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Cowton, Christopher J. and Avison, Lynn

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Original Citation

Cowton, Christopher J. and Avison, Lynn (2012) UK audit committees and the Revised Code. *Corporate Governance*, 12 (1). pp. 42-53. ISSN 1472-0701

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UK audit committees and the Revised Code

Purpose: The audit committee is one of the most prominent board sub-committees, having a potentially important role to play in ensuring sound corporate governance. This paper examines and discusses the behaviour of companies following revisions to the UK's Revised Code.

Research design/methodology/approach: A variety of annual report data from a sample of 50 UK companies, stratified according to size, is collected and analyzed.

Findings: General compliance with many provisions of the Revised Code was found. All but one company had an audit committee comprising solely non-executive directors. However, in about a quarter of cases the chairman was a member, and in some cases directors were not 'independent' according to the Code's definition. Nevertheless, many companies exceeded the minimum stipulated requirements, for example the number of non-executive directors on the audit committee or the number of meetings held. Some companies, though, did not follow recommended practice, particularly regarding the disclosure of information, and some explanations for non-compliance were weak.

Implications: Compliance with disclosure demands regarding audit committees could be improved, as could the quality of explanations when the recommendations of the Code are not followed. It would be sensible for regulators to monitor this, provide more detailed guidance and highlight examples of good practice. Given the resistance of many companies to corporate governance regulation and accusations of 'box ticking', future research should probe why many companies do more than is required or recommended. The research should be repeated when further revisions to the Code are made in respect of audit committees, and practice in countries other than the UK should be researched to provide comparative insights.

INTRODUCTION

When compared with the board itself, relatively little attention has been paid to board sub-committees (Spira and Bender, 2004), in spite of their growing importance. This is significant, for as corporate governance has evolved, so has the role of the audit committee, to the point where 'it is arguably the most important board sub-committee' (Mallin, 2004, p. 98). Given the place of non-executive directors (NEDs) on the audit committee, this growth in importance can be seen as part of a trend 'to establish and increase the independence and powers of non-executive directors' (Clarke, 2007, p. 50).

The independence of NEDs on the board of directors is considered vital if they are to perform an effective monitoring role and thus ensure satisfactory ‘conformance’ on the part of executive management (see Spira and Bender, 2004) who, given the separation of ownership and control in the modern corporation (Berle and Means, 1932), are prone to agency problems such as shirking and moral hazard (Jensen and Meckling, 1976). The audit committee offers a check on executive directors’ potential manipulation of earnings, through reviewing the financial statements and associated accounting principles and practices, liaising with internal and external auditors, and reviewing the effectiveness of internal controls.

A succession of UK initiatives has advocated the adoption of audit committees and made recommendations regarding their composition and operation. The ‘Revised Code’ of corporate governance was issued in July 2003 and applied to financial year ends from 31 October 2004 onwards. As rules or guidelines continue to evolve, it is appropriate to examine how companies responded to this particular set of changes, especially since, as at late 2009, the UK Code is undergoing a major review.

The aim of this paper is to determine the extent to which companies adopted the audit committee provisions of the Revised Code when it was introduced, and to identify and discuss significant issues that became apparent. Given the UK’s leadership, since the publication of the Cadbury Report, in “principles-based” approaches to corporate governance, such experience is of wider significance than just the UK, providing possible lessons for other jurisdictions. The paper is structured as follows. The first main section provides a review of the literature, which falls into two broad types: first, the various policy documents that have guided the development of audit committees in the UK; and second, research literature on audit committees. From this review are developed a set of research questions. The second section describes the research design and methods. The third and fourth sections, respectively, present and discuss the research findings. The paper ends with conclusions and an outline of limitations and possibilities for future research.

LITERATURE REVIEW

Prior to the 1970s few companies in the UK had an audit committee, although they were more common in the US and Canada. Kalbers and Fogerty (1998) suggest that their inclusion in contemporary corporate governance should be seen as a reaction to corporate abuses, which would appear to be the case in the UK, with three peak periods in their formation: 1979 to 1981; 1986 to 1990; and 1992 to 1993 (Collier, 1996). The first peak seems to have been a response to failures in auditing and accounting which arose in the latter half of the 1970s from a number of well publicised financial scandals such as Rolls Royce, Court Line and Pergamon Press. The second is identified with the spectacular corporate failures of the period – for example Polly Peck, Coloroll and BCCI – and the high level of debt in the corporate sector. These failures led to renewed pressure from both inside and outside the accounting profession, which resulted in the appointment of the Cadbury Committee and consequently the third peak in audit committee formation, since the Committee's Code of Best Practice made it virtually mandatory for UK-listed companies to have one (Cadbury, 1992; see Tolley's, 2003, p. 871). Audit committees are now widespread among listed companies in the US and UK (Hemscott, 2003; Spira and Bender, 2004), for example, thus limiting opportunities to research their impact. However, recent research that has been able to compare firms that have an audit committee with those that do not has found evidence that an audit committee adds value. In their comparison of foreign registrants in the US, Chen et al. (2008) found that those that chose not to establish an audit committee tended to have significantly lower earnings-return associations.

The Cadbury Code recommended that the board should establish an audit committee of at least three non-executive directors (NEDs), at least two being independent, and that it should have written terms of reference. The Cadbury Code was superseded by the Combined Code in 1998. Derived from the report of the Hampel Committee, which had been set up in 1995 to review the implementation of the recommendations of the Cadbury Code (Hampel, 1998) and the Greenbury report on directors' remuneration, the Combined Code recommended that listed companies establish an audit committee with written terms of reference and at least three members, all of whom should be NEDs and the majority of whom should be independent.

The Combined Code on Corporate Governance (the Revised Code), which was issued in July 2003 (FRC, 2003), superseded the original Combined Code, following reviews by Derek Higgs on the role and effectiveness of non-executive directors (Higgs, 2003) and by Sir Robert Smith on audit committees (Smith, 2003). It incorporates their guidelines. The Smith Guidance had recommended that:

all members of the committee should be independent non-executive directors and that the board should satisfy itself that at least one member of the audit committee has recent and relevant experience and appointments should be for a period of up to three years, extendable by no more than two additional three-year periods, so long as members continue to be independent.

The section in bold is incorporated within the Revised Code (C.3.1) whilst the remainder forms part of The Smith Guidance to the Revised Code. Table 1 summarises the development of the recommendations regarding audit committees.

Insert Table 1 here

As can be seen from Table 1, the requirements for audit committees have been modified gradually as a result of successive reports. Whereas the number of NEDs required for smaller (but not actually small) companies (those below the FTSE 350)¹ has been relaxed slightly, there has generally been an increasing emphasis on their independence. The Cadbury requirement of at least two independent NEDs meant that they could, in principle, have found themselves in a minority, a shortcoming that was remedied by the 1998 Combined Code.

The Revised Code states that the board should determine whether a director is independent in character and judgement, and whether there are relationships or circumstances which are likely to affect, or could appear to affect, the director's judgement. Independence is overwhelmingly seen as the most significant attribute of an audit committee member (Windram and Song, 2004; see Mangena and Tauringana, 2008). This is empirically supported by Chan and Li (2008) who, in their study of the

¹ FTSE 350 refers to the 350 largest companies by market capitalization listed on the London Stock Exchange. It is made up of the FTSE 100 and the FTSE 250.

top 200 firms in the Fortune 500, found that the presence of expert-independent directors (i.e. top executives of another independent, publicly traded firm) tended to be associated with enhanced firm value.

The independence of NEDs could be affected by a number of factors. One is whether a director has served on the board for more than nine years from the date of their first election; such a relationship requires disclosure. Keasey and Hudson (2002) argue that it is difficult for NEDs to make a meaningful contribution to performance without forming a working relationship with executives, but this in turn could affect their independence. Another is the existence of any 'relationship' between audit committee members and the external auditors; for example, if a NED has been employed by, or been a partner in, the firm of external auditors. Brennan and McDermott's (2004) study of Irish listed companies identified four cases of former employees of the external auditors who were NEDs on the audit committee and no indication of time lapse since employment given; therefore independence could not be ascertained. The Revised Code comments that the board should state its reasons if it considers that a director is independent even though there are relationships or circumstances which might suggest otherwise.

The Revised Code also deals with the roles and responsibilities of audit committees. These now include a review of the integrity of financial reporting, internal controls and risk management systems, monitoring and reviewing the effectiveness of the internal audit function, and responsibility for overseeing the external audit process, including auditor independence and the provision of non-audit services.

The role of NEDs in audit committees might clash with their other roles, depending on what contribution is expected from them as members of the board. Pye and Camm (2003) produce a matrix of four types of NED role contribution by identifying two role dimensions – risk management and strategic contribution – which point towards responsibilities focused on monitoring and performance. Keasey and Hudson (2002) similarly argue that roles are to do with performance and accountability, but the precise role fulfilled by a particular NED would be expected to take into account the difference in assigned tasks resulting from differing sub-board committee membership. However, Spira (2003) argues that the audit committee role is advisory

and largely reactive. Spira and Bender (2004) similarly note that the audit committee is concerned with accountability and supervisory roles and thus the role is focused on conformance or risk management rather than performance.

Such an important agenda suggests not only the need for an audit committee to be formed but also for it to meet frequently enough to discharge its responsibilities effectively (see Xie et al., 2003) and for members to devote sufficient time to its activities. The Revised Code recommends at least three meetings per annum for larger companies and at least two for those outside FTSE 350.

The increasing technical demands upon audit committees have led to the requirement for them to have at least one member with recent and relevant financial experience. This requirement, introduced by the Smith Report (Smith, 2003), is supported by Xie et al. (2003), who found that the financial sophistication of audit committee members seemed to reduce earnings management by executives. Similarly, Mangena and Tauringana's (2008) findings suggest that, along with independence, the presence of financial expertise makes a useful contribution to an audit committee's effectiveness.

Finally, although reference has been made to the "requirements" of the Revised Code, it should be noted that it is appended to The Stock Exchange Listing Rules ('the Purple Book') rather than a part of them. Adherence is thus voluntary. The Listing Rules simply require that a listed company should state within its annual report whether it complies with the provisions of the Code and, if not, which provisions it does not comply with and the reason for non-compliance (Tolley's, 2002). This is the so-called "comply or explain" approach.

Although a significant amount has been written about how audit committees should operate, relatively little has been written about how they actually do operate. Gendron et al. (2004) got inside the "black box" (Spira, 2003) of the audit committee, conducting a field study of three Canadian audit committees, but there is little or no systematic research on many of the issues identified above. This paper is therefore intended to make a contribution to understanding how audit committees operate, with a particular emphasis on how they responded – or not – to the Revised Code.

Using secondary data, the following eight research questions relating to the existence, composition and activities of audit committees are addressed.

- Q1 Do all companies have an audit committee, and how many members do they have?
- Q2 Are all audit committee members independent non-executive directors?
- Q3 Is there any relationship between non-executive directors who are audit committee members and the external auditors?
- Q4 How many audit committee meetings are held each year?
- Q5 Do companies disclose individual attendance at audit committee meetings?
- Q6 Are members of the audit committee on any other board sub-committees?
- Q7 Do companies have at least one financial expert on their audit committee, and do they name them?
- Q8 What are the relevant expertise and qualifications of 'financial experts'?

RESEARCH METHOD

Different methods, both quantitative and qualitative, have been adopted by previous researchers. For example, some have used postal questionnaire surveys (e.g. Windram and Song, 2004; Pye and Camm, 2003), others have conducted interviews (e.g. Spira and Bender, 2004; Roberts et al., 2005; Gendron et al., 2004), while some have used a mixture of methods.

Interviews can be very valuable in eliciting insights into the operation of audit committees, if the interviewees are able to speak with authority on the issues in question and are not too guarded in their responses. However, it can be difficult to gain access, or even have sufficient time, to conduct enough interviews to provide confident generalizations. Postal (or internet-based) questionnaires offer the prospect of much wider coverage, but there are problems in obtaining responses and the possibility of non-response bias. Furthermore, where sensitive issues are being addressed, there is a risk of social desirability response bias (Fernandes and Randall, 1992; Randall and Fernandes, 1991).

Interviews and questionnaires are not without value, but for this study it was decided to examine corporate annual reports. One reason is that some of the research questions relate to the matter of disclosure itself. Another is that data can be collected on a systematic basis and, though not infallible, are less likely to be subject to bias; this is a common benefit of using secondary data to research sensitive issues (Cowton, 1998). Previous authors have also used annual report data (e.g. Brennan and McDermott, 2003; Mangena and Tauringana, 2008).

The population from which the sample of companies was selected was UK companies listed on the London Stock Exchange at 31 December 2004. Foreign companies were removed because their corporate governance is likely to be driven principally by their own national requirements. Some UK companies are listed on more than one exchange, but all the companies examined in this paper reported under the Revised Code. Specialist categories such as investment companies (850) and investment entities (890) were eliminated before 50 companies were selected from the remaining 947.. The stratified random sample comprised 5 FTSE 100 companies, 11 FTSE 250 companies (i.e. 101-350) and 34 others from outside the FTSE 350. Given that corporate governance practices of listed companies can vary by size (sometimes reflected in corporate governance codes), the stratified sample provided both good coverage and an opportunity to undertake further analysis of the results.

The first year end for compulsory adoption of the Revised Code was 31 October 2004. In order to get a sufficiently large number of companies operating under the new system, and bearing in mind the length of time that some companies take to publish their annual report, the sample selected from companies with financial year ends between 31 October 2004 and 31 March 2005.

The annual reports were analysed and the data entered on a spreadsheet to facilitate quantitative analysis. Qualitative data, largely in the form of quotations from the corporate governance statements or directors' reports, were also extracted. Finding all the relevant data in the annual reports presented practical challenges, since there is no standard content for corporate governance statements or reports; some was found in the directors' report their biographies, rather than in the corporate governance statement itself.

FINDINGS

The eight research questions will be considered in turn, divided into three groups: existence and composition of audit committees; audit committee operation; and financial expertise.

Existence and composition of audit committees

Q1 Do all companies have an audit committee, and how many members do they have?

All the companies, except one – Daejan Holdings PLC, a FTSE 350 company – had an audit committee. Daejan Holdings had only three directors – the executive Chairman, an executive director, and a non-executive director who joined the board in 1971. The Board did not consider that non-executive participation would benefit the shareholders and stated that an audit committee would be introduced only when considered to be in the best interests of the company.

Table 2 summarizes audit committee size for the remaining 49 companies.

Insert Table 2 here

As might be expected, there is a positive association between company size and the size of audit committees; the mean number for FTSE 350 companies in the sample (see Table 2) is 4.06, while for those outside FTSE 350 it is only 3.30. However, only 3 out of the 33 smaller companies (i.e. 9% of those outside the FTSE350) took advantage of the less stringent requirement to have only 2 NEDs (see Table 1). Indeed, Table 2 shows that most companies (43 out of 49, i.e. 88%) more than met the minimum requirement for the number of NEDs on their audit committee. Given the claims that suitable NEDs are difficult to recruit and should not be overloaded with

work and that corporate governance requirements are too onerous, this is a surprising finding and worthy of further investigation. Perhaps some of the 21 smaller companies (64%) that only just met the previous, 1998 Combined Code requirement to have at least three NEDs on their audit committee will in due course take advantage of the lower numerical requirement introduced by the Revised Code

Q2 Are all audit committee members independent non-executive directors?

All the audit committee members were NEDs, but not all those NEDs were independent. Some companies may not have complied for part of the year but were able to rectify the position during the year or for the start of the next financial year (e.g. William Hill plc). Nevertheless, 3 companies included at least one non-independent NED and it seemed unlikely that they were going to comply; they provided explanations instead.

For example, Business Post Group plc stated that, despite his significant shareholding, a non-independent NED's membership of the committee was appropriate because his experience and knowledge were invaluable. Henry Boot plc, a company with no independent NEDs at all, commented that the appointment of additional independent directors would lead to unwieldy board numbers and additional costs relative to the size of the company – though they stated that they might in future years bring in independent NEDs if there were shown to be compelling need or it were advantageous to do so.

Furthermore, 10 companies included their non-executive chairman on their audit committee, which was not in accordance with the Code. However, the FRC has more recently amended the Code with regard to companies outside the FTSE 350, so that the chairman can sit on the audit committee if considered independent on appointment. Of the 10 companies, only one was within the FTSE350.

Q3 Is there any relationship between non-executive directors who are audit committee members and the external auditors?

A review was made of information in the directors' biographies to determine if there had been any recent relationship with the external auditors. Several directors had been partners in other audit firms, but the analysis revealed no case of a NEDs who had been associated with the current auditors. In this area, Tthe Revised Code is reinforced by the professional ethics requirements of the UK accountancy profession.

Audit committee operation

Q4 How many audit committee meetings are held each year?

The Code states that there should be as many meetings as the audit committee's role and responsibilities require; Xie et al.'s (2003) findings suggest that increased frequency of meeting can be beneficial. The Code recommends at least three per annum for larger companies and at least two for those outside FTSE 350. As Table 3 shows, there was significant variation in practice amongst the sample of companies, with five holding as many as six per year.

Insert Table 3 here

The arithmetic mean of audit committee meetings per year according to Table 3 is 3.58 meetings, which is broadly in line with, but higher than, Windram and Song's (2004) finding of an average of 3.26 meetings per annum. At first sight this appears to be consistent with the Code's recommendation that there should be not fewer than three meetings during the year. All FTSE 100 and FTSE 250 companies in the sample, 5 and 11 respectively, complied with the requirement to hold at least three meetings per year. One company outside the FTSE 350, the Durlacher Corporation, failed to reveal how many meetings the audit committee had held – nor did it explain why it did not disclose this information. Of the remaining 32 smaller companies, the vast majority (26) held more than the minimum number of two. Just one, REA Holdings, held only one meeting. It explained this by stating that members discharge their responsibilities by informal discussions and by holding at least one formal meeting in each year, as two of the independent NEDs are based in Singapore.

Of the 10 companies with the relatively high frequency of 5 or more audit committee meetings during the year, 8 were in the FTSE 350 and thus amongst the larger companies, which is consistent with Kalbers and Fogarty's (1998) finding that organization size was highly associated with the number of audit committee meetings. Of the other two companies, for one 2004 was its first full year as a publicly listed company, which might explain the need for more meetings, and the other saw significant growth during the period under review.

It is notable that 41.7% (20/48) of the companies for which figures are given, including many outside the FTSE 350, chose to hold more than three audit committee meetings during the year. Indeed, given that companies outside the FTSE 350 need hold only two meetings per year, 79.2% (38/48) held more meetings than the Revised Code recommends as a minimum. This suggests that they are not just meeting the bare letter of the Code but, perhaps, choosing to meet more frequently in order to fulfil their substantive responsibilities. Of course, they may simply be meeting after the main board or other sub-board meetings. This is an area for further research.

Q5 Do companies disclose individual attendance at audit committee meetings?

The Code states that a company should set out in its annual report the number of meetings of the board and the nomination, audit and remuneration committees and individual attendance by directors (A.1.2). However, of the 49 companies with an audit committee in the sample, six (12%) did not comply with this requirement.

Q6 Are members of the audit committee on any other board sub-committees?

Most non-executive directors are on at least one board sub-committee (audit, nomination or remuneration committee) and many are on more than one. 44% of all NEDs on audit committees were also members of both the remuneration and nomination committees, while 22% were also on the remuneration committee but not the nomination committee. For 10 companies there were no nomination committee meetings during the period, whilst 30% of companies did not have all the audit

committee members on the other committees. This appears to be the case for companies with a large pool of NEDs on the board. These are in line with the Hemscott (2003) survey, which found that in FTSE 100 companies approximately 42% of NEDs sit on both audit and remuneration committees. They found for FTSE 250 companies that it rose to 64%, which was similar to that in other listed companies.

Details are not available in the annual reports regarding the time taken up by audit committee duties. However, Scottish & Newcastle plc commented specifically about the extra commitment entailed by committee membership, estimating one or two days per month, with more for committee chairmen(.

Financial expertise

Q7 Do companies have at least one financial expert on their audit committee, and do they name them?

Insert Table 4 here

Keasey and Hudson (2002) remark that it would be difficult to be an independent NED without a sound grasp of accounting practice. It is possible to be financially literate without being a qualified accountant, but given the technical demands of audit committee membership and, perhaps, the desire to demonstrate financial competence to external parties, it would be understandable if qualified accountants were preferred.

The Code states that, “The board should satisfy itself that at least one member has recent and relevant financial experience” and requires a company to name its financial expert. Eight companies claimed that all the members had the relevant experience. In four of those cases it was possible to identify this experience from the biographies, but in the other four cases no information was available to substantiate the companies’ claims. This is consistent with the general finding of Brennan and McDermott (2004) that biographical disclosure varied and was often inadequate.

40.8% of companies specifically named their 'expert'; in the majority of cases it was possible to discover that they were qualified accountants. Another 38.7% failed to name or provide any details of the 'expert', but it was again possible to find out that the majority of companies did have at least one qualified accountant on the audit committee.

Table 4 shows that two companies had no NEDs with recent and relevant financial experience, but they stated that they were actively seeking to recruit. Investec plc seemed to be encountering problems in securing suitable candidates and were considering the appointment of an external search consultancy to assist with this. Geest plc and Collins Stewart Tullet plc provide explanation of not having a 'financial expert' on the audit committee following the expiry of their term of office; the former selecting to do without an expert and the latter requesting the Chairman to continue to chair the audit committee as he was the only NED who could be classified as a 'financial expert'.

Q8 What are the relevant expertise and qualifications of 'financial experts'?

As can be seen from Table 4, at least 29 (61.7%) companies have qualified accountants on the audit committee. However, the quality of disclosure in this area is not as high as for other issues covered by this paper, so for many companies it is not clear the basis on which a particular NED is deemed to have recent and relevant financial experience.

DISCUSSION

Having presented the answers to the research questions developed in relation to the Revised Code and the literature, the findings will now be discussed in more depth.

The research of Chen et al. (2008) suggests that having an audit committee can bring financial benefits to a company. However, in itself this will not bring competitive advantage, for our research confirms previous findings (Hemscott, 2003; Spira and Bender, 2004) that audit committees are now a well-established component of the corporate governance of UK listed companies, consistent with the guidelines provided

by the Revised Code. (Only one company in our sample did not have an audit committee.) Our findings add to previous research by showing the widespread presence of audit committees is the case not just for FTSE 100 and FTSE 350 companies, but also for smaller listed companies. However, there was some evidence of a size effect, with audit committees of larger companies tending to have larger memberships and to hold more meetings. The latter might help to reduce earnings management (Xie et al., 2003), though it is possible that, with a larger company and its complexities, the audit committee needs to make more effort to hold earnings management at a certain level.

All audit committee members were found to be non-executives directors (NEDs) and no evidence was found of any relationship between an audit committee member and the external auditors. This might be reassuring to those who, mindful of the agency problems of the modern corporation (Jensen and Meckling, 1976), view audit committees as having an important monitoring, supervisory or conformance role to play (see Spira and Bender, 2004). However, in the case of a minority of companies, not all audit committee members were independent according to the terms of the Code, which entails the risk that their objectivity and effectiveness in monitoring could be undermined, to the detriment of performance (see Chan and Li, 2008; Mangena and Taurigana, 2008). In some cases this appeared to be a temporary or transitional stage, but there was also evidence that some companies disagreed with the Code, particularly in relation to length of “association”. This was an area, therefore, where some companies chose to explain rather than comply, which is entirely consistent with a principles-based code. Nevertheless, where a particular recommended practice becomes widespread it is increasingly likely to be regarded as normative and hence explanations for non-compliance or deviation have more work to do to convince interested external parties. In such cases, at least those parties have the opportunity to form a judgement based on the explanation and to respond accordingly if they wish.

A rather more common deviation from the provisions of the Code was found regarding the company chairman; almost a quarter of companies within the sample had the chairman on the audit committee. It is interesting, therefore, that the Code was being brought into line with practice (albeit with restrictions regarding company

size) rather than vice-versa (see FRC, 2007). At one level it might be argued that this is unnecessary, since compliance with the Code is not mandatory; those companies that do not follow a particular provision need only explain their reasons.

Nevertheless, where such a large number of companies are non-compliant, it begins to call into question the authority and credibility of the Code and so adjustments come to be made.

Another area in which companies were non-compliant was the disclosure of certain items of information. In particular, several companies failed to disclose individual attendance at audit committee meetings and a significant proportion of companies failed to name their financial expert. There are two points to be made about this. First, while the companies concerned disclose the existence of an audit committee, they are reducing the information available about its operation. Second, there is a difference between these and other areas of non-compliance, referred to above, for those discussed earlier tend to come with an explanation. One of the features of this type of non-compliance is that an explanation is not provided – perhaps because it is difficult to think of a suitable reason for not disclosing what the Code asks for and which most companies follow. If the issue of non-disclosure were drawn to the annual report reader's attention, it would be natural for the reader to react, "so tell me". On these issues of disclosure, then, "comply or explain" does not seem to be working; companies either comply (the majority) or they do not comply and do not explain (the minority). It would be sensible for regulators to monitor this, provide more detailed guidance, and highlight examples of good practice.

However, although the Code is part of a principles-based, "comply or explain" regime that does not require adherence to particular provisions, many companies were following much of the guidance. Where they were not, there were two types of situation. First, there were cases where companies indicated that were not complying but intended to do so (or had not complied until some time into the reporting period). Sometimes they alluded to difficulties in making a particular adjustment to the Code. This suggests that the initial period of implementation of the Revised Code was proving challenging or, at least, companies did not see a need to comply promptly. Such transitional problems would be expected to be temporary, and explanations for them if they were to continue into a second year would be unconvincing.

Second, some companies provided explanations regarding why they did not comply and, presumably, would not be complying in the future. While it is wholly consistent with a “comply or explain” regime for a company to pursue a different course of action, in some cases the explanations did not seem particularly convincing or persuasive (see also FRC, 2007). It is particularly difficult for companies to put forward a strong case when they appear to disagree with the principle expressed in the Code; in contrast, say, to an explanation that demonstrates how a given principle is being followed through a divergent action in their particular context. Thus, for example, contentions that long-serving directors can still be independent would appear to apply to all companies or to none, unless some rather sophisticated reasoning – more than mere assertion – is brought to bear.

Nevertheless, there is clear evidence of many companies complying with much of the Code. It might be surmised that some are merely treating this aspect of corporate governance as a “box-ticking” exercise (FRC, 2007), but it is notable that in some respects (e.g. number of members and frequency of meetings) many companies are doing significantly more than the guidelines suggest. Given the complaints that are sometimes voiced about “onerous” governance requirements, we believe it is one of the most significant findings of our research that so many companies are prepared to go beyond the letter of the Code.

CONCLUSION

This paper has shown that many UK companies are following many of the provisions of the Revised Code, but there are areas of non-compliance. In the most significant area of non-compliance (the presence of the chairman on the audit committee), the Code was being adjusted in such a way that the actions of most of the companies involved would in future be accommodated.

However, the ‘good’ practices in the Revised Code are not mandatory, and we found evidence of companies choosing to explain rather than comply. Some explanations expressed an intention to comply in the future, whereas others clearly signalled an intention to continue not to comply. The latter explanations are not easy to construct

in such a way that they are convincing, especially when the non-compliant company is in a very small minority.

Finally, although this research, like previous surveys, has focused on whether companies meet minimum specified or recommendations or requirements, it found that many companies go beyond the bare minimum, notwithstanding the complaints that have often been voiced about the burden of corporate governance.

LIMITATIONS AND FUTURE RESEARCH

This study has several limitations, providing opportunities for further research. First, although it has examined the operation of audit committees in greater depth than most other studies, it relies on secondary data; it has not attempted to go behind the information contained in the annual reports to delve deeper into companies' practices and the reasons for them (e.g. why they do more than the minimum required to comply). More work of the kind undertaken by Spira (2003) would be helpful to explore some of the issues identified here. Second, the sample was not a large one – though, in contrast to other studies that have concentrated on FTSE100 or FTSE250 companies, it was spread over all UK listed companies. Third, in concentrating on the period when the last major set of changes was implemented in the UK, it has not provided insights into the most recent practice or practice in other countries. Similar studies elsewhere would provide useful comparative insights. It would be particularly useful to undertake follow-up research when any changes to audit committees brought about by the most recent review of the UK Code have been implemented. Such studies such investigate not only whether companies meet the minimum standards required, but also whether – and why – they voluntarily go significantly beyond those standards.

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Table 1: Summary of the development of UK audit committee requirements

	No. of NEDs	Independent NEDs
Cadbury Code (1992)	At least 3	At least 2
Combined Code (1998)	At least 3	Majority
Revised Code (2003)	At least 3 for larger companies At least 2 for smaller companies*	All All

* I.e. those below FTSE 350

Note: Further guidance on audit committees was published by the Financial Reporting Council in October 2008. This did not represent a change to the Code as such and publication was after the date for which the research data for this paper were collected. Any impact of the guidance takes some time to be reflected in corporate annual reports, giving reporting cycles and lead times.

Table 2: Size of audit committees

No. of non-executive directors	No. of companies	FTSE 350	Others
2	3	0	3
3	24	3	21
4	14	9	5
5	8	4	4
Total	49	16	33

Table 3: Number of audit committee meetings

No. of meetings	No. of companies FTSE 350	Others
6	5	4
5	5	4
4	10	4
3	22	4
2	5	-
1	1	-
	<u>48</u>	<u>16</u>
No details	<u>1</u>	<u>1</u>
Total	<u>49</u>	<u>32</u>

Table 4: Naming of financial expert and professional accountancy qualification

	No. of companies
<i>All members claimed to have relevant experience</i>	
Qualified accountant *	4
No details available	<u>4</u>
	8
<i>Some claimed to have relevant experience and named**</i>	
Qualified accountant	12
No details available	<u>8</u>
	20
<i>Not named/mentioned/detailed</i>	
Qualified Accountant*	13
No details available/or none	<u>6</u>
	19
<i>State no members with relevant experience</i>	<u>2</u>
	49
* Qualification determined from Directors' biographies	
** Non-executive Chairman of the Board in one company is 'expert' and in another the 'expert' is a non-independent NED	