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Auditor Communications with the Audit Committee and the Board of Directors: Policy Recommendations and Opportunities for Future Research

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SYNOPSIS: To contribute to the Public Company Accounting Oversight Board (PCAOB) project on auditor communications with audit committees and boards of directors, we present in this paper a review of relevant academic literature. We also identify promising future research opportunities for the academic community. We specifically focus on how the communication process may affect overall financial reporting quality, internal controls, control environments, and external auditors' performance, as well as matters that potentially impact financial reporting and should interest the PCAOB (e.g., in the area of management discussion and analysis). We specifically link the findings from academic research to the discussion questions posed by the PCAOB in its 2004 briefing paper. Several potential implications of the findings should also interest standard-setters and regulators addressing issues related to corporate governance and financial reporting quality.

Keywords: communication between audit committees and external auditors; financial reporting quality; corporate governance; board of directors; internal control reports.

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INTRODUCTION

In 2004 the Public Company Accounting Oversight Board (PCAOB) began considering a standard to improve guidance on the communication process between external auditors and audit committees. Historically, many have considered the extent and the effectiveness of the communication between external auditors and audit committees to be limited (e.g., Cohen et al. 2002). However, the Sarbanes-Oxley Act of 2002 (SOX, U.S. House of Representatives 2002) expands and emphasizes the role of audit committees in ensuring the quality of reported financial results. This increased responsibility requires improved and expanded dialogue between audit committees and external auditors.[1] The PCAOB's Standing Advisory Group (SAG) has discussed this communication process and has considered a list of PCAOB-developed discussion questions (DQs) about the existing process and the need for changes (see Exhibit 1). In this paper, we review the extant academic literature to address relevant issues pertaining to communications between external auditors and audit committees on matters relevant to the integrity of the financial reporting process as well as to the DQs.[2]

Specifically we examine literature regarding communications pertaining to overall financial reporting quality, internal controls, the external auditor's job performance, the form of communications (oral or written), and communications pertaining to the Management's Discussion and Analysis (MD&A) section of the annual report. For each major area, we discuss the implications of the academic research for standard-setters and identify future research opportunities for the academic community. We present a summary of these implications in Table 1.

The literature review primarily features research published in academic accounting and auditing journals. In an effort to capture the latest research available—as well as research on emerging topics, such as many of those precipitated by the passage of SOX—we also include working papers submitted to major archiving services. We searched electronic databases such as Ingenta, ABI/Inform, and American Accounting Association (AAA) Electronic Publications using keywords or combinations of keywords related to the various topics and subtopics discussed in this paper. We also searched Social Science Research Network (SSRN) and scholar.google.com to identify relevant working papers. Working papers were included on the basis of the relevance of the research to the audit communication process and on the assessed reliability of the results and implications. The overall objective is to ensure that the information provided is as relevant, complete, and reliable as possible.

[1] For example, Section 202 of SOX requires that the audit committee pre-approve all services that the external auditor will provide, while Section 204, among other things, requires that the external auditor communicate to the audit committee on a timely basis such matters as critical accounting policies and practices.

[2] To facilitate the development of auditing standards and to inform regulators of insights from the academic auditing literature, the Auditing Section of the American Accounting Association (AAA) decided to develop a series of literature syntheses for the PCAOB. This paper is a literature synthesis prepared under this program. Additional information about the Research Synthesis Program is available on the Auditing Section website http://aaahq.org/audit/index.htm. The views expressed in this paper are those of the authors and do not reflect an official position of the AAA or of its Auditing Section. In addition, while discussions with the PCAOB staff helped us identify the issues that are most relevant to setting auditing standards, the author team was not selected or managed by the PCAOB, and the resulting paper expresses our views, which may or may not correspond to views held by the PCAOB or its staff.

EXHIBIT 1
PCAOB Standing Advisory Group Discussion Questions (DQs) and Related Implications of Research Findings

Discussion Questions (DQs)	Implications of Research Findings[a] (See Table 1)
Communications to the Board of Directors	
• **DQ 1:** Because of an auditor's responsibility to communicate certain items directly to an issuer's entire board of directors, should a standard on auditor communications with the audit committee include communications with the board of directors?	**FRQ1; IC2; IC4**
Form of Required Auditor Communication	
• **DQ 2:** Should a standard on communications with audit committees require an auditor to make all required communications to the audit committee in writing?	**OI2**
• **DQ 3:** Alternatively, should a standard require only that certain matters be communicated in writing? If so, which matters should be required?	
Timeliness of Required Communications	
• **DQ 4:** Should a standard on communications with audit committees define timeliness based on the matter to be communicated? In other words, should the timeliness of the communication be gauged by the type of communication the auditor makes? Alternatively, should the standard define timeliness in the same way for all required communications?	**FRQ1**
• **DQ 5:** Ultimately, should the auditor's decision about what constitutes a timely communication be based on other factors, such as the relative significance of the matter noted and the urgency of corrective follow-up action required? (If the auditor were to encounter significant difficulties with management or other matters that adversely affect the progress of the audit, for example, should the standard require the auditor to communicate those matters to the audit committee as soon as practicable?)	
Mandatory Engagement Letter	
• **DQ 6:** Should a standard on communications with audit committees mandate the use of an engagement letter?	**EAP 5; EAP6**
Compliance with Listing Standards of the Various Stock Exchanges	
• **DQ 7:** Should a standard on communications with audit committees require an auditor to make communications to the audit committee to enable the audit committee to comply with the listing standards, even though (a) the issuer might not be a listed company, or (b) the issuer might be listed on an SRO that requires compliance only with rule 10A-3?	**OI1**
• **DQ 8:** Specifically, what additional communications (that is, communications beyond those required to enable the audit committee to comply with the requirements of the Act and Rule 10A-3) should the auditor be required to make to assist an audit committee in complying with listing standards?	
Aggressiveness versus Conservatism	
• **DQ 9:** In connection with an auditor's views of the quality of	**FRQ2; FRQ3; IC3**

(*continued on next page*)

EXHIBIT 1 (continued)

Discussion Questions (DQs)	Implications of Research Findings[a] (See Table 1)
an issuer's accounting policies, is it sufficient to require the auditor to discuss with the audit committee items that have a significant impact on the representational faithfulness, verifiability, and neutrality of the accounting information included in the financial statements?	
• **DQ 10:** If not, should an auditor be required to discuss with the audit committee the degree of aggressiveness or conservatism of the accounting principles applied in the financial statements? Should these or other terms be used to describe the range of management's judgments?	
SAS No. 61 Communications No Longer Necessary	
• **DQ 11:** Are any communication requirements in SAS No. 61 no longer considered necessary?	
Broader Communication Responsibilities	
• **DQ 12:** Should auditors have broader responsibility for communicating their views with an issuer's audit committee about the overall quality of the financial statements and related disclosures? If so, what communications in addition to those already discussed in this document should the auditor be required to make to an audit committee?	**FRQ3; IC1; IC2; IC5; IC6; EAP2; EAP3; OI1**
• **DQ 13:** Should auditors have broader responsibility for communicating their views with an issuer's audit committee about the quality of other financial information included in a document that also includes the financial statements and related disclosures? If so, what additional communication responsibilities should the auditor assume?	
• **DQ 14:** Should auditors have a responsibility for communicating to an audit committee their views about the fair presentation of an issuer's earnings release?	

[a] The labels below refer to research implications identified in Table 1. For instance, FRQ1 is Financial Reporting Quality implication number 1.

REVIEW OF THE LITERATURE

Communications Pertaining to Overall Financial Reporting Quality

A survey of the practitioner literature yields the general observation that a positive relationship is expected to exist between governance strength and financial reporting quality (Jonas and Blanchet 2000). As expected, a review of the academic literature generally supports the proposition that strong governance is associated with good financial reporting quality. In this section, we review research findings concerning how well audit committees and boards have met their responsibilities for ensuring quality financial reporting. We then consider the types of auditor communications that are likely to significantly assist the audit committee and the board in fulfilling their roles and responsibilities.

Academic researchers have grappled with defining corporate governance, financial reporting quality, and the expanding role of the audit committee. Cohen et al. (2004) provide a framework, or "corporate governance mosaic," that links the principal players involved in financial reporting and describes how the players' interactions potentially impact financial reporting quality. DeZoort et al. (2002) review existing academic literature regarding the

TABLE 1
Implications of Research Findings for PCAOB Standard on Communications and Relations with the Audit Committee

Financial Reporting Quality

- FRQ1: Given the significant impact of the audit committee and the board in reducing the likelihood of fraud and restatements, it is advisable that there be frequent communications between the auditor, the audit committee, and the board.
- FRQ2: Communications between the audit committee and the auditor should include discussions of areas susceptible to earnings management.
- FRQ3: The auditor and the audit committee should discuss factors that are not included in the financial statements that might drive managers to make aggressive accounting choices, such as analyst forecast data.

Internal Controls

- IC1: The nature and extent of communication between the auditor and the audit committee should vary based on whether the control weakness/deficiency relates to entity- or account-level controls.
- IC2: Firm-specific factors (e.g., financial distress, client size) should influence the communication about internal control issues between the auditor and the audit committee and/or require the auditor to communicate directly with the board on matters related to internal control.
- IC3: The audit committee and the auditor should pay attention to accruals quality when material internal control weaknesses or deficiencies are identified.
- IC4: Auditors' observations with respect to the effectiveness of the audit committee in discharging its responsibilities should be directly communicated to the board of directors.
- IC5: Given the important role played by the internal audit function in enhancing internal controls and quality financial reporting, there should be required communication between the audit committee and the external auditor on the quality of the internal audit function.
- IC6: The audit committee should take a proactive role in promoting an atmosphere to protect whistleblowers including discussing this process with the auditor.

External Auditor Performance

- EAP1: It is important for the auditor to communicate to the audit committee not only all relationships with the client and the nature of all services, but also if and how a proposed nonaudit service will be beneficial to the audit.
- EAP2: The auditor should report all consequential issues and proposed adjustments to the audit committee, regardless of whether they are resolved with the client.
- EAP3: The auditor should describe to the audit committee the process used for resolving contentious issues.
- EAP4: The auditor should report the nature of the partner-CFO relationship and explain the reason(s) for proposing a change of partner prior to the rotation period mandated by the Sarbanes-Oxley Act.
- EAP5: The auditor should not only communicate the proposed level of audit and nonaudit fees to the audit committee, but also indicate how the fees were determined, with explicit consideration of achieving quality services. One avenue for disclosing this information is in the engagement letter.
- EAP6: Mandating the requirement for an engagement letter conforms to current best practices. It might also be useful to consider explicitly outlining the responsibilities of the audit committee in the engagement letter along with those of management and the auditor.

Other Issues

- OI1: The audit committee and the auditor should pay more attention to the Management's Discussion and Analysis (MD&A), and they should evaluate each of the components of the MD&A as well as look at the convergence of the MD&A with external information.
- OI2: The complexity of information being conveyed, the potential issues of conflict, and the need for a formal record or precise language should determine whether communication should be written and/or oral. Using combinations of communication forms may be preferable in many circumstances.

effectiveness of audit committees in achieving their financial oversight responsibilities. They describe the literature in terms of audit committee composition, authority, resources, and diligence. We expand on these papers by exploring the relationship between governance and several significant indicators of reporting quality, such as earnings management and restatements, to better understand how audit committee and board communications may lead to improvements in financial reporting quality. To the extent aggressive management choices may cause earnings management restatements, communications between auditors and audit committees are essential to reducing their likelihood (DQs 9 and 10).

Earnings Management

Management may use accrual accounting to distort the true financial performance of a firm, so researchers have considered using discretionary accruals (through aggressive accounting estimates or large period-end adjustments, for example) as one testable measure of earnings management and low-quality financial reporting. A consistent result is that firms with audit committees composed mainly or in whole of independent directors are less likely to feature large discretionary accruals (Klein 2002; Xie et al. 2003). Research also finds that the presence of financial experts on the audit committee and a higher degree of financial sophistication on the board are negatively related to the magnitude of discretionary accruals (Xie et al. 2003; Bédard et al. 2004; Dhaliwal et al. 2006).

Restatements

A restatement is considered an admission of a prior-period material misstatement in the financial statements; thus, a higher incidence and magnitude of restatements indicates poor financial reporting. Evidence on the relationship between governance attributes and the likelihood of restatements is mixed. Abbott et al. (2004) find that wholly independent audit committees—those with at least one financial expert—and that meet frequently are significantly less likely to issue a restatement. Agrawal and Chadha (2005) find no relation between restatements and audit committee independence, but do find that audit committees that have an independent director with financial expertise have a lower incidence of restatements. Baber et al. (2005), however, find little support for a relationship between accounting restatements and many corporate governance indicators, such as board and audit committee independence, and financial expertise on the audit committee. However, the authors do find a link between a company's G-Index[3] and the limitation of shareholder rights and restatements. The link between financial sophistication on the board (i.e., financial expertise) and higher reporting quality suggests that such communications should be frequent and well informed (DQ 4). Inasmuch as financial expertise is also important in reducing earnings management opportunities, knowledge obtained through communication by the auditor with the board and audit committee might be beneficial (DQs 9, 10, and 12).

Fraud

Perhaps the most catastrophic consequence of poor reporting quality is financial reporting fraud. As with the relatively lesser problems of earnings management and restatements, research evidence suggests a link between governance and likelihood of fraud. The evidence on the degree to which the audit committee is associated with fraud risk is unclear. Some studies (Beasley 1996; Dechow et al. 1996; McMullen 1996) find that board independence is related to a lower likelihood of fraud, but that the presence or composition of

[3] Gompers et al. (2003) constructed the G-score, a measure that compiles 24 corporate-governance factors into one measure of the balance of power between shareholders and top executives. Higher G scores indicate less power for the shareholder and, thus, a weaker governance structure.

the audit committee does not yield incremental value with respect to decreasing fraud risk. However, the frequency of audit committee meetings is associated with a decreased likelihood of fraud and nonfraudulent misstatement (Abbott et al. 2000). Later research also suggests that, within certain industries, systematic audit committee and board differences exist between firms with and without fraud (Beasley et al. 2000). This finding implies that different corporate governance mechanisms may be appropriate in different industries.

Other Indicators of Financial Reporting Quality

Although many academic studies have used such measures as discretionary accruals as an indicator of (low) financial reporting quality, discretionary accruals are subject to measurement errors that, if correlated with audit committee characteristics, can lead to erroneous conclusions (Kothari et al. 2005). Thus, some researchers have looked at other potential measures of financial reporting quality, such as earnings response coefficients, comparisons with benchmarks, analyst ratings, voluntary disclosures, and use of accounting discretion.

For example, Anderson et al. (2005) find that smaller, more independent, and more active audit committees are associated with more informative earnings as measured by the earnings response coefficient (ERC). Because the ERC is a measure of the relationship between unexpected earnings and stock returns, it is considered an indicator of the amount of the information content, or statistical "noise," that investors perceive reported earnings to contain. Vafeas (2005) reports that firms with weaker governance (measured according to the factors identified by the Blue Ribbon Committee [BRC 1999]) are more prone to reporting small earnings increases (defined in the study as a positive change of up to 2 percent of prior year's net income over market value) and/or better able to avoid negative earnings surprises, which suggests lower earnings quality. Felo et al. (2003) find that financial analysts perceive that firms with audit committees including financial experts offer higher quality reporting; however, this relationship does not extend to the question of independence of audit committees.

Research in the area of voluntary disclosures suggests that when governance is good, less information asymmetry exists between managers and investors, and investors have greater confidence in their forecasts (Karamanou and Vafeas 2005). However, research on the relationship between governance and the use of multiple approaches to manage reported earnings (such as discretionary accruals, earnings smoothing, and generation of small positive earnings surprises) is mixed. In general, Bowen et al. (2005) find that firms with lower governance quality have greater accounting discretion. The use of this accounting discretion, however, does not necessarily lead to subsequent poor performance.

Altogether, research based on alternative measures of reporting quality, such as ERC, benchmarks, analyst ratings, and voluntary disclosures indicates that, in general, "better governance" is associated with "better financial reporting quality." However, many of these studies do not permit distinguishing between improved reporting as a function of the attributes of the audit committee versus the attributes of the overall board. It is therefore difficult to assess which of these best describes a "good governance structure." In light of the regulatory attention to the structures of the audit committee, this question would benefit greatly from a more directed focus of future research.

Further, firms with weaker governance systems are more apt to report small earnings increases and are more likely to avoid a negative earnings surprise and to use greater accounting discretion. Audit committees and auditors, therefore, may need to be sensitive to these areas and ensure that their discussions include analysis of factors that are not included in the financial statements, such as differences between reported earnings and other measures such as prior years' earnings and analyst forecasts (DQs 13 and 14).

In general, financial reporting quality would appear to be enhanced if increased interaction and communication occurs among the essential players of the corporate governance mosaic, including the external auditors and the audit committee, as increased interaction may increase financial literacy, provide better understanding of management's intentions, mitigate the influence of insider directors, and increase overall involvement (i.e., activity) (DQ 12).

Communications Pertaining to Internal Controls

Section 404 of SOX has increased the importance of ensuring high-quality internal control and has greatly enhanced the importance of communicating information relating to weaknesses in controls to the capital markets. In this section, we address the relevant literature pertaining to major internal control issues, including the role of the audit committee, the effectiveness of the internal audit function, and the discovery of material weaknesses by company employees (whistle-blowing).

All firms, regardless of size, should strive to maintain strong internal controls and to provide a control environment that supports sound financial reporting (COSO 2004). However, the motivation and the resources necessary to support strong internal controls vary based on a number of firm-specific characteristics such as size, financial strength, and operational complexity. Prior research in this area is scant due to the lack of public data, but with increased data availability resulting from SOX requirements, research in this area is emerging.

A few studies provide useful information regarding potential ramifications of material internal control weaknesses (hereafter, material weaknesses). For example, Ge and McVay (2005) find that material weaknesses may be associated with inadequate accounting resources—resulting in deficiencies in the end-of-period reporting process, account reconciliation process, and general accounting policies, especially with respect to revenue-recognition policies and segregation of duties among employees. In addition, they find that disclosure of a material weakness is positively related to business complexity and presence of foreign currency translation and negatively related to firm size and profitability. Ashbaugh-Skaife et al. (2006) examine financial and organizational factors that impact a firm's exposure to internal control weaknesses and management willingness to discover and report them. They find that, pre-SOX, firms reporting material weaknesses have more complex operations, structural changes, and higher institutional ownership. In addition, these firms have higher accounting risk exposure, fewer resources to invest in internal control, higher incidence of auditor resignation, and are less likely to use a dominant audit firm. Doyle et al. (2005) find that material weaknesses are also more common among firms that are smaller, younger, financially weaker, more complex, growing rapidly, or undergoing restructuring. Notably, these characteristics also appear to drive whether the firm is likely to manifest an entity-wide or account-specific material weakness: Firms with account-specific internal control deficiencies tend to be larger, older, financially healthier, more complex, and growing more quickly than firms that demonstrate entity-wide control weaknesses.

Significant prior research documents the association between earnings/accruals quality and pricing of securities in capital markets. Given the importance of information relating to accruals quality to the financial markets, Doyle et al. (2006) examine the relationship between accruals quality (as measured by the extent to which accruals are realized as cash flows) and internal control deficiencies, using a sample of firms that disclosed at least one material weakness. Material internal control weaknesses signal a potentially weak control environment that may allow management to engage in earnings management or earnings manipulation, resulting in poor accrual quality. Findings indicate that firms with material weaknesses in internal control tend to have lower accruals quality, with especially poor accruals quality for company-level internal control weaknesses (as opposed to account-specific internal control weaknesses).

Governance Mechanisms and Material Control Weaknesses

An issue of importance is whether audit committees themselves influence the quality of internal controls in an organization. To fulfill their monitoring role within an organization, more effective audit committees should engender a stronger control environment through a greater focus on high-quality financial reporting. Although significant prior research exists on the association between audit committee effectiveness and various dimensions of financial reporting quality, such as research conducted in the areas of earnings management or fraud, little research examines the association between audit committee effectiveness and quality of internal controls. Recent research (e.g., Krishnan 2005) examines the association between audit committee quality and the quality of internal controls in the pre-SOX era and demonstrates that audit committees with financial expertise and independent members (as proxies for audit committee quality) are less likely to be associated with internal control problems. This finding provides support for the recent regulatory emphasis on audit committee independence and expertise.

Boards that more effectively fulfill their monitoring function are likely to place greater emphasis on the quality of internal controls within an organization. Although we are not aware of any study that directly examines the relationship between a board's monitoring effectiveness and the quality of internal controls, a study by Cohen et al. (2007) finds that auditors' assessment of control risk is lower when the board is focused on monitoring the financial reporting process. This result suggests that the monitoring focus of the board (defined in terms of traditional measures such as independence of board members, diligence, etc.) may be associated with the quality of controls in an organization.

Although the literature pertaining to the communication of internal controls and material weaknesses between the auditor and the audit committee is scarce, studies to date (e.g., Ashbaugh-Skaife et al. 2006) suggest some structural characteristics that must be considered when evaluating the risk of these weaknesses. Audit committee members must not only understand the nature of the control weaknesses identified by management and the auditor, but also be alert to the types of weaknesses that are likely to occur for the specific company on whose audit committee they serve. Future research could examine if audit committee members who possess both industry and financial expertise are better able to understand the nature and type of control weaknesses that are likely to occur and, hence, able to work with management and the auditor to ensure a strong control environment and a strong system of internal controls.

Prior research suggests that the emphasis placed on auditor communication with the audit committee should differ depending on whether the identified deficiency relates to an entity-level control or an account-specific control. This result implies that a material weakness at the entity-level could be considered more severe than a material weakness at the account-level, requiring greater time and attention with respect to discussions between the auditor and the audit committee (DQ 12). For example, an ineffective control environment (an entity-level material weakness) could be considered more severe than a material weakness with respect to recognition of loan loss reserves (an account-level material weakness), since the effect of an ineffective control environment can be more pervasive than the material weakness localized to the loan loss reserves account.

Another worthy issue is whether the presence of specific factors (e.g., financial distress or restructuring) should influence the nature and extent of communication about internal control issues between the auditor and the audit committee (DQ 12). For example, financially weak firms that are growing rapidly or undergoing restructuring may have a higher level of risk with respect to material weaknesses and, hence, deserve a greater level of attention and discussion between the audit committee and the auditor. Likewise, it may be necessary for the auditor to communicate directly with the board on very significant matters related to internal control problems. For example, it may be appropriate for auditors to be required to communicate directly with the board of directors when heightened risk factors such as financial distress or business complexity are present (DQ 1). Future research should examine the specific risk factors that would benefit from communications with both the board and the audit committee and whether such communications to both parties results in stronger internal controls and improves the overall quality of financial reports.

Research also suggests that audit committees should pay greater attention and employ greater scrutiny with respect to the quality (and not just the acceptability) of accounting principles, especially when material weaknesses relating to internal controls have been identified by external auditors. An issue for future research is whether a greater than normal level of discussion about accruals quality should take place between the auditor and audit committee when material internal control weaknesses or deficiencies are identified, and whether such a discussion will result in higher quality financial reports.

PCAOB Auditing Standard No. 2 (PCAOB 2004a) requires that the auditor assess the effectiveness of the audit committee in monitoring the components of internal control over financial reporting, within the overall evaluation of the control environment of an organization. If the auditor concludes that the audit committee is ineffective in fulfilling its financial oversight responsibilities, then such a finding constitutes a material weakness that will need to be noted in the auditor's report. However, if the auditor has recommendations to enhance the committee's efficiency or effectiveness, then current auditing standards do not seem to require that external auditors explicitly communicate such recommendations to either the audit committee or the board. While an explicit evaluation of audit committee effectiveness is the board's responsibility, the auditor typically gathers significant information relating to the audit committee's effectiveness that could potentially be useful to the board and the audit committee in helping improve the audit committee's performance. Given the importance of an effective audit committee in maintaining strong internal control and, hence, high-quality financial reporting, future research should examine whether feedback from the auditors can enhance the board and audit committee's ability to improve audit committee effectiveness on a continual basis.

With respect to DQ 1, an issue to consider is whether the auditor's observations with respect to improving the effectiveness of the audit committee should be directly communicated to the board. If such communications were to occur, then it is particularly important to ensure that the auditor is not inhibited from engaging in frank and open communication with the board, given that recent regulatory reforms have emphasized the role of the audit committee in decisions with respect to auditor appointment and compensation.

Internal Audit Function

A strong internal audit function is a key ingredient to strong internal controls and an important component of the overall control environment of an organization (Read and Rama 2003). Further, the importance of the internal audit function to the overall governance structure of a firm has grown significantly since the passage of SOX (Asare et al. 2003; COSO 2004). In part, due to the renewed emphasis on the role of the internal audit function in helping fulfill the monitoring function of the board and the audit committee, several important issues with respect to the internal audit function are worthy of research by academics and practitioners. Some issues of importance are whether internal auditors are effective players in the governance mosaic (Cohen et al. 2004), whether external auditors effectively use the internal audit function, and how the audit committee may potentially provide oversight and support to the internal auditors through communications with the external auditors.

External auditors' provision of nonaudit services to audit clients may affect their decision to rely on the work of internal auditors. Felix et al. (2005) find that when auditors do not provide nonaudit services, they are more apt to consider the quality of the internal audit function in their reliance decisions. However, when the external auditor provides nonaudit services, perceived client pressure appears to influence the reliance decision such that the quality of internal audit and coordination issues do not affect the level of reliance (Felix et al. 2005).

Other actors in the governance structure may also affect internal auditors' work, including audit committees' quality and effectiveness. Research finds that internal auditors' fraud risk assessments and planning judgments are affected by management incentives as well as by the independence and financial expertise of the audit committee (Asare et al. 2003).

Overall, research suggests a potential link between governance quality, including the audit committee, and the internal audit function. These factors are not obvious or intuitive; therefore, auditors and audit committees should be careful to maintain a joint awareness of this dynamic, suggesting an active dialogue is needed between these parties on such issues.

Research highlights a need for required communication between the audit committee and the external auditor about the quality of the internal audit function. The audit committee and the external auditor should discuss the reasons why the external auditor has or has not relied on the internal audit function. Given the tendency of the external auditors to rely on internal audit work under some circumstances, it may be worth requiring the audit committee to evaluate the quality of the internal audit function and to discuss the suitability of using the internal auditors as part of the financial statement audit. Such required evaluations and subsequent communications may strengthen the role of the internal audit function within a firm. Although not directly addressed by the SAG, it appears that the communication about the internal auditor would be concerned with broader communication responsibilities that could affect the overall quality of the financial reporting process (DQ 12).

Collectively, the studies suggest a number of opportunities for future research. This is especially important considering the potential importance that the internal audit function could play in the governance structure. For example, research could explore whether requiring external auditors and the audit committee to discuss their respective evaluations of the internal audit function will lead external auditors to rely more or less on the internal audit function. Similarly, future research may explore how the growth of the internal audit function in the post-SOX era has affected the reliance external auditors place on internal auditors and whether this reliance has been communicated to the audit committee. Finally, when considering the importance external auditors should place on the internal audit function, future research may consider how the expertise of the internal audit function affects the ability to incorporate management incentives and audit committee quality into the internal audit judgments.

Whistle-Blowing

As part of SOX, public companies must provide safeguards to protect whistle-blowers who file allegations with the audit committee. The increased importance of whistle-blowing raises the potential that audit committees and external auditors should discuss significant whistle-blowing complaints. According to responses from chief internal auditors of U.S. public companies, whistle-blowing complaints were handled in a more thorough fashion by internal auditors who were more involved in monitoring a firm's code of conduct and had higher organizational status as measured by the audit committee's effective oversight over the internal audit department (Read and Rama 2003).

Other papers attempt to address the question of what constitutes effective whistle-blowing policy. An organizational commitment to protect internal whistle-blowers is essential in sending a powerful and positive image to all parties who engage in contractual relationships with the organization, and managers must publicly support the protection of whistle-blowers (Schmidt 2003). Currently, the job of providing protection to whistle-blowers falls on OSHA (Vera-Muñoz 2005); SOX provides little guidance on the appropriate circumstances that should allow whistle-blowers to report their concerns. Vera-Muñoz (2005) suggests that audit committees should have more responsibility over protecting whistle-blowers, and that more explicit guidelines must be spelled out on what constitutes legitimate conditions for reporting concerns about the financial reporting process.

These studies imply that a clearly defined internal policy on whistle-blowing should be elaborated and disseminated to all employees of the organization. Internal auditors should communicate legitimate whistle-blowing complaints to audit committees, and to the extent the complaints relate to the integrity of the financial reporting process, the audit committee should also discuss them with the external auditor. Schmidt (2003) suggests that audit committees evaluate the atmosphere that exists within the organization (especially the tone at the top) toward protecting whistle-blowers and that audit committees discuss this evaluation with the external auditors.

The primary implication of the research into whistle-blowing is that the audit committee must take a more proactive role in promoting an atmosphere to protect whistle-blowers, including discussing this process with the external auditor. Second, the audit committee should communicate all substantive whistle-blowing activities to the external auditor. Third, audit committees may find that having a member with an expert understanding of the legal and human resource aspects of whistle-blowing may promote an environment that is more conducive for effective whistle-blowing. The discussion in this section pertains to the rubric of "broader communication responsibilities" but does not appear to be raised in any of the DQs.

If the audit committee is given more responsibility to protect whistle-blowers, then future research could examine whether the expertise of the audit committee in potential areas of fraud affects employees' ability and willingness to blow the whistle and whether disclosing whistle-blowing to the external auditor is more conducive to motivating whistle-blowers to come forward. Further, future research may examine whether the type of code of conduct (to protect the company versus the public interest) affects individuals' willingness to blow the whistle and the effectiveness of the audit committee to protect whistle-blowers. In addition, a future study can investigate whether discussing the audit committee's evaluation of the organizational climate with external auditors affects the willingness of individuals to blow the whistle.

Communications Pertaining to External Auditor Job Performance

One primary responsibility of the audit committee is to hire and oversee the external auditor. This entails pre-approving audit and nonaudit services and working with the auditor to ensure that the highest quality of service is provided by the audit firm.

Research highlights the importance of an effective audit committee in the appointment of a quality auditor. Effective audit committees are found to focus on the accuracy and wording of the financial statements, the effectiveness of controls, and the quality of the work of the auditor (Gendron et al. 2004). They are also noted for asking challenging questions and being demanding in evaluating the responses of managers and auditors. In this section, we examine recent research on audit quality, audit fees, auditor independence, and nonaudit services.

Audit Quality

An important function of the audit committee is to monitor the quality of the external audit—to ensure that the auditor detects and reports material misstatements in the face of management's pressures (DeAngelo 1981a). The literature consistently reports that auditors frequently waive proposed adjustments contingent upon characteristics such as client size, internal controls, financial health, repeat adjustments, and type of adjustment (Wright and Wright 1997; Braun 2001; Joe et al. 2006).[4] Subjective adjustments (those requiring judgment, such as estimates) or offsetting adjustments (income increasing versus income decreasing) are more likely to be waived than objective adjustments (those requiring little judgment) (Wright and Wright 1997). Adjustments are also less likely to be waived for clients in poor financial health (Knapp 1985; Braun 2001).

Another consistent result involves auditors' willingness to take advantage of ambiguity in the reporting standards. When engagement risk is moderate, auditors are more likely to accept client reporting choices and justify the acceptance by aggressively interpreting ambiguous reporting standards (Hackenbrack and Nelson 1996).[5] Research demonstrates that auditors with large incentives to accommodate client preferences use the ambiguity present in standards as a means to justify aggressive reporting by unconsciously interpreting the client's choice to be of high quality (Kadous et al. 2003). Despite the requirements of SFAS No. 90 (AICPA 2000) to assess the quality (not only the acceptability) of reporting choices, the sensitivity of auditors to client preferences seems to persist.

An emerging body of research addresses the client-auditor negotiation process and finds that communications between management and auditor, specifically auditors' attempts to understand the perspectives of client management, mitigate auditors' willingness to accommodate client preferences (Trotman et al. 2005). A strong audit committee may help in this process in that it seems to compensate for a lack of clear accounting standards (Ng and Tan 2003). Clients' concessionary moves may also lead auditors to concede disputed points (Ng and Tan 2003). Of concern is research that finds it is the audit partner's responsibility to ensure a strong relationship with the client; if the "fit" is poor, then the partner will likely be subsequently replaced (Gibbins et al. 2005). Evidence suggests that the quality of the audit committee may mitigate problems arising from these conflicting incentives: Audit committees with more independence, greater governance experience, and less company

[4] As Wright and Wright (1997) show, this occurs even when the proposed adjustments exceed planning materiality thresholds.

[5] However, when engagement risk is high, Hackenbrack and Nelson (1996) find that auditors interpret standards conservatively.

stockholdings are less likely to terminate the auditor following the receipt of a going-concern opinion (Carcello and Neal 2003).

The research findings highlight the impact on auditors of pressure from management to achieve improved reported performance. Auditors appear to exhibit conscious and unconscious willingness to aggressively interpret accounting standards and waive proposed audit adjustments. Currently auditors are not required to report audit adjustments if they are considered inconsequential or have been resolved with the client. However, the effects of client pressures as shown in research findings suggest that the audit committee should be apprised of all consequential issues and proposed adjustments in order to properly evaluate audit quality and to assess whether the resolution appears proper.[6] In this respect, the auditors should report all consequential matters to the audit committee along with their conclusions.

Research has shown that certain situations greatly pressure the auditor (e.g., subjective matter, ambiguous accounting standards, and strong client financial condition). In these situations, audit committees should be especially vigilant. The audit committee may also want to know the auditor's process for resolving contentious issues and whether the auditor specifically considered the client's incentives. Finally, the external auditor may report the nature of any partner-CFO relationship and explain the basis for proposing a change of partner prior to the rotation period mandated by the Sarbanes-Oxley Act. Ideally, the audit committee will take actions to prevent a relationship in which the audit partner is responsible for conforming to the desires of the CFO. For instance, the CFO may try to dictate when issues that surface are first identified and discussed with the auditor (proactive versus reactive) and/or the nature of the relationship (contentious/adversarial or close working rapport). These matters relate to the extent of the auditor's communications to the audit committee (DQs 9, 10, and 12). These discussion questions focus on the quality of reporting; the discussion above suggests the need for the auditor to also identify significant risks of potential misstatements and/or an improper auditor-client relationship.

Little post-SOX research has been done on the role the audit committee plays in helping to resolve contentious accounting matters, which is especially important in light of SOX's expansion of the committee's responsibilities. Researchers may wish to address questions of how audit committees work to appropriately resolve a conflict, and how they counteract the tendency for placing the burden on the audit partner to promote a smooth working relationship with the client while also maintaining objectivity.

Audit Fees

Critics have alleged that auditors "low ball" audit fees on some engagements in an effort to obtain clients and to secure a future stream of lucrative fees (DeAngelo 1981b). The concern is that low fees pressure the audit team to reduce testing, potentially adversely affecting audit quality. Empirical evidence suggests that client firms with effective audit committees and boards (defined as independent, holding frequent meetings, and possessing financial or broad business expertise) pay higher audit fees, thus reducing the potential for dysfunctional behavior from low-balling pressures (Lee and Mande 2005; Abbott et al. 2003b; Carcello et al. 2002). However, more recent research that directly examines audit effort suggests that auditors lower (extend) audit scope when the board is considered strong

[6] Consequential matters have been defined by nine national or international assurance firms (BDO Seidman et al. 2004) as greater than 20 percent of annual or interim financial statement materiality (assuming no materially qualitative factors are present, e.g., reversal of earnings trends).

(weak), suggesting that auditors appropriately adjust audit plans to reflect the board's strength (Cohen et al. 2007). Further, it is not clear that the incremental effect of the audit committee is stronger than that of the overall board; Abbott et al. (2003b) find that strong audit committees are associated with higher audit fees beyond that contributed by the board, while Carcello et al. (2002) do not report an incremental impact.

The research findings suggest that the audit committee plays an important role in ensuring that audit fees are sufficient for auditors to perform a quality audit engagement. This implies that the external auditor should not only communicate the level of audit and non-audit fees to the audit committee, but should also indicate how the fees were determined with the explicit consideration of achieving quality services. One avenue for disclosing this information is in the engagement letter (DQ 6). The audit committees of client firms that are changing auditors and client firms participating in a competitive bidding process for the audit should take care to ensure that independence is not likely to be compromised by lowball fees.

The research stream would benefit from studies directed toward examining the new (post-SOX) environment to determine whether the average level of audit fees sufficiently compensates auditors for client complexities and risks. It would also be beneficial to examine the extent to which corporate governance mechanisms (e.g., audit committee and board) impact audit fees.

Auditor Independence and Nonaudit Services

External auditing is of value to the extent that the auditor provides an independent evaluation of the fair presentation of the financial statements and the effectiveness of internal controls. Therefore, a critical role of the audit committee is to ensure that the auditor is independent both in fact and in appearance. A significant concern that many have raised as potentially impairing auditor independence is the provision of nonaudit services. Accordingly, SOX prohibits certain nonaudit services and requires the audit committee to pre-approve each allowed nonaudit service the auditor provides.

Given the concerns raised, a number of studies have examined whether nonaudit services do, in fact, impair the objectivity of auditors' judgments. The evidence, although mixed, predominately finds no systematic association between the provision of nonaudit services and auditor independence in-fact (Romano 2004). For example, some studies find that nonaudit fees (but not total fees) are positively associated with common earnings management measures, especially for smaller management-controlled firms (Frankel et al. 2002; Larcker and Richardson 2004). This may be a function of the firm's performance, as Ashbaugh et al. (2003) do not find a relationship between nonaudit fees and earnings management. It may also be a function of the size of the auditor, as Kim et al. (2003) find that Big 6 auditors are more effective than non-Big 6 auditors at curbing income-increasing accruals, but not as effective at curbing income-decreasing accruals. Some evidence suggests that providing tax-related nonaudit services may improve audit quality as a result of a "spillover" effect due to knowledge gained that benefits the audit, such as a more accurate tax accrual (Kinney et al. 2004).

While some studies examine whether nonaudit services lead to less auditor independence, other studies examine the effect of these services on user perceptions of independence. Despite mixed findings in earlier literature, recent evidence generally suggests that nonaudit services impair perceptions of auditor independence. Research finds a negative relationship between nonaudit fees and the earnings response coefficient (Krishnan et al. 2005). Despite the evidence that tax services may provide benefits to the audit function, voting behavior suggests that shareholders do not approve of these and other nonaudit services (Mishra et al. 2005). This evidence is supported by findings that bond ratings also suffer when auditors provide nonaudit services (Brandon et al. 2004).

The findings suggest that while evidence of the impact of nonaudit services on auditor independence is inconclusive, these services appear to negatively affect user perceptions of independence. Thus, the audit committee must carefully evaluate the types of services provided to ensure that independence in fact and in appearance is preserved. Reaction to public disclosure of nonaudit services appears to have a negative effect on the audit committee's propensity to engage the auditor for such services even if they can improve the quality of the audit. Therefore, it is important for the auditor to communicate to the audit committee not only all relationships with the client and the nature of all services, but also why and how a proposed nonaudit service will be beneficial to the audit.

Communications between the client firm and its investors affect the firm's inclination to request nonaudit services. Strong audit committees are less likely to request nonaudit services (Abbott et al. 2003a). Further, audit committee members are less likely to recommend nonaudit services when the fees are disclosed to shareholders than when not disclosed, even when those services would likely improve the quality of the audit (Gaynor et al. 2006). Other research supports the notion that mandatory communication of nonaudit fees may have deleterious consequences. For instance, Dopuch et al. (2003) find that the disclosure of these fees results in inaccurate assessments by investor surrogates of the actual level of auditor independence and, therefore, impairs market efficiency. When disclosures indicate the existence (nonexistence) of nonaudit fees, users overestimate the actual level of auditor nonindependence (independence) than when no disclosures are made. Gaynor (2006) finds that except for very high levels of auditor involvement, investors prefer disclosures to the audit committee (e.g., nature and magnitude of nonaudit fees) over strict independence rules. These findings suggest that disclosure to the audit committee may be more effective in promoting perceptions of auditor independence than prohibitions such as outright restrictions on nonaudit services.

A promising avenue for future research is to examine how and when nonaudit services are likely to improve audit efficiency and effectiveness, without compromising auditor independence in fact. Further research is also needed regarding investors' perceptions of whether independence appears to be impaired and for which types of services.

Other Communication Issues

Management's Discussion and Analysis

Management's Discussion and Analysis (MD&A) has come under increased scrutiny from the Securities and Exchange Commission (SEC 2002, 2003) because the SEC perceives a lack of quality and consistency in these disclosures. Some suggest that it would be beneficial to have the auditor evaluate this disclosure for consistency with other public disclosures, including press releases (Meiers 2006). Since the MD&A is a required component of information that is disclosed to stakeholders and usually contains financial information, it is important to examine what form of scrutiny should occur in the communication concerning the MD&A between the external auditor and the audit committee.

The research to date suggests that MD&A tends to be biased toward providing "good" news rather than "bad" news (Pava and Epstein 1993; Clarkson et al. 1994). Furthermore, the quality of the disclosures that can be objectively measured is demonstrably lacking, especially for firms with financial problems (Holder-Webb and Cohen 2007). The problem for investors in these firms is exacerbated by the poor quality of information, and suggests a need for improving the quality of MD&A disclosures.

Research (Bryan 1997; Clarkson et al. 1999) demonstrates that the MD&A has the potential to be a useful source of information for investors and the audit committee. Evidence from other studies suggests that the SEC's concerns over MD&A quality are warranted, and that the client firm and its auditors may need to pay more attention to the MD&A in their discussions of the overall quality of the financial reporting process. Currently, NYSE listing standards require audit committees of listed firms to discuss with the auditor disclosures made in the MD&A section of annual and quarterly reports filed with the SEC. Hence, it is important that the audit committee and the external auditor evaluate each of the components of the MD&A, looking at the convergence of the MD&A with financial reporting information. Given that prior research suggests bias and lack of quality and consistency in the MD&A disclosures, it seems that the overall quality of MD&A disclosures can be enhanced significantly if the audit committee and the auditor collaboratively provide greater monitoring of such disclosures. Accordingly, it may be fruitful to require auditors to discuss with the audit committee the quality of financial information that is included in the MD&A disclosures (DQs 8 and 13), since much of the discussion with respect to the quality of information disclosed in other financial reports is already required under current auditing standards and regulatory requirements.

The increasing regulatory focus on the MD&A suggests that further research into communications pertaining to MD&A may be beneficial. Given the current regulatory and listing requirement that audit committees discuss the MD&A financial disclosures with management and auditors, future research could examine whether requiring audit committee members and external auditors to evaluate each of the components as well as the overall MD&A will indeed increase the consistency and quality of the evaluation of the MD&A. If these in-depth and meaningful discussions between the audit committee and the auditor about the contents of the MD&A increase the quality of MD&A disclosures, future research may examine whether greater emphasis is placed on the MD&A by current and potential investors.

Audit Committee Responsibilities and Qualifications

At present, little, if any, research examines the qualifications (e.g., financial expertise, prior audit committee and board affiliations, business experience) of audit committee appointees in the post-SOX period. SOX introduced changes that are particularly pronounced in terms of the composition of the audit committee; therefore, it will be critical to develop a stream of research into the effects of this regulatory change on the workings of the audit committee and the company as a whole.

Form of Required Auditor Communications

DQs 2 and 3 are concerned with whether audit committees should require auditors to make all or certain communication matters in writing or whether oral communication is sufficient. While we found no research that directly addresses this issue in the accounting literature, a great deal of research dealing with the general topic of media choice has been published in the communications literature. According to Reinsch (2006), the complexity of the information being conveyed should dictate the communication form such that more complex information should be conveyed through a "richer" form[7] (e.g., face-to-face) and less complex information should be conveyed with a "leaner" form (e.g., written).

[7] Much of the related research relies on "richness theory," which argues that communication forms vary in terms of their richness, which, in turn, is determined by the types of cues that are conveyed (e.g., sight, sound, etc.). Daft and Lengel (1984, 1986) provide seminal papers on the topic.

This research suggests that the type of information being conveyed and the need for a formal record should determine whether communication should be written and/or oral. Using combinations of communication forms may be preferable in certain circumstances. In addition, as is often the case in financial reporting, required communications or communications that necessitate a permanent record or precise language should probably be in writing and supplemented with oral interaction. It is important to note, however, that legal and liability concerns in the current financial reporting environment may influence the need or preference for a certain type of communication, given the specific issues being communicated as well as the risks or exposure involved.

Future research could explore what specific audit committee-auditor communications would best be communicated in written form, oral form, or some combination. In addition, the research discussed above raises some research questions as to how technology might promote effective communication. For example, situations may arise in which audio or video conferencing may provide the benefits of both the oral (free, interactive exchange and dialogue among participants) and written forms of communication (documentation and record-keeping), thus increasing the overall effectiveness of the exchange between the auditor and the audit committee.

LIMITATIONS OF THIS REVIEW

In the accounting literature, relevant research seems not to exist or appears to be scarce regarding several of the DQs presented in Exhibit 1. Some examples include the timeliness of required communications between the auditor and the audit committee (DQs 4 and 5), communications in the case of issuers that are not listed companies (DQ 7), and opinions on or responsibilities for earnings releases (DQ 14).

Other issues appear to be addressed through best practices, although not through the academic literature. Among these are questions pertaining to the mandatory use of engagement letters (DQ 6) and SAS No. 61 communications that are no longer necessary (DQ 11). Engagement letters appear to be considered "best practices" for audit firms and help ensure audit quality by clearly delineating the scope and responsibilities of management and the auditor. It may also be useful to consider outlining the responsibilities of the audit committee more explicitly in the engagement letter.

We also found no research directly relevant to the question of earnings releases (DQ 14). However, research suggests a link between governance systems, the underlying quality of the accounting earnings, and the consequent reception of the earnings release by market participants (Anderson et al. 2005; Karamanou and Vafeas 2005; Vafeas 2005). These results do not provide direct evidence as to whether auditors should express their views about an issuer's earnings release, but the results do inform auditors that they should be aware that governance systems are related to earnings' releases and that the market (i.e., the investor) makes inferences about such releases.

CONCLUSIONS

In this paper we review and synthesize the literature pertaining to communications between audit committees and external auditors. Where appropriate, we reference the discussion questions (DQs) posed by the PCAOB Standing Advisory Group (2004b). While Table 1 lists what we consider are the most significant implications of the research, the following briefly summarizes each topic area. These implications should interest the PCAOB, the SEC, other standard-setters, and regulators that focus on issues related to corporate governance and financial reporting quality.

Financial Reporting Quality

Prior research suggests that frequent communications with a well-informed, financially sophisticated audit committee and communications among the audit committee, the auditor, and the full board improve financial reporting quality. Effective communications should include discussions of areas more susceptible to earnings management (e.g., discretionary accruals) and factors that might drive managers to make aggressive accounting choices (e.g., analyst forecasts and other performance measures). We have identified a number of research opportunities, including investigating the characteristics of a "good" audit committee (versus the characteristics of a "good" board) in improving financial reporting quality, an area that has been difficult to address in the past but is needed in light of the increased attention to the structure of the audit committee.

Internal Controls

The nature and the extent of communications between the auditor and the audit committee should be sensitive to whether a control weakness or deficiency relates to entity-level controls or account-level controls, given the differentially serious implications of these two types of weaknesses. In addition, firm-specific factors (e.g., financial distress, company size) should influence communications and may require the auditor to report directly with the board on matters related to internal control.

The audit committee and the external auditor should discuss the quality of the internal audit function and the extent to which the external auditor is able to rely on the work performed by internal audit. In order to encourage prompt and reliable internal reporting of material weaknesses, the audit committee should also discuss with external auditors their policy to protect whistle-blowers. We have identified several research opportunities, including investigation of how the communication between the audit committee and the auditor on the effectiveness of the internal audit function affects the reliance external auditors place on internal auditors.

External Auditor Performance

Research indicates that it is important for the auditor to communicate to the audit committee all relationships with the client, the fees and nature of all services provided, and the extent to which any nonaudit services are beneficial to the audit. In addition, the auditor should report all issues and proposed adjustments to the audit committee and the process used for resolving contentious issues. The auditor should also report to the board its evaluation of the quality, effectiveness, and authority of the audit committee in discharging its responsibilities. One interesting research opportunity could be to investigate how the audit committee might aid the audit partner in promoting a smooth working relationship with the client while also maintaining objectivity.

Other Issues

A review of the literature suggests that the MD&A should be more emphasized in the discussions between the audit committee and the auditors. For example, the MD&A could be a significant component of the discussion of business risks and the overall quality of the financial reporting process. One interesting research opportunity could be to examine whether requiring each component of the MD&A to be evaluated will, in turn, cause management to produce a higher quality MD&A.

Our review identifies insights for practice and opportunities for research on communication issues between the auditor, the audit committee, and the board. Finally, we strongly believe that the academic and the practice communities must have a continual dialogue so that standards reflect research, and research is directed to issues with the greatest potential to positively affect public policy.

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