THE LONDON SCHOOL OF ECONOMICS AND POLITICAL SCIENCE

Department of Accounting

The Audit Committee: Management Watchdog or Personal Friend of the CEO?

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Abstract

To ensure that audit committees provide sufficient oversight over the auditing process and quality of financial reporting, legislators have imposed stricter requirements on the independence of audit committee members. Although many audit committees appear to be "fully" independent, anecdotal evidence suggests that CEOs often appoint directors from their social network. Based on a sample of U.S. listed companies after SOX (i.e., between 2004 and 2008), we consistently find that these social ties have a detrimental effect on variables that proxy for oversight quality. In particular, we find that firms whose audit committees have "friendship" ties to the CEO purchase less audit services and engage more in earnings management. Auditors are also less likely to issue going-concern opinions or to report internal control weaknesses when friendship ties are present. Social ties formed through advice networks, on the other hand, do not seem to hamper the quality of audit committee oversight.