

The Effects of Audit Committees and Supervisory Boards: A Comparative Study

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Abstract Shareholders and stakeholders expect effective supervisory mechanism of corporate governance. Since Audit Committees (ACs) and Supervisory Boards (SBs) act simultaneously as the monitors in governance structure, it is questioned which system is more effective. Currently, both systems co-exist in Taiwan, giving the reasons to collect the data and evidence from Taiwan. Two approaches were adopted to compare corporate performance between the listed companies with ACs and those without (with Supervisors). The results of the first approach indicate that companies with Supervisors (without ACs) perform better than those companies with ACs. The results of second approach verify the results of the first approach showing adverse effects of ACs. Based on comparing both results, this study is inclined to suggest that ACs should not replace Supervisors in Taiwan. This finding may also assist users in assessing which governance structure could make companies to perform better as well as more effective within organization.

Keywords Corporate governance, Audit committees, Supervisory Boards, Effects

1. Introduction

The series of corporate scandals in recent years in the world as well as in Taiwan have exposed the penchant of management of the listed companies to reap huge benefits by all illegal means including manipulating the public disclosure of accounting information, inflated turnover, overstated the company's profit, and concealing the company's debt and company's share price to raise or fall. It is obvious that defective corporate governance could incur a significant impact as well as great financial loss to the national economy, the stock market, the companies and investors, even the general public at large. All these defects show the importance and necessity of establishing sound and effective corporate governance within publicly listed

companies.

The internal supervisory corporate governance (CG) mechanism is not compulsory in the regulations of certain countries. National conditions would normally determine whether these countries should develop CG supervisory mechanisms by encouraging the listed companies to establish the Audit Committee (AC) or the Supervisory Board (SB). It is rooted on comparatively understanding both the internal and external supervisory mechanism of CG to construct that both the shareholder theory and stakeholder theory are the principal theories relied upon and to report both the effects of the AC and the SB respectively are the purpose of this research. All the shareholders and stakeholders expect to have the effective supervisory mechanism of CG. Given that AC and SB two main governance structures of supervisory mechanism of corporate governance exist in the world simultaneously, it is questioned which system of the AC or the SB is more effective.

Currently, both with- and without-AC systems exist simultaneously in Taiwan's listed companies. Some have chosen to establish ACs to replace the Supervisors (Ss), while others have opted to maintain the Supervisors (Ss). The background study of Taiwan's supervisory mechanism provides the reason to collect the data and evidence from Taiwan. This study uses two approaches to examine the listed companies' performance with ACs and with Supervisors; and the effects of ACs with findings to prove two hypotheses. Phase I examines the corporate performances by comparing the "mean" of the EPS and ROA between companies with ACs and those without (with Supervisors), and the empirical results show that companies without ACs (with Supervisors) perform better than companies with ACs. Phase II, the regression results agree with the first phase's results, indicating difference from the current literature reviews and is opposed to requirements of related regulations on ACs. On the basis of this comparative study, it is suggested that the AC is not convincing enough to replace the monitoring system of Supervisors in Taiwan.

Table 1. Taiwan's Listed Companies Introducing ACs between 2007 and 2013 (Source: Author, as supported by the TEJ Database)

Year	2007	2008	2009	2010	2011	2012	2013
No. of Co.	658	686	719	756	801	822	854
Increase in No. of Co.		28	33	37	45	21	32
Increase in % of Co.		4.26%	4.81%	5.15%	5.95%	2.62%	3.89%
No. of Co. with AC	11	22	27	48	73	108	140
Increase in No. of Co. with AC		11	5	21	25	35	32
% of Co. with AC	1.67%	3.21%	3.76%	6.35%	9.11%	13.14%	16.39%

The results support the stakeholder theory more than the shareholder theory. Both results also reveal that the stakeholders may contribute more than the shareholders to the effects of supervisory mechanism of corporate governance. In summary, the findings in this research may be of useful reference to users such as regulators, supervisors or Boards of Directors in considering which governance structures for internal supervisory functions within companies may enable companies to perform better and will be more effective within organization. Furthermore, the research finding and proposals in this paper may offer a basis for continuing research on the effects of supervisory governance after the introduction of an AC, as well as for future studies of other monitoring functions such as audit and internal control.

The remainder of this paper is organized as follows. Section II first introduces the literature and theory; Section III describes the background and hypothesis; Section IV research design and method; Section V presents the empirical findings, and Section VI concludes the study.

2. Literature and Theory

Corporate Governance

It has been generally agreed that the 21st Century is marked by the development of global CG. CG structures have been in place for many decades in highly developed countries such as the United States and the United Kingdom, but their adoption in Asia gathered momentum only in the aftermath of the regional financial crisis of 1997. CG covers a large spectrum of distinct economic phenomena and affects the legality and the effects of a company's performance worldwide. Hence, a universally agreed upon definition and scope of CG is yet to be established. However, as a starting point for the discussion in this paper, it seems useful to refer to the following definition from the OECD's perspective:

Corporate Governance is the system by which business corporations are directed and controlled. The Corporate Governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as the board, managers, shareholders and other stakeholders, and spells out the rules and procedures

for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance. [46,47]

The promotion of global governance is illustrated by the World Bank's efforts to encourage countries to voluntarily comply with formal and informal systems of rules and arrangements. The concept of CG refers essentially to the mechanisms of governance and supervision. With respect to governance, it seeks to establish a mechanism to maximize the corporate value of promoting what is beneficial, such as pursuing maximum return for stakeholders, shareholders, creditors and employees. With respect to supervision, CG strives to minimize the chance of the occurrence of events or incidents harmful to the company, such as the potential for wrongdoing and fraudulent practices. International organizations and various countries' CG criteria generally require or propose some *external* and *internal* supervisory mechanisms to be established.

The external supervisory mechanism: Environmental factors such as policies and systems included in established legal frameworks for firms impose discipline and demand accountability of the firm's directors and management [66]. These factors provide the foundation for the external supervisory mechanism, which includes administrative regulations as well as accounting and auditing criteria. This involves a combination of various professional groups, such as accountants, lawyers, investment banks, financial and economics media, investment consultants and research institutions and personnel analyzing CG.

The internal supervisory mechanism: A narrow focus for CG is that of relations between shareholders and management layers within the company [68]. The core of CG lies in the BoD, who is accountable to shareholders and creditors as well as the whole company. Here, the focal point of CG lies in designing a set of systems to enable the external shareholders to supervise the company's management. Hence, a company's internal supervision mechanism constitutes a critical part of CG in constraining the controlling management from looking after only their own interests, taking advantage of their position and power, at the expense of the interests of the stockholders.

The supervisory mechanism may be equipped in the two

primary patterns of board structure: the unitary board system - Anglo-American system, and the two board system - German system. Under the unitary board system, a company has only one board, comprised of the executive directors and the independent directors. The executive directors are in charge of the company's business operation, while the independent directors act as supervisors of the management. Under the two-board system, a firm has two boards – the BoD and the SB. The SB functions as the special monitoring organ and may have the same mandates as the BoD or even higher status than the BoD.

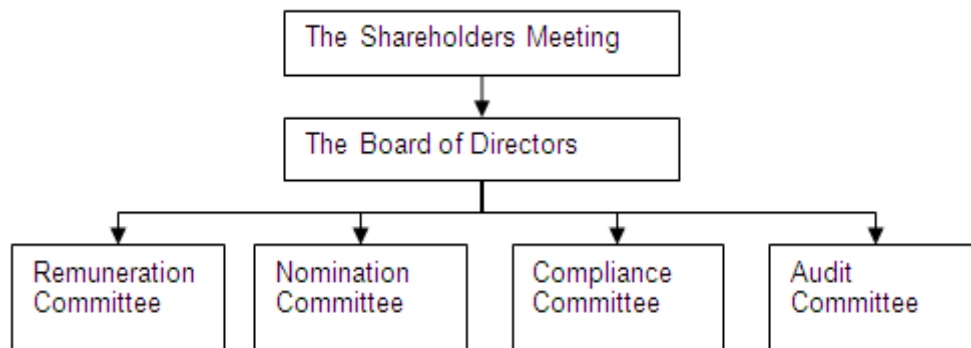
The one-board system: The board may establish several committees such as the AC, the remuneration committee and the nomination committee illustrated as Figure 1: The Anglo-American Single-Pronged Governance Structure. To prevent the erosion of the right of the ownership, a unitary BoD, also known as the independent directors' system, is established at the top of the managerial hierarchy of the company, to represent the shareholders' interest and directly report to the shareholders' meetings.

Two-board system: The governance structure is based on a

two-tier board. These are the SB and the Management Committee in Germany illustrated as Figure 2: The German Two-Tier Governance Structure.

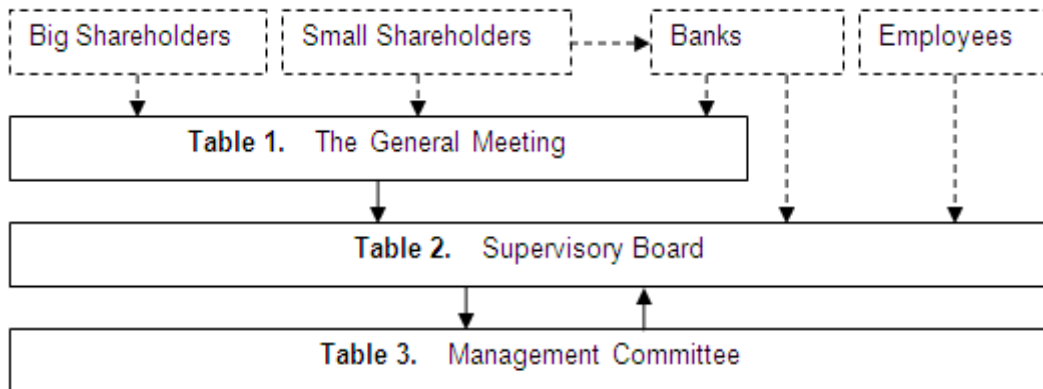
The SBs are responsible to the broader society, and the scope of its service extends beyond the company, as it can report to the Security Regulatory Commission and other institutions. The AC is responsible to the company and the scope of its service is therefore confined within the company. The SB reports directly to the general meetings of shareholders in overseeing the BoD, and subsequently the AC reports directly to the BoD; its recommendations need to be approved by the BoDs before their implementation. Both the AC and the SB are the internal supervisory organization of the listed companies. The AC is one of the committees under the jurisdiction of the BoD. The SB is the unit parallel or above the BoD.

Given that ACs and SBs two main governance structures of supervisory mechanism of corporate governance exist in the world simultaneously, it is considered which system of the AC or the SB is more effective. The following research question is therefore raised:



(Source: Author, referenced to the named studies)

Figure 1. The Anglo-American Single-Pronged Governance Structure



(Source: Author, referenced to the named studies)

Figure 2. The German Two-Tier Governance Structure

Which system, with the AC or with the SB, has more effective supervisory functions?

Applied Theories

One of the main purposes of CG is to facilitate maximization of shareholders' value, and to increase the stock price of the enterprise. It needs to establish an effective supervisory mechanism to minimize the potential risk to the corporation, in which managers are accountable to the shareholders, to align and to protect the interests of both shareholders and managers. Hence, it has become an extremely important task to design and execute an effective supervisory mechanism. Guy and Pei (2005) suggest that supervisory mechanism of CG control over the management could be further enhanced, especially through CG reform under a transition economy. Shareholders and stakeholders are identified as the key links in the reliability of financial reporting quality, internal control¹ and auditing. Most of all, they expect the Supervisory Boards and Audit Committees to supervise the tendency to manipulate the monitoring process of financial reporting, internal control and auditing. From the theoretical perspective of applying both of stakeholder theory and shareholder theory, shareholders and stakeholders expect effective monitoring by the supervisory mechanism.

Shareholder Theory: Shareholder's proxy problems not only exist among the shareholders and managers, but also between minority and large shareholders, also known as 'control shareholders' [57]. Shareholder theory implies a need for supervisory functions, as managers cannot be trusted to act in the interests of shareholders. The control shareholders might deprive other shareholders of their utilities in much of the same way that the managers might deprive shareholders of their utilities. These two kinds of agency problems are often interlinked. The mechanism of CG is therefore to solve these two kinds of agency problems and to determine which mechanism can be regarded as a security measure for the protection of minority shareholders from the larger ones. In other words, it is mandated to protect the external body of shareholders from encroachment by the internal management and control shareholders. Since the interests of the shareholders and managers are usually inconsistent, the mechanism of CG is used to alleviate the proxy problems between them. Its essence is to protect shareholder's interests from being infringed upon, and at its core is a set of rules and systems to provide protection for shareholders and to guarantee that shareholders can receive fair repayment from their investment. The owners' checks and balances on the managers are performed through the supervisory mechanism of CG. Eisenhardt [19] assumes that managers are opportunists intent on gaining self-satisfaction instead of maximizing profit on behalf of the principal, so

she points out there is potential conflict of interest of risk sharing between the enterprises and agents. Furthermore, she argues that agency theory has a clear implication for the monitoring and control role of the BoD. Zahra and Peace [69] highlight the importance of the BoD role in establishing guidelines for operations and effective control. Fama [21] states that the BoD is viewed as "the ultimate internal monitor of the set of contracts called a firm". Wang [64] argues that the AC's CG system in the US and UK is categorized as shareholder agency theory. The shareholder theory is the focus in the research of CG. In particular, the importance of ACs' functions is highlighted by the assumptions of shareholder theory. The AC is deemed to play a monitoring and controlling function in safeguarding the interest of shareholders because manager is assumed to act opportunistically to further their own interest before that of shareholders [35].

Stakeholder Theory: Fort and Schipani [25] defined stakeholder theory of CG as ensuring the conditions of the responsibilities to the various stakeholders to create value and co-ordinate the management levels among various stakeholders including stockholders, employees, customers, creditors, suppliers, competitors, even the whole society. Clarkson [11:322] defines stakeholder theory in these terms: "The firm is a system of stakeholders operating within the larger system of the host society that provides the necessary legal and market infrastructure for the firm's activities. The purpose of the firm is to create wealth or value for its stakeholders by converting their stakes into goods and services." Sternberg [61] reports stakeholder theory as the doctrine that enterprises should be run not for the financial benefit of their owners but for the benefit of all their stakeholders. Though there is no agreed definition of stakeholder theory, the term is widely described as the duty of the management to take into account the interests of anyone who has a significant "stake" in the firm [54]. Jones and Wicks [36] state that the theory is concerned with the nature of these relationships in terms of both processes and outcomes and focuses on managerial decision-making; the interest of all legitimate stakeholders have intrinsic value, and no set of interests is assumed to dominate others. Therefore, stakeholders' theory has suggested that a company should allow other stakeholders in addition to shareholders to participate in CG [20,30]. Freeman (1984, page 31) defines "A stakeholder in an organization is any group or individual who can affect or is affected by the achievement of the organization's objective"; Porter [49,p.17] suggested to "nominate significant owners, customers, suppliers, employees, and community representatives to the BoD"; Wang [64] analyses that the SB's CG system in Germany and Japan is considered as stakeholder theory.

The shareholder and stakeholder theories are the principal theories relied upon in this research. Fama [21] comments that separation of ownership and control can be explained because of efficient forms of economic organization. Furthermore, this paper argues to compare the effects of the

¹ The definition of Internal Control by the COSO Report (COSO 1992): "Internal control is broadly defined as a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories: 1. Effectiveness and efficiency of operations. 2. Reliability of financial reporting. 3. Compliance with applicable laws and regulations."

AC to the SB system, within which stakeholder theory is considered to take care of the interest of not only shareholders but stakeholders. Both theories suggest the effects of the AC and the SB of supervisory mechanism need to be analyzed, since a gap exists between the regulations and standards and actual practice [60].

The Effects of Audit Committees

It seems there is no universally accepted definition of the AC that may be found in regulations, reports, surveys and research studies. Instead, different definitions are presented, such as Section 404 of SOX [58], Klein [39], Collier [13], Marian (1988), Peat Marwick McLintock (1987) and Braiotta (1981). Some examples of these definitions are quoted below:

“The term “Audit Committee” means – a committee (or equivalent body) established by and amongst the BoD of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer” (US Securities Exchange Act of 1934 #3 (a)(58); SOX Section 404, 2002)

“Each member of the Audit Committee of the issuer shall be a member of the BoD of the issuer, and shall otherwise be independent.” (See US Securities Exchange Act of 1934 #10 (m) (3); SOX Section 404, 2002)

These definitions state that the AC is a sub-committee of the BoD; and confine the definition mainly to the composition and the key responsibilities of ACs. These definitions emphasize the composition of the AC by the participation of independent directors with the professional abilities to perform the key responsibilities of financial reporting, audit and internal control. In summary, all definitions of the AC tend to emphasize two attributes of its composition, namely independence and financial expertise, as well as its responsibility or operations.

A company's AC includes at least three members. The AC function is to monitor its board of directors to confirm that it operates well. There are various characteristics associated with AC's effects [31, 10, 6, 33]. Bedard et al. [4] find a significant association between earnings management and audit committee governance practices. Goodwin et al. [27] found that the existence of an AC, more frequent committee meetings, and increased use of internal audits are related to higher audit fees. These findings are consistent with an increased demand for higher quality auditing by ACs and by firms that make greater use of internal audits. Chen and Zhou [8] finds that firms with effective audit committees are associated with less earnings management and less audit fees, and are less likely to have modified opinions and delayed filings. Chien et al. [10] found that the presence of a committee and the committee's specific qualities of independence, financial expertise, and increased activity positively correlate with reduced frequencies of internal control problems. Ika et al. [33] suggested that AC effects are likely to reduce financial reporting lead times. In addition,

Iyer et al. [34] found that professional accounting certification and AC experience are valued positively by the board of directors when designating an AC member as a financial expert. The research issues associated with the AC's effects [31, 10, 6, 33] and the discussion of the relationship between the AC characteristics and its effects (Carcello et al. 2006; 52, 26, 7), all highlighted the AC's characteristics of the independence, expertise and diligence in association with the effects of the AC [70, 31, 2, 12, 56].

The Effects of Supervisory Boards

According to the German regulations on CG, the SB (*Aufsichtsrat*) oversees and advises the BoD (Executive Board, *Vorstand*), and also has control over fundamental and important decisions. According to Paragraph 1 of Article 111 of the German Company Act (*Aktiengesetz*; AktG), the SB has the right and responsibility to oversee (*überwachen*) the operations of the company [9: 154].

The characteristic of the existing German system of CG indicates that the SB plays the role of overseeing the operations and finance of the company. In addition to the appointment and removal of directors, the most important right and responsibility of the SB is to oversee the operations of the directors (Yang, 2004: 102).

Qin [50] used the characteristics of supervisory board to examine the relationship between corporate performance and supervisory board. He proves that the supervisory board of listed companies is effective. Firth et al. [23] find that the types of the dominant shareholder, the size of the supervisory board, and the percentage of independent directors have an impact on the frequency of modified audit opinions. Ding et al. [18] reveal that China's corporate governance system implements both the American and the German style mechanisms, but the supervisory board, a typical feature of German style governance is generally considered dysfunctional. Qin [50] analyzed the characteristics of supervisory board in China to examine the relationship between corporate performance and supervisory board. He analyzed the size, number of meetings, members and remuneration as proxies of the supervisory board and found that there was a significantly negative relation between the numbers of meetings and corporate performance; a significantly positive relation between shareholdings of supervisors and performance; and a U curve relation between size and performance. Therefore, he concluded that the supervisory board of listed companies is effective in China. Thus, improvement of the supervisory board functions could have better corporate performance. Lee [41] used the independence, expertise, and diligence such like the size and the meeting times of the SB to examine the effectiveness of the supervisory functions. In summary, the supervisory characteristics of independence, expertise and diligence (size and meeting times) of the SB and the AC are the prerequisite and basis to exercise monitoring functions and viewed as the positive relationship with achieving effective oversight and supervisory characteristics

which needs to be strengthened and protected. These findings indicate that corporate governance could be considered an effective internal tool to achieve greater monitoring effectiveness. It concludes that the better supervisory effects of CG will cause better corporate performance.

If the governance institutions can implement effective supervisory functions well, it will increase investors' trust in the company's CG and its operations because of increased earnings. The ultimate test of earnings quality is the earnings per share (EPS) and return on assets (ROA) which provides a measure of the extent to which new earnings information and the return rate [38,55]. Holthausen and Verrecchia [32] documented a positive association. Burgstahler and Eames [5] and Abarbanell and Lehavy [1] suggested that earnings may also be managed to meet simple earnings expectations in the stock market. Teoh and Wong [62] and Balsam et al. [3] suggested that investors' responses to an earnings surprise depend on the perceived quality and credibility of the earnings reported. The survey evidence in Graham et al. [29] indicated that reporting increases in quarterly earnings per share (EPS) is an important goal for management, and may be even more important than either beating analyst forecasts or reporting profits. DeGeorge et al. [17] provided evidence that the management's first objective was to report positive earnings, then to increase quarterly earnings, and last to beat analyst forecasts. Myers et al. [45] demonstrated that many more firms reported a longer series of consecutive increases in earnings per share than would be expected by chance. They interpreted this phenomenon as evidence of earnings management and provided the evidence that business managers had incentives to maintain their firms' earnings trends. The foregoing discussion illustrates that many studies have used an earnings-based measure as a proxy variable. According to James (2005), he used EPS as a determinant to value a corporation; Kim and Kross [38] support a positive relationship between stock market price and earnings. Earnings Per Share (EPS) and Return on Assets (ROA) are measured as indexes to reflect the performance of a company [43,53, 67].

In order to answer the key research question, the following study and data collection for comparison is chosen from the evidence of Taiwan. The background study of Taiwan's internal supervisory mechanism may help to explain the reason and further the data comparison may provide the empirical results to answer the question in this paper.

3. Background and Hypothesis

Background

In the aftermaths of the Asian financial crisis in 1998, many domestic enterprises in Taiwan have been indicted for hollowed assets, fraudulent dealings, and other scandals. The major problem was their poor implementation of

corporate governance both internally and externally. For example, the board of directors doesn't intervene in supervision, resulting in the company executives having the leeway to manipulate at will. Therefore, in order to thoroughly implement the corporate governance system, the relevant agencies in Taiwan have promulgated the relevant laws and regulations. Thus, the Taiwan Stock Exchange (STE) has set the mandatory provisions for regulating outside directors for the new publicly listed companies. On October 4, 2002, the Taiwan Stock Exchange and the Gre Tai Securities Market promulgated the Listed Corporate Governance Code of Practice. Earlier in 2001, they have amended the Companies Act to increase the obligations of directors and in 2002 also passed the Investor Protection Law. These measures were adopted with focus on synchronization with international corporate governance issues.

In addition, on January 7, 2003, the Executive Yuan (the Cabinet) announced the approval of the composition of the "Ad Hoc Team for Reforming Corporate Governance." The task of the team was to undertake reform based on the existing corporate governance system, and with reference to the direction of corporate governance reform both in the international and domestic context, with the aim to promote and establish a sound corporate governance mechanism in Taiwan. Unfortunately, the outbreak of the Procom scandal in June, 2004, compelled the government agencies to shift its focus by emphasizing more on corporate governance standards and principles. For this reason, the Financial Supervisory Commission has to take the issues of corporate governance more seriously and to strengthen internal controls. The Legislative Yuan in December 2005 passed the Securities Exchange Act and the relevant provisions for requiring all publicly listed companies to establish minimum standards of independent directors and supervisors.

To strengthen corporate governance, the Legislative Yuan passed the amended articles of the Securities Exchange Act on December 30, 2005 which was promulgated by the President, and became effective as of January 1, 2007. The passing of the amended Act ushered in establishment of the Audit Committee as well as the adoption of the one-tier system of corporate governance model in Taiwan. According to Section 14-4-1 of the existing Securities and Exchange Act, companies which have issued stocks are required to set up either an Audit Committee or Supervisors. To set up an Audit Committee or Supervisors is to be decided by the size of the company, the nature of business, the scope of authority and other necessary conditions. The Financial Supervisory Commission regulates the monitoring setting. This model of corporate governance provides for the co-existence of the one-tier and the two-tier systems in Taiwan illustrated as Figure 3: The Taiwan's Duality Governance Structure. The legal amendment triggered considerable debates on issues as to whether the establishment of the Audit Committee would strengthen corporate governance, and whether it was

desirable to let the companies decide for themselves the best way for establishing corporate governance.

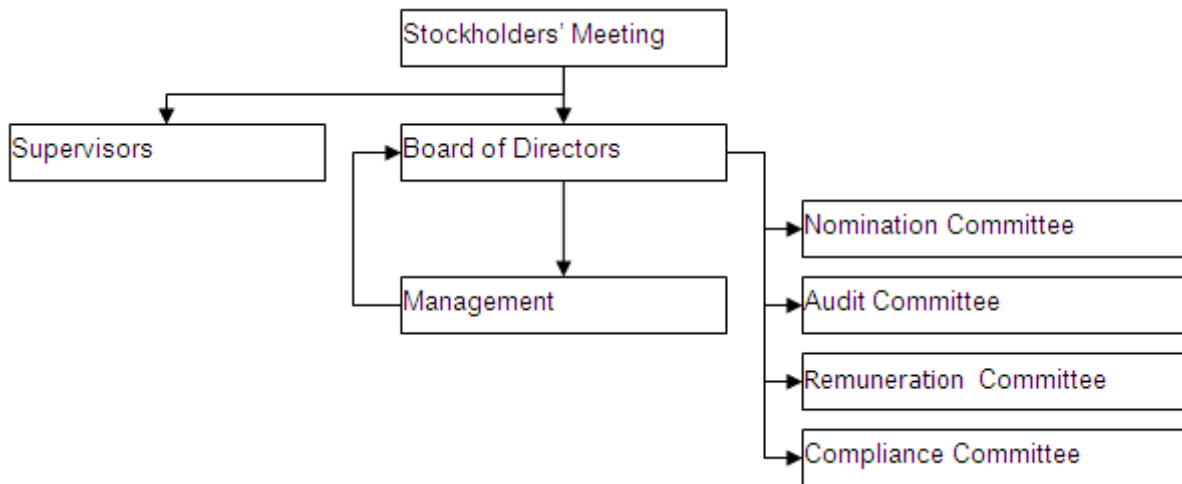
The Comparison between Supervisory Board in Germany and Supervisors in Taiwan

Taiwan publicly listed companies only have Supervisors, without forming the Supervisory Board. Table 2 illustrates Taiwan Supervisors with their prerogative powers and Supervisory Board in Germany, indicating that Supervisors in Taiwan have less power than the powers of German Supervisory Board.

The Supervisors have been adopted in Taiwan for quite some time. A company’s Supervisors require at least two members. The duration of a supervisor’s term is three years. Supervisors hold stock in the company but they do not serve as directors, managers, or staff in the company. Instead, supervisors monitor directors and managers, and evaluate the management performance of the company. In Germany, the corporate board system is two-tiered. There is the supervisory board, which is the board of non-executive

directors, and there is the management board, which consists of the executive directors and is chaired by the CEO. It is the management board that determines the strategic direction of the firm. The supervisory board on the other hand, oversees the management board, approves or rejects its decisions, and appoints its members and decides their salaries. Gorton and Schmid [28] find that under the German corporate governance system of codetermination, employees are legally allocated control rights over corporate assets through seats on the supervisory board—that is, the board of nonexecutive directors.

After the comparison, the government may reference to German system to intensify the effects of the corporate governance in Taiwan by forming up as the Supervisory Board as well as further strengthening the Supervisors’ power especially about the powers of approving or rejecting management board’s decisions, and appointing its members and deciding their salaries.



(Source: Author, referenced to the named studies)

Figure 3. The Taiwan’s Duality Governance Structure

Table 2. Comparison of the Power of the Supervisory Board in Germany and the Supervisor in Taiwan

The “Supervisory Board” adopted in Germany	The “Supervisor” adopted only in Taiwan
Liability for compensation. ¹	The rights of debrief.
The power of convening shareholders’ meeting.	To make a claim of dismissal liquidator
The right on behalf of the corporation.	The right of investigation the establishment of company and report
The supervisory authority with business and finance. (The power of approving or rejecting the management board’s decisions)	When companies issue new shares, the right to exam issuance of capital stock for noncash assets. ²
The power of appointing the management board members and deciding their salaries	No equivalent power

1. When Supervisors or Supervisory Board carry out their duties, if they violate the law, the Articles of Association or neglect of duties leading that damage of the company, they have the responsibility for compensation.

2. When the company issues new shares with issuance of capital stock for noncash assets, Supervisors or Supervisory Board should check the prices or valuation standards to see whether if they are equivalent with shares which company give.

Hypothesis Development

Nowadays, some companies in Taiwan have established the ACs to monitor their boards of directors and enhance the company performance. The AC was first adopted in Taiwan in 2007 to replace the existing monitoring system of the Supervisors. By the end of 2013, however, because only less than 17% of publicly listed companies in Taiwan have willingly established ACs, this low percentage has raised a question as to whether the existing system of the Supervisors is effective to make the performance of the companies better than those with the ACs. This particular issue serves as the motivation of collecting the evidence from Taiwan on comparing their effects. Thus, the first phase of this study compares the performance of companies between with ACs and without ACs (with Supervisors). Further, the second phase intends to verify the phase one by examining whether the AC is effective from three perspectives: independence, expertise, and diligence.

Phase I: Comparing the Performance of Companies with Audit Committees and those without (with Supervisor)

It is hypothesized that companies with ACs perform better than companies without ACs (with Supervisors).

H1: Companies with ACs perform better than companies without (with Supervisors) in Taiwan.

Phase II: The AC helps companies to perform better by three characteristics: independence, expertise and diligence

Thus, the hypothesis is:

H2: The Effects of Audit Committee requirements in terms of independence, expertise and diligence on corporate performance are positive in Taiwan.

4. Design and Method

Variables Definitions

This study adopts EPS and ROA as dependent variables to examine if companies with an AC perform better. The Definition of Variables and Expected sign is shown in Table 3.

Table 3. Definition of Variables and Expected sign

Variables	Definitions	Expected sign
Dependent Variables		
EPS	(Net Income-Dividends on Preferred Stock)/Average Outstanding Shares	
ROA	Net income/ Average total assets	
Independent Variables		
Independence		
ROIDD	The number of independent directors / Number of board of directors	+
Expertise		
LECTURER	Number of Audit Committee for more than five years of teaching experience required for financial, legal, accounting or business/Total members of Audit Committee	+
LICENSE	Number of Audit Committee for more than five years of judge, prosecution, lawyer or accountant/ Total members of Audit Committee	+
EXPERIENCE	Number of Audit Committee for more than five years of work experience required for financial, legal, accounting or business/ Total members of Audit Committee	+
Diligence		
ACMT	Total meeting of Audit Committee	+
ACSZ	Total number of independent directors	+
Control Variables		
DE	Total liability/ Total Equity	-
SIZE	Ln (Asset): the natural logarithm of the assets as the proxy variable of firm size	+
GROWTH	(Total asset (t)-Total asset (t-1))/ Total asset(t-1)	+
Opinion	Company change the audit opinion	
Firm	Company changes CPA firm	
Big 4 CPA firms	Company has audited by Big 4 CPA firms	

Consider whether independence, expertise, and diligence influence the effects of an AC. First, the ratio of the independent director is a proxy variable of independence. Next, each member of the AC needs to have at least five years' experience in finance, legal, accounting, or business. The ratios of expertise are used as proxy variables for expertise. Finally, meeting times and size of the AC are used as proxy variables for diligence.

Dependent variables

Earnings per Share (EPS): Investors use Earnings per Share (EPS) to evaluate profits of a company [5]; Abarbanell and Lehavy [1]; Teoh and Wong [62]; Balsam et al. [3] and Graham et al. [29]. This study adopts EPS and Return on Assets (ROA) measured as an index to reflect the performance of a company [43, 53, 67] to compare performance of different companies.

Independent variables

Independence

Ratio of Independent Directors (ROIDD): Independent directors are independent of the board of directors in a company [22,42]. The ROIDD is measured that independent directors divided by directors of boards.

Expertise

LECTURER, LICENSE and EXPERIENCE focus especially on financial accounting expertise because previous researches show that it impacts financial reporting quality [16, 40].

Diligence

The Meeting of Audit Committee (ACMT): Raghunandan and Dasaratha (2007) indicated that the number of AC meetings is the only publicly available quantitative signal regarding the diligence of ACs. Private sector bodies and Securities and Exchange Commission officials have emphasized the need for frequent meetings of the AC.

The Size of Audit Committee (ACSZ) is measured as the number of AC members because research suggests that a large AC tends to enhance the AC's function [37].

Control variables

Debt to equity ratio: This measures closeness to the violation of debt covenant of debt covenant controls for leading contract incentives (Yang and Krishnan 2005). This measures Debt to Equity to examine the financial structure of a corporation.

Firm Size: Mutchler [44] suggests that auditors will more often issue going-concern modifications to smaller companies. It is possible that auditors are more confident that large firms could weather financial difficulties. Thus, expect ceteris paribus, that the larger the company, the less likely for it to receive the going-concern modification.

Growth Rate: Many studies used total assets increased

percentage to evaluate the growth rate [63,24,41]. Use growth rate to predict future growth of company.

Opinion dummy: Opinion dummy variable equals 1 if company changes the audit opinion, otherwise equals 0.

Firm dummy variable: Firm dummy variable equals 1 if company changes Certified Public Accountant (CPA) firm, otherwise equals 0.

Big 4 CPA firms' dummy variable: Big 4 CPA firms dummy variable equals 1 if company is audited by a Big 4 CPA firm, otherwise equals 0.

Regressions

Two equations are listed as follows:

Phase I

$$\text{Performance} = \alpha_2 - \alpha_1 > 0 \quad (1)$$

Phase II: Effects (Independence, Expertise, and Diligence on EPS and ROA)

$$\begin{aligned} &= \alpha_1 + \alpha_2 \text{ROIDD} + \alpha_3 \text{LETRUER} + \alpha_4 \text{LICENSE} + \\ &\alpha_5 \text{EXPERIENCE} + \alpha_6 \text{ACMT} + \alpha_7 \text{ACDN} + \alpha_8 \text{DE} + \\ &\alpha_9 \text{Ln(Assets)} + \alpha_{10} \text{GROWTH} + \alpha_{11} \text{OPINION} + \\ &\alpha_{12} \text{FIRM} + \alpha_{13} \text{BIG} \quad (2) \end{aligned}$$

First, it compares the "mean" of corporate performance in terms of EPS and ROA between companies with ACs and those without ACs (with Supervisors).

Then, this study uses multiple regressions to examine the relationship between the AC three characteristics in terms of independence (ROIDD), expertise (LECTURER, LICENSE, and EXPERIENCE) and diligence (ACMT and ACDN) on the corporate performance (EPS and ROA) in Taiwan.

5. Empirical Results

Descriptive Analysis

The samples in this study are collected from the Taiwan Economic Journal (TEJ). The sampling criteria covered the period from 2006 to 2010 of publicly listed companies in Taiwan. Table 4-6 shows the descriptive statistics. In order to avoid the results being affected by extreme value, the extreme values of each variable is winsorized. This study consists of 76 companies and effective numbers are 155 in Taiwan. The maximums of EPS and ROA are 11.33 and 20.81, respectively, and the minimums of EPS and ROA are -3.67 and -9.66, respectively. The standard deviation of ROA (7.26) is greater than EPS (2.87). Next, compare companies with ACs and SBs in Taiwan. In Table 6, EPS1 represents companies without ACs, while EPS2 represents companies with ACs. The mean of EPS1 is 3.08 and that of EPS2 is 2.44. ROA1 represents companies without ACs; ROA2 represents companies with ACs. The mean of ROA1 is 7.88, and that of ROA2 is 4.98. The standard deviations of EPS1 and EPS2 are 5.36 and 4.99, respectively. The standard deviations of ROA1 and ROA2 are 11.1 and 11.7, respectively. There is no significant difference in standard deviations in this study.

Table 4. Descriptive Analysis-Company with Audit Committee (EPS)

Variables	N	Minimum	Maximum	Mean	Std. Deviation
EPS	155	-3.67	11.33	2.4602	2.87423
ROIDD	155	0.02	0.60	0.3621	0.08667
LECTURER	155	0.00	1.00	0.3455	0.33774
LICENSE	155	0.00	1.00	0.2595	0.25013
EXPERIENCE	155	0.00	1.00	0.9555	0.15473
ACMT	155	0.00	15.00	5.9290	3.10448
ACSZ	155	2.00	5.00	3.1226	0.44628
DE	155	0.02	40.99	2.9735	5.91859
SIZE	155	5.39	9.67	7.2563	1.06484
GROWTH	155	-0.61	10.66	0.2066	0.92647
Opinion	155	0.00	1.00	0.1935	0.39636
Firm	155	0.00	1.00	0.0129	0.11322
Big4	155	0.00	1.00	0.9161	0.27809

ROIDD stands for ratio of independent directors. LECTURER, LICENSE, EXPERIENCE represent expertise of independent directors, respectively. ACMT and ACSZ represent diligence of the Audit Committee. DE is defined as total debts divide total equities. It measures financial structure of a company. SIZE is defined as the logarithm of total assets. GROWTH is to measure growth rate of assets. Opinion is defined as company change the audit opinion. Firm stands for company changes CPA firm. Big4 is defined as company has audited by Big 4 CPA firms.

Table 5. Descriptive Analysis-Company with Audit Committee (ROA)

Variables	N	Minimum	Maximum	Mean	Std. Deviation
ROA	155	-9.66	20.81	5.9805	7.26454
ROIDD	155	0.02	0.60	0.3601	0.08594
LECTUER	155	0.00	1.00	0.3693	0.34353
LICENSE	155	0.00	1.00	0.2552	0.24878
EXPERIENCE	155	0.00	1.00	0.9555	0.15473
ACMT	155	0.00	20.00	6.0903	3.37556
ACSZ	155	2.00	5.00	3.1226	0.44628
DE	155	0.02	40.99	3.0255	5.91825
SIZE	155	5.39	9.67	7.2868	1.03726
GROWTH	155	-0.61	10.66	0.2321	0.95133
Opinion	155	0.00	1.00	0.1871	0.39125
Firm	155	0.00	1.00	0.0129	0.11322
Big4	155	0.00	1.00	0.9032	0.29661

ROIDD stands for ratio of independent directors. LECTURER, LICENSE, EXPERIENCE represent profession of independent directors, respectively. ACMT and ACSZ represent diligence of the Audit Committee. DE is defined as total debts divide total equities. It measures financial structure of a company. SIZE is defined as the logarithm of total assets. GROWTH is to measure growth rate of assets. Opinion is defined as company change the audit opinion. Firm stands for company changes CPA firm. Big4 is defined as company has audited by Big 4 CPA firms.

Table 6. Descriptive Analysis-Compare with and without Audit Committee

	Number	Mean	Standard Deviation	Standard of Mean
EPS1	191	3.0820	5.35904	0.38777
EPS2	191	2.4350	4.98781	0.36091
ROA1	186	7.8794	11.09880	0.81380
ROA2	186	4.9757	11.16501	0.81866

The table is summary statistics. EPS1 stands for companies with Supervisor (without ACs) and EPS2 means companies with Audit Committee. Thus, ROA1 stands for companies with Supervisor (without ACs) and ROA2 mean companies with Audit Committee.

Table 7. Pair-wise Pearson and Spearman Correlation Analysis (EPS)

	EPS	ROIDD	LECTURER	LICENSE	EXPERIENCE	ACMT	ACSZ	DE	SIZE	GROWTH
EPS	1	0.266**	-0.021	0.055	-0.062	-0.082	0.055	-0.178*	-0.077	0.130
		0.001	0.798	0.496	0.445	.308	0.499	0.027	0.339	0.106
ROID	0.266**	1	0.102	0.066	0.0107	-0.156	0.161*	-0.435**	-0.381**	-0.067
			0.208	0.412	0.184	.052	0.045	0.000	0.000	0.404
LECTURER	-0.021	0.102	1	0.034	-0.196*	.117	0.089	-0.130	0.050	-0.013
				0.674	0.014	.148	0.271	0.106	0.533	0.877
LICENSE	0.055	0.066	0.034	1	0.242**	.120	0.020	-0.100	-0.163*	0.038
					0.002	.137	0.802	0.214	0.042	0.643
EXPERIENCE	-0.062	0.107	-0.0196*	0.242**	1	.095	0.051	0.119	0.104	0.011
						.237	0.526	0.139	0.197	0.893
ACMT	-0.082	-0.156	0.117	0.120	0.095	1	0.175*	0.254**	0.443**	0.067
							0.029	0.001	0.000	0.410
ACSZ	0.055	.0161*	0.089	0.020	0.051	.175*	1	0.117	0.304**	-0.011
								0.147	0.000	0.890
DE	-0.178*	-0.435**	-0.130	-0.100	0.119	.254**	0.117	1	0.593**	0.020
									0.000	0.809
SIZE	-0.077	-0.381**	0.050	-0.163*	0.104	.443**	0.304**	0.593**	1	0.013
										0.877
GROWTH	0.130	-0.067	-0.013	0.038	0.011	.067	-0.011	0.020	0.013	1
										0.877

Table 8. Pair-wise Pearson and Spearman Correlation Analysis (ROA)

	ROA	ROIDD	LECTURER	LICENSE	EXPERIENCE	ACMT	ACSZ	DE	SIZE	GROWTH
ROA	1	0.278**	0.091	0.026	-0.149	-0.183*	0.032	-0.307**	-0.156	0.144
		0.000	0.261	0.748	0.064	0.023	0.689	0.000	0.053	0.075
ROIDD	0.278**	1	0.145	0.047	0.102	-0.146	0.169*	-0.434**	-0.360**	-0.069
			0.071	0.560	0.208	0.069	0.036	0.000	0.000	0.393
LECTURER	0.091	0.145	1	0.022	-0.173*	0.162*	0.068	-0.149	0.056	-0.002
				0.788	0.031	0.044	0.398	0.065	0.489	0.975
LICENSE	0.026	0.047	0.022	1	0.238**	0.107	0.025	-0.095	-0.161*	0.008
					0.003	0.184	0.756	0.239	0.045	0.921
EXPERIENCE	-0.149	0.102	-0.173*	0.238**	1	0.102	0.051	0.122	0.115	0.018
						0.208	0.526	0.131	0.153	0.820
ACMT	-0.183*	-0.146	0.162*	0.107	0.102	1	0.148	0.245**	0.433**	0.072
							0.066	0.002	0.000	0.376
ACSZ	0.032	0.169*	0.068	0.025	0.051	0.148	1	0.115	0.304**	-0.018
								0.156	0.000	0.821
DE	-0.307**	-0.434**	-0.149	-0.095	0.122	0.245**	0.115	1	0.599**	0.010
									0.000	0.897
SIZE	-0.156	-0.360**	0.056	-0.161*	0.115	0.433**	0.304**	0.599**	1	0.017
										0.832
GROWTH	0.144	-0.069	-0.002	0.008	0.018	0.072	-0.018	0.010	0.017	1
										0.832

Spearman Correlation Analysis

Pair-wise person and Spearman correlation analyses show on Tables 7 and 8. First, there is a positively significant relationship between ROIDD and EPS (0.27). Also, there is a significant relationship between ROIDD and ROA (0.28). Next, there is a negatively significant relationship between ACMT and ROA (-0.18). Finally, there is a negatively significant relationship between DE and EPS (-0.18). Also, there is a negatively significant relationship between DE and ROA (-0.31).

Results of Multiple Regressions

Phase I: Comparing the performance of the companies with ACs and those without (with Supervisors)

The study compares the corporate performance with ACs

and without. In Table 9, the findings indicate that companies without ACs (with Supervisors) perform better with significance. However, the “mean” of companies with an AC (2.43 and 4.98) lower than that of companies without ACs (3.08 and 7.88) for both of EPS and ROA. The finding shows that companies with ACs do not perform better than those without ACs. This study rejects Hypothesis 1.

Phase II: The Effects of Audit Committees

The study examines the effects of AC’s characteristics on EPS and ROA. In Table 10, the empirical results show that the ROIDD of EPS and ROA are 10.26 (p-value = 0.001) and 20.20 (p-value = 0.009). The ROIDD is significant in that the finding indicates that there is a positively significant relationship between ROIDD and the effects of ACs. Yet, the AC reports directly to the BoDs; its recommendations need

to be approved by the BoDs before their implementation. Therefore, the independence standpoint of the AC is less than the Supervisors within organization. Otherwise, the empirical result shows that there is a negatively significant relationship between EXPERIENCE and AC effects of EPS -2.75 (p-value = 0.074) and ROA -8.37 (p-value = 0.025).

In addition, the finding indicates that there is a negatively significant relationship between ACMT and AC effects of ROA -0.35 (p-value = 0.048). Furthermore, there is no evidence to explain that LECTURER and LICENSE will influence the effects of the AC.

Table 9. Multivariate Regressions for the Effects of Audit Committee and Supervisor

	T	Degree of freedom	Significance	Mean	Lower	Upper
EPS1	7.948	190	0.000***	3.08199	2.3171	3.8469
EPS2	6.747	190	0.000***	2.43497	1.7231	3.1469
ROA1	9.682	185	0.000***	7.87941	6.2739	9.4849
ROA2	6.078	185	0.000***	4.97570	3.3606	6.5908

EPS1 is company with Supervisor and the mean is 3.08. EPS2 is company with Audit Committee and the mean is 2.4. EPS1 is higher than EPS2. ROA1 is company with Supervisor and the mean is 7.88. ROA2 is company with Audit Committee and the mean is 4.9. ROA1 is higher than ROA2. *** denotes statistical significance at 1% level.

Table 10. Multivariate Regressions for the Effects of Audit Committee

Dependent Variables	EPS	ROA
(Constant)	-2.211 (0.403)	-1.054 (0.870)
ROIDD	10.258*** (0.001)	20.203*** (0.009)
LECTURER	-0.989 (0.152)	-0.416 (0.801)
LICENSE	1.054 (0.275)	1.548 (0.508)
EXPERIENCE	-2.754* (0.074)	-8.374** (0.025)
ACMT	-0.077 (0.339)	-0.353** (0.048)
ACSZ	-0.009 (0.987)	0.027 (0.983)
DE	-0.046 (0.338)	-0.260** (0.029)
SIZE	0.185 (0.553)	0.433 (0.580)
GROWTH	0.413* (0.079)	1.181** (0.034)
Opinion Dummies	Yes	Yes
Firm Dummies	Yes	Yes
Big4 Dummies	Yes	Yes
R ²	0.208	0.276
Adj. R ²	0.141	0.215

P-value ***, **, * denote significance at the 1%, 5%, 10% levels.

ROIDD stands for ratio of independent directors. DE is defined as total debts divide total equities. It measures financial structure of a company. SIZE is defined as the logarithm of total assets. GROWTH is to measure growth rate of assets. Opinion is defined as company change the audit opinion. Firm stands for company changes CPA firm. Big4 is defined as company has audited by Big 4 CPA firms.

6. Conclusions

This study uses two approaches to examine the listed companies' performance with ACs and with Supervisors; and the effects of ACs with findings from two phases. Phase I examines the corporate performances by comparing the "mean" of the EPS and ROA between companies with ACs and those without (with Supervisors), and both empirical results show that companies without ACs (with Supervisors) perform better than companies with ACs. Phase II, the regression results indicate: First that ROIDD is significant and that independent director will influence the effects of ACs on corporate performance. Yet, the AC reports directly to the BoDs; its recommendations need to be approved by the BoDs before their implementation, so the independence standpoint of the AC is less than the SB in organization comparatively; Second, the findings indicate that the AC members with financial experience (EXPERIENCE) and AC meeting times (ACMT) both are negatively significant evidence to report difference from the current literature reviews and is against from requirements of related regulations on ACs. On the basis of this study, the AC is not persuasive to replace the monitoring system of Supervisors and the government may reference to German system to intensify the effects of the corporate governance in Taiwan by forming up as the Supervisory Board as well as further strengthening the Supervisors' power.

Both results support the stakeholder theory more than the shareholder theory. Both results report that the stakeholders may contribute more than the shareholders to the effects of internal supervisory mechanism of corporate governance. In summary, the findings report in this paper may be of assistance to users such as regulators, supervisors or Boards of Directors in considering what governance structures for internal supervisory functions within companies will be better for performance and more effective within organization. If the AC is practiced for longer periods, its monitoring function may cause companies to perform better. Therefore, it calls for further researches on this issue to assess its progress in Taiwan. Finally, the investigation and results reported in this paper may offer a basis for continuing research on the effects of supervisory governance after the introduction of an AC, as well as for future studies of other monitoring functions such as audit and internal control.

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