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On the Interrelation between Corporate Governance, Audit and Earnings Quality: A Review of the Underpinning Theories

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Abstract
The quality of reported earnings is important to investors in the financial market, as investors and analysts heavily rely on the company's reported earnings in making investment decisions. The board of directors, the audit committee, and the internal audit function represent the internal monitoring mechanism within a company, whereas the external auditors serve as an external monitoring mechanism providing independent verification of the quality of a company's financial reporting. Besides that, interdependencies exist between a firm's internal corporate governance structure and its external audit function. Given the important effect of these monitoring mechanisms on a company's financial reporting process, this paper aims to to discuss the relevance of various theories used in academic research in explaining the role of corporate governance and auditors in promoting higher earnings quality. Through the review of literature, we have found that the agency theory, stewardship theory, institutional theory, and managerial hegemony theory as the main theories that provide significant insights into the efficiency and effectiveness of corporate governance and audit functions from various perspectives. Hence, this suggests that future research could consider the use of multiple theories together in the explanaining the interrelation between corporate governance, audit, and earnings quality. Our paper would be of interest to academicians, practitioners, regulators, and policymakers in trying to understand how a company's internal corporate governance characteristics such as the board, audit committee, and internal audit function, as well as how the external auditors affect the quality of financial reports produced by companies. Our paper also contributes to the literature as this paper comprehensively provides a synthesis and a holistic view of how these four theories complement each other in explaining the interrelation between the different governance mechanisms and financial reporting.

Keywords: Corporate Governance, External Audit, Board, Audit Committee, Internal Audit, Agency Theory, Stewardship Theory, Managerial Hegemony Theory, Institutional Theory, Earnings Quality, Financial Reporting

Introduction

The quality of reported earnings is important to investors in the financial market, as investors and analysts heavily rely on the company's reported earnings in making investment decisions. The generally accepted accounting principles (GAAP) provide flexibility for managers to choose the type of accounting policy or procedures that suit their business operating environment when making assumptions and estimations in the financial reporting process. Hence, managers would be most likely to choose the type of accounting policy or procedure that will maximise the wealth of all the contracting parties (Watt and Zimmerman, 1990). This flexibility in GAAP provides opportunities for earnings management where the company's actual performance is being masked so that shareholders, debt holders and investors at large are being misled about the true economic value of the company (Watt and Zimmerman, 1990; Fields *et al*., 2001).

Earnings management is the inverse measure of earnings quality. Schipper (1989) defines earnings management as intentional intervention in the external financial reporting process, with the aim of attaining personal benefit either for managers or shareholders, for Healey and Wahlen (1999) earnings management happens when managers apply their judgements and structure the transactions to modify the company's financial reporting outcome with the intention either to mislead certain parties about the true economic performance of the company, or to influence contractual outcomes that rely on the reported figures. Schipper's (1989) definition is broader than Healy and Wahlen's (1999) as it emphasis that earnings management is an intentional action, and does not limit the types of accounting manipulation that can be done to include both legitimate (within GAAP) and illegitimate practices (such as accounting fraud). Schipper (1989) also highlights that such earnings management practices could either be opportunistic (for the benefit of managers) or informative (for the benefit of shareholders).

Literature

Corporate Governance Mechanisms

Corporate governance has been defined in various ways based on different theories adopted, perspectives and interests of the parties which are involved and affected by the corporate governance system (Solomon, 2007). The most widely recognised definition of corporate governance is offered by Sir Adrian Cadbury (Cadbury Report, 1992), which succinctly and clearly defines corporate governance as "*the whole system of controls, both financial and otherwise, by which a company is directed and controlled*". From the shareholder's point of view, Denis (2001: 192) describes corporate governance as "*a set of institutional and market mechanisms that aim to motivate self-interested managers to maximise the shareholders' wealth, measured by the value of the residual cash flows of the companies*". Focusing more on investors' protection, Shleifer and Vishny (1997: 737) describe corporate governance as "*dealing with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment*". Consistent with this, Du Plessis *et al* (2011: 81) summarise the board functions and responsibilities as being to "*direct, govern, guide, monitor, oversee, supervise and comply*". "The board sets the link between managers and investors, and is essential to good corporate governance and investor relations" (Mallin, 2010; 164).
These definitions suggest that the board of directors plays a very strategic and tactical role in determining business success. Thus, it follows that it is very important that the board

members have the appropriate balance of skills, experience, independence and knowledge of the company to enable them to discharge their respective duties and responsibilities effectively (U.K. Corporate Governance Code (2010, 2014). The U.K. Companies Act (2006) also outlines the board duties in ensuring transparency and fairness in a firm's financial reporting, where all accounts of the public listed companies that have been prepared and approved by the directors have to be independently audited by an external auditor to verify their credibility, objectivity and reliability. In order to carry out its responsibility effectively, the board may, however, delegate its authority to sub-committees, such as the audit committee, nomination committee and remuneration committee. However, it is important to note that this delegation of authority does not make the board less accountable for the sub-committee's actions.

The fact that rewards are linked to the performance of the directors gives rise to accountability problems and scrutiny issues. For example, the 2018 financial crisis can be linked to the corporate governance failures in the banking industry, specifically 1) the failure of the boards of directors, particularly the independent non-executive directors in their monitoring role over risk management activities, and 2) the inappropriate and lucrative performance-related remuneration packages provided to the directors and managers of the banks encouraging them to engage in risk-taking activities (MacNeil, 2010: 518; Walker Review, 2009). In addition, the bank failures raise questions about the value of company audits, auditor independence and quality of audit work, as well as the competency and knowledge base of the auditors (Sikka, 2009).

The interdependencies between a firm's internal corporate governance structure and external audit function

The board of directors, the audit committee and the internal audit function represent the internal monitoring mechanism within a company, whereas the external auditors serve as an external monitoring mechanism providing independent verification of the quality of a company's financial reporting. Interdependencies exist between a firm's internal corporate governance structure and the external audit function, and this is discussed in more detail below.

Looking at the accounting fraud landscape where 89 percent of the perpetrators are mainly the company's CEO or Chief Financial Officer (CFO) from top management (Beasley *et al*. 2010), the effectiveness of the board monitoring role needs to be carefully assessed by the external auditor to determine the strength of the control environment and to assess the audit risk (Carcello *et al*., 2011). Consistently, Bedard and Johnstone (2004) suggest that auditors take into consideration clients' strength of internal control, risk of earnings manipulation and effectiveness of corporate governance in making audit planning and pricing decisions, then adjust their audit effort and billing rates accordingly. Cohen *et al* (2007) reported that auditors' control risk assessments and audit planning decisions are affected by the client's board characteristics and effectiveness. Stewart and Munro (2007) documented that the auditor risk assessment is lower in the presence of an active audit committee. This means that the auditor assesses risk to be higher and plans more audit hours for companies with weak governance (Carcello *et al*., 2011).
The relationship between the audit committee and the external auditor is manifested in its responsibility for overseeing the audit process and liaising between the external auditor and

management. This includes making recommendations to the board on the appointment of the external auditor, discussing the level of audit fees, reviewing the audit engagement scope and activities, and protecting the auditor's independence (U.K. Corporate Governance Code, 2010; 2014). Auditor independence is protected by the audit committee controlling the type and amount of non-audit services purchased from the incumbent auditor while ensuring that the proposed audit fees do not potentially jeopardise the quality of audit work (U.K. Corporate Governance Code, 2010; 2014). This is due to auditors trying to balance their audit costs with expected future losses as a consequence of legal liability arising from audit failure (Carcello *et al*., 2002).

Many researchers, particularly in Anglo-American settings, have examined the relationship between corporate governance and accounting or auditing outcomes. Amongst the studies are by Turley and Zaman (2004); Gramling *et al* (2004); DeFond and Francis (2005); Cohen *et al* (2007); Schneider *et al* (2009); Garcia-Meca and Sanchez-Ballesta (2009), Bedard and Gendron (2010), and Lin and Hwang (2010). Consistently, most of these meta-analyses studies have generally found evidence that supports the notion that an effective board and audit committee are associated with "*good*" accounting and auditing outcomes and more effective internal controls within the business environment (Carcello *et al*., 2011). The most popular characteristics of the board and audit committee that have been examined are their independence and expertise (Dechow *et al*., 1996; Beasley, 1996; Abbott *et al*., 2004), whereas accounting outcomes are measured in terms of lower earnings management (e.g., Klein, 2002), lower restatements (e.g., Abbott *et al*., 2004), or fraudulent financial reporting (e.g., Beasley 1996; Beasley *et al*., 2000). Auditing outcomes that have been examined include going concern reporting (e.g., Carcello and Neal, 2000, 2003a), auditor type (e.g., Beasley and Petroni, 2001), and auditor fees (audit and non-audit fees) (e.g., Abbott *et al*., 2003; Carcello *et al*., 2002). The strength of internal controls has been measured by reference to SOX Section 404 internal control in the U.S., audit opinions, or management disclosures of internal control effectiveness under SOX section 302 in the U.S. (e.g. Krishnan and Visvanathan 2007; Hoitash *et al*., 2009). Overall, research has demonstrated that the two roles of the board and audit committee are integral in the company's financial reporting process in order to protect shareholders' interests and maintain investors' confidence in the financial markets.

The relationship between corporate governance and external audit can be explained using two competing theories, namely, the substitution theory and the signaling theory (Wu, 2012). The substitution theory posits that firms with effective corporate governance have lower agency costs, which contribute to lower audit risk and lower audit effort, thus lowering the audit fees charged by the auditor. In other words, effective corporate governance, to some degree, represents a substitute for the audit external auditor function. A study by Tsui *et al*. (2001) provides support for this argument by showing that a corporate board independent of the CEO enhances financial reporting quality, and is positively associated with lower audit fees. In addition, Felix *et al* (2001); Prawitt *et al* (2009) found evidence that indicated that external audit fees are lower in companies that employ higher-quality internal audit functions. On the other hand, the signaling theory argues that companies with an effective board and audit committee may signal to management and the auditor that they exercise a more effective monitoring role, and they are thus likely to be more demanding and insist on having a higher quality audit (Carcello *et al*., 2002; Carcello *et al*., 2011). Consistent with this a study by Carcello *et al* (2000) reported that a higher proportion of non-executive directors increase the demand for assurance and audit quality, leading to higher fees. Lee *et al* (2004) document that companies with more independent audit committees prefer higher quality successor auditors. Bronson *et al* (2009) reported that an external auditor is seldom likely to be dismissed following a going-concern report when the audit committee is fully independent. Wu (2012) asserts that the inconclusive results reported in prior studies make it difficult to ascertain which theory actually better explains the relationship between corporate governance and auditing.

To summarise, effective corporate governance and high quality audits are important and beneficial for investors and to the financial statement users in order to minimise the potential for damage to reputation and legal exposure while, at the same time, raising the support from shareholders. The next section reviews a number of theoretical perspectives for corporate governance research that are widely used in the academic research.

The Underpinning Theories

Although there is no agreed theoretical base for research in corporate governance and audit (Parum, 2005), the paper identifies four main theories that are relevant in explaining the association between corporate governance, external audit function and earnings quality. These are agency theory, stewardship theory, institutional theory and managerial hegemony theory. This paper reviews these four theories and their relevance in providing competing or complementary explanations to each other, in explaining the association between corporate governance, external audit function and earnings quality. The theories are further discussed in the respective sections below.

Agency Theory

Agency theory is a predominant theory in accounting and auditing literature underpinning the role of corporate governance and external auditing in improving financial reporting processes. Modern companies with widely dispersed ownership are characterised by their separation of ownership and control, where the shareholders (the principal) appoint managers (the agent) to run the daily operations of the business on their behalf. The distinction between ownership and control creates potential conflicts of interest between the two parties (Jensen and Meckling, 1976). Agency theory posits that managers are likely to act opportunistically by pursuing their personal gains (e.g. luxury company cars, lavish offices, excessive entertainment expenses) at the expense of maximising the shareholders' wealth (Jensen and Meckling, 1976; Fama and Jensen, 1983). Furthermore, the shareholders' inability to monitor management closely due to separation of ownership and control gives rise to information asymmetry which results in moral hazard (hidden actions by agents) and adverse selection problems (hidden information by agents), where both are being incurred at the expense of the shareholders' wealth (Fama, 1980). Earnings management can be referred to as a form of adverse selection problem, as it represents a misreporting of information by management (Singh and Davidson, 2003).

In order to reduce the conflict of interests, the shareholders incur some forms of agency costs which include a monitoring cost, a bonding cost and a residual loss (Jensen and Meckling, 1976). Monitoring cost relates to the appointment of internal as well as external monitoring mechanisms to constrain management opportunistic behaviour (Jensen and Meckling, 1976). Bonding cost relates to management compensation contracts, whereas the residual loss refers to the reduction in shareholders' wealth caused by any disparity between monitoring and bonding costs (i.e., in other words, when there is an imperfect alignment between the principal and agent interest) (Jensen and Meckling, 1976). As a form of monitoring cost, the corporate governance system reduces the agency costs through a number of mechanisms such as the presence of the board of directors and the audit committee (Lin and Hwang, 2010; Gracia-Meca and Sanchez-Ballesta, 2009). Empirical research provides evidence that an effective board of directors and audit committee contributes to higher audit quality and "good" financial reporting outcomes (Carcello et al., 2011).

Another form of monitoring cost incurred by the shareholders is by engaging an independent external auditor to perform verification on the financial reports prepared by the management in respect of its truth and fairness in accordance with the applicable financial reporting standards (Lin and Hwang, 2010). Hence, an external audit enhances the credibility of the financial information provided to shareholders, reduces information asymmetry between the two parties and, therefore, limits management opportunistic behaviour such as earnings management (Lin and Hwang, 2010; Piot, 2001; Watts and Zimmerman, 1983). In order to signal to the market that they exercise a more effective monitoring role, companies with effective corporate governance characteristics are more likely to hire auditors that are perceived to deliver a high quality audit (Carcello et al., 2000; 2002; 2011). As noted earlier, high audit quality is defined by DeAngelo (1981) as the market assessed joint probability that an auditor will detect material misstatements and report them in the audit opinion. Thus, high audit quality refers to the auditors' competency and the amount of effort devoted to the audit, as well as their objectivity and independence in reporting any identified breach in the client's accounting system (Watts and Zimmerman, 1986). The auditing literature shows a positive association between the Big 4 industry leadership with various proxies of audit quality such as audit fees (e.g. Palmrose, 1986; Craswell et al., 1995; Ferguson et al., 2003; Basioudis and Francis, 2007; Mohd Kharuddin and Basioudis, 2018; Kharuddin et al., 2019), auditor opinion reporting (e.g. Lim and Tan, 2008; Reichelt and Wang, 2010; Kharuddin et al., 2021) and earnings management (e.g. Balsam et al., 2003; Choi et al., 2010; Kharuddin et al., 2021).

In reality, the internal corporate governance mechanism (e.g. the board of directors, an audit committee, internal audit) and external corporate governance mechanism (external auditing) do not operate independently but interact with each other (Sharma et al., 2011) to have an impact on the quality of the financial reporting outcome. Furthermore, the auditor's monitoring role varies depending on the strength of the company's corporate governance structure (Larcker and Richardson, 2004). This argument is supported by evidence from auditor choice studies that the auditor differentiation strategy (industry specialisation) is valued by the board of directors, audit committee and shareholders as signalling a higher quality audit, as they are more likely to choose high quality auditors, either based on their brand name reputation or industry specialisation (Abbott and Parker, 2000; Beasley and Petroni, 2001; Velury et al., 2003; Kane and Velury, 2004; Chen et al., 2005).
The agency theory framework associates corporate governance with the issue of ownership and control and maximisation of shareholders' wealth. The agency theory has the capacity to illustrate the drivers for earnings management as well as the expected relationship between corporate governance and external auditor monitoring mechanisms and earnings management.

Stewardship Theory

In contrast to agency theory, stewardship theory proposes that the interests of the company management and the shareholders are in alignment (Albrecht et al., 2004). Management is assumed to be trustworthy and that their interests are properly aligned with the organisation and its owners. Thus, opportunistic behaviour such as earnings management would be unlikely to happen and there is no need for monitoring cost to be incurred.

Under the stewardship theory, management and executive directors represent the best people to enhance shareholders' wealth given their familiarity with the business environment and expertise in business operational activities. Thus, the role of the board is more seen as a support tool for the trustworthy executive directors, particularly the CEO, rather than as a control tool over management undertakings (Albrecht et al., 2004). Nevertheless, the shareholders' assumption that management is trustworthy might also open doors of opportunities for management to commit fraud or other misrepresentations (Albrecht et al., 2004). This may be due to the lack of management experience of board members (Choo and Tan, 2007) and may give ample space for management to exercise their desires and pursue their self-serving endeavour, as there might be times where management may not find their interests coincide with the shareholders.

Clarke (2004) asserts that both agency theory and stewardship theory are important in explaining the behaviour of management, despite their opposing views (Muth and Donaldson, 1998). Ignoring the stewardship theory in the explanation of agency theory or one over the other does not sufficiently justify the cause of effect of board duality and performance. This is because management has to be controlled but at the same time enabled/empowered in order to perform effectively. Despite their contradiction, there are similarities between agency theory and stewardship theory in terms of motivation, identification, and use of power (Clark, 2004).

Institutional Theory

The institutional theory suggests that companies operate in an environment that pressures them to conform to certain rules and regulations to ensure their survival and legitimacy, as well as to allow access to the resources needed for their survival and sustainability (DiMaggio and Powell, 1983). Thus, companies shape themselves into appropriate structures following other companies in the same environment (Judge and Zeithaml, 1999), so as to avoid any disputes or investigations of their function by external parties (Meyer and Rowan, 1977). Such conformity and compliance to rules and regulations as well as the socially acceptable factors do not necessarily confirm that the company is indeed operating effectively in substance (Meyer and Rowan, 1977).

Under the institutional theory, corporate governance is viewed as a ritualistic role which the company needs to fulfil in order to legitimise its interactions with other players within the corporate governance mosaic (Cohen et al., 2007). In other words, the institutional theory suggests that board and management of companies tend to adopt best practices (such as the Code of Corporate Governance) and employ high quality auditors (e.g. Big 4 auditors and industry specialist auditors) in order to align the perception of their practices and characteristics with regulatory requirements and social expectations which, in turn, enhance their legitimacy. However, the adoption of such best practices does not necessarily mean that they are effectively functioning (Meyer and Rowan, 1977; Meyer and Scott, 1983), as it could simply be ceremonial in nature to mimic other successful companies in their environment or in order to avoid regulatory sanctions or political pressures (DiMaggio and Powell, 1983).

This mimicking process is known as isomorphism, which could be further classified into coercive isomorphism, mimetic isomorphism and normative isomorphism (DiMaggio and Powell, 1983). Coercive isomorphism refers to compliance to political pressure and regulatory requirements to enhance the legitimacy of the corporations. Mimetic isomorphism, on the other hand, is driven by internal motivation by the management from within the company itself (DiMaggio and Powell, 1983). For instance, the management decision to imitate another company's strategy that is foreseen to be successful and legitimised by society. In respect of financial reporting, mimetic isomorphism takes place when management decide to adopt the corporate governance structure or accounting practices of the successful or leading companies within their field, in order to become more competitive in the market. Over time, this will eventually lead to an increase in the overall compliance with the accounting standards and corporate governance best practices recommendations issued by the regulatory bodies. Finally, normative isomorphism is a mimicking process influenced by the professionalism of involved individuals, or the professionals working in the organisation. Professionalism here refers to the practices or actions advocated by the professional bodies to their members. For example, the chartered accountants and the auditors are respectively governed by their professional bodies which continuously push for increased compliance with listing rules, accounting and auditing standards as well as corporate governance best practices.

In other words, the institutional theory asserts that a company's corporate governance processes will turn out to be closely comparable over time (DiMaggio and Powell, 1983) through their compliance with regulation and mimicking rival best practices, in order to enhance their legitimacy (Cohen et al., 2007). Kalbers and Fogarty (1998, p.131) describe this ceremonial effort as a symbolic display of organisational structures to demonstrate their conformity and social accountability. Institutional theory is able to explain the reason why there is a gap between the symbolic display of the organisation and its actual accomplishment. Fogarty and Roger (2005) assert that institutional theory explains the gap between a firm's actual accomplishments and its external structure on display.
In short, this theory might provide an explanation of why the adoption of corporate governance best practices insignificantly affects a company's financial reporting quality.

Managerial Hegemony Theory
Managerial hegemony theory suggests that the board of directors plays a passive role in decision making within the company as they are dominated by management. Moreover, their internal position as top management gives managers the advantage of obtaining strategic and confidential information about the business, which might not come to the non-executive director's attention. Thus, the board would be dependent on the management for information and insights about the firm and its industry for decision making purposes (Wolfson, 1984). In other words, the board only plays a "rubber-stamp" function within the company (Herman, 1981).

Managerial hegemony theory and institutional theory are similar in that the role of the board of directors is more ceremonial in nature in order to meet regulatory requirements. This is in contrast to agency theory and stewardship theory where the board is a substantive and effective monitoring mechanism over the opportunistic actions of management. The board's functions, according to managerial hegemony theory, are limited to ratifying management's actions, satisfying regulatory requirements, and enhancing senior management compensation (Core et al., 1999). As found by Nowak and McCabe (2003), outside non-executive directors have the perception that the CEO has control over the flow of information which influences the decisions and effectiveness of directors. The adverse implication of managerial hegemony is that independent directors within the board and audit committee will be dysfunctional as they are under management influence and will be unlikely to question management actions (e.g. during disputes with the external auditor).

Criticisms of this theory primarily highlight the lack of empirical support (Stiles and Taylor, 2001). Furthermore, the board has become more empowered since the 1980's (Kiel and Nicholson, 2003) through the separation of CEO and Chairman roles within a company and the increased composition of independent non-executive directors on the board. Thus, the board is no longer under the definitive control of management as they have the power to terminate the CEO whenever the duty of trust is breached (Mizruchi, 1983).

In short, this theory explains the possible reason for an ineffective board or audit committee governance role in promoting high quality financial reporting.

Conclusion

The aim of this paper is to discuss the relevance of various theories used in academic research in explaining the role of corporate governance and auditors in promoting financial reporting quality. The theories discussed are the agency theory, stewardship theory, institutional theory, and managerial hegemony theory. These theories provide significant insights into the efficiency and effectiveness of corporate governance and audit functions from various perspectives. In conclusion, while agency theory focuses on conflicting interests between principals and agents, stewardship theory neglects the power of interest-based behaviour, which is important for explaining the motives of earnings management. However, there is a similarity between agency theory and stewardship theory where corporate governance is viewed as an effective monitoring mechanism to control management self-serving actions. Managerial hegemony theory, however, asserts that the board is dysfunctional and consistently supportive of management, and, hence, offers virtually no monitoring at all. To some extent, the managerial hegemony theory agrees with institutional theory in that the role of the board of directors is perceived only as ceremonial in nature. Nevertheless, the influence of agency theory in the literature has been instrumental in the development of corporate governance standards, principles, and codes.

Researchers often find that audit committee members interviewed about governance processes provide responses that are consistent with a mix of governance theories, as directors are balancing their monitoring roles under agency theory with other considerations, such as promoting legitimacy under institutional theory or being dominated by management under managerial hegemony theory. Thus, it is suggested that all these four theories are relevant and should be considered together in the explanation of the interrelation between corporate governance, audit and earnings quality.

In terms of implication and contribution, our paper would be of interest to academicians, practitioners, regulators, and policymakers in trying to understand how a company's internal corporate governance characteristics such as the board, audit committee, and internal audit function, as well as the external auditors, can contribute to better financial reporting quality. Our paper also contributes to the literature as this paper comprehensively provides a synthesis and a holistic view of how these four theories complement each other in explaining the role of corporate governance and audit in promoting financial reporting quality.

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