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FEGReG Working Paper 08/06

Responding to the Revised Code on corporate governance: UK audit committees

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ABSTRACT

Purpose: The audit committee is one of the most prominent sub-committees of the board of directors, having a potentially important role to play in ensuring sound corporate governance. The purpose of this paper is to examine and discuss the behaviour of companies following the most recent 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 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 case directors were not 'independent' according to the definition of the Code. 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. Nevertheless, some companies did not follow recommended practice, particularly regarding the disclosure of information, and some explanations for non-compliance seemed 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. 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.

Responding to the Revised Code on corporate governance: UK audit committees

INTRODUCTION

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), part of a trend 'to establish and increase the independence and powers of non-executive directors' (Clarke, 2007, p. 50), or NEDs. NEDs are pivotal, since the audit committee provides a potentially vital check on executive directors 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 initiatives in the UK has advocated the adoption of audit committees and made recommendations regarding their composition and operation. The most recent is the 'Revised Code' of corporate governance, which was issued in July 2003 and applies to financial year ends from 31 October 2004 onwards. As rules or guidelines continue to involve, both in the UK and elsewhere, it is appropriate to examine how companies responded to a particular set of changes.

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 any significant issues apparent during the initial stages of implementation. 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 many other jurisdictions. The paper is structured as follows. The first main section provides a brief review of the background to the Revised Code, highlights the themes to be addressed in this paper and presents the research questions. The second section describes the research design and methods. The next section then presents the research findings, before the concluding section highlights and discusses the paper's principal contributions.

CORPORATE GOVERNANCE AND AUDIT COMMITTEES

Prior to the 1970s few companies in the UK had an audit committee, although they were more common in the US and Canada. There have been 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 (Tolley's, 2003, p. 871); it regarded their role as essential. 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. Cadbury's provisions of best practice also covered the composition of the board of directors and the independence of NEDs. It stated that the board should include NEDs of sufficient calibre and number for their views to carry significant weight in the board's decisions, comprising not less than one third of the board. The majority should be independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgement, and any NEDs considered by the board not to be independent in this sense should be identified in the annual report.

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 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 current framework for corporate governance is the Combined Code on Corporate Governance (the Revised Code), which was issued in July 2003. It superseded the original Combined Code, following reviews by Derek Higgs on the role and effectiveness of non-executive directors and by Sir Robert Smith on audit committees, and 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 rest forms part of The Smith Guidance to the Revised Code. Table 1 summarises the development of the recommendations regarding audit committees from Cadbury to the Revised Code.

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 which specified that they should be in the majority.

The Revised Code, which includes suggestions of good practice from the Higgs Report on NEDs, states that the board should determine whether a director is independent in character and judgement, and whether there are relationships or

[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.

circumstances which are likely to affect, or could appear to affect, the director's judgement. 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. 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. 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 foregoing outline of the development of the UK framework for audit committees gives rise to a set of research questions relating to their existence and composition.

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?

The Revised Code (section C.3 main principle and code provisions) 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. 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 and for members to devote sufficient time to its activities, which might be affected by any other responsibilities they have at the company. The Revised Code recommends at least three meeting per annum for larger companies and at least two for those outside FTSE 350. This gives rise to three further research questions regarding the activities of audit committees.

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?

The increasing technical demands placed upon audit committees have also led to the requirement for them to have at least one member with recent and relevant financial experience. This was introduced by the Smith Report (Smith Guidance) and prompts the following questions.

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'?

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. The design of the research to address the eight research questions is explained in the next section.

RESEARCH METHOD

A number of different methods, both quantitative and qualitative, have been adopted by researchers into corporate governance. 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), while some have used a mixture of methods. In addition to primary data, researchers have also used secondary data. For example, annual reports were used by Brennan and McDermott (2003) in their examination of the independence of NEDs in Irish plcs. Annual reports were likewise used in this study, because they were expected to provide accessible public information of relevance to the research questions addressed in this paper.

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, for example the Sarbanes-Oxley Act in the US and the South African King II Report. Some UK companies are listed on more than one exchange, but any companies examined in this paper reported under the Revised Code and made reference to other corporate governance regulations as appropriate. Specialist categories such as investment companies (850) and investment entities (890) were eliminated from the list before random sampling from the remaining 947 companies took place.

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 obtained from the FT Annual Reports Service or the Hemscott website or, if unavailable from these sources, they were downloaded directly from company websites. The annual reports of 50 companies were obtained. This was considered a reasonable sample for exploratory analysis and of a sufficient size to produce meaningful results. The sample comprised 5 FTSE 100 companies, 11 FTSE 250 companies (i.e. 101-350) and 34 others from outside the FTSE 350.

The annual reports were analysed and the data entered on an Excel spreadsheet to enable basic quantitative analysis to take place. 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 sometimes presented practical challenges, since there is no standard content for corporate governance statements or reports. The information required to answer some of the research questions was often found in the report of the directors or the directors' biographies rather than in the corporate governance statement itself.

FINDINGS

The findings of the research will be presented by considering each of the first eight research questions in turn, divided into four groups: existence and composition of audit committees; audit committee operation; and financial expertise. The ninth question, relating to "comply or explain", forms the basis for the Discussion.

Existence and composition of audit committees

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

All companies, except one, Daejan Holdings PLC, had an audit committee. This company had only three members on the board of directors – the executive Chairman, an executive director, and a non-executive director who joined the board more than thirty years ago, in 1971. It provided the following reasons for non-compliance with the requirement to have an audit committee.

> Your board fully supports the goal of better corporate governance and we comply with the majority of the provisions of the revised code. We do not comply with the provisions of the revised Code in connection with non-executive representation on the Board, as we are doubtful that further extending non-executive participation at present would benefit our shareholders…..the matters which the Code recommends should be reserved for audit, nomination and remuneration committees are dealt with by the entire Board and it is intended to continue this practice…changes should be made when they are appropriate and in the best interests of the Company, rather than for the sake of change itself**…**the current structure has stood the Company is [sic] good stead over many years and should continue to do so in the future.

With such a small board, Daejan Holdings is effectively treating it as an audit committee in its own right, although not in a way that complies with the provisions of the Code. However the preamble to the Code states 'that while it is expected that listed companies will comply with the Code's provisions most of the time, it is recognised that departure may be justified in particular circumstances. Every company must review each provision carefully and give a considered explanation if it departs from the Code provisions'. Whether Daejan Holdings' explanation of its

departure from expectations is considered appropriate and convincing, though, is a moot point.

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

Insert Table 2 here

As might be expected, there seems to be a positive association between company size and the size of audit committees; the average number of members for FTSE 350 companies is 4.06, while for those outside the FTSE 350 it is only 3.30. As can be seen from Table 2, 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 belief that is sometimes voiced that suitable NEDs are difficult to recruit and should not be overloaded with work, and the complaint by some companies and commentators 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, though it should be noted that the independence requirement was made more demanding. The issue of independence is addressed by the second research question.

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

All the audit committee members were NEDs, but not all those NEDs were independent. 46 of the 49 companies (94%) had an audit committee comprised entirely of independent NEDs, whereas 3 companies included at least one non-independent NED, thus not following the Revised Code guidance.

It should also be noted that 10 companies included their non-executive chairman on their audit committee, which is not in accordance with the Code. However, the FRC (2007) is proposing to amend the Code with regard to companies outside the FTSE 350, so that the chairman can sit on the audit committee where he or she was considered independent on appointment. Of the 10 companies mentioned above only one was within the FTSE350.

Fully complying with the Code in that all members of the audit committee should be independent NEDs seems to have posed a challenge for a number of companies in the first reporting period after the revision of the Code. Some companies were in transition and stated that they were actively recruiting independent NEDs. Some may have failed to comply for part of the year but were able to rectify the position during the year or for the start of the next financial year. For example, William Hill plc disclosed that:

> The Board identified the need to recruit an additional independent non-executive director during 2004…during the period, the majority of members of the (audit) committee were independent non-executive directors and with effect from 1 January 2005, all members of the committee are independent non-executive directors.

Following this appointment it was felt appropriate that the Chairman of the Board step down from the committee.

However, others were satisfied with providing explanations as to why they were not intending to comply. Henry Boot plc, a company without any independent non-executives, and so none on its audit committee, commented as follows:

> The Board currently comprises of three executive directors and three non-executive directors, none of whom can be considered by 'the Code' as independent.…neither does it seem appropriate to simply appoint additional members with their attendant costs, as this would give rise to an unwieldy number of board members, given the size of the company. Two of the existing non-executive directors have substantial shareholdings in the company, and all three directors have served for a period in excess of nine years. These strong ties with your company are seen in a positive light, as it strongly aligns their interests with that of the company's ongoing success.

Nevertheless, they stated that they might in future years bring in independent non-executive directors if there is shown to be compelling need or it is advantageous to do so.

Business Post Group plc had a non-independent non-executive director who was a member of the audit, remuneration and nomination. They stated that,

> with over 30 years of in-depth experience of the business, and as a significant shareholder, his membership of these committees is appropriate and that he brings an invaluable knowledge and experience to their operation.

One of the ways in which independence can be compromised is the length of time that the NED has been associated with the company. However, as can be seen from the above quotation, Henry Boot portrayed this as positive.

Moreover, in the sample there are a number of NEDs who could arguably be identified as the 'tame pensioner' using Pye and Camm's (2003) quadrant of non-executive roles. There are 10 directors who are 70 years old or over. Many of these have a non-executive role but that role often fails the independence test due to their long association with the company. One company from the sample, REA Holdings, had a non-executive director on the audit committee who was 86 years old and who had been a non-executive director since 1989 and so not formally independent according to the Code – thought the board provided an explanation as to why they were satisfied that the independence of long serving independent non-executive directors was not affected by their length of service.

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

A review was made of auditors of the companies and compared with the information included in the directors' biographies to determine if there had been any recent relationship. The analysis did not reveal any NEDs who had had any recent past relationship with the external auditors; there were a number of cases where the directors had been partners in auditing firms, but these firms were not the current auditors of the company. The requirements of the Code are reinforced by the

professional ethics codes of the UK accountancy profession, which have been tightened over recent years and are based on section 290.144 of the International Federation of Accountants (IFAC) code of ethics.

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, but at least three 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 average number 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. 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 – which was discussed in the previous section too – 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, one is a supplier of products for the digital consumer market for which 2004 was its first full year as a publicly listed company on the London Stock Exchange, which might explain the need for more meetings, and the other a property management company which 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 meeting 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, remuneration committee) and many are on more than one. It was found that 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 ten 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

Hemscott (2003) who 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.

Information is not available in the annual reports detailing the time commitment to audit committee or other sub-board duties. All that is available is the number of meetings held each year of all the boards and, for most companies, details of individual directors' attendance. There is little information provided as to the time spent in preparation for the board meetings or the time that these meetings last.

Scottish & Newcastle plc provided more information than most and included the following in the annual report, which indicates the extra commitment entailed by committee membership.

> We also ensure that prospective non-executive directors can devote sufficient time to the appointment – which we estimate to be around one or two days per month overall, with more for committee Chairmen. We recognize the benefit that can flow from non-executive directors holding other appointments but, although we do not have a formal limitation on the number of other appointments for non-executive directors, we do require them to seek agreement of the Chairman before accepting any commitments that might affect the time they are able to devote to the company.

Financial expertise

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

Insert Table 4 here

The Code states that, "The board should satisfy itself that at least one member has recent and relevant financial experience, and the Chairman of the company should not be an audit committee member". The Code also 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.

40.8% of companies specifically named their 'expert'; in the majority of cases it was possible to discover that they 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 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:

> The board recognised the requirement for the appointment of an independent non-executive director with recent and relevant UK financial experience, as well as additional skills identified by the board, with a view to appointing that director to the Investec plc Audit Committee'. Throughout the period under review, members of the Nomination Committee interviewed suitable candidates. The process is ongoing and the committee is reviewing the feasibility of appointing an external search consultancy to assist in the identification of further candidates. (Investec plc)

And Geest PLC reported as follows:

> The members of the committee are myself (AC acting Committee Chairman, David Wallis) and the other independent non-executive Director (excluding Chairman of the Board) and we usually meet three times each year. Following the expiry of term of office of Bob Davies in May 2004, we have not had a member with the relevant financial experience within the terms of the Combined Code. However, we are confident that the affairs of the Audit Committee have been conducted with rigour.

Collins Stewart Tullett plc dealt with the expiry of the term of office of their financial expert differently from Geest PLC.

> The board has requested Keith Hamill to continue to chair the Audit Committee as he is the only Non-Executive director who can be classified as a "financial expert" for governance and regulatory purposes. The Smith Committee, which was established by the Financial Reporting Council, recommended that the Chairman of the Company should not be a member of the audit committee of UK listed companies. The recommendations of this committee were partially incorporated in the Revised Combined Code by the Financial Reporting Council. However, in the view of the need for relevant experience and training, the complexity of the Company's current financial control and regulatory requirements, and the changes taking

> place in the Group and its financial reporting, the Board has asked KH to continue to undertake this responsibility in the best interests of the company. This decision took account of his general independence and will be kept under review, particularly if the Company is in a position to recruit a Non-executive director with appropriate experience. ()

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

The Code states that it is desirable that the member considered to have recent and relevant financial experience should have a professional accountancy qualification. 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 someone with recent and relevant financial experience.

DISCUSSION AND CONCLUSION

The principal answers to the research questions can be summarised as follows:

- Only one company did not have an audit committee.
- Audit committees of larger companies tend to have larger memberships and hold more meetings.
- All audit committee members were NEDs. However, in the case of a small minority of companies, not all were independent according to the terms of the Code – with which some companies disagreed, particularly in relation to length of "association".
- Contrary to the Code, almost a quarter of companies within the sample had the Chairman on the audit committee.
- No evidence was found of any relationship between an audit committee member and the external auditors.
- Members of the audit committee are very often on other board sub-committees too.
- Six companies failed to disclose individual attendance at audit committee meetings.

- A significant proportion of companies failed to name their financial expert. Two companies disclosed that they had no such expert but that they were actively seeking to appoint.

In assessing the significance of the findings, it should be remembered that the Revised Code is part of the principles-based, "comply or explain" regime that operates in the UK (though it can be argued that to explain (satisfactorily) is to comply). The Code does not require adherence to particular actions. Nevertheless, 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 in their particular context. Thus, for example, contentions that long-serving directors are still independent would appear to apply to all companies or to none, unless some rather sophisticated reasoning is brought to bear.

An interesting suggestion from the research, though, is that, where a substantial number of companies do not follow the Code – in this case, having the chairman on the audit committee – the Code might be brought into line with practice (albeit with restrictions regarding company size) rather than vice-versa (see FRC, 2007).

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, it would be interesting to research why so many companies are prepared to go beyond the letter of the Code.

Perhaps the most striking shortcoming was not in the audit committee practice compliance (or explanations) as such, but in the disclosure of information. Several companies failed to disclose individual directors' attendance at audit committee meetings and a significant proportion were also failing to name the "financial expert" on the audit committee. One of the features of this type of non-compliance is that is does not come with an explanation – 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 reader's attention, it would be natural to react, "so tell me". In this respect, then, "comply or explain" does not seem to be working.

As with all research, this study has several limitations. First, it focuses 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). Second, the sample was a relatively small 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 to the Code was implemented, it has not provided insights into the most recent practice. Nevertheless, given that corporate governance systems throughout the world seem to be in undergoing a period of evolution, it is useful to focus on such periods; and future studies can update the findings here, particularly if further changes to the Code's provisions on audit committees are made. Fourth, as audit committees are a global phenomenon, equivalent studies in other countries would provide interesting comparative insights.

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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

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	1
5	5	4	1
4	10	4	6
3	22	4	18
2	5	-	5
1	1	-	1
	48	16	32
No details	1		
Total	49		

Table 4: Naming of financial expert and professional accountancy qualification

	No. of companies	
All members claimed to have relevant experience		
Qualified accountant *	4	
No details available	4	
		8
*Some claimed to have relevant experience and named***		
Qualified accountant	12	
No details available	8	
		20
Not named/mentioned/detailed		
Qualified Accountant*	13	
No details available/or none	6	
		19
State no members with relevant experience		2
		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