

THE IMPACT OF AUDIT COMMITTEE SKEPTICISM AND REWARDING POWER ON AUDITOR COMMUNICATION WITH THE AUDIT COMMITTEE

Haryo Wahyu^{1*}, Dewi Susilowati²

^{1,2} Accounting/Faculty of Economics and Business, Jenderal Soedirman University, Indonesia

*Email corresponding author: haryo.hatmoko@mhs.unsoed.ac.id

Abstract

This study analyzes how audit committee skepticism and reward power affect auditor communication with the audit committee. Based on accountability theory, this study examines the prediction that high skepticism and audit committee reward power encourage auditors to convey more and more timely information. Through the literature review method of previous research, especially experimental research involving audit partners and managers, this study examines how audit committee skepticism (high/low) and reward power (high/low) affect auditor communication. The study results show that audit committee skepticism and reward power encourage auditors to communicate more information and report more timely. Further analysis reveals that audit committee skepticism has the strongest influence on auditor communication levels, while reward power affects communication timing more. These findings confirm the importance of audit committee skepticism and reward power in improving auditor communication.

Keywords: Audit Committee Skepticism, Reward Power, Auditor Communication, Accountability Theory, Corporate Governance

INTRODUCTION

Communication between auditors and audit committees is an important element in improving the quality of financial reporting and audit oversight. Auditing standards emphasize the importance of strong communication between auditors and audit committees to improve the quality of financial reporting (PCAOB, 2012; IAASB, 2008; CICA & CPAB, 2013). Information gathered by auditors about a company's financial reporting practices, misstatement risks, and internal controls is valuable to the audit committee in fulfilling its objectives of monitoring financial reporting, internal controls, and the audit process.

Although auditing standards identify the range of issues that auditors are required to communicate to audit committees, auditors have discretion in determining the amount of information to report, whether to communicate immaterial issues, or whether to disclose issues that have been resolved with client management. Auditing standards also provide significant discretion to the auditor regarding the timing of the submission of information to the audit committee (PCAOB, 2012). For example, the auditor may identify a matter during interim work and then choose to report the matter to the audit committee immediately or decide to wait until the following week, the next audit committee meeting, or until the end of field work.

Accountability theory (Tetlock, 1983, 1992; Lerner & Tetlock, 1999) suggests that there are incentives for auditors to communicate issues fully and timely. One motivation is to please the audit committee because disclosure is likely to help the committee fulfill its responsibilities. In addition, auditors typically face significant reputational and litigation risks, and communication with the audit committee helps the committee provide a higher level of monitoring that reduces the risk of audit

failure. In disputes with management, it is also important for the auditor to have the support of the audit committee.

On the other hand, communicating contentious issues to the audit committee may result in management's displeasure with the auditor if the disclosure raises questions in the minds of the audit committee and/or board about the quality of management's reporting judgment and/or the level of aggressive reporting. In addition, auditors do not want to burden the audit committee with insignificant or resolved issues.

The purpose of this study is to examine the impact of two important audit committee characteristics, skepticism and reward power, on auditor communication with the audit committee through a comprehensive literature study. Essentially, skepticism and reward power result in different forms of auditor accountability to the audit committee. Following previous accounting literature (Donnelly & Donnelly, 2023), accountability is defined as "the implicit or explicit expectation that one may be required to justify one's beliefs, feelings, or actions to others" (Lerner & Tetlock, 1999, 255). Skepticism is a reflection of the committee's propensity to ask questions about matters relevant to the oversight of the financial reporting process, while reward power represents the committee's power vis-à-vis management to hire and compensate the auditor. Both of these characteristics increase auditor accountability for greater communication to the audit committee. Research shows that audit committees vary widely in both of these characteristics (Cohen, Krishnamoorthy, & Wright, 2010). Notably, auditing standards do not explicitly recognize and provide guidance to auditors on how to consider audit committee characteristics when deciding the level and timing of auditor communication with the audit committee.

LITERATURE REVIEW AND HYPOTHESIS FORMULATION

Audit Committee Skepticism and Auditor Communication

Research in psychology (Tetlock, 1992, 1983) and in auditing (Donnelly & Donnelly, 2023; Gibbins & Newton, 1994; Kennedy, 1993) has shown that accountability has a strong and broad effect on behavior. In deciding the level and timing of auditor communication with the audit committee, accountability theory predicts that auditors are expected to consider the level of accountability to the committee.

Prior studies suggest that professional skepticism is an important aspect of auditor behavior (Nelson, 2009; Hurltt, Brown-Liburd, Earley, & Krishnamoorthy, 2013). However, less literature has addressed how audit committee skepticism affects auditor behavior. Kang, Trotman, and Trotman (2015) found that audit committees vary significantly in the level of skepticism they exhibit. Audit committee skepticism, reflected in the tendency to question and ask for further explanation, may serve as an accountability mechanism for auditors.

Cohen, Krishnamoorthy, Gaynor, and Wright (2007) found that auditors tend to be more responsive to audit committees that actively question and show interest in the audit work. Meanwhile, Beasley, Carcello, Hermanson, and Neal (2009) identified that more skeptical audit committees tend to get more communication from external auditors about important issues.

Based on this literature, audit committee skepticism is expected to have a positive relationship with the level and timeliness of auditor communications. Audit committees that exhibit a high level of skepticism are likely to be perceived by auditors as more involved in financial reporting oversight, thus encouraging auditors to communicate more information and do so in a timely manner.

Audit Committee Reward Power and Auditor Communication

The Sarbanes-Oxley Act (U.S. House of Representatives, 2002) stipulates that the legal power (authority) for auditor appointment and compensation rests with the audit committee, not with management. Nonetheless, research finds that in many cases, auditors still consider management to be the primary driver of these decisions (Fiolleau, Hoang, Jamal, & Sunder, 2013; Cohen, Gaynor, Krishnamoorthy, & Wright, 2011; Cohen et al., 2010).

Reward power refers to the audit committee's ability to control auditor appointment and compensation. When reward power is high, the audit committee actively exercises its authority for auditor appointment and compensation decisions with little or no input from management. In contrast, when reward power is low, the audit committee tends to delegate these decisions to management or strongly consider management's preferences.

Cohen, Krishnamoorthy, and Wright (2010) found that auditors tend to be more responsive to audit committees that have active control over auditor appointment decisions. This study suggests that when the audit committee has high reward power, auditors tend to feel more accountable to the audit committee than to management.

In a recent report, the PCAOB (2022b) noted that audit committee chairs indicated that their satisfaction with the auditor's work is strongly influenced by comprehensive and timely communication. This suggests that when audit committees have high reward power, auditors may be more motivated to provide good and timely communications.

Based on this literature, audit committee reward power is expected to have a positive relationship with the level and timeliness of auditor communications. When audit committees actively control auditor appointment and compensation, auditors are likely to feel more accountable to the audit committee and therefore more likely to communicate more complete and timely information.

RESEARCH METHOD

This research uses a systematic literature study approach to examine the effect of audit committee skepticism and reward power on auditor communication. The literature study process involves a comprehensive search, identification, and analysis of relevant scholarly articles published in leading accounting and auditing journals. The main data sources came from academic databases including Business Source Complete, ABI/INFORM, Science Direct, Emerald, and Google Scholar.

The keywords used in the search include: "audit committee skepticism," "audit committee power," "audit committee characteristics," "auditor communications," "auditor-audit committee interactions," "audit committee effectiveness," and "accountability theory." The inclusion criteria for the articles analyzed were: (1) published in peer-reviewed journals, (2) focused on auditor communications or auditor-audit committee interactions, (3) addressed audit committee skepticism or reward power, and (4) published in English.

From the search results, 42 articles that met the inclusion criteria were identified and thoroughly analyzed. The articles consisted of experimental studies, surveys, case studies, and theoretical studies. The analysis focused on findings related to how audit committee skepticism and reward power affect auditor communication, both in terms of the level of information communicated and the timeliness of such communication.

RESULTS AND DISCUSSION

The Effect of Audit Committee Skepticism on Auditor Communication

Analysis of the literature shows strong support for a positive relationship between audit committee skepticism and auditor communication. Fiolleau, Hoang, and Pomeroy (2019) report that auditors communicate the most information to audit committees that proactively ask questions (high skepticism). This finding is consistent with the results reported by Beasley et al. (2009) that more active and skeptical audit committees tend to get more complete communication from auditors.

The experimental study by Kang et al. (2015) shows that when audit committees apply strict audit judgment rules (reflecting high skepticism), audit committee members tend to exhibit a higher level of professional skepticism in their evaluation of accounting estimates. This implies that auditors working with such audit committees may be motivated to provide more complete information to avoid possible challenging questions.

The study by Cohen et al. (2007) found that auditors view communication with audit committees as an important tool for managing litigation risk. When audit committees exhibit high skepticism, the

perceived risk that undisclosed audit or reporting issues will be detected increases, thereby encouraging more extensive and timely disclosure by auditors.

In the context of timeliness, Abernathy, Beyer, Masli, and Stefaniak (2014, 2015) find that audit committee chairs with accounting expertise are associated with shorter audit report lags, suggesting that more timely communication is possible when audit committees have members with the expertise and inclination to critically evaluate audit information (an aspect of skepticism).

The above literature suggests that audit committee skepticism encourages auditors to communicate more information and do so more timely. Therefore, the literature supports the proposition that auditors will communicate more information and in a more timely manner when the audit committee exhibits high skepticism compared to low skepticism.

The Effect of Audit Committee Reward Power on Auditor Communication

Analysis of the literature also shows support for a positive relationship between audit committee reward power and auditor communication. Cohen et al. (2010) found that the audit committee's influence over the auditor appointment and replacement process is an important factor affecting auditor-audit committee interactions. When the audit committee is active in the auditor appointment process (high reward power), auditors tend to feel more accountable to the audit committee.

Research by Fiolleau et al. (2013) investigated how regulatory reforms to improve auditor independence work in practice, particularly with regard to the auditor appointment process. They found that although audit committees are formally responsible for the appointment of auditors as per regulation, management often has significant influence on the process. The relationship between management and the audit committee in auditor appointment decisions may affect auditors' perceptions of who has real reward power and thus to whom they feel most accountable.

The study by Cohen et al. (2011) examined the impact of CEO influence on audit committee independence on auditor judgment. They found that auditors tend to be more responsive to audit committee preferences when the audit committee exhibits greater independence from management, which may reflect higher reward power. This implies that when audit committees have high reward power (i.e., when they actively control auditor appointment and compensation decisions), auditors may be more likely to communicate more complete and timely information.

A study by the PCAOB (2022b) found that audit committee chairs highly value comprehensive and timely communications from auditors. Since such communications may affect the audit committee's assessment of the auditor's performance, which in turn may affect the reappointment decision, auditors may be motivated to provide good communications when they believe that reward power resides with the audit committee.

The above literature suggests that audit committee reward power encourages auditors to communicate more information and do so more timely. Therefore, the literature supports the proposition that auditors will communicate more information and in a more timely manner when the audit committee exhibits high reward power compared to low reward power.

Interaction between Skepticism and Audit Committee Reward Power

Although accountability theory predicts that audit committee skepticism and reward power will both improve auditor communication, the literature is less clear on how these two factors interact. Some studies suggest that these two factors may reinforce each other, while others suggest that they may operate independently.

Krishnamoorthy, Wright, and Wright (2023) report experimental results showing that while audit committee skepticism has the strongest influence on auditor communication levels, audit committee reward power has a stronger influence on communication timing. This suggests that although both factors affect auditor communication, they may operate through different mechanisms or affect different aspects of communication.

The study by Fiolleau et al. (2019) found that the audit committee's oversight approach, which includes elements of skepticism and strength, affects auditor communication. Specifically, they found that auditors communicate the most information to audit committees that choose not to engage in the auditor-management negotiation process, proactively ask questions (high skepticism), and rely on auditors for insight. This implies a complex interaction between various audit committee characteristics in influencing auditor communication.

The above literature suggests that although audit committee skepticism and reward power both positively influence auditor communication, they may operate through different mechanisms and may have different effects on different aspects of communication. In particular, audit committee skepticism may have a stronger influence on the level of information communicated, while reward power may have a stronger influence on the timing of communication.

Discussion of Literature Study Results

The literature suggests that both audit committee skepticism and reward power have a positive influence on auditor communication, both in terms of the level of information communicated and the timeliness of communication. However, there are some nuances in this relationship that deserve further discussion.

First, although skepticism and reward power both improve auditor communication, they seem to operate through different mechanisms. Audit committee skepticism, reflected in a tendency to question and question, creates an expectation that auditors should be prepared to defend their decisions and judgments. This encourages auditors to communicate more complete information to avoid difficult questions or criticism later on. On the other hand, reward power creates incentives for auditors to please the audit committee, which can be achieved through complete and timely communication.

Second, the effects of skepticism and reward power may vary depending on the context and type of issue being communicated. For issues involving significant professional judgment or controversial areas, audit committee skepticism may have a stronger influence because auditors will anticipate more questions and challenges. For issues related to reporting timelines or procedural issues, reward power may be more influential as it relates to the auditor's ability to meet the audit committee's expectations.

Third, the findings from this literature review have important implications for practice and regulation. To improve the effectiveness of audit committees in obtaining complete and timely information from auditors, companies and regulators should consider promoting both audit committee skepticism and strengthening their reward power. This can be achieved through training audit committee members in skeptical questioning techniques, ensuring that audit committees are actively involved in auditor appointment and compensation decisions, and creating a culture where audit committees are encouraged to challenge both management and auditors when necessary.

Fourth, although this literature study finds support for a positive relationship between audit committee characteristics and auditor communication, there are still gaps in the literature. Specifically, there is limited research on the interaction between skepticism and reward power, as well as on how these audit committee characteristics interact with auditor characteristics (such as experience level, industry specialization, or personality traits) in influencing communication.

CONCLUSION

This literature review examines the impact of two important audit committee characteristics, skepticism and reward power, on auditor communication with the audit committee. By analyzing the relevant literature, this study finds support for the proposition that high levels of audit committee skepticism and reward power encourage auditors to communicate more information and do so in a more timely manner.

Audit committee skepticism, reflected in the tendency to ask probing questions about issues relevant to the oversight of the financial reporting process, creates an accountability mechanism that encourages auditors to share more information. When auditors realize that the audit committee is likely to ask questions, they are more likely to proactively communicate relevant information to avoid difficult questions or criticism later on.

Audit committee reward power, which refers to the audit committee's ability and willingness to exercise its authority in auditor appointment and compensation decisions, also creates an important accountability mechanism. When auditors feel that their future assignment and compensation depend on the audit committee's judgment, they are more likely to communicate information in a complete and timely manner to please the audit committee.

Further analysis of the literature suggests that while both audit committee characteristics enhance auditor communication, they may affect different aspects of communication. Audit committee skepticism appears to have a stronger influence on the level of information communicated, while reward power has a stronger influence on the timing of communication.

These findings have important implications for practice and regulation. To improve the effectiveness of audit committees in obtaining necessary information from auditors, it is necessary to promote both the skepticism and reward power of audit committees. Corporate governance regulations and practices should consider developing guidelines and training to enhance audit committee skepticism and to ensure that audit committees actively exercise their authority in auditor appointment and compensation decisions.

Limitations and Future Research Directions

While this literature review provides valuable insight into the relationship between audit committee characteristics and auditor communication, there are several limitations that need to be recognized. First, this study relied on analyzing the existing literature, which mostly consists of experimental studies and surveys. These research methods have limitations in terms of generalizability and the ability to establish cause-and-effect relationships. Future research could consider more diverse methodological approaches, including longitudinal studies and analysis of archival data.

Second, this study focused on two audit committee characteristics: skepticism and reward power. However, audit committees have various other characteristics that may affect auditor communication, such as accounting expertise, industry experience, or independence. Future research could expand the analysis to include additional audit committee characteristics and their interactions with skepticism and reward power.

Third, this study relies primarily on research conducted in the United States environment, which has a specialized regulatory framework and governance practices. The findings may not be fully applicable to other jurisdictions with different regulatory regimes and governance practices. Future research could adopt an international or comparative perspective to determine whether the relationships identified apply cross-culturally.

Fourth, this study focused on auditor communication to audit committees, but did not consider other communication directions, such as from audit committees to auditors or between audit committees and management. Future research could adopt a more holistic perspective on communication in the financial reporting process.

Some promising directions for future research include:

1. Examining the interaction between audit committee skepticism and reward power in influencing auditor communication;
2. Investigating how auditor characteristics (such as experience, personality, or firm affiliation) moderate the relationship between audit committee characteristics and auditor communication;
3. Examine the practical implications of the findings for the training and development of audit committee members and auditors;

4. Expand the analysis to include the implications of improved communication for audit quality and financial reporting;
5. Investigate how changes in audit regulations or standards affect the relationship between audit committee characteristics and auditor communication.

In conclusion, this literature review provides valuable insights into how audit committee skepticism and reward power affect auditor communication. It highlights the importance of promoting these audit committee characteristics to improve the effectiveness of auditor-audit committee communication, which in turn can improve audit quality and financial reporting.

BIBLIOGRAPHY

- Abernathy, J. L., Beyer, B., Masli, A., & Stefaniak, C. (2014). The association between characteristics of audit committee accounting experts, audit committee chairs, and financial reporting timeliness. *Advances in Accounting*, 30(2), 283-297.
- Abernathy, J. L., Beyer, B., Masli, A., & Stefaniak, C. (2015). How the source of audit committee accounting expertise influences financial reporting timeliness. *Current Issues in Auditing*, 9(1), P1-P9.
- Beasley, M., Carcello, J., Hermanson, D., & Neal, T. (2009). The audit committee oversight process. *Contemporary Accounting Research*, 26(1), 65-122.
- Canadian Institute of Chartered Accountants & Canadian Public Accountability Board (CICA & CPAB). (2013). *Enhancing Audit Quality: The Role of the Audit Committee in External Auditor Oversight*. Toronto, Canada: CICA and CPAB.
- Chambers, A. E., & Penman, S. H. (1984). Timeliness of reporting and the stock price reaction to earnings announcements. *Journal of Accounting Research*, 22(1), 21-47.
- Cohen, J., Gaynor, L. M., Krishnamoorthy, G., & Wright, A. (2011). The impact on auditor judgments of CEO influence on audit committee independence. *Auditing: A Journal of Practice & Theory*, 30(4), 129-147.
- Cohen, J., Krishnamoorthy, G., & Wright, A. (2004). The corporate governance mosaic and financial reporting quality. *Journal of Accounting Literature*, 23, 87-152.
- Cohen, J., Krishnamoorthy, G., & Wright, A. (2010). Corporate governance in the post Sarbanes-Oxley era: Auditor experiences. *Contemporary Accounting Research*, 27(3), 751-786.
- Cohen, J., Krishnamoorthy, G., Gaynor, L., & Wright, A. (2007). Auditor communications with the audit committee and the board of directors: Policy recommendations and opportunities for future research. *Accounting Horizons*, 21(2), 165-187.
- Dhaliwal, D., Naiker, V., & Navissi, F. (2010). The association between accruals quality and the characteristics of accounting experts and mix of expertise on audit committees. *Contemporary Accounting Research*, 27(3), 787-827.
- Donnelly, A. M., & Donnelly, D. P. (2023). A systematic review of experimental research on accountability in auditing. *Behavioral Research in Accounting*, 35(2), 1-28.
- Fiolleau, K., Hoang, K., & Pomeroy, B. (2019). Auditors' communications with audit committees: The influence of the audit committee's oversight approach. *Auditing: A Journal of Practice & Theory*, 38(2), 125-150.
- Fiolleau, K., Hoang, K., Jamal, K., & Sunder, S. (2013). How do regulatory reforms to enhance auditor independence work in practice? *Contemporary Accounting Research*, 30(3), 864-890.
- Free, C., Trotman, A., & Trotman, K. (2021). How audit committee chairs address information-processing barriers. *The Accounting Review*, 96(1), 147-169.
- Gibbins, M., & Newton, J. (1994). An empirical exploration of complex accountability in public accounting. *Journal of Accounting Research*, 32(2), 165-186.

- Hurt, R. K., Brown-Liburd, H., Earley, C. E., & Krishnamoorthy, G. (2013). Research on auditor professional skepticism: Literature synthesis and opportunities for future research. *Auditing: A Journal of Practice & Theory*, 32(Supplement 1), 45-97.
- International Auditing and Assurance Standards Board (IAASB). (2008). *International Standard on Auditing (ISA) 260: Communication with Those Charged with Governance*. New York, NY: IAASB.
- Kang, Y., Trotman, A., & Trotman, K. (2015). The effect of an audit judgment rule on audit committee members' professional skepticism: The case of accounting estimates. *Accounting, Organizations and Society*, 46, 59-76.
- Kennedy, J. (1993). Debiasing audit judgment with accountability: A framework and experimental results. *Journal of Accounting Research*, 31(2), 231-245.
- Krishnamoorthy, G., Wright, A., & Wright, N. S. (2023). The impact of audit committee skepticism and reward power on auditor communications with the audit committee. *Behavioral Research in Accounting*, 35(2), 93-110.
- Krishnan, G., & Visvanathan, G. (2008). Does the SOX definition of an accounting expert matter? The association between audit committee directors accounting expertise and accounting conservatism. *Contemporary Accounting Research*, 25(3), 827-858.
- Kross, W., & Schroeder, D. (1984). An empirical investigation of the effect of quarterly earnings announcement on stock returns. *Journal of Accounting Research*, 22(1), 153-176.
- Lerner, J., & Tetlock, P. (1999). Accounting for the effects of accountability. *Psychological Bulletin*, 125(2), 255-275.
- Nelson, M. W. (2009). A model and literature review of professional skepticism in auditing. *Auditing: A Journal of Practice & Theory*, 28(2), 1-34.
- Public Company Accounting Oversight Board (PCAOB). (2012). *Communications with Audit Committees. Auditing Standard (AS) 1301*. Washington, DC: PCAOB.
- Public Company Accounting Oversight Board (PCAOB). (2022a). *AS 1015: Due Professional Care in the Performance of Work*. Washington, DC: PCAOB.
- Public Company Accounting Oversight Board (PCAOB). (2022b). *Spotlight: 2021 Conversations with Audit Committee Chairs (March)*. Washington, DC: PCAOB.
- Sarbanes-Oxley Act. (2002). Public Law No. 107-204. Washington, DC: Government Printing Office.
- Securities and Exchange Commission (SEC). (2015). *Possible revisions to audit committee disclosures. Release Nos. 33-9862, 34-75344, File No. S7-13-15, July 2015*. Washington, DC: SEC.
- Tetlock, P. (1983). Accountability and complexity of thought. *Journal of Personality and Social Psychology*, 45(1), 74-83.
- Tetlock, P. (1992). The impact of accountability on judgment and choice: Toward a social contingency model. *Advances in Experimental Social Psychology*, 25, 331-376.