

**The Effects of Audit Committee Compensation, Fairness,
and Responsibility on the Resolution of Accounting Disagreements**

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ABSTRACT

This study examines the effects of audit committee compensation, perceived fairness, and responsibility on audit committee members' judgments in accounting disagreements. Fifty-six public company audit committee members completed a written case describing an accounting disagreement between management and the external auditor. Three types of audit committee compensation schemes were manipulated randomly between subjects (i.e., cash only, cash and short-term stock options, or cash and long-term stock options). The results indicate that audit committee members are more likely to support the auditor in an accounting disagreement when: (a) audit committee compensation includes long-term stock options, (b) members perceive that failure to record the auditor's adjustment is less fair to current shareholders, and (c) members perceive great task clarity for resolving the disagreement. In contrast, we find that audit committee members are less likely to support the auditor when they perceive more personal control over the outcome of the disagreement. Finally, we find that the relation between long-term compensation and support for the auditor is fully mediated by a sense of fairness to shareholders. We offer implications for practice and suggestions for future research.

Keywords: Audit committee, incentive compensation, fairness, responsibility

Data Availability: Contact the last author

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In the aftermath of high profile financial reporting scandals such as Enron, WorldCom, and Tyco, corporate governance has been a topic of increased emphasis both in practice and academic research (DeZoort et al. 2002; Cohen et al. 2004; Cohen et al. 2008; Beasley et al. 2009). Strengthening audit committee independence and financial expertise has been a goal in practice for some time (BRC 1999), and reforms to improve the effectiveness of the audit committee address both independence and financial expertise (Sarbanes-Oxley 2002). However, the effect of financial incentives on audit committee members' judgments has not been widely studied, despite questions about whether audit committee members should be paid with equity to align their interests with the long-term interests of shareholders (e.g., Barrier 2002).

The first objective of this study is to examine how incentive compensation affects audit committee member judgments in auditor-management accounting disagreements. Archambeault et al. (2008), for example, provide archival evidence of an association between audit committee stock option pay and accounting restatements and find that companies with accounting restatements compensate their audit committees more heavily with stock options than do similar "clean" companies. We complement such archival research by examining audit committee compensation effects using a controlled experimental approach that allows us to directly examine audit committee member judgments and the factors affecting their judgments (e.g., fairness, responsibility). Prior experimental research (e.g., Knapp 1987; DeZoort et al. 2003a, 2003b, 2008) provides evidence that audit committee members often support auditors in auditor-management disagreements, although a variety of factors affect the strength of this support. We use an agency framework to predict and test whether short-term and long-term incentive

compensation for audit committee members affects their support for auditors in accounting disagreements. When compared to a cash-only compensation plan, we expect short-term incentive compensation to reduce audit committee member support for the auditor (the short-term interests of audit committee members are aligned with management's desire for higher current profits). We also expect long-term incentive compensation to increase audit committee support for the auditor (the long-term incentives of audit committee members are aligned with those of shareholders).

Second, we assess the effects of outcome fairness on audit committee members' judgments in the varied compensation scenarios. Prior research suggests that managers' perceptions about outcome fairness mitigate their opportunistic behavior (Libby 2001). For example, individuals who are concerned with issues of outcome fairness are more likely to take into account the interests of other stakeholders and not just act in their own self-interest (Cohen et al. 2007). Thus, if audit committee members emphasize outcome fairness to shareholders when evaluating an auditor-management disagreement, they should provide stronger support for the auditor to ensure that the financial statements are presented fairly.

Third, we examine the relation between audit committee members' perceived responsibility for helping to resolve the disagreement and their support decisions. The extant literature (e.g., Schlenker 1997; DeZoort and Harrison 2009) highlights the potential for perceived responsibility and its formative components (i.e., task clarity, professional obligation, and personal control) to affect individual attitudes and behavior in challenging professional settings. For example, DeZoort and Harrison (2009) provide evidence of a link between auditors' perceived fraud detection responsibility and their brainstorming performance. Accordingly, we

evaluate how perceived responsibility for resolving the disagreement affects audit committee member support in an accounting disagreement.

We manipulate three types of audit committee member compensation schemes randomly between subjects. Specifically, participants were told that their audit committee member compensation either involves (1) a competitive cash retainer and per meeting fee only, (2) a cash retainer, per meeting fee, and short-term incentive compensation in the form stock options that vest in the current year, or (3) a cash retainer, per meeting fee, and long-term stock options that vest in five years. Additional independent variables measure the perceived outcome fairness of not supporting the auditor's position and perceived responsibility for resolving the disagreement. The dependent variable is the strength of audit committee member support for the auditor or management in the accounting disagreement. We also measure and control for audit committee members' financial and governance background in the analysis.

The results indicate that audit committee members are more likely to support the auditor in an accounting disagreement when (a) audit committee compensation includes long-term stock options, (b) members perceive that failure to record the auditor's adjustment is less fair to current shareholders, and (c) members perceive higher task clarity for resolving the disagreement. Conversely, audit committee members are less likely to support the auditor when they perceive more personal control over the outcome of the disagreement. Finally, we find that perceived outcome fairness for shareholders fully mediates the relation between long-term compensation and support for the auditor.

The study contributes to the audit committee effectiveness literature by evaluating compensation schemes that may affect members' independence and judgment quality – we provide experimental evidence that incentive compensation affects audit committee members'

judgments, while also considering important variables such as fairness and responsibility. Specifically, long-term audit committee compensation schemes may enhance the likelihood of audit committee members supporting the auditor in an auditor-management disagreement. If so, then long-term audit committee member compensation may enhance independence from management. Furthermore, although perceived fairness and responsibility have been studied extensively in the social psychology literature, these constructs have not been applied widely in governance and auditing contexts. These constructs have strong potential importance in governance settings where audit committee members have a responsibility to protect shareholders while balancing their own financial rewards and attempting to maintain a good working relationship with management. The results also highlight for external auditors the potential for audit committee member compensation to affect audit committee judgments and support in auditor-management disagreements.

The next section provides background on the audit committee incentive compensation issue and develops our study's hypotheses. Subsequent sections present the method, results, and conclusions.

HYPOTHESIS DEVELOPMENT

Incentive Compensation Effects

Audit committee oversight of financial reporting is designed to promote the integrity of financial reports. The audit committee oversees the work of the external and internal auditors and considers the effectiveness of internal controls (NACD 2000; Beasley et al. 2009). Previous research has focused mainly on the independence, diligence, and expertise of the audit committee (see DeZoort et al. 2002; Cohen et al. 2004), with relatively little research examining

audit committee compensation. However, the literature is starting to provide some initial insights into audit committee (director) compensation and its relation to accounting outcomes.

For example, Sharma and Iselin (2006) use archival data to examine the relation between audit committee stock option compensation and accounting restatements. Using an indicator variable (stock options provided or not), they find no relation between stock option compensation to audit committee members and accounting restatements. However, they do not consider the magnitude or vesting period of the options. Cullinan et al. (2008) also use archival data and find that the negative link between director independence and revenue misstatements is undermined when directors are compensated with stock options. Archambeault et al. (2008) use archival data to examine the relation of short-term and long-term incentive compensation for audit committee members and accounting restatements. They find that both short-term and long-term stock options for audit committee members are positively related to accounting restatements. However, as discussed below, their findings regarding long-term options are subject to some limitations and were contrary to their prediction.

The research literature also includes one experimental study of audit committee compensation effects. Persellin (2009) uses EMBA student subjects as proxies for audit committee members to examine the effect of audit committee compensation type (cash only versus cash and stock options vesting in one week) on audit committee support in an auditor-management accounting disagreement. She finds that the participants provide less support for the auditor when they are compensated with stock options that vest in one week. However, the study does not consider the effect of long-term stock options, and the design does not consider other behavioral variables, such as fairness or responsibility, that may influence participants' decisions.

Incentive compensation often is used to align managers' or directors' interests with those of shareholders, the owners of the corporation. We use an agency framework (e.g., Jensen and Meckling 1976; Fama 1980; Fama and Jensen 1983) as a basis for expecting audit committee members compensated with long-term stock options to have greater incentive to promote the long-term interests of shareholders and to make judgments that constrain management's opportunistic reporting behavior. Based on an agency framework, long-term incentive compensation for audit committee members should align their incentives with those of long-term shareholders, rather than aligning them with the short-term concerns of management.

Archambeault et al. (2008) also used an agency framework to predict that accounting restatements would be less common when audit committee members were provided long-term equity compensation. However, their results somewhat surprisingly contradicted prediction and revealed that long-term stock option compensation was positively related to restatements. However, given the low mean dollar amount of long-term stock options in their study, the authors questioned whether small long-term incentives are strong enough to promote vigilant oversight by audit committee members. Our focus in the present study is on the effects of long-term stock option compensation for audit committee members that represents a substantial portion of their overall compensation. Accordingly, consistent with agency theory, we expect audit committee members receiving long-term options to be more supportive of the auditor in an accounting disagreement where the auditor favors a more conservative, income-decreasing position:

H1: Audit committee members who receive long-term stock option compensation will provide *more* support for the auditor in an auditor-management accounting disagreement than members who receive only cash compensation.¹

¹ In H1 and H2, we use the cash-only condition as the baseline treatment, as this condition involves no incentive compensation at all. In a cash-only setting, the audit committee member is paid the same regardless of the future stock performance of the company.

Archambeault et al. (2008) find that accounting restatements are more likely when audit committee member compensation includes a larger percentage of short-term stock options, and Persellin (2009) finds that very short-term stock options (vesting in one week, versus in one year in the present study) are associated with greater support for management in an accounting disagreement. Short-term incentive compensation for audit committee members has the potential to align members' interests with managements' short-term (opportunistic) reporting interests rather than with the long-term interests of shareholders. For example, audit committee members receiving short-term stock options have increased incentive to allow management greater latitude to manage income to improve reported results and short-term compensation. Extending this logic to audit committee member support for the auditor versus management in an accounting disagreement, we predict that audit committee members compensated with short-term stock options will be less likely to support the auditor because the audit committee's interests are more aligned with management's desire for higher current profits. Stated formally:

H2: Audit committee members who receive short-term stock option compensation will provide *less* support for the auditor in an auditor-management accounting disagreement than members who receive only cash compensation.²

Fairness Effects

Fairness has been the focus of significant theoretical work in economics (see Fehr and Schmidt (1999) for a review) and management accounting (Luft 1997), but the extant literature lacks research on the role of fairness in a financial reporting context. Fehr and Schmidt (1999) define concern for fairness as an aversion to inequity. The literature in economics (e.g., Kahneman et al. 1986; Rabin 1993; Piron and Fernandez 1995) suggests that individuals who

² Given H1 and H2, we expect that audit committee members who receive long-term stock option compensation will provide *more* support for the auditor in an auditor-management accounting disagreement than members who receive short-term stock option compensation. We test this in the Results section.

perceive that a self-interested action is unfair may undertake behavior that is less self-interested and more in the common good. In the management accounting literature, Libby (2001) and Evans et al. (2001) find that concern for fairness influences budget decisions. Cohen and Holder-Webb (2006) note that fairness has been an understudied component to agency-based research. In a recent study on project allocation judgments, Cohen et al. (2007) find that individuals who placed a high value on fairness are less likely to engage in unethical behavior even under conditions of high information asymmetry and significant potential for rewards. These results suggest that the importance placed on fairness at times attenuates agency theory predictions. Similar to Cohen et al. (2007), we focus on the perceived outcome fairness of a possible decision (Wentzel 2002). To our knowledge, no one has examined the role that fairness plays in influencing the judgments of audit committee members. Whether audit committee members are strictly influenced by agency theory expectations or they are also influenced by the importance placed on fairness is an unexamined question. We predict that audit committee member support for a proposed audit adjustment in disagreement will be related to the perceived fairness for shareholders of making the adjustment. Those members who believe that failure to record the adjustment is relatively unfair to shareholders are expected to indicate more support for the auditor. Stated formally:

H3: Audit committee members who perceive that not making the auditor's proposed adjustment is unfair to shareholders will be more likely to favor the auditor in the auditor-management accounting disagreement.

Responsibility Effects

We also evaluate the effects of audit committee members' perceived responsibility for resolving the auditor-management disagreement on their support decisions. Schlenker (1997, 241) describes responsibility as "the psychological glue that connects an individual to a set of

prescriptions for conduct and to an event that is governed by those prescriptions.” Specifically, the triangle model of responsibility (Schlenker et al. 1994; Schlenker 1997) suggests that an individual’s sense of responsibility in a given setting is a function of the strength of the psychological links among three formative elements: (1) event (e.g., the situation in question), (2) prescription (i.e., the guidance available to manage individual conduct in a specific situation), and (3) identity (i.e., the individual’s roles, qualities, convictions, and aspirations). Perceived responsibility in this context depends on the extent to which clear prescriptions are linked to the event (*task clarity* link), an individual feels bound by the prescriptions given his/her position (*professional obligation* link), and the individual feels able to affect the event (*personal control* link).

The extant literature in psychology and accounting (e.g., Schlenker et al. 1994; DeZoort and Harrison 2009) highlights the importance of considering the extent to which perceived responsibility affects individual judgment and decision-making in challenging tasks. For example, DeZoort and Harrison (2009) use the triangle model of responsibility and find that auditors’ perceived responsibility for fraud detection mediates the relation between accountability and fraud-related brainstorming performance. We examine the extent to which perceived responsibility and the triangle model of responsibility’s formative links affect audit committee member support in the disagreement. Specifically, responsibility, task clarity, professional obligation, and personal control have the potential to affect audit committee member support for the auditor in the auditor-management disagreement. Accordingly, we pose the following research question:

RQ1: To what extent will audit committee members’ perceived responsibility, task clarity, professional obligation, and personal control affect audit committee member support for the auditor in an auditor-management accounting disagreement?

METHOD

We randomly assigned the audit committee member participants to three compensation conditions between subjects. The annual audit committee compensation was \$100,000 in all cases. According to the *2007-2008 NACD Director Compensation Report* (NACD 2008), median total director compensation for companies with \$500 million to \$1 billion in revenues is \$114,000. We chose \$100,000 for the case to be reasonable in comparison to market conditions. The hypothetical company in the case has revenues of \$650 million. The audit committee member participants were told that their compensation was 100 percent cash (cash condition), 20 percent cash and 80 percent short-term stock options vesting this year (short-term compensation condition), or 20 percent cash and 80 percent long-term stock options vesting in five years (long-term compensation condition).³

We recognize the limitation that the participants' actual audit committee compensation (see the Demographics section below for evidence of heavy concentration of cash, followed by restricted stock) typically is not similar to our LTCOMP and STCOMP conditions, where 80 percent of the compensation is in stock options. However, our purpose is to examine the effects of audit committee incentive compensation, and it is important for the manipulation to be extreme enough to reveal an effect, if one exists. See Archambeault et al. (2008) for discussion of the possible lack of incentive created by small stock option grants to audit committee members. In addition, we encourage future research to investigate the effects of restricted stock holdings by audit committee members.

³ Across all experimental conditions in the hypothetical case, management's compensation mix is 20 percent salary, 30 percent performance-based bonus, and 50 percent long-term incentive pay. Mercer (2007) reports that the average CEO compensation mix in large U.S. public companies for 2006 is 16 percent salary, 26 percent bonus, and 58 percent long-term incentive, consistent with the percentages in our case.

Instrument

The appendix provides the company background and disagreement description the participants reviewed in the study. Portions of the case, including the financial statement amounts were patterned after earlier research (Libby and Kinney 2000; DeZoort et al. 2003a; Cohen et al. 2007; DeZoort et al. 2008). After receiving company, industry, and audit committee background information, the participants received one of the three audit committee compensation descriptions – cash, short-term compensation (STCOMP = 1), or long-term compensation (LTCOMP = 1).

Following the audit committee compensation information, participants were provided with a financial reporting summary and with the current year's pre-audit balances for key items, such as sales, assets, net earnings, and EPS. Participants then were told that the external auditor proposes an audit adjustment to management's estimate of the inventory obsolescence allowance. The proposed adjustment related to two specialized products that now face intense competition from new products being released by competitors. After describing the products, the participants received the auditor's basis for proposing the adjustment and management's argument against making the adjustment (five arguments on each side of the issue). Next, the participants were told that the auditor believes the current allowance overstates current EPS by \$0.03. This proposed adjustment amount is less than three percent of earnings, one percent of inventory, and 0.3 percent of total assets. The adjustment would reduce current EPS (\$1.20 per share pre-audit) to \$1.17, a level below the financial analysts' forecast of \$1.19 per share.

After receiving the case details, we asked participants to indicate their support for the auditor or management in the accounting disagreement (SUPPORT) using a 0-100 scale where 0 = favor management (no adjustment) and 100 = favor auditor (record adjustment). Next, we

asked the participants to explain the primary factors underlying their support decision. We also asked about the EPS amount that should be reported (EPSSHOULD, range from \$1.17 to \$1.20), as well as the EPS amount that other audit committee members would recommend (EPSOTHER, range from \$1.17 to \$1.20).

Perceived fairness (FAIRNESS) was measured by the response to the question, “If the auditor’s proposed adjustment is not made, how do you judge the fairness of the outcome for current Dynamic shareholders?” The scale was anchored by -50 = “Very Unfair” and +50 = “Very Fair”. Although in the prior literature fairness has been used to refer to either process or outcomes (Libby 2001), in this study we follow Cohen et al. (2007) and focus specifically on the dimension of outcome fairness.

We then asked a series of questions to assess the participants’ perceived responsibility for resolving the disagreement. The link questions were adapted in first person format from Schlenker et al. (1994) and randomized in order. After asking about overall responsibility, two questions each addressed the prescription-event link (CLARITY, range from 0-200), prescription-identity link (OBLIGATION, range from 0-200), and identity-event link (CONTROL, range from 0-200).

We asked a manipulation check question to assess whether the participants understood the compensation condition. The remainder of the instrument asked the participants to provide their perceptions of the case and to provide demographic information and financial and governance experience information. Several of these items are included in the model below as control variables.

Model and Control Variables

Based on the discussion above, we use the following OLS regression model to test our hypotheses and address our research question:

$$\begin{aligned} SUPPORT = & b_0 + b_1LTCOMP + b_2STCOMP + b_3FAIRNESS + b_4CLARITY + \\ & b_5OBLIGATION + b_6CONTROL + b_7EXPDISAG + b_8EXPACM + b_9EXPEA + \\ & b_{10}MASTERS + b_{11}JD + b_{12}PHD + e_i \end{aligned}$$

In addition to the dependent variable and test variables described above, we include six control variables in the model.⁴ EXPDISAG is dummy variable indicating whether the participants have encountered a disagreement like this one in their experience as audit committee members. We do not have an expected sign for this variable. EXPACM measures the number of audit committees the participants have served in their careers. We do not have an expected sign for this variable.⁵ EXPEA is a dummy variable indicating whether the participants have experience working as external auditors. We expect participants with experience as external auditors to be more likely to identify with and favor the auditor. Finally, we include three variables to capture whether the participants have advanced educational degrees (MASTERS, JD, and PHD). We do not have expected signs for these variables.

⁴ Previous research (e.g., DeZoort et al. 2003a, 2003b; DeZoort and Salterio 2001) has used a variety of control variables, sometimes with inconsistent results. Specifically, DeZoort et al. (2003a) find CPAs to be less supportive of the auditor, while DeZoort et al. (2003b) find the opposite. Our evaluation of control variables in the present study is admittedly exploratory, given the limited basis provided by earlier research.

⁵ Both DeZoort et al. (2003b) and DeZoort and Salterio (2001) find audit committee experience (current number of boards or audit committees served) to be positively related to support for the auditor. However, Beasley et al. (2009) indicate that audit committee members appointed post-SOX tend to be more conservative. Thus, it is unclear how audit committee experience will relate to support for the auditor in the present study.

Participants

Sixty-seven audit committee members participated in the study. We solicited audit committee participants in two ways.⁶ First, we used *Audit Analytics* to identify all audit committee members who were appointed from 1/1/05 – 12/31/05 to serve companies with revenues greater than \$0, but less than \$2 billion. We used the time period of 2005 to ensure that the audit committee members had been serving for at least two or three years by the time of our first mailing in early 2008, even if they did not serve on any other audit committees (and many serve on multiple audit committees). The size range of up to \$2 billion in revenues is designed to be reasonably consistent with the hypothetical company in the case, which has revenues of \$650 million. Using this approach, we identified 757 target audit committee members to whom we mailed the case materials (given the information available, the materials were mailed to the company's address, not to the board member's home address, which may have reduced the response rate), following the Dillman (2000) approach (e.g., personalized letters, hand stamped return envelopes, etc.). From this group, we received 31 responses to the first mailing and 20 responses to the second mailing, for a total of 51 participants, a response rate of 8 percent after considering 90 invalid addresses or contacts who were no longer in our target group (e.g., no longer serving on a public company audit committee). While this response rate is lower than in audit committee studies sponsored by large accounting firms (e.g., DeZoort et al. (2003a, 2008) had response rates of 28 percent and 19 percent, respectively), it is consistent with some other studies targeting high-level participants (e.g., Beasley et al. (2005) had a 10 percent response

⁶ We attempted to secure a prominent sponsor for the study (e.g., a large accounting firm or professional organization) to help access audit committee members and to write a cover letter encouraging participation in the study. We approached two organizations that both indicated strong interest in the study and results. However, the organizations also indicated that the proposed study was simply too controversial for them to sponsor (specifically, the focus on audit committee compensation was perceived to be too controversial). Accordingly, we proceeded without a sponsor.

from chief internal auditors). Second, we supplemented the *Audit Analytics* data with a convenience sample of 16 audit committee members obtained through professional contacts, including contacts of our respective deans.⁷

RESULTS

Manipulation Check

We used one multiple-choice question to evaluate the effectiveness of the audit committee member compensation manipulation. Specifically, we asked the 67 participants to indicate whether their pay in the case was cash only, cash and short-term stock options, or cash and long-term stock options. After excluding the eight participants who failed the manipulation check, as well as three participants with incomplete case responses, 56 participants are left for the remainder of the analysis.⁸

Participants' Perceptions of the Case

The participants found the case to be understandable (mean of UNDERSTANDABLE = 79.56, SD = 15.73 on a 0-100 scale anchored “not at all understandable” and “very understandable”) and realistic (mean of REALISTIC = 63.29, SD = 23.68 on a 0-100 scale anchored “not at all realistic” and “very realistic”). In addition, the participants indicated that they would find the disagreement challenging if they faced it in practice (mean of CHALLENGING = 60.00, SD = 24.96 on a 0-100 scale anchored “not at all challenging” and “very challenging”). The means of UNDERSTANDABLE, REALISTIC, and CHALLENGING all differ significantly from the scale midpoint of 50 ($p < 0.01$). One-way ANOVAs indicate no

⁷ Supplemental analysis revealed no evidence of early/late response differences or differences based on using *Audit Analytics* versus the convenience sample.

⁸ The study's primary results are qualitatively similar when we include participants who failed the manipulation check question ($n = 63$ due to missing data).

significant differences in UNDERSTANDABLE, REALISTIC, or CHALLENGING across the three compensation groups ($p > 0.40$ in all cases).

The participants found the total amount of audit committee member compensation (\$100,000) to be reasonable in the case. On a 101-point scale labeled “far too low” (-50), “about right” (0), and “far too high” (+50), the overall mean of 6.39 suggests the participants found the overall compensation amount reasonable in the case.

Demographics

Table 1 presents demographic information for the 56 participants. Most participants are male (96 percent) and educated beyond a Bachelors degree (63 percent). Approximately half of the participants are CPAs (52 percent), have external audit experience (46 percent), or have seen a similar auditor-management disagreement in practice (50 percent). A majority of the participants (80 percent) are considered audit committee financial experts and should be well equipped to deal with the accounting disagreement, and they represent audit committees of companies of various sizes.

[Insert Table 1 here]

As shown at the bottom of Table 1, the participants average 62 years of age, and they have fairly extensive audit committee experience – with means of 1.71 public company audit committees currently served, 3.04 public company audit committees served in their career, and 7.70 years of public company audit committee experience. Finally, the participants’ actual compensation for audit committee service (on the largest company served) is weighted most heavily toward cash (mean of 65 percent) and restricted stock (mean of 16 percent).

Descriptive Statistics

Table 2 presents descriptive statistics for the dependent variable and the test variables. Overall, the participants are neutral in terms of supporting management versus the auditor in the accounting disagreement (mean of SUPPORT = 50.43 on a scale from 0 = favor management (no adjustment) to 100 = favor the auditor (record adjustment)). The mean of SUPPORT is higher for participants in the LTCOMP condition (mean = 62.06) than for the other conditions combined ($p < 0.05$).

[Insert Table 2 here]

Overall, the participants view the fairness of not recording the adjustment as fairly neutral (mean = 9.38 on a scale from -50 = very unfair to +50 = very fair). The failure to record the adjustment is viewed as less fair by participants in the LTCOMP condition (mean of -2.94) than in the other two conditions combined ($p < 0.05$).

The means for CLARITY, OBLIGATION, and CONTROL range from 138 to 154 (on scales with a maximum value of 200), suggesting that the participants perceive moderately high levels of clarity, obligation, and control. The responsibility link ratings do not vary by experimental condition.

Correlations

Table 3 presents a correlation matrix for the dependent variable and test variables. SUPPORT and FAIRNESS are highly correlated ($r = -0.719$), indicating that participants are more likely to favor the auditor if they view the failure to record the adjustment as less fair. Within the responsibility links, CLARITY and CONTROL ($r = 0.500$) and OBLIGATION and CONTROL ($r = 0.464$) are positively related. The highest VIF is 2.04, indicating that multicollinearity is not an issue.

[Insert Table 3 here]

Regression Results

The regression results are presented in Table 4. The overall model is highly significant ($F = 9.31, p < 0.001$), and the adjusted R^2 is 64.45 percent.⁹ Consistent with H1, the coefficient on LTCOMP is positive and significant ($p = 0.035$). Participants in the long-term compensation condition are more likely to favor the auditor than are participants in the cash condition (in the intercept). We find no support for H2 regarding STCOMP, as the coefficient is not significant ($p = 0.183$ two-tailed, as the coefficient is not in the expected direction). There is no evidence of a difference in SUPPORT between the cash condition and the short-term compensation condition.¹⁰ The significant negative coefficient for FAIRNESS ($p < 0.001$) is consistent with H3. Participants are more likely to favor the auditor if they view the failure to record the adjustment as less fair to shareholders.¹¹

[Insert Table 4 here]

In terms of RQ1, CLARITY has a positive coefficient ($p = 0.002$), indicating that participants are more likely to favor the auditor when they have a clear sense of how to resolve the disagreement. Conversely, the significant negative coefficient for CONTROL ($p = 0.051$) indicates that participants perceiving greater control are more likely to favor management's less conservative accounting treatment and are less likely to support the auditor.¹² It is possible that

⁹ The Breusch-Pagan/Cook-Weisberg test provides no evidence of heteroskedasticity, and using robust standard errors produces similar results.

¹⁰ H1 and H2 would imply that the coefficient on LTCOMP (expected to be positive) should be greater than the coefficient on STCOMP (expected to be negative). However, the coefficients on LTCOMP and STCOMP are not significantly different ($F = 0.30, p = 0.588$). The results for STCOMP are not as expected.

¹¹ Our FAIRNESS measure captures fairness to current shareholders. We also asked the participants about fairness to prospective shareholders. The two fairness measures are very highly correlated ($r = 0.93$). If we replace the current FAIRNESS variable with fairness to prospective shareholders, this alternative fairness variable also is negative and significant ($p < 0.001$). However, with this alternate fairness variable in the model, CONTROL and EXPEA are no longer significant ($p > 0.10$).

¹² CONTROL is not significantly correlated with the experience measures – EXPDISAG, EXPACM, or EXPEA.

participants perceiving less control over resolving the disagreement rely on the auditor more given that their lack of control may make them feel vulnerable.¹³

The results also show that that several demographic and background variables are significantly related to SUPPORT.¹⁴ First, the results for EXPDISAG indicate that participants with prior experience with this type of disagreement are more likely to support the auditor ($p = 0.041$). Such participants possess relevant domain expertise (Bedard and Biggs 1991) and may be more assertive in identifying such disagreements. They also may have an appreciation of the importance of resolving the disagreement in a conservative manner.

Second, experience as an audit committee member (EXPACM, equal to the number of audit committees ever served) is negatively related to SUPPORT ($p = 0.004$).¹⁵ One possible explanation for this result is that in the post-SOX period, a number of companies sought to add financial experts to their audit committees, and audit committee members joining boards post-SOX appear to be more conservative on some dimensions (Beasley et al. 2009). Thus, the participants with more audit committee experience are likely to be individuals who have served on audit committees since the pre-SOX period, and thus may be less conservative members.

Third, as expected, participants with prior experience as external auditors (EXPEA) are more likely to support the auditor ($p = 0.085$). Finally, in terms of educational level effects, we find that participants with a JD are more likely to support the auditor ($p = 0.012$). It is possible

¹³ In RQ1, we also question whether overall responsibility is related to SUPPORT. If we replace the three responsibility link variables (CLARITY, OBLIGATION, and CONTROL) with a single overall measure of responsibility (RESPONSIBILITY, measured on a scale from 0 = no responsibility to 100 = total responsibility for resolving the disagreement), RESPONSIBILITY is not significantly related to SUPPORT. This result is not surprising given the different signs for CLARITY and CONTROL above. Given the insignificant result, we do not tabulate the RESPONSIBILITY analysis.

¹⁴ In addition, we find that when UNDERSTANDABLE is added to the model, it is positive and significant ($p = 0.028$). Participants finding the case more understandable are more likely to support the auditor. With UNDERSTANDABLE in the model, the other results are similar, except that LTCOMP has $p = 0.097$ and EXPEA is not significant. Also, when CHALLENGING is added to the model, it is negative and significant ($p = 0.029$). Participants finding the case more challenging are less likely to support the auditor. With CHALLENGING in the model, the other results are similar. Finally, REALISTIC is not significant when added to the model.

¹⁵ The results for this variable are similar if we use a natural log transformation ($p = 0.012$).

that such participants have a strong appreciation for the potential legal and reputational risks of audit committee service, and thus are more likely to support the auditor (also see DeZoort et al. (2008) for discussion of legal liability changes post-SOX).¹⁶

Interactions

We find two significant interactions that are presented in Table 5.¹⁷ In Panel A, the CLARITY*LTCOMP interaction ($p = 0.01$) indicates that support for the auditor is particularly high (mean of SUPPORT = 69.30) when the participant has strong clarity about how to resolve the disagreement and there is long-term compensation. In such cases, the participant may feel well qualified to resolve the disagreement, and the person's compensation promotes long-term shareholder protection.

[Insert Table 5 here]

In Panel B, the CLARITY*FAIRNESS interaction ($p = 0.02$) indicates that support for the auditor is particularly high (mean of SUPPORT = 76.86) when the participant has strong clarity about how to resolve the disagreement and the participant views the failure to record the adjustment as less fair to shareholders. In such cases, the participant may feel well qualified to resolve the disagreement, and the person is swayed by a sense of injustice if the adjustment is not recorded.

SUPPORT Justifications

We asked the participants to provide justifications for their SUPPORT decision to better understand why they supported management or the auditor in the disagreement. Two researchers

¹⁶ A number of other variables are not significantly related to support ($p > 0.10$): management's perceived influence over the outcome, perceived appropriateness of the compensation level (\$100,000) in the case, perceived optimal audit committee compensation mix for public companies similar to this one, assessed realism of the case, age, gender, number of audit committees currently served, years of audit committee experience (or its natural log), CPA status, audit committee financial expert status, size (revenues) of largest public company served as an audit committee member, and actual mix of audit committee compensation on largest public company currently served.

¹⁷ We also find that one of the control variables, JD, significantly interacts with LTCOMP, CLARITY, and OBLIGATION.

independently reviewed the justifications and came up with seven categories to code for management and the auditors. The four management support categories are “management expertise” (e.g., “management including CEO, CFO, operating management and controller should understand business better than auditor”), “valuation” (e.g., “auditor’s number is also an estimate – not necessarily better than management”), “operating reasons” (e.g., “one year’s inventory does not seem excessive in this industry”), and “other” (e.g., “I would want the audit committee to review the results of each quarter next year”). The three auditor support categories are “conservatism” (e.g., “management objectivity tainted possibly by Wall Street expectations”), “quantity of inventory” (e.g., “company likely has way too much inventory relative to sales, indicating disappointing sales-to-date”), and “new competing products” (e.g., “new competition coming soon”).

The two researchers independently coded the justifications and had over a 95 percent degree of convergence with all differences successfully reconciled after discussions between the two coders. For audit committee members in support of management, the results in Table 6 indicate that the most common justification was management expertise, followed by valuation and operating reasons. The most common justification for audit committee members in support of the auditor was conservatism, followed by quantity of inventory. These results suggest that participants who supported management’s position perceived that management had more knowledge about the salability of their products, while participants who favored the auditors focused on the auditors being more conservative and objective in their advocacy of a write-down.

[Insert Table 6 here]

Between-group comparisons reveal that management expertise was clearly the dominant justification for audit committee members supporting management in the long-term incentive compensation group. However, participants supporting management in the short-term incentive and cash compensation schemes provided equal use of the expertise, valuation, and operating justifications. For audit committee members supporting the auditor, the conservatism justification was consistently prominent across the three compensation schemes, with participants in the short-term group also showing some concern about the quantity of inventory. Collectively, participants in the long-term compensation group focused almost exclusively on auditor conservatism or management expertise, while participants in the other two compensation groups provided more varied justifications.

Mediation Test Results

Given the strength of the long-term incentive compensation and fairness effects on audit committee member support, we evaluate the extent to which FAIRNESS mediates the relation between LTCOMP and SUPPORT. Similar to other accounting studies (e.g., Jackson and Hatfield 2005; Holt and DeZoort 2009), we use Baron and Kenny's (1986) three-step regression approach to test for mediation. Specifically, we estimate the following three equations:

$$\text{MEDIATOR}_i = \alpha_0 + \alpha_1 \text{IV}_i + e_i \quad (1)$$

$$\text{DV}_i = \beta_0 + \beta_1 \text{IV}_i + e_i \quad (2)$$

$$\text{DV}_i = \delta_0 + \delta_1 \text{IV}_i + \delta_2 \text{MEDIATOR}_i + e_i \quad (3)$$

The first step in establishing mediation is to have a significant relation between the independent variable (IV) and the mediator variable in equation (1). Second, the IV must significantly affect the dependent variable (DV) in equation (2). Third, the mediator must be significantly related to the dependent variable in equation (3), while the relation between the

independent variable and the dependent variable must be weaker in equation (3) than in equation (2).

The results in Panels A and B of Table 7 provide evidence that FAIRNESS fully mediates the relation between LTCOMP and SUPPORT. The equation (1) results indicate a significant relation between LTCOMP and FAIRNESS ($p = 0.02$). The equation (2) results show that LTCOMP is significantly related to SUPPORT ($p = 0.02$). Finally, the equation (3) results reveal a significant relation between FAIRNESS and SUPPORT ($p < 0.001$) and an insignificant relation between LTCOMP and SUPPORT ($p = 0.47$) that is weaker than in equation (2). The Sobel test statistic (Baron and Kenny 1986) provides evidence of significant mediation ($Z = 2.19$; $p = 0.01$).¹⁸ These results suggest that long-term incentive compensation affects audit committee members' fairness judgments, which in turn affect audit committee members' ultimate support for the auditor or management in the accounting disagreement.

[Insert Table 7 here]

Other Dependent Variables

In addition to asking the participants about their support for management or the auditor, we also asked them (a) EPSSHOULD – what EPS amount they believed the company should report, with a range from \$1.17 (make entire adjustment) to \$1.20 (make no adjustment), and (b) EPSOTHER – what EPS amount other audit committee members would say the company should report, using the same scale. For each question, the participants used a four-point scale (\$1.17, \$1.18, \$1.19, and \$1.20), thus making it more difficult to detect differences.

If we replace SUPPORT with EPSSHOULD and rerun the model in Table 4, we find significant coefficients for CLARITY ($p = 0.001$), FAIRNESS ($p < 0.001$), EXPACM ($p = 0.085$), EXPEA ($p = 0.087$), and JD ($p = 0.085$). The model's adjusted R^2 is 68.02 percent. If we

¹⁸ The results provide no evidence of mediation for the triangle model of responsibility links.

replace SUPPORT with EPSOTHER, we find significant coefficients for CLARITY ($p = 0.083$), FAIRNESS ($p < 0.001$), and JD ($p = 0.060$). The model's adjusted R^2 is 38.88 percent.

Finally, to control for a potential social desirability response bias (Cohen et al. 1998), we examine the difference between EPSSHOULD and EPSOTHER. Only 10 respondents reported a difference in the two questions, with seven respondents stating that they would support a lower EPS number than others and three stating that they would support a higher EPS figure than others. Overall, these results suggest that our results are not driven by a social desirability response bias.¹⁹

CONCLUSION

This study examines the effects of audit committee compensation, outcome fairness, and responsibility on audit committee members' judgments in accounting disagreements. We find that audit committee members are more likely to support the auditor in an accounting disagreement when (a) audit committee compensation includes long-term stock options, (b) members perceive that failure to record the auditor's adjustment is less fair, and (c) members perceive great clarity for resolving the disagreement. Audit committee members are less likely to support the auditor when they perceive more personal control over the outcome of the disagreement. Finally, we find that the relation between long-term compensation and support for the auditor is fully mediated by the audit committee members' sense of fairness to shareholders.

This study has a number of implications for practice, policy, and research. The findings highlight that audit committee compensation structure has the potential to affect audit committee member decisions and the quality of the financial reporting process. To the extent that the audit committee is a critical governance mechanism responsible for overseeing financial reporting and

¹⁹ We attempted to analyze regression results with EPSDIFF (= EPSSHOULD – EPSOTHER) as the dependent variable, but the overall model was not significant.

protecting shareholder interests, it may be important to emphasize long-term compensation for audit committee members. While further research is needed, long-term audit committee compensation may serve to enhance audit committee members' independence from management. Further, when selecting members to the audit committee, the results suggest the need for the nominating committee to pursue individuals who place great emphasis on issues of fairness to shareholders. Beyond such initial screening, one way to improve the quality of the financial reporting process could be to educate audit committee members to explicitly consider the outcome fairness of the financial statement presentation especially in matters that involve ambiguous accounting issues. In addition, the finding that audit committee members who perceived a greater sense of task clarity are more likely to act in the shareholders' interests suggests that as audit committee members increasingly over time perceive their role as substantive as opposed to ceremonial (Beasley et al. 2009) they will be more likely to be effective allies to the auditor in maintaining the integrity of the financial reporting process.

The results also highlight for external auditors and audit committee members the potential for audit committee member compensation to affect audit committee judgments and support in auditor-management disagreements. Just as external auditors should understand management's incentive compensation plan, auditors also should understand how audit committee members are compensated. Audit committee members also need to understand the potential for self-serving or unconscious bias in their own decisions (see Taylor et al. 2003). Finally, based on our results, it may be advantageous to have some audit committee members with a legal background so that the legal consequences of committee decisions are fully understood.

We highlight several limitations that affect interpretation of the results and represent opportunities for future research. For example, we only focus on one component of fairness (i.e., the perceived fairness of an outcome). We recognize that fairness has multiple components that include process elements in addition to outcome fairness (Welbourne et al. 1995). To understand the effect of fairness more thoroughly, a future study should look at which specific component(s) of fairness best explain an audit committee member's decision to support or oppose auditors in negotiations with management.

Second, we employ an experimental design to elicit the responses. A future study can employ qualitative methods such as an interview approach or information process tracing to probe deeper in to the thought processes that guide audit committee members' decision-making process (Beasley et al. 2009). Third, we use an agency theory perspective to guide our predictions. Future research could use institutional theory to explore whether audit committee members are socialized over time in the manner that they approach accounting disagreements between the auditor and management (Cohen et al. 2008). Our results for audit committee member experience provide only initial insights into this issue.

Finally, we examine decisions made on an individual level. Future research should examine how the group dynamics of audit committees affect their willingness to side with the auditor over management in an accounting disagreement. Future research also can use different disagreement scenarios, compensation types and amounts, participant groups, and independent variables (e.g., perceived litigation risk).

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TABLE 1
Demographics
(n = 56)

Gender	Female	<u>%</u>	
	Male	4	
Highest Education	Bachelors	96	
	Masters	37	
	JD	43	
	Ph.D./DBA	11	
CPA?	Yes	9	
External Audit Experience?	Yes	52	
Experience with Similar Disagreement in Practice?	Yes	46	
AC Financial Expert?	Yes	50	
Annual Revenue of Largest Company Served	< \$250 million	80	
	\$250-\$500 million	27	
	\$501 million - \$1 billion	18	
	> \$1 billion	31	
		24	
		<u>Mean</u>	<u>s.d.</u>
Age		62.20	8.48
Public Company AC Experience	Current # ACs served	1.71	0.78
	Total # ACs served	3.04	2.57
	Total years as AC member	7.70	6.02
AC Compensation from Largest Company Served	Cash retainer & meeting fees (%)	64.59	25.86
	Stock options (vest < 1yr) (%)	4.55	13.05
	Stock options (vest > 1yr) (%)	8.21	15.71
	Stock grants (%)	1.34	5.76
	Restricted stock grants (%)	15.86	21.74
	Other (%)	1.70	7.64

TABLE 2
Descriptive Statistics

<i>AC COMPENSATION</i>				
	CASH (n = 19)	STCOMP (n = 19)	LTCOMP (n = 18)	TOTAL (n = 56)
	Mean (s.d.)	Mean (s.d.)	Mean (s.d.)	Mean (s.d.)
SUPPORT	43.16 (30.26)	46.68 (27.52)	62.06 ^a (26.23)	50.43 (28.77)
FAIRNESS	12.16 (30.72)	18.26 (26.83)	-2.94 ^a (25.19)	9.38 (28.64)
CLARITY	139.84 (34.30)	140.05 (24.43)	135.00 (43.35)	138.36 (34.15)
OBLIGATION	158.00 (44.11)	150.63 (39.68)	152.17 (41.84)	153.63 (41.27)
CONTROL	153.16 (30.41)	146.95 (27.61)	152.94 (26.18)	150.98 (27.79)

^a One-way ANOVAs suggest significant differences across groups for SUPPORT ($p = 0.105$) and FAIRNESS ($p = 0.067$). Further testing of SUPPORT and FAIRNESS reveals that the mean of the LTCOMP group is significantly different from mean of other two groups combined at $p < 0.05$ (two-tailed). One-way ANOVAs reveal no significant differences between groups for the other variables.

Legend:

- CASH = dummy variable with 1 if all cash compensation, 0 otherwise.
- STCOMP = dummy variable with 1 if short-term stock option compensation included, 0 otherwise.
- LTCOMP = dummy variable with 1 if long-term stock option compensation included, 0 otherwise.
- SUPPORT = audit committee member support in the disagreement measured on a scale anchored 0 = “favor management (no adjustment)” and 100 = “favor auditor (record adjustment)”.
- FAIRNESS = perceived fairness of the outcome for current shareholders if the auditor’s proposed adjustment is not made; scale from very unfair = -50 to very fair = +50.
- CLARITY = audit committee member perceived clarity for resolving the disagreement; scale from 0-200 (prescription-event link).
- OBLIGATION = audit committee member perceived obligation to resolve the disagreement; scale from 0-200 (prescription-identity link).
- CONTROL = audit committee member perceived control over resolving the disagreement; scale from 0-200 (identity-event link).

TABLE 3
Pairwise Correlations

	1	2	3	4
1. SUPPORT				
2. FAIRNESS	-0.719			
3. CLARITY	0.019	0.207		
4. OBLIGATION	0.232	-0.197	0.188	
5. CONTROL	0.138	-0.178	0.500	0.464

Notes:

Bold correlations indicate significance at 0.05 level.

Variables are defined in Table 2.

TABLE 4
Overall SUPPORT Results

Variable	Predicted Sign	Coeff.	t-stat	p-value
Intercept	?	20.96	1.39	0.172
LTCOMP	H1 (+)	11.53	1.87	0.035
STCOMP	H2 (-)	8.09	1.35	0.183
FAIRNESS	H3 (-)	-0.70	-7.14	<0.001
CLARITY	RQ1 (?)	0.32	3.36	0.002
OBLIGATION	RQ1 (?)	0.11	1.59	0.120
CONTROL	RQ1 (?)	-0.24	-2.00	0.051
EXPDISAG	?	10.25	2.10	0.041
EXPACM	?	-3.13	-3.02	0.004
EXPEA	+	6.83	1.40	0.085
MASTERS	?	6.97	1.21	0.233
JD	?	23.53	2.61	0.012
PHD	?	14.14	1.57	0.123
Observations		56		
Model F (p)		9.31	(p < 0.001)	
Adj R ² (%)		64.45		

One-tailed p-values when results are in the predicted direction. Two-tailed p-values provided otherwise.

- EXPDISAG = 1 if have audit committee experience with an auditor-management disagreement like this, 0 otherwise.
- EXPACM = total number of audit committees served in career.
- EXPEA = 1 if have experience working as an external auditor, 0 otherwise.
- MASTERS = 1 if highest degree is masters degree, 0 otherwise.
- JD = 1 if highest degree is a law degree, 0 otherwise.
- PHD = 1 if highest degree is doctoral degree, 0 otherwise.

The other variables are defined in Table 2.

TABLE 5
Interaction Results
Cell Means for SUPPORT

Panel A: CLARITY*LTCOMP Interaction (p = 0.01)

CLARITY		LTCOMP	
		0	1
< Median (Less Clear)	Mean	45.50	53.00
	SD	23.57	22.10
	n	18	8
≥ Median (More Clear)	Mean	44.40	69.30
	SD	33.07	28.08
	n	20	10

Note: The cell mean of 69.30 is significantly greater than the means of 45.50 (p = 0.024) and 44.40 (p = 0.051). The other cell means are not significantly different.

Panel B: CLARITY*FAIRNESS Interaction (p = 0.02)

CLARITY		FAIRNESS if Adjustment is Not Made	
		< Median (Less Fair)	≥ Median (More Fair)
< Median (Less Clear)	Mean	56.43	37.75
	SD	20.63	22.14
	n	14	12
≥ Median (More Clear)	Mean	76.86	31.56
	SD	16.86	29.43
	n	14	16

Note: All cell means are significantly different from each other at p < 0.05, except for 37.75 and 31.56.

TABLE 6
SUPPORT Justifications

Support for Management (SUPPORT < 50; n = 25)

<u>Justification</u>	<u>n</u>
Management expertise – management is more knowledgeable about product than auditor	22
Valuation – inventory still has value, auditors’ estimate is ambiguous	14
Operating reasons – product still selling, early in lifecycle	13
Other – immaterial, strong control environment	4

Support for Auditor (SUPPORT > 50; n = 28)

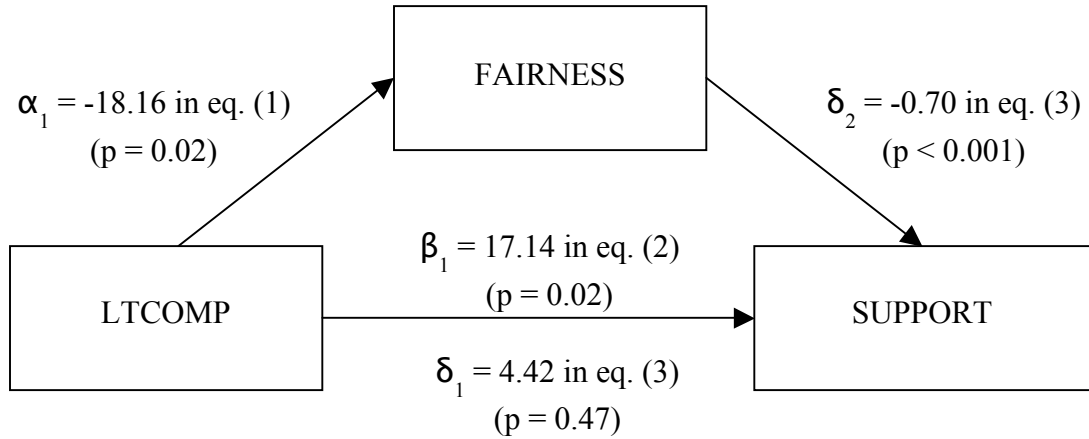
<u>Justification</u>	<u>n</u>
Conservatism – auditor more objective and conservative	35
Quantity of inventory – amount of the inventory is too large	14
New competing products – very competitive industry	5

Note 1: There were three participants with SUPPORT = 50. They are excluded from the analysis above. In addition, a small number of participants supporting the auditor (management) provided a justification that favored management (the auditor), or provided a justification that was neutral. These few “wrong way” and neutral justifications also have been excluded.

Note 2: Some participants provided multiple responses that fall into the same category above (e.g., two different justifications that relate to auditor objectivity and conservatism above).

TABLE 7
Mediation Test Results

Panel A: FAIRNESS Mediation of LTCOMP-SUPPORT Relation



Panel B: Mediation Regression Results

Eq.	Dependent Variable		Intercept	LTCOMP	FAIRNESS	F-value	Adj. R ²
(1)	FAIRNESS	Coefficient	15.21	-18.16		5.29	7.2%
		Std error	(4.48)	(7.89)			
		p-value*	0.001	0.02			
(2)	SUPPORT	Coefficient	44.92	17.14		4.62	6.2%
		Std error	(4.52)	(7.97)			
		p-value*	< 0.001	0.02			
(3)	SUPPORT	Coefficient	55.58	4.42	-0.70	28.93	50.4%
		Std error	(3.62)	(6.08)	(0.10)		
		p-value*	< 0.001	0.47	< 0.001		

Sobel test statistic for mediation: $Z = 2.19$, $p = 0.01$.

APPENDIX Experimental Materials

COMPANY AND INDUSTRY BACKGROUND

Dynamic Products, Inc. is a publicly traded manufacturing company in the consumer home products industry. Dynamic's primary customers are homeowners and contractors. The industry is very competitive, and product performance, availability, reliability, price, and customer service are primary competitive factors. The company has maintained fairly steady revenue growth of 4-6% per year.

Dynamic's top management team has been stable in recent years and has developed a good reputation in the industry by building positive relationships with customers and vendors. Top executives have a positive attitude about maintaining an effective control environment. As with most public companies, executives face pressure to meet analysts' earnings forecasts. All company officers receive competitive compensation that is in line with industry averages for companies the size of Dynamic. The CEO's compensation comprises 20% annual salary, 30% performance-based bonus, and 50% long-term incentive pay (including restricted stock and stock options). This compensation mix is similar for other company officers.

YOUR AUDIT COMMITTEE

Your audit committee has only independent directors. One of your colleagues on the committee has been designated as the financial expert. The committee meets five times per year and has private sessions with the external auditor and internal auditor. Your audit committee member annual compensation is consistent with the prior year and includes:

(Cash only treatment)

Cash Retainer & Meeting Fees	<u>\$100,000</u>	<u>100%</u>
Total Remuneration	<u>\$100,000</u>	<u>100%</u>

(STCOMP treatment)

Cash Retainer & Meeting Fees	\$20,000	20%
Stock Options (vesting in <u>one year</u>)	<u>\$80,000</u>	<u>80%</u>
Total Remuneration	<u>\$100,000</u>	<u>100%</u>

(LTCOMP treatment)

Cash Retainer & Meeting Fees	\$20,000	20%
Stock Options (vesting in <u>five years</u>)	<u>\$80,000</u>	<u>80%</u>
Total Remuneration	<u>\$100,000</u>	<u>100%</u>

FINANCIAL REPORTING SUMMARY

Dynamic's auditor is a Big 4 firm that has served the company for several years. The auditor has experience in Dynamic's industry and has provided unqualified (clean) audit opinions in previous years, with no material weaknesses in internal control and no significant auditor-management accounting disagreements. For the current year, relevant **pre-audit** balances are:

Sales	\$650 million
Total Assets	\$550 million
Inventory	\$187.5 million
Net Earnings	\$55 million
Actual EPS	\$1.20 per share
Analysts' Consensus EPS Forecast	\$1.19 per share

**APPENDIX (cont.)
Experimental Materials**

AUDIT DISAGREEMENT

The external auditor proposes one potentially important audit adjustment related to management’s estimate of the inventory obsolescence allowance. The issue involves two specialized products that Dynamic launched two years ago, which now are facing intense competition from new products being released by other companies. The matter has now come before your audit committee.

The auditor’s basis for proposing an adjustment to increase the obsolescence allowance includes:

- At current sales levels, the company has approximately one year of inventory for these two products.
- The short history of the two products and their special purpose nature suggest that there will be a significant decrease in demand caused by the new competition.
- A reliable industry publication recently suggested that the two products will become obsolete very soon.
- The rapid rate of technological change in the industry suggests that the products’ technology is quickly becoming outdated.
- There is a historical industry practice of having old technology products written down and sold at or below cost. Significant discounts will likely need to be offered to move this inventory.

Management disagrees with the auditor’s proposed adjustment and argues that:

- The slowdown in new orders is due to seasonal factors, and there is reason to remain bullish on the two products and their attributes.
- The competitors’ new products are likely to be less reliable than Dynamic’s products, and the technical and economic viability of the competitors’ products has not been objectively established.
- It is too early in the life cycle of the two products to consider a write-down of the inventory.
- The current turnover of this inventory is sufficient to cover the cost of inventory. Subsequent sales prove that this inventory has value that is at least equal to its cost.
- The inventory can be written down in future periods if the two products truly become unsellable.

The auditor believes that the recorded allowance for obsolete inventory **overstates current earnings per share by \$.03**. This amount is less than 3% of earnings, less than 1% of inventory, and less than .3% of total assets. The auditor’s proposed adjustment **would reduce earnings per share from \$1.20 to \$1.17 and would put earnings below the financial analysts’ forecast**.

Measurement of SUPPORT:

1. Based on the information provided, which side do you favor in this accounting disagreement? (place a slash on the line to the right)
- | | | |
|--|---|---------------------|
| | - - - - - - - - - - - - - - - - | |
| | Favor | Favor |
| | Management | Auditor |
| | (No adjustment) | (Record adjustment) |