentive to manage earnings (and therefore stock price) for the short term. However, in an annual report on director pay (Koors 2006) conducted by a collaboration between Pearl Meyer & Partners, the NACD and The Center for Board Leadership[1], it was noted that although the use of full-value shares over options is gaining favor because of both governance concerns and the new requirements related to mandatory option expensing, more than 50 percent of all companies examined still use stock options to compensate their directors and the percentage of total remuneration from stock options ranged from 23 to 29 percent depending upon the size of the company.

Largely in response to concerns over the amount and form of executive and director compensation, the Securities and Exchange Commission (SEC) recently approved regulations that would require expanded disclosures related to executive and director compensation, including stock-option grants and corporate stock option programs (SEC 2006). In addition, the NYSE has recently expressed its concern over the potential influence that option compensation may have on directors' judgments.

2.3 Impact of Stock Option Compensation on Financial Reporting

There is an extensive body of literature that examines the potential adverse consequences of option compensation on the decisions made by management when fulfilling their responsibility to maximize shareholder wealth**.** Research has suggested that CEOs receive stock option awards shortly before favorable corporate news (Yermack's 1997), and that CEOs make opportunistic voluntary disclosure decisions that maximize their stock option compensation (Aboody and Krasznik 2000). In addition Chauvin and Shenoy (2001) show an abnormal decrease in stock prices during a 10-day period immediately preceding the grant date of stock options. These studies all provide evidence that management opportunistically manage either award dates or disclosure dates to maximize option value.

Additional research focused on the possibility that in addition to managing award dates and disclosure dates, companies were also possibly managing earnings to maximize option value. Baker, Collins and Reitenga (2003) findings suggest that relatively high option compensation is associated with income-decreasing discretionary accrual choices in the periods leading up to award dates, which would result in lowering the exercise price of the options. Cheng and

Warfield's (2005) findings suggest that managers with high equity incentives are more likely to engage in earnings management to increase the value of their shares. Burns and Kedia (2006) found that the sensitivity of a CEO's option portfolio to stock price was significantly and positively associated with the propensity to misreport, providing support for the authors' assertions that the incentives from options encourage aggressive accounting practices that result in restatement.

Audit committees are specifically charged with evaluating the quality of both accounting principles and estimates used by management. In addition, they are also responsible for the ultimate resolution of disputes between management and the external auditors related to these principles and estimates. Given that a significant portion of audit committee members are being compensated with options, the same motivation management has to engage in opportunistic behavior would seem to also exist for audit committee members.

Based upon the extensive literature that supports the finding that stock options provide incentives for management to make opportunistic financial decisions, and given the expanded role that audit committee members play in the financial reporting process, as well as the data that shows that a majority of directors are compensated using stock options and that it is a significant portion of their total remuneration, I propose the following hypothesis in alternative form:

> **H1:** Audit committee members who receive a significant portion of their compensation in the form of stock options will be more likely to support management in disputes with the auditor than will members who do not receive such compensation.

2.4 Public Company Accounting Oversight Board

The PCAOB is charged with conducting public company inspections of registered audit firms. The review process includes interviewing substantially all audit committee chairpersons of the companies they select for inspection and also encompasses a review of the communications between the public accounting firms and the audit committees. If the findings of these inspections indicate that the financial statements under audit are materially misstated, the PCAOB has the authority to report this information to the SEC. Potentially, this could result in the company in question having to restate their financial statements.

Results of the 2004 full inspections conducted by the PCAOB reveal numerous instances in which the inspection staff concluded some audit deficiencies were so significant that they did not believe that the audit firm had obtained sufficient competent audit evidence to support the opinion rendered (PCAOB 2005d). The PCAOB has demonstrated a willingness to take the inspection process very seriously and has shown that it is not going to "rubber stamp" the engagements that it selects for review.

2.5 Exposure Draft – The Auditor's Communication With Those Charged With Governance

The Auditing Standards Board (ASB) has issued an exposure draft that would replace SAS No. 61, *Communication with Audit Committees*, if approved. This exposure draft, among other things, details the specific form in which significant audit findings should be communicated to "those charged with governance". The exposure draft states that the auditor should communicate in **writing** the auditor's views about the qualitative aspects of the entity's accounting practices, including accounting estimates. The draft also states that the auditor should explain to those charged with governance why the auditor considers a significant accounting practice not to be appropriate and when considered necessary, request that changes be made. If requested changes are not made, the auditor should inform those charged with governance that the auditor will consider the effect of this on the financial statements of the current and future years, and on the auditor's report.

The exposure draft elaborates on the type of information that may be included when discussing the qualitative aspects of accounting practices. The exposure draft states that for items for which estimates are significant, information regarding management's process for making accounting estimates, the risk of material misstatement related to these estimates, indicators of possible management bias, and disclosure of estimation uncertainty should be communicated to the audit committee by the auditors

Given that under the proposed standard communications between the audit committee and the auditors regarding significant accounting estimates are required to be in writing and contain expanded dialogue regarding certain qualitative aspects of the estimate, if the auditors have taken a stand against the use of the estimate, the potential review of these communications by the PCAOB in the event of a review of the engagement would increase the pressure on audit committee members to make conservative judgments when determining whether an accounting estimate is appropriate. This would especially be the case given the latitude that the PCAOB has in initiating a review by the SEC which could result in the company having to restate their financial statements.

2.6 Consequences of Firm Performance on Outside Directors

Zajac (1988) asserts that individuals join boards for financial remuneration, prestige and contacts that may prove useful in securing subsequent employment opportunities. Fama and Jensen (1983) and Lorsch and MacIver (1989) mirror some of these findings by arguing that the primary benefits to outside directors from board membership are prestige, reputation, learning opportunities and networking.

Presumably, directors who fulfill their roles effectively will be rewarded by not only maintaining the current board positions that they hold, but also by securing additional board appointments. Perceived ineffective performance, whether or not it is the result of actual audit committee performance is costly to directors. Specifically, research has shown that directors, especially audit committee members, are penalized for both financial restatements and financial failures of companies on whose boards they serve (Gilson 1990; Srinivasan 2005). The authors' findings suggest that directors are not only significantly more likely to lose their seat on the board experiencing the financial difficulties, but that their other board appointments may be in jeopardy as well.[2]

The PCAOB not only has the authority, but has demonstrated the willingness to report findings that may result in financial restatements on the part of a company under inspection. Prior research has shown that these restatements significantly impact the retention of board seats by audit committee members, not only on the company actually making the restatement, but for other companies on whose boards these directors serve. Therefore, I propose the following hypothesis in alternative form:

> **H2:** Audit committee members facing a high likelihood that the company on whose committee they serve will be selected for PCAOB inspection will be more likely to support the auditor in disputes with management than will members facing a low likelihood of selection.

2.7 Form of Compensation versus Risk of PCAOB Inspection

Ultimately, audit committee members will have to assess the relative cost/benefits of their governance decisions. Shamir (1990) examined various forms of collectivistic work motivation. One form of motivation is calculation. This results when rewards or sanctions are anticipated to follow from group performance. Potential rewards for effective performance as an audit committee member would be future board appointments and respect within the business community. Potential costs from perceived ineffective audit committee performance could be litigation costs, and/or damage to reputation and loss of standing in the business community.

Prior research has shown that the use of stock options as compensation can create incentives for individuals to make opportunistic financial decisions. Given that a majority of directors are still receiving stock options as a form of compensation, as noted above, there have to be forces in place to counteract the incentives created by the use of these options. A relatively new potential force is a PCAOB inspection. If the PCAOB discovers material departures from Generally Accepted Accounting Principles (GAAP) during the course of its inspection, the PCAOB reports the information to the SEC, which has the jurisdiction to determine the proper accounting treatment in the issuer's financial statements, which may result in the company in question having to restate its financial statements. Furthermore, the results of the PCAOB's audits are publicly disclosed.

Financial remuneration has been identified as one of the primary reasons that individuals accept board positions (Zajac 1988), and prior research suggests that the type of compensation that board members receive can result in opportunistic decisions by the director in question, thereby increasing the likelihood that these board members will make financial decisions that align themselves with management. However, given the significant sanctions in terms of both current and future board appointments that may be imposed on audit committee members as a result of an inspection by the PCAOB that ultimately results in an accounting restatement, a strong argument can be made that the risk of PCAOB inspection will moderate the effect of form of compensation on the side an audit committee member takes in management/auditor disputes. Therefore, when the risk of PCAOB inspection is high, form of compensation will have less impact on the audit committee member's willingness to side with management. However, when the risk of PCAOB inspection is low, form of compensation is expected to have a greater influence on the side an audit committee member will take in a management/auditor dispute.

Specifically, I expect the greatest support for management by audit committee members to occur when these members' primary form of compensation is stock options and the risk of audit by the PCAOB is low. Therefore, I offer the following hypothesis in alternative form:

> **H3:** Form of compensation and likelihood of PCAOB inspection will interact to reduce the support shown for management in a dispute, with likelihood of PCAOB inspection moderating the effect of form of compensation on the side an audit committee member will take in management/auditor disputes.

Figure 1 presents the pattern of predicted effects of the form of compensation and risk of PCAOB inspection on the side taken in a dispute between the external auditors and management.

III. METHODOLOGY

3.0 Participants

Participants are Executive MBA students from two U.S. large universities. McDaniel et al. (2002) used recent Executive M.B.A. graduates as proxies for audit committee members. The use of Executive MBA students as proxies for audit committee members is appropriate because these individuals provide an adequate level of financial literacy as well as diversity in terms of their backgrounds. These attributes provide a good match to the backgrounds found in actual audit committee members.

3.1 Experimental Task

The participants evaluated an audit case (see Appendix A) for a hypothetical company (Technology Advances Inc.) for which they are audit committee members. The case involved a dispute between management and the external auditors related to the adequacy of the warranty reserve. Subjects were asked to indicate their support for either management (i.e. definitely allow the use of the estimate) or the auditors (i.e. definitely do not allow the use of the estimate). In addition, subjects were asked to explain the rationale for their decision.

Case materials also included two manipulation checks related to form of compensation and risk of PCAOB audit in order to ensure that participants understood the treatment conditions. In addition, demographic information was collected.

The hypotheses were tested using a between-subjects design with form of compensation (a substantial retainer and per meeting fee versus a minimal retainer, per meeting fee and stock options) and risk of PCAOB inspection (unlikely versus likely) as the experimental variables.

3.1.1 Accounting Issue

The accounting issue involved the adequacy of the warranty reserve as proposed by management. The warranty reserve in question was related to a new product line acquired by the company as the result of a recent acquisition. The subjectivity involved in determining the adequacy of the warranty reserve is appropriate for this study because it allows for greater influence of other contextual factors, which are the focus of this study. In addition, subjective accounting issues are representative of the types of issues that would be brought before actual audit committees for resolution (DeZoort et al., 2003b).

3.1.2 Form of Compensation

I manipulated compensation as being either completely cash based or a minimal amount of cash and significant potential stock option compensation. Specifically, the **cash compensation condition** stated "your compensation as an audit committee member consists of an annual fixed retainer of $200,000, plus meeting fees of approximately $40,000, resulting in total cash compensation of $240,000" and the primarily **option compensation condition** indicated that total cash compensation was $40,000 and "in addition, you currently hold 20,000 stock options that will vest within the next week…… If the current market price of the shares remains the same and you choose to exercise your options and sell the shares, total compensation will be $40,000 in cash compensation and $200,000 in proceeds from the options, resulting in total compensation of $240,000”.

3.1.3 Risk of PCAOB Inspection

I manipulated this risk as being either unlikely or likely. In the likely condition, I state that although the risk of this company is average for the audit firm in question, the new acquisition by the company makes it highly likely to be selected for inspection. The low condition also states that the risk of the company is average for the audit firm in question; however it states that it is highly unlikely that it will be selected for inspection.

3.1.4 Dependent Variable

The dependent variable is the subject’s willingness to support either management or the auditor in the accounting dispute. I measured this on a continuous Likert scale ranging from 1 = support management’s position (i.e. definitely allow the use of the estimate) to 11 = support the auditor’s position (i.e. definitely do not allow the use of the estimate). I also asked participants to provide justification for their decisions.

IV. DATA AND RESULTS

Results were analyzed using a 2 X 2 (form of compensation by likelihood of PCAOB inspection) analysis of variance (ANOVA) and planned comparisons. Table 2 presents treatments means and the results of testing hypothesis H1 through H3.

4.0 Manipulation Checks

The results of the manipulation checks were as follows: risk of PCAOB inspection (8 percent failure rate), and form of compensation (8 percent failure rate). All participants who failed at least one manipulation check were eliminated, leaving 92 participants available for hypothesis testing. I ran the ANOVA model with the full sample included and the results were similar to those reported below. Significance for all hypotheses was still achieved at the $p < .05$ level.

4.1 Demographics

Table 1 presents descriptive statistics related to participants. The age of participants ranged from 25 to 62, with a mean age of 35. In addition, 73 percent of the respondents were male. Only 2 percent had prior experience on an audit committee. Similarly, only 2 percent had been involved in a PCAOB audit. 35 percent of the participants had received stock option compensation in the past. For those members receiving stock option compensation, it comprised, on average, 8.8 percent % of their total salary.

4.2 Form of Compensation

Hypothesis 1 predicts audit committee members who receive a significant portion of their compensation in the form of stock options will be more likely to side with management than will members who do not receive this form of compensation. Table 2, Panel A, provides marginal means for the cash and options form of compensation of 7.44 and 6.34, respectively. Panel B shows that the form of compensation significantly affects the side audit committee members take in auditor/management disputes ($F= 6.597$, $p<.01$, one-tailed). Specifically, audit committee members who receive a significant form of their compensation in the form of stock options were more likely to side with management in disputes with the auditor than were members who do not receive such compensation. This result is consistent with and provides support for the prediction made in H1.

4.3 Risk of PCAOB Inspection

Hypothesis 2 predicts that audit committee members facing a high likelihood that the company on whose committee they serve will be selected for public company inspection will be more likely to support the auditor in disputes with management than will members facing a low likelihood of selection. Table 2, Panel A provides marginal means for low and high likelihood of PCAOB inspection of 6.13 and 7.60, respectively. Panel B shows that a high likelihood of public inspection significantly affects the side audit committee members take in auditor-management disputes ($F = 10.490$, $p < .01$, one-tailed). Specifically, audit committee members who face a high likelihood of inspection by the PCAOB will be more likely to side with the auditor in disputes with management than will members facing a low likelihood of inspection by the PCAOB, therefore the predictions made in H2 are supported.

4.4 The Moderating Effect of Risk of PCAOB Inspection on Form of Compensation

Hypothesis 3 predicted that the likelihood of PCAOB inspection would moderate the effect of form of compensation such that subjects would have a greater tendency to support the external auditor when the likelihood of PCAOB inspection was high (without regard to the form of compensation) and the strongest support for management when the likelihood of PCAOB inspection was low and subjects were compensated primarily in the form of options. A planned comparison (see Figure 1) was conducted for the dependent variable measure to test the moderation prediction in H3. The planned comparison tests whether:

[Cell 1 mean – Cell 2 mean] > [Cell 3 mean – Cell 4 mean], where:

Cell 1 = Cash and low likelihood of PCAOB audit

Cell 2 = Significant stock option compensation and low likelihood of PCAOB audit

Cell 3 = Cash and high likelihood of PCAOB audit

Cell 4 = Significant stock option compensation and high likelihood of PCAOB audit

As depicted in Figure 1, it was predicted that there would be a significant difference between the Cell 1 and Cell 2 mean absolute difference (2.04) and the Cell 3 and Cell 4 mean absolute difference (.33). As shown in Panel C of Table 2 (and depicted in Figure 2) the absolute difference between Cells 1 and 2 and Cells 3 and 4 was significantly different and in the direction predicted ($t = 1.853$, $p = .034$). Specifically, the absolute difference between Cells 1 and 2 was significantly greater than the difference between Cells 3 and 4 therefore the moderation predicted in H3 is supported.

4.5 Supplemental Analysis – Simple Effects

As discussed in section 4.4 above, form of compensation and risk of PCAOB inspection were found to interact to affect the side an audit committee member would take in the management/external auditor dispute. The initial test of the interaction does not provide an indication as to which cell means are different from the others. Additional tests were conducted, using planned comparisons, to explore the nature of the interactions. Figure 2 illustrates the simple effects of the form of compensation and likelihood of PCAOB inspection on the side taken in a management/external auditor dispute in a hypothetical audit setting.

The planned comparisons (not tabulated) revealed that for subjects receiving primarily options as their form of compensation, a high likelihood of PCAOB inspection led to greater support for the auditors than for those with a low likelihood of PCAOB inspection ($F = 13.202$, $p < .01$). For subjects receiving cash as their form of compensation, likelihood of PCAOB inspection had no effect ($F = .948$, $p = .333$).

4.6 – Supplemental Analysis – Comparison of Cell Means versus Mid-point

In order to assess the strength of participants' support for either management or the auditor in the hypothetical audit case one sample t-tests were conducted to compare cell means for each of the four possible setting combinations versus the dependent variable measurement scale (11-point Likert scale, with 1 indicating support for management and 11 indicating support for the auditor) mid-point of 6. Table 2, panel D, shows that all four possible combinations were significantly different than the mid-point of 6.

Participants in the Cash/Unlikely PCAOB inspection setting had a mean of 7.13, exceeding the mid-point of 6 by 1.13 ($t = 2.26$, $p = .017$). The mean in the Cash/Likely PCAOB inspection setting was 7.77, exceeding the mid-point by 1.77 ($t = 3.93$, $p = .000$). In addition, the mean in the Options/Likely PCAOB setting of 7.44, exceeding the mean by 1.44 ($t = 3.22$, $p = .002$). The results of the *t*-tests for these three conditions indicate support for the auditor in the hypothetical dispute.

The mean in the Options/Unlikely PCAOB inspection was 5.09, which was lower than the mid-point by .91 ($t = -2.06$, $p = .026$) thereby indicating support for management in the hypothetical dispute.

4.7 – Supplemental Analysis – Analysis of Demographic Covariates (ANCOVA)

ANCOVA's were performed (not tabulated) using selected demographic information as individual covariates. The inclusion of age, gender, and prior and/or current stock option compensation were analyzed as covariates. None of these variables were found to significantly impact the dependent variable while controlling for the two independent variables. Because of the small number of subjects who reported having either a CPA designation, prior audit committee experience or prior participation in a PCAOB inspection, ANCOVA's could not effectively be performed on these variables.

4.8 Rationale for Dispute Decision

For participants supporting management (DISPUTE < 6), the most common explanation was that management would have more expertise in this area and that their advice should be followed. The second most frequent response was concern over the impact that making the adjustment would have on the company's financial performance. This response underscores the fact that participants did strongly consider the financial consequences of the potential adjustment.

For participants supporting the auditors (DISPUTE > 6) the most frequent explanation given was the objectivity and independence of the auditors.

V. DISCUSSION AND IMPLICATIONS

This study experimentally investigates the impact of form of compensation and likelihood of PCAOB inspection on the side taken by audit committee members in a dispute between management and the external auditors**.** Prior literature (DeZoort et. al. 2003), suggests that audit committee members have a tendency to support the auditor when there are disputes related to subjective accounting estimates. This study examines additional variables that may impact the decision process. Specifically, two questions are investigated. First, does the use of option compensation by management provide a strong enough incentive in these dispute settings to change the position taken by audit committee members from the auditors to management particularly when negative financial consequences result from siding with the auditors? Second, will the potential consequences associated with an inspection by the PCAOB be enough to mitigate the incentives created by option compensation? The study's results suggest that the answer to both of these questions is yes.

As was predicted, the experimental results suggest that audit committee members are more likely to support management when they are compensated with stock options and when the likelihood of PCAOB inspection is low. The predicted interaction between likelihood of PCAOB inspection and form of compensation was also supported. An analysis of the simple effects showed that the moderating effect of likelihood of PCAOB inspection only holds when participants are compensated with options. Participants demonstrated a significant preference for the auditor's position, as compared to the mid-point of the measurement scale in all but the Options/Low Likelihood of PCAOB inspection condition; with these individuals demonstrating a significant preference for the position of management.

The main effects of form of compensation and risk of PCAOB inspection highlight the potential incentives/pressures that can both directly and indirectly impact the decisions an audit committee member makes related to accounting disputes that ultimately determine the numbers presented in the financial statements. Gaining a better understanding of how both form of compensation and PCAOB inspection risk individually and jointly impact audit committee members' decisions allows stakeholders to gain valuable insights into ways in which loyalties that have been potentially misaligned due to option compensation can be realigned by regulatory requirements aimed at improving the corporate governance process.

Although there has been much discussion among the investing and regulatory community[3] regarding both the need for increased disclosure of the type of director compensation as well as the more global issue as to whether the use of options as director compensation should be eliminated altogether, currently options are still used by a majority of companies to compensate their directors (Koors 2006). The results of this study suggest that option compensation may in fact create misaligned loyalties on the part of audit committee members. The consequences of this shift in behavior can be substantial, given that audit committee members are charged with oversight of the financial reporting process. However, the results of this study also suggest that these loyalties can be realigned through the use of mechanisms put in place to improve the entire corporate governance process, namely PCAOB inspections. While these inspections were not meant to specifically impact audit committee member decisions, it would appear that this has been a positive unintended consequence.

Interestingly, the existence of previous stock option compensation did not impact the side taken by participants in the dispute. However, as indicated in Table 1, the reported average stock option compensation as a percentage of total compensation was relatively small (8.8%). Perhaps, the amount of option compensation received by participants in the past would have had to be more significant in order for it to impact their choices. In addition, an analysis of the remaining demographic covariates (age and gender) indicated no significant impact on the side taken in the hypothetical dispute.

The findings in this study are subject to a number of limitations. Given that participants were Executive MBA students as opposed to actual audit committee members the issue of external validity has to be considered. Although, executive MBAs have been used in the past as proxies for audit committee members (McDaniel et al 2002) there is the possibility that actual audit committee members may behave differently than the participants in this study.

In addition, actual audit committee members would have a wide array of qualitative and quantitative information to draw from when making a decision as to the appropriateness of the warranty reserve that can not be replicated in a study of this complexity and length.

Also, audit committee members are typically making this type of decision in a group setting as opposed to individually and the influences of member dominance and group processing and interaction may lead to different outcomes than those found in this paper.

This study raises several issues for future research. First, while this study investigated the impact of option compensation on audit committee member decisions, it did not explore the characteristics of companies that choose to compensate their directors with options. The question of whether this form of compensation is used intentionally as a mechanism by companies in an attempt to align audit committee members more closely with management would be an interesting issue to explore.

In addition, as mentioned previously, the impact of the audit committee decision making process as it plays out in a group setting deserves further attention. While this study examines the individual choices made by audit committee members given certain incentives/pressures, it does not explore how the ultimate outcome of these decisions may change in a group setting. The role of the financial expert and the diverse financial backgrounds that can be used to satisfy the expertise requirements as mandated by SOX increase the potential complexities of the group dynamics in an audit committee. The impact of member dominance and the potential for differing loyalties based upon factors that go beyond the variables explored in this study are fruitful areas for future research.

CHAPTER 2: AN EXPERIMENTAL INVESTIGATION OF THE IMPACT OF ROLE IDENTITY AND FINANCIAL EXPERT DESIGNATION ON AUDIT COMMITTEE MEMBER JUDGMENTS AND DECISIONS

I. INTRODUCTION

Regulatory agencies have focused primarily on implementing structural changes in order to improve audit committee effectiveness. They have done this by providing rules related to independence, specifying levels of financial expertise, mandating expanded communications with external auditors, and providing guidelines as to audit committee size and frequency of meetings (BRC 1999; NACD 2000; Sarbanes-Oxley (U.S. House of Representatives 2002)). Regulators seem to be attempting to shape the group interactions of the audit committee by providing specific structural guidelines within which the committee is allowed to operate. Research examining the manner in which the audit committee, as individuals and as a group, incorporate these structural changes into their decision-making process would provide regulators with useful insights into whether or not these new guidelines contribute to a more effective audit committee.

This paper uses a hypothetical audit case to experimentally examine the impact of the mandate by The Sarbanes-Oxley Act (SOX) which requires publicly traded companies to disclose whether they have a financial expert on their audit committee. This disclosure requirement resulted in companies not only adding financial experts to their audit committees when there were none present, it also prompted many companies to add additional financial experts even though they already had one serving on the committee (Williams 2005; Carcello et al., 2006).

I initially examined the question of whether the audit committee financial expert (ACFE) would have the most influence on decisions made by the audit committee related to accounting estimates and judgments. I then used role identity theory to make predictions regarding the impact of the ACFE's opinions on other non-expert members of the committee. A role identity is a particular social object that defines the self. Research examining role identity in our culture has found that occupational role-identity is typically the most dominant or salient aspect of the self. Therefore, an individual's actions and behavior are largely predicated on making decisions that validate their occupational role-identity (Callero 1981; Stryker and Serpe 1982; Stryker and Burke 2000). Given these findings, directional predictions can be made, based upon an audit committee member's occupation (accounting versus non-accounting) as to the relative weight that the member will place on an ACFE's opinion when there are two (ACFE's) on the committee from different (accounting versus non-accounting) backgrounds.

The implications of appointing an ACFE go beyond the actual knowledge that individual brings to the committee. The dynamics and potentially the power structure of the group are changed. Given the increased role that the audit committee is expected to play in the financial reporting process, including the specific mandate by SOX that charges audit committees with the resolution of financial reporting disagreements between management and the external auditors, the designated ACFE has the potential to play a dominant role in decisions made by the audit committee as a whole, particularly in those decisions related to accounting judgments and estimates.

Furthermore, companies with more than one designated ACFE have potentially created a source of conflict within the confines of the audit committee itself. Two ACFE's serving on the same committee with potentially divergent views is a very real possibility, given the large number of companies who have more than one ACFE designated and the wide range of professional experience that can be used to fulfill the financial expertise requirement as mandated in the final version of SOX. The legislation as passed allows a broad definition of financial expertise that encompasses both accounting and non-accounting backgrounds. Specifically, the revised rules allow individuals to qualify as experts who have had only oversight, as opposed to direct responsibility of the financial reporting and preparation process. Therefore, this definition allows CEOs and company presidents to qualify as experts.

It was hypothesized that when there are two designated audit committee financial experts and they disagree as to the resolution of an issue in a management/auditor dispute, audit committee members would show stronger support for the expert whose role identity they identify with the most. A regression model was run in order to test this prediction. The results of the regression indicated a significant positive association between occupational background and the relative weight given to the opinion of the financial expert with a similar background. These results provide insight into the manner in which audit committee members will resolve conflicting advice given to them when there are two financial experts serving on the same committee. Gaining a better understanding of the manner in which these judgments are made is increasingly important given the growing number of committees that have multiple experts serving.

II. BACKGROUND AND HYPOTHESES DEVELOPMENT

2.0 Regulatory Changes Related to Audit Committees

The role of the audit committee in the corporate governance process has continued to evolve since the initial call in 1940 by the Securities and Exchange Commission (SEC) for the establishment of these committees in order to provide another layer of financial oversight. Financial transaction have become increasingly complex and the audit committee has been charged with taking additional responsibility for the acceptability and quality of the accounting principles and estimates that underlie these transactions (SAS 90). Given these increased demands, regulatory agencies have placed special emphasis on the need for audit committees to have the required expertise to fulfill their governance role effectively.

Numerous regulatory agencies and committees have examined the issue of financial expertise (BRC 1999; SOX 2002) and both the NASD (Rule 4350 (d) (2a)) and the NYSE (Section 303.01 (B) (2c)) have adopted the expertise provisions provided by these groups almost in their entirety.

The current expertise requirements as implemented by the SEC (Item 401 (h)(2) of Regulation S-K), address both disclosure requirements related to financial expertise, as well as the financial qualifications necessary to qualify as an audit committee financial expert. Under these rules, a company is required to disclose that its board of directors has determined that the company either has at least one audit committee financial expert serving on its audit committee, or does not have an audit committee financial expert serving on its committee. If a company does not have a financial expert, they must explain why they do not. If a company does have a financial expert, they must disclose the expert's name.

The question of how financial expertise should be defined by SOX has been somewhat controversial. The original proposal by SOX was that the financial expert should have primarily accounting experience. There was widespread criticism over mandating such a restrictive view of financial expertise. The legislation as passed allowed a broader definition of financial expertise that encompassed both accounting and non-accounting backgrounds. Specifically, the revised rules allowed individuals to be experts who have had oversight responsibility of the individuals in charge of the financial reporting and preparation process. This definition allowed CEOs and company presidents to qualify as experts under SOX guidelines.

2.1 Characteristics of Audit Committee Financial Experts

Williams (2005) examined the proxy statements for all available S&P 500 firms, as well as a random sample of smaller firms (489 firms total) in order to more fully understand the composition of audit committees post SOX. The author found that 98 percent of the firms in the sample name at least one financial expert, and 46 percent designate two or more financial experts. Carcello et al (2006) examined the financial expert disclosures of 100 sample companies from four different groups: Fortune 500 companies, companies traded on the NYSE, Nasdaq's NMS and Nasdaq's NDQ. Their findings indicate that 30% of the companies in their sample have increased the number of experts on their audit committees since the passage of SOX.

In addition to the above financial expert characteristics, Williams (2005) also discovered some interesting findings regarding the professional experience of the audit committee financial expert. Almost half of the financial experts of the large firms sampled have held the positions of Chief Executive Officer and/or Chairman of the Board of other firms, while smaller firms have a significantly greater number of their financial experts who have held the position of President or Chief Financial Officer.

DeFond et al. (2005) examined whether the market reacts favorably to the appointment of directors with financial expertise on the audit committee. The authors also examined whether the market reaction varied depending upon the manner in which the financial expertise requirement was met. Specifically, they examined accounting financial experts (public accountant, auditor, principal or chief financial officer, controller, or principal or chief accounting officer) versus non-accounting financial experts (CEOs and company presidents). Their findings suggest that the market reacts positively to the appointment of accounting financial experts, but that there is no market reaction to the appointment of non-accounting financial experts. These findings raise additional questions regarding why firms still predominantly use non-accounting financial experts to fulfill their expertise requirement and also provides additional motivation to further examine whether there are systematic differences in how these groups behave in an audit committee decision-making context.

2.2 Impact of Leadership on Group Decision Making

Some of the prior literature on the impact of individual members on group decisions focuses on the perception of the group members as it relates to the expertise that their fellow group members possess. Specifically, it has been suggested that when group members feel an individual possesses expertise they will tend to choose the preference of this group member, even when the opinion of the member is the minority view (Kameda et al 1997). The authors assert that other group members perceive the cognitively central member to possess expertise on "focal domain knowledge" and were therefore likely to accept their judgment.

In addition, research has also examined the impact of stress on group decision making (Kruglanski et al. 2002, 1993; De Grada et al. 1999). Ultimately, these studies suggest that stressful conditions create a greater need for "closure" by the group, a greater need for uniformity of opinion and a tendency towards centralization of power by one or more key leaders of the group. Kerr and Tindale (2004) summarize these findings by stating that "stressful conditions tend to result in a closing of the "group mind"- an aversion to unpopular options, an acceptance of autocratic leadership and extant group norms".

There is a strong argument that can be made that in an audit committee setting the designated financial expert would be perceived as the cognitively central member of the group. Certainly, a situation that involves the resolution of a dispute between management and the external auditors is often times stressful in terms of both time pressure and task complexity depending upon the financial issue in question, thereby creating an environment that is even more susceptible to the influence of dominant members. Therefore, I propose the following hypothesis in alternative form:

> **H4:** Audit committee members will show the strongest support for the opinion of the audit committee financial expert when resolving management/auditor disputes.

2.3 Impact of Role Identity on Group Decision Making

Identity is defined by Stryker (2000) as "parts of self composed of the meanings that persons attach to the multiple roles they typically play in highly differentiated contemporary societies". Researchers view the self as a structure of roles. The significance of these roles in decision making lies in the findings that individuals tend to assign a hierarchy to their various role-identities and align their behavior choices with the roles they consider to be the most salient (Stryker 1968, 1980; McCall and Simmons 1978; Turner 1978).

Callero (1985) asserts that salient role identities are important because they announce to others who we are. In addition, he acknowledges the importance that we attach in our society to occupational roles. The author suggests that we are largely identified by our occupations, and that typically society tends to label and define us according to what we choose to do for a living.

Therefore, social and behavioral expectations are formed based upon society's determination of our most salient role-identity. Stryker (1981) argues that the more salient the role identity, the greater the likelihood that situations will be viewed as opportunities for performing the role-identity, and the greater the likelihood that stable relationships with others will be premised on the role-identity.

Research has typically shown that the occupation of an individual is their most salient role identity (Callero 1985, Jackson 1981). Therefore, the argument can be made that the degree to which an audit committee member is able to identify with either management or the auditors will in large part be dependent upon their occupational background. Therefore, I propose the following hypothesis in alternative form:

> **H5**: Role identity will be positively associated with occupational background.

Researchers have noted that the salience of a role identity influences our relations with others in important ways (Mead 1934; Bolton 1981). These authors suggest that salient role identities contribute greatly to establishing individual perspectives used in the perception and evaluation of others. Stryker (1981) notes that salient role identities have important implications for how we define others and with whom we develop specific social relationships. In addition, role-identities that are salient also have close ties to self-esteem. Zurcher (1977) asserts that self-definitions are in large part formed by socially recognized positions. Therefore when a role identity is salient it is more representative of the self and therefore one's self-definition will more likely reflect salient role identities. It would logically follow then that an individual's self esteem is inextricably tied to one's successful performance of those role-identities that are the most salient.

Several studies have attempted to empirically examine the link between the salience of a role identity and behavior. Stryker and Serpe (1982) found that the salience of religious identities predicts time spent in religious activities. Callero (1985) demonstrated that the salience of a donor identity predicts the frequency of blood donations. Serpe (1987) found some evidence to support the stability of salient role identities over time and across varied situations. The author also found that individuals seek new relationships by joining organizations that provide opportunities to behave in accord with highly salient identities before entrance. If they are successful in their attempts, then they remain committed to their role identities, if they are not, the salience of the role-identity in question diminishes.

The literature suggests that occupation is typically an individual's most salient role identity. In addition, social relationships with others, perceptions of others, and self-esteem have been shown to be strongly associated with the successful performance of salient role identities (Zurcher 1977; Stryker 1981; Callero 1985).

Therefore, if an individual has an accounting background, it would seem to follow that their behavior will be predicated on that background and that they will identify more strongly with and have a greater incentive to perform their role as an audit committee member in a manner that reinforces this role. It would also be expected that the strength of social ties, as well as the overall ability to relate to and the tendency to be supportive of other audit committee members will be positively associated with similarities in professional background. In addition, prior research has shown that individuals tend to continue to behave in a manner consistent with their most salient role identity across varied situations and roles. Therefore, it would be expected that even when performing their role as an audit committee member, role identity salience would still be a driving force in terms of predicting behavior.

Therefore, role identity theory suggests that audit committee members with accounting backgrounds will tend to show stronger support for the audit committee financial expert with similar professional experience and will be more likely to support the views of that individual. Similarly, audit committee members with non-accounting backgrounds would be expected to show stronger support for the opinion of the audit committee expert with a non-accounting background.

Therefore, I propose the following in alternative form:

> **H6**: When there are two designated audit committee financial experts and they disagree as to the resolution of an issue in a management/auditor dispute, audit committee members will show stronger support for the expert whose role identity they identify with the most.

III. METHODOLOGY

3.0 Participants

Participants were actual audit committee members. An initial sample was obtained from individuals attending the spring 2007 regional KPMG Audit Committee Roundtable. The instrument was included, along with a postage-paid envelope, in the participants' conference materials. Participation was completely voluntary. Additional participants were hand collected, by both soliciting individuals known by the researcher to currently sit on audit committees and by obtaining a listing of publicly traded companies in the surrounding geographical area, obtaining the names of their audit committee members using the Audit Analytics database and contacting these individuals directly to solicit their participation.

The demographic information related to participants obtained from the KPMG Roundtable and hand collected as described above was compared. No significant differences were found between the two groups.

3.1 Experimental Task

The research instrument is attached as Appendix B. The survey consists of two parts. In the first part, participants evaluated an audit case for a hypothetical company (Technology Advances, Incorporated) on whose audit committee they were purported to serve. The audit case included company background information, the unresolved accounting issue, questions to ascertain the reasoning behind the participants' decisions and manipulation checks. The cases were randomly distributed across the experimental conditions. Guidance for the development of the case materials was provided by DeZoort et al., 2003a and DeZoort et al., 2003b as well as Staff Accounting Bulletin (SAB) No. 99 (SEC 1999a). In addition, input was received from an audit accounting partner for one of the Big 4 firms with approximately 25 years of public accounting experience.

Part two of the survey consisted of collecting demographic information including age, gender, educational background, audit committee experience, professional experience, and professional designations. The survey also gathered information related to committee interaction and decision making, along with questions related to committee composition and other relevant characteristics. These questions were identical for all participants.

3.1.1 Accounting Issue

The accounting issue involved the adequacy of the warranty reserve as proposed by management. The warranty reserve in question was related to a new product line acquired by the company as the result of a recent acquisition. Subjects were asked to indicate their support for either management (i.e. definitely allow the use of the estimate) or the auditors (i.e. definitely do not allow the use of the estimate). Subjects responded on an 11-point Likert scale with 1 = definitely support management and 11 = definitely support auditors. In addition, the subjects were asked to explain the rationale for their decision. The subjectivity involved in determining the adequacy of the warranty reserve is appropriate for this study because it allows for greater influence of other contextual factors, which are the focus of this study. In addition, subjective accounting issues are representative of the types of issues that would be brought before actual audit committees for resolution (DeZoort et al., 2003b).

IV. DATA AND RESULTS

4.0 Descriptive Data

Table 3 presents the descriptive information on the 30 audit committee members. The age of participants ranged from 40 to 74, with a mean age of 59. 90 percent of the respondents were male. 56.7 percent of the participants had a CPA designation, and 56.7 percent were designated as the financial expert of the committee[4]. The number of committees on which participants served ranged from 1 to 4, with an average of 1.77 committees and the average numbers of years served was 4.53 years. 43.3 percent of participants had previously been involved in a PCAOB inspection. In addition, 35.7 percent of audit committee members reported being compensated in part for their audit committee service with stock options. The relative percentage stock options comprised of total compensation was 54.6 percent.

4.1 Support for Audit Committee Financial Expert

Hypothesis 4 predicts that audit committee members will tend to take the position of the audit committee financial expert when resolving management/auditor disputes. In order to test this hypothesis, audit committee members were asked "when financial issues are brought before the committee, whose opinion do you tend to rely on the most?". The responses were coded with 1 = the financial expert and 0 = another member of the committee. Table 4, Panel A, shows the results of a t-test performed to determine whether the percentages reported were statistically different from the null which would indicate that the proportions associated with choosing either the financial expert versus another audit committee member would be equal. The results of this t-test indicate that the mean response of .97 was significantly different than the mean ($t = 14$, $p = .000$). This result is consistent with H4, providing strong support for the prediction that audit committee members do predominantly look to the financial expert when they are faced with financial decisions.

4.2 Relationship Between Role Identity and Occupation

Hypothesis 5 predicts that role identity will be positively associated with occupation. In order to test this hypothesis, I collected information from participants regarding their professional background. In addition, I asked participants to indicate whose perspective they found the easiest to relate to on an 11-point scale (1 =external auditor and 11 = management). An independent samples t-test was conducted to compare the scores for accounting and non-accounting audit committee members. Table 4, Panel B, provides the results of the independent samples t-test. The results indicate that there is a significant difference in scores related to the question of whose perspective members felt they could relate to the easiest, with audit committee members having an accounting background indicating the external auditors and those with a non-accounting background indicating a significant preference for management ($t = 2.410$, $p = .012$). These results provide evidence to support the prediction made in H5 that role identity is in fact positively associated with occupation.

4.3 Disagreements Between Audit Committee Financial Experts

Hypothesis 6 predicts that when a company has two designated audit committee financial experts, audit committee members will show stronger support for the financial expert whose occupational identity they identify with the most.

Specifically, I anticipated that audit committee members with an accounting background would be more likely to shift their position in the direction of the retired audit partner and those with a non-accounting background would be more likely to shift their position to that of the financial expert who is a retired CEO.

In addition to the above analysis, I also included CPA designation and board member experience as control variables. Prior research has shown that audit committee members with a CPA designation tend to show stronger support for the auditor than do other audit committee members in management/auditor disputes (DeZoort 2003a, DeZoort and Salterio 2001). Role identity theory suggests that length of board member experience might result in a tendency on the part of audit committee members over time to decrease their reliance on their role identity and instead adopt the prevailing views of the organization within which they are entrenched (Serpe 1987). Therefore, I anticipated that longer audit committee tenure would result in a greater tendency to adopt the view of management.

To test for the predicted effects, the following regression was run:

$$\mathbf{FDEC = b_0 + b_1(PAFE) + b_2(CPA) + b_3(EXP) + e}$$

where:

FDEC = final decision – initial decision (a negative coefficient indicates a move towards management, a positive coefficient indicates a move towards auditors).
PAFE = Position of financial expert with similar occupational background; 0 = agrees with management, 1 = agrees with auditors.
CPA = 0 = not CPA and 1 = CPA
EXP = Longest number of years served on an audit committee.

I expected to find significant positive coefficients for $b_{1\ \text{and}}\ b_2$ and a significant negative coefficient for b_3**.**

Table 4, Panel C, provides the results of the multiple regression model specified above. The adjusted R^2 was .548, indicating that the model has accounted for approximately 55 percent of the variance in FDEC. The coefficient on PAFE was significantly positive ($t = .824$, $p < .001$, one-tailed) and the CPA coefficient was positive and significant at the .10 level ($t = 1.332$, $p <$

.098, one-tailed). The coefficient on EXP, while in the predicted direction (negative), was not significant at conventional levels ($t = -.112$, $p = .43$, one-tailed).

Before interpreting the regression results, the data was analyzed to ensure that there were no issues related to multicollinearity, normality, linearity and/or homoscedasticity that would indicate that a regression was not the appropriate statistical tool to use to analyze this data. Upon review of the Correlation Coefficients, the Tolerance and Variance Inflation Factors, as well as the Normal Probability Plot of the standardized residuals and the Scatterplot of the standardized residuals, no violations of these major assumptions were found. One outlier was identified as a result of this analysis and is discussed below. The guidelines provided in Tabachnick and Fidell (2001) were used to evaluate these assumptions.

4.4 Supplemental Analysis

In addition to the above analyses, separate independent sample t-tests were performed to investigate whether there was a significant difference in the absolute value of the change in dispute scores related to age, number of committees served, financial expert designation, previous PCAOB inspection experience or stock option compensation. The results indicate that there was no significant difference in the mean scores for these groups.

In addition, given the small sample size, a sensitivity analysis was performed in which the regression results were re-estimated excluding one influential observation that was identified. The exclusion of this observation did not impact the significance of the regression results as discussed above.

4.5 Rationale for Dispute Decision

The most significant reason listed by participants who shifted toward the perspective of the retired accounting partner was the belief that this individual was capable of being more objective and also that the audit partner would tend to take the more conservative approach. Those shifting toward the position of the retired CEO expressed the overall belief that the CEO possessed the better business skills with which to more appropriately assess the adequacy of the reserve. One respondent stated "this is not an auditor's issue". Those participants who did not change their position primarily stated that the fact that the two experts disagreed invalidated their opinions, thereby causing the participant to stand firm on their original decision.

V. DISCUSSION AND IMPLICATIONS

This study experimentally examines the impact of conflicting advice given by two audit committee financial experts with accounting versus non-accounting backgrounds on the decisions made by audit committee members as to the appropriate resolution of an accounting dispute between management and the external auditors. Specifically, this study investigates whether audit committee members will be swayed from their initial decision by the opinion of the audit committee financial expert whose role identity they relate to the most.

Two preliminary questions are posed before this final question can be answered. The first asks whether audit committee members primarily seek the opinion of the audit committee financial expert when financial issues are brought before the committee. The results of this study (see results of testing H4 above) strongly support the contention that members do in fact seek the financial expert's opinion.

The second question addresses the issue of whether role identity is positively associated with occupation. This question was also positively supported, with the results indicating that audit committee members with accounting backgrounds related the easiest to the perspective of the external auditors and those members with a non-accounting background could more easily relate to management.

Support for the above two hypotheses allows the third question to be investigated. Namely, when a company has two designated audit committee financial experts, will audit committee members show stronger support for the financial expert whose role identity they identify with the most? The results of this study indicate that the answer is yes. Regression results indicate a positive association between role identity and the relative weight given to the financial expert with a similar background. Specifically, audit committee members with an accounting background were more likely to shift their position in the direction of the retired audit partner and those with a non-accounting background were more likely to shift their position to that of the financial expert who is a retired CEO. The two control variables, CPA (CPA designation) and EXP (longest years served on an audit committee) were not find to be significant.

SOX specifically charges audit committee members with the resolution of disputes between management and the external auditors. Including a financial expert on the audit committee is strongly encouraged by the SEC and disclosure in the proxy statement is required as to whether or not a financial expert has been appointed. Williams (2005) examined the proxy statements for all available S&P 500 firms, as well as a random sample of smaller firms (489 firms total), the author found that 98 percent of the firms in the sample name at least one financial expert, and 46 percent designate two or more financial experts. The final rules promulgated by the SEC, as previously discussed, related to the financial qualifications required of the audit committee financial expert are broad and allow not only individuals with direct accounting experience to qualify, such as CPAs and CFOs, but also those individuals with indirect oversight of the accounting process, such as CEOs and company presidents.

This paper provides some insight into the potential power struggles created by experts with varying backgrounds and sheds light on the manner in which audit committee members may resolve these conflicts in the context of a management/external auditor dispute. The increased role the audit committee plays in the financial reporting process makes investigating the dynamics within the audit committee an ever-increasing priority. Many important financial reporting decisions are negotiated within an audit committee setting. Understanding some of the underlying factors that may contribute to the ultimate decisions made by the committee may not only help regulators assess the appropriateness of existing legislation, but may guide future legislation as well.

DeZoort et al (2002) published a summary of the audit committee literature and stated as part of their findings that "relatively little research has been done on group variables (e.g. committee member interaction and teamwork, group process loss and gain, member dominance) that can affect effectiveness. The team aspect of audit committees is relatively unexplored". McDaniel et al (2002) also called for additional research into the group dynamics of audit committee decision-making. Obtaining a clearer understanding of the impact that individual audit committee member characteristics may have on the ultimate decisions and judgments of the group, especially when these decisions relate to financial issues that have a direct impact on the financial statements, is a crucial step toward understanding the factors that may contribute to increased audit committee effectiveness.

This experimental study is subject to a number of limitations. Although external validity is strengthened by the use of actual audit committee members, the sample size is relatively small (30 members). While the small sample size should bias against finding results, it is possible that this group differs significantly from the general population of audit committee members, thereby impacting the generalizability of the results.

In addition, actual audit committee members would have a wide array of qualitative and quantitative information to draw from when making a decision as to the appropriateness of the warranty reserve that can not be replicated in a study of this complexity and length.

Further, while this study attempts to replicate some of the group decision dynamics that would occur in an actual audit committee setting, in reality the negotiation process is more complex and presumably additional factors would be considered prior to making a final decision on a financial issue.

This study raises several issues for future research. First, this study is just an initial attempt to explore the impact of the group aspect of audit committee decision making. Additional studies could actually attempt to replicate the group setting itself by allowing participants to negotiate the outcomes of accounting disputes within the confines of a simulated group setting. This would allow researchers to gain additional perspective into the negotiation process itself and would facilitate a greater understanding of the potential characteristics associated with the audit committee member whose opinion "wins" in the end.

Also, further examination of the characteristics of the companies that choose financial experts with accounting versus non-accounting backgrounds would be an interesting area to explore.

TABLE 1: Demographic Information of Participants

	Mean
	(s.d.)
Age	35.41
	(7.86)
Gender	**N = 92**
Male (73%)	67
Female (27%)	25
Relevant Background Information:	**Percentages**
Percentage of respondents with audit committee experience	2 %
Percentage of respondents who have participated in a PCAOB inspection	2 %
Percentage of respondents who have received option compensation	35 %
Average percentage of total compensation comprised of stock options	8.8 %[a]

[a] The calculation of this percentage excludes one observation in which the participant received 100% of their compensation in the form of options.

TABLE 2: Treatment Means and Results of Testing Hypotheses H1 Through H3

Panel A: Treatment means (standard deviation) – side taken in dispute between management and external auditors[a]

	Form of Compensation[b]		
PCAOB Inspection[c]	Cash	Options	Marginal Means
Unlikely	7.13(2.40)	5.09(2.07)	6.13(2.45)
Likely	7.77(2.11)	7.44(2.24)	7.60(2.16)
Marginal Means	7.44(2.26)	6.34(2.44)	6.88(2.41)

Panel B: Between-Subjects ANOVA

Source	*df*	Mean Square	F-statistic	p-value[d]
Form of Compensation (H1)	1	32.271	6.597	.006
Likelihood of PCAOB (H2)	1	51.313	10.490	.001
Compensation X PCAOB (H3)	1	16.705	3.415	.034
Residual	88	4.891		

Panel C: Planned Comparison

Hypothesis	Comparison (Panel C)	t-statistic	p-value[d]
(H3)	[Cell 1 – Cell 2] > [Cell 3 – Cell 4]	1.853	.034

Panel D: Comparison of Cell Means versus Mid-point

Cell	N	Mean	Mid-point	Difference	t-statistic	p-value[d]
Cash/Unlikely PCAOB(Cell 1)	23	7.13	6	1.13	2.26	.017
Options/Unlikely PCAOB(Cell 2)	22	5.09	6	.91	-2.06	.026
Cash/Likely PCAOB(Cell 3)	22	7.77	6	1.77	3.93	.000
Options/Likely PCAOB(Cell 4)	25	7.44	6	1.44	3.22	.002

Notes:

[a] Participants were asked to indicate their support for either management or the external auditor on an 11-point Likert scale from 1 ("Definitely support management") to 11 ("Definitely support auditor").

[b] Participants receiving the cash form of compensation were told "your compensation as an audit committee member consists of an annual fixed retainer of $200,000, plus meeting fees of approximately $40,000" while those receiving primarily options were told that their cash compensation totaled $40,000 and "in addition, they currently hold 20,000 stock options that will vest within the next week" from which they could net $200,000 if current market price of the stock remains the same.

[c] Participants receiving the low likelihood of PCAOB treatment read "TA's client profile and risk characteristics are average for the accounting firm that performs the annual audit of TA. Therefore, it is **unlikely** that the TA engagement will be selected by the PCAOB for inspection" the high likelihood condition read "**although** TA's client profile and risk characteristics are average ……………, the firm believes that due to TA's recent acquisition, it is **highly likely** that the engagement will be selected…."

[d] Results are one-tailed.

TABLE 3: Demographic Information of Audit Committee Members

	Mean (s.d.)
Age	59 (9.31)
Gender	**N = 30**
Male (90%)	27
Female (10%)	3
Relevant Background Information	
Percentage of participants who are CPAs	56.7 %[a]
Percentage of participants who are financial experts	56.7 %[a]
Average number of committees on which participants serve (ranging from 1 to 4 committees)	1.77
Average total years of audit committee service (ranging from 1 to 18 years)	4.53
Percentage of participants who have been involved in a PCAOB inspection	43.3 %
Percentage of participants compensated with stock options	35.7 %
Relative percentage stock options comprise of total compensation	54.6 %

Notes

[a] Although the percentage of audit committee members who are CPAs and those designated as financial experts is the same, there was actually one member who was not a CPA, but served as the financial expert and one individual who was a CPA, but was not designated as the financial expert.

TABLE 4: Results of Testing Hypotheses H4 Through H6

Panel A: Comparison of Mean versus Mid-point

H4	N	Mean	Mid-point	Difference	t-statistic	p-value
Opinion[a]	30	.97	.5	.47	14	.000[d]

Panel B:

H5		N	Mean	Difference	t-statistic	p-value
Perspective[b]	Nonaccounting	14	6.88			
	Accounting	16	5.36	1.52	2.410	.012[d]

Panel C: Regression Results $FDEC = b_0 + b_1(PAFE) + b_2(CPA) + b_3(EXP) + e$[c]

H6 Independent Variables	Predicted Sign	Coefficient and (t-statistic)
Intercept		-1.135 (-2.573)**
Position of Financial Expert	+	.824 (6.087)**
CPA Designation	+	.175 (1.332)*
Years on Board	-	-.112 (-.860)

Adjusted R^2 = .548

**, * Significant at the .01 and .10 levels respectively, one-tailed.

Notes

[a] **A**udit committee members were asked "When financial issues are brought before the committee, whose opinion do you tend to rely on the most ?". The responses were coded with 1 = the financial expert and 0 = another member of the committee.

[b] Audit committee members were asked to indicate whose perspective they found the easiest to relate to on an 11-point scale (1 =external auditor and 11 = management).

[c] **where:**

FDEC = final decision – initial decision (a negative coefficient indicates a move towards management, a positive coefficient indicates a move towards auditors).

PAFE = Position of financial expert with similar occupational background; 0 = agrees with management, 1 = agrees with auditors.

CPA = 0 = not CPA and 1 = CPA

EXP = Longest number of years served on an audit committee.

[d]results are one-tailed

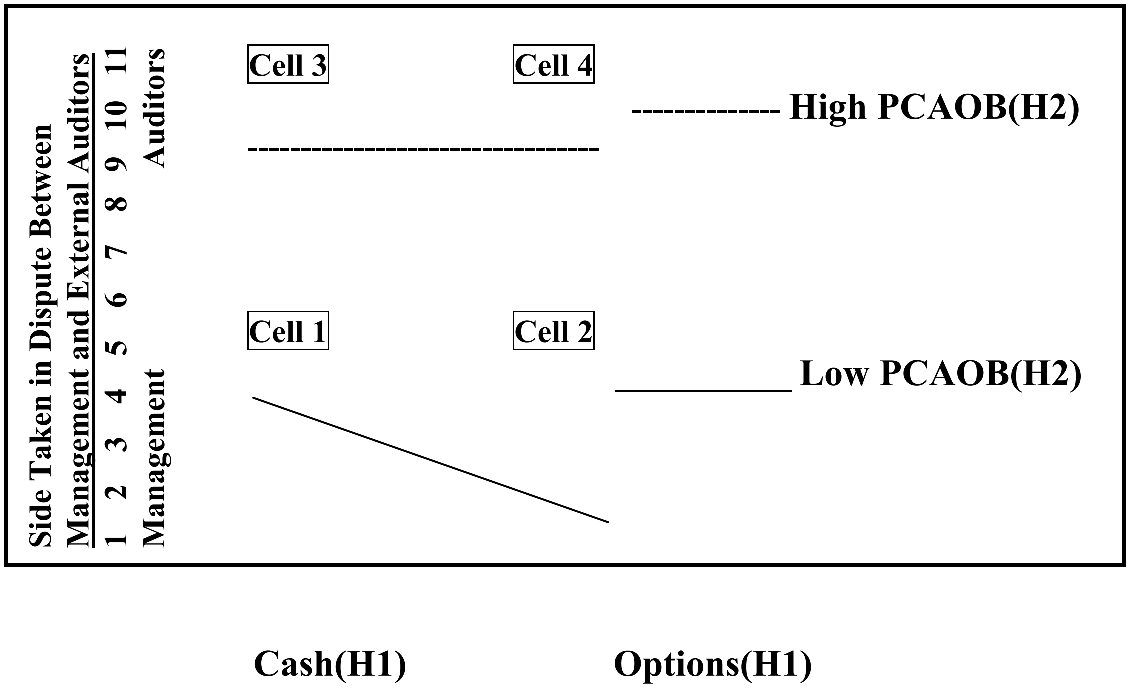

FIGURE 1: Predicted effects of form of compensation (cash or options) and likelihood of PCAOB inspection (high or low) on the side taken by audit committee members in a dispute between management and external auditors in a hypothetical audit case.

This figure depicts the predicted pattern of the side taken by participants' involving a management/external auditor dispute regarding the appropriate amount of a warranty reserve when form of compensation (cash versus options) and likelihood of PCAOB inspection (high or low) is manipulated. Participants were asked to indicate their support for either management or the external auditor on an 11-point Likert scale from 1 ("Definitely support management") to 11 ("Definitely support auditor"). This pattern is used to derive the contrast coefficient for the planned contrast to test the moderation prediction in H3. H3 predicts that subjects will show the strongest support for the auditor when likelihood of PCAOB inspection is high and the strongest support for management when the likelihood of PCAOB inspection is low and subjects were compensated primarily in the form of options. Because the consequences associated with a failed PCAOB inspection are so high, I expect that the likelihood of PCAOB inspection will moderate the incentives created by form of compensation. Therefore, the slope of high likelihood of PCAOB inspection depicted above is flat. Cell references are to the cells in Table 2, Panel D.

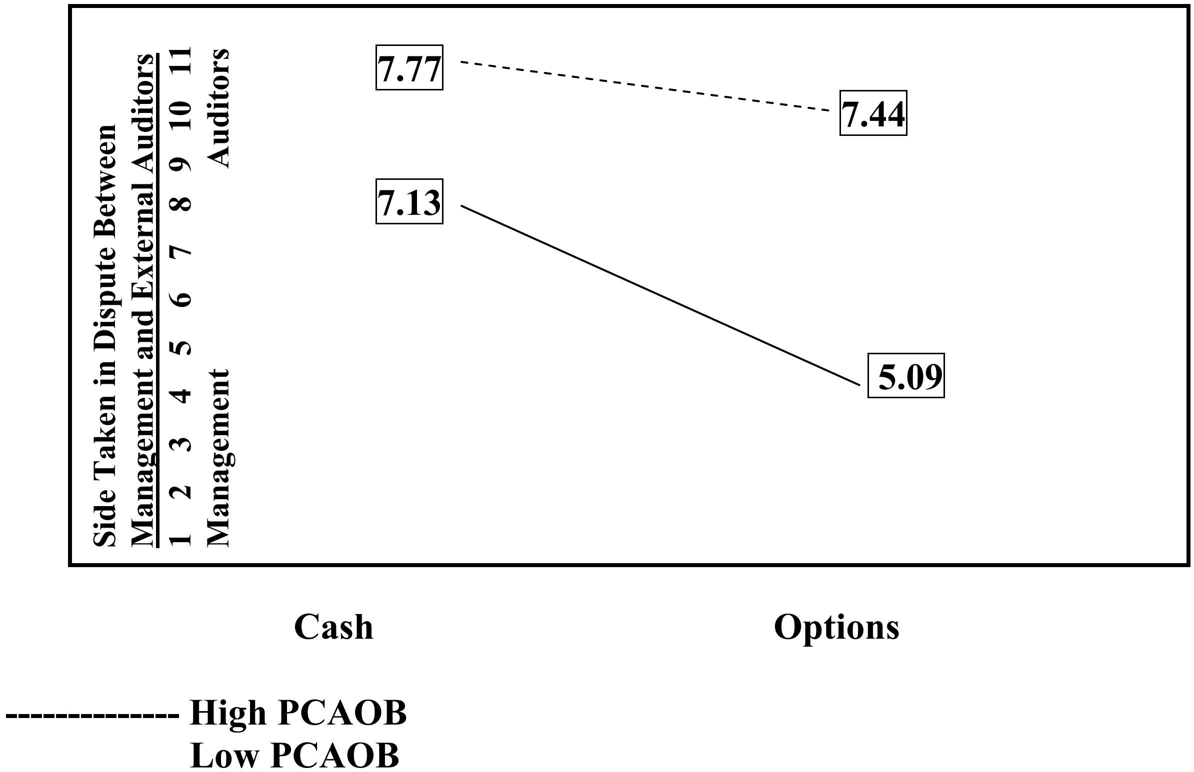

FIGURE 2: Simple effects of form of compensation (cash or options) and likelihood of PCAOB inspection (high or low) on the side taken by audit committee members in a dispute between management and external auditors in a hypothetical audit case.

This figure depicts the simple effects of the side taken by participants' involving a management/external auditor dispute regarding the appropriate amount of a warranty reserve when form of compensation (cash versus options) and likelihood of PCAOB inspection (high or low) is manipulated.. Participants were asked to indicate their support for either management or the external auditor on an 11-point Likert scale from 1 ("Definitely support management") to 11 ("Definitely support auditor"). The planned comparisons revealed that for subjects receiving primarily options as their form of compensation, a high likelihood of PCAOB inspection led to greater support for the auditors than for those with a low likelihood of PCAOB inspection ($F = 13.202$, $p < .01$). For subjects receiving cash as their form of compensation, likelihood of PCAOB inspection had no effect ($F = .948$, $p = .333$).

Endnotes

[1]This study examined director pay for the Top 200 U.S. Companies, along with 1,187 randomly selected companies representing 26 industries and five revenue tiers using 2004 and 2005 proxy statements.

[2] The study showed that these individuals were no longer directors on 25 percent of their other board appointments.

[3]The SEC recently passed regulations to increase disclosure related to director compensation. The NYSE has expressed concerns over the use of options to compensate directors. Peter Gleason, COO of the National Association of Corporate Directors (NACD) expressed the view that eliminating options as a form of director compensation reduces controversy because any potential for manipulation just goes away.

[4]Although the percentage of audit committee members who are CPAs and those designated as financial experts is the same, there was actually one member who was not a CPA, but served as the financial expert and one individual who was a CPA, but was not designated as the financial expert.

APPENDIX A

BACKGROUND

Please assume that you are the chair of the audit committee of Technology Advances Incorporated (TA), a large publicly traded company that manufactures home appliances. TA has just completed its **fiscal year**. Previous audits have resulted in standard unqualified reports. TA recently decided to expand into the high-end television market by acquiring a company that manufactures big-screen televisions and home theater systems.

The following items are on the audit committee's agenda for discussion at the next meeting which will take place prior to the release of TA's annual earnings. The **first** issue relates to **Public Company Accounting Oversight Board (PCAOB)** inspections. An audit committee member who was not knowledgeable regarding the process or the implications of these inspections requested a brief overview. The **second** relates to an **unresolved accounting issue** that has been brought to the audit committee for resolution.

AUDIT COMMITTEE RESPONSIBILITIES

Audit committees are responsible for providing critical oversight of companies' financial reporting by, among other things, helping to ensure the transparency and integrity of the financial reports. Audit committees are required to **discuss** with the auditors, the auditor's judgments about the quality, not just the acceptability, of the company's accounting principles and underlying estimates in its financial statements. In addition, the audit committee is responsible for the resolution of financial reporting disagreements between management and the external auditors.

AUDIT COMMITTEE COMPENSATION

Your compensation as a member of the audit committee consists of an **annual fixed retainer** of $200,000, plus **meeting fees** of approximately $40,000. This will result in total **<u>cash compensation</u>** of **$240,000**.

<u>OR</u>

Your compensation as a member of the audit committee consists of an annual fixed retainer of **$25,000**, plus meeting fees of approximately **$15,000**, resulting in total **<u>cash compensation</u>** of **$40,000**. In addition, you are also compensated with **<u>stock options.</u>**

You currently hold 20,000 stock options that will vest within the next week. The **exercise price** of these options is **$60** per share. The **current market price** of the company's stock, **<u>before</u>** consideration of the accounting issue described below is **$70** per share. If the current market price of the shares remains the same and you choose to exercise your options and sell the shares, total compensation will be **$40,000** in **cash compensation,** plus **$200,000** in **proceeds from the options**, resulting in total compensation of **$240,000**. If the market price of the shares should fall below the **$60 exercise price**, then total compensation would only be **$40,000** because the options would not be exercised.

PCAOB PUBLIC COMPANY INSPECTIONS

The Sarbanes-Oxley Act of 2002 established the Public Company Accounting Oversight Board (PCAOB) as a private-sector, non-profit corporation to oversee the auditors of public companies. The PCAOB is charged with conducting public company inspections of registered audit firms. Audit engagements of these firms are selected based upon the Board's criteria and the audit firm is not allowed an opportunity to limit or influence the selection process. Part of the review process includes interviewing substantially **all audit committee chairpersons of the selected audit engagements** and also encompasses a review of the **communications** between the auditors and the audit committees.

The results of the PCAOB's inspections are **publicly** disclosed. Material violations of Generally Accepted Accounting Principles (GAAP) are reported to the SEC, which has the jurisdiction to determine the proper accounting treatment in the issuer's financial statements, which may result in the company in question having to **restate** their financial statements.

TA's client profile and risk characteristics are **average** for the **Big 4** accounting firm that performs the annual audit of TA. Therefore, it is **highly unlikely** that the TA engagement will be selected by the PCAOB for inspection.

OR

Although, TA's client profile and risk characteristics are **average** for the **Big 4** accounting firm that performs the annual audit of TA, the firm believes that due to TA's recent acquisition, it is **highly likely** that the TA engagement will be selected by the PCAOB for inspection.

ACCOUNTING ISSUE

There is one accounting issue that has been brought before the audit committee for resolution. It involves management's estimate for the warranty reserve on the home theater systems line that was recently acquired by TA.

Although the **external auditors** believe that management's warranty reserve estimate was made in good faith, based upon their analysis the **external auditors** believe that the warranty reserve is outside a reasonable range by an amount that overstates current pre-tax income by **4.2**%, with a corresponding **$.02 (4.2%)** overstatement of EPS and that an adjustment should be made to increase the warranty reserve. If TA makes this adjustment, the company's current four year trend of EPS increases will be disrupted, which has typically been shown to have a **negative impact** on stock price.

Management has indicated, after discussions with analysts that TA's current stock price could decline by as much as **20%** if the warranty reserve estimate is increased to the level that the auditors are proposing. Current market price per share is **$70**, assuming management's predictions are correct, the market value would decline to **$56** per share.

Management has notified the audit committee that it is **not** inclined to increase the warranty reserve to the auditor's estimate because based upon their analysis and experience they feel that the estimate is reasonable.

The audit committee, of which you are a member, has been asked to provide guidance as to the appropriate resolution of this issue.

*Based only on the information presented, please indicate your response on the scale below by circling **ONE** number to indicate how likely you are to support either management or the auditor.*

1	2	3	4	5	6	7	8	9	10	11
Definitely Support Management (i.e., definitely do not make the adjustment)										**Definitely Support Auditor** (i.e., definitely make the adjustment)

In the space provided below, please explain the factors that contributed to your decision.

____

____

____

____

____

Please respond to the additional questions on the following pages.

Please answer the following questions with respect to your assumed role as the chair of the audit committee member of Technology Advances, Inc. Please do not go back to the previous page.

1. Based on the case materials, how likely was it that Technology Advances, Inc., (TA) would be inspected by the PCAOB?

1	2	3	4	5	6	7
Highly Unlikely						**Highly Likely**

2. Based on the case materials what type of compensation did you receive for your service as an audit committee member? **Please circle the letter that corresponds to the correct answer.**

   a. Cash
   b. Cash and Stock Options
   c. No Compensation Was Provided

Please complete the demographic information on the next pages.

Please carefully respond to the questions below, which relate to YOU personally, NOT to the materials presented on the preceding pages.

1) Age ________

2) Gender ______ M ______ F

3) Please indicate in the space provided the educational degrees received and major area of study. (Please check all degrees that apply)
_____ Undergraduate Major: _________________________ (Please specify)
_____ Masters Concentration: ___________________(Please specify)
Other ____ (Please specify)

4) What is your professional experience (past and present)? (Please check all that apply)
_____ Certified Public Accountant
_____ Chief Accounting Officer
_____ Chief Executive Officer
_____ Chief Financial Officer
_____ Company President
_____ Controller
_____ Independent Auditor
_____ Internal Auditor
Other ____
____(Please specify)

5) Have you ever served on an audit committee? _____Yes _____No

If **Yes**, please provide the following information with respect to each company on whose committee you serve:

	Years Served	**Role on Committee** (i.e. chair and/or financial expert, non-financial expert member)	**Primary Industry Of Company**	**Approximate Annual Revenues**
1.				
2.				
3.				
4.				

6) Have you ever been involved in an inspection by the Public Company Accounting Oversight Board (PCAOB)?

_____Yes

_____ No

If **Yes,** what role did you play in the inspection? (Please specify)

____

____

7) Have you ever received stock options as part of your compensation package?

_____Yes

_____ No

If **Yes,** please indicate approximately what percentage these options comprised of your total compensation in the space provided: ___________________________.

Thank you very much for your participation.

APPENDIX B

BACKGROUND

Please assume that you are a non-financial expert member of the audit committee of Technology Advances Incorporated (TA), a large publicly traded company that manufactures home appliances. TA has just completed its **fiscal year**. Previous audits have resulted in standard unqualified reports. TA recently decided to expand into the high-end television market by acquiring a company that manufactures big-screen televisions and home theater systems.

The following items are on the audit committee's agenda for discussion at the next meeting which will take place prior to the release of TA's annual earnings. The **first** issue relates to Public Company Accounting Oversight Board (PCAOB) inspections. An audit committee member who was not knowledgeable regarding the process or the implications of these inspections requested a brief overview. The **second** relates to an unresolved accounting issue that has been brought to the audit committee for resolution.

PUBLIC COMPANY INSPECTIONS

The Sarbanes-Oxley Act of 2002 established the Public Company Accounting Oversight Board (PCAOB) as a private-sector, non-profit corporation to oversee the auditors of public companies. The PCAOB is charged with conducting public company inspections of registered audit firms. Audit engagements of these firms are selected based upon the Board's criteria and the audit firm is not allowed an opportunity to limit or influence the selection process. Part of the review process includes interviewing substantially **all audit committee chairpersons** and also encompasses a review of the **communications** between the auditors and the audit committees.

The results of the PCAOB's inspections are **publicly** disclosed. Material violations of Generally Accepted Accounting Principles (GAAP) are reported to the SEC, which has the jurisdiction to determine the proper accounting treatment in the issuer's financial statements, which may result in the company in question having to **restate** their financial statements.

TA's client profile and risk characteristics are **average** for the **Big 4** accounting firm that performs the annual audit of TA. Therefore, it is <u>**highly unlikely**</u> that the TA engagement will be selected by the PCAOB for inspection.

<u>OR</u>

Although, TA's client profile and risk characteristics are **average** for the **Big 4** accounting firm that performs the annual audit of TA, the firm believes that due to TA's recent acquisition, it is <u>**highly likely**</u> that the TA engagement will be selected by the PCAOB for inspection.

ACCOUNTING ISSUE

There is one accounting issue that has been brought before the audit committee for resolution. It involves management's estimate for the warranty reserve on the home theater systems line that was recently acquired by TA.

TA's **external auditors** believe, based upon their analysis, that the warranty reserve is outside a reasonable range by an amount that overstates current pre-tax income by **4.2**%, with a corresponding **$.02 (4.2%)** overstatement of EPS and that an adjustment should be made to increase the warranty reserve. If TA makes this adjustment, the company's current four year trend of EPS increases of 6% will be disrupted, which has typically been shown to have a **negative impact** on stock price.

Management has notified the audit committee that it is **not** inclined to increase the warranty reserve to the auditor's estimate because based upon their experience they feel that the estimate is reasonable. In addition, management has also expressed their belief that the adjustment is immaterial given that the auditors have historically not proposed adjusting entries less than 5% of pre-tax earnings.

The audit committee has been asked to provide guidance as to the appropriate resolution of this issue.

*Based only on the information presented above, please indicate your response on the scale below by circling **ONE** number to indicate how likely you are to support either management or the auditor.*

1	2	3	4	5	6	7	8	9	10	11
Definitely Support Management's Position									**Definitely Support Auditor's Position**	

Please list below all significant factor(s) that impacted your decision.

____
____
____
____
____
____

Please continue the scenario on the next page.

ADDITIONAL INFORMATION

After making your initial assessment of your degree of support for management or the auditors regarding the auditors' proposed warranty reserve adjustment, you discuss the matter with the other members of the audit committee. TA's audit committee currently has **two** financial experts. One is a **retired audit partner of a Big 4 accounting firm with experience in this industry** and the other is a **retired CEO of a company in a related industry**.

The two experts disagree as to the appropriate resolution of the management/auditor dispute. The **retired accounting partner** believes, based upon his analysis, that the **adjustment** is warranted and **should be made**. The **retired CEO** on the committee believes, based upon his experience, that the existing reserve is reasonable and that **no adjustment** is necessary.

<u>OR</u>

The **retired accounting partner** believes, based upon his analysis, that the existing reserve is reasonable and that **no adjustment** is necessary. The **retired CEO** on the committee believes, based upon his experience that the **adjustment** is warranted and **should be made**.

*Based on the additional information presented above, please indicate your response on the scale below by circling **ONE** number to indicate how likely you are to support either management or the auditor.*

1 2 3 4 5 6 7 8 9 10 11

Definitely Support Management's Position	Definitely Support Auditor's Position

Please list below all significant factor(s) that impacted your decision.

____

____

____

____

____

Please respond to the additional questions on the following pages.

Please answer the following questions with respect to your assumed role as a non-financial expert audit committee member of Technology Advances, Inc. Please do not go back to the previous page.

1. Based on the case materials, how likely was it that Technology Advances, Inc., (TA) would be inspected by the PCAOB?

1	2	3	4	5	6	7
Highly Unlikely						**Highly Likely**

2. Did the financial experts agree as to the resolution of the dispute between management and the auditors?
   ______ Yes
   ______ No

3. Which financial expert supported **management** as to the appropriate resolution of the dispute?
   ______ Retired Partner of Public Accounting Firm
   ______ Retired CEO
   ______ Both

Please carefully respond to the questions below, which relate to YOU personally, NOT to the materials presented on the preceding pages. Please do not turn back to any prior page.

1) Age ________

2) Gender ______ M ______ F

3) Please indicate in the space provided the educational degrees received and major area of study. (Please check all degrees that apply)
_____ Undergraduate Major: __________________________ (Please specify)
_____ Masters Concentration: ____________________(Please specify)
_____ Doctorate Concentration: ____________________(Please specify)
Other ____ (Please specify)

4) What is your professional experience (past and present)? (Please check all that apply)
_____ Certified Public Accountant
_____ Chief Accounting Officer
_____ Chief Executive Officer
_____ Chief Financial Officer
_____ Company President
_____ Controller
_____ Independent Auditor
_____ Internal Auditor
Other ____ (Please specify)

5) Please provide the following information with respect to each company on whose committee you serve:

	Years Served	**Role on Committee** (i.e. chair and/or financial expert, non-financial expert member)	**Primary Industry Of Company**	**Approximate Annual Revenues**
1.				
2.				
3.				
4.				

Please answer the remaining questions based upon the <u>largest</u> public company (by revenue) on which you serve.

6) What is the professional background of the financial expert(s) on your audit committee? **(If you are the financial expert on your committee and you have a second designated financial expert, please provide the other expert's information below. If you are the <u>only</u> financial expert on the committee, please proceed to question 7.)**

Expert 1
______ Certified Public Accountant
______ Chief Accounting Officer
______ Chief Executive Officer
______ Chief Financial Officer
______ Company President
______ Controller
______ Independent Auditor
______ Internal Auditor
Other ____ (Please specify)

Expert 2 (if applicable)
______ Certified Public Accountant
______ Chief Accounting Officer
______ Chief Executive Officer
______ Chief Financial Officer
______ Company President
______ Controller
______ Independent Auditor
______ Internal Auditor
Other ____ (Please specify)

7) Is the financial expert also the chair of the committee?
______ Yes
______ No

8) Was the financial expert added to your committee as a result of the Sarbanes-Oxley Act?
______ Yes
______ No

9) In your opinion, what is the most significant change to the committee post Sarbanes-Oxley? (Please specify below)

____
____
____

10) Please indicate below the form(s) of compensation that you receive for your service as an audit committee member and the relative percentages each make up of your total compensation. (**Please note that your responses are completely <u>anonymous</u> and you do not have to specify the amount of compensation, just the percentage**)

Cash	%
Stock or Restricted Stock	%
Stock Options	%
Other ________________________________ (Please specify)	______%
Total:	**100%**

11) When financial issues are brought before the committee, whose opinion (**within** the committee) do you tend to rely on the most? (Please check only one)

_____ Chair of the committee
_____ Financial expert of the committee
_____ Chair/Financial Expert (If the chair is also the financial expert)
_____ Non-financial expert member
Other ____ (Please specify)

12) When financial issues are brought before the committee, whose opinion (**outside** of the committee) do you tend to rely on the most? (Please check only one)

_____ Chief Executive Officer
_____ Chief Financial Officer
_____ External Auditors
_____ Internal Auditors
Other ____ (Please specify)

13) Approximately how long have the **external auditors** been auditing the **largest** company on whose audit committee you serve?

_____ 1-3 years
_____ 4-8 years
_____ 9 years or longer

14) Approximately how long has the current **Chief Executive Officer** been with the **largest** company on whose audit committee you serve?

_____ 1-3 years
_____ 4-8 years
_____ 9 years or longer

15) Approximately how long has the current **Chief Financial Officer** been with the **largest** company on whose audit committee you serve?

_____ 1-3 years
_____ 4-8 years
_____ 9 years or longer

16) Has SEC Staff Accounting Bulletin No. 99 ever been discussed by **any** audit committee on which you serve?

_____ Yes
_____ No

17) How familiar are you with the content of SEC Staff Accounting Bulletin No. 99 that describes qualitative factors that deserve consideration when evaluating materiality? (Please circle only ONE number)

1	2	3	4	5	6	7	8	9	10	11
Minimal Familiarity									**Complete Familiarity**	

18) How confident do you feel in your ability to assess the quality and acceptability of accounting judgments and estimates? (Please circle only ONE number)

1	2	3	4	5	6	7	8	9	10	11
Not at all Confident									**Very Confident**	

19) How confident do you feel in your ability to assess judgments made by the external auditors? (Please circle only ONE number)

1	2	3	4	5	6	7	8	9	10	11
Not at all Confident									**Very Confident**	

20) Who typically initiates communications related to the existence of a potential financial issue to the audit committee? (Please check only one)

_____ Chief Executive Officer
_____ Chief Financial Officer
_____ External auditors
_____ Internal auditors
Other ____________________________ (Please specify)

21) Which perspective do you find the easiest to relate to? (Please circle only ONE number)

1	2	3	4	5	6	7	8	9	10	11
External Auditor										**Management**

22) In your opinion, what is the likelihood that the **largest** company on whose audit committee you serve will be inspected by the PCAOB? (Please circle only ONE number)

1	2	3	4	5	6	7	8	9	10	11
Very Unlikely										**Very Likely**

23) Have you ever been involved in an inspection by the Public Company Accounting Oversight Board (PCAOB) either in your role as an audit committee member or as part of your other professional experience?

_____Yes
_____ No

If Yes, what role did you play in the inspection? (Please check all that apply)

_____ Management of company chosen for inspection
_____ Auditor on engagement chosen for inspection
_____ Audit committee member of company that was chosen for inspection
Other ____ (Please specify)

24) In your opinion, what do you consider to be a **material** misstatement of pre-tax earnings? (Please check only one)

_____ Less than 1%
_____ Between 1% and 2%
_____ Between 2% and 3%
_____ Between 3% and 4%
_____ Between 4% and 5%
_____ Greater than 5%

25) How would you describe the financial health of the **largest** firm on whose audit committee you serve? (Please circle only ONE number)

1	2	3	4	5	6	7	8	9	10	11
Poor									**Excellent**	

26) Who do you feel more responsible to in your role as an audit committee member? (Please circle only ONE number)

1	2	3	4	5	6	7	8	9	10	11
Management									**External Auditors**	

27) Please rank order the following in terms of which are considered when making decisions in your role as an audit committee member. **(1 = most important, 6 = least important)**

_____ Risk of PCAOB Inspection
_____ Responsibility to Management
_____ Potential Litigation Risk
_____ Responsibility to Shareholders
_____ Compliance with Sarbanes-Oxley
_____ Impact on Professional Reputation

Thank you very much for your participation!

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VITA

Julie Sara Persellin was born in Shelby, Ohio on August 28, 1965, the daughter of Dr. John McHugh and Connie McCormick. She graduated from Fort Myers High School, Fort Myers, Florida, in 1982. Julie graduated with a BBA in accounting from Florida Atlantic University in Boca Raton, Florida in 1989. She joined the international accounting firm of Arthur Andersen in 1990 in their Fort Lauderdale, Florida practice and transferred later that year to their San Antonio, Texas practice. Julie was a senior in the audit division of Arthur Andersen when she left in 1993 to pursue a Masters in Professional Accounting at the University of Texas at Austin. She received her MPA from the University of Texas in 1994. She went on to teach accounting both full and part-time for Texas Lutheran University in Seguin, Texas, St. Mary's University in San Antonio, Texas and the University of Texas at San Antonio. In 2002, she began pursuing her Doctor of Philosophy in Business Administration at the University of Texas at San Antonio. Julie married Mark Persellin in May 1995; they have two children, Ellie and Joshua.