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Form versus Substance: The Implications for Auditing Practice and Research of Alternative Perspectives on Corporate Governance

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SUMMARY: The objective of this paper is to provide a more comprehensive view of corporate governance than that considered by the traditional agency literature predominately employed in auditing and accounting studies of governance. Specifically, we discuss three widely recognized additional theoretical perspectives: resource dependence, managerial hegemony, and institutional theory. Resource dependence is developed in the strategic management literature and focuses on the contribution of governance mechanisms as a vehicle to help a firm achieve or further its strategic objectives. In contrast with the agency and resource dependence perspectives which offer a functional view of governance, the managerial hegemony perspective views the board and its attendant committees as being under the control of management and hence could be potentially viewed as dysfunctional from a stakeholder viewpoint. Finally, institutional theory, developed in the sociology of organizations and organizational behavior literatures, suggests that it is necessary to understand the substance of the interactions between different governance parties and how these parties use at times symbolic gestures and activities to maintain their form to all relevant parties. Although the value of using multiple theoretical perspectives with respect to governance has been well recognized in the economics and behavioral literatures, this is the first paper that we are aware of that examines the effect of using alternative theories of governance on auditing issues that are influenced by the governance structure of a firm. In addition, we examine how these theories provide a useful basis for reconciling conflicting findings in the existing agency-based audit-related governance literature. Finally, we provide examples of how these alternative theories provide important new insights to issues in auditing research and practice.

Keywords: corporate governance; resource dependence; managerial hegemony; institutional theory; agency theory.

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INTRODUCTION

The spate of accounting scandals at firms such as Enron and subsequent regulatory reforms introduced through the Sarbanes-Oxley Act of 2002 (SOX) have resulted in a dramatic increase in corporate governance studies in accounting and auditing research. The predominate theoretical focus of these studies rests upon the foundation of agency theory (see a review by Cohen et al. [2004]). These studies examine how the monitoring roles of the board and the audit committee (AC) have been used to protect (or fail to protect) stockholder rights, largely ignoring the effect management may have on the governance process. Studies that use the agency approach implicitly assume that boards and ACs that meet the standard definitions of independence are more likely to be effective monitors of management's actions. Although this perspective has given us many useful insights, an important limitation of this approach is that proxies for board independence used in prior research (e.g., outside versus inside directors) are imperfect and noisy, and often do not capture the underlying "substance" of board independence, i.e., whether, in fact, these mechanisms effectively serve to protect shareholders' interests (MacAvoy and Millstein 2004).

The findings of Cohen et al. (2002, 2008) suggest, however, that auditors take a broader view of the parties involved in governance. They include management as part of the governance framework, acknowledging the role managers play in determining the effectiveness of other governance structures. That is, management may have a significant influence on who is appointed to the board and AC as well as override controls in place. The notion that management is an important party in corporation governance is somewhat inconsistent with the agency theory perspective that suggests that governance parties must monitor and thus be independent of management.[1] In fact, several of the auditors participating in the Cohen et al. (2002) study argue that if management does not want to be "monitored" (governed), effective monitoring cannot be provided.[2] Furthermore, while managers may participate in governance, members of the governance structure may take on roles that go beyond the strict interpretation of monitoring management actions; for instance, Williamson (1999) notes that boards may help set the strategic direction of the firm. Thus, research that looks at governance exclusively from an agency-based perspective may be unable to fully detect whether a company has an effective governance structure. The traditional reliance on the agency and monitoring perspective can thus hamper our ability to understand the roles and importance of corporate governance.

In this paper, we provide a more comprehensive view of corporate governance than currently available from the agency literature so often employed in auditing and accounting studies. Specifically, we explore three widely recognized additional theoretical perspectives: resource dependence, managerial hegemony, and institutional theory.[3] Resource dependence is a theory developed in the strategic management literature, and focuses on the contribution of governance mechanisms as a vehicle to help a firm achieve or further its strategic objectives (Boyd 1990; Cohen, Krishnamoorthy, and Wright 2007). The managerial hegemony perspective is based in the strategy literature and in contrast to the agency theory paradigm; it views the board and its attendant committees as being under the control of management and existing merely to fulfill regulatory requirements (Kosnik 1987). A third source of theory is institutional theory, developed

[1] Non-independent directors may include insiders (e.g., top management) and affiliated/gray directors (e.g., a key supplier or customer).

[2] For example, management may place passive, compliant members on the board who satisfy regulatory requirements but provide minimal oversight over management's actions.

[3] These theories represent four dominant theories from the finance and management literatures on understanding and explaining the impact of corporate governance on accounting and business issues. We acknowledge that other perspectives not specifically covered in this study (see Clarke 2004 for an overview of theories of corporate governance) may also provide useful insights and are hence worthy of future study.

in the sociology of organizations and organizational behavior literatures (Powell 1991). Institutional theory suggests that it is necessary to understand the substance of the interactions between different governance parties and how these parties use at times symbolic gestures and activities to maintain their form to all relevant parties. Although this is the first paper that we are aware of that examines the insights of using alternative theories of governance on accounting/auditing issues, the value of this approach has been well recognized by researchers outside of accounting/auditing. For example, Eisenhardt (1989) states: "the recommendation here is *to use agency theory with complementary theories*. Agency theory presents a partial view of the world that, although it is valid, also ignores a good bit of the complexity of organizations. Additional perspectives can help to capture the greater complexity." (emphasis in the original)

In the remainder of this paper we provide a review of the three alternative theories and discuss how the use of these theories can be used to explain governance practices.[4] Further, we demonstrate that these theories provide a useful basis for reconciling conflicting findings in the existing agency-based audit-related governance literature. We also provide examples of how these alternative theories provide important new insights to issues in auditing research and practice. In the next section we discuss the different theoretical perspectives in depth. We then discuss the implications of the different theoretical perspectives for audit research and practice. We conclude the paper with a summary of significant points and directions for further research.

OVERVIEW OF THEORETICAL PERSPECTIVES

Agency Theory

The view of governance commonly held in the accounting and finance domain relies heavily on agency theory (see, for example, Fama and Jensen 1983; Baysinger and Hoskisson 1990; Bathala and Rao 1995). Due to separation of ownership and control, agency theory views managers as self-interested actors who could engage in opportunistic behavior (Jensen and Meckling 1976). Various contractual mechanisms, including corporate governance, are presumed to reduce the agency costs resulting from information asymmetries between managers and owners. A common contractual means for reducing these agency costs is the provision for an independent party (the board) to monitor the agent (the management) while reporting back to the owner (the stockholders). Hence, the primary attributes for a board member in the agency perspective are independence from management and expertise in monitoring and control. However, measures of independence used in prior studies have led to inconclusive results in part because these proxies of independence "shed little light on the conduct of an independent board" (MacAvoy and Millstein 2004, 37). Further, "the simple tallying of the affiliations of individual board members provides insufficient information to assess whether or not that board is active and independent" (MacAvoy and Millstein 2004, 37–38). Instead, MacAvoy and Millstein (2004) argue the focus should be on the actions and the conduct of the board, a notion that has proved difficult to capture using the agency framework. For example, using an agency framework it is difficult to establish causal links between measures of governance quality and the performance of the firm (Larcker et al. 2007) and to ascertain whether an active audit committee truly exerts an independent influence on governance.

Since the accounting and auditing literature draws heavily upon agency theory, a primary focus has been on understanding the impact of the independence of the board and/or the AC on a

[4] Although each perspective is presented separately, we do not suggest that these perspectives are mutually exclusive in a given governance environment. For instance, a board may be structured so as to be strong in both the agency and the resource dependence perspectives. Thus, we recognize that in practice, corporate governance can be a combination of the different perspectives (Warther 1998; Dalton and Daily 1999).

number of financial reporting and auditing issues. Accounting research hypothesizes that independence is of value to shareholders. For example, Rosenstein and Wyatt (1990) found that the appointment of outside directors was associated with positive abnormal returns in the stock market. Auditing researchers have explored the impact of the independence of the AC on financial reporting. For instance, Beasley et al. (1999, 2000) found that companies that committed financial statement fraud were less likely to have a strong and independent AC. Carcello et al. (2007) found that when CEOs had influence in the selection of AC members there were a greater number of financial restatements than when CEOs were not involved. This occurred even though the audit committees in the Carcello et al. (2007) study were comprised solely of members who fulfilled all regulatory requirements for independence. In studies using agency theory to motivate examination of internal board structures, the implication is that the independent AC and board acts to ensure the quality of the financial reporting process. Carcello et al. (2002) show that independent boards are willing to pay for extra audit services, thus presumably acquiring better audits. Further, agency theory implies that as the owners' agents, the board and the AC will ally with the monitor (the auditor) in disputes with management, thereby reducing agency costs by promoting greater transparency and fairness in financial reporting.

Some scholars have criticized the enactment of government regulation such as the Sarbanes-Oxley Act that is based upon the prescriptions of agency theory because definitive evidence to support agency theory as an effective model for organizational behavior has not been provided. For example, Romano (2004) argues that the research has been inconclusive in demonstrating the advantage of requiring independence of all AC members, versus having only a majority of independent AC members. This is consistent with the notion that while complete independence may be required to achieve independence in "form" (appearance), "substantive" independence may be achieved with a majority of independent directors on the AC. This stream of research emphasizes the need to compare the marginal costs of full implementation of agency theory to the marginal benefits.

Resource Dependence

Resource dependence theory (Pfeffer and Salancik 1978; Boyd 1990) posits that stockholders and/or management may rely on the board as a means to access and manage scarce resources (Aldrich and Pfeffer 1976; Boyd 1990; Pfeffer and Salancik 1978) and help set the strategy of the firm (Williamson 1999). The primary role of the board is less that of a monitor than a partner to management, and one that helps set effective policies and strategies for the firm.

Dalton and Daily (1999) argue that a resource dependence perspective enhances a company's long-term success as board members' connections confer access to necessary strategic resources, networking, and information.[5] Because of this focus on business strategy, valuable attributes of a board member include industry expertise, knowledge in helping set corporate strategy, and providing access to external resources (Boyd 1990). As Reingold (2000) states, "many of today's high-tech board members see their job as actively setting the company's course. Indeed, on many high-tech boards, outsiders are brought in for their connections or specific technical knowledge rather than their independent perspective." For example, the inclusion of a significant number of non-independent directors may be appropriate for an R&D-intensive firm that needs efficient access to knowledge and resources that would allow management and other key constituencies to communicate and take decisive action in a quick and an effective manner. In contrast, a predominant focus on independent, outside directors may be optimal for a more stable firm where

[5] The findings of Boyd (1990) lend support to this proposition: high-performing firms have smaller boards, but these smaller boards are able to help the company better navigate uncertainty.

monitoring of the financial reporting process is of primary concern. It must be noted though that even in an R&D-intensive firm there is a need for strong financial monitors that would complement directors who assist with their strategic and networking skills (Cohen, Krishnamoorthy, and Wright 2007).

Thus, non-independent directors that include members of the management team may provide information on a timely basis that enables the board to act more effectively (Klein 2002a). Further, AC members with industry expertise are likely to have a superior ability to understand, interpret, and assess the quality of financial reports than members with no industry expertise but who are completely independent. Indeed, in a perfect world, companies may wish to appoint directors who are both independent as well as possess significant business knowledge and access to resources, but given the significant challenges in hiring and retaining board members in the current environment, companies may need to make difficult trade-offs.

Evidence from current research suggests that AC accounting financial expertise is significantly associated with stock market reaction (DeFond et al. 2005) and various measures of financial reporting quality (e.g., Dhaliwal et al. 2006), but in general, prior research has not found a significant association between non-accounting financial expertise (e.g., supervisory or finance expertise) and financial reporting quality. Although the effect of auditor *industry expertise* on audit judgments (Moroney 2007; Owhoso et al. 2002) and financial reporting quality has been well documented in the literature (Kwon et al. 2007; Krishnan 2003; Gramling and Stone 2001), the effect of such expertise on the effectiveness of the AC has not been fully explored in prior research. Given that a resource-dependent focus of the board may contribute to effective governance, an AC with a resource-dependent focus evinced through industry expertise of the members may significantly improve the effectiveness of the AC. For instance, the strong industry expertise implied by the resource dependence perspective suggests that members of the audit committee would have sufficient knowledge to assess the business activities and risks for a company to be able to evaluate whether accounting methods properly reflect the economic substance of transactions and whether estimates are realistic, leading to higher quality financial reporting.

Cohen, Krishnamoorthy, and Wright (2007), the only auditing study to date that we are aware of that has considered resource dependence, find support for the proposition that a resource-dependent focus can add value to the governance structure. Audit partners and managers were asked to evaluate an audit risk assessment and planning case where the strength of the agency and resource dependence roles of the board were manipulated. Results indicate that auditors' control risk assessments were significantly affected by both the relative strength of resource dependence and agency factors. Characteristics associated with a resource-dependence focus also affected audit-planning judgments. This study demonstrated that while the traditional agency factors are considered relevant, the additional factors involved in resource dependence are also considered highly relevant to audit planning. Finally, results indicated that when both agency and resource dependence were stronger, auditors decreased planned audit effort while effort was increased for all other conditions. The implications of this study are that researchers who limit their perspective to the monitoring role of the board based strictly on agency theory may lose some of the richness that alternative roles of governance provide.

Managerial Hegemony

A third theory of corporate governance that has been proposed in the strategy literature is managerial hegemony (Galbraith 1967; Wolfson 1984; Kosnik 1987). This theoretical perspective suggests that senior management selects cronies and colleagues who will not curtail their actions (Patton and Baker 1987), are willing to be passive participants in the governance process, and are dependent on the company management for information and insights about the firm and its industry (Wolfson 1984). This approach can be viewed as more symbolic (meeting regulatory requirements) rather than substance (a tool to effect organizational change or provide substantive oversight of management). This is in contrast to an agency theory perspective where emphasis is placed on the board acting as an independent and an effective monitor over management's actions. Consequently, from a hegemony perspective the board's functions are limited to ratifying management's actions, satisfying regulatory requirements, and enhancing senior management compensation (Core et al. 1999; Molz 1995). Indeed, a survey conducted by Epstein and Palepu (1999) found that 87 percent of "star analysts" hold that the board of directors represents only the interests of corporate management to the exclusion of other stakeholders.

The hegemony board has detrimental consequences for shareholders, in that it yields little independent monitoring (Westphal and Zajac 1994), impairs the stewardship function (Beatty and Zajac 1994), and enhances the entrenchment of management (Core et al. 1999). Regulatory requirements for appointing independent directors do not solve this problem. Westphal and Zajac (1994) suggest that entrenched CEOs may simply stock the board with sympathetic outsiders (see also Shivdasani and Yermack 1999). As Nowak and McCabe (2003) find, outside directors perceive that the CEO controls the flow of information and thus influences the effectiveness of even the most diligent directors.[6]

With respect to the internal workings of the board of directors, the implication of managerial hegemony is that even independent members of a fully "compliant" AC will be under the influence of management and likely to ask very easy and unobtrusive questions of management. Further, this theory implies that the AC will generally act as an ally to management in disputes that the auditor may have with management. This theory has a negative connotation in its implication that the audit committee is a toothless "paper tiger."

Institutional Theory

The final theory we address, institutional theory, considers a comprehensive set of organizational dynamics including the institutional environments and the ceremonial structures that actors within this dynamic display.[7] DiMaggio and Powell (1983) argue that institutions become similar over time through the process of institutional isomorphism as organizations adapt to become more similar to those around them. Isomorphism arises through three avenues: coercive, normative, and mimetic. Coercive isomorphism comes about as the result of external regulatory-type pressures for organizational convergence. An example of coercive isomorphism is the mandate by SOX for independent audit committee members, which results in all public companies having audit committees that possess these characteristics irrespective of the particular environment in which the company operates. Normative isomorphism suggests convergence through socialization. This could be typified by the offering of academic courses on "good governance" provided through M.B.A. and continuing education programs or organizations such as the Audit Committee Institute of KPMG. Mimetic isomorphism is a function of significant environmental uncertainty that leads organizations to "follow the leader" regardless of whether there is evidence that the leader's practices are effective. For example, companies can "mimic" (i.e., follow) the guidelines that are used by such publications as *BusinessWeek* for the rankings of governance to establish a gover-

[6] In practice, and particularly in the post-SOX era, directors have a number of incentives to not act completely under the control of management that mitigate a pure hegemony condition. For instance, Fama and Jensen (1983) point out directors face legal liability, have their personal reputation as a monitor at stake, and often have their personal wealth tied to their ownership stake in the firm.

[7] Another feature often talked about in institutional theory is known as loose coupling. However, Orton and Weick (1990) note that it is open to a number of interpretations. Thus, for this review we omit reference to this element of institutional theory.

nance framework. This framework is established by companies to enhance their "objective" rankings and is not necessarily done within the context of whether these particular sought-after characteristics (e.g., percentage of total board members who are independent) are best suited for a specific company operating within a particular industry.

One implication institutional theory holds for understanding corporate governance is that in periods of ambiguous and uncertain environments the board and AC may emphasize ceremonial and symbolic roles. For example, one "ceremonial" role of the AC is its formal tasking to hire and fire the auditor. A "symbolic" role is in the redefinition of the audit client as the AC rather than the company's management. Collectively assigning the hiring and firing of the auditor to the AC, as well as redefining the business relationship with the auditor, adds an aura of credibility in the eyes of the investing public to the integrity of the auditor-client relationship (Orton and Weick 1990). To fulfill the need for legitimacy, the AC emphasizes member expertise and its relationship to the committee's task of monitoring management. Thus, individuals will be chosen for an AC based on their objectively discernible credentials (e.g., certification, prior job responsibilities) and not necessarily on their ability to be effective monitors of management's practices.

Institutional theory also suggests that there is a tendency to attract homogeneous individuals into institutions (Tuttle and Dillard 2007). The implication for corporate governance is that board members may come from similar backgrounds and thus be less inclined to challenge each other or the management. Further, Dillard et al. (2004) emphasize that researchers must consider the relevance of social culture and environment on the practice of accounting and the use of accounting practices to rationalize and maintain legitimacy. In essence, institutional theory emphasizes how governance mechanisms fulfill ritualistic roles that help legitimize the interactions among the various actors within the corporate governance mosaic.

There are a limited number of auditing studies that consider institutional theory. Kalbers and Fogarty (1993) find that a strong organizational charter or mandate, institutional support (information support from management and auditors and a supportive environment by top management), and diligence enhanced the committee's effectiveness, and conclude that AC members operate in an institutionalized environment where they depend on interactions with others to achieve their power. Fogarty and Kalbers (1998) provide a test of the relative strength of agency theory and institutional theory predictions in explaining the effectiveness of the AC. They are unable to demonstrate a strong link between AC effectiveness and agency theory factors and suggest that institutional theory's premise that ACs can exist for ritualistic and ceremonial purposes may warrant further investigation. Gendron et al. (2004) interviewed AC members and the external auditors for two corporations and found that the manner in which AC members achieve legitimacy in the eyes of other attendees at AC meetings was affected by their ability to ask questions, the extent to which they have private meetings with the external auditors, and through the ceremonial and substantive components of the meetings. Gendron et al.'s (2004) findings indicate that AC meetings fulfill both symbolic and substantive purposes. Finally, Holder-Webb (2008) conducted a content analysis study of codes of ethics to find out if codes of conduct that demonstrated convergence after Section 406 of SOX mandated that public companies either have a code of ethics or present a reason why they do not have a code. Holder-Webb found strong evidence of convergence in the language and content of the code across a number of industries (e.g., software, oil extraction) despite the various differences in the industry characteristics. She attributed this finding as evidence of mimetic isomorphism in that companies tried to model their code of ethics after codes already in existence irrespective of their relevance for a particular company.

With respect to the internal workings of the board, the implication of institutional theory is that AC members will act to conform to other institutions and that ACs will tend over time to become similar to others within the same industry. AC members are likely to come from similar backgrounds, often similar to the backgrounds of management as well. The AC and the board will fulfill an important signaling mechanism to those outside the institution such as current or potential stockholders by conferring perceptions of trust and competency in the workings of the AC. This theory has an indeterminate prediction on whether the AC will act as an ally to management or the auditor in disputes that the auditor may have with management. For example, the AC often fulfills an important symbolic role that in practice could lead its members to legitimize their role by asking questions of management. However, similar backgrounds and ties with management may lead the AC to accept management's views.

Table 1 outlines the four theories of corporate governance and their implications for the composition and role of the board and the AC. The importance and effectiveness of the AC in the governance process is likely to vary based on the organizational perspective driving the governance process. The importance of outside, independent board members will be greater in a governance structure where the agency perspective dominates and monitoring is emphasized. Conversely, the hegemony perspective that, in contrast to an agency theory perspective, provides little emphasis on monitoring management, is likely to lead to a relatively "weak" AC. Finally, an institutional theory perspective suggests that the AC's role is primarily symbolic and ritualistic and likewise leads to indeterminate predictions, as it cannot by definition be decoupled from the institutional context of the organization.

Despite the richness of these perspectives in understanding existing governance structures, prior accounting research has generally limited analysis to the predictions of agency theory. This may be a function of the primary role of quantitative finance in influencing accounting research (e.g., Fama and Jensen 1983; Jensen 1993); the agency model leads to a higher degree of mathematical tractability than do the competing theoretical perspectives. However, examining standard agency measures of governance has led to inconsistent findings of the connections between "good" governance and performance measures (Brown and Caylor 2004; Larcker et al. 2007; Romano 2004; Gibbins et al. 2007). In the following section we discuss the implications of alternative corporate governance perspectives in the auditing arena.

IMPLICATIONS FOR AUDIT RESEARCH AND PRACTICE

The focus on agency theory within the general body of accounting research translates—for audit and governance research—into an emphasis on understanding the impact of the independence and financial expertise of the board and/or the AC (e.g., DeZoort et al. 2002). In this section of the paper, we outline how practice and existing streams of research in auditing and governance can benefit from the competing theories discussed above. To illustrate this, we examine three areas of prior research: evaluation of internal controls, financial distress and auditors' going-concern opinions, and governance and the audit process. We also discuss how alternative research methodologies (e.g., experimental, field studies) can help address important governance-related issues raised by the theoretical perspectives discussed earlier.

Evaluation of Internal Controls

Section 404 of SOX greatly expanded the prior responsibilities of the external auditor in evaluating and testing internal controls. The auditor's view of the scope and nature of these responsibilities will vary depending on which of the governance perspectives described above the auditor subscribes to. For example, a focus on the agency perspective would lead the auditor to focus on control activities such as segregation of duties and the independence and expertise of monitoring mechanisms such as the AC in ensuring sound financial reporting. Under this perspective, such mechanisms are necessary to oversee management given their incentives that often conflict with shareholder interests. In fact, prior research has overwhelmingly focused on

TABLE 1

A Comparative Evaluation of the Agency, Resource Dependence, Managerial Hegemony, and Institutional Perspectives

	Agency	**Resource Dependence**	**Managerial Hegemony**	**Institutional Theory**
Selection of Board Members	Primarily by stockholders	By stockholders and/or management	Primarily by management	Primarily by management
Primary Board Member Attributes	Independence, and expertise in monitoring and control	Industry expertise, expertise in helping setting corporate strategy, and providing access to external networks	Independence in "form" but not in "substance"	Perceived knowledge and independence. Frequent meetings.
Primary Focus of the Board	Monitoring management's actions	Aiding management in setting corporate strategy	Board consisting of "cronies" of management who will meet external requirements	To provide assurance to outsiders that information provided by management is legitimate
Other Board Foci	Corporate Performance Global Risk Management CEO and Management Compensation Monitoring and Control	Strategic Planning Identifying new products, markets and technologies Helping management execute the business model, strategic plans, and managing business risk	Ratifying management's actions Satisfying regulatory requirements Enhancing senior management compensation	Ritualization of activities Impression management Enhancing legitimacy of management Enhancing legitimacy of financial reporting process
Importance of the AC in ensuring a high quality financial reporting process	Highest	Indeterminate	Lowest	Indeterminate
Role of the auditor	Independent party working with other governance parties to ensure sound financial reporting	Auditor plays key role in independently ensuring sound financial reporting. Little or no role in assisting the company to achieve operational goals and strategies	With governance under management's control, the auditor is the sole independent party responsible for sound financial reporting	With the AC and board symbolic, the auditor is heavily responsible for sound financial reporting

externally observable measures that relate to agency/monitoring (Larcker et al. 2007), and hence there has been a preponderance of the archival research method in governance-related research in accounting/auditing. In contrast, a focus on resource dependence would lead the auditor to consider the company's mechanisms for developing sound strategies and controlling business risks. A synergistic relationship between management and knowledgeable members of the board (regardless of independence) would be seen as valuable in accomplishing these objectives. However, observable measures of a company or its board's emphases on strategy and risk management are difficult to obtain using archival methods. Alternative research methodologies, such as experiments where the strategic versus monitoring emphasis of the board can be experimentally manipulated (e.g., Cohen, Krishnamoorthy, and Wright 2007), can provide useful insights that may be difficult to obtain with archival methods that rely on publicly available data.

A managerial hegemony perspective held by the auditor would lead to a focus on the selection process and activities of members of the board and the AC. With respect to audit practice, auditors may employ greater professional skepticism if they perceive that top management controls the selection process to promote members who are closely aligned to them. They may investigate why the board and AC engage in little questioning of management actions. Further, an AC that is in effect under the management's thumb may pay perfunctory attention to the mechanisms such as the effectiveness of the whistle-blower program resulting in a corporate culture that is detrimental to achieving sound controls and effective financial reporting. These judgments could further lead the auditor to assess higher levels of control risk, which may lead to increased internal substantive testing. If such risks exceed the allowable thresholds, or the audit cannot be performed in a cost-effective manner, the auditor may choose to resign from the engagement altogether. From a research standpoint, the managerial hegemony perspective presents challenges since management intent is not readily observable using the traditional archival methods that use publicly available data. Field study methodologies (e.g., interviews) could offer significant opportunities in this area and have the potential for providing important insights about the influence of management in the board recruitment process, and the resulting effects on the quality of internal controls.

Finally, institutional theory would lead the auditor to focus on whether formal mechanisms are in place to comply with rules and regulations. For instance, is the AC comprised only of independent members, all having financial literacy, and one who is a financial expert, as specified in the Sarbanes-Oxley Act? Does the AC meet frequently? These are all formal indications that the company is complying with expected norms. The auditor must at the same time avoid focusing excessively on form over substance, as an AC can meet these requirements and yet not assume the diligence and questioning manner necessary to confront management when needed to ensure financial reporting is of high quality. With respect to effectiveness of internal controls, an AC that is consistent with the predictions of the institutional theory will focus on ritualistically following a "checklist" approach to internal controls, rather than getting at the "substance" of whether controls are effective and not being overridden by management. Again, from a research perspective, field-based research methodologies can be useful in drawing the distinction between a board or AC that is consistent with the institutional theory versus one that has been put in place by management for its benefit (managerial hegemony). A field study involving interviews with auditors or audit committee members may provide significant insights on the extent of management influence on selection of members to the audit committee and its resulting impact on audit committees' effectiveness in monitoring internal controls.

As discussed earlier, these perspectives are not mutually exclusive in developing audit strategies. For instance, an auditor can emphasize both the agency and resource dependence perspectives in considering mechanisms used to monitor management, as well as those adopted to develop sound corporate strategies and control business risks. Using this approach, the auditor would consider whether a sufficient balance between independence and industry expertise is achieved within the governance structures in such a way as to maximize the quality of financial reporting. An auditor incorporating both an agency and an institutional perspective, on the other hand, would consider whether the independence of the AC was a matter of monitoring strength or merely a ritualistic conformation with regulatory guidelines.

Research that considers the different perspectives of corporate governance has the potential to contribute to both research and practice with respect to internal controls. Research needs to examine how the factors associated with each of these perspectives incrementally impact controls over financial reporting and fraud. For instance, how does the role of the board in helping to set corporate strategies (resource dependence) affect business risks and the resulting reporting of financial performance (estimates, uncertainties, etc.)? How does management potentially influence the appointment and effectiveness of board and AC members, who outwardly appear independent but are, in fact, consciously or unconsciously biased (hegemony)? For audit practice, auditors need to consider the complexity of the different governance perspectives in evaluating the overall effectiveness of the AC and board in achieving a strong control environment and sound controls over financial reporting.

Financial Distress and Auditors' Going-Concern Opinions

From an agency perspective, Carcello and Neal (2000) argue and find support for the expectation that independent AC members will be more likely to side with auditors who wish to issue a going-concern report for companies with financial difficulties than affiliated AC members. Carcello and Neal (2003) also find that auditors are less likely to be dismissed by a client following a going-concern opinion when AC members are independent than when affiliated. While these studies focus on the impact of agency factors on auditor reporting, consideration of the resource-dependence perspective may provide additional insights. If the board with industry expertise is engaged in providing strategic support to management, the company may be more likely to overcome its financial difficulties than companies that do not offer a resource dependency focus on the board.[8] Board members with a resource-dependent industry expertise may not conform to the notion of outside or independent individuals as defined by regulatory agencies. For example, a board member who is an officer of a major customer or supplier may add significant value to the board from the industry perspective, but may not be considered "independent" under current regulations. Thus, additional research is needed to examine the importance of the incremental effects of the resource dependence of the board relative to the independence of directors and the degree to which this affects audit planning and judgments with respect to the going-concern status of a company.

Hillman et al. (2000) provide a taxonomy of the different roles that individual directors can play within the resource dependence framework. The four categories of directors referred to by the Hillman et al. (2000) study include insiders (e.g., current and former officers of the company), business experts (e.g., current and former CEOs of other firms, industry experts), support specialists (e.g., lawyers, public relations experts), and community influentials (e.g., politicians, university faculty). An important avenue for future research is to examine if companies within an industry that have stronger resource dependence boards with respect to a specific category of directors (e.g., business experts) are less likely to be financially distressed as compared to other companies within the same industry. For example, a mortgage lender that has a board with a high

[8] This should not be construed as a suggestion that a resource-dependent board will keep the firm out of financial distress; a general slump in the economy or industry-wide downturn may precipitate distress. We merely argue that the resource-dependent board is uniquely qualified to assist management in successfully navigating the distress to a productive conclusion.

proportion of directors with expertise in the banking and home-building industries may be less likely to enter into financial distress related to engaging in subprime lending practices. However, it is important to recognize the significant data limitations relating to classifying boards based on the taxonomy in Hillman et al. (2000), since proxy statements may not provide complete and consistent information on the backgrounds of board members, and where such information is provided, extracting it may prove tedious and time-intensive. Innovative, computer-assisted methods that parse through proxy statements and other publicly available information to gather information relevant to classify boards in accordance with the resource dependence perspective may be useful avenues to explore in future research.

Going-concern opinions represent significant risks to the company and the capital markets; incorrect assessment of a firm's going-concern status results in high costs to the firm, the auditor, and market participants. AC independence has been shown to be a significant factor in determining whether an auditor issues a going-concern opinion or not (Carcello and Neal 2000). Further, recent research suggests that it is crucial to distinguish between independence in form and independence in substance when understanding the role of the AC on financial reporting quality (Carcello et al. 2007). This distinction is manifest in the managerial hegemony and institutional theory settings; if auditors fail to incorporate the symbolic or ritualistic factors associated with the appearance of independence, or to incorporate the possibility that a seemingly independent director is actually in thrall to management, they risk incorrectly estimating the board's true oversight function. Overreliance on the effectiveness of the board may lead to an overestimation of the board's ability to discipline poorly performing management, subsequently engendering an increase in the risk of a "missed" going-concern opinion.

For audit practice, examining the issue from a managerial hegemony perspective, it is also important for auditors to exhibit professional skepticism toward a reorganization plan that management proposes. Board members who are under the influence of management may routinely approve reorganization plans without challenging them. From an institutional theory perspective, management desires to send a signal to stakeholders that the reorganization effort is serious. Thus, there may be symbolic shakeups of management and the board that ultimately do not translate to effective change. A strong resource-dependent focus on the board may enhance the probability of a successful turnaround. Audit researchers who examine the chances of an incorrect going-concern report and why some firms are more successful in turning around than others should grant serious consideration to these alternative theoretical perspectives when developing hypothesis tests and structuring research designs.

Governance and the Audit Process

Cohen, Krishnamoorthy, and Wright (2007) demonstrate that auditors are sensitive to both agency and resource dependency roles of the board in their risk assessments and subsequent program planning judgments. A board with a narrow monitoring focus may not actively evaluate management's strategic plans. A broader focus on strategic, product, and technology risks may be required to proactively address difficult issues such as inventory valuation and product obsolescence. Auditors and auditing researchers thus need to go beyond a narrow governance lens and consider the broader corporate governance "mosaic," which includes not only the AC, but also the board and other key governance players such as management and major shareholders.

Over the past decade auditing firms have adopted a more strategic, business-risk oriented approach to auditing (Winograd et al. 2000; Bell et al. 1997, 2005). This approach requires an understanding of the client's business processes, business risks, and strategies to address risks. If auditors focus exclusively on interactions with the AC, they may fail to fully consider the important strategic role undertaken by the resource-dependent board. While a board may be fully independent, it may nonetheless be unable to sufficiently fulfill its role in helping the company develop sound strategies and mitigate business risks.

An opportunity for future research is to examine the nature and extent of interaction between the board's resource dependence focus and audit committee's consideration of strategic and business risks in fulfilling its responsibilities with respect to financial reporting. Since the audit committee is a subcommittee of the board, an important research question to address is whether audit committees emphasize strategic and business risks more when there is a greater board focus with respect to resource dependence. Experimental methods may be better suited to address such an issue since it provides an avenue to predict and test for such interactions in relatively more controlled, but realistic settings.

From an audit practice perspective, examining the audit process from multiple governance perspectives can lead auditors to question accounting estimates. For instance, in auditing the estimate for bad debts, auditors may obtain greater comfort in understanding that the independent board members are providing quality monitoring over estimates (as predicted by agency theory), but also that the resource-dependent members are providing industry expertise and strategic support that may reduce credit risk without negatively affecting sales. From a research perspective, examining issues such as waived adjustments on accounting estimates (Wright and Wright 1997) should consider the influence that these different factors have on inventory valuation decisions. While agency-based researchers might consider only issues of independence to predict what adjustments may be waived, researchers may also consider the influence of the resource-dependent board on strategy and development of accounting estimates.

Agency and resource-dependent theories are not mutually exclusive, as discussed above. Firms should aspire to have boards that are strong on both the agency and resource dependence dimensions. However, given the finite size of the board and the regulatory restrictions imposed on its composition (e.g., that majority of the directors need to be independent), a board that is strong on both dimensions may be challenging to accomplish in practice. An example of future research that could benefit from multiple perspectives relates to board size. While smaller boards can be more efficient and cohesive, larger boards can select members with varying skill sets and hence may have a higher quality board from a resource dependence perspective. Hence, an issue worthy of future research is whether board size is systematically associated with the emphasis placed on the type of governance in an organization (e.g., agency versus resource dependence).

The research on the efficacy of the strategic systems approach to auditing has been somewhat mixed (O'Donnell and Schultz 2003, 2005). One interesting research implication is that a strategic systems audit is likely to be more effective if auditors pay more attention to the substantive role that boards may play in the client's strategic decision-making and in controlling overall business risks. If boards fulfill all regulatory requirements of independence and activity (which would be the primary variables examined by researchers using an agency perspective) but are either under the thumb of management (managerial hegemony) or are merely fulfilling symbolic roles (institutional theory) then researchers need to also capture the strategic focus of the board (resource-dependence perspective) to help understand prevention and detection of material misstatements in financial statements.

Research on auditor-client dispute resolution (see DeZoort et al. 2003, for example) may also benefit from considering multiple organizational theories. Ng and Tan (2003) found that auditors in such a situation take a stronger position where accounting standards are ambiguous when a strong AC is present than a weak AC. The question arises as to when the auditor can effectively rely on the usefulness of the monitoring activities of the AC (Krishnamoorthy et al. 2002; Gibbins et al. 2007; Cohen, Gaynor, Krishnamoorthy, and Wright 2007). From both a practice and a research orientation, a reliance on an agency theory perspective might curtail the effectiveness of the audit process because operationalizing the agency perspective routinely emphasizes outward form (e.g., that directors should be primarily unaffiliated) but may not always capture the true substance of a board or AC's monitoring activities in asking probing questions and confronting management when necessary (MacAvoy and Millstein 2004; Cohen et al. 2002).

From an audit practice perspective, the managerial hegemony perspective suggests that auditors should ascertain the personal relationships between management and directors and examine the processes followed by the nominations committee in determining the slate of directors that are brought before the stockholders for a reelection. If the CEO influences the selection of a large number of individuals who are on the board, then the board is likely to be unduly biased to support the CEO, thus diminishing the ability of the board to provide effective monitoring. This also implies that researchers need to control for management's influence on selection of board members (Carcello et al. 2007). From an institutional theory perspective, practitioners should be aware that the board may be engaging in ritualistic or symbolic activities primarily to convey to external parties that the trappings of governance are in place and that the regulatory requirements are being met. Thus, audit researchers who explore how auditing and accounting disputes are resolved should consider whether substantive power has been granted to the AC. Understanding the true power dynamics will enhance researchers' development of audit theories and lead to an improvement in research designs for investigations of the ability of auditors to confront management successfully on contentious issues (DeZoort et al. 2002).

CONCLUSIONS

In this paper we provide a review of alternative theories that may be useful in research on corporate governance from an accounting and auditing perspective. The traditional focus of governance research in the accounting and auditing literature has been on structural factors arising from the implementation of agency theory. We argue that this focus, while useful, is overly restrictive in that it disregards the contextual richness within which governance structures are developed. We present three alternative theoretical perspectives that offer useful insights for accounting and auditing researchers engaged in investigations of corporate governance: resource dependence (a strategic perspective), managerial hegemony (an entrenchment perspective), and institutional theory (a legitimation perspective).

These perspectives are useful in exploring the links between elements in the corporate governance mosaic highlighted by Cohen et al. (2004), who suggest consideration of both the internal and external interrelationships between the various actors and mechanisms that affect a corporate governance system. From the standpoint of internal relationships, these perspectives permit researchers to explore the interactions among the AC, the external auditor, the internal auditor, the board, and the management. Cohen et al. (2004) also describe external actors and mechanisms, such as regulators, legislators, financial analysts, stock exchanges, courts and the legal system, and the stockholders, that may influence the effectiveness of a company's governance system. For example, researchers exploring audit failures may wish to examine whether jurors absolve auditors that incorporated governance merely by documenting that the client firm had adhered to all pertinent governance regulations. Alternatively, jurors might consider whether this adherence was a ritualistic demonstration, emphasizing form over substance. This implementation of institutional theory permits greater understanding of the processes following upon an alleged audit failure than the simple examination of whether compliance is associated with legal judgments. Findings of such a study might yield a superior understanding of how governance currently works and how it could be shaped to more effectively operate in the future.

These perspectives also appear useful in examining the governance of auditing firms and how auditors evaluate their own effectiveness. For example, institutional theory suggests a focus on ritualistic and symbolic matters; this goal might drive auditors to give the appearance of diligence and heightened expertise through use of standardized risk and program checklists despite evidence that such tools do not translate to effective detection of fraud where the engagement presents unique risks (Asare and Wright 2004).

Finally, researchers can use these different theories to enhance their understanding of financial reporting quality. A number of prior studies have reported a link between the strength of corporate governance and financial reporting quality, including finding an association between AC independence and decreases in fraud (Beasley et al. 2000), restatements (Abbott et al. 2004), and earnings management (Klein 2002b). However, this literature, at times, yields inconclusive findings. Agrawal and Chadha (2005) and Baber et al. (2005) do not find that independent ACs are associated with a lower incidence of restatements. Institutional theory provides useful insights in evaluating prior research and establishing practice guidelines in this area. ACs and boards may appear to comply with regulatory requirements on independence and best practices, yet in actuality serve only a ritualistic role. AC members may be independent and have sufficient financial expertise, but lack sufficient power to fulfill its responsibilities effectively by confronting management when appropriate. This may account for the conflicting findings noted above. Institutional theory suggests that it is insufficient to focus on isolated AC or board surface characteristics in determining the driving factors that affect reporting quality. Rather, it is also necessary to consider the nature of the relationship between management and other corporate governance players.

In all, this review of alternative perspectives highlights the complexity and richness of corporate governance in affecting financial reporting risk and the audit process. As such, this broader view suggests promising directions for future research and practice in understanding the role of corporate governance and improving audit practice.

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