City University London Business School

THE EFFECTIVENESS OF AUDIT COMMITTEES:

AN ANALYSIS OF GOVERNANCE MECHANISMS AS SURROGATES FOR EFFECTIVENESS

BY

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ABSTRACT

Current recommendations in the UK identify the audit committee as a key component of effective corporate governance. These recommendations emphasise the importance of structure and processes in an effective audit committee. It is therefore important to consider if these structures and processes are effective in promoting corporate accountability and control.

This thesis therefore considers the extent to which the composition and structure of the audit committee is associated with the ability of the audit committee to fulfil its roles and objectives effectively in UK listed companies.

It is reasonable to assume that an audit committee may be considered effective where it achieves its stated roles. The audit committee is not required to report to the shareholders within the financial statements on the extent to which they have achieved their roles. Thus, actual audit committee effectiveness cannot be externally observed.

It is possible to measure audit committee effectiveness indirectly if it is considered that the absence of financial reporting problems indicates an audit committee has been effective in achieving their financial reporting oversight role. I.e. the extent to which the audit committees discharge their functional roles could be used as a surrogate for an external indication of audit committee effectiveness.

This thesis therefore considers if the key governance mechanisms thought to impinge on audit committee effectiveness are present in companies in which the audit committee is considered to have failed in their financial reporting oversight role.

The key governance mechanisms examined were:

- The presence of the joint role of the CEO and the chairman;
- Board Balance;

- Existence of an audit committee;
- Independence of the audit committee;
- No. of audit committee members;
- Existence of charter/terms of reference;
- No. of meetings held by the audit committee per year;
- Evidence of Interaction with / existence of Internal audit;
- Financial literacy of members;
- Technical competency of members;
- Additional directorships of members.

The results, based on comparing the above governance mechanisms in companies with no financial reporting problems ("CNFRP") to companies that have financial reporting problems (CFRP), indicate that "CNFRP's" have audit committees with significantly higher percentages of financially literate and technically competent members.

This thesis provides insight into the effectiveness of governance mechanisms in UK audit committees during the period 1995-1999. This thesis contributes by updating our understanding of the factors that influence the effectiveness of the audit committee. It highlights that current recommendations in the United Kingdom, with their focus on audit committee composition and structure, should also consider the competency of audit committee members and determine a benchmark by which competency may be measured.

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CHAPTER 1: INTRODUCTION

1 INTRODUCTION

1.1 WHAT IS CORPORATE GOVERNANCE

"Corporate governance is concerned with the process by which corporate entities, particularly limited liability companies, are governed: that is with the exercise of power over the direction of the company, supervision of executive duties, accountability..." Tricker 1984 p.482-3

A country's economy depends on the drive and efficiency of its companies. Thus the effectiveness with which the their boards discharge their responsibilities determines competitive position. The board must be free to drive the company forward but must exercise that freedom within a framework of accountability. A good system of governance must therefore: -

- fulfil of the long term strategic goals of the owners;
- consider and care for the interest of employees;
- take account of the needs of the local community and the environment;
- maintain good relations with customers and suppliers; and
- ensure compliance with legislation and regulations.

The interactions of the various parties result in several conflicts. An analysis of the underlying issues provides a useful starting point in the analysis of corporate governance and the specific issues arising therein.

"The shareholders provide the capital the corporation needs and thus own the property of the corporation and have certain legal rights to see that this property is used to further their interests." Bucholz (1986 p.235)

This traditional model as defined by Bucholz (1986) of the company sees directors acting in the interests of the company as agents of the shareholders and management being selected by the board to carry out the day to day tasks involved in serving the shareholders' interests. The duties of the Board, e.g. governance, and management are distinct. The focus of governance is concerned with the overall direction of the company and its interaction with the company stakeholders. The focus of management is the attainment of specific goals over a definite time frame.

(Dayton, 1984 p.34) summarises the distinction as:

"By corporate governance, I mean the process, structure and relationships through which the board of directors oversees what its executives do. By management, I mean what the executives do to define and achieve the objectives of the company".

The critical issue is whether directors who are also members of top management can be relied upon to monitor and control their own managerial performance.

Donaldson (1990) argues a view of managerial motivations contrary to agency theory that can be defined as stewardship theory. This theory argues that non-financial motivators-McCelland (1961) i.e. the need for intrinsic job satisfaction result in managers being able to carry out actions which may not necessarily be in their own personal interests- Etzioni (1957).

Exponents of stewardship theory argue that the classical concept of the corporation, enshrined in company law, has been that power lies with the shareholders. These powers enable the shareholders to choose the structure of their company's board and members of it, with independent external auditors appointed to report on the truth and fairness of the reports that the directors are required to regularly present.

However, many commentators e.g. Berle and Means (1932) have pointed out that large public companies have many shareholders who are geographically dispersed, hold diverse expectations from their investment, and are separate and remote from management. The classical approach under stewardship theory for shareholders to oversee directors is therefore considered inappropriate.

Agency theory argues that in the modern corporation, in which share ownership is widely held, managerial actions depart from those required to maximise shareholder returns (Berle and Means, 1932).

If agency theory is applied to corporate governance, it is posited that managers will not act to maximise returns to shareholders unless appropriate governance structures are in place.

Eisenhardt (1989) specifies certain mechanisms to reduce the cost of agency. These mechanisms include the need for boards to have: -

- non-executive directors who are genuinely independent of management;
- committees of the board comprising of non-executive directors to be concerned with audit, nomination of new directors, and remuneration of top management; and
- the roles of the chief executive officer and chairman as separate positions.

The current recommendations on corporate governance appear to embody agency theory and this is reflected in the various mechanisms included in current corporate governance recommendations.

1.2 Developments in Corporate Governance

Corporate governance issues became prominent in the early 1980's in the United States during the period of aggressive corporate take-over activity. During this period, many boards instituted measures that were aimed to prevent undesirable take-over bids. Whilst these measures may have proved effective, some shareholders felt that the boards were not acting in the best interests of the shareholders. The difference in the 1980s was that institutional shareholders were much more likely to address these issues and debate possible solutions.

The problems associated with the divergence of interests between shareholders and the board are not new. Berle and Means (1932) defined the agency problem as:

"The inherent tension created when the directors running the companies were not the major shareholders". Berle and Means (1932)

In contrast, in the UK, the corporate governance debate came into the spotlight due to several high-profile corporate failures - such as Polly Peck, Coloroll and BCCI. In these cases, directors were not only seen as acting against the shareholders' interests, they were also in breach of their duties to the company.

In the aftermath of these cases, a committee, chaired by Sir Adrian Cadbury, was formed in 1991 to examine the financial aspects of corporate governance in publicly quoted UK companies. The subsequent Cadbury Report, which was published in December 1992, focused the corporate governance debate in four main areas:

- The responsibilities of executive and non-executive directors for reviewing and reporting on performance to shareholders;
- The case for establishing audit committees;
- The principal responsibilities of auditors;
- The links between shareholders, boards of directors and auditors.

Following a series of highly publicised large pay awards, amidst poor corporate performance, to certain directors primarily in the privatised utilities, public awareness of the divergence between the interests of directors and shareholders was raised. The Greenbury Committee was set up, chaired by Sir Richard Greenbury.

The Greenbury Code (1995) made a series of recommendations on the role of remuneration committees, disclosure of directors' remuneration and provisions for approval of long-term incentive schemes, corporate remuneration policy, the length of directors' service contracts and the compensation paid to directors when these contracts come to an end.

The Committee on Corporate Governance (known as the Hampel Committee) was issued in 1998 and reviewed the previous codes and made proposals for updating them.

The Combined Code (1998) was a consolidation of the work of the three prior governance inquiries. The Combined Code has been incorporated into the Stock Exchange Listing Rules as part of the Yellow Book's 'Continuing Obligations'. While companies are under no formal obligation to comply with the Combined Code, they are obligated to report on their compliance with guidelines set out in the first section of the Code and to identify and explain areas of non-compliance as a stock exchange listing condition.

The importance of corporate governance lies in its contribution both to business prosperity and to accountability. As a result of the events in the early 1980's, the corporate governance debate in the United States has focused on shareholder rights. However, the emphasis in the UK has predominantly focused on accountability and the structure and processes to ensure accountability.

The Institute of Directors' report, stated that:

"The key purpose of the board is to ensure the company's prosperity by collectively directing its affairs and meeting the legitimate interests of the shareholders and other interested parties. To achieve this, Standards for the Board highlights four key tasks for the board:

- Establishing vision, mission and values
- Setting strategy and structure
- Delegation to management
- Exercising responsibility to shareholders and other interested parties". **Standards for the Board (1995)**

National Association of Pension Funds (NAPF) suggested that:

"The debate should concentrate on two issues:

Board integrity - ensuring that accounting and other statutory concerns are addressed

Enterprise - encouraging boards to drive businesses forward in the long-term interests of the shareholders." **Good Corporate Governance (1996)**

Both reports (Institute of Directors and NAPF) were clear that the promotion of business enterprise was a key issue in corporate governance. They served to highlight the fact that the recommendations on corporate governance published to date (Cadbury and Greenbury) had not emphasised this issue.

Criticisms of the current recommendations on corporate governance before the publication of the Turnbull report were mainly as a result of the focus on the issues concerning accountability as opposed to those concerned with promoting corporate enterprise.

The Turnbull Report (1999) which has also been incorporated into the Combined Code completes the current recommendations on corporate governance for UK listed companies. The key features of the guidance are:

- It aims to reflect good practice whereby internal controls are 'embedded' in the business.
- It adopts a risk-based approach to sound internal control.
- Clarification is provided of the respective roles of the board, its committees and management.
- It covers all internal controls, not just the financial ones.
- It requires that companies should undertake an annual review of its internal audit department or, if it does not have one, they should review the need for such a function.
- It provides a series of questions covering risk assessment, control, information and communication and monitoring to assist companies in reviewing internal control.

The Turnbull Report was therefore not focused solely on disclosure. With the guidance provided on risk control and assessment, the management of the significant business risks representing a threat to the achievement of a company's objectives was considered. It was clear that this report had taken steps to ensure that the corporate governance debate was now focused on the promotion of business enterprise as well as accountability.

The emphasis on structure and process in the current recommendations on corporate governance still remains. It is therefore important to consider if these structures and processes are effective in promoting corporate accountability and control.

1.3 PURPOSE OF THE STUDY

Given the highly publicised business failures in many countries, attention has been increasingly focused on audit committees as one of the primary means of improving corporate governance.

There is no specific definition of an audit committee in private sector organisations but they are generally described as: -

- a sub-committee of the board;
- composed exclusively or predominantly of non-executive directors; and
- having the responsibility for reviewing the financial statements and the accounting principles and practices underlying them, liasing with the internal and external auditors, and reviewing the effectiveness of internal controls.

Pincus et al (1988) note that audit committees enhance the board's capacity to act as a management control by providing a more detailed knowledge and understanding of the financial statements and other financial information issued by the organisation.

Accountability to shareholders and other stakeholders is achieved primarily through financial reports that have been subject to a statutory external audit. The external audit process has been much criticised due to the apparent failure of auditors to discover fraud and error and to foresee corporate failure and the apparent non-independence of auditors caused by their provision of non-audit services.

Whilst the problems regarding user perception may be to some extent addressed by better disclosure and an expansion in the nature and scope of external audit assignments to reflect these concerns, the problems associated with the credibility of external auditors and the perceived lack of independence still remains.

A great deal of research has been undertaken to date about audit committees. However, most of this research has been concerned with structure and existence of audit committees. Fried (1976) noted that the pre-occupation with the form of audit committees was not conducive to evaluating the effectiveness of audit committees. Prior to the mandatory listing requirements of the Stock Exchanges in the UK and USA, the establishment of audit committees provided some indication of their usefulness. Existence is now no longer a criteria in evaluating audit committee effectiveness.

Studies regarding the effectiveness of audit committees in meeting their objectives have been limited. McMullen (1996) and Wild (1996) found positive associations between the presence of audit committees and improved financial reporting. These studies provide limited evidence of audit committee effectiveness given that Stock Exchange requirements in the UK and USA have resulted in large quoted companies being required to have audit committees. The study provides useful evidence on the consequences of not having an audit committee.

Beasley (1996) highlights the significance of board composition as opposed to the existence of an audit committee in relation to the likelihood of financial statement fraud. Given that the monitoring of financial reporting is one of the main roles of the audit committee, if board composition is the more significant factor, the role of the audit committee in financial reporting is questionable. Beasley (2000) considered the key structural elements of audit committees in fraud as compared to no-fraud firms. It was found that whilst both types of firm had audit committees, the structure of the fraud firms audit committee was unsatisfactory.

This highlights that the mere presence of an audit committee is not an important governance mechanism. It is rather the structure and composition of the audit committee that influences the effectiveness of the audit committee.

This thesis therefore considers the extent to which the composition and structure of the audit committee is associated with the ability of the audit committee to fulfil its roles and objectives effectively in UK listed companies.

1.4 Research Hypotheses

The overall purpose of this thesis therefore considers if the key factors thought to impinge on audit committee effectiveness are present in companies in which the audit committee is considered to have failed in their financial reporting oversight role. It was considered that the extent to which the audit committees discharge their functional roles could be used as a surrogate for an external indication of audit committee effectiveness.

For the purpose of this thesis, it was decided to focus on the audit committee's oversight role in respect of the financial statements. Audit committees were considered ineffective where disclosures within the financial statements did not reflect the true state of affairs in the company. The overall null hypothesis of this thesis considers that companies with financial reporting problems have ineffective audit committees.

The balance of the board i.e. the proportion of executive to non-executive directors may result in a board in which non-executive directors are ineffective and may therefore result in an ineffective audit committee.

Hypothesis 1 states that companies with financial reporting problems are more likely to have ineffectively composed boards

The separation of the role and chief executive officer is considered important to the effectiveness of the overall board and by implication the audit committee.

Hypothesis 2 states that companies with financial reporting problems are more likely to have boards where the same person holds the positions of Chairman and Chief Executive Officer.

The literature specific to audit committee was also considered. The factors considered influencing the ability of the audit committee to be effective were the structure of the audit committee, the independence of audit committee members and the quality of non-executive directors.

It was important to consider if companies with financial reporting problems were more likely to have audit committees.

Hypothesis 3 therefore states that companies with financial reporting problems are less likely to have audit committees

The membership of the audit committee was considered to impinge on the effectiveness of the audit committee in respect of the number of members on the audit committee. A minimum of three non-executive directors was considered necessary for the audit committee to be effective.

Hypothesis 4 therefore states that companies with financial reporting problems are more likely to have audit committees that have less than three members

The governance procedures considered to impinge on the effectiveness of the audit committee in respect of the structure of the audit committee were:

- The existence of an audit committee charter or terms of reference.
- The number of audit committee meetings in a given period.
- The existence of an internal audit function.

Hypothesis 5 therefore states that companies with financial reporting problems are more likely to have audit committees with poor governance procedures

- The independence of audit committee members. All members of the audit committee were to be independent for the audit committee to be considered effective.

Hypothesis 6 therefore states that companies with financial reporting problems are more likely to have audit committees composed of non-independent members

The quality of non-executive directors was considered to impinge on the effectiveness of the audit committee. Audit committee members were assessed in terms of:

- The extent to which the audit committee members are financially literate.

Hypothesis 7 therefore states that companies with financial reporting problems are more likely to have audit committees with non-financially literate members

- The extent to which the audit committee is considered technically competent.

Hypothesis 8 therefore states that companies with financial reporting problems are more likely to have audit committees with no technically competent members

Research evidence highlighted that as the number of additional directorships held by non-executive directors' increases, their ability to fulfil their monitoring responsibility decreases.

It was considered that as the number of additional directorships held by non-executive directors' influenced their ability to fulfil their monitoring responsibilities.

Hypothesis 9 therefore states that companies with financial reporting problems were more likely to have audit committees with directors who hold additional directorships.

The above hypotheses therefore consider if the key factors thought to impinge on audit committee effectiveness are present in companies in which the audit committee is considered to have failed in their financial reporting oversight role.

1.5 LIMITATIONS OF THE STUDY

Several limitations were evidenced during the study. These included:

- A focus on limited listed companies only.
- Company selection.
- Board member data.
- Audit committee data.
- Audit committee members.
- The use of secondary data sources.

1.5.1 Limited Company Focus

The focus on listed companies resulted in the fact those large private limited companies whom, by choice, have not converted to PLC status were ignored by the study. Whilst this may have resulted in some significantly large companies with financial reporting problems being excluded from the population, this problem is not considered to have invalidated the results of the study.

1.5.2 Company Selection

Four main data sources were used to identify companies with financial reporting problems (FRP Companies). These were:

- Dialogue database.
- Press notices issued by the Financial Reporting Review Panel (FRRP) in the period from 1.1.93 to date.

- Hemmington Scott Quarterly Publications 1993-1997 and Hemmington Scott Quarterly Database 1988 to date.
- Macmillan's Stock Exchange YearBook 1999.
- Companies house Statutory Returns.

The populations of companies with financial reporting problems were drawn from these sources. The FRRP primarily focuses on large PLC's – i.e. the TOP 350 UK companies. The Dialogue Database does not distinguish companies in terms of size. The criterion for inclusion in this database is PLC status. The Hemmington Scott Quarterly Publications / Hemmington Scott Quarterly Database details all listed companies that have been removed due to liquidation, administration, or receivership. The selection of companies from these three sources therefore results in a population which may be considered representative, in terms of size, of the overall population of UK listed companies. The amalgamation of the companies identified from these three sources limits this study but is not considered to invalidate this study.

The identification of companies with no financial reporting problems is however biased due to the assumption that the absence of an audit report qualification indicates the lack of a financial reporting problem.

The literature review highlights the reasons for which audit reports may not be qualified in situations where a qualification was justified. The FRRP is however there to prevent this situation from occurring. The problem however lies with the manner in which cases are brought to the attention of the FRRP. The financial statements of all listed companies are not routinely examined. The FRRP relies on any inconsistencies to be brought to their attention. The lack of a pro-active approach limits the extent to which the FRRP may be considered effective.

There is currently no other alternative source of information on the company that would guarantee that a company selected would have no financial reporting problems.

1.5.3 Board Member Data

Certain weaknesses were evidenced in the collection of data on board members. Reliance was placed on the disclosures within the financial statements that stated if the role of the chief executive officer and the chairman were combined or separated. In reality, there may be cases where the separation of these roles may be more due to job title as opposed to a clear separation of the role.

This may limit this study but is not considered to invalidate this study as there is currently no other alternative external source of information on the company that discloses the role and duties of the chief executive officer and the chairman. Without this information, reliance must be placed on disclosures within the financial statements.

1.5.4 Audit Committee Member Data

Certain weaknesses were evidenced in the collection of data on audit committee members. The assessment of independence to some extent relied on the disclosure of family and other significant director relationships. There is no requirement to disclose family relationships and unless an obvious pattern is evidenced, this evidence is unobtainable. This clearly limits the extent to which this criteria may be evaluated.

The criteria used to assess independence this study were based on the provisions of the Code (1998). Other bodies e.g. The ABI have other formal measures to assess independence.

This study was limited to financial reporting problems within the financial statements. It was therefore considered that the focus of the criteria used to assess the adequacy of governance mechanisms should be based on provisions that these companies were required to comply with.

Section 4.1.2 of the Cadbury Report (1992) acknowledged that ".. non-executive directors should be independent of management and free from any business or other relationship that could materially interfere with their judgement."

This statement highlights that there may be other issues e.g. friendship and personality that might compromise the independence of the directors. Whilst the possible existence of these impediments to independence may be present and may limit the true assessment of independence in this study, there is a lack of available data to test these issues.

Director loans and other significant relationships are required to be disclosed by the Companies Act 1985 and FRS 8 respectively. However, FRS 8 was only introduced in 1995 and is effective only for companies with accounting periods commencing after 23rd December 1995. Many companies included in the qualifying period may not have been required to make the relevant disclosures. This clearly limits the extent to which this criteria may be evaluated in some companies.

1.5.5 Member Backgrounds

The categorisation of the backgrounds in terms of the technical competency and financial literacy of audit committee members introduced a certain amount of bias as audit committee members were classified into categories based on published biographical information and prior employment history.

Problems therefore arose where no biographical information was available on the director. It was therefore only possible to assume certain competencies based on the directorships disclosed in the statutory returns by the director.

1.5.6 Secondary Data

The use of secondary data sources only is a potential weakness. The decision to rely on secondary data sources was taken for the following reasons:

- Data availability. Given that a number of the companies to be reviewed were dissolved, the use of primary data sources was not considered feasible.

- Audit committees should be perceived as effective. The perception of effectiveness is influenced by the composition of the audit committee. The availability of data within the public domain to evaluate audit committees is thus required.

However, in order to ensure that the results gained using secondary data were valid, a sample of audit committee members were interviewed to ensure that their opinions validated the results obtained.

1.6 THESIS STRUCTURE

Chapter 2 first considers a governance model showing the main functions of the board and main board committees to which these functions are delegated. The model shows that the board is influenced by extrinsic influences i.e. the ability of external parties to influence the board and intrinsic factors i.e. those attributes of composition and structure that influence the ability of the board to perform. The available literature on intrinsic and extrinsic influences on board and where applicable the audit committee is then reviewed.

This chapter also examines the literature to date on the relationship between the structure of the board and its effectiveness and highlights the factors that might also influence audit committee effectiveness. Throughout this chapter, the issues, which the author intends to utilise as bases for future hypotheses, are highlighted as research questions

The main activities of the audit committee are examined in detail in chapter two as it is considered that the extent to which the audit committees discharge their functional roles can be used as a measure of audit committee effectiveness.

Chapter 2, given the roles delegated to the audit committee, also reviews the composition and structure of the audit committee. The key governance mechanisms particular to the audit committee are examined.

The literature to date on the relationship between the composition and structure of the audit committee and its effectiveness and highlights the factors that might also influence audit committee effectiveness is also reviewed. Throughout this chapter the issues, which the author intends to utilise as bases for future hypotheses, are highlighted as research questions.

Chapter 3 contains the research hypotheses, the methodology to be used in testing the stated hypotheses, and justification for the choice of methodology. This chapter sets out the criteria used in: -

- Determining the nature of the study;
- Collecting and collating the data;
- Evaluating the data;
- Defining the nature of the testing to be undertaken; and
- Considering the limitations and strengths of the data collected.

Chapter 4 contains detailed descriptive results of the testing. Chapter 5 shows the detailed statistical results of the testing. Chapter 6 contains the research conclusions and highlights areas where additional studies are suggested.

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CHAPTER 2: LITERATURE REVIEW

2 LITERATURE REVIEW

2.1 INTRODUCTION

A system of corporate governance is concerned with the checks and balances on the exercise of power and with, if necessary, it's peaceful transfer - I.e. a framework for effective accountability. Corporate governance varies between countries as a result of differing ideologies, histories, political beliefs, social and economic factors. It is therefore not possible to impose one uniform system of governance across the board.

Governance systems mature and evolve over time. There are essentially three models of governance namely: -

- the European Model as practised in Germany and most continental European countries;
- The Japanese model;
- The Anglo-Saxon system (as practised in the UK, USA and Canada);

The two-tier model (the European model) has no common membership between the supervisory board and the management team. The Japanese model tends to have boards composed solely of executive management.

In the Anglo-Saxon model, boards are comprised of a combination of non-executive directors and management. In the UK there tends to be management dominated boards whilst in the USA and Canada non-executive directors tend to form the majority of the board.

The governance model shown in section 2.3 reflects the Anglo-Saxon Model of governance. The differences in the models of governance result in the fact that only comparisons of the differences in corporate governance systems of countries within the same model of governance are made.

2.1.1 UK Governance

The UK system of corporate governance relies mainly on the board of directors and, to some extent, the shareholders to achieve good governance.

The traditional model of the company sees the directors as acting in the interests of the company as the agents of the shareholders, and management being selected by the board to carry out the day to day tasks involved in serving the shareholders' interests. Shareholders delegate the power to run the company to managers. In theory, management (headed by the chief executive officer) is accountable to boards who are elected by the shareholders. Accountability can therefore be considered in terms of: -

- the accountability of management to the Board; and
- the accountability of the Board to shareholder.

The board therefore should play a pivotal role in ensuring that management is accountable for their actions and that these actions are in the best interests of the shareholder.

There is an enormous body of law that pertains to the legal duties of the board. These laws however do not give specific definitions of the roles and functions of the board. Publications in the USA and the UK[1] however have tended to describe the roles and functions of the board as: -

- the selection, evaluation and if necessary dismissal of the chief executive officer;
- The review of corporate strategy and financial objectives;
- Review of internal control systems; and
- The selection and recommendation to shareholders of appropriate directors for election.

The existence of boards is therefore based on the premise that they oversee management, and select or dismiss managers who are able or unable, respectively, to fulfil corporate objectives.

This thesis is primarily concerned with the effectiveness of the key mechanisms of the corporate governance framework. It considers if these mechanisms and structures, in respect of UK companies and in particular their audit committees constitute an adequate framework for effective accountability.

2.2 CHAPTER STRUCTURE

Section 2.3 first considers a governance model showing the main functions of the board and main board committees to which these functions are delegated. The model shows that the board is influenced by extrinsic influences i.e. the ability of external parties to influence the board and intrinsic factors i.e. those attributes of composition and structure that influence the ability of the board to perform.

The available literature on intrinsic and extrinsic influences on board and where applicable the audit committee is then reviewed. The factors considered in detail include: -

- Board size;
- Age/experience;
- Director remuneration;
- The separation of the role of the Chief executive officer and Chairman;
- Director independence; and
- The balance of the board - given the importance of the non-executive director's role within the framework, the literature to date on the effectiveness of non-executive directors in achieving their roles is reviewed.

This section also examines the literature to date on the relationship between the structure of the board and its effectiveness and highlights the factors that might also influence audit committee effectiveness. Throughout section 2.3, the issues, which the author intends to utilise as bases for future hypotheses, are highlighted as research questions.

Section 2.4 reviews the role and structure of the audit committee, given the roles delegated to the committee and the overall purpose of this thesis as discussed in chapter 1. The key governance mechanisms particular to the audit committee are examined. These include: -

- Audit committee composition;
- Audit committee structure; and
- Audit committee member backgrounds and skills.

The literature to date on the relationship between the composition and structure of the audit committee and its effectiveness and highlights the factors that might also influence audit committee effectiveness is also reviewed. Throughout section 2.4, the issues, which the author intends to utilise as bases for future hypotheses, are highlighted as research questions.

Section 2.5 considers the main findings of the literature review.

2.2.1 Corporate Governance Theories

2.2.1.1 Agency Theory

Agency theory with reference to the modern corporation in which share ownership is widely held, may be defined in terms of the manner in which the agents (the directors) will exercise their roles. This theory argues that the actions of the agents depart from those required to maximise shareholder returns (Berle and Means, 1932). I.e. agents will act in their own self-interest as opposed to that of the principals (the shareholders)

If agency theory is applied to corporate governance, it is posited that managers will not act to maximise returns to shareholders unless appropriate governance structures are in place.

Based on an economic theory of monitoring by Jensen and Meckling (1976), it is argued that managerial agents have economic incentives to adopt optimal controls to reduce agency costs that arise because of the separation of ownership and control.

Eisenhardt (1989) specifies certain mechanisms to reduce the cost of agency. These include incentive schemes for managers that reward them financially for maximising shareholder interests and the use of the board of directors to monitor and control management.

Fama and Jensen (1983) theorise that the board of directors is the highest internal control mechanism responsible for monitoring the actions of top management and thus should curtail any actions of management that are not in the shareholder interest.

The critical issue is whether board directors who are also members of top management can be relied upon to monitor and control their own managerial performance.

Agency theory therefore supports the arguments for boards to have non-executive directors who are genuinely independent of management and for the separation of the roles of the chief executive officer and chairman.

The effectiveness of the board must therefore be influenced by the ability of management to manipulate the board. Crucial to this debate must therefore be the selection process of the board[2], the extent to which executive management can influence the selection process, and the implementation of structures[3] that result in a board that is balanced enough to ensure that executive management is unable to dominate.

Agency theory therefore supports the arguments for committees of the board comprising of non-executive directors to be concerned with audit, nomination of new directors, and remuneration of top management.

Shareholder interests, as argued in agency theory, must be protected by governance structures that do not rely on the individual motivations of management.

2.2.1.2 Stewardship Theory

Stewardship theory with reference to the modern corporation, in which share ownership is widely held, may also be defined in terms of the manner in which the agents (the directors) will exercise their roles. This theory argues that the actions of the agents will be in the best interest of the principals in order to maximise shareholder returns.

Exponents of stewardship theory argue that the classical concept of the corporation, enshrined in company law, has been that power lies with the shareholders. I.e. the shareholders have the power to choose the structure of their company's board and members of it and to appoint independent external auditors to report on the truth and fairness of the reports that the directors are required to regularly present.

However, many commentators e.g. Berle and Means (1932) have pointed out that large public companies have many shareholders who are geographically dispersed, hold diverse expectations from their investment, and are separate and remote from management. The classical approach under stewardship for shareholders to oversee directors is therefore inappropriate.

Donaldson (1990) argues a view of managerial motivations contrary to agency theory that can be defined as stewardship theory. This theory argues that non-financial motivators-McCelland (1961) i.e. the need for intrinsic job satisfaction may result in managers being able to carry out actions which may not necessarily be in their own personal interests- Etzioni (1957).

Agency theory, on the other hand, points to many examples of the abuse[4] of power stemming from the domination of the board by incumbent management who have acted in their own interests rather than those of the owners. Given that a breakdown in controls and a lack of managerial accountability appears to have characterised most of the financial scandals of the in the USA and the UK, the notion of reliance on positive managerial motivation is not acceptable.

The current recommendations on corporate governance consider agency theory as justification for the various mechanisms to strengthen the board, the use of board committees, and the promotion of the roles of both internal and external auditors as a means of improving accountability and control.

2.3 GOVERNANCE MODEL

The model was developed in order to reflect the UK system of corporate governance. Fama and Jensen (1983) and Keasey and Wright (1993) both consider that the board is central to good governance. The UK system of governance largely relies on that fact and thus the importance of the board is reflected in the model below.

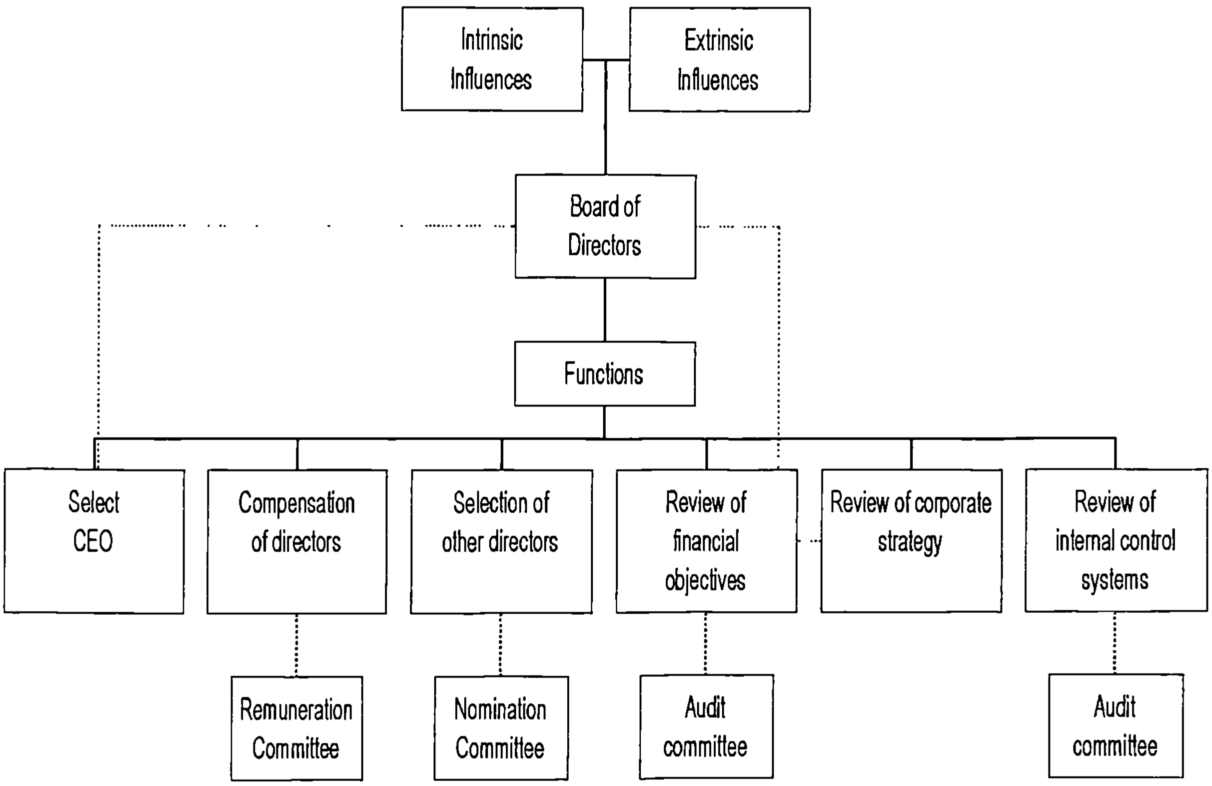

FIGURE 1 GOVERNANCE MODEL

The model (see Figure 1) therefore shows the use of three board committees namely nomination, remuneration and audit. The model also reflects the functions of the board and the various board committees to which these functions may be delegated.

The model also reflects the functions of the board and highlights the generally accepted board[5] functions- see Mace (1971), Chitayat (1984), and the committees to which these functions may be delegated. This serves to emphasise the significance of the board's role and the extent to which poor performance on the part of the board can materially affect the future viability of the company.

The performance of the board may be affected by: -

- The pressures from external parties who hold the board accountable for the company's performance i.e. extrinsic influences[6]; and
- The structure of the board - I.e. intrinsic influences[7] - the extent to which the composition of the board in terms of its structure and the attributes of the individual board members will influence the ability of the board to be effective.

2.3.1 Intrinsic influences

Fama and Jensen (1983) contend that the composition of individuals who serve on the board is an important factor in creating a board that is an effective monitor of management actions.

The corporate governance framework developed by Keasey and Wright (1993) also considers that one of the key mechanisms of the corporate governance framework to be directors and board structure. John and Seibert (1998) also support this premise as they argue that size, independence and composition determine the effectiveness of board monitoring.

Given that the regulatory authorities in the UK and USA appear to have embodied these concepts in their corporate governance codes, it is therefore reasonable to accept the premise that board composition is central to the effectiveness of the board - Koontz (1967).

Figure 70 [see appendices page 244] shows a model developed to show the intrinsic factors that influence the board's effectiveness. The factors were classified in terms of director attributes (factors relevant to the individual director) and board attributes (relevant to the overall board)

2.3.1.1 Experiences of the Directors

Koontz (1967) and Juran et al (1975) consider that many corporate boards have too many older less productive board members. Research conducted by Cochran, Warwick and Wood (1984) showed a positive correlation, albeit a very weak one, between younger boards of directors and financial performance. Vance (1983) however argues that a positive correlation exists between financial performance and the average age of directors as a result of greater experience.

Research to date on the issue of age is therefore inconclusive. Furthermore, the existence of a positive/negative correlation between director age and financial performance must be considered alongside other factors such as director skills, the complexity of the business and the environment in which the business operates.

If the number of years of board service is considered a proxy for age then research undertaken by Beasley (1996), highlights that as the number of years of board service increases in non-executive directors, the likelihood of financial statement fraud decreases. I.e. the ability of non-executive directors to fulfil their financial reporting oversight role is influenced to some extent by greater number of years of experience.

This suggests that experience as opposed to age is a more important determinant of non-executive director effectiveness. Olson (1999) and Livingston (1999) both stress the importance of experienced non-executive directors.

In line with the agency theory of governance, this thesis considers the role of the non-executive director and the extent to which the intrinsic factors affect their ability to fulfil their financial reporting roles with respect to the audit committee. Only the definition of experience in respect of non-executive directors[8] is therefore examined in section 2.4.3.10.

Based on the above argument, the following research question therefore arises.

IS THERE A POSITIVE RELATIONSHIP BETWEEN NON-EXECUTIVE DIRECTOR EXPERIENCE AND AUDIT COMMITTEE EFFECTIVENESS?

2.3.1.2 Remuneration of Directors

The compensation of executive directors is considered to be an important factor on board effectiveness. The remuneration committee, composed of non-executive directors, has the responsibility to determine, on behalf of the board and the shareholders, the company's policy on remuneration and the remuneration packages of each of the executive directors.

The Cadbury Code (1992: para. 3.3) stated that "...executive directors pay should be subject to the recommendations of a remuneration committee made up of wholly or mainly non-executive directors".

The reasoning behind this recommendation being that if executive directors rewards are to be linked to performance, those directors benefiting, should not decide on their own remuneration, due to a conflict of interest.

The Greenbury Report (1995) was the result of the Study Group on Directors Remuneration. The recommendations of this Code, which have since been included in the Combined Code on Corporate Governance (1998) required that:

- Boards of directors should set up remuneration committees of independent non-executive directors to determine, on behalf of the board and the shareholders, within agreed terms of reference, the company's policy on executive remuneration and the specific remuneration packages for each of the executive directors. (Para. A1)

- The Code stated that non-executive directors be independent. It also however highlighted the fact that these directors must have no cross-directorships with the executive directors due to the possibility of mutual agreements to increase each other's remuneration.
- The remuneration committee should report to shareholders as part of or annexed to the annual financial statements.

The remuneration committee should result in: -

- Accountability - I.e. the delegation and determination of executive management pay to non-executive directors who should have no conflicts of interest.
- Transparency - I.e. the provision of explanations to shareholders as to the manner in which remuneration is decided, the disclosure of all elements of individual directors remuneration packages, and the availability of information with which the shareholders can assess if the non-executive members of the nomination committee are independent.

The Greenbury Report (1995) noted that the key to enhancing directors performance lay in remuneration packages which: -

- Link rewards to performance; and
- Align the interests of directors and shareholders in promoting the company's progress.

The levels of executive management pay have been criticised in recent years due to apparent lack of correlation between performance and directors remuneration. Major criticisms were directed at the large increases in the remuneration packages of the executive directors of the then newly privatised utility industries in spite of poor financial performance and declining customer service.

Figure 2 shows the increases in UK Board Pay between 1983 and 1999 as compared to other economic indicators.

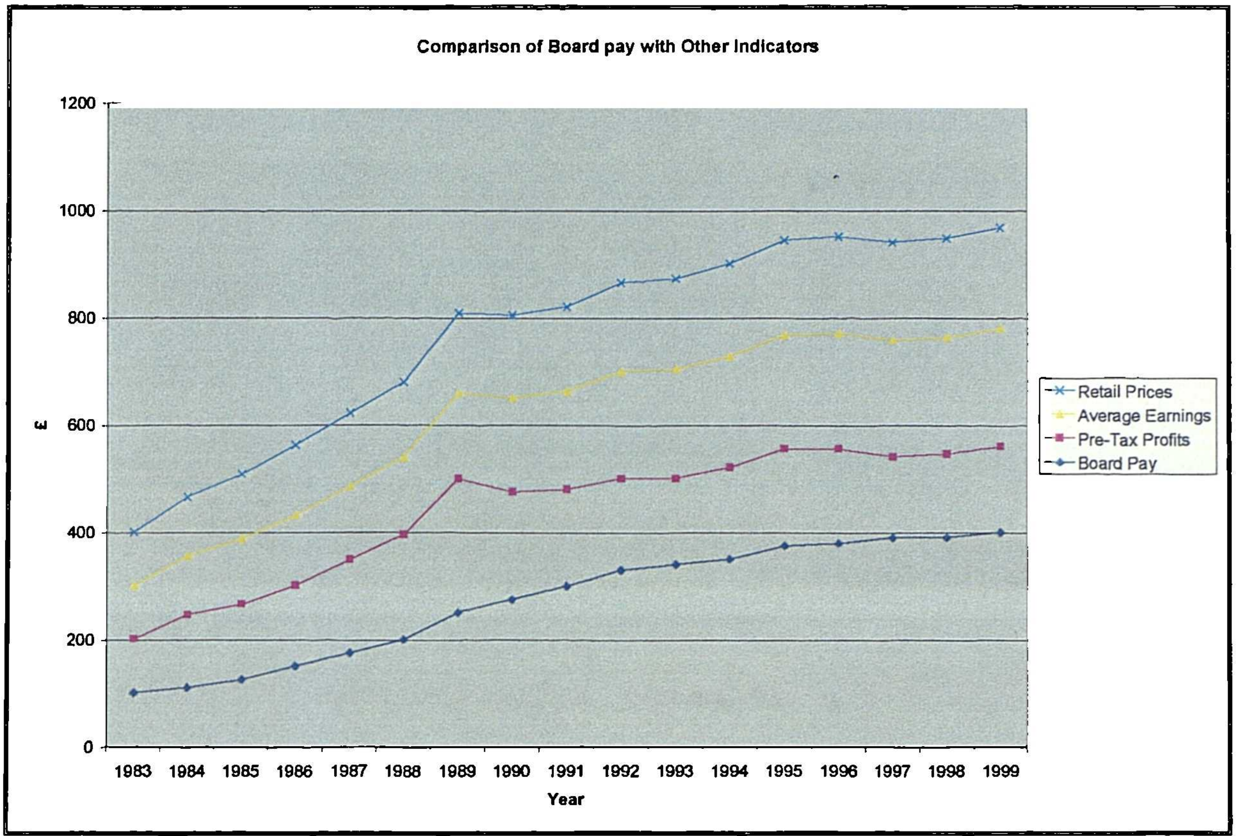

FIGURE 2 - COMPARISON OF BOARD PAY WITH OTHER INDICATORS[9]

These figures emphasise that levels of board remuneration have increased over and above levels of pre-tax profits. Whilst pre-tax profits may not be the best indicator of firm performance, they can be assumed to be an indication of short-term corporate performance. These figures appear to justify the general perception that board remuneration is not linked to performance. A recent example in the case of the final entitlements and new salary paid to the CEO of Railtrack appears to further support this perception. Empirical evidence from both UK and US research e.g. Conyon (1995) suggests the actual link between pay and performance is very weak. Core et al (1997) report that CEO compensation correlated positively with the proportion of non-executive directors on a company's board but negatively with the firm's future performance. Lambert et al (1993) noted that CEO compensation was higher in firms with a larger proportion of non-executive directors. This study did not however consider if higher pay was correlated to improvements in performance.

Research evidence overall does not seem to support the link between increased pay and performance. Notwithstanding research evidence to date, the linking of compensation to performance is increasingly reflected in the use of long term incentive schemes and board shareholdings.

Given the emphasis placed on the award of shares as part of directors' remuneration, the influence of directors' ownership on governance is considered relevant in the Greenbury Report. This emphasis is clearly warranted as Keasey and Short (1999) reported that directors' average equity shareholding in a random sample of UK quoted companies was 11.5%.

Morck, Shleifer and Vishny (1988) noted that board shareholdings act as an incentive to directors to act like owners in terms of how rigorously they monitor management. Kren and Kerr (1997) also found empirical evidence to support the proposition that increased board shareholdings were positively associated with the corporate performance -compensation link. This positive association was however dependent on the extent of the board shareholding. Other research e.g. Kole (1995), McConnell and Servaes (1990 and 1995) differ in their analysis of the size of shareholding that creates a positive association.

All research does tend to suggest a link between performance and board shareholdings at low levels of board shareholding. Keasey et al (1999) found similar relationship exists for UK companies.

Weisbach (1988) noted that boards in which executive management has large shareholdings tend to have a lower proportion of non-executive directors. I.e. as the interests of directors become more closely aligned to those of the shareholders, the agency costs of monitoring and mechanism (the proportion of non-executive directors) are reduced.

It is important that the number of non-executive directors is not reduced to a point where they are considered ineffective as Loebbecke (1989) noted that the extent of shareholdings by executive management was a key fraud motivational factor. Dechow et al (1996) also noted that at higher percentage of shareholdings was held by executive directors in firms experiencing financial statement fraud.

Increasing board shareholdings may align the interests of directors to shareholders and provide directors with incentives to improve their performance. Care must be taken to ensure that these shareholdings are not granted in a fashion that may result in executive management decisions that are designed to artificially boost the value of their shareholdings.

Given that the audit committee is composed of non-executive directors who should not be financially dependent on the company, executive management compensation is not considered to be a factor that influences audit committee effectiveness.

The manner in which non-executive directors are remunerated is of concern. There are increasing calls for non-executive directors to be partly or wholly remunerated in shares as a result of the view that board shareholdings increase the incentive of the directors to monitor managerial outcomes. Shivdasani (1993) and Jensen (1989) suggest that non-executive directors who hold a larger equity stake in the firm are likely to have a greater incentive to monitor executive directors.

Whilst this may positively align the interests of non-executive directors with shareholders, the existing tax regime in the United Kingdom may result in punitive tax liabilities for non-executive directors. At present, non-executive directors can only be included in unapproved[10] share option schemes. Under an unapproved scheme, the non-executive director faces two potential tax liabilities.

- An income tax liability on exercise of the option.

- A capital Gains tax liability on disposal of the shares.

These schemes are however not popular with companies as the set-up costs associated with the scheme are not allowable for tax purposes. Companies tend to prefer approved share option schemes. Under an approved scheme[11], executive directors are subject only to capital gains tax on the disposal of the shares.

It is unlikely that non-executive directors are going to be prepared to accept tax liability that exceed that incurred by executive directors for share options exercised and disposed of at the same price.

Overall evidence from US research studies suggests that directors' shareholdings play a significant role in governance and provides support for the recommendations contained within the Combined Code (1998) with respect to long-term board shareholdings.

2.3.1.3 Director Independence

Non-executive directors can be classified as independent or "grey" directors. It is important for non-executive directors to be independent so that there exists no conflicts of interests that might affect their judgement. An independent director is a director with no affiliation to the firm aside from being a member of the board of directors. Grey non-executive directors are those who have some non-board affiliation with the organisation. Gilson (1990) and Shivdasani (1993) found being relatives of management, consultants, suppliers, lawyers, bankers or retired management of the firm could impair independence of grey directors. Vicknair (1993) found that at least 74% of the companies on the NYSE had at least one 'grey' director. Peasnell et al (1998) found that approximately one-third of all non-executive directors in the U.K. could be classified as "grey".

The Hampel Report (1998: para.3.9) concurred with the recommendations of the Cadbury code in that it required that "... a majority of non-executive directors be independent".

The audit, remuneration, and nomination committees all require independent non-executive directors. The "independence" of judgement required: -

- establishes the integrity of the financial statements in the case of the audit committee;
- the legitimacy of the awards given to top management in the case of the remuneration committee; and
- the integrity and transparency of the selection process in the case of the nomination committee.

The independence of the non-executive director may also be threatened in cases where the ex-chief executive officer is invited to sit on the board as a non-executive director.

Cosh and Hughes (1997) found that even though there appeared to be an increase in the percentage of non-executive directors on the boards of UK companies, a significant number of these non-executive directors were past or present CEO's or executive managers[12]. This suggests difficulties in the ability of non-executives to be impartial in key monitoring roles.

The potential of an existing chief executive officer to dominate the board is well-documented e.g. Menon and Williams (1994). However, the retired chief executive officer may also continue to dominate board decisions. Executive directors may feel a sense of loyalty to the retired CEO as this CEO may have appointed them.

Non-executive directors may also feel a need to be loyal to an individual who may have been instrumental in their appointment. This sense of loyalty may compromise the independence of the non-executive director if this sense of loyalty results in their inability or fear to oppose the decisions of the retired chief executive officer.

The director nomination process appears to be a key mechanism through which the independence of non-executive directors may be achieved. Latham (1999) noted that CEO's involvement in the process of nominating prospective non-executive directors for board approval might still be an undue influence of process,

However, Vafeas (1999) noted that the existence of a nominations committee, which was composed of independent directors, had a significant positive impact on board quality.

The importance of non-executive director independence is also highlighted in consideration of top manager remuneration. The Combined Code (1998) stated that the remuneration committee should consist of only independent non-executive directors.

Main and Johnston (1993) found, in their study of UK remuneration committees, that the level of pay was unaffected regardless of whether there was a remuneration committee. This study also highlighted that most remuneration committees were not composed solely of independent non-executive directors. It should be noted that this study was undertaken prior to the recommendations of the Cadbury code (1992) and the Greenbury Code (1995).

Notwithstanding the period of the study, this study suggests that the ability of non-executive director to fulfil this monitoring role was compromised and highlights the need for independent non-executive directors.

Research evidence therefore suggests that the independence of the non-executive director on board committees and in particular the audit committee is a crucial factor in determining board effectiveness. Accordingly, the following research question arises: -

2.3.1.4 Size of the Board of Directors

Many researchers have examined board size. Koontz (1967) and Pfeiffer (1972) found that larger companies had larger boards. This correlation is explained by the fact that the complexity of larger organisations results in:

- More bureaucratic administration;
- The representation of certain stakeholder groups on the board;
- The use of board sub-committees to ensure those important areas is effectively monitored.

Jones (1986) argues that large boards are able to contribute more expertise and experience. Chaganti (1985) reviewed the relationship between the size of the board and business failures. Chaganti (1985) found that the smaller size of board was significantly correlated to the incidence of business failure.

Jensen (1993) however argues that a smaller board of directors is more likely to play a more controlling function. Beasley (1996) also found evidence to support the argument for a smaller board. He noted that as board size increases the likelihood of financial statement fraud increases. Yermack (1996) and Conyon et al (1998) found a negative relationship between board size and performance.

Small boards may be able to play a more controlling function. However, it is important that the size of the board does not fall to a level that results in there not being enough members to fulfil their roles effectively.

The Hampel Report (1998: para. 3.14) states that "...we believe that it is difficult for them (the non-executive directors) to be effective if they make up less than one third of the board. Thus board size to some extent must be considered to influence board effectiveness. Furthermore, if the size of the board influences the effectiveness of the non-executive directors, audit committee effectiveness may also be compromised.

The Cadbury Report (1992) stipulated a minimum of three non-executive directors. The Hampel Report (1998) went further as it also stated that boards with less than three non-executive directors could not be considered effective. Many of the smaller listed[13] companies felt that this recommendation in view of their size and nature was punitive.

The Quoted Companies Alliance[14] – (QCA) was established in 1992 in order to recommend amendments more suitable to the "smaller company".

The QCA recommended that it was acceptable for "smaller" companies to have two non-executive directors. While the recommendations of the QCA have garnered significant support, they have not been formally adopted into the Combined Code (1998).

As such this thesis still considers that companies with less than three non-executive directors and, by implication, audit committees with less than three non-executive directors to be ineffective. Accordingly, the following research question arises: -

IS THERE A POSITIVE RELATIONSHIP BETWEEN THE SIZE OF THE AUDIT COMMITTEE AND AUDIT COMMIITTEE EFFECTIVENESS?

2.3.1.5 Board structure

The proportion of non-executive directors to executive directors is an important feature of board structure. Fama and Jensen (1983) argue that it is natural for the most influential members of the board to be executive management because of their privilege of information. Williamson (1984) however notes that because executive management does have informational advantage due to their full-time status and insider knowledge, the board of directors may become an instrument of executive management. Fama (1980) contends that domination of the board by top management may lead to collusion and a transfer of shareholder wealth to management.

The domination of the board by executive management is clearly an issue in the UK context. Kesner and Dalton (1986) contend that the ability of the board to perform effectively is related to the lack of independence from the management it is meant to control. The separation of the role of Chief Executive Officer and Chairman and competent, independent non-executive directors is often advanced as a means to prevent domination of the board by a powerful chief executive and top management.

Non-executive directors are considered to be in a better position to play a monitoring and controlling function as opposed to executive management due to their independent nature. Research on the ability of non-executive directors to determine compensation Core et al (1997) may suggest otherwise.

Vance (1983) contends also that non-executive directors are more likely to be obligated to the Chief Executive Officer for their position and are therefore less likely to aggressively challenge and oversee executive management.

Research on chief executive turnover disputes this argument to some extent as Morck, Shleifer and Vishny (1988) shows that boards can and do remove top managers as a result of poor performance. Weisbach (1988) also noted that boards dominated by non-executive directors were more likely to dismiss top management as a result of poor corporate performance.

Scott and Kleidon (1994) find that firms with a majority of non-executive directors that replace Chief executive officers tend to have worse pre-replacement share prices than firms with executive dominated boards. This appears to suggest that non-executive directors are able to replace Chief executive officers where externally observable indicators suggest poor performance. However, the extent to which non-executive directors may replace a poor CEO when external indicators remain constant is not known.

Klein (1998) considers if the existence of a board committee affects firm performance and finds no evidence to suggest that performance is improved where a greater number of non-executive directors are on the board. Bhagat and Black (1997) dispute this argument as they find that a direct albeit weak relationship exists between board composition and firm performance.

The AICPA's paper - Strengthening the Professionalism of the Independent Auditor (1994) - included recommendations on changes in board composition to enhance the board's independence for the purposes of minimising the occurrence of financial statement fraud. This appears to be justified as Beasley (1996) noted that boards of no-fraud firms[15] were significantly more likely to have a higher proportion of non-executive directors than fraud firms. Dechow et al (1996) supported this premise and also concluded that firms with a higher percentage of executive directors and no audit committee were more likely to commit financial statement fraud.

Most of the evidence to date, with the exception of Chaganti (1995)[16] considers that board structure is an important determinant of board effectiveness and by implication audit committee effectiveness. The balance of the board i.e. the proportion of non-executive directors to executive directors is therefore considered to be a factor that might influence the ability of the non-executive directors to be effective, and by implication, the ability of the audit committee to be effective. The following research question arises: -

DOES A POSITIVE RELATIONSHIP EXIST BETWEEN AUDIT COMMITTEE EFFECTIVENESS AND THE BALANCE OF THE BOARD?

2.3.1.6 Chief Executive Officer and Chairman Duality of Role

Russell Reynolds Associates Survey Board Practices (1998) highlight that 85% of S&P 500 Companies in the USA do not have separate individuals as Chief Executive Officer and Chairman. However, if the evaluation and compensation of the chief executive officer is delegated to the remuneration committee, which consists of solely independent non-executive directors, the combined role may not affect the monitoring function of the board in that respect. In this case, clearly the independence of the non-executive directors and their ability to influence decisions is important. Non-êxecutive directors generally dominate boards in the USA and evidence –Weisbach (1997) exists to show that non-executive directors in the USA are more likely to dismiss the chief executive officer for poor corporate performance.

Daily and Dalton (1997) identified a variety of arguments for and against combining the role of CEO and chairman. The main arguments for being to strengthen the leadership of the company through the superior knowledge of the business as a result of the joint position. Donaldson et al (1990) and Barney (1990) contend that it is essential for the Chairman and Chief Executive Officer to exercise complete authority over the corporation and that their role be unambiguous and unchallenged. Donaldson and Davis (1990) results indicate that having an independent chairman does not lead to shareholder wealth and that shareholder wealth increases when the chief executive officer and chairman role is combined.

Daily et al (1997) found conflicting evidence on the empirical link between CEO role duality and firm performance. Baliga et al (1996) were also unable to detect a significant relationship between role duality and firm performance.

The main arguments against being to achieve greater board independence. The main argument for the separation of the role was that board independence would be improved. Jensen (1983) argues that the role of the chairman includes the evaluation and compensation of the Chief Executive Officer and thus separation of the role must occur if the board is to be effective in its monitoring function.

Millstein et al (1998) noted that even where the role was split the chairman in many instances was not independent. Furthermore, Daily et al (1997) considered the independence of the chairman under both the dual and separate role structures. No statistically significant relationship was found to show that the independence of the chairman was any less when the role was joint as compared to when the role was split. Rechner and Dalton (1986) noted that shareholder returns were inferior when Chief Executive Officer and chairman role was combined.

Differences in the governance structures of the USA and The UK show that: -

- In the USA, re. Korn/ Ferry (1993, 1999) survey, the roles of chairman and chief executive officer are combined, the boards are dominated by non-executive directors; and
- In The UK, re. Peasnell et al (1998), the roles of chairman and chief executive officer are usually separated and the boards tend to be dominated by executive directors.

The Combined Code on Corporate Governance (1998) in the UK however considers that the separation of the roles to be important to board effectiveness and by implication, audit committee effectiveness.

Many of the smaller listed[17] companies felt that this recommendation in view of their size and nature was punitive. The QCA recommended that the presence of two independent non-executive directors offset the need for the separation of the role of chairman and CEO.

Given that these recommendations have not been formally adopted into the Combined Code (1998), this thesis still considers that the separation of the role of CEO and Chairman as an important determinant of board and audit committee effectiveness. Research to date has not examined if the separation of these roles is positively associated with audit committee effectiveness. In view of the above argument, the following research question arises: -

IS THE EFFECTIVENESS OF THE AUDIT COMMITTEE POSITIVELY ASSOCIATED WITH CHIEF EXECUTIVE OFFICER AND CHAIRMAN ROLE SEPARATION?

2.3.2 Extrinsic influences

Extrinsic influences consider the role of shareholders and other regulators in corporate governance. Their roles are considered from the perspective of their ability to exert pressure on the board and to what extent they consider the structure of the board a factor in board effectiveness. Figure 71 (see appendices page 245) shows the groups that may influence the board.

2.3.2.1 The Role Of Shareholders

Under the current legal and regulatory framework, UK shareholders have no responsibilities, other than a requirement to disclose any equity shareholdings greater than equal to 3% and to abide by the provisions of the Take-over code. This framework however provides shareholders with certain rights, which include: -

- the right to receive a dividend;
- the right to transfer ownership;
- The right to appoint and remove directors;
- The right to appoint and remove auditors;
- The right to submit resolutions;
- The right to be consulted over changes to the memorandum and articles of association; and
- The right to be consulted over any changes to the share capital of the companyn

Historically, private individuals owned shares. The ownership of shares conferred the above rights. The right to receive dividends and transfer ownership is not under threat. However, the rights to elect directors and external auditors' i.e. the parties who are meant to protect the shareholders interest do not appear, in practice, to permit private shareholders to either veto the election of directors or the choice of auditors and thus apply pressure to the board. This is partly due to the diversity of private ownership as this results in them being unable to form an effective group and thus influence the board. However the manner in which private shareholders vote, i.e. their voting rights are partly responsible for their inability to influence the board. Section 2.3.2.4 considers the voting rights of shareholders and the options available to them to influence the board.

2.3.2.2 Institutional Investors

The pattern of share ownership has since evolved. Figure 3 shows that in the UK institutional investors[18] are now the single largest group of shareholders.

	UK (%)
Individuals	18
Banks	1
Institutions	60
Companies	2
Governments	3
Foreign	16

FIGURE 3 OWNERSHIP OF SHARES [19]

Given the extent of the shareholdings held by institutions, the ability of the private shareholder to exercise stewardship is further limited. It is for this reason that only the role of the institutional investor is examined in detail. It is clear that since the institutional investors are the only group of shareholders that have enough voting power to bring pressure on the board and management, the extent to which they utilise this power is important.

Effective exercise by shareholders of their powers of intervention and control is a very important component of the governance system. In order to understand the issues concerning the role of institutional investors, it is important to determine the definition of a shareholder.

A shareholder under section 22(2) of the Companies Act 1985 is defined as a person who has agreed to become a member and whose name is entered in the register of members. This definition establishes who the legal owner is and therefore who can transfer good title. The legal owner differs from the beneficial owner i.e. the person with the economic interest in the share and entitled to some or all the benefits of ownership. This may come about in a variety of ways, but two are of particular significance:

- A private individual who owns the rights to a share may elect that it should be held through a nominee, such as a broker, or a professional nominee who may be selected and dealt with by the broker on the individual's behalf.
- A fund manager or pension funds trustee may employ a specialist custodian for similar administrative convenience, or security reasons. The custodian is the legal owner, and the rights of the legal owner and the beneficial owner are set out in a contract between them.

The financial aspects of share ownership are not a matter of concern. It is more the "control rights" attached to a share that influence the extent to which the shareholder may exercise their rights. These control rights include the right to:

- receive the report and accounts and notices of general meetings;
- to attend and vote at general meetings;
- to combine with other shareholders to propose a shareholder resolution;
- to requisition an Extraordinary General Meeting (EGM).

These rights rest with the legal owner and there are no statutory or other rules requiring them to be passed back to the beneficial owner. The separation of legal and beneficial ownership of shares may well inhibit the corporate governance role of both individual and institutional shareholders.

According to a NAPF survey[20], the average proportion of votes cast on resolutions at AGMs remains at less than 50 per cent, despite some recent increase. It is now widely accepted that the right to vote a share has an economic value and that those who hold voting rights on behalf of others have a fiduciary responsibility to consider whether (and if so how) to vote.

The recent report of the National[20] Association of Pension Funds Committee of Inquiry into Vote Execution found that a significant proportion of instructions given to custodians were not carried out, and that procedures for verifying that votes had been cast were inadequate.

Black and Coffee (1994) reviewed UK institutional shareholder activism in the early 1990s. They noted[21] that the specific areas of shareholder activism focused upon included:

- Protecting shareholders' rights, especially against the adoption of take-over defences;
- CEO replacement (where there is limited evidence of institutional pressure leading to CEO turnover - and usually this pressure is only effectively applied when institutions have greatest leverage, e.g. when companies need new equity capital and need investors to agree to an offering);
- Changes to board structure and membership (where greater proportions of executive directors exist);
- Voting behaviour;
- Management and director compensation;
- Proxy fights.

Russell Reynolds Associates (1998) survey noted that the governance practices considered important by institutional investors included:

- Separation of the role of chairman and chief executive officer[22].
- The evaluation of Chief Executive Officer compensation by the board and the importance that the Chief Executive Officer and other executive management remuneration be linked to performance.

- The need for the board to play a more active role in succession planning. The investors surveyed further noted that the existing Chief Executive Officer participate but not chair the committee in place to search for the successor.
- The survey highlighted board composition issues such as interlocking directorships, family relationships, and directors who serve on too many other listed companies boards as important to investors.

Russell Reynolds Associates (1998) survey also noted that the weight given to corporate governance by the fact that non-financial factors including governance structure were of increasing importance to institutional investors when making a decision as to whether to invest in a company.

However, the above survey noted that investors still indicated that good governance practices might be sacrificed for a higher return on investment. However, a significant number of institutional investors had made the decision not to invest in a company due to poor corporate governance practices.

Solomon, Solomon, Joseph and Norton (2000) in a questionnaire survey of UK institutional investors' attitudes to corporate governance reform noted that institutional investors have generally welcomed the recent reforms and attach more relevance to initiatives aimed at monitoring the principal/agent problem.

According to a McKinsey & Co (2000) survey of 200 institutional investors from the US, Europe, Latin America and Asia, three-quarters of institutional investors were of the opinion that board practices were just as important to them as financial performance when evaluating companies for investment. These investors stated that they would be prepared to I pay an average premium of 18%[23] for well-governed[24] companies in the UK and US, and a higher premium in other countries.

Recent cases e.g. The Royal Bank of Scotland highlight that institutional investors may no longer all be willing to accept the trade off between good governance and return on investment.

2.3.2.3 Shareholder Resolutions

It is important to therefore consider the options open to shareholders should they wish to exercise their rights by putting forward resolutions at the AGM.

Sections 376 and 377 of the Companies Act provide the corresponding regulation of the process of submitting shareholder resolutions in the UK. Section 376 provides that 'members representing not less than one-twentieth of the total voting rights or 100 members holding shares on which there has been paid up an average sum per member of not less than £100 may require the company to give notice of their resolutions which can then be considered at the next AGM.'

The notice must be deposited with the company at least six weeks before the AGM and the proposers must meet the company's costs of distributing the notice. This provides management with ample forewarning of opposition and, given that the company is not required to disclose details of its timetable six weeks ahead of time, is also a logistically impossible.

Members are allowed to circulate statements of up to 1000 words in support of their own resolutions or in opposition to specific proposals of the board through the company's communication 'machinery', the expenses involved make this option not very much more attractive than acting independently in contacting shareholders directly.

Davies (1997) notes that, in large public companies with dispersed membership, 'victory normally goes to those who first state their case and first solicit proxies.'

While the AGM does provide a forum for both the board and the opposition to state their cases again, in reality, the result of any disputed resolution is determined in advance through the system of proxy votes.

This suggests that small shareholders do not generally have any hope of tabling a resolution for discussion at the AGM due to the associated costs and logistics of such an action. Furthermore, the system of proxy votes does not tend to allow the smaller shareholder the right to influence the board.

2.3.2.4 Proxy Voting

In the UK, section 372 of the Companies Act governs proxy voting. Even though post-1948 regulatory reform relating to proxy voting has seen to it that the board must now send out a 'two-way' proxy form, allowing members to direct the proxy vote either for or against management proposals, directors are still afforded 'tactical advantages'.

Their position enables them to get their materials out first, stating their case without immediate opposition. By the time opposition to any of the resolutions may have been organised and circulated to the members, a substantial number of shareholders who intended to vote might already have done so.

In the UK the evidence on shareholder voting pertains mainly to institutional shareholder voting. Stapledon (1996) overviews evidence on UK institutional investor voting up to 1994. He notes that the evidence for pre-1994 shows that the overall level of proxy voting by UK investors, including fund managers, was quite low.

The most recent evidence cited was for the lodgement of proxies between November 1993 and September 1994 for a sample of 101 of the largest 250 UK listed companies. This sample reflected that only 35% of ordinary shares were voted.

Stapledon (1996) suggested that the practical difficulties associated with passing votes through from nominees to fund managers to trustees in the short amount of time between the issue of the notice and the 48 hour cut-off before the AGM or EGM were responsible for these low levels.

The recent rise in voting levels, and the increase in routine voting, is attributed to

- increased awareness of corporate governance issues among investors;

- pressures on institutional investors to exercise their votes; and
- the emergence of voting information services institutions, such as that provided by PIRC (Pensions Investment Research Consultants).

Short and Keasey (1997) note that in the recent past there have been calls for mandatory voting of shares, along with the publication of detailed voting policy statements by institutions. Many institutional investors have not been willing to disclose their voting policies to date.

2.3.2.5 AGM

Another form of shareholder activism is addressing questions to directors at the AGM. Shareholders' questions are required to relate to the subject matter under debate but many companies allow for an open 'question-and-answer' session.

Discussion of the reform of the AGM centres on the failure of shareholders to use this forum to any significant degree as a corporate control mechanism. Institutional shareholders, who have privileged access to company directors and management through private meetings, tend not to attend AGM's[25].

Davies (1997) argues that the AGM, particularly the opportunity to ask questions, is the only forum for effective individual shareholder activism as the outcome of voting on resolutions is *de facto* determined beforehand by the proxy voting system, mainly by institutional shareholder votes.

The fact that voting outcomes are determined by proxy votes that are held on behalf of institutional investors further highlights the importance of the role of the institutional investor. It also highlights the need for institutional investors to vote in a responsible fashion.

There have been increasing calls for changes to be made to the way AGM's are conducted in order to allow more shareholders to exercise their fights. The use of the Internet has been debated for: -

- Notices calling meetings;

- Circulation of annual reports to members;
- Electronic voting;
- Communications between nominee and beneficial shareholders;
- Registering proxy votes;
- Real time video broadcasts of General Meetings to desktops of 'subscribed' members; and
- 'Virtual meetings' with real time broadcasting and interactive features.

It is hoped that these advances will improve shareholder activism and voting.

The need for the institutional investor to influence the board and governance practices is paramount, as they are the only shareholder group large enough to effect any changes.

The ability of institutional investors to influence governance practices lies in their willingness to monitor the board and ensure that poor governance practices are not acceptable. In so far as a trade-off between financial return and good governance exists, the potential influences are reduced.

2.3.3 Regulators

The regulators are considered to be groups who are able to exert pressure on companies (in particular the board) to effect governance changes. The three main groups therefore considered are:

- The Financial Services Authority – FSA. Listed companies are required to meet the rules set out in the Yellow Book – Continuing Obligations in order to maintain their listing on the London Stock exchange. The FSA, with its responsibility for the supervision of this exchange, is therefore examined.
- The Financial Reporting Council- FRC. Listed companies are required to publish annual audited financial statements. The FRC and its sub-committees are therefore examined.
- Government.

2.3.3.1 *The FSA*

The Financial Services Authority (FSA)[26] is an independent non-governmental body, which exercises statutory powers under the Financial Services Act 1986 and the Banking Act 1987 (and certain other legislation). It is a company limited by guarantee, financed by levies on the industry.

Under the Financial Services Act, the FSA also has responsibility for overseeing the integrity of UK investment markets. In practice, the FSA does this by:

- Recognising and supervising a number of specialist organisations with responsibility
- for particular markets and services;
- Listing and supervising institutions involved in certain inter-professional markets; and
- Maintaining the London Code of Conduct with which market participants are expected to comply.

The FSA supervises the six UK Recognised Investment Exchanges (RIEs). The exchanges are: -

- The London Stock Exchange;
- Tradepoint;
- The London International Financial Futures and Options Exchange (LIFFE);
- The OM London Exchange;
- The London Metal Exchange (LME); and
- The International Petroleum Exchange (IPE).

2.3.3.2 *The London Stock Exchange*

In the UK a number of corporate governance codes were conceived to address perceived corporate governance weaknesses. These codes were self-regulatory controls and enforceable only through shareholder pressure and the Stock Exchange Listing Rules.

The first, the Cadbury Code, was issued in 1992 following the deliberations of the Committee on the Financial Aspects of Corporate Governance. The second, the Greenbury Code, was issued in 1995 following the deliberations of the Committee on Executive Pay.

The Cadbury Committee was set up by the Financial Reporting Council, the Stock Exchange and the accountancy profession following financial mismanagement scandals and made recommendations on accounting and auditing issues, on the proper structure of boards and on the appropriate standards of conduct for directors.

The Greenbury Committee was set up on the initiative of the Confederation of British Industry in reaction to controversies surrounding increases in managerial remuneration, especially in privatised utilities.

The Committee on Corporate Governance (known as the Hampel Committee) was set up in 1996. Its report, published in August 1998, reviews the previous codes and makes proposals for updating them.

The Combined Code (1998) was a consolidation of the work of the previous three governance codes. The Combined Code has been incorporated into the Stock Exchange Listing Rules as part of the 'Continuing Obligations' of the Yellow Book.

While companies are under no formal obligation to comply with the Combined Code, they are obligated to report on their compliance with guidelines set out in the first section of the Code and to identify and explain areas of non-compliance as a Stock Exchange listing condition.

The Combined Code is organised according to 14 principles (general guidance statements) and 45 provisions (specific requirements) in five separate categories. The first section of the Code covers the first four categories and applies to company boards. The categories of provisions include:

- directors' duties and responsibilities and the composition of the board;
- directors' remuneration;

- communications with institutional and private investors; and
- accountability and audit.

The second section of the code covers the fifth set of provisions and applies to institutional investors. It sets out a new set of responsibilities for institutional investors to become more proactive in corporate governance.

The Stock Exchange Listing Rules enforce the Combined Code on Corporate governance indirectly by requiring disclosure of non-compliance. The extent to which this can be seen as a truly effective means of enforcement is where investors, who consider corporate governance to be important, takes steps to ensure that these matters are redressed.

2.3.3.3 The FRC

The Financial Reporting Council and its subcommittees - the Accounting Standards Board and the Financial Reporting Review Panel - were established in 1988.

Although the FRC and its companion bodies have the strong support of Government they are not government-controlled, but rather part of the private sector process of self-regulation.

The remit of the Council is to provide support to the operational bodies—the Accounting Standards Board and the Financial Reporting Review Panel—and to encourage good financial reporting generally. At its first meeting, in May 1990, the Council codified this role as being to: -

- promote good financial reporting, and in that context from time to time make public reports on reporting standards; and
- provide guidance to the Accounting Standards Board on work programmes and on broad policy issues.

2.3.3.4 The Accounting Standards Board

The Accounting Standards Board Limited (ASB) is formally a subsidiary of the FRC that acts as its sole director. The role of the ASB is to make, amend and withdraw accounting standards.

Unlike the former Accounting Standards Committee, the Accounting Standards Board is autonomous; it needs neither outside approval for its actions, nor approval from the company's director. It is however the practice of the Board to consult widely on all its proposals.

2.3.3.5 The Financial Reporting Review Panel

The Financial Reporting Review Panel Limited (FRRP) is a subsidiary of the FRC, which acts as its sole director. The company contains a Review Panel, which is autonomous in carrying out its functions; it needs neither outside approval for its actions nor approval from the company's director. By agreement with the Department of Trade and Industry, the normal ambit of the Panel is public and large private companies.

The role of the Review Panel is to examine departures from the accounting requirements of the Companies Act 1985, including applicable accounting standards, and if necessary to seek an order from the court to remedy them.

A chief concern of the Panel is with an examination of material departures from accounting standards with a view to considering whether the accounts in question nevertheless meet the statutory requirement to give a true and fair view.

The Panel does not scrutinise on a routine basis all company accounts falling within its ambit. Instead it acts on matters drawn to its attention, either directly or indirectly.

Groups normally aim to discharge their tasks by seeking voluntary agreement with the directors of a company on any necessary revisions to the accounts in question. The Companies Act 1985 makes possible the voluntary revision of accounts as well as their revision by court order.

If this approach fails and the Panel believes that revisions to the accounts are necessary, it will seek a declaration from the court that the annual accounts of the company concerned do not comply with the requirements of the Companies Act 1985, and for an order requiring the directors of the company to prepare revised accounts.

Where accounts are revised at the instance of the Panel, either voluntarily or by order of the court, but the company's auditor had not qualified the audit report on the defective accounts the Panel will draw this fact to the attention of the auditor's professional body.

2.3.3.6 Government

Governments are elected to represent the public interest and provide conditions within which economic progress can be made. The UK government has so far been reluctant to intervene[27] in the corporate governance arena and thus move away from the self-regulatory framework in existence. The role of government in promoting corporate governance is limited to the introduction of legislation in support recommendations from private sector initiatives. This support is evident in the: -

- Extent of funding given to private sector regulators e.g. the FRC;
- The role of the DTI in promoting and facilitating consultative reviews of the main issues in UK corporate governance;
- The introduction of changes to the accounting provisions of the Companies Act 1989;
- The provision for the compulsory revision of accounts where the court is satisfied that the original accounts do not show a true and fair view or do not otherwise comply with the requirements of the Companies Act 1985. The legislation also made possible the voluntary revision of defective accounts, and it is this procedure that in practice has so far been followed when correction has been needed; and

- The introduction of a legal definition of Accounting standards and the requirement that large companies must disclose whether or not they have complied with them.

2.4 AUDIT COMMITTEES

The role played by independent non-executive directors on the board continues to be a prominent feature of corporate governance. In recent years, increasing attention has been paid to audit committees by both regulatory authorities and academics. SEC, the National Commission on Fraudulent Financial Reporting (1987) and the Kirk Panel (1994) state that the audit committee is an important element in corporate governance and instrumental in ensuring the quality of financial reporting.

Academic research examines the relation between audit committee characteristics and aggressive reporting (DeFond and Jiambalvo 1991; Dechow et al. 1996), the incidence of fraud (Beasley 1996; McMullen 1996) and other firm characteristics. Most studies consider that a positive relationship exists between the existence of an audit committee and the quality of financial reporting.

This section therefore considers: -

- the development of audit committees;
- the roles of the audit committee; and
- the structure and composition of the audit committee.

The development of the audit committee is considered using the experiences of companies[28] in the UK, USA and Canada. Overall, the main reasons for audit committee development regardless of country remain the same i.e. the need to improve the credibility of financial reporting.

The roles of the audit committee are then considered. For the purpose of this thesis, the main focus is the audit committee role in financial reporting within the financial statements.

Bearing in mind the nature of the audit committee, the structure and composition of the audit committee is examined. Available literature on the relationship between structure and the audit committee effectiveness where relevant is examined.

2.4.1 Development of Audit Committees

The concept of the audit committee is not new. A report of the audit committee of the Great western Railway CO. Dated 1872 highlights this fact. Venables and Impey (1991) noted that audit committees in the USA and Canada were developed in order to: -

- increase confidence in the credibility and objectivity of the financial statements;
- assist directors in discharging their financial reporting responsibilities; and
- to strengthen the independence of the external auditors.

A historical review of the development of audit committees in the USA, Canada and the UK highlights the importance of financial reporting and thus by implication the need for an effective audit committee.

2.4.1.1 Development of Audit Committees in the USA

The development of the modern audit committee can be traced back to 1940 when both the Securities and Exchange Commission (SEC) and the New York Stock Exchange (NYSE) recommended the establishment of audit committees following the McKesson and Robbins fraud case in the 1930's.

The 1967, the AICPA recommended that all publicly owned companies should have audit committees composed of non-executive directors. Mautz and Neumann (1970) noted in their study of audit committees highlighted that only 38% of quoted organisations had audit committees.

The Bar Chris case in 1968 and the post-Watergate findings in the early 70's once again resulted in the audit committees being promoted to increase confidence in financial reporting. In response, SEC issued Accounting Series Release (ASR) no. 123[29] which stated "...SEC endorses the establishment by all publicly held companies of audit committees composed of non-executive directors ...to assist in affording the greatest possible protection in investors who rely on such financial statements". The NYSE issued a white paper in 1973 that contained a similar recommendation.

In the 1970s, massive financial disclosure problems at companies such as Lockheed and Penn Central created a furore as some blamed financial accounting irregularities on too-familiar relationships between corporate boards and outside auditors. To mitigate the problem, Congress passed the Foreign Corrupt Practices Act of 1977, and securities exchanges adopted rules requiring a corporate board to have an independent audit committee. The Foreign Corrupt Practices Act (1977) also imposed a statutory liability on directors of quoted companies to maintain adequate internal control systems. By 1979, with the exception of AMEX- the American Stock Exchange - all regional exchanges had included this recommendation as a mandatory listing rule.

So far, most groups had made recommendations on the establishment and general composition of the audit committee. It was not until the publication of the report by the Treadway Commission (1987) that specific guidelines for audit committees were recommended. The Report contained specific guidelines on the roles and structure of audit committees and further recommended that all public companies be required by SEC to establish audit committees composed solely of non-executive directors. SEC has not changed its stance from that of a recommendation to a requirement.

During the 1990s, as some companies increasingly began to "manage" their financial disclosures, the practice prompted some to question the integrity of company financial statements.

The matter reached a head with a now well-known speech, "The Numbers Game," by SEC Chairman Arthur Levitt at New York University in September 1998. Levitt called for a committee to examine the financial reporting system.

The result was the creation of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audits to study management's role in financial disclosures.

The committee issued a report in February 1999, recommending that the various securities exchanges and SEC implement rules that would provide audit committees with a self-regulatory framework emphasising disclosure, transparency and accountability. SEC has since implemented the recommendations of the Blue Ribbon Report of which the most important are:

- Financial literacy. NYSE and NASD rules (SEC release no. 34-41982) provide that companies with a stated market capitalisation must have audit committees consisting of at least three directors who are financially literate or who become financially literate within a reasonable time after their appointment. The audit committees also must have at least one member with accounting or related financial management expertise.
- Committee charters. The new SEC rules provide that a company proxy statement must indicate whether the audit committee has a charter; if so, the company should attach the charter to the proxy statement once every three years (SEC release no. 34-42266).
- Independent committee members. The SEC rules require companies to disclose whether audit committee members are independent and the relationship that makes a specified member not independent.
- Audit committee statements. SEC rules require that proxy statements include a representation by the audit committee that its members have reviewed and discussed the financial statements with management and the external auditors and that they have received the required information from the external auditors verifying the auditors' independence.

Boards, audit committees, companies and auditors all have been given new responsibilities. The full impact of these changes remains to be seen as companies will apply the rules and make the required disclosures in the year commencing 2001.

2.4.1.2 Development of Audit Committees in Canada

Following the collapse of the Atlantic Acceptance Corporation in 1965, a Canadian Royal Commission Report (1965) recommended that audit committees be formed in all public corporations. In 1967 the Lawrence Commission recommended that the establishment of an audit committee be mandatory for all companies issuing shares.

The Ontario Business Committees Corporation Act (1970) introduced legislation which made audit committees mandatory in the province. Central government followed suit with the Canadian Business Corporation Act (1971). This Act was amended in 1975 to require all public companies to have an audit committee whose duty is to approve the financial statements prior to submission to the main board of directors for approval. The Adams Report (1978) made further recommendations with respect to the responsibilities of the audit committees.

The Macdonald Report (1988) issued by the Canadian Institute of Chartered Accountants made recommendations which included: -

- all public companies to have audit committees composed primarily of non-executive directors;
- audit committees to report annually to shareholders; and
- audit committees to review both the interim and annual financial statements prior to publication.

The Bank Act, the Trust and Loan Companies Act, and the Insurance Companies Act were all amended with effect from June 1992 to ensure that the audit committee be composed of at least three non-executive directors of whom none should be officers or employees of the company or its subsidiaries. These Acts also set out specific audit committee duties that included: -

- Reviewing annual financial statements prior to board approval;

- Ensuring that appropriate internal controls were in place;
- Meeting with external auditors to discuss the financial statements or any matters affecting the company; and
- Meeting with chief internal auditor and management to discuss the effectiveness of control procedures.

The Toronto Stock Exchange (TSE) established a Committee on Corporate Governance in 1993. The Committee issued a report[30] in December 1994.

The Dey Report proposed fourteen guidelines for corporate governance. For fiscal years ending on or after June 30, 1995, the TSE implemented a requirement that TSE-listed firms report on their corporate governance system and on whether their system was in accordance with the fourteen guidelines.

The TSE guidelines suggest that a firm's board of directors should assume responsibility for stewardship, including strategic planning, risk management and internal control. The guidelines also suggest that the board of directors should be constituted with a majority of independent directors and that the firm should disclose whether the majority of board members are independent. The guidelines also discuss orientation and training for new board members, compensation committees, the composition and responsibilities of audit committees, and related matters. Implementation of the fourteen corporate governance guidelines was however voluntary.

As a follow-up to the Dey Report, the TSE and the Institute of Corporate Directors surveyed senior executives of TSE-listed firms in November 1998 to assess how much progress had been made in improving the quality of corporate governance since the release of the Dey Report. In June 1999, the results of this survey were released in the "Report on Corporate Governance, 1999: Five Years to the Dey."

In October 1999, responding to one of the recommendations arising out of "Five Years to the Dey," the TSE amended its corporate governance disclosure requirements. For years ending on or after December 31, 1999, TSE-listed firms are required not only to describe their approach to corporate governance on an annual basis, but also to specifically address each of the fourteen corporate governance guidelines.

The impact of this change can be seen most readily in the expanded corporate governance disclosure sections in the 1999 annual reports of many TSE-listed corporations.

The extent of compliance with the TSE corporate governance guidelines was also evaluated by the authors by reviewing the fiscal 1997 corporate governance disclosures of all TSE 300 firms. Results indicated that 94% of TSE 300 firms made corporate governance disclosures as required by the TSE, but the quantity and quality of the disclosures made varied widely.

2.4.1.3 Development of Audit Committees in the UK

The support for audit committees has gained momentum in the last two decades primarily as a result of company failures due to poor corporate controls and diminishing confidence in the credibility of financial statements, independence, and effectiveness of the external audit function. In view of these problems, attention was focused on the establishment of audit committees and their role in promoting the financial aspects of corporate governance.

The Companies Bill (1977) tried to advocate for legislation on the establishment of audit committees but without success and there is still no statutory requirement to have an audit committee in the UK. However, public sector initiatives are in evidence from as early as 1973. The Civil service[31] noted the advantages of having an audit committee that included the discussion of audit plans and results as one of its roles. Private sector initiatives have been most active in the last two decades.

In 1982, PRO-NED, an organisation for the PROMOTION OF NON-EXECUTIVE DIRECTORS, was set up by the Bank of England, CBI, and other financial institutions. In 1987, the Code of Recommended Best Practice was published and it included the recommendation that "...the appointment of non-executive directors ...to facilitate the establishment of audit committees in large quoted companies".

In 1986, an ICAEW working party recommended that audit committees be responsible for both the appointment and remuneration of auditors, the approval of audit plans, and the review of management reports issued by auditors.

In 1987, The Bank of England issued a paper entitled-the Role of Audit Committees in Banks- that recommended that all banks have audit committees. In 1987 The Stock Exchange also recommended that all listed companies have audit committees composed of non-executive directors.

The Committee on the Financial Aspects of Corporate Governance was set up in May 1991 by the Financial Reporting Council, The London Stock Exchange, and the Accountancy Profession to address the financial aspects of corporate governance. The committee published in its recommendations in a Code of Best Practice - The Cadbury Report.

The Cadbury Report (1992) required that all companies listed on the Stock Exchange should issue, as a continuing listing obligation, a statement of compliance with the Code of Best Practice. It further recommended that this statement of compliance be reviewed by the external auditors who were also required to state if the company had complied with the Code of Best Practice.

Paragraph 4.3 of the Code recommended that "...the Board should establish an audit committee of at least 3 non-executive directors with written terms of reference, which deal clearly with its authority and duties".

The Hampel Report (1998) restated the recommendations with respect to the establishment, structure, role and duties of audit committees in the UK. The recommendations of both codes have now been included in The Combined Code on Corporate Governance (1999).

The Turnbull Report (1999) considered the role of the audit committee and highlighted that that the annual review of the effectiveness of internal control could be delegated to the audit committee. The definition of internal control was however widened by this report to include all controls rather than just financial controls.

The delegation of this review to the audit committee therefore inferred that the audit committee roles could be extended[32] to include an assessment of the overall risks to the organisation.

2.4.2 Roles of Audit Committees

Audit committees provide a focus and a means for a fuller review and analysis of the matters relating to internal controls, auditing, and financial reporting. Wolnizer (1995) summarised the functional audit committee recommendations of corporate governance commissions and committees in the US, UK, Canada, and Australia. He demonstrated that the audit committee is expected to perform almost exclusively in the technical areas of financial reporting, auditing, and internal control.

These expectations are also cited in the literature of public accounting firms (e.g. Arthur Andersen, 1994; Coopers & Lybrand, 1995:) and professional bodies responsible for setting standards (e.g. AICPA, 1988; ICAEW, 1994:). Verschoor (1993) study of the functions of the audit committees disclosed by some of the largest US companies reported that they operated in the aforementioned areas.

The detailed functions, common in all recommendations, which audit committees, should undertake include but are not limited to:

- Internal control Assessment i.e. review the adequacy of the system of internal control; and review the scope and results of internal auditing activities.
- Financial reporting.

- External Auditing; i.e. recommendations on the appointment or removal of the external auditors; review the plan and results of the audit with the external auditors; approve the provision of consultancy services by the external auditors; Review the independence of the external auditors.
- Investigations within its terms of reference.

2.4.2.1 Internal Control Assessment

The control environment represents the collective effect of many factors. These include the management's philosophy and operating style, the company's organisational structure, the functioning of the board and the audit committee, the methods of communicating and implementing the assignment of authority and responsibility, and practices of monitoring and following-up on performance. The control environment includes activities of top management and the board of directors.

The objective of the Treadway Commission Report (1987) was to identify causes and make recommendations to reduce fraudulent financial reporting. One of the recommendations was the integration of the various concepts and definitions of internal control to develop a common frame of reference for assessing all types of controls. As a result, Internal control - Integrated Framework also known as the COSO Report was published in September 1992.

The primary responsibility for an effective system of internal control lies with the board of directors. The Cadbury Code considered it good practice for companies to set up an internal audit department to help discharge this responsibility. The audit committee's involvement with the internal controls of the organisation is primarily a review of the report on the effectiveness of internal control on behalf of the board of directors.

An effective internal audit department is a valuable resource to an audit committee. According to the IIA's Standards for the Professional Practice of Internal Auditing, ". The scope of internal auditing should encompass the examination and evaluation of the organisations system of internal control and the quality of performance in carrying out assigned responsibilities".

The internal audit department is in a key position to review and assess the adequacy of internal controls. Furthermore, it may ideally provide the audit committee with the support for the public statements required by the directors on internal control.

It follows that the audit committee can therefore look to an internal audit department functioning within the IIA's standards to be an effective monitor of the controls within an organisation.

A key characteristic of an effective internal audit department is the independence with which it operates. Independence is crucial to the nature of internal audit as it allows the auditor to render impartial and unbiased judgement. It is best achieved through organisational status and objectivity.

The essence of the internal auditor - audit committee relationship is to provide "reporting independence". I.e. the internal auditors have an avenue to report all deficiencies to an authority without fear of reprisal by management. The chief internal auditor should have direct communication with the audit committee. Price Waterhouse (1993) survey highlighted that in 62% of all cases surveyed, the internal auditor had exclusive communication with the audit committee.

The audit committee can also protect the independence of the Internal audit department by ensuring that the chief internal auditor is not dismissed as a result of reports which reflect unfavourably on management. The Treadway Commission stressed this fact as it noted that "... given the importance of internal audit to the audit committee ...the audit committee should review the appointment and dismissal of the chief internal auditor. A survey by Price Waterhouse (1993) highlighted that the audit committee reviewed and concurred with the decision to hire or fire the chief internal auditor in only 40% of all cases.

The Cadbury Code (1992) highlighted these recommendations in their guidance on audit committee relationships with internal audit. However, surveys e.g. (Price Waterhouse 1993, KPMG 2000) undertaken highlight that in practice, organisational status is still under threat.

Scarborough (1998) examined the relationship between the audit committee and internal audit. He found that audit committee composition did influence the extent of interaction between the audit committee and internal audit. Whilst limited to the examination of the audit committee role in internal control assessment, this study provides evidence that audit committee composition influences the effectiveness of the audit committee in relation to internal controls. Raghunandan et al (2001) examined the association between audit committee composition and the committee's interaction with internal auditing. They found that audit committee composition[33] influenced the extent of committee interaction with internal auditing.

These studies provide empirical support for the recommendations of the Combined Code (1998) on audit committee composition.

2.4.2.2 Outsourcing

The value of internal audit in an organisation is not under scrutiny. It is more a question of how this service is best delivered. It is argued that an external provider cannot efficiently acquire the knowledge possessed by internal auditors employed within the organisation.

Outsourcing occurs when a business entity takes work traditionally performed internally and gives it to an external provider. Outsourcing as defined by the IIA[34] refers to " the processes whereby an organisation reviews headquarters functions and invites outside contractors to bid against internal departments for the work". The IIA states that "a competent internal audit department that is properly organised with trained staff can perform the internal audit function more efficiently and effectively than a contracted service".

Petravick (1997) compares organisations in the USA that have outsourced their internal audit departments to those who have staffed it in-house The study finds that the number of institutions using outsourcing nearly equals the number with in-house functions. The study notes that the decision to outsource was usually based on access to expertise and management of internal audit costs. . Selim et al (2000) however note that companies in the UK are not as likely to outsource the internal audit department and prefer to keep this function in-house.

The choice to maintain an in-house function was also highly correlated with the management of external audit costs. A survey undertaken by Kusel and Scull (1998) provides data on the scope and depth of outsourcing in the USA and Canada. Survey data[35] shows that management decisions to outsource are strongly influenced by cost-saving factors. It is clear that management must perceive that the value-added to the organisation by an in-house function supersedes the financial gains to be made if the function is outsourced.

There is empirical evidence – Scarborough (1998) and Raghunandan et al (2001) to suggest that the existence and composition of an audit committee greatly improves the level of interaction and reporting access of internal audit. The data available does not highlight if the audit committee plays a role in the decision to partially or wholly outsource the internal audit department. Given the potential reliance of the audit committee on the reports and recommendations of the internal audit department, the audit committee should at least review and concur with management's decision to outsource the internal audit department.

2.4.2.3 Financial Reporting

The audit committee is responsible for reviewing the financial statements and considering whether they are complete and consistent with the information known to management. Audit committees, in order to undertake this review, require background knowledge of the business that includes: -

- a detailed knowledge of the company's operations;
- awareness of political, economic, and technological risks and information on economic trends, competitive forces that may impact on the business;
- an awareness of the actual performance of the company as compared to the expected performance; and
- an awareness of the accounting policy choices in the industry in which the company operates.

A review of the financial statements should involve consideration of the following issues:

- The choice of accounting practices and policies or changes in accounting principles which may have a significant impact on the results of the company; The audit committee should understand and be adequately briefed by management and the external auditor on the impact of these policies or changes to the policies.
- The compliance of the chosen practices and policies with legislation, SSAP's, FRS's, and SORPs issued by the industry bodies.
- Significant changes in company performance and the judgmental areas that impact on the company's results. Accruals, reserves, and estimates are often matters that require significant judgement and they can significantly alter the results of the company. 85% of the audit committees surveyed by Price Waterhouse (1993) discussed significant accruals and reserves strongly influenced by estimates.

Given that the financial reporting oversight role is often delegated to the audit committee, Beasley (1996 and 2000) considered if the existence of an audit committee was associated with a reduced likelihood of financial statement fraud. The study found that it was board composition as opposed to the existence of an audit committee that was "...significantly more likely to reduce the likelihood of financial statement fraud".

Other studies, also undertaken in the USA, have found positive associations between the existence of the audit committee and various proxies for the quality of financial reporting. Defend and Jiambalvo (1991) found that companies overstating their earnings were less likely to have an audit committee. McMullen (1996) found a positive association between audit committee existence and the quality of financial reporting. Wild (1996) found a positive association between audit committee formation and the quality of accounting earnings.

The review of interim financial statements is also part of the financial oversight role of the audit committee. The publication of half-year financial reports has been mandatory for companies listed on the London Stock Exchange and the USM since 1964. Interim reports have become increasingly important to investors and security analysts. The price of a company's shares may change dramatically in response to interim reports that show earnings that are materially different to forecasted projections.

The Treadway Commission Report (1987) recommended that the Audit committee oversee the interim reporting process. This recommendation has been adopted in the USA, as SEC rules require that the audit committee review the interim reports. It is not mandatory for the audit committee to undertake this review in Canada and the UK respectively as:

- The Macdonald Commission only recommended that the audit committee review interim financial information before publication.
- The Cadbury Report in the UK only recommended that the audit committee review the half-year reports before submission to the Board for approval.

The survey undertaken by Price Waterhouse (1993) notes that, on average, only 29% of UK audit committees were involved in the interim reporting process.

Recommendations in the UK have resulted in audit committees being a mandatory requirement for listed companies. Support for audit committees cannot therefore be justified if it is based on research that considers the associations between various financial reporting proxies and the existence or formation of an audit committee. Support may only be justifiable in instances where improvements to the quality of financial reporting are evidenced post formation of the audit committee.

There is limited evidence to show company earnings and financial reporting improve post audit committee formation – Wild (1996) and McMullen (1996) respectively. Research evidence to date does not however consider if the composition and structure of the audit committee is related to the quality of financial reporting.

Furthermore, most of the research evidence is based on the experiences of US companies as opposed to UK companies. Given the differences noted in Section 2.3.1.5 between USA and UK Board structures, research conclusions may therefore be inappropriate in the UK context.

Research to date on audit committees is limited and in some cases inconclusive. This thesis therefore considers the associations between various financial reporting proxies and the composition and structure of audit committees in UK companies.

The extent to which the quality of financial reporting can be directly attributable to the audit committee is debatable. However, it can be inferred that if there is an effective audit committee, financial reporting irregularities should at least be disclosed within the financial statements.

2.4.2.4 Reporting on Internal Controls

The Cadbury Code recommended that directors report in financial statements on the effectiveness of their system of internal control. Following the publication of the Cadbury code, companies and their external auditors, alarmed at the requirements for reporting on the effectiveness of internal controls suggested by the commission, required that the Code be clarified.

As a result, a committee chaired by Paul Rutteman, set up to provide guidance to the directors of the affected companies, published a paper in 1994 - Internal Control And Financial Reporting: Guidance For Directors Of Listed

Companies- also known as the Rutteman Report (1994). This report provided further guidance in complying with the requirements of the Cadbury code to directors of listed companies. The report allowed directors to limit the scope of their report to internal financial controls. The report defined internal financial controls as the internal controls established to provide reasonable assurance of: -

- The safeguarding of assets against unauthorised use or disposition;
- The maintenance of proper accounting records; and
- The reliability of financial information used within business or for publication.

The Rutteman Report (1994) maintained that directors reporting that a review of the internal financial controls had been undertaken in the year under review would achieve effective compliance with the code. A shortcoming was that the Rutteman report did not lobby for directors to express an opinion on the effectiveness of their internal financial control systems.

Whilst the Rutteman report (1994) sought to limit the scope of review to financial as opposed to operational, the need for a review of all areas must still be undertaken. Failures of operational controls will lead to failures to safeguard the assets and ultimately a financial loss. The Hampel Report (1998) revisited the subject of internal control reporting. It noted[36] that internal controls...cover not only financial controls but operational and compliance controls, and risk management, since there are potential threats to the shareholders investment in each of these areas.

It is important to note the audit committee conducts the annual review of the effectiveness of internal control on behalf of the board. The report on the internal controls within the financial statement is issued collectively by the board. The extent to which the quality of internal control reporting can be directly attributable to the audit committee is debatable.

However, it can be inferred that if there is an effective audit committee irregularities in internal controls, which have resulted in a material loss to the company, should be highlighted within the financial statements.

2.4.2.5 External Audit

One of the main reasons put forward by the Cadbury Committee on the benefits of audit committees was that they "...offer added assurance to the shareholders that the auditors, who act on their behalf, are in a position to safeguard their interests"

The Cadbury report (1992) noted that "...the annual audit is one of the cornerstones of corporate governance. The audit provides an external and objective check on the way the financial statements have been prepared and presented and it is an essential part of the checks and balances required[37]."

One of the key functions of the audit committee is to act as an interface between the external auditors and the board of directors. Furthermore, the external auditors can provide an objective report on internal financial controls to the audit committee.

The other roles of the audit committee with respect to the external auditors include:

- Consideration of the selection, reappointment, and dismissal of the external auditor; The audit committee should share the selection responsibility with management. The results of the survey by Price Waterhouse (1993) showed that on average 60% of the audit committees surveyed were involved in the selection of the external auditor. The audit committee should also be involved in the annual re-appointment process. In considering the appointment of the external auditors, the committee should consider the quality of services received.
- Reviewing the independence of the external auditor; it is important that the audit committee protect and enhance the independence of the external auditor. The committee should therefore consider if there are any factors that might impair the independence of the external auditors.

The ultimate objective of the audit process is to arrive at an opinion on the truth and fairness of the financial statements and therefore convey to the users of the financial statements an independent opinion as to whether the financial statements as a whole represent a true and fair view of the company's profits or losses and its state of affairs at balance sheet date. The external audit has been criticised due to perceived problems with auditor independence.

An auditor can be said to be independent when free from the authority, control or influence of others. Objectivity, which is implied by independence, is the state of mind, which has regard to all considerations relevant to the task. It implies integrity. Independence is central to the concept of auditing. Shareholders, it is held, would not employ them if their ability to form judgements independent of management were questionable. United States v Arthur Young[38] described the independent audit as "...the public watchdog function" and noted that ' ...if investors were to view the auditor as advocate for the corporate client, the value of the audit might well be lost'. This view was corroborated by the fact that a review undertaken by the Public Oversight Board [POB] into alleged audit failures which showed that '...in too many cases, preference of client management...prevailed over the preference of the audit or consulting partner."

The extent of auditor independence from management is open to criticism. The major areas of controversy are:

- Audit fees are paid to the auditors; thus financial independence is therefore questionable. Critics would also maintain that as audit fees are in reality set by the directors regardless of the statute giving shareholders the right to ratify these fees at an Annual General Meeting. Financial independence may be further compromised the practices of 'opinion shopping' and 'low balling'.
- Low Balling describes the practice whereby firms competing for tendered audit engagements deliberately under-price their bids. This may result in auditors reducing the scope of their work in order to ensure that break-even on costs is achieved. It is however thought that this practice usually occurs where audit firms consider that

lucrative consultancy assignments will be gained once they are appointed as external auditors.

- UK auditors are permitted to provide non-audit services. It is argued that independence may be eroded due to the fact that auditors may be under pressure to capitulate in situations where financial reporting disputes arise if larger, more lucrative consultancy fees may be lost as a result of managerial dissatisfaction. The 'quarantining' of audit services as an option has been considered on several occasions. The Dearing Report[39] in 1986 advocated that audit firms should not provide 'related' services to audit clients as independence was compromised. This suggestion was rejected then and once again during the considerations of the Cadbury Committee. The Cadbury Report[40] advocated full disclosure of fees paid to external auditors for non-audit work.

  The sale of the consultancy businesses of large accounting firms to third parties has been a recent new development. However, this is voluntary and does not debar them from retaining certain elements of the consultancy business within the practice[41].

  The provision of consultancy services is a contentious issue and it appears that accountancy firms in the UK have responded by distancing their audit from their consultancy practices. The manner in which this has been achieved suggests these changes are primarily cosmetic.

  Recent SEC[42] pronouncements on external auditor independence highlight nine non-audit areas where external auditor independence is compromised. Due to the provision of related services. This includes specific limits[43] on the provision of internal audit services by the external audit provider.

  The provision of 'related' services is not subject to such stringent requirements in the UK. However, in a study conducted by Brand Finance PLC in June 2000, 96% of the analysts surveyed were of the opinion that significant non-audit fees were likely to compromise audit independence.

- Opinion shopping[44] describes the practice whereby the client seeks a second opinion from another audit firm. Both firms in this scenario may be compromised: The existing auditors giving way on an audit issue to retain the engagement or the advisory firm providing an agreeable opinion in anticipation of gaining a new client. In this situation, the objectivity of the existing auditor is clearly threatened.

It is therefore important that the audit committee review the criteria required for external auditor independence. Following up on recommendations of the Blue Ribbon Committee on the Effectiveness of Corporate Audit Committees, in December 1999, the SEC adopted rule amendments[45] requiring reporting companies to include in their annual meeting proxy statement a report disclosing whether the audit committee has taken certain actions. Specifically, the audit committee report will have to disclose: -

- whether the audit committee has reviewed and discussed certain matter with the independent auditors; whether the audit committee has reviewed and discussed the audited financial statements with management;
- whether the audit committee has discussed with the independent auditors certain matters required under SAS 61 auditing standards and whether they have received and discussed the information required by Independent Standards Board Standard No. 1 regarding the auditors' independence; and
- whether, based on any such reviews, the audit committee recommended to the board of directors that the audited financial statements be included in the company's Annual Report to SEC.

The disclosure requirements on external auditor independence in the USA highlight the extent to which the role of the external auditors and their relationship with the audit committee is considered to be a key mechanism in corporate governance.

2.4.2.6 Going Concern Reporting

Given the functions of most audit committees, the review of the going concern status of the company may be delegated to the audit committee.

The Companies Act 1985[46] states " the company shall be presumed to be carrying on business as a going concern." SAS 130 defines a going concern as " an enterprise that will continue in operational existence for the foreseeable future[47]". This means that in particular that the balance sheet and profit and loss account assumes no intention or necessity to liquidate or significantly curtail the scale of operations.

The Stock Exchange Listing rules require that directors make an assessment of the going concern status of the company and set out a statement on going concern in the operating financial review. Auditing Guidelines state that "... where there is a significant uncertainty about the enterprise's ability to continue in business, this fact should be stated in the financial statements." I.e. the auditor is required to alert shareholders as to the significant possibility that the company will enter bankruptcy by giving a "going concern" qualification in the audit report. The external auditor is required to consider if the disclosures given by the directors are adequate. They are required to set out the reasons for disagreement with any of the disclosures in the corporate governance report. They are required to qualify their opinion on the Cadbury statement of compliance and going concern report if they do not agree with the actual statement.

A responsibility for directors to consider the appropriateness of the going concern basis is not new. The effect of the Cadbury Code (1992) and the accompanying guidance for directors on "Going Concern and Financial Reporting" [48] is to make this recommendation more explicit.

The audit committee will generally consult with the external auditors and management during the review. The audit committee should be confident that the external auditor's opinion on the going concern status of the company is reliable.

During the early 1980's and 1990's there were a number of well-publicised cases in which auditors were criticised following corporate failure leading to concerns that auditors were failing to give investors adequate warnings about bankruptcy.

Kida (1980) was the first to suggest the separation of the identification of a going concern problem to the issue of issuing a going concern report. Kida's results indicate that the auditor may be influenced by the perceived consequences of issuing or not issuing a qualified audit report. De Angelo (1981) defined audit quality as the "...probability that a given auditor will both discover a breach in the client's accounting system and report the breach. Based on this definition, the going concern decision comprises of two variables, namely: -

- The discovery of the breach - related to the competence of the auditor; and
- The disclosure of the breach - dependent on the independence of the auditor.

Empirical evidence - Koh (1991), Citron & Taffler (1992) indicates that auditors rarely give qualified audit reports to companies that subsequently file for bankruptcy.

Given the auditor is assumed competent, independence considerations must influence their decision as to whether an actual qualification will be made. If the auditor believes that a firm is going to fail and chooses not to disclose, the auditor must clearly weigh the risks associated with disclosure/non-disclosure - i.e. the risk of client bankruptcy and client loss or the risk of litigation and the loss of reputation, respectively.

The risk of a client going bankrupt as a result of going concern qualification is known as the "self-fulfilling prophecy". I.e. " the auditor's early warning could be the proximate cause of bankruptcy" - Elliot & Jacobson (1987). Citron & Taffler (1992) did not find any evidence to support the self- fulfilling prophecy. Studies in this area are however limited. The results of the study undertaken by Citron and Taffler (1992) may not constitute conclusive evidence as to the non-existence of the self-fulfilling prophecy due to the small size of their sample data.

The number of successful cases brought against audit firms to date is evidence of the risks associated with litigation. Empirical research- Wilson &

Grimlund (1990) has shown that audit firms involved in disciplinary actions or litigation tend to lose market share relative to their competitors.

The above arguments highlight that where impairments to auditor independence exist, going concern qualifications may not be made. However, given the risk of litigation and the ensuing loss of reputation, it follows that auditors must consider that the self-fulfilling prophecy does exist.

It is important to re-state that the audit committee reviews the going concern status of the company on behalf of the board. The report on going concern within the financial statement is issued collectively by the board. The extent to which an incorrect statement on going concern can be directly attributable to the audit committee is debatable.

It can be inferred, however, that since this role is delegated to them, regardless of whether the findings of the audit committee are made available to the shareholders, the statement of going concern within the financial statements should reflect the true nature of the company where there is an effective audit committee.

It is therefore considered that certain financial reporting problems primarily due to inadequate disclosures within the financial statements may be attributable to an ineffective audit committee.

2.4.3 Composition of Audit Committees

The Cadbury Report noted that "...The committee regards the appointment of properly constituted audit committees as an important step in raising standards of corporate governance. Their effectiveness depends on their having a strong chairman who has the confidence of the board and the external auditors and on the quality of the non-executive directors". The committee also noted the importance of good structure in order to ensure that audit committees were soundly based.

It is therefore reasonable to consider that audit committee structure and the quality of the non-executive directors will influence the ability of the audit committee to be effective.

2.4.3.1 Audit Committee Structure

The terms of reference and organisational structure of the audit committee will differ from organisation to organisation. However, there are certain elements that should be present in order for the audit committee to be considered effective. These include:-

2.4.3.2 Audit Charter / Terms of Reference

A well-designed audit committee charter detailing the terms of reference is essential. The charter should be used to guide the audit committee in their performance in order for them to adequately fulfil the roles required of them by the main board of directors, shareholders and other third parties. The audit charter should clearly define the roles and responsibilities and the authority to investigate of audit committee. A survey conducted by Price Waterhouse (1993) noted that on average 62% of companies surveyed had an audit committee charter. Recent surveys e.g. ICAEW (1998) suggest that most large listed UK companies now have an audit charter. A survey of US audit committee conducted by KPMG (2000) noted that 70% of companies surveyed had an audit committee charter.

Recent SEC pronouncements[49] which require that the annual proxy statement must state whether the audit committee has adopted a written charter will result in all US listed companies having charters. There is to date no such requirement in the UK.

The audit committee roles and responsibilities are laid down in the charter. It is reasonable to infer that audit committee effectiveness must be affected by the existence of a charter.

2.4.3.3 Terms of Office

The Cadbury Report recommended that audit committee members be appointed for a specified term and that re-appointment should not be automatic. Price Waterhouse (1993) survey indicated that most companies did not have a formal rotation policy for committee members. It is important for those companies to conduct performance evaluations of individual committee members in order for a balance between experience and complacency to be struck.

2.4.3.4 Meetings

Price Waterhouse (1993) survey noted that audit committees meet an average of 3.3 times per year. The survey further noted that such meetings lasted for an average of two hours. The committee members surveyed considered the number and length of meetings adequate to fulfil their duties. The KPMG (2000) survey noted that audit committees meet an average of 4.3 times per year. This survey noted that such meetings also lasted for an average of two hours. It would appear that whilst the number of meetings held by audit committees had on average increased[50] over the period, the time spent during each meeting remained constant. Menon and Williams (1994) examined the extent of use of audit committees for monitoring by focusing on the frequency of meetings held by the audit committee and factors associated with such frequency. Beasley (1996) noted that as the number of additional directorships held by non-executive directors increases, their ability to fulfil their monitoring responsibilities decreases as evidenced by his results which showed a greater likelihood for financial statement fraud where non-executive directorships had significantly more appointments. Given the above arguments, it is reasonable to infer that audit committee effectiveness must be affected by the time devoted to business and by the availability of directors to attend these meetings.

2.4.3.5 Agenda

Given the infrequency of meetings and the limited time available, it is important for a detailed agenda to be prepared for each meeting. This agenda is necessary to focus the attention of members on the objectives of the meeting and, over the course of the year, should address all the duties and responsibilities outlined in the audit charter. This agenda should be circulated along with any relevant submissions to clarify the subject to the audit committee members in advance of the meeting.

2.4.3.6 Reporting on the Committee's Activities

Price Waterhouse (1993) survey noted that most committee's -73% provide a written report of their meetings to the main board of directors. The Treadway Commission recommended that companies also include a report from the audit committee in their financial statements. This report would clarify the role and responsibilities of the audit committee to the shareholders and ensure that the committee was meeting its responsibilities by focusing their attention on them. SEC rules require that proxy statements include a representation by the audit committee that its members have reviewed and discussed the financial statements with management and the external auditors. There is no requirement for UK audit committees to report to shareholders within the financial statements to date.

This section considers the key mechanisms of the corporate governance framework that relate to the structure of the audit committee. It is important to consider if these mechanisms improve the effectiveness of the audit committee. The following research question therefore arises: -

IS THERE A POSITIVE RELATIONSHIP BETWENN GOVERNANCE MECHANISMS AND THE EFFECTIVENESS OF THE AUDIT COMMITTEE?

2.4.3.7 Membership of the Audit Committee

2.4.3.8 Number of Members

The Cadbury Report (1992) recommended that there should be a minimum of three members. The Hampel Report (1998) considered that audit committees composed of less than three non-executive directors might be ineffective.

2.4.3.9 Independence

The Cadbury Report (1992) noted that membership should be confined to non-executive directors and that the majority of members be independent. I.e. that, apart from their director's fees and shareholdings, they should be independent of management and free from any involvement that might significantly interfere with their ability to judge matters independently.

The Cadbury Report noted that it was for the board to decide if the relevant directors achieved the criterion for independence. In contrast, The American Law Institute (1984), in it's "Principles of Corporate Governance- Analysis and Recommendations" was more specific as it defined[51] any involvement that might significantly impair independence. Other impairments to independence in the form of significant relationships with customers and suppliers and interlocking directorships were examined in the Price Waterhouse (1993) study. This study noted that 75% of audit committee chairmen considered a significant affiliation to a customer or supplier as impairment to independence. They however indicated that ten percent of their current audit committees would not be considered independent if customer/supplier affiliations were considered.

Interlocking directorships may also be considered as a possible threat to director independence. Research data[52] on US companies highlights the extent of the problem. Whilst interlocking directorships may result in a conflict of interest, it is also important to remember that the skills and experiences that are contributed may outweigh the threat.

However, interlocking directorships present a clear conflict of interest where directors are also in a position to influence remuneration and nomination by virtue of them being on each other's boards and committees.

Independence is crucial to the effectiveness of the committee. Furthermore, the audit committee must also be perceived as independent before they can be considered to be objective, credible and therefore useful. Given the above, the following research question arises: -

CAN UK AUDIT COMMITTEES BE CONSIDERED EFFECTIVE IN TERMS OF THEIR COMPOSITION?

2.4.3.10 Quality of Non-Executive Directors

Regulatory commissions have highlighted the importance of audit committees and their composition of non-executive independent directors. However corporate failures involving fraud, poor accounting, inadequate internal controls, and apparent ineffective monitoring by audit committees – (Mitchell, 1991, Beasley (2000)) highlight that audit committee composition is not the only factor to influence audit committee effectiveness.

Wolnizer (1995) summarised the functional audit committee recommendations of corporate governance commissions and committees in the US, UK, Canada, and Australia. He demonstrated that the audit committee is expected to perform almost exclusively in the technical areas of financial reporting, auditing, and internal control.

The Institute of Internal Auditors and Price Waterhouse (1993) study indicated a need for audit committees to contain sufficient relevant experience to discharge their responsibilities. Other individuals (e.g. Somer, 1991) and bodies (e.g. ICAEW, 1993) have stated similar concerns. Kalbers and Fogarty (1993) identified financial reporting as the functional area that requires prior experience. A global study by Arthur Andersen (1994) reported the views of executive management and the external auditors. They all considered that audit committee composition was a key factor in determining the effectiveness of an audit committee.

Each of these studies identified audit committee member experience and an awareness of technical issues as a prerequisite for committee effectiveness. The Price Waterhouse (1993) study recommended that at least one member with a financial, accounting or auditing background as useful in guiding the committee in the financial areas.

It is therefore reasonable to consider that an audit committee comprised of non-executive directors, who, as a whole, possess sufficient background experience, will be effective.

Lee (1997) considered the disclosed audit committee responsibilities of a sample of US Fortune 500 companies. He noted that the experience backgrounds of the audit committee members to be inconsistent with the disclosed audit committee responsibilities.

Regardless of whether those audit committees are actually ineffective, external parties may perceive them as ineffective if it is considered that the members have neither the experience nor the technical background with which to make an informed judgement. It follows that member backgrounds should reflect the functional responsibilities of the audit committee.

Evidence exists to suggest that the Chief Executive Officer may influence the composition of the board – Mace, 1971; Vancil, 1989; Hermalin & Weisbach, 1988). Given that audit committee members are chosen from the board, the preferences of the chief executive officer may affect the composition of the audit committee. This may result in an audit committee composed of the non-executive directors who are preferred by the chief executive officer as opposed to those members who possess the appropriate skills and experience.

The audit committee is composed of non-executive directors and the financial reporting oversight role is usually delegated to the audit committee. Assuming that audit committee members possess the necessary background and the skills to undertake this role, it follows that they are more likely to be effective in this role.

It follows that an audit committee may be considered effective if the members of this committee possess experience in this role. The problem that arises is what constitutes an adequate amount of experience.

The Blue Ribbon Report (1999) provides guidelines as to when an audit committee may be considered experienced. SEC (release no. 34-41982) provides that companies with a stated market capitalisation must have audit committees consisting of at least three directors who are financially literate[53] or who become financially literate within a reasonable time after their appointment. The audit committees also must have at least one member with accounting or related financial management expertise.

A survey undertaken by Price Waterhouse (1993) identified the key to audit committee effectiveness as background experience and training. The report considered that audit committee effectiveness was only possible where the members understood their responsibilities and how to meet them. It further noted that 40% of the chairmen interviewed considered that their audit committees would benefit from additional briefings on committee responsibilities and best practice in meeting these responsibilities. A survey of US companies undertaken by Investor Business relations (March 2000) highlighted the fact that audit committee members did not consider that they needed extra training in order to fulfil their functional roles.

Training is considered important to the effectiveness of the audit committee. It is important for training to ensure that both the functional and executive roles of the non-executive directors are reviewed. In cases where a mismatch exists between member backgrounds and functional roles, extra training should be of benefit.

2.5 CONCLUSION

This chapter examined the nature of corporate governance systems, theories that have influenced these systems and considered a model of governance that embodied all of these concepts.

The governance model highlighted the role of the board[54] and the factors that might influence board effectiveness. It was considered that director age/experience, board size, board structure, and duality of the role of chairman and chief executive officer as factors intrinsic to the board that might impinge on the effectiveness of the board and the audit committee. It noted that: -

- Director age may be an indicator that reflects the experience of non-executive directors on the audit committee. However, it was noted that experience as opposed to age might be indicative of the audit committee members' ability to discharge their role.
- The balance of the board i.e. the proportion of executive to non-executive directors may result in a board in which non-executive directors are ineffective and may therefore result in an ineffective audit committee.
- The separation of the role and chief executive officer is considered important to the effectiveness of the overall board and by implication the audit committee.

This factors extrinsic to the organisation that might influence the effectiveness of the board and therefore the audit committee was also examined. The role of institutional investors, regulators, and government[55] in influencing board effectiveness were reviewed. In most cases, the recommendations issued by all extrinsic parties tended to focus on improvements of factors intrinsic to the board examined in detail in section 2.3.1.

This chapter has considered the factors that might impinge on the ability of the audit committee to fulfil its oversight role. The roles of the audit committee were therefore examined. It was considered that the extent to which the audit committees discharge their functional roles could be used as a surrogate for an external indication of audit committee effectiveness.

For the purpose of this thesis, it was decided to focus on the audit committee's oversight role in respect of the financial statements. Audit committees were considered ineffective where disclosures within the financial statements did not reflect the true state of affairs in the company.

The literature specific to audit committee was also considered. The factors considered influencing the ability of the audit committee to be effective were the structure of the audit committee, the independence of audit committee members and the quality of non-executive directors.

The main issues considered to impinge on the effectiveness of the audit committee in respect of the structure of the audit committee were:

- The existence of an audit committee charter or terms of reference. A well-designed audit committee charter detailing the terms of reference was essential as this charter should be used to guide the audit committee in their performance in order for them to adequately fulfil the roles required of them by the main board of directors, shareholders and other third parties.
- The number of audit committee meetings in a given period. Research evidence highlighted that the number of audit committee meetings held was an indication of the adequacy of the audit committee's oversight role.
- The number of additional directorships held by audit committee members. Research evidence highlighted that as the number of additional directorships held by non-executive directors' increases, their ability to fulfil their monitoring responsibility decreases.

The main factors considered to impinge on the effectiveness of the audit committee in respect of the membership of the audit committee were:

- The number of members on the audit committee. A minimum of three non-executive directors was considered necessary for the audit committee to be effective.

- The independence of audit committee members. All members of the audit committee were to be independent for the audit committee to be considered independent.

The quality of non-executive directors was considered to impinge on the effectiveness of the audit committee. Audit committee members were assessed in terms of:

- The extent to which the audit committee members are financially literate.
- The extent to which the audit committee is considered technically competent.

The overall purpose of this thesis therefore considers if the key factors thought to impinge on audit committee effectiveness are present in companies in which the audit committee is considered to have failed in their financial reporting oversight role. The overall null hypothesis of this thesis is therefore:

COMPANIES WITH FINANCIAL REPORTING PROBLEMS HAVE INEFFECTIVE AUDIT COMMITTEES.

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ENDNOTES

[1] E.g. Guidelines for Directors (Institute of Directors, 1990), The Roles and Duties of Directors: A Statement of Best Practice (institutional Shareholders' Committee, 1991)

[2] See Cadbury Report (1992) para 4.3 for references to the importance of nomination committees

[3] i.e. recommendations on effective board structure contained in the Combined Code on Corporate governance (1999)

[4] The Maxwell Case is perhaps one of the best examples of the problems that may occur where a dominant individual may be unaccountable to the shareholders and is in a position where all actions are unquestioned.

[5] Guidelines for Directors (Institute of directors, 1990), The Role & Duties of Directors: A Statement of Best Practice (Institutional Shareholders' Committee, 1991).

[6] Shown in detail in **Figure 70**

[7] Shown in detail in **Figure 71**

[8] with respect to their oversight role on the audit committee

[9] Source: Hendry et al (1992) for statistics 1989-1992

[10] Inland Revenue Scheme

[11] a non-executive director cannot be included in an approved share option scheme

[12] These directors are not considered independent.

[13] A smaller listed company is taken to be a company listed outside of the FTSE-350

[14] formerly known as CISCO

[15] A fraud firm is one in which evidence of financial statement fraud has been publicly reported

[16] No significant differences were found in composition of failed companies as compared to non-failed companies.

[17] A smaller listed company is taken to be a company listed outside of the FTSE-350

[18] Pension funds and insurance companies

[19] Source: International Markets Group

[20] Review of a study by Oxford University's SAID Business School in 'Money, risk and return: Can the good guys win at work?' (1999), Guardian, 27 March.

[21] Background evidence from a number of sources that they gained from in-depth interviews with senior executives from a sample of leading UK insurance companies in order to characterise institutional monitoring in the UK.

[22] US institutional investors did not consider this to be an important aspect

[23] 'Good Governance Pays off: Institutions Will Pay a Premium for an Independent Board', Investor Relations Business, Editorial, 10/7/2000.

[24] Investors define good governance as having a majority of outside investors on the board who have no ties with management, holding regular director evaluations and being responsive to investor requests for information on governance issues.

[25] Re. Stapledon (1996)

[26] until October 1997 known as the Securities and Investments Board (SIB) –

[27] Notwithstanding amendments to Companies Act 1985.

[28] The history of audit committee development is restricted to the USA, Canada, and the UK as they represent the countries with the more advanced governance systems within countries whose governance system is primarily based on the Anglo-Saxon model.

[29] Standing Audit Committees Composed of Non-executive directors-

[30] "Where were the Directors? Guidelines for Improved Corporate Governance in Canada" (also known as the "Dey Report")

[31] Internal audit in the Civil Service 1973

[32] The KPMG Audit Committee Survey (2000) highlights that the audit committee role in business risk review is becoming increasingly popular in the large listed companies.

[33] In terms of all members being independent and at least one member having a finance or accounting background.

[34] Institute of Internal Auditors (UK) - Professional Briefing Note Three

[35] Kusel and Scull (1998) - More than 21% (USA), 31.5% (Canada) have outsourced some of the internal audit function; 57.6% (USA), 62.2% (Canada) use Big Six firms as external providers. 60% (USA), 52% (Canada) give financial savings as the main reason or some outsourcing of the internal audit function; 11.4% (USA), 25.6% (Canada) have considered outsourcing the whole of the internal audit function;

[36] Para 2.2.

[37] Cadbury Report Para 5.1

[38] United States v Arthur Young 465 US 805(1984)

[39] 'Regulating the Auditing Profession' - Consultative document issued by the DTI in 1986 - chaired Lord R. Dearing

[40] Cadbury Report para 5.10

[41] Andersen's, formerly known as Arthur Andersen, still undertakes consultancy work even though consultancy practice – Accenture (formerly known as Andersen Consulting) exists.

[42] SEC Release 33-7919, Released November 2000

[43] The external audit provider may not perform more than 40% of Internal audit assignments

[44] Discussed in the previous paragraphs with direct reference to going concern considerations. Firms may look to another firm for the more favourable treatment allowed by an accounting standard option to be utilised.

[45] New Item 306 of Regulations S-K and S-B and Item 7(e)(3) of Schedule 14A

[46] Schedule 4 p.10

[47] There is a presumption in both law and accounting standards that the financial statements are prepared on a going concern basis and that the foreseeable future should normally extend for a period of a minimum of six months following the date of the audit report or one year after the balance sheet date whichever period ends on the later date.

[48] Developed by nominees of the accountancy profession and the Hundred Group of Finance Directors

[49] Effective from June 2001

[50] The main reason given in the KPMG (2000) survey for the increase in meetings was the increasing duties and responsibilities ascribed to the audit committee

[51] a director who is a member of the family of a current director;

a director who paid to or received from the company commercial payments exceeding $200,000 in the preceding two years;

a director who owns or has the power to vote an equity interest in a company which paid to or received from the company commercial payments exceeding $200,000 in the preceding two years;

a director who is affiliated in a professional capacity with a law firm that was primary legal adviser with respect to corporate law or securities matters;

a director who is affiliated in a professional capacity with an investment-banking firm retained in advisory capacity or as underwriter in an issue of the company's securities

[52] Korn Ferry International (1999) Annual Study of Boards.

[53] Financially literate being defined as having background experience in financial or banking and or being or been a chief executive officer of a company.

[54] Including those roles delegated to board committees

[55] used as a proxy for the general public

CHAPTER 3:
METHODOLOGY

3 METHODOLOGY

3.1 INTRODUCTION

The structure and composition of the board is considered to be a factor that influences the effectiveness of the board. It therefore follows, given that the audit committee is a subset committee of the board, structure and composition of the audit committee must also be considered to influence the effectiveness of the audit committee.

Current recommendations[1] on audit committees appear to justify this assumption as they emphasise the structure and composition of the audit committee as crucial to the effectiveness of the audit committee.

In principle audit committees should perform an oversight role and thus provide a focus and a means for a fuller review and analysis of matters relating to internal controls, auditing [internal and external], and financial reporting.

The main activities of the audit committee were examined in detail in chapter two. It was considered that the extent to which the audit committees discharge their functional roles could be used as a measure of audit committee effectiveness.

The activities of the audit committee in relation to internal control assessment and internal auditing were considered. Given the contribution that internal audit can make to the audit committee's ability to assess internal controls, the extent to which the audit committee interacts with internal audit was also considered to be a measure of audit committee effectiveness.

Scarborough (1998) and Raghunandan et al (2001) both examined the relationship between the audit committee and internal audit. They found that audit committee composition did influence the extent of interaction between the audit committee and internal audit. Scarborough (1998) focused on the non-executive directors in terms of their number and their relative independence. Raghunandan et al (2001) extended their research to examine if the composition of the audit committee in terms of independence and financial literacy influenced the extent to which the audit committee communicated with internal audit. Whilst limited to the examination of the audit committee role in internal control assessment, this study provides evidence that audit committee composition influences the effectiveness of the audit committee in relation to internal controls. This thesis therefore does not consider the role of audit committee in respect of internal controls in any great detail.

The activities of the audit committee in respect of external audit were considered. Management is principally responsible for selecting the company's accounting policies and the preparation of the financial statements. The external auditors are responsible for the auditing of the company's financial statements and providing an independent opinion on the truth and fairness of these financial statements.

Given that the external auditors are usually selected or recommended by management for ratification by shareholders, the relationship between the external auditors and management may be compromised in certain situations. The audit committee provides an additional link between management and the external auditors in so far as the external auditors are able to discuss all matters in confidence.

Kalbers and Fogarty (1993) considered how external auditors and management perceived the audit committee. They argued that audit committee effectiveness was conditional on institutional and personal power. I.e. the power given to the audit committee members and the willingness of the members to monitor. This study noted that it was only in the area of financial reporting that member technical expertise was considered as necessary for audit committee effectiveness.

This study did not conclude that audit committees were perceived as ineffective. In fact, it widened the debate as to how audit committee effectiveness could be evaluated by including institutional and personal power as conditions for audit committee effectiveness. It was therefore decided not to focus in this thesis on the relationship between external auditors and the audit committee as an indicator of audit committee effectiveness.

The activities of the audit committee in terms of financial reporting were examined. Most of the studies to date have been limited to the study of US companies and to considering if the existence of an audit committee improved the quality of financial reporting. Since most UK Listed companies now have audit committees, these studies are therefore of limited value.

It was therefore decided that the focus of this thesis would be limited to the financial reporting role of the audit committee and consider the extent to which the composition and structure of the audit committee was associated with the ability of the audit committee to fulfil this role effectively.

3.2 Audit Committee Effectiveness

It is reasonable to assume that an audit committee may be considered effective where it achieves its stated roles. The audit committee is not required to report to the shareholders within the financial statements on the extent to which they have achieved their roles. Thus, actual audit committee effectiveness cannot be externally observed.

It is possible to measure audit committee effectiveness indirectly if it is considered that the absence of financial reporting problems indicates an audit committee has been effective in achieving their financial reporting oversight role.

Financial reporting is the term used to cover all the reports of a financial nature that are issued to external users by a company. The financial statements are the most important areas of financial reporting and thus this thesis focuses on the financial reporting problems evidenced within the financial statements.

Financial reporting problems within financial statements may range from inadequate disclosure to corporate failure. It would be inappropriate to consider that the audit committee effective or otherwise would be in a position to prevent corporate failure. That is not the role of the audit committee. The audit committee should review the financial statements to ensure that they reflect the true state of affairs of the company. The audit committee is considered ineffective where the following financial reporting problems arise:

- Non-disclosure within the financial statements of impending corporate failure.
- Financial statement audit report qualification.
- Referral to the Financial Reporting Review Panel.

3.2.1 Non-Disclosure of Potential Insolvency

The external auditor is required to consider if the disclosures given by the directors are adequate. Auditing Guidelines –SAS 130[2] state that "... where there is a significant uncertainty about the enterprise's ability to continue in business, this fact should be stated in the financial statements." This infers that the external auditor is required to alert shareholders as to the significant possibility that the company may not continue in business by giving a "going concern" qualification in the audit report. The failure to qualify the financial statements of a company that subsequently fails must be considered a failure in the effectiveness of the external auditors.

It must also be considered in this situation that the audit committee has been unable to exercise the financial reporting oversight role effectively. Thus a company that fails without prior warning should be deemed to have had a financial reporting problem in the year prior to failure.

3.2.2 Audit Report Qualification

The audit report may be qualified for any of the following other reasons:

- A disclaimer of opinion. This indicates that the auditors are unable to form an opinion due to a material limitation in the scope of their work.
- An adverse opinion. This indicates that the auditor considers that the financial statements do not show a true and fair view.
- A qualified opinion arising from a limitation in the scope of their work that does not result in the inability to form an opinion on the financial statements.
- A qualified opinion arising from disagreement about an accounting treatment.
- A qualified opinion arising from the omission of a primary statement required by the Financial Reporting Standards.

Given that most companies will attempt to avoid qualification, qualification types 1 and 2 indicate that the external auditors and the audit committee have succeeded in ensuring that the true state of affairs within the company has been reflected in the financial statements. Any company with this type of qualifications is not considered to have a financial reporting problem.

Qualification type 3 indicates that the external auditors have been unable to form an opinion due to a limitation in the scope of their work. Where this limitation is as a result of a lack of audit evidence, it is considered that any company with this qualification has a financial reporting problem.

Qualification types 4 and 5 indicate that management has disagreed with the external auditors and that the discussions with the audit committee have failed to resolve these issues. Any company with this type of qualifications can be considered to have a financial reporting problem.

3.2.3 Report to the FRRP

The Financial Reporting Council established the Financial Reporting Review Panel in 1989. It is authorised by the Secretary of State for Trade and Industry for the purposes of section 245B[3] of the Companies Act 1985 (introduced by the Companies Act 1989).

The Panel is empowered to apply to the court for a declaration that the annual financial statements of a company do not comply with the accounting requirements of the Companies Act and for an order requiring the directors to prepare revised financial statements.

The Panel's main concern is with material departures from accounting standards, i.e. where the financial statements in question do not give a true and fair view, but it also considers other departures from the accounting provisions of the Companies Act 1985. The main areas of concern include: -

- Where a material departure from accounting standards or an accounting requirement of the Companies Act 1985 has been disclosed in the financial statements or is the subject of an audit qualification; and
- Where there is no such disclosure or audit qualification but where there nevertheless appears to be a substantial matter for concern.

The Panel only deals with the financial statements of public and large private companies. These companies within the Panel's remit are:

- Plc's (except where they are subsidiaries in a small or medium-sized group).
- Subsidiaries in a Group headed by a PLC.
- Large companies that are not PLC's.
- Any company in a "large"[4] group.

The FRRP issues press notices to report on companies who have voluntarily agreed to revise their financial statements or take other corrective action in respect of any apparent breaches of the Companies Act 1985. The FRRP has the power via the courts to compel companies to take corrective action. To date, all companies subject to FRRP consideration have voluntarily agreed to remedial action.

A referral to the FRRP that results in an amendment to the financial statements indicates that the company has a financial reporting problem.

3.3 DATA SELECTION

In order to consider the extent to which the composition and structure of the audit committee was associated with the ability of the audit committee to fulfil the financial reporting oversight role effectively, it was necessary to: -

- Select a group of companies with financial reporting problems;
- Determine the criteria to evaluate the nature of the board (where relevant) and audit committees of these companies; and
- Select another group of comparable companies with no financial reporting problems as a control group in order to evaluate the extent to which composition and structure could be hypothesised as an influence on audit committee effectiveness.

This thesis considers the role and structure of audit committees. Many companies prior to release of the Cadbury Report (1992) did not have audit committees. The period 1993 – 1999 was chosen in order to select only companies with reporting dates after the release of this report.

3.3.1 Company Selection

The criteria to determine that a company was included in the population was that:

- A financial reporting problem as defined in section 3.2 was in evidence.
- The year in which the problem was evidenced was within the reference date of the study.

Four main data sources were used to identify companies with financial reporting problems (FRP Companies). These were:

- Dialogue database.
- Press notices issued by the Financial Reporting Review Panel in the period from 1.1.93 to date.
- Hemmington Scott Quarterly Publications 1993-1997.
- Macmillan's Stock Exchange YearBook 1999.

- Companies house Statutory Returns.

3.3.1.1 Press Notice Review

Press notices from inception to date are published on the Accounting Standards Board (ASB) web-site[5]. This web-site is updated on a quarterly basis. An update service, by subscription, however communicates by e-mail any additional press notices released since the last update.

Press notices are issued by the FRRP for a variety of reasons. The press notices issued were reviewed. The following press notices were excluded:

- Press notices required in amendments to financial statements with year-ends prior to 1.1.93.
- Policy statements.
- Press notices on companies that were no longer in existence as a result of merger, take-over, or substantial re-organisation.

This review of the web-site resulted in a population of companies that met the following criteria: -

- Being a separate identifiable entity; and
- Having had a financial reporting problem within the qualifying periods.

3.3.1.2 Dialogue Database Review

The Dialogue database houses the text of all UK Listed Companies financial statements. An initial search of this database[6] was undertaken to choose companies that met the following criteria:

- The reporting date of the financial statements for each company selected fell within the qualifying period.
- All companies selected were still separate and identifiable entities as at 30th September 1999.
- All companies selected had financial statements in which the auditors had qualified the audit report for the reasons stated in section 3.2.2.

This review of the Dialogue database was incomplete due to problems with availability of a complete database for the entire reference period. The Business Information Resource Unit therefore undertook a second database search at City Business Library using the same criteria. This search yielded a source of companies that could be defined as: -

- Being a separate identifiable entity; and
- Having had a financial reporting problem within the qualifying periods.

3.3.1.3 Hemmington Scott Quarterly Publications

The last group of companies to be included in the population was those companies where inadequate disclosure of an insolvency problem had occurred. It was however necessary to determine the nature of the insolvency problem and consider which problem would be included in the population. It was decided to include all companies in creditor liquidation, receivership or administration.

The first step was to determine all the listed companies that had any of the above insolvency problems within the reference period. Different data sources were initially tried. The Companies House Dissolved Database was used. A search of this database resulted in an initial sample of about 1200 companies. As there were no advanced search facilities within this database to eliminate unlisted companies, it was therefore necessary to find another data source.

The Hemmington Scott quarterly publications on companies were found to include a section that highlighted reasons why listed companies had been removed from the database. It was noted that companies were removed for a variety of reasons including liquidation, administration and receivership. Details for companies removed were found for companies removed between 1993 and 1997.

For companies removed after 1997, the website[7] was used. The companies highlighted in these searches were then noted. The last available financial statements prior to this date were examined to highlight if the financial statements referred to the possibility of a going concern problem or if the financial statements had stated that the company was not a going concern.

The companies in which the financial statements provided no warning signals were considered to have a financial reporting problem and were therefore added to the population of companies with financial reporting problems

A variety of sources were used to find the financial statements of these companies. These included:

- Financial statements held at City University Business School Library.
- Financial statements held at City Business Library.
- The Dialogue database CD-ROM's.
- Statutory Financial statements filed at Companies House, London.

It was important to verify that the Hemmington Scott database was a complete source of companies due to the fact that companies can request to be de-listed and not provide a reason for this request. The Macmillan Stock Exchange yearbook was therefore reviewed. This publication also contained a section that noted the companies that were removed due to liquidation, receivership, or administration problems. There were no companies listed there that were not already included in the population. It was therefore assumed that the Hemmington Scott database was an accurate data source.

3.3.1.4 NFRP Company Selection

To create a control group of companies with no financial reporting problems (NFRP companies), a search of the Extel database was undertaken using the following steps. For each FRP company included within the population, the database was searched for another company that: -

- was within the same industrial sector;
- was listed on the London Stock Exchange;
- had a year end date was co-terminus with that of the FRP company; and

- The market capitalisation of the NFRP Company was within ± 10% of the market capitalisation of the FRP Company.

The result of each search was evaluated and the company, closest in size that met all the other criteria was chosen. The financial statements of this company were reviewed to ensure that the financial statements did not contain a qualification of the type detailed in section 3.2.2 that would result in this company being considered to have a financial reporting problem. It was not considered necessary to consider any other determinants of a financial reporting problem given that: -

- All companies reported to the FRRP were included in the FRP population; and
- All companies in liquidation, receivership, and administration were already included in the population.

3.3.1.5 NFRP2 Company Selection

The date analysis of the companies included in the FRP population highlighted that a significant number of companies fell within the earlier years of the reference period.

It was therefore decided to undertake a time series analysis in order to highlight if improvements in board and audit committee composition and structure had taken place over time. It was expected over time, companies with no financial reporting problem would have improved in the areas relating to the board and audit committee that might have been considered ineffective.

A second control group of companies with no financial reporting problems (NFRP2 companies) were therefore created. This group comprised all the companies included within the first control group. However, the data used to evaluate these companies was now taken from the latest available financial statements.

Access to the details of directors and the latest financial statements were found using the Hemmington Scott Internet website. It was found that some companies, which were included in the NFRP1 population, no longer existed in 2000. The main reasons were as a result of:

- Mergers.
- Take-overs.
- Liquidations.

In the case of merger and take-overs an alternative company which met all the criteria of the NFRP1 population was chosen. This new company was used only in the NFRP2 population.

Where the NFRP1company had since entered into liquidation, the company was removed from the NFRP1 population and a new company was used in both the NFRP1 and NFRP2 population.

The financial statements of these new companies were reviewed to ensure that the financial statements did not contain a qualification of the type detailed in section 3.2.2 that would result in this company being considered to have a financial reporting problem. It was not considered necessary to consider any other determinants of a financial reporting problem given that:

- All companies reported to the FRRP were included in the FRP population.
- All companies in liquidation, receivership, and administration during the reference period were already included in the population.

3.3.2 Test Data Collection

Data to evaluate any hypothesises can be collected from two basic sources i.e.

- Secondary data i.e. data already available in the public domain.
- Primary data i.e. data generated by the researcher.

3.3.2.1 *Secondary Data*

The nature of the data required to evaluate the hypotheses highlighted that secondary data would be the main data source. The decision to rely on secondary data sources was taken for the following reasons:

- Data availability. Given that several of the companies to be reviewed were dissolved, the use of primary data sources was not considered feasible. Furthermore, the analysis of the key governance mechanisms was primarily based on disclosures within the financial statements. Given the availability of the financial statements within the public domain, it was not considered necessary to generate new data for this specific research study.
- Audit committees should be perceived as effective. The perception of effectiveness is influenced by the composition of the audit committee. The availability of data within the public domain to evaluate audit committees is thus required.
- Information on directors and their backgrounds is generally historic data and therefore secondary data sources are usually available. It is a more time and cost effective solution to use secondary data sources where available.

3.3.2.2 *Primary Data*

It was considered important to evaluate the results of the empirical analysis where the hypothesised result differed from the actual result. Secondary date sources were of no use in evaluating these differences. It was decided to generate new information (i.e. primary data source) to explain these differences.

There are advantages and disadvantages associated with the use of primary data and the methods in which primary data is usually collected.

Figure 4 highlights the main primary data collection methods and highlights the advantages and disadvantages inherent in each method.

	QUESTIONNAIRES	INTERVIEWS
ADVANTAGES	Less expensive to conduct Bigger sample sizes possible Bias is not a problem	Higher response rate Explanations can be given to misunderstood questions More information may be gained during the interview
DISADVANTAGES	Poor response rate Only certain types of person respond to a questionnaire which may introduce a certain amount of bias	Possibility for the introduction of bias Response rate may be low Time consuming

FIGURE 4 DATA COLLECTION METHODS

The information required to evaluate differences was based on the opinions of non-executive directors in the FRP population and the control group populations.

Given the nature of the information required, it was decided that questionnaires were not a viable option. It was decided that interviews would be conducted to evaluate the results gained using secondary data in the analysis as the information required was not suitable for a questionnaire due to:

- The types of people being interviewed. Senior executives were considered more likely to respond to a request for an interview as opposed to a request to complete a questionnaire.
- The nature of the topic did not lend itself to the production of questionnaire that could be easily completed.

Interviewer bias was considered important so that the opinions of the interviewer were not inadvertently communicated to the interviewee.

Guidelines for each interview were therefore drawn up and a form, reflecting these guidelines (see appendix page 250) was completed during the course of each interview.

3.3.2.3 Hypothesis 1

The Combined Code on Corporate Governance (1998) in the UK considers those Boards where non-executive directors constitute less than one-third of the overall board to be ineffective. Therefore, hypothesis 1 considers that:

COMPANIES WITH FINANCIAL REPORTING PROBLEMS MORE LIKELY TO HAVE INEFFECTIVE BOARDS.

The financial statements of the companies were the main data source for details on the numbers of directors in total and the number of non-executive directors. Figure 5 highlights the specific data collected and the sources of this data.

DATA DETAILS	DATA SOURCES
Total number of Board members	Financial statements
Number of executive directors	Financial statements
Number of non-executive directors	Financial statements
Percentage of non-executive directors to overall board	Author

FIGURE 5 BOARD COMPOSITION DETAILS

3.3.2.4 Hypothesis 2

The Combined Code on Corporate Governance (1998) in the UK considers that the separation of the roles to be important to board effectiveness. Therefore, hypothesis 2 considers that:

COMPANIES WITH FINANCIAL REPORTING PROBLEMS MORE LIKELY TO HAVE BOARDS WHERE THE SAME PERSON HELD THE POSITIONS OF CHAIRMAN AND CHIEF EXECUTIVE OFFICER

The data collected in order to evaluate this hypothesis is shown in Figure 6.

DATA DETAILS	DATA SOURCES
Name of Chairman	Financial statements
Name of C.E.O.	Financial statements
C.E.O. = chairman indicator	Author

FIGURE 6 TEST DATA: CEO / CHAIRMAN ROLE DUALITY

3.3.2.5 Hypothesis 3

The audit committee is an important element in corporate governance and instrumental in ensuring the quality of financial reporting. Academic research examines the relation between audit committee characteristics and aggressive reporting and most studies consider that a positive relationship exists between the existence of an audit committee and the quality of financial reporting. Accordingly, hypothesis 3 considers that:

COMPANIES WITH FINANCIAL REPORTING PROBLEMS ARE LESS LIKELY TO HAVE AUDIT COMMITTEES.

The financial statements of the companies were reviewed to find out if an audit committee existed. The financial statements of the companies in most cases provided all relevant information required and were the main data source. The data collected in order to evaluate this hypothesis is shown in Figure 7.

DATA DETAILS	DATA SOURCES
Audit committee Existence	Financial statements, Hemmington Scott Database / Publications

FIGURE 7 TEST DATA: AUDIT COMMITTEE EXISTENCE

The financial statements of the companies in most cases provided all relevant information required and were the main data source. There were some companies; notably FRP companies that noted the existence of an audit committee but did not state which of the directors were on the audit committee. These companies were removed from the population.

3.3.2.6 Hypothesis 4

The Hampel Report (1998) considered that audit committees composed of less than 3 non-executive directors might be ineffective. Accordingly, Hypothesis 4 considers that:

COMPANIES WITH FINANCIAL REPORTING PROBLEMS WERE MORE LIKELY TO HAVE AUDIT COMMITTEES THAT HAD LESS THAN THREE MEMBERS.

The data collected in order to evaluate this hypothesis is shown in Figure 8.

DATA DETAILS	DATA SOURCES
Company size – AIM, Fledgling etc.	Hemmington Scott Publications / Database
Number of Audit committee Members	Financial statements, Hemmington Scott Publications / Database

FIGURE 8 TEST DATA: AUDIT COMMITTEE MEMBERSHIP

The financial statements of the companies in most cases provided all relevant information required and were the main data source.

There were some companies, notably FRP companies, which noted the existence of an audit committee but did not state which of the directors were on the audit committee. These companies were removed from the population.

3.3.2.7 Hypothesis 5

Key mechanisms of the corporate governance framework that relate to the structure of the audit committee. It is important to consider if these mechanisms improve the effectiveness of the audit committee. Therefore, hypothesis 5 considers that:

COMPANIES WITH FINANCIAL REPORTING PROBLEMS WERE MORE LIKELY TO HAVE AUDIT COMMITTEES WITH POOR GOVERNANCE PROCEDURES.

The data required to evaluate this hypothesis is shown in Figure 9.

DATA DETAILS	DATA SOURCES
The existence of an audit committee terms of reference or charter	Financial statements
The number of meetings held by the audit committee	
The existence of an internal audit department	

FIGURE 9 TEST DATA: GOVERNANCE PROCEDURES

Non-disclosure of any of the relevant details within the financial statements was assumed to indicate that these mechanisms did not exist. The financial statements of the companies selected in most cases provided all relevant information required and were the main data source.

3.3.2.8 Hypothesis 6

The Combined Code (1998) noted that membership of the audit committee should be confined to non-executive directors and that all the members should be independent. I.e. that, apart from their director's fees and shareholdings, they should be independent of management and free from any involvement that might significantly interfere with their ability to judge matters independently. The independence of the non-executive director is considered crucial to the effectiveness of the audit committee. Therefore, hypothesis 6 considers that:

COMPANIES WITH FINANCIAL REPORTING PROBLEMS WERE MORE LIKELY TO HAVE AUDIT COMMITTEES COMPOSED OF NON-INDEPENDENT MEMBERS.

Impairments to independence, for the purpose of this study, are defined as: -

- any non-executive director who has been an executive director of the company ;
- any non-executive director who is related to an executive director; and
- any non-executive director that is a major supplier, customer, or consultant to the company;

The data required to evaluate this hypothesis is shown in Figure 10.

DATA DETAILS	DATA SOURCES
Name of committee member	Financial statements
Current status within the company	Financial statements, Hemmington Scott Publications / Database, Companies House Annual Returns
Previous status within the company	Financial statements, Hemmington Scott Publications / Database, Companies House Annual Returns
Familial relationship	Financial statements
Major supplier to company	Financial statements
Consultant to company	Financial statements, Directory of Directors.

FIGURE 10 TEST DATA: INDEPENDENCE

The information required to evaluate audit committee independence was taken primarily from the financial statements. However many of the smaller FRP companies did not provide adequate information within the financial statements.

The Directory of Directors (1999) proved very useful in being able to evaluate the audit committee members for all criteria except that of being a consultant to the relevant company. It was therefore assumed that unless evidence could be found to the contrary, all directors were assumed to be independent.

3.3.2.9 Hypothesis 7

The audit committee is composed of non-executive directors and the financial reporting oversight role is usually delegated to the audit committee. Assuming that audit committee members possess the necessary background and the skills to undertake this role, it follows that they are more likely to be effective in this role.

It follows that an audit committee may be considered effective if the members of this committee possess experience in this role. The Blue Ribbon Report (1999) provides guidelines as to when an audit committee may be considered experienced. This report considers that audit committees should be composed of at least three directors who are financially literate[8]. Accordingly, hypothesis 7 considers that:

COMPANIES WITH FINANCIAL REPORTING PROBLEMS WERE MORE LIKELY TO HAVE AUDIT COMMITTEES WITH NON-FINANCIALLY LITERATE MEMBERS.

The data required to evaluate this hypothesis is shown in Figure 11.

DATA DETAILS	DATA SOURCES
Director Name	Financial statements Hemmington Scott Publications/ Database Companies House Return Records

DATA DETAILS	DATA SOURCES
A member of a recognised professional body	Membership Handbooks of the Recognised Institutes[9] Who's who (1999) Directory of Directors (1999)
Familial relationship	Financial statements Hemmington Scott Publications/ Database Companies House Return Records
Having banking / investment management experience	Financial statements Hemmington Scott Publications/ Database Companies House Return Records Who's who (1999) Directory of Directors (1999)
Holding / having held the position of Chief Executive Officer	Financial statements Hemmington Scott Publications/ Database Companies House Return Records Who's who (1999) Directory of Directors (1999)
Financial literacy score	Author

FIGURE 11 TEST DATA: FINANCIAL LITERACY

The financial statements were reviewed and where possible, details of director backgrounds were utilised. Where information was not given in the financial statements, the references shown Figure 11 were utilised.

Each individual audit committee member was evaluated and a cumulative score for each committee was gained. The relative financial literacy all the audit committees selected was then evaluated.

3.3.2.10 Hypothesis 8

The Blue Ribbon Report (1999) provides guidelines as to when an audit committee may be considered experienced. This report considers that audit committees be composed of financially literate members and that at least one member be technically competent. Accordingly, hypothesis 8 considers that:

COMPANIES WITH FINANCIAL REPORTING PROBLEMS WERE MORE LIKELY TO HAVE AUDIT COMMITTEES WITH NO TECHNICALLY COMPETENT MEMBERS.

Audit committee members was evaluated in terms of their current professional qualifications. The data required to evaluate this hypothesis is shown in Figure 12.

DATA DETAILS	DATA SOURCES
Director name	Financial statements,
Director qualifications	Membership Handbooks of the above named institutes [See note 9] Who's Who (1999). Directory of Directors (1999). Companies House Return Records.
Audit committee competency score	Author

FIGURE 12 TEST DATA: TECHNICAL COMPETENCY

The financial statements were reviewed and where possible, details of the director's qualifications were utilised. Where information was not given in the financial statements, the references shown in Figure 12 were utilised.

The audit committee of each company selected was therefore considered to be technically competent if at least one member of the audit committee was professionally qualified.

3.3.2.11 Hypothesis 9

Beasley (1996) noted that as the number of additional directorships held by non-executive directors' increases, their ability to fulfil their monitoring responsibilities decreased. His results showed a greater likelihood for financial statement fraud where non-executive directorships had significantly more appointments. Given the above arguments, it is reasonable to infer that audit committee effectiveness must be affected by the time devoted to business and by the availability of directors to attend these meetings. Therefore, hypothesis 9 considers that:

COMPANIES WITH FINANCIAL REPORTING PROBLEMS WERE MORE LIKELY TO HAVE AUDIT COMMITTEES WITH DIRECTORS WHO HOLD ADDITIONAL DIRECTORSHIPS.

The data required to evaluate this hypothesis is shown in Figure 13.

DATA DETAILS	DATA SOURCES
Additional Directorships	Annual Returns Directory of Directors (1999) Who's Who (1999) Financial Statements
Average Directorships per audit committee	Author

FIGURE 13 TEST DATA: ADDITIONAL DIRECTORSHIPS

The statutory returns held at Companies House was used to check the number of additional directorships held by directors as Annual Returns require that all directorships held are reported to Companies House. The average number of additional directorships held by each committee was therefore calculated.

3.3.3 Descriptive Data Analysis Methods

It was decided to use Microsoft Excel spreadsheet software to initially collate the data. For each company, the data in Figure 14 was collated and then separate spreadsheets see appendices on pages 246 to 239 were created for each group of data within the population – i.e.

- Sheet One – Data in respect of all companies in the population of companies with financial reporting problems.
- Sheet two – Data in respect of companies in Control Group 1.
- Sheet two – Data in respect of companies in Control Group 2.

The data on each sheet was then evaluated in order for the description of the data to be undertaken in chapter 4.

DATA COLLECTED	EVALUATION METHOD
No. of Board Members	Average no. of board members Median number of board members Range in board size
No. of Executive directors	Average no. of executive members Median number of executive members Range in executive members size
No. of non-executive directors	Average no. of non-executive members Median number of non-executive members Range in non-executive members size Percentage of non-executive director compared to total board size
Name of chairman and of Chief Executive Officer	Total number of companies where position of Chief Executive Officer and Chairman is held by the same person

DATA COLLECTED	EVALUATION METHOD
Existence of audit committee	Total number of companies where there is no audit committee
No. of Audit committee members	No. of members per committee Average number of members per control group population Total number of companies with less than or equal to 2 members
Terms of Reference	Total number of audit committees with no formal charter of terms of reference
Meetings	No. of meetings per committee Average number of meetings per control group population. Total number of companies with less than or equal to 2 meetings per year
Internal audit department	No. of companies with an internal audit department
Independence	Total number of companies where the audit committee is not considered to be independent
Financial literacy	Percentage of financially literate directors per company Average financial literacy per population. Number of companies where all directors are financially literate. Number of companies where all directors are financially literate and the audit committee is considered technically competent.

DATA COLLECTED	EVALUATION METHOD
Technical competence	Total number of companies where there is no audit committee
Additional directorships	Average number of additional directorships per audit committee Average number of additional directorships per population

FIGURE 14 SUMMARY TEST DATA

Charts were constructed using the results to compare changes over time in respect of certain key governance mechanisms. FRP companies and control group1 companies were further analysed by year-end date.

This analysis allowed for comparisons over time to be made for both groups of companies. 6 charts were prepared and Figure 15 reflects the information analysed in the charts:

CHART NO.	DATA SOURCE	DATA ANALYSED
Chart 1 Chart 2	FRP Control group 1	BOARD COMPOSITION ▪ Average Size Of Board ▪ Average No. of Executive Directors ▪ Average No. Of Non-Exec. Directors ▪ No. of companies where there are less than 3 NED's. ▪ No. of companies where the CEO is the chairman

CHART NO.	DATA SOURCE	DATA ANALYSED
Chart 3 Chart 4	FRP Control group 1	GOVERNANCE DISCLOSURE ▪ No. of companies with a terms of reference ▪ Average number of meetings ▪ No. Of companies with an internal audit dept.
Chart 5 Chart 6	FRP Control group 1	AUDIT COMMITTEE ANALYSIS ▪ No. of companies with an audit committee ▪ Average no. of audit committee members ▪ No. Of companies with a qualified Ned. ▪ Average no. of financially literate audit committee members ▪ Average no. of add directorships ▪ No. of companies with an independent audit committee

FIGURE 15 CHART ANALYSIS

The charts were designed such that all control group charts i.e. chart 2,4, and 6 were produced on transparent film. These charts could therefore be superimposed on the FRP paper charts i.e. charts 1, 3, 5. All trends were therefore immediately visible. An analysis of all visible trends was undertaken and reasons for these trends were put forward.

3.3.4 Statistical Data Analysis Methods

The statistical analysis of the results was undertaken using SPSS version 9.0. IT was therefore necessary to input the data into this program in a format accessible by SPSS.

The data was first copied across from Excel. Changes to the data descriptions used in Excel were then made.

Figure 16 shows the data descriptions and the associated codes in SPSS.

Per Excel Analysis	Per SPSS Analysis		
	FRP Companies	Control Group 1	Control Group 2
CEO=CHAIR	CEOFRP	CEOCON1	CEOCON2
BAL	IMBFRP	IMBCON1	IMBCON2
AUDIT COMM	ACFRP	ACCON1	ACCON2
NO. OF AC MEM	ACMEMFRP	ACMEMCON1	ACMEMCON2
TERMS OF REF	TREFFRP	TRECON1	TRECON2
MEETINGS	MEETFRP	MEETCON1	MEETCON2
IA DEPT	IAFRP	IACON1	IACON2
INDEP	INDFRP	INDCON1	INDCON2
FINL LIT	LITFRP	LITCON1	LITCON2
QUAL	QUALFRP	QUALCON1	QUALCON2
ADD DIR AVE.	DIRFRP	DIRCON1	DIRCON2

FIGURE 16 DATA DESCRIPTIONS RE-CODES

The type of data transferred was then amended as follows:

- Numeric data was unchanged.
- Alphanumeric data was re-coded to reflect three possible circumstances – see Figure 17.

Per Excel Analysis	Per SPSS Analysis
Yes	2
No	1

Per Excel Analysis	Per SPSS Analysis
N/A (i.e. missing data where there was no audit committee)	0

FIGURE 17 DATA RE-CODED

Appropriate statistical tests of significance were undertaken and the results are detailed in chapter 5. SPSS raw data sheets are contained in appendix page [282 to 290].

3.4 INTERVIEWS

Interviews were carried out in order to investigate the results of the empirical testing undertaken in section 5. A letter [appendix page 251] was sent to all the directors within the population. There were 375 directors in total. The first replies received agreeing to interviews were very disappointing. A second circularisation was therefore undertaken 5 weeks later. This proved more successful. Appendix page 252 shows details of the directors interviewed.

Prior to each interview, an interview guideline form (see appendix page 250) was prepared. This form was completed during the course of the interview to ensure that the same questions and topics were covered in each interview.

An interview was conducted with at least one director in 20% of the companies within the population. Results of the interviews are contained in chapter 5 alongside the empirical analysis.

3.4.1 Data Strengths and Weaknesses

Several limitations in the data were evidenced during the study. These included:

- A focus on limited listed companies only.
- Company selection.
- Audit committee data.

- Audit committee members.
- The use of secondary data sources.

3.4.1.1 Limited Company Focus

The focus on listed companies resulted in the fact those large private limited companies whom, by choice, have not converted to PLC status were ignored by the study. Whilst this may have resulted in some significantly large companies with financial reporting problems being excluded from the population, this problem is not considered to have invalidated the results of the study.

3.4.1.2 Company Selection

The populations of companies with financial reporting problems were drawn from three distinct sources, namely:

- The FRRP primarily focuses on large PLC's – i.e. the TOP 350 UK companies.
- The Dialogue Database does not distinguish companies in terms of size. The criterion for inclusion in this database is PLC status.
- The Hemmington Scott publications and database that includes all companies that have been placed in liquidation, administration, and or receivership.

The selection of companies from these three sources therefore results in a population which may be considered representative, in terms of size, of the overall population of UK listed companies. The amalgamation of the companies identified from these three sources limits this study but is not considered to invalidate this study.

The identification of companies with no financial reporting problems is however biased due to the assumption that the absence of an audit report qualification indicates the lack of a financial reporting problem.

The literature review highlights the reasons for which audit reports may not be qualified in situations where a qualification was justified. The FRRP is however there to prevent this situation from occurring. The problem however lies with the manner in which cases are brought to the attention of the FRRP. The financial statements of all listed companies are not routinely examined. The FRRP relies on any inconsistencies to be brought to their attention. The lack of a pro-active approach limits the extent to which the FRRP may be considered effective.

There is currently no other alternative source of information on the company that would guarantee that a company selected would have no financial reporting problems.

3.4.1.3 Audit Committee Member Data

Certain weaknesses were evidenced in the collection of data on audit committee members. The criteria for independence to some extent relied on the disclosure of family and other significant director relationships. There is no requirement to disclose family relationships and unless an obvious pattern is evidenced, this evidence is unobtainable. This clearly limits the extent to which this criteria may be evaluated.

Director loans and other significant relationships are required to be disclosed by the Companies Act 1985 and FRS 8 respectively. However, FRS 8 was only introduced in 1995 and is effective only for companies with accounting periods commencing after 23rd December 1995. Many companies included in the qualifying period may not have been required to make the relevant disclosures. This clearly limits the extent to which this criteria may be evaluated in some companies.

3.4.1.4 Member Backgrounds

The categorisation of the backgrounds in terms of the technical competency and financial literacy of audit committee members introduced a certain amount of bias as audit committee members were classified into categories based on published biographical information and prior employment history.

Problems therefore arose where no biographical information was available on the director. It was therefore only possible to assume certain competencies based on the directorships disclosed in the statutory returns by the director.

3.4.1.5 Secondary Data

The use of secondary data sources only is a potential weakness. The decision to rely on secondary data sources was taken for the following reasons:

- Data availability. Given that a number of the companies to be reviewed were dissolved, the use of primary data sources was not considered feasible.
- Audit committees should be perceived as effective. The perception of effectiveness is influenced by the composition of the audit committee. The availability of data within the public domain to evaluate audit committees is thus required.

However, in order to ensure that the results gained using secondary data were valid, a sample of audit committee members were interviewed to ensure that their opinions validated the results obtained.

3.5 DATA EVALUATION METHODS

The data on all the selected companies was collated and a description of the data observed on audit committee composition and member backgrounds was undertaken. The data observations are shown in chapter four.

An empirical investigation was then undertaken to highlight the variations in the data observed. The methodology and results of the empirical investigation are shown in chapter five.

3.6 REFERENCES

Cadbury Committee (1992) Report of the Committee on the Financial Aspects of Corporate Governance (London - Gee)

Directory of directors (1999)

Hemmington Scott Quarterly Publications (1993-1997)

Kalbers, L. P. and Fogarty, T. J. (1993) Audit Committee Effectiveness *Auditing:* A Journal of Theory and Practice, Vol. 12 Issue. Pp. 24-49

Macmillan's Stock Exchange Year Book (1999)

Scarborough, P. And R. Dasaratha And K. Raghunandan (1998) Audit Committee Composition And Interaction With Internal Auditing Accounting Horizons Vol. 12 No. 1 P.51-62

The Blue Ribbon Report (1999)

Who's Who in Britain (1999)

ENDNOTES

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[1] E.g. Cadbury Report (1992)

[2] SAS 130 – The Going Concern Basis In Financial Statements. Issued November 19994 By The APB

[3] the power to apply to the court for an order for the revision of defective company financial statements

[4] By "large" is meant companies or groups that are not small or medium-sized as defined by the Companies Act

[5] WWW.ASB/FRG.ORG.UK

[6] CD-ROM Based held at CUBS Library

[7] WWW. HEMSCOTT. CO. UK

[8] Financially literate being defined as having background experience in financial or banking and or being or been a chief executive officer of a company.

[9] Membership of The Institute of Chartered Accountants in England And Wales

Membership of The Institute of Chartered accountants of Scotland

Membership of the Institute of Chartered Accountants in Ireland.

Membership of The Chartered Association of Certified Accountants

Membership of The Institute of Chartered Institute of Management Accountants

Membership of The Chartered Institute of Public Finance and Accountancy

CHAPTER 4: DESCRIPTIVE ANALYSIS

4 DESCRIPTIVE DATA RESULTS

4.1 INTRODUCTION

In principle audit committees should play an oversight role and thus provide a focus and a means for a fuller review and analysis of matters relating to *internal controls, auditing* [internal and external], and financial reporting.

It is reasonable to assume that an audit committee may be considered effective where it achieves its stated roles. However, given the nature of these roles, actual audit committee effectiveness cannot be externally observed.

It is possible to measure audit committee effectiveness indirectly if it is considered that the absence of financial reporting problems indicates an effective audit committee.

Thus by comparing the composition and structure of audit committees in companies with no financial reporting problems ("CNFRP") with audit committees in companies that appears to have a financial reporting problem (CFRP), characteristics common to CFRP's should be highlighted. The following are descriptions of the data observed for the above mentioned companies.

4.2 FINANCIAL REPORTING PROBLEMS

The criteria, defined in chapter 3, resulted in an overall population of 49 companies with financial reporting problems (CFRP). This population was analysed in order to compare and contrast the companies by reason for inclusion, size, and sector in the population.

Figure 18 shows the analysis of companies in relation to the reason for inclusion in the population. This showed that a majority of the companies (67%) were considered to have had insolvency problems.

CFRP COMPANY ANALYSIS		
Panel A :Criteria Analysis		
	No.	%
Referred to FRRP[1]	15	31%
Liquidation	10	22%
Administration/receivership	23	45%
Disagreement	1	2%
	49	100%

PANEL B :SIZE CHARACTERISTICS		
	No.	%
AIM	12	24
Fledgling	30	62
Small Cap	4	8
MID 250	1	2
FTSE 100	2	4
	49	100

FIGURE 18 CFRP ANALYSIS BY CRITERIA AND SIZE

Figure 18 also shows the analysis of CFRP's using FTSE classification as a proxy for size. This table highlighted that 76% of all the companies in the population were either AIM or FTSE Fledgling companies.

It was also noted that all companies considered to have had insolvency problems were either AIM or FTSE Fledgling Companies.

Figure 19 shows the analysis of CFRP's using the FTSE Industrial Classification.

	No.	%
Engineering	6	12%
Retailers	5	10%
Leisure	5	10%
Media	4	8%
Distributors	3	6%
Extractive Industries	3	6%
Support services	3	6%
Building materials	2	4%
Computer services	2	4%
Construction	2	4%
Electrical equipment	2	4%
Household Products	2	4%
Paper & Packaging	2	4%
Property	1	2%
Aerospace	1	2%
Beverages	1	2%
Diversified Industrials	1	2%
Health	1	2%
Insurance	1	2%
Telecommunications	1	2%
Transport	1	2%
Total	49	100%

FIGURE 19 CFRP ANALYSIS BY SECTOR

Figure 19 highlights that the engineering, leisure, and general retailing sectors constitute about 33% of the overall population. It was also found that 88% of the companies in these sectors had been included as a result of insolvency problems.

4.2.1 Board Composition in CFRP's

The number of directors on average in the CFRP's was 6.10. The average number of executive directors in these companies was 3.48 and the average number of non-executives was 2.61.

	Mean	Median	Range
Number of directors	6.10	6	3-14
Number of executive directors	3.48	3	1-7
Number of non-executive directors	2.61	2	0-8

FIGURE 20 CFRP BOARD ANALYSIS

Figure 20 highlighted that on average most of the boards in the companies observed were still dominated by executive management. This finding appears to be consistent with existing literature on the composition of UK Boards.

There were 9 companies in which there were more non-executive directors than executive directors, The dominance of the board by non-executive directors is more prevalent in US boardroom situations and is usually coupled with Chief Executive and Chairman Role duality. Of the companies highlighted, only 2 companies were observed as having CEO Chair Role Duality.

4.2.1.1 The Number of Non-Executive Directors

The Hampel Report (1998)[1] considers that non-executive directors should constitute not less than one-third of the overall board. 39 out of the 49 companies (80%) were observed to have boards in which the non-executive directors constituted at least one-third of the overall board. Figure 21 however highlighted that the number of non-executives directors in most companies fell short of the three considered being necessary in order for non-executives to form an effective audit committee. 63% of the companies observed had less than three non-executive directors.

	No	%
Number of boards with less than 3 non- Executive Directors	29	59
Of Which AIM Companies	10	
Fledgling Companies	18	
MID 250 Company	1	

FIGURE 21 CFRP BOARD COMPOSITION

Figure 21 also compared the size of the companies to the number of companies that did not have an adequate number of non-executive directors. 10 out of the 29 companies were known to be AIM companies. This appeared to highlight that most[2] AIM companies in this study (91%) did not comply. AIM companies are not required to comply with the Listing Rules and thus, this result is to be expected.

The Cisco Report (2000) updated their guidance for small quoted companies. They noted that the requirement to have at least three non-executive directors might be excessive in some companies. They therefore recommended that two non-executives directors were sufficient in smaller companies. The Cisco Report (2000) is only a set of guidelines and does not supersede Stock Exchange Listing Requirements.

However, if the assumption that companies with less than three directors were in fact relying on the recommendations of the Cisco Report (2000), 7 out of the 49 companies had less than 2 non-executive directors.

4.2.1.2 Separation of Chair and CEO Role

The data observed showed that the role of chief executive and chairman is shared by the same individual in only 9(18%) of the cases examined. Given the period over which the data is observed i.e. post 1995, post Cadbury, this result is to be expected and supports the literature which considers that role duality of the chairman and CEO to be a more common attribute of US Board structure.

4.2.2 Audit Committee Analysis

Audit committees are considered to be one of the primary means of improving corporate governance. Whilst it would be incorrect to directly attribute corporate failure to audit committee effectiveness, it is necessary to consider the structure and composition of the audit committee and analyse if ineffective structure and composition is more prevalent in companies with financial reporting problems.

It is important to firstly consider if companies with financial reporting problems are therefore less likely to have audit committees. Of the cases observed, 11 companies (22%) did not have audit committees. However, given that 50% of these companies were AIM companies that do not have to comply with the Governance requirements of the Listing rules, there were in fact only six companies that should have had audit committees.

It was noted however that the companies in which non-executive directors dominated the boards were more likely (87%) to have audit committees as opposed to the overall population (78%).

It is also important to consider the structure and composition of the audit committee to highlight the attributes common to companies with financial reporting problems.

4.2.2.1 Number of Audit Committee Members

The Hampel Report (1998) considered that audit committees composed of less than 3 non-executive directors might be ineffective. The Cisco Report (2000) however considers that 2 non-executive directors are sufficient in a small company. Whilst the Cisco Report (2000) is only a set of guidelines, the results emphasise that a significant number of small companies do not have at least three non-executive directors and that there may be a case for alternate rules for smaller companies.

The average number of audit committee members was 2.85 [ranging from 2 to 6 members]. The low average membership of the audit committee results due to the fact that a significant number of companies did not have 3 non-executive directors. Figure 22 shows an analysis of the membership by type of company.

	No.	%
Total population	49	100
Less: CO's with no audit committee	(11)	(22)
	38	88
Less than 3 members	17	45
3 or more members	21	55
	38	100
AIM CO's with at least 2 members	4	
Other CO's with less than 3 members	13	

FIGURE 22 CFRP AUDIT COMMITTEE COMPOSITION ANALYSIS COMPANY

It was noted that in six of the cases observed the audit committee was composed of two non-executive directors and either the CEO or the Executive Chairman. Clearly, this poses a problem with the independent nature of the audit committee and this is examined further in section 4.2.2.3.

4.2.2.2 Governance Disclosures

The disclosure requirements examined in the financial statements of all companies observed were: -

- indication of an audit committee charter or terms of reference;
- indication of the number of meetings held by the audit committee;
- references to communication with an internal audit department;
- the scope of disclosure on internal controls within the financial statements; and
- The scope of the external auditors report on corporate governance.

Figure 22 highlights that only 38 of the 49 companies observed had audit committees. Analysis of the financial statements in respect of these companies revealed that:

- 23% i.e. 9 out of the 38 companies with audit committees had or made reference to the existence of a formal charter or terms of reference for the audit committee.
- 46% of these companies examined stated the number of audit committee meetings held. Of the companies that stated the number of meetings held the average number of meetings held was 2. A significant number of the companies - 54% did not state the number of meetings or made no reference to the number of meetings held within the financial statements.
- The extent of interaction between the audit committee and internal audit was examined. It was noted however that only 7 of the 38 companies had internal audit departments. This result was expected, as it is not mandatory to have an internal audit department. The analysis of these seven companies highlighted that they were the companies with the largest market capitalisation of all cases observed.
- The scope of the external auditors' report on governance was considered as a measure of the interaction between the audit committee and the external auditors. In all cases examined, where relevant, the report given by the external auditors was adequate.

4.2.2.3 Member Independence

The criteria used to evaluate the independence of the non-executive directors were as follows:-

- any non-executive director who has been an executive director of the company ;
- any non-executive director who is related to an executive director; and
- any non-executive director that is a major supplier, customer, or consultant to the company.

Even though both the Cadbury and the Hampel Report required that all members of the audit committee be non-executive and a majority be independent, the audit committee of any of the companies examined was not considered independent if any member did not meet the above criteria.

Whilst this criteria was not in strict compliance with the provisions of the UK code (Section A.2.3), it was considered that the presence of a director not considered independent could compromise the overall effectiveness of the audit committee.

Figure 23 analyses the independence of the audit committees in the companies observed. It reveals that 14 audit committees were considered not independent. The companies were further examined to highlight any common attributes. The criteria for independence were examined. It was noted that the most common reasons for failing the independence test were: -

- the presence of a former executive director ;
- a non-executive director also acting as a consultant to the company;

The size of the companies with non-independent audit committees was examined. As expected, most of the companies were small companies with one notable exception. We noted that a majority of companies with non-independent audit committees (73%) had been considered to have insolvency problems. The relationship between audit committee independence and board structure was examined. It was found that non-executive dominated boards were more likely not to be independent.

INDEPENDENCE ANALYSIS		
PANEL A: OVERALL ANALYSIS		
	No.	%
No. of Companies with audit committees	38	100
Independent committees	24	69
Not Independent	14	31

INDEPENDENCE ANALYSIS		
PANEL B: OVERALL ANALYSIS		
	Id.	Not Ind.
No. of Companies with audit committees	24	14
Of which:		
Executive dominated boards	19	11
Non-executive dominated boards	5	3
PANEL C: ANALYSIS BY CRITERIA		
	No.	%
Executive director	2	16
Former executive director	6	38
Related to executive director	1	8
Consultant	5	38
	14	100
PANEL D: ANALYSIS BY SIZE		
	No.	%
Aim Companies	3	23
Fledgling	10	69
Mid 250	0	0
FTSE 100	1	8
	14	100
PANEL E: ANALYSIS BY INCLUSION IN POPULATION		
	No.	%

INDEPENDENCE ANALYSIS		
Referred to the FRRP	3	23
Insolvent	11	77
	14	100

FIGURE 23 CFRP AUDIT COMMITTEE INDEPENDENCE ANALYSIS

4.2.2.4 Competencies

The Blue Ribbon Report recommended that companies should have "..Audit committee comprised of a minimum of three directors, each of whom is financially literate and.. that at least one member have accounting expertise".

The technical competencies of the directors in the 38 companies with audit committees were analysed. An audit committee was considered to be technically competent where at least one member was a member of a professional accounting body. It was noted that (55%) of audit committees were technically competent.

The financial literacy of the directors was examined. The Blue Ribbon Report recommended that members were considered to be financially literate if: -

- A member of a recognised professional body;
- Having banking or investment management experience; and
- Holding or having held the position of Chief Executive Officer.

The financial literacy of each audit committee member was assessed using the above criteria. The total score for each committee was found and averaged over the number of audit committee members. The audit committee was given a score based on the percentage of financially literate members.

There were only 9 companies that were considered to be completely financially literate. The average score for financially literacy was (0.61). There were only 6 committees that were considered both technically competent and financially literate.

4.2.2.5 Additional Directorships

The number of additional directorships held by the audit committee members was assessed. Figure 24 shows that the average number of directorships per audit committee was 1.40.

	Average Add. Directorships
Average	1.40
Median	1.27
Range	0 – 5.17

FIGURE 24 CFRP'S ADDITIONAL DIRECTORSHIPS

This average was distorted by the high number of additional directorships held by one of the FTSE100 companies and the fact that this company also had a higher than average number of non-executive directors. After allowing for this distortion, the average number of additional directorships per audit committee was 1.27.

4.3 COMPARISON WITH CONTROL COMPANIES

The control companies were selected in accordance with the criteria defined in chapter 3. As a result of these selection criteria, 49 control companies were selected.

Given that corporate governance standards have only been introduced in the last five years, improvements in governance disclosures are to be expected. Information on the control companies was therefore drawn from:

- The financial statements in the same year in which the comparable FRP company experienced a problem (Year-end date matched companies) Control Group 1.
- The last available set of financial statements (during the year ended 1999) Control Group 2.

This resulted in two control group populations that would therefore allow analysis to reflect if the control group of companies did have better governance standards and disclosures over time.

Figure 25 shows the analysis of CFRP's using FTSE classification as a proxy for size. This table highlighted that 78% of the both groups of control companies in the population were either AIM or FTSE Fledgling companies as compared to 88% in the FRP Company population.

		FRP Companies		Control Group 1	
		No.	%	No.	%
AIM		12	24	10	22
FLEDGLING		30	62	28	56
SMALL CAP		4	8	9	18
MID 250		1	2	-	-
FTSE100		2	4	2	4
Total		49	100	49	100

FIGURE 25 CONTROL COMPANY SIZE ANALYSIS

4.3.1 Board Composition Analysis – Control Group 1

The number of directors on average in control group 1 was 5.90. The average number of executive directors in these companies was 3.47 and the average number of non-executives was 2.41.

	FRP Companies			Control Group 1		
	Mean	Median	Range	Mean	Median	Range
Number of directors	6.10	6	3-14	5.90	5	3-12
No. of executive directors	3.48	3	1-7	3.47	3	1-6
No. of non-executive directors	2.61	2	0-8	2.41	2	0-7

FIGURE 26 CONTROL COMPANY BOARD COMPOSITION

This highlighted that on average most of the boards in the companies observed in both populations were still dominated by executive management.

There were 11 (9 FRP) companies in which there were more non-executive directors than executive directors. None of the control companies (2 FRP) highlighted were observed as having CEO Chair Role Duality.

4.3.1.1 The number of non-executive directors

The Hampel Report (1998)[3] considers that non-executive directors should constitute not less than one-third of the overall board. 34 out of the 49 companies (69%) were observed to have boards in which the non-executive directors constituted at least one-third of the overall board.

Figure 27 highlighted that the number of non-executives directors in the control companies also fell short of the three considered being necessary in order for non-executives to form an effective audit committee. Control companies were more likely to have less than three non-executive directors.

	FRP Companies		Control Group 1 [DATE MATCHED]	
	No.	%	No.	%
Number of boards with less than 3 NED's	29	59	30	61
Of which:				
AIM Companies	10		5	
FLEDGLING Companies	18		22	
MID 250/SMALL CAP Companies	1		3	

FIGURE 27 CONTROL COMPANY BOARD ANALYSIS

Figure 27 compared the size of the companies with the number of companies that did not have an adequate number of non-executive directors. 5 out of the 30 control companies were known to be AIM companies. Once again, this appeared to highlight that most AIM companies did not comply. However a smaller percentage of AIM companies (52%) as opposed to 91% in the FRP population did not comply.

However, if the assumption that companies with less than three directors were in fact relying on the recommendations of the Cisco Report (2000), 11 out of the 49 companies (7 out of 49 in the FRP population) had less than 2 non-executive directors. Given that data for the control companies was taken from financial statements in the relevant years, this result was not expected.

4.3.1.2 Separation of Chair and CEO Role

The data observed showed that the role of chief executive and chairman is shared by the same individual in 25% (18%-FRP Companies) of the cases examined. This was a higher percentage than that seen in the FRP population. Given data for the control companies was taken from financial statements in the relevant years, this result was not expected.

4.3.2 Audit Committee Analysis – Control Group 1

The structure and composition of the audit committees in control group 1 companies was analysed in order to compare their characteristics to those in companies with financial reporting problems.

Of the 49 control group 1 companies observed, cases observed, 9 companies (18%) did not have audit committees, 5 of these 9 companies were AIM companies that do not have to comply with the Governance requirements of the Listing rules. There were therefore only 4 companies that did not meet the requirement for an audit committee. It was noted that companies with financial reporting problems were less likely to have audit committees.

Figure 28 summarises the relationship between the structure of the board and the existence of the audit committees in both populations. It was noted that:

- Control Group 1 audit committees were marginally less likely to be dominated by non-executive directors.
- Companies with financial reporting problems were marginally less likely to be dominated by executive management.

	FRP COMPANIES	Control Group 1
Executive Dominated Board	13%	25%
Non-Executive dominated Board	87%	75%

FIGURE 28 AUDIT COMMITTEE – BOARD STRUCTURE COMPARISON

4.3.2.1 Number of Audit Committee Members

The Hampel Report considered that audit committees composed of less than 3 non-executive directors might be ineffective. The Cisco Report (2000) however considers that 2 non-executive directors are sufficient in a small company. Figure 29 analyses the composition of the audit committees in the control group 1 companies and highlights that the average number of audit committee members was 2.93.

	FRP COMPANIES	CONTROL GROUP 1
Average	2.85	2.93
Median	3	3
Range	2-6	1-6

FIGURE 29 CONTROL COMPANY AUDIT COMMITTEE COMPOSITION ANALYSIS

The low average membership of the audit committee results due to the fact that a significant number of companies (16 out of 40) had audit committees composed of only 2 non-executive directors.

There did not on average appear to be notable differences in audit committee composition in both populations. Figure 30 shows an analysis of the membership by type of company.

	FRP Companies		Control Group 1	
	No.	%	No.	%
Total population	49	100	49	100
Less: CO's with no audit committee	(11)	(22)	(9)	(23)

	FRP Companies		Control Group 1	
	No.	%	No.	%
	38	78	40	77
Of which:				
	FRP Companies		Control Group 1	
	No.	%	No.	%
Less than 3 members	17	45	16	40
3 or more members	21	55	24	60
	38	100	40	100
AIM CO's with at least 2 members	4		4	
Other CO's with less than 3 members	13		12	

FIGURE 30 CONTROL COMPANY AUDIT COMMITTEE ANALYSIS

4.3.2.2 Governance Disclosures

The disclosure requirements examined in the financial statements of all companies observed were: -

- indication of an audit committee charter or terms of reference;
- indication of the number of meetings held by the audit committee;
- references to communication with an internal audit department;
- the scope of disclosure on internal controls within the financial statements; and
- the scope of the external auditors report on corporate governance.

The analysis of the financial statements of the 40 companies showed that:

- 45% i.e. 18 out of the 40 companies with audit committees had or made reference to the existence of a formal charter or terms of reference for the audit committee.
- 52% of these companies examined stated the number of audit committee meetings held. Of the companies that stated the number of meetings held, the average number

of meetings held was 2.1. A significant number of the companies - 48% did not state the number of meetings or made no reference to the number of meetings held within the financial statements.

- The extent of interaction between the audit committee and internal audit was examined. It was noted however, that only 7 of the 40 companies had internal audit departments. This result was expected, as it is not mandatory to have an internal audit department. The analysis of these seven companies highlighted that they were the companies with the largest market capitalisation of all cases observed.
- The scope of the external auditors' report on governance was considered as a measure of the interaction between the audit committee and the external auditors. In all cases examined, where relevant, the report given by the external auditors was adequate.

Figure 31 compares the governance disclosure levels in the two populations and highlights that the governance disclosures in control group 1 companies appeared to be better than those in the FRP Company population.

		FRP Companies		Control Group 1	
		NO.	%	NO.	%
Terms of Reference		9	23	18	45
No. of meetings		18	46	21	52
Internal audit department		7	18	7	18

FIGURE 31 GOVERNANCE DISCLOSURES

4.3.2.3 Member Independence

The criteria used to evaluate the independence of the non-executive directors were as follows:-

- any non-executive director who has been an executive director of the company ;
- any non-executive director who is related to an executive director; and
- any non-executive director that is a major supplier, customer, or consultant to the company.

Even though both the Cadbury and the Hampel Report required that all members of the audit committee be non-executive and a majority be independent, the audit committee of any of the companies was not considered independent if any member did not meet the above criteria.

Whilst this criteria was not in strict compliance with the provisions of the UK code (Section A.2.3), it was considered that the presence of a director not considered independent could compromise the overall effectiveness of the audit committee.

Figure 32 analyses the independence of the audit committees in the companies observed. It reveals that 21 audit committees were considered not independent. The companies were further examined to highlight any common attributes. The criteria for independence were examined. It was noted that the most common reasons for failing the independence test were: -

- the presence of a former executive director; and
- a non-executive director also acting as a consultant to the company.

The size of the companies with non-independent audit committees was examined. As expected, most of the companies were small companies with one notable exception.

It was also noted that there seemed to be little difference in the likelihood of audit committee independence when related to board structure.

	FRP Companies		Control Group 1	
PANEL A: OVERALL ANALYSIS				
	No.	%		
No. of Companies with audit committees	38	100	40	100
Independent committees	24	69	21	53

	FRP Companies		Control Group 1	
Not Independent	14	31	19	47
PANEL B: OVERALL ANALYSIS				
	Ind.	Not Ind.	Ind.	Not Ind.
No. of Companies with audit committees	24	14	21	19
Of which:				
Executive dominated boards	19	11	14	16
Non-executive dominated boards	5	3	7	3
PANEL C: ANALYSIS BY CRITERIA				
	No.	%	No.	%
Executive director	2	16	3	16
Former executive director	6	38	10	52
Related to executive director	1	8	2	11
Consultant	5	38	4	21
	14	100	19	100

FIGURE 32 CONTROL COMPANY AUDIT COMMITTEE INDEPENDENCE ANALYSIS

4.3.2.4 Competencies

The Blue Ribbon Report recommended that companies have "..Audit committee comprised of a minimum of three directors, each of whom is financially literate and.. that at least one member have accounting expertise".

The technical competencies of the directors in the 40 companies with audit committees were analysed. An audit committee was considered to be technically competent where at least one member was a member of a professional accounting body. It was noted that (82%) of audit committees were technically competent.

The financial literacy of the directors was examined. Members were considered to be financially literate if: -

- A member of a recognised professional body;
- Having banking or investment management experience; and
- Holding or having held the position of Chief Executive Officer.

The financial literacy of each audit committee member was assessed using the above criteria. The total score for each committee was found and averaged over the number of audit committee members. The audit committee was given a score based on the percentage of financially literate members. There were 17 companies that were considered to be completely financially literate. The average score was 0.74. Figure 33 summarises the differences in the competencies of audit committee members in both populations. Control companies appeared to be both more technically sound and financially literate.

	FRP Companies	Control Group 1
Technical competency	55%	82%
Average financial literacy	0.61	0.74
Technically competent & completely financially literate [no.]	6	12

FIGURE 33 COMPETENCIES COMPARISON

4.3.2.5 Additional Directorships

The number of additional directorships held by the audit committee members was assessed. It was found the average number of directorships per audit committee was 1.5.

Figure 34 highlights that control companies seemed to have on average more additional directorships than FRP companies.

	FRP COMPANIES	CONTROL GROUP 1
	No.	No.
Average	1.4	1.5
Median	1.27	1.47
Range	0-5.17	0-6

FIGURE 34 CFRP'S ADDITIONAL DIRECTORSHIPS

4.4 COMPARISON WITH CONTROL GROUP 2 COMPANIES

The control companies used in section 4.3.1 utilised but with the relevant information being extracted from current financial statements in order to see if the had been improvements in the quality of governance procedures over time.

4.4.1 Board Composition Analysis Control Group 2

The number of directors on average in the Companies with no financial reporting problems was 6.16. The average number of executive directors in these companies was 3.47 and the average number of non-executives was 2.69.

	FRP Companies			Control Group 2		
	Mean	Median	Range	Mean	Median	Range
Number of directors	6.10	6	3-14	6.16	3	3-13
No. of executive directors	3.48	3	1-7	3.47	3	1-7
No. of non-executive directors	2.61	2	0-8	2.69	2	0-8

FIGURE 35 CONTROL COMPANY BOARD COMPOSITION

This highlighted that on average most of the boards in the companies observed in both populations were still dominated by executive management.

There were 13 (9 FRP) companies in which there were more non-executive directors than executive directors. None of the control companies (2 FRP) highlighted were observed as having CEO Chair Role Duality.

4.4.1.1 *The Number of Non-Executive Directors*

The Hampel Report (1998)[4] considers that non-executive directors should constitute not less than one-third of the overall board. 38 out of the 49 companies (78%) were observed to have boards in which the non-executive directors constituted at least one-third of the overall board. Figure 36 highlighted that the number of non-executives directors in the control companies also fell short of the three considered being necessary in order for non-executives to form an effective audit committee.

	FRP Companies		Control Companies	
	No.	%	No.	%
Number of boards with <3 NED's	29	58	28	57
Of which:				
AIM Companies	10		6	
FLEDGLING Companies	18		19	
MID 250/SMALL CAP Companies	1		3	

FIGURE 36 CONTROL COMPANY BOARD ANALYSIS

Figure 36 compared company size to the number of companies that did not have an adequate number of non-executive directors. Six out of the 28 control companies with less than three non-executive directors were known to be AIM companies. Once again, this appeared to highlight that most AIM companies did not comply. However a smaller percentage of AIM companies[5] (60%) as opposed to 91% in the FRP population did not comply.

However, if the assumption that companies with less than three directors were in fact relying on the recommendations of the Cisco Report (2000), 7 out of the 49 companies (7 out of 49- FRP Companies) had less than 2 non-executive directors.

4.4.1.2 Separation of Chair and CEO Role

The data observed showed that the role of chief executive and chairman is shared by the same individual in 25% (18%-FRP Companies) of the cases examined. This was a higher percentage than that seen in the FRP population. Given data for the control companies were predominantly taken from financial statements with years-ended 1998 or later, this result was not expected.

4.4.2 Audit Committee Analysis - Control Group 2

The structure and composition of the audit committees in the control companies was analysed in order to compare their characteristics to those in companies with financial reporting problems.

Of the 49 control companies observed, cases observed, 7 companies (14%) did not have audit committees, 5 of these 7 companies were AIM companies that do not have to comply with the Governance requirements of the Listing rules. There were therefore only 2 companies that did not meet the requirement for an audit committee.

It was noted that companies with financial reporting problems were less likely to have audit committees. Figure 37 summarises the relationship between the structure of the board and the existence of the audit committees in both populations.

	FRP Companies	Control Group 2
Executive Dominated Board	13%	19%
Non-Executive dominated Board	87%	81%

FIGURE 37 AUDIT COMMITTEE – BOARD STRUCTURE COMPARISON

It was noted that:

- Control Company audit committees were marginally less likely to be dominated by non-executive directors.
- Companies with financial reporting problems were marginally less likely to be dominated by executive management.

4.4.2.1 Number of Audit Committee Members

The Hampel Report considered that audit committees composed of less than 3 non-executive directors might be ineffective. The Cisco Report (2000) however considers that 2 non-executive directors are sufficient in a small company. Figure 38 analyses the composition of the audit committees in the control companies and highlights that the average number of audit committee members was 2.51.

	FRP Companies	Control Group 2
Average Members	2.85	2.51
Median Members	3	3
Range Members	2-6	1-7

FIGURE 38 CONTROL COMPANY AUDIT COMMITTEE COMPOSITION ANALYSIS

The low average membership of the audit committee results due to the fact that a significant number of companies (18 out of 42) had audit committees composed of only 2 non-executive directors.

There did not on average appear to be notable differences in audit committee composition in both populations. Figure 39 shows an analysis of the membership by type of company.

	FRP COMPANIES		CONTROL GROUP 2	
	No.	%	No	%
Total population	49	100	49	100
Less: CO's with no audit committee	(11)	(22)	(7)	(14)
	38	78	42	86
Of which:				
Less than 3 members	17	45	18	43

	FRP COMPANIES		CONTROL GROUP 2	
3 or more members	21	55	24	57
	38	100	42	100
AIM CO's with at least 2 members	4		4	
Other CO's with less than 3 members	13		14	

FIGURE 39 CONTROL COMPANY AUDIT COMMITTEE ANALYSIS

4.4.2.2 Governance Disclosures

The disclosure requirements examined in the financial statements of all companies observed were: -

- indication of an audit committee charter or terms of reference;
- indication of the number of meetings held by the audit committee;
- references to communication with an internal audit department;
- the scope of disclosure on internal controls within the financial statements; and
- the scope of the external auditors report on corporate governance.

Analysis of the financial statements of the 42 companies revealed that:

- 45% i.e. 19 out of the 42 companies with audit committees had or made reference to the existence of a formal charter or terms of reference for the audit committee.
- 52% of these companies examined stated the number of audit committee meetings held. Of the companies that stated the number of meetings held, the average number of meetings held was 2. A significant number of the companies - 48% did not state the number of meetings or made no reference to the number of meetings held within the financial statements.
- The extent of interaction between the audit committee and internal audit was examined. It was noted however that only 8 of the 42 companies had internal audit departments. This result was expected, as it is not mandatory to have an internal audit

department. The analysis of these eight companies highlighted that they were the companies with the largest market capitalisation of all cases observed.

Figure 40 compares the governance disclosure levels in the two populations and highlights that the governance disclosures in the control companies appeared to be better than those in the FRP Company population.

	FRP Companies		Control Group 2	
	No.	%	No.	%
Terms of Reference	9	23	19	45
No. of meetings	18	46	22	52
Internal audit department	7	18	8	19

FIGURE 40 GOVERNANCE DISCLOSURES

4.4.2.3 Member Independence

The criteria used to evaluate the independence of the non-executive directors were as follows:-

- any non-executive director who has been an executive director of the company;
- any non-executive director who is related to an executive director; and
- any non-executive director that is a major supplier, customer, or consultant to the company.

Even though both the Cadbury and the Hampel Report required that all members of the audit committee be non-executive and a majority be independent, the audit committee of any of the companies was not considered independent if any member did not meet the above criteria.

Whilst this criteria was not in strict compliance with the provisions of the UK code (Section A.2.3), it was considered that the presence of a director not considered independent could compromise the overall effectiveness of the audit committee.

Figure 41 analyses the independence of the audit committees in the companies observed. It reveals that 18 audit committees were considered not independent. The companies were further examined to highlight any common attributes. The criteria for independence were examined. It was noted that the most common reasons for failing the independence test were: -

- the presence of a former executive director; and
- a non-executive director also acting as a consultant to the company.

The size of the companies with non-independent audit committees was examined. As expected, most of the companies were small companies with one notable exception.

It was also noted that there seemed to be little difference in the likelihood of audit committee independence when related to board structure.

	FRP Companies		Control Group 2	
PANEL A: OVERALL ANALYSIS				
	No.	%	No.	%
No. of Companies with audit committees	38	100	42	100
Independent committees	24	69	24	57
Not Independent	14	31	18	43
PANEL B: OVERALL ANALYSIS				
	Ind.	Not Ind.	Ind.	Not Ind.
No. of Companies with audit committees	24	14	24	18
Of which:				
Executive dominated boards	19	11	17	14
Non-executive dominated boards	5	3	7	4

	FRP Companies		Control Group 2	
PANEL A: OVERALL ANALYSIS				
	No.	%	No.	%
PANEL C: ANALYSIS BY CRITERIA				
	No.	%	No.	%
Executive director	2	16	6	33
Former executive director	6	38	6	33
Related to executive director	1	8	2	11
Consultant	5	38	4	23
	14	100	18	100

FIGURE 41 CONTROL COMPANY AUDIT COMMITTEE INDEPENDENCE ANALYSIS

4.4.2.4 Competencies

The Blue Ribbon Report recommended that companies have "..Audit committee comprised of a minimum of three directors, each of whom is financially literate and.. that at least one member have accounting expertise".

The technical competencies of the directors in the 42 companies with audit committees were analysed. An audit committee was considered to be technically competent where at least one member was a member of a professional accounting body. It was noted that (88%) of audit committees were technically competent.

The financial literacy of the directors was examined. Members were considered to be financially literate if: -

- A member of a recognised professional body;
- Having banking or investment management experience; and
- Holding or having held the position of Chief Executive Officer.

The financial literacy of each audit committee member was assessed using the above criteria. The total score for each committee was found and averaged over the number of audit committee members. The audit committee was given a score based on the percentage of financially literate members. There were 21 companies that were considered to be completely financially literate. The average score was 0.77. Figure 42 summarises the differences in the competencies of audit committee members in both populations. Control companies appeared to be more technically sound but less financially literate.

	FRP Companies	Control Group 2
Technical competency	55%	88%
Average financial literacy	0.61	0.77
Technically competent & completely financially literate	6	18

FIGURE 42 COMPETENCIES COMPARISON

4.4.2.5 Additional Directorships

The number of additional directorships held by the audit committee members was assessed. It was found the average number of directorships per audit committee was 1.78.

	FRP COMPANIES	CONTROL GROUP 2
	No.	No.
Average	1.4	1.78
Median	1.27	1.5
Range	0-5.17	0-4

FIGURE 43 CFRP'S ADDITIONAL DIRECTORSHIPS

Figure 43 highlights that control companies seemed to have on average more additional directorships than FRP companies.

4.5 Trend Analysis

The data of both the FRP population and NFRP Date matched population was further analysed to highlight if there were any trends in the data streams. The number of companies analysed by date is shown in Figure 44.

Year	No. of Companies
1995	9
1996	11
1997	17
1998	5
1999	7
Total	49

Figure 44 Analysis of Companies by date

4.5.1 Analysis of Board Composition

Analysis of the FRP population over time (see Figure 45 and Figure 46) highlighted that on average board sizes had fallen over the period. Furthermore, boards were tending to have a more equal balance between executive and non-executive directors.

The NFRP boards also appeared to falling in size but the average size of the boards in these companies were larger. There was however a difference in the balance of the board. There tended, with the exception of year 1998, o have more executives than non-executive directors.

The number of FRP boards with three non-executive directors or more was fairly constant. There were, over the period however, more NFRP boards that did not have at least three non-executive directors.

The number of boards where the CEO was also the chair was fairly constant with the exception of the year 1998 in which a significant number of boards had CEO/Chairman role duality.

The NFRP Date matched boards appeared to have fewer instances of CEO/Chairman role duality over time.

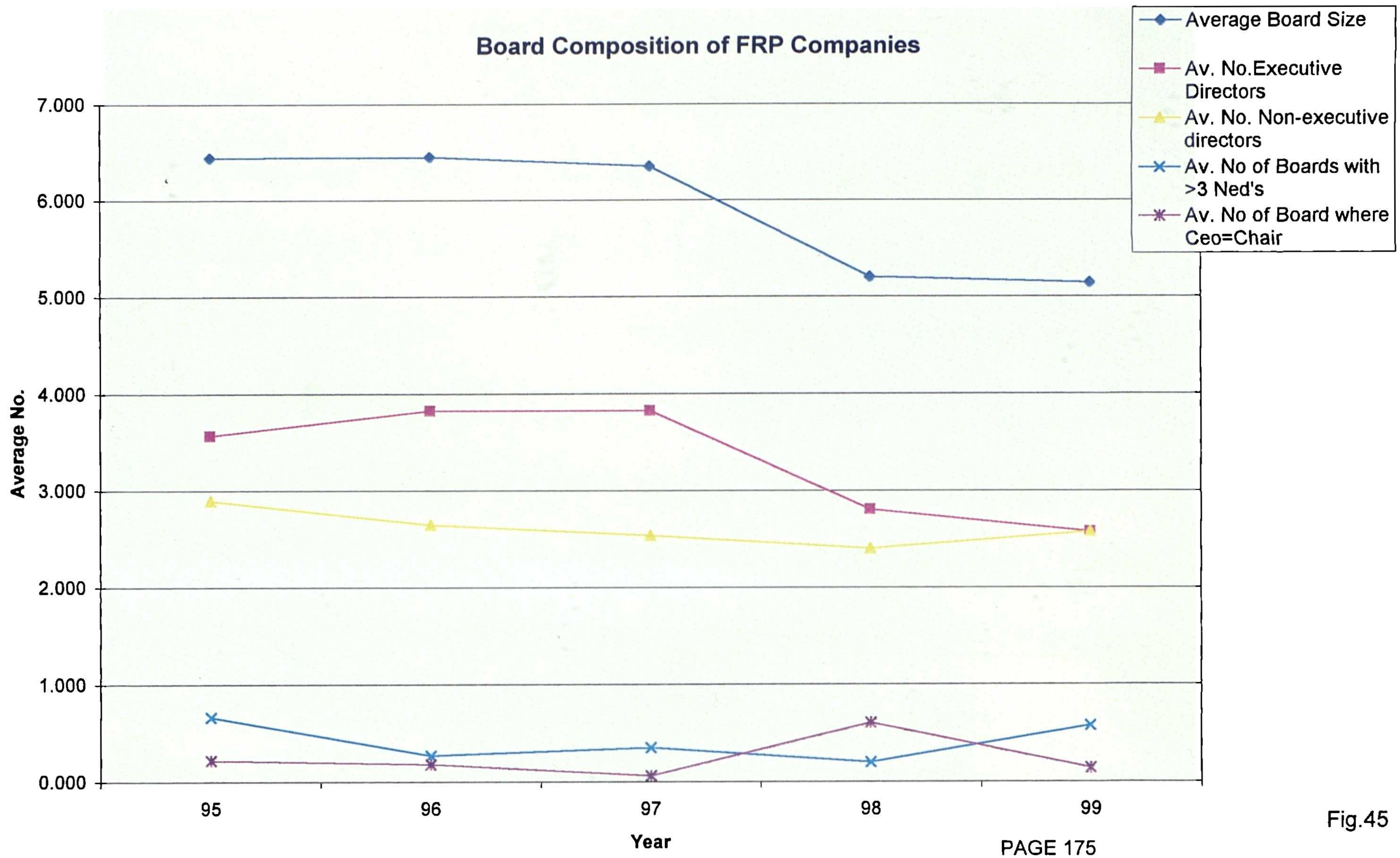

Board Composition of FRP Companies
7.000
6.000
5.000
4.000
3.000
2.000
1.000
0.000
Average No.
95
96
97
98
99
Year
Average Board Size
Av. No.Executive Directors
Av. No. Non-executive directors
Av. No of Boards with >3 Ned's
Av. No of Board where Ceo=Chair

Fig.45

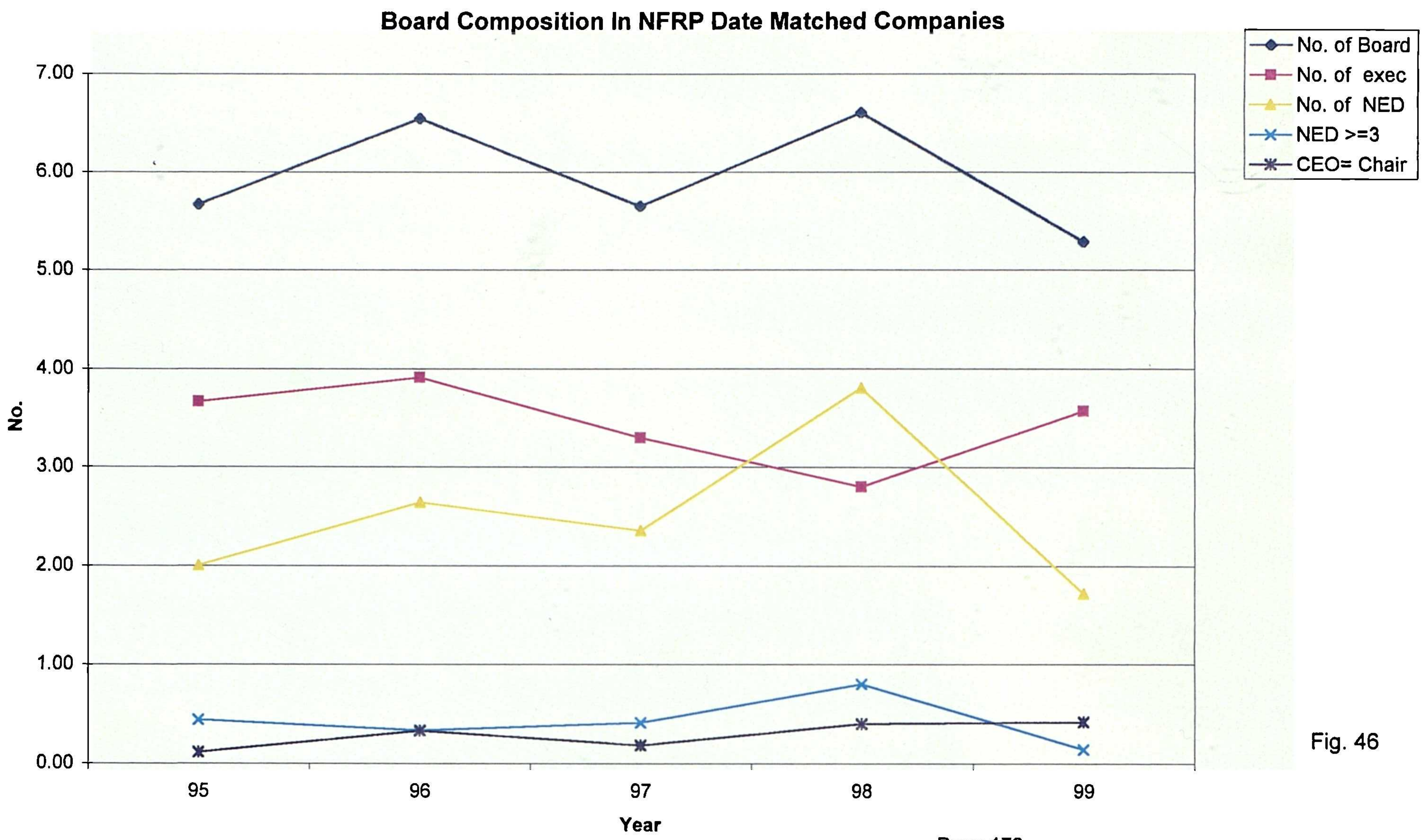

Board Composition In NFRP Date Matched Companies
7.00
6.00
5.00
4.00
3.00
2.00
1.00
0.00
No.
95
96
97
98
99
Year
No. of Board
No. of exec
No. of NED
NED >=3
CEO= Chair

Fig. 46

4.5.2 Analysis of governance disclosures

Analysis of the FRP population (see Figure 47 and Figure 48) over time highlighted that on average governance disclosures had improved over the 5-year period. Figure 47 highlighted the following:

- The number of companies disclosing the number of audit committee meetings held was rising in period (1995-1997) but appeared to decline sharply.
- The number of companies stating an appropriate internal control policy in the financial statements showed marked improvements over the period.
- The number of companies with internal control departments remained fairly constant over the period.

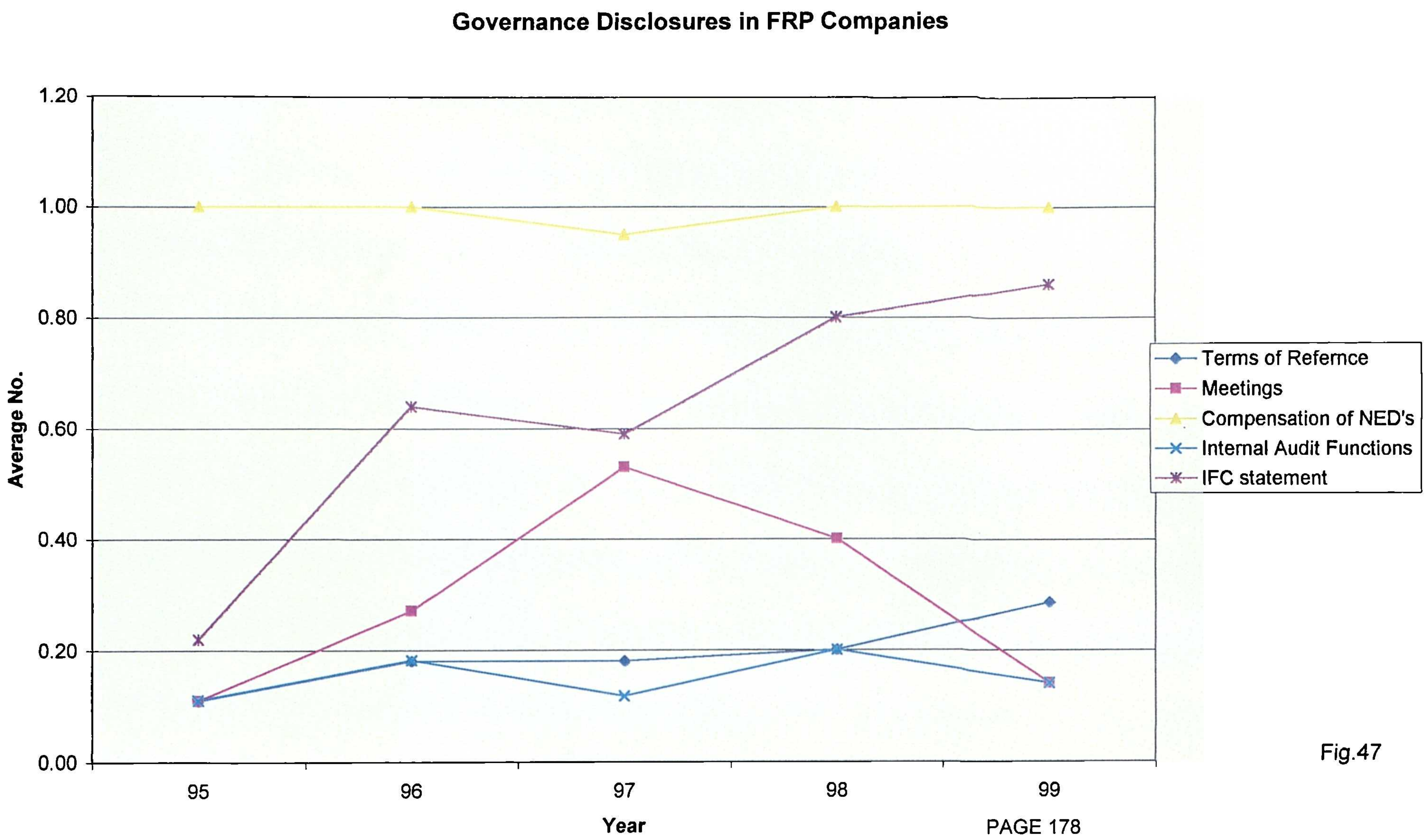
There appeared to be a small improvement in the number of companies that stated they had a terms of reference /charter for the audit committee. However, the overall number of companies making this disclosure was still low.

Figure 48 (below) highlights that the governance disclosures in the date matched control companies appeared on average to be much better than those in the FRP population.

All companies made an appropriate statement on internal controls. The number of companies disclosing the number of audit committee meetings held was rising in period. However, the overall number of companies making this disclosure was also still low.

The number of companies disclosing the existence of terms of reference/charter for the audit committee rose over the period but does not appear to be significantly better than the FRP Company experience.

The number of companies with internal control functions also remained constant over the period.



Governance Disclosures in FRP Companies
1.20
1.00
0.80
0.60
0.40
0.20
0.00
Average No.
95
96
97
98
99
Year
Terms of Refernce
Meetings
Compensation of NED's
Internal Audit Functions
IFC statement

Fig.47

Governance Disclosures In NFRP Date Matched Control Companies

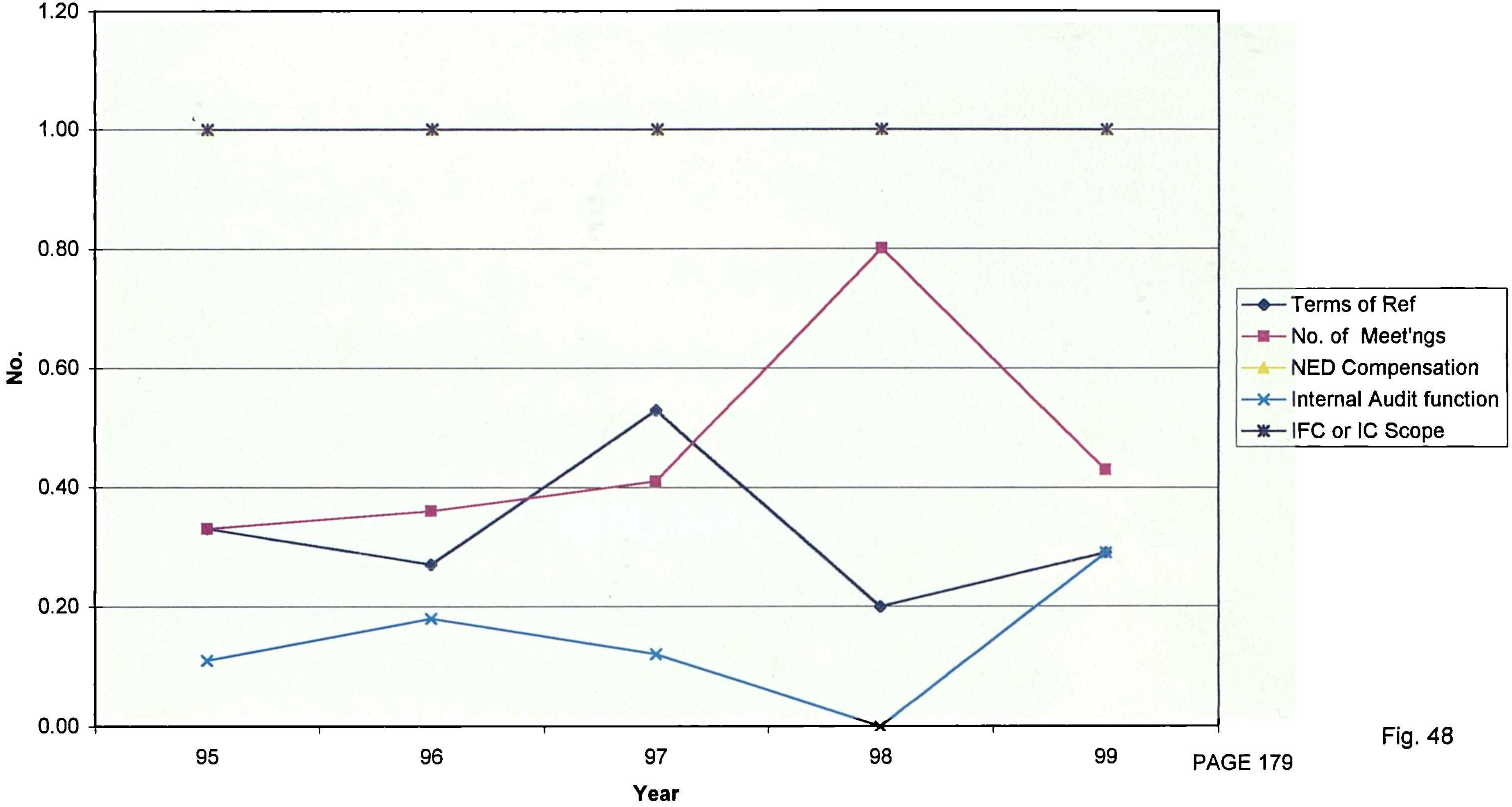


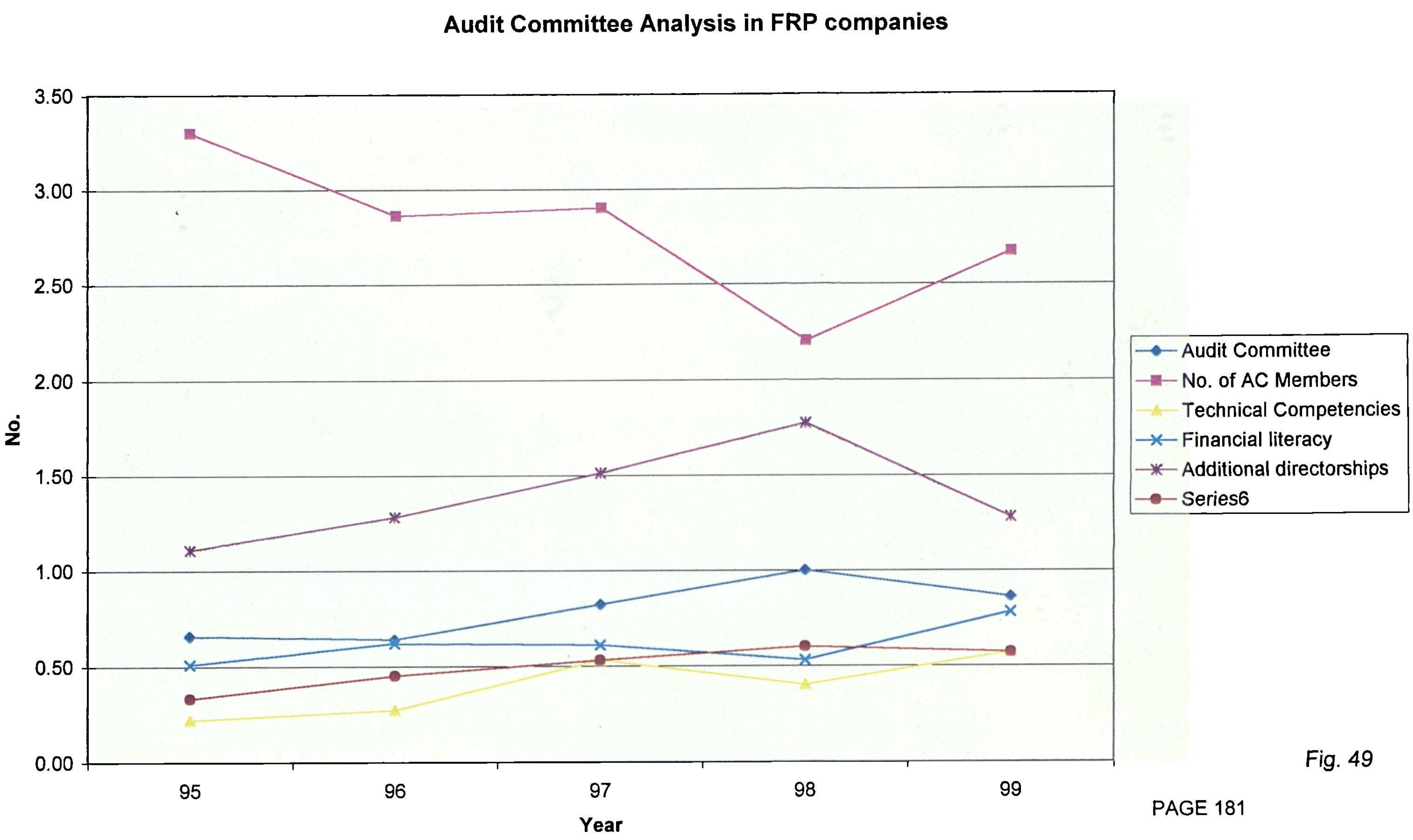
Fig. 48

4.5.3 Analysis of Audit Committees

Analysis of the populations (see Figure 49 and Figure 50) over time highlighted the following trends in the FRP and the Date matched NFRP Population:

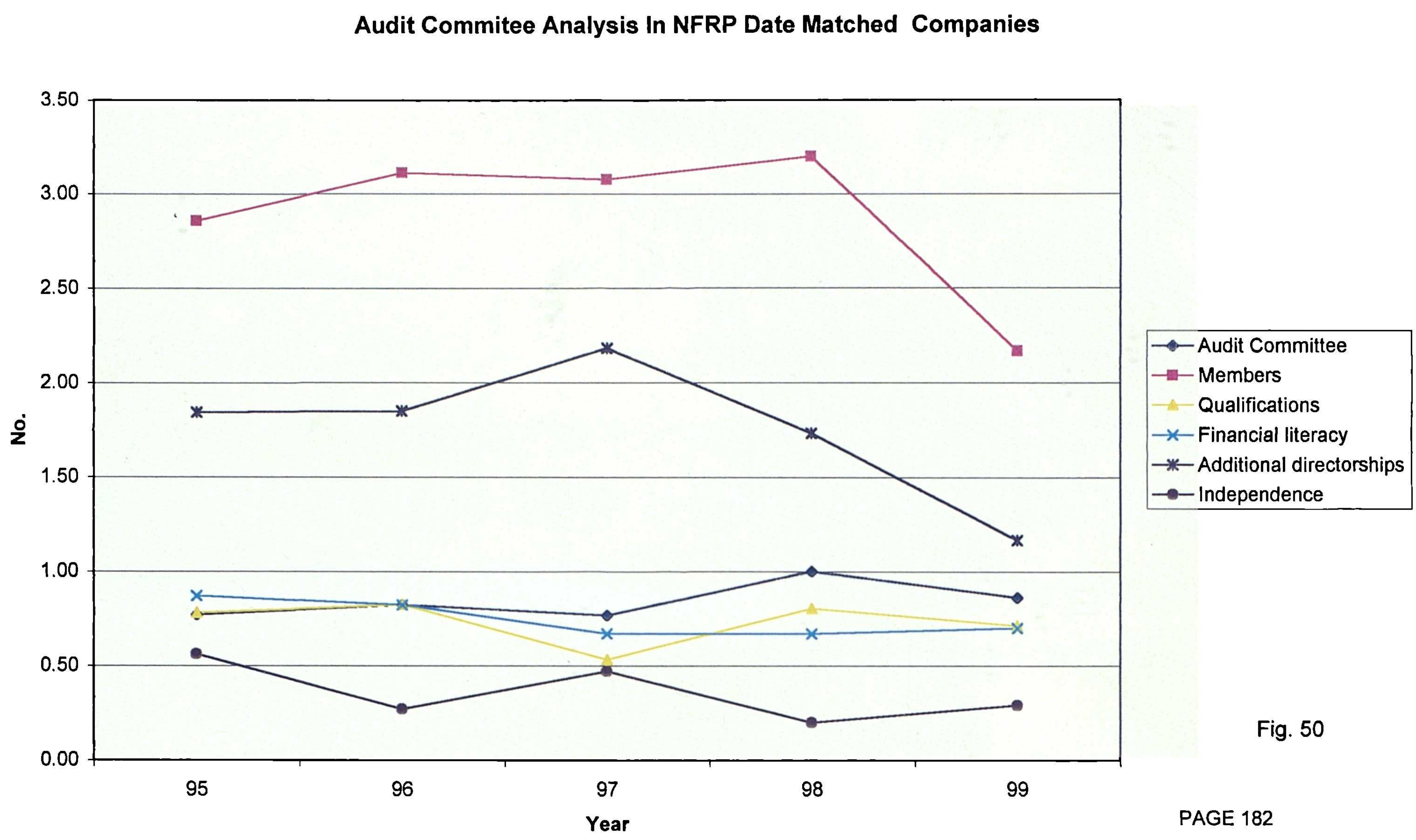
- Audit committee membership in both populations appeared to still be below the prescribed number.
- There were less additional directorships on average in the FRP population. The number of additional directorships held appeared to be declining over the five year in the NFRP population.
- Both populations highlighted that over the five-year period the number of companies with audit committees was rising.
- The financial literacy of the audit committee members in the control groups was consistently higher than that in the FRP population.
- The number of companies in each year with a technically competent member was on average on the increase and more so within the NFRP population.

There were on average more independent FRP companies in each period. On average the number of independent companies in both populations was fairly constant over the period.



Audit Committee Analysis in FRP companies
3.50
3.00
2.50
2.00
1.50
1.00
0.50
0.00
No.
95
96
97
98
99
Year
Audit Committee
No. of AC Members
Technical Competencies
Financial literacy
Additional directorships
Series6

Fig. 49



Audit Commitee Analysis In NFRP Date Matched Companies
3.50
3.00
2.50
2.00
1.50
1.00
0.50
0.00
No.
95
96
97
98
99
Year
Audit Committee
Members
Qualifications
Financial literacy
Additional directorships
Independence

Fig. 50

4.6 Summary

Previous sections have considered the main differences in the populations.

The results in most cases justify the hypothesised expectation that companies with financial reporting problems would have ineffective governance mechanisms considered to render the audit committee ineffective. Figure 51 summarises the main differences between the population groups.

The shaded areas of the table represent the variables for which an unexpected result was exhibited. Whilst these differences were unexpected, they were marginal.

	FRP COMPANIES	CONTROL GROUP 1	CONTROL GROUP 2
Board structure (Dominated by)	Executive Directors	Executive Directors	Executive Directors
NED <= 1/3 board	80%	70%	78%
Less than 3 members	58%	59%	57%
CE0 = Chair	18%	25%	25%
Audit Committee =Yes	78%	82%	86%
Audit committee < 3	45%	60%	43%
Terms of reference	23%	55%	45%
Number of meetings	46%	52%	52%
Internal audit department	18%	18%	19%

	FRP COMPANIES	CONTROL GROUP 1	CONTROL GROUP 2
Independent audit committee	69%	53%	57%
Technically competent	55%	83%	88%
Financially literate	0.61	0.74	0.77
Additional directorships	1.4	1.5	1.78

FIGURE 51 SUMMARY OF DIFFERENCES

Figure 51 highlights that with the exception of the results for C.E.O.= Chair Role duality, audit committee independence, and additional directorships, control companies appeared to have better results regardless of the year end date used.

4.7 REFERENCES

Cadbury Committee (1992) Report Of The Committee On The Financial Aspects Of Corporate Governance. (London - Gee)

Guidance for Smaller Quoted Companies – CISCO (2000)

Hampel, R. (1998). Committee On Corporate Governance. Final Report

The Blue Ribbon Report (1999) Improving the effectiveness of corporate audit committees

ENDNOTES

[1] Code provision A.3.1

[2] Given that there were only 13 AIM companies in the population

[3] Code provision A.3.1

[4] Code provision A.3.1

[5] I.e. The number of AIM companies with less than three directors compared to the overall number of AIM companies in the respective populations

CHAPTER 5: EMPIRICAL ANALYSIS

5 EMPIRICAL DATA RESULTS

5.1 INTRODUCTION

The research design of this study involves the use of both parametric and non-parametric statistical analysis due to the nature of the data collected. The estimation is based on a choice based sample in which 50% of the firms have experienced financial reporting problems and 50% have not experienced financial reporting problems.

This method was chosen in order to highlight if companies that had experienced financial reporting problem were different in terms of board composition and audit committee structure to companies of a similar size and nature.

The sample was taken from a period from 1995 to 1999. Clearly, governance disclosure requirements had been considerably amended during this period. Additional data was therefore collected on the original control group companies but from the latest available financial statements to see if disclosures had improved or declined over time.

5.2 ASSUMPTIONS

5.2.1 Data Assumptions

Siegel (1996) considers that parametric significance tests rest upon the assumptions that the data has certain characteristics. The assumptions for using parametric tests are:

- Observations are drawn from a population with a normal distribution. It is important to stress that this assumption requires that the overall population being considered normal and not necessarily the sample extracted from it.
- There is homogeneity of variance between the data a sample sets. However this assumption is not considered important given that the groups are of an equal size. Foster (1998) states that parametric tests are still valid where the variance of one

group is double that of the other. Where parametric testing has been used, there have been no significant differences in the variances of the appropriate data sets.

- The data is measured on an interval or ratio scale. All data in this study to be tested using parametric tests have been measured on a ratio scale.

Non-parametric tests have been used to examine the data sets that do not meet these assumptions.

5.2.2 Variables

Eleven variables for each group of data were identified. These are shown in detail Figure 52.

	Variable Name	Data	Measurement
1	IMB	Ratio	The percentage of non-executive directors to total board in each company.
2	CEO	Ordinal	A dummy variable given a value of 0 if C.E.O. = Chair otherwise 1.
3	AC	Ordinal	A dummy variable given a value of 1 if there is an audit committee otherwise 0.
4	TREF	Ordinal	A dummy variable given a value of 1 if the existence of an audit committee charter or terms of reference is disclosed or otherwise 0
5	IA	Ordinal	A dummy variable given a value of 1 if there is an internal audit department or otherwise 0.
6	MEET	Ratio	The number of disclosed audit committee meetings.
7	ACMEM	Ratio	The number of audit committee members
8	QUAL	Ordinal	A dummy variable given a value of 1 if there is a technically qualified audit committee member or otherwise 0.

	Variable Name	Data	Measurement
9	FLIT	Ratio	The percentages of financially literate audit committee members for each company.
10	DIR	Ratio	Average number of additional directorships held by audit committee members.
11	IND	Ordinal	A dummy variable given a value of 1 if the audit committee is considered independent or otherwise 0.

FIGURE 52 VARIABLE ANALYSIS

The hypotheses were all formulated so as to achieve one main goal i.e. to see if board, and audit committee structure and composition differed between the problem cases and the control group. On that basis, statistical tests of difference were employed. In the cases of rank data Paired Sample T-Tests (parametric test) were used. Where ordinal data had been collected, the Wilcoxon Test (non-parametric test) was used.

5.2.3 Significance levels

If it is considered that there is a real difference between the groups when in fact there is not with an alpha level of 5%, it is likely to make a type 1 error. Testing at an alpha level of 1% reduces the likelihood of a type 1 error but however increases the chances of a type II error which states that we consider there to be a difference when no difference exists. Appendices pages 264 and 277 respectively summarise the results of the statistical testing using an alpha level of 1%.

5.2.4 Directional Testing

We have considered that the control group should perform better that the problem cases and thus it is relevant to use directional significance testing. The data is tested using SPSS version 9. This software assumes a two-sided (i.e. a non-directional test). Where this is not the case, it is appropriate to divide the results by two in order to find the true significance of the test.

5.3 RESULTS

Statistical tests of significance were used to analyse the differences between:

- The FRP companies and the date matched companies (control group 1). These tests were conducted to highlight if there were any significant differences in corporate governance disclosures when comparing the above stated groups.
- The FRP companies and the 1999-year end date-matched companies (control group 2). Given that governance disclosure requirements had improved during the period under examination, it was relevant to see if there were any statistically significant differences between these groups.

5.3.1 Empirical results Control Group 1

5.3.1.1 Hypothesis 1- Control Group 1

Hypothesis 1 considered companies with financial reporting problems are more likely to have ineffective boards. Boards were considered ineffective where non-executives directors constituted less than one-third of the overall board.

	FRP Companies	Control Group 1
No. of companies	49	49
NED > one-third of board	39/49	34/49

FIGURE 53 BOARD COMPOSITION

Figure 53 highlighted that non-executive directors were more likely to constitute more than one-third of the overall board in FRP companies than in control group 1. Whilst this pattern of results was not in the expected direction, the difference was not statistically significant (p =0.74) see appendices page 253.

5.3.1.2 Hypothesis 2- Control Group 1

Hypothesis 2 considered companies with financial reporting problems are more likely to have boards where the same person held the positions of chairman and chief executive officer.

More control group companies (see Figure 54) were seen to have CEO role duality as compared to the FRP companies. This result whilst not significant (p=0.47) see appendices page 254 was not in the predicted direction.

	FRP Companies	Control Group 1
No. companies	49	49
CEO = Chair	8	12
CEO ≠ Chair	41	37

FIGURE 54 ROLE DUALITY

5.3.1.3 Hypothesis 3- Control Group 1

Hypothesis 3 considered companies with financial reporting problems are less likely to have audit committees. It is possible to measure audit committee effectiveness indirectly if it is considered that the absence of financial reporting problems indicates an effective audit committee. The analysis of the FRP group of companies and control group 1 was expected to highlight that companies with no financial reporting problems were more likely to have audit committee. Figure 55 highlights this positive trend which while expected was not considered statistically significant (p= 0.62) see appendices page 258.

	FRP Companies	Control Group 1
No. of companies	49	49
No. co.'s with audit committees	38	40
% co.'s with audit committees	78%	82%

FIGURE 55 AUDIT COMMITTEE

The Hampel Report (1998) considered that audit committees composed of less than three non-executive directors might be ineffective.

5.3.1.4 Hypothesis 4- Control Group 1

Hypothesis 4 stated that companies with financial reporting problems are more likely to have audit committees with an inadequate number of non-executive directors.

Figure 56 highlights that the control group had more companies in which there were greater than or equal to three non-executive director members. Furthermore, the control groups had fewer companies in which there were less than three members.

This result see appendices page 259 was expected but the differences whilst positive were not significant (p= 0.31) statistically.

	FRP Companies	Control Group 1
No. of companies	49	49
No. with audit committees	38	40
<3 members	45%	40%
>3 members	55%	60%

FIGURE 56 AUDIT COMMITTEE MEMBER COMPOSITION

Cadbury Report (1992) and the Hampel Report (1998) both required that all members of the audit committee be non-executive and independent to be effective. The audit committee of any of the companies was not considered independent if any member did not meet the criteria.

5.3.1.5 Hypothesis 5- Control Group 1

Hypothesis 5 stated that companies with financial reporting problems are more likely to have audit committees with poor governance procedures. The governance disclosures chosen were these considered more likely to influence the ability of the audit committee to be effective.

The financial statements of the FRP companies and control group 1 were therefore examined for: -

- the existence of an audit committee charter or terms of reference;
- the number of meetings held annually by the audit committee; and
- the existence of an internal audit department.

In all cases the control group appeared to have better governance procedures than the FRP companies with the exception of the existence of an internal audit department.

The differences between the FRP companies and the control companies (see Figure 57) were in the expected direction but were not considered statistically significant.

	FRP Companies	Control Group 1	P	Page Ref.:
Terms of reference	23%	45%	1.00	255
Meetings	46%	52%	0.39	256
Internal audit	18%	18%	1.00	257

FIGURE 57 GOVERNANCE DISCLOSURES

5.3.1.6 Hypothesis 6- Control Group 1

Hypothesis 6 therefore considered companies with financial reporting problems are more likely to have audit committees that are not considered independent. Figure 58 highlighted that this was not case. This result see appendices page 262 was not expected but was not significantly (p= 0.48) significant.

	FRP Companies	Control Group 1
No. companies	49	49
No. with audit committees	38	40

	FRP Companies	Control Group 1
Independent committees	26	21
% independent	69%	53%

FIGURE 58 AUDIT COMMITTEE INDEPENDENCE

The Blue Ribbon Report (1999) recommended that companies have "..Audit committee comprised of a minimum of three directors, each of whom is financially literate and.. that at least one member have accounting expertise". The competencies of the directors in the companies with audit committees were analysed.

5.3.1.7 Hypothesis 7- Control Group 1

Hypothesis 7 stated that companies with financial reporting problems are more likely to have audit committees with fewer financially literate members. The analysis of data reflected the predicted result pattern as Figure 59 shows that control group1 had a higher proportion of financially literate directors. This result see appendices page 261(p = 0.03) was statistically significant.

5.3.1.8 Hypothesis 8- Control Group 1

Hypothesis 8 stated that companies with financial reporting problems are more likely to have audit committees with no technically competent members.

The analysis of data reflected the predicted result pattern as Figure 59 shows that control group 1 had a higher proportion of technically competent members. This result, in the predicted direction, was statistically (p=0.03) significant –see appendices page 260.

	FRP Companies	Control Group 1
No. companies	49	49
No. with audit committees	38	40
% of Tech. Competent members	55%	82%

	FRP Companies	Control Group 1
Average financial literacy	0.61	0.74

FIGURE 59 COMPETENCIES

5.3.1.9 Hypothesis 9- Control Group 1

Hypothesis 9 stated that companies with financial reporting problems are more likely to have audit committees members who hold additional directorships. Figure 60 highlights that on average the non-executive directors in control group 1 held more additional directorships as compared to the FRP group of companies.

This result was not in the predicted direction and as unexpected. However the difference - see appendices page 263 -was not considered to be statistically significant (p= 0.20).

	FRP Companies	Control Group 1
No. companies	49	49
No. with audit committees	38	40
Average Additional directorships	1.4	1.5

FIGURE 60 ADDITIONAL DIRECTORSHIPS

5.3.2 Empirical Results Control Group 2

5.3.2.1 Hypothesis 1- Control Group 2

Hypothesis 1 considered companies with financial reporting problems are more likely to have ineffective boards. Boards were considered ineffective where non-executives directors constituted less than one-third of the overall board. Figure 61 highlighted that non-executive directors were more likely to constitute more than one-third of the overall board in FRP companies than in control group 2. Whilst this pattern of results was not in the expected direction, the difference –see appendices page 266 was not statistically significant (p = 0.52).

	FRP Companies	Control Group 2
No. of Companies	49	49
NED > one-third of board	39/49	38/49

FIGURE 61 BOARD COMPOSITION

5.3.2.2 Hypothesis 2- Control Group 2

Hypothesis 2 considered companies with financial reporting problems are more likely to have boards where the same person held the positions of chairman and chief executive officer.

More Control group 2 companies (see Figure 62 were seen to have CEO role duality as compared to the FRP companies. This result- see appendices page 267 -whilst not significant (p= 0.59) was not in the predicted direction.

	FRP Companies	Control Group 2
No. companies	49	49
CEO = Chair	8	12
CEO ≠ Chair	41	37

FIGURE 62 ROLE DUALITY

5.3.2.3 Hypothesis 3- Control Group 2

Hypothesis 3 considered companies with financial reporting problems are less likely to have audit committees. It is possible to measure audit committee effectiveness indirectly if it is considered that the absence of financial reporting problems indicates an effective audit committee.

The analysis of the FRP group of companies and control group 2 was expected to highlight that companies with no financial reporting problems were more likely to have audit committee. Figure 63 highlights this positive trend which while expected was not considered statistically significant (p= 0.29) – see appendices page 271.

	FRP Companies	Control Group 2
No. of companies	49	49
No. co.'s with audit committees	38	42
% co.'s with audit committees	78%	86%

FIGURE 63 AUDIT COMMITTEE

The Hampel Report (1998) considered that audit committees composed of less than three non-executive directors might be ineffective.

5.3.2.4 Hypothesis 4- Control Group 2

Hypothesis 4 stated that companies with financial reporting problems are more likely to have audit committees with an inadequate number of non-executive directors. Figure 64 highlights that control group 2 had more companies in which there were greater than or equal to three non-executive director members. Furthermore, control group 2 had fewer companies in which there were less than three members. This result (see appendices page 272) was expected but the differences whilst positive were not significant (p=0.47) statistically.

	FRP Companies	Control Group 2
No. with audit committees	38	42
<3 members	45%	43%
>3 members	55%	57%

FIGURE 64 AUDIT COMMITTEE MEMBER COMPOSITION

The Cadbury Report (1992) and the Hampel Report (1998) both required that all members of the audit committee be non-executive and independent to be effective. The audit committee of any of the companies was not considered independent if any member did not meet the criteria.

5.3.2.5 *Hypothesis 5- Control Group 2*

Hypothesis 5 stated that companies with financial reporting problems are more likely to have audit committees with poor governance procedures.

The governance disclosures chosen were these considered more likely to influence the ability of the audit committee to be effective. The financial statements of the FRP companies and control group 2 were therefore examined for: -

- the existence of an audit committee charter or terms of reference;
- the number of meetings held annually by the audit committee; and
- the existence of an internal audit department.

In all cases control group 2 appeared to have better governance procedures than the FRP companies. The differences between the FRP companies and the control companies (see Figure 65) were in the expected direction but were not considered statistically significant.

	FRP Companies	Control Group 2	P	Page Ref.
Terms of reference	23%	45%	0.052	268
Meetings	46%	52%	0.288	269
Internal audit	18%	19%	0.74	270

FIGURE 65 GOVERNANCE DISCLOSURES

5.3.2.6 *Hypothesis 6- Control Group 2*

Hypothesis 6 therefore considered companies with financial reporting problems are more likely to have audit committees that are not considered independent. Figure 66 highlighted that this was not case. This result (see appendices page 273) was not expected but was not statistically (p=1.00) significant.

	FRP Companies	Control Group 2
No. companies	49	49
No. with audit committees	38	42
Independent committees	26	24
% independent	69%	57%

FIGURE 66 AUDIT COMMITTEE INDEPENDENCE

The Blue Ribbon Report (1999) recommended that companies have "..Audit committee comprised of a minimum of three directors, each of whom is financially literate and.. that at least one member have accounting expertise". The competencies of the directors in the companies with audit committees were analysed.

5.3.2.7 Hypothesis 7- Control Group 2

Hypothesis 7 stated that companies with financial reporting problems are more likely to have audit committees with fewer financially literate members. The analysis of data reflected the predicted result pattern as Figure 67 shows that control group 2 have a higher proportion of financially literate directors. This result (p=0.03) was statistically significant – see appendices page 274.

5.3.2.8 Hypothesis 8- Control Group 2

Hypothesis 8 stated that companies with financial reporting problems are more likely to have audit committees with no technically competent members. The analysis of data reflected the predicted pattern as Figure 67 shows that control group 2 have a higher proportion of technically competent members. This result (see appendices page 275) was statistically (p=0.01) significant.

	FRP Companies	Control Group 2
No. companies	49	49
No. with audit committees	38	42

	FRP Companies	Control Group 2
% of Tech. competent members	55%	88%
Average financial literacy	0.61	0.77

FIGURE 67 COMPETENCIES

5.3.2.9 *Hypothesis 9- Control Group 2*

The number of additional directorships held by the non-executive directors was considered to influence the amount of time available to them to devote to their duties on the audit committee and thus therefore impinge on the effectiveness of the audit committee. Hypothesis 9 stated that companies with financial reporting problems are more likely to have audit committees members who hold additional directorships.

Figure 60 highlights that on average the non-executive directors in control group companies held more additional directorships as compared to the FRP group of companies.

This result was not in the predicted direction and as unexpected. However the difference was not considered to be statistically (see appendices page 276) different (p=0.29).

	FRP Companies	Control Group 2
No. companies	49	49
No. with audit committees	38	42
Average Additional directorships	1.4	1.78

FIGURE 68 ADDITIONAL DIRECTORSHIPS

5.3.3 Summary

The descriptive analysis of the data showed some data trends that highlighted the predicted differences between companies with financial reporting problems and the control groups. The statistical analysis however disputes this fact (except in the case of hypotheses 7 and 8) as there were no statistically significant differences found. I.e. the differences found originated through chance as opposed to there being a real difference between the problem company data and the control group data. Figure 69 highlights the hypotheses tested and shows whether they were accepted (due to statistically significant differences being found in the predicted direction) or rejected.

	HYPOTHESIS DESCRIPTION	DECISION	
		CONTROL GROUP 1	CONTROL GROUP 2
1	Companies with financial reporting problems are more likely to have ineffective boards. I.e. where NED's are deemed to be ineffective in that they constitute less than 1/3 of the total board.	REJECT	REJECT
2	Companies with financial reporting problems are more likely to have ineffective boards I.e. where there is CEO Chair role duality	REJECT	REJECT
3	Companies with financial reporting problems are less likely to have audit committees.	REJECT	REJECT
4	Companies with financial reporting problems are more likely to have audit committees with less than three NED's.	REJECT	REJECT
5	Companies with financial reporting problems are more likely to have audit committees with poor governance procedures.	REJECT	REJECT
6	Companies with financial reporting problems are more likely to have audit committees that are not considered independent.	REJECT	REJECT

	HYPOTHESIS DESCRIPTION	DECISION	
		CONTROL GROUP 1	CONTROL GROUP 2
7	Companies with financial reporting problems are more likely to have audit committees with fewer financially literate members	ACCEPT	ACCEPT
8	Companies with financial reporting problems are more likely to have audit committees with no technically competent members.	ACCEPT	ACCEPT
9	Companies with financial reporting problems are more likely to have audit committees members who hold additional directorships.	REJECT	REJECT

FIGURE 69 HYPOTHESIS SUMMARY

Figure 69 highlighted that a majority of the hypotheses were rejected. Additional tests[1] were therefore conducted to examine if there was a likelihood of there being significant differences using a confidence level of 99% (Alpha =1%).

Figure 87 (appendices page 265) highlighted that there were no statistically significant differences (except in the case of hypotheses 7 and 8) found between FRP data and control group 1 data using an alpha level of 1%. Figure 99 -see appendices page 278 (except in the case of hypotheses 7 and 8) highlighted that there were no statistical differences found between FRP data and control group 2 data using an alpha level of 1%.

5.3.4 Interviews

The rejection of a majority of the hypotheses had serious implications for the validity of this study. It was important to establish if these unexpected results were a reflection of the true state of corporate governance affairs in UK companies.

The characteristics of firms' subject to an adverse ruling by the FRRP were considered by Peasnell et al (2000). the governance characteristics examined within their study of these firms (i.e. board size, CEO role Duality, audit committee existence) as compared to a control sample were largely indistinguishable. This to some extent validates the results in this thesis.

It was therefore decided to conduct interviews to see if directors' opinions concurred with the results of the study. It was considered that if directors' opinions concurred with the results of the study, the results could therefore be considered as evidence that audit committee effectiveness in terms of the financial reporting monitoring role was not influenced by the current governance recommendations designed to ensure their effectiveness.

5.3.4.1 Hypothesis 1

The directors were asked if they agreed with hypothesis 1 which stated that:

Companies with financial reporting problems are more likely to have ineffective boards. I.e. where non-executive directors are deemed to be ineffective in that they constitute less than 1/3 of the total board.

Most directors noted that the number of non-executive directors on the board was important but considered that 2 non-executive directors were sufficient. A board imbalance that resulted because there were only 2 non-executive directors was not considered important.

It was interesting to note that most of the directors who felt that only 2 non-executive directors were sufficient and that board imbalance was not an issue in these circumstances were directors in board that had these characteristics. A certain amount of bias was therefore evident.

In order to further explain this result, additional analysis of the companies was undertaken. It was found that most of the companies where non-executive directors constituted less than 1/3 of the overall board could be classified "small" companies in line with the CISCO Report (2000).

There appeared to be a relationship between the size of the company and the number of non-executive directors on the board. This study did however not control for company size as current governance recommendations do not distinguish listed companies based on the size.

Most directors noted that the size of the board and the percentage of non-executive directors therein were not the most important factors. They all considered that the personal reputation and experience of the members were more important factors determining the board effectiveness.

No statistically significant differences were found in the balance of the board between the FRP population and the control groups. Directors' opinions emphasise that board balance was not a crucial factor.

If company size is considered to influence the number of non-executive directors and board balance, it follows that significant differences between FRP and control groups where these companies are of a similar size should not exist.

The companies examined within this study were predominantly "small companies" and thus may explain why no statistically significant differences were found in the composition of the board between the FRP population and the control groups.

5.3.4.2 Hypothesis 2

The directors were asked if they concurred with the following hypothesis:

Companies with financial reporting problems are more likely to have ineffective boards I.e. where the same person holds the role of the chairman and chief executive officer.

The directors were asked to comment on whether they agreed with this hypothesis. Whilst most considered that the separation of the roles did prevent dominance and protect accountability, they all noted that:

- There was no real basis for the premise as many successful companies had combined the roles in the past.
- The separation of the roles did not preclude the dominance of the chief executive officer or chairman. A significant number of respondents considered that the role of the chairman to be a figurehead position and thus the combination or separation of the roles did not change the dominant position of the chief executive officer. In many cases, these directors felt the combination of the roles to be cost-effective.

It was interesting to note that the directors who felt that role separation was unimportant were all from small companies and a certain amount of bias might therefore exist. Once gain, directors were of the opinion that the incidence of role separation was influenced by the size of the company. It can be assumed that, given the predominance of smaller companies within the population, no statistical differences should exist.

Role separation is considered important for all companies regardless of size. Current governance recommendations stress this fact. The CISCO Report (2000) also highlights the importance of this separation of these roles for small companies.

This study therefore highlights that in respect of audit committee effectiveness, the separation of the role of the chairman and chief executive officer is not important.

Hypothesis 1 and 2 have considered certain board governance mechanisms and examined to see if they are associated with the incidence of financial reporting problems (used as a proxy to measure audit committee ineffectiveness). No positive associations are found. The opinions of the directors go some way to explaining this result.

5.3.4.3 Hypothesis 3

The directors were asked to comment on whether they agreed with hypothesis 3, which stated that:

Companies with financial reporting problems are less likely to have audit committees.

The results of this study showed no statistically significant differences between audit committee existence between the population groups. This result was not in the predicted direction.

Most directors considered that the audit committee was necessary. They all however qualified this opinion by stating that only an effective audit committee could prove useful. They all agreed that the quality most required by any audit committee to be effective was member experience.

The size of the companies included in the population was once again a factor. A significant number of AIM companies were included within the populations and that these companies do not have to comply with corporate governance listing requirements. This may have contributed to why the result was not statistically significant.

This result does however confirm the recent empirical studies on US companies. Beasley (2000) noted the importance of audit committee structure and composition as opposed to the mere existence of an audit committee.

5.3.4.4 Hypothesis 4

Companies with financial reporting problems are more likely to have audit committees with less than three non-executive directors.

The directors were asked to comment on whether they agreed with this hypothesis. Most directors noted that the number of non-executive directors on the audit committee was important but considered that 2 non-executive directors were sufficient. It was interesting to note that most of the directors who felt that only 2 non-executive directors were sufficient were directors in boards that had these characteristics. A certain amount of bias was therefore evident.

Most respondents felt that the personal reputation and experience of the members were more important factors determining audit committee effectiveness.

It follows that if overall board size and board balance is influenced by company size, the number of non-executive directors on the audit committee must be also be directly affected. Directors' opinions on company size explains why no statistically significant differences were found in the composition of the audit committee in terms of size between the FRP population and the control groups.

5.3.4.5 Hypothesis 5

Companies with financial reporting problems are more likely to have audit committees with poor governance procedures.

All respondents considered that an unstructured audit committee (in respect of a charter or terms of reference) was undisciplined and therefore in most cases ineffective. Some directors however considered that the size and nature of the company determined the extent to which disclosures were made within the financial statements.

Furthermore, it was noted that a significant number of AIM companies were included within the populations and that these companies do not have to comply with corporate governance listing requirements. The result of the study, which found no statistically significant differences in the governance procedures of audit committees of FRP companies as compared to the control groups, was understandable.

With regards to other specific governance procedures considered in this study, the following opinions were noted:

- Two meetings per year were considered to be a sufficient number of meetings. The descriptive analysis highlighted that this was the average number of meetings held regardless of population. The size and nature of most companies in either of the groups resulted in the audit committees activities in respect of the financial reporting monitoring role being confined to the review of the financial statements prior to overall board approval. This was evidenced during the financial statement review of all the companies in population during the data analysis stage of this study. This concentration of audit committee activities around the external audit process does not require a great number of meetings explains why most companies only held 2 audit committee meetings annually. This therefore explained why there were no statistically significant differences between the populations.

- The internal audit department whilst useful was not necessary. Furthermore, most directors felt that the size of their respective companies precluded the need for an internal audit department. This therefore explained why there were no statistically significant between the populations.

5.3.4.6 *Hypothesis 6*

Companies with financial reporting problems are more likely to have audit committees that are not considered independent.

The study found that whilst no statistically significant differences in audit committee independence of the FRP companies and control groups were found, the descriptive analysis highlighted that that more FRP companies audit committees were considered independence as compared to the control groups.

This result was unexpected. The directors interviewed were asked their opinion on the importance of audit committee independence. All directors considered the independence of non-executive directors to be important. They however commented on the criteria used to determine independence.

They noted that the nomination process could compromise the independence of the non-executive director. I.e. where non-executive directors who met the criteria used in the study but had other connections to the executive directors. They all noted that this was possible but agreed that it would be impossible to lay down prescriptive guidelines on independence that covered all potential scenarios. It was for that reason that they mostly all concluded that the competency of the non-executive director was important.

It was clear that the result of the study was contrary to the opinions of directors interviewed. Other reasons therefore needed to be found to explain this variation. Empirical studies (e.g. Dechow, 1996; Beasley, 2000) have all found independence to be a factor strongly associated with audit committee effectiveness. There was therefore no reason to assume that the hypothesised prediction was incorrect.

The analysis of audit committee independence was based on the assumption that all directors were considered to be independent unless information disputing this assumption was available. The review of the financial statements during the data analysis stage of this thesis revealed that the quality of corporate governance disclosures in the financial statements of FRP companies was poor.

It must therefore be considered that directors in FRP companies assumed independent were not. The lack of statistically significant differences may to some extent be attributable to poor financial statement disclosures.

5.3.4.7 Hypothesis 7

Companies with financial reporting problems are more likely to have audit committees with fewer financially literate members.

The study found statistically significant differences in the financial literacy of audit committee members in the control groups as compared to FRP companies.

All directors considered the financial literacy of non-executive directors to be important. The result shown in the statistical analysis was considered justified.

5.3.4.8 Hypothesis 8

Companies with financial reporting problems are more likely to have audit committees with no technically competent members.

The study found statistically significant differences in the technical competency of audit committee members in the control groups as compared to FRP companies.

All directors considered the technical competence of non-executive directors to be important. The result shown in the statistical analysis was considered justified.

5.3.4.9 Hypothesis 9

Companies with financial reporting problems are more likely to have audit committees members who hold additional directorships.

Most directors agreed that the number of non-executive directorships held compromised the abilities of non-executive directors. They however considered that the number of directorship held was dependent on the personal circumstances of the director.

Some directors considered 3 additional directorships to be the maximum amount of directorships to be held and this was reflected in the analysis of directorships in sections 4.3.2.5 and 4.4.2.5.

Given that there is no guidance or legislation on this issue, the result highlighting the lack of significant significance is understandable.

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ENDNOTES

[1] Parametric tests Only

CHAPTER 6: CONCLUSIONS

6 Conclusion and Future Research Opportunities

6.1 Conclusion

There has been considerable emphasis placed on corporate governance structures as an aid to improving long term performance of the organisation. Most of the recent developments in UK corporate governance have focused on board structure and composition and board committees.

The role played by independent non-executive directors on the board continues to be a prominent feature of corporate governance. In recent years, increasing attention has been paid to audit committees by both regulatory authorities and academics. SEC, the National Commission on Fraudulent Financial Reporting (1987) and the Kirk Panel (1994) state that the audit committee is an important element in corporate governance and instrumental in ensuring the quality of financial reporting.

Academic research examines the relation between audit committee characteristics and aggressive reporting (DeFond and Jiambalvo 1991; Dechow et al. 1996), the incidence of fraud (Beasley 1996; McMullen 1996) and other firm characteristics. Most studies consider that a positive relationship exists between the existence of an audit committee and the quality of financial reporting.

The activities of the audit committee in terms of financial reporting were examined. Most of the studies to date have been limited to the study of US companies and to considering if the existence of an audit committee improved the quality of financial reporting. Since most UK Listed companies now have audit committees, these studies are therefore of limited value.

It was therefore decided that the focus of this thesis would be limited to the financial reporting role of the audit committee and consider the extent to which the composition and structure of the audit committee (i.e. the governance structure) was associated with the ability of the audit committee to fulfil this role effectively.

It is reasonable to assume that an audit committee may be considered effective where it achieves its stated roles. The audit committee is not required to report to the shareholders within the financial statements on the extent to which they have achieved their roles. Thus, actual audit committee effectiveness cannot be externally observed.

It is possible to measure audit committee effectiveness indirectly if it is considered that the absence of financial reporting problems indicates an audit committee has been effective in achieving their financial reporting oversight role.

It is important to note that the absence of a financial reporting problem may not always be indicative of an effective audit committee. This thesis however highlights that the presence of financial reporting problems is associated with audit committee ineffectiveness.

Financial reporting is the term used to cover all the reports of a financial nature that are issued to external users by a company. The financial statements are the most important areas of financial reporting and thus this thesis focuses on the financial reporting problems evidenced within the financial statements.

Financial reporting problems within financial statements may range from inadequate disclosure to corporate failure. It would be inappropriate to consider that the audit committee effective or otherwise would be in a position to prevent corporate failure. That is not the role of the audit committee. The audit committee should review the financial statements to ensure that they reflect the true state of affairs of the company. The audit committee is considered ineffective where the non-disclosure of financial reporting problems was evidenced.

The main objective of this study is to consider if governance structures are positively associated with financial reporting and disclosure. It was therefore hypothesised that companies with financial reporting problems would be more likely to have poor governance structures. I.e. Ineffective audit committees should have ineffective governance structures.

The study collated data on 49 companies that were considered to have financial reporting problems. A control group of similar companies with no financial reporting problems was also collated. The governance structures of these boards were analysed using the variables defined in chapter 4.

This study found positive associations between audit committee effectiveness and the financial literacy and technical competence of non-executive directors. These were found to be the only areas where there were significant statistical differences found when comparing the FRP population and the control group populations. No other statistically significant differences were evidenced. This was clearly not as predicted.

Peasnell et al (2000) considered the characteristics of firms subject to an adverse ruling by the FRRP. They noted that the governance characteristics of these firms (i.e. board size, CEO role Duality, audit committee existence) as compared to a control sample were largely indistinguishable. This to some extent validates the results in this thesis.

Based on these results and the opinions of directors in interviews, certain conclusions may be drawn from this result:

The emphasis on audit committee structure may be inappropriate. The results of this study highlight the need for focus on the quality of members on the committee.

There were significant statistical differences found between the competencies of the non-executive directors. The current UK recommendations do not contain clear guidelines on the competencies of non-executive directors. There is a need to consider if the guidelines on non-executive competencies detailed in the Blue Ribbon Report (1999) should be included in UK recommendations.

It may be argued that the size of the sample precludes this conclusion. It is still contended that the sizes of these samples form an adequate basis to conclude that the focus on composition and structure of the board in the smaller listed companies may be inappropriate. It is perhaps necessary to consider if governance requirements should be tailored to the needs of smaller companies. The CISCO Report (2000) considers that governance requirements in the Stock Exchange Listing Rules should be tailored towards the needs of the smaller listed companies. The opinions of directors interviewed concur with this need.

The people who are responsible for governance in the company determine the quality of governance. Regardless of the need to focus on quality, the absence of basic structures must still be rectified so that audit committees and boards operate within a disciplined framework. This study highlights the need for improvements in the governance framework of smaller companies.

6.2 OPPORTUNITIES FOR FUTURE RESEARCH

Corporate governance, in terms of both accountability and enterprise, involves complex interrelated mechanisms. As yet research (particularly in the UK) into the extent of the relationships between the various governance mechanisms is extremely limited. Further research is required into the interdependence these mechanisms.

Both the Hampel Report and the Cadbury Report stressed the need to apply recommendations regarding board structure, etc., flexibly. It is however unclear whether merely complying with the recommendations will improve accountability.

Research evidence gained from the study of US companies suggests that there is a relationship between governance mechanisms and accountability. It is not clear that these findings may be appropriate in the UK context as there are a number of significant differences between the two countries with respect to:-

- the balance of non-executive to executive directors in board structures; and
- the separation of the role of chairman and chief executive officer.

Given these differences, it is possible that US research findings are not directly appropriate to UK companies. There are a number of key research questions which research could usefully investigate:

The relationship between audit committee governance structures and firm performance.

There is some evidence from the US that audit committee formation is positively associated with improvements to quality of the firms accounting earnings. Further research may include an investigation as to whether the audit committee is perceived to add value to the business in the long-term and whether the quality of audit committee members would affect this perception.

The relationship between audit committee effectiveness and external auditing.

One of the key functions of the audit committee is to act as an interface between the external auditors and the board of directors. Furthermore, the external auditors can provide an objective report on internal financial controls to the audit committee. Research evidence from the USA indicates that audit committees are perceived as effective by external auditors in the area of financial reporting where they are considered to have technical experience. Research may therefore consider an attitudinal survey of external auditor perceptions of the audit committee effectiveness, the adequacy of member qualifications and the extent to which any negative perceptions may be filled by training.

The relationship between audit committee effectiveness and internal audit.

One of the key functions of the audit committee is to act as an interface between the internal auditors and the board of directors. Research evidence from the USA and Canada indicates that the composition of the audit committee influences the extent of interaction between the audit committee and internal audit. Further research may therefore investigate whether this relationship exists in UK companies.

Future research may also consider:

- An attitudinal survey of directors' perceptions of audit committee effectiveness and the extent to which they consider that the governance mechanisms used in this thesis are effective.
- A replication of this thesis using a different proxy for audit committee effectiveness. This would result in a different population of companies to be analysed using the same governance mechanisms employed in this thesis. This study would therefore further investigate the results evidenced in this thesis.
- This thesis considered the adequacy of governance structures in the financial year in which the problem was evidenced. Given that the problem might have existed in prior years, it was necessary to consider if governance mechanisms of the audit committee in the year the problem was evidenced were the same in the year the problem actually occurred. A longitudinal study of governance mechanisms in companies with financial reporting problems would highlight if this time lapse exists.

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APPENDICES

8 APPENDICES

INTRINSIC INFLUENCES

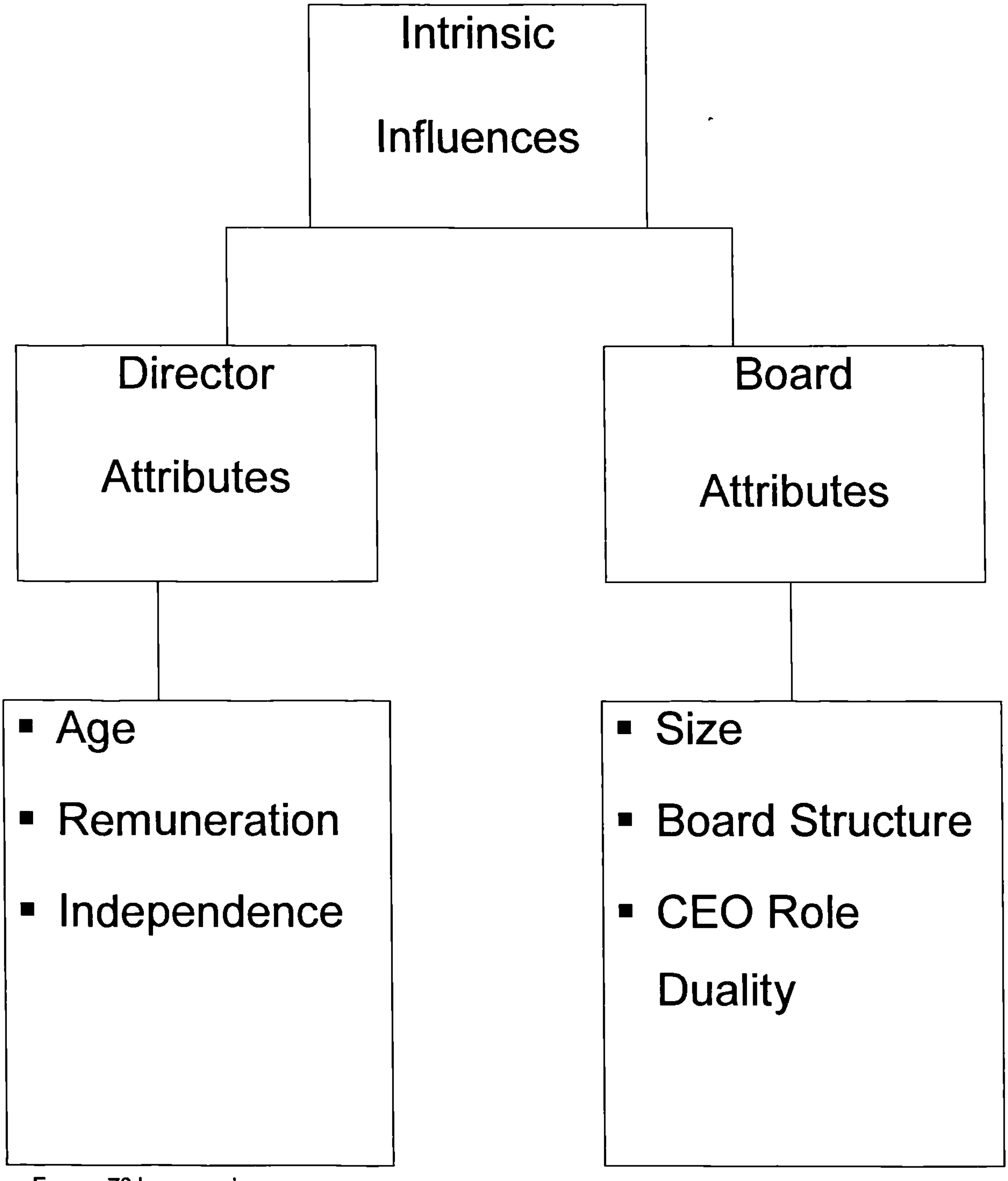

FIGURE 70 INTRINSIC INFLUENCES ON BOARD EFFECTIVENESS

EXTRINSIC INFLUENCES

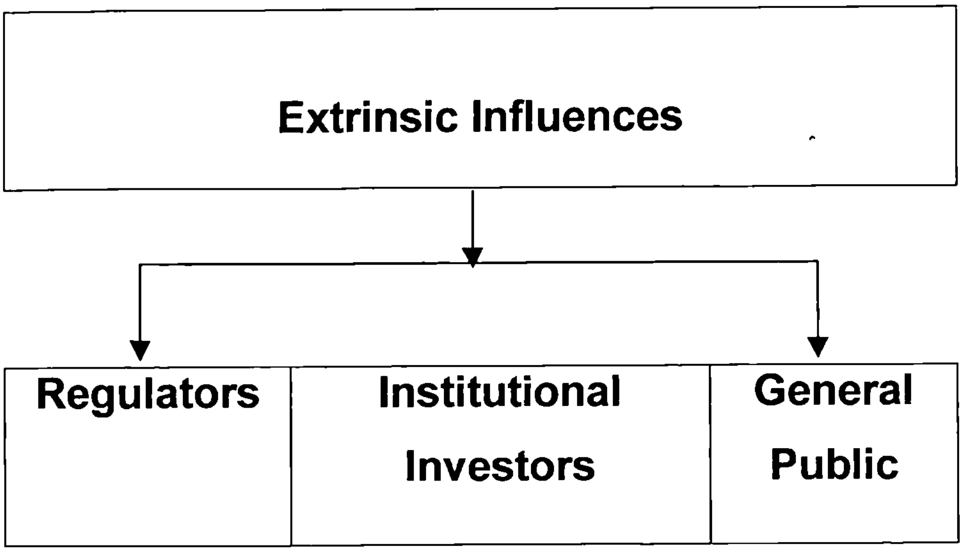

FIGURE 71 EXTRINSIC INFLUENCES ON BOARD EFFECTIVENESS

	Control Companies 1999 DATE	No. of Board	No. of exec	No. of NED	NED >=3	CEO= Chair	Bal	Audit Comm	Terms of Ref	No of Meet'ngs	Comp'n	IA Dept	IFC or IC Scope	Ext Audit on CG	No of AC Mem.s	Qual	Fin Lit	Add Dir Ave.	Indep
								✓ ✗	✓ ✗		✓ ✗	✓ ✗	✓ ✗	✓ ✗					
1	Aram Resources Plc	7	3	4	YES	NO	57%	NO	N/A	N/A	YES	NO	IFC	NO	N/A	N/A	N/A	N/A	N/A
8	Bulgin	5	3	2	NO	NO	40%	YES	YES	2	YES	YES	IFC	YES	2	YES	1 00%	0.50	YES
10	Bullough	6	2	4	YES	NO	67%	YES	N/S	N/S	YES	NO	IFC	YES	5	YES	0 60%	3.40	YES
16	RPC	10	6	4	YES	NO	40%	YES	N/S	2	YES	NO	IFC	YES	4	YES	1 00%	2.00	YES
20	Black (Peter) Holdings Plc	7	4	3	YES	NO	43%	YES	YES	2	YES	YES	IFC	YES	3	YES	1.00%	2.33	NO
23	Reece Plc	3	1	2	NO	NO	67%	YES	YES	2	YES	NO	IFC	YES	2	YES	1.00%	1.50	YES
32	StYESle Holdings Plc	8	5	3	YES	NO	38%	YES	N/S	N/S	YES	NO	IFC	YES	3	YES	1.00%	1.00	YES
39	MICE	5	3	2	NO	YES	40%	YES	YES	N/S	YES	NO	IFC	YES	3	YES	0.67%	1.00	NO
40	Carisbrooke shipping	6	3	3	YES	NO	50%	YES	N/S	N/S	YES	NO	IFC	YES	3	YES	0.33%	0.67	YES
2	Brancote Holdings	5	3	2	NO	NO	40%	YES	N/S	N/S	YES	NO	IFC	YES	2	YES	0 50%	1.50	YES
17	Lowe (RH)	4	2	2	NO	NO	50%	YES	N/S	2	YES	NO	IFC	YES	2	YES	0.50%	3.50	YES
18	Glenmorangie	9	4	5	YES	NO	56%	YES	N/S	2	YES	YES	IFC	YES	5	YES	1.00%	3.00	NO
19	Black Arrow	6	4	2	NO	NO	33%	YES	YES	2	YES	NO	IFC	YES	2	YES	1.00%	1.50	NO
21	Tepnel Life Sciences	5	4	1	NO	YES	20%	YES	YES	N/S	YES	NO	IFC	YES	1	YES	1.00%	2.00	NO
24	AbbeYEScrest	9	7	2	NO	YES	22%	YES	N/S	N/S	YES	NO	IFC	YES	7	YES	1.00%	1.29	NO
25	BS Group Plc	6	3	3	YES	NO	50%	YES	N/S	N/S	YES	NO	IFC	YES	3	YES	1.00%	1.67	NO
29	Multimedia	4	2	2	NO	NO	50%	NO	N/A	N/A	YES	NO	IFC	YES	N/A	N/A	N/A	N/A	N/A
33	Partridge Fine Arts	8	6	2	NO	YES	25%	YES	N/S	N/S	YES	NO	IFC	YES	2	YES	1.00%	0.00	YES
42	Tom Hoskins Plc	5	3	2	NO	NO	40%	YES	N S	N/S	YES	YES	IFC	YES	2	YES	1 00%	3.00	YES
43	CGU	13	5	8	YES	NO	62%	YES	YES	4	YES	NO	IFC	YES	3	YES	0 67%	1.67	YES
3	Firestone Diamonds AVOCET MINING	7	2	5	YES	NO	71%	YES	N/S	2	YES	NO	IFC	YES	4	YES	0 75%	3.25	YES
4	Chieftain	4	3	1	NO	NO	25%	NO	N/A	N/A	YES	NO	IFC	YES	N/A	N/A	N/A	N/A	N/A
5	Utilitec	5	3	2	NO	NO	40%	YES	YES	N/S	YES	NO	IFC	YES	2	NO	0 00%	3.00	YES
6	Latham james	7	6	1	NO	NO	14%	YES	YES	3	YES	NO	IFC	YES	3	YES	0 67%	2.67	NO
7	Whitecroft UNIDARE	5	2	3	YES	NO	60%	YES	YES	N/S	YES	NO	IFC	YES	3	YES	0.67%	5.33	YES
11	Gooch & Housego	7	5	2	NO	NO	29%	YES	N S	2	YES	NO	IFC	YES	2	YES	1 00%	1.00	YES
12	Cirqual	5	3	2	NO	YES	40%	YES	N S	N/S	YES	NO	IFC	YES	2	YES	1 00%	0 50	YES
13	Locker	6	4	2	NO	NO	33%	YES	YES	2	YES	NO	IFC	YES	3	NO	1 00%	1 00	NO
22	Sanderson Bramall group	8	6	2	NO	YES	25%	NO	N A	N/A	YES	NO	IFC	YES	N/A	N/A	N/A	N/A	N/A
26	Nottingham Forest Plc	5	2	3	YES	NO	60%	NO	N A	N/A	YES	NO	IFC	YES	N/A	N/A	N/A	N/A	N/A
27	Digital animations Plc	4	4	0	NO	NO	0%	NO	N/A	N/A	YES	NO	IFC	YES	N/A	N/A	N/A	N/A	N/A
28	Zetters Plc	6	4	2	NO	NO	33%	YES	N S	N/S	YES	NO	IFC	YES	6	NO	0 50%	1 33	NO
30	Pearson Plc	10	5	5	YES	NO	50%	YES	YES	N/S	YES	YES	IFC	YES	3	NO	1 00%	3 33	YES
31	Jacques Vert	5	3	2	NO	YES	40%	YES	YES	1	YES	NO	IFC	YES	2	YES	0 40%	1 50	YES
38	Ricardo Group	6	3	3	YES	NO	50%	YES	YES	2	YES	YES	IFC	YES	3	YES	1 00%	1 50	YES
44	Creston Plc	7	2	5	YES	NO	71%	YES	YES	2	YES	NO	IFC	YES	2	YES	1 00%	1 67	YES
46	Rodime	4	1	3	YES	NO	75	YES	YES	N/S	YES	NO	IFC	YES	3	YES	0 67%	1 33	NO
14	Eleco	4	2	2	NO	YES	50%	YES	YES	2	YES	NO	IFC	YES	2	NO	1 00%	2 00	NO
15	Bridport	6	3	3	YES	YES	50%	YES	N/S	2	YES	NO	IFC	YES	3	YES	0 67%	4 00	NO
35	QS Group PLc	9	4	5	YES	NO	56%	YES	N S	N S	YES	NO	IFC	YES	4	YES	0 50%	1.00	NO
36	Forminster Plc	7	3	4	YES	NO	57%	YES	N S	2	YES	NO	IFC	YES	4	YES	0 50%	0 00	NO
45	CNC Properties	7	2	5	YES	NO	71%	YES	N S	2	YES	NO	IFC	YES	5	YES	0 67%	1 67	YES
9	Dewhurst Plc	6	5	1	NO	NO	17%	YES	N S	n/s	YES	YES	IFC	YES	2	YES	1 00%	1 00	NO
37	Wilmington Group Plc	6	5	1	NO	NO	17	YES	N S	2	YES	NO	IFC	YES	2	NO	1 00%	1 50	YES
47	QualitYES Software Holdings Plc	5	3	2	NO	NO	40%	YES	YES	2	YES	NO	IFC	YES	2	YES	0 50%	2.00	YES
48	Radiant Metal Finish	4	2	2	NO	YES	50%	YES	YES	2	YES	NO	IFC	YES	2	YES	0 50%	0.00	NO
49	Equator Group	6	3	3	YES	YES	50%	NO	N/A	N/A	YES	NO	IFC	YES	N/A	N/A	N/A	N/A	N/A
50	EurocopYES plc	7	5	2	NO	NO	29%	YES	N/S	N/S	YES	NO	IFC	YES	2	YES	0 50%	0.50	YES
51	Shaw (Arthur) Plc	3	2	1	NO	YES	33%	YES	N/S	N/S	YES	YES	IFC	YES	3	YES	0 67%	2.00	NO

FIGURE 72 EXCEL SHEETS CONTROL GROUP 2

		Year end	No of Board NO	No of exec di ect'rs	No of non exec directrs	Ba anced/ Unbal Board %	CEO= Char ✓ ✗	No NED 3 ✓ ✗	Audit Comm ✓ ✗	Terms of Ref ✓ ✗	No of Meetngs	omp n NOT ✓ ✗	A Dept ✓ ✗	FC or IC Scope ✓ ✗	Ext Aud t on CG ✓ ✗	No of AC Mem 6	Qual	Fin lt	Add Dr
1	Butle M n ng P c	95	6	4	2	0 333	YES	no	YES	NO	0	YES	NO	N/S	NO	3	NO	0 3300	0 33
8	W akebourne P c	95	4	2	2	0 50	NO	no	YES	NO	N/S	YES	NO	FC	YES	2	NO	0 5000	1 50
10	Ransomes P c	95	6	4	2	0 333	NO	no	NO	N/A	N/A	YES	NO	N/S	NO	N/A	N/A	N/A	N/A
16	Fe guson Holdings nternational P c	95	9	5	4	0 444	NO	yes	YES	NO	N/S	YES	NO	N/S	NO	3	NO	0 6670	1 33
20	Reck tt & Coman P c	95	9	6	3	0 333	NO	yes	YES	N/S	N/S	YES	YES	FC	YES	3	y	0 3300	1 33
23	Heritage Plc	95	5	3	2	0 400	YES	no	NO	N/A	N/A	YES	NO	N/S	NO	N/A	N/A	N/A	N/A
32	A exon G oup Plc	95	4	2	2	0 500	NO	no	YES	N/S	N/S	YES	NO	N/S	NO	2	y	0 5000	1 00
39	V rtue ly Group P c	95	7	5	2	0 286	NO	no	NO	N/A	N/A	YES	NO	N/S	NO	N/A	N/A	N/A	N/A
40	Sutton Harbour ho d ngs Plc	95	8	1	7	0 875	NO	yes	YES	YES	N/S	YES	NO	N/S	NO	7	y	0 7100	1 20
			6 44	3 56	2 89	NE=1 ED=8	Yes 2/9	bal=6/9	6/9	1 9	0/9	A	1/9	2/9	2/9	3 3	2/9	0 506	1 117
2	NSM Plc	96	6	3	3	0 500	NO	yes	YES	NO	N/S	YES	NO	FC	YES	3	y	0 67	1 67
17	Secu ty & gene al media Plc SER F PLC	96	5	3	2	0 400	NO	n	YES	NO	N/S	YES	YES	IFC	YES	3	y	0 67	0 00
18	Burns Stewart D st le s Plc	96	6	4	2	0 333	NO	no	YES	YES	2	YES	NO	IFC	YES	2	NO	0 00	1 00
19	De aney Group	96	3	1	2	0 667	YES	no	NO	N/A	N/A	YES	NO	N/S	NO	N/A	N/A	N/A	N/A
21	Assoc ated Nursing Services Plc	96	4	4	0	0 000	NO	no	NO	N/A	N/A	YES	NO	N/S	NO	N/A	N/A	N/A	N/A
24	Hamlet Group Plc	96	9	5	4	0 444	NO	yes	YES	N/S	2	YES	NO	IFC	YES	4	NO	0 75	0 80
25	Crown Products G oup P c	96	4	3	1	0 250	YES	no	YES	N/S	N/S	YES	N	IFC	NO	2	NO	1 00	1 50
29	F rst nformat on Group P c	96	8	5	3	0 375	NO	yes	NO	N A	N/A	YES	NO	N/S	NO	N/A	N/A	N/A	N/A
33	Essex Furn turePlc	96	7	5	2	0 286	NO	no	YES	N S	2	YES	NO	FC	YES	2	y	0 50	1 50
42	Greenh s P c	96	5	3	2	0 400	NO	no	NO	N/A	N/A	YES	NO	N/S	NO	N/A	N/A	N/A	N/A
43	Guard an Royal exchange P c	96	14	6	8	0 571	NO	yes	YES	YES	N S	YES	YES	IFC	YES	4	NO	0 75	2 50
			6 45	3 82	2 64	NE 2 ED	Y=2/11	BAL=3 11	7/11	2/11	3/11	A	02 Nov	7/11	6 11	2 86	3/11	0 62	1 28
3	Rackwood M nera s Ho d ngs Plc	97	6	4	2	0 333	NO	no	YES	NO	N/S	YES	NO	IFC	YES	2	NO	0 5000	0 50
4	Campbe & Armstrong P c	97	5	3	2	0 400	NO	no	YES	NO	2	YES	NO	FC	NO	2	NO	0 5000	2 00
5	Ut ity Cab e Plc	97	7	5	2	0 286	NO	no	YES	NO	2	YES	NO	IFC	NO	2	NO	0 5000	3 00
6	Dr ngs of Bath	97	4	4	0	0 000	NO	no	NO	N A	N/A	YES	NO	N/S	NO	N/A	N/A	N A	N/A
7	Strategen group Plc	97	5	3	2	0 400	YES	no	YES	NO	2	YES	NO	IFC	YES	2	y	0 5000	0 00
11	Prospect ndustries Plc	97	8	3	5	0 625	NO	yes	YES	NO	2	YES	NO	IFC	NO	3	y	0 3300	0 00
12	Concentr c P c	97	6	3	3	0 500	NO	yes	YES	NO	2	YES	NO	FC	YES	3	NO	0 3300	0 67
13	Mack e nternat onal Group Plc	97	6	3	3	0 500	NO	yes	YES	N	N/S	YES	NO	IFC	YES	3	y	0 3300	1 33
22	Car Group Plc	97	7	3	4	0 571	NO	yes	YES	YES	2	YES	NO	IFC	YES	4	y	0 7500	1 00
26	Brent W a ker Group	97	7	5	2	0 286	NO	no	NO	n a	n/a	YES	NO	N/S	NO	N/A	N/A	N/A	N/A
27	ABI Leisure Group P c	97	5	4	1	0 200	NO	no	YES	N S	N/S	YES	NO	FC	YES	2	y	1 0000	1 00
28	Tr ng nt group P c	97	5	3	2	0 400	NO	no	YES	YES	N/S	YES	NO	FC	YES	2	y	1 0000	1 50
30	Reuters Holdings P c	97	13	6	7	0 538	NO	yes	YES	N S	2	YES	YES	IFC	YES	6	y	1 0000	5 17
31	Reve ation P ccad y Hold ngs Plc	97	5	3	2	0 400	NO	no	YES	YES	2	NO	NO	IFC	YES	3	y	0 6670	3 00
38	Photo-me nternat ona P c	97	12	7	5	0 417	NO	yes	YES	N S	2	YES	YES	FC	YES	4	NO	0 5000	1 00
44	Deves DY) Plc	97	4	4	0	0 000	NO	no	NO	n a	n/a	YES	NO	N/S	NO	N/A	N/A	N/A	N/A
46	Scottswood Industries P c	97	3	2	1	0 333	NO	no	YES	N S	N S	YES	NO	FC	NO	3	y	0 67	1 00
			6 35	3 82	2 53	ne=3 ed=14	y=1 17	y 6 17	14 17	17	9 17	16 17	2/17	14/17	10/17	2 9265714	9/17	0 61	1 5119
14	So vera P c	98	4	2	2	0 500	YES	no	YES	NO	3	YES	NO	FC	YES	2	NO	0 50	3 50
15	A M Group P c	98	7	5	2	0 286	YES	no	YES	YES	N/S	YES	NO	IFC	YES	2	y	0 50	0 50
35	Cadoro Plc	98	4	2	2	0 500	NO	no	YE	N S	2	YES	NO	IFC	YES	2	NO	0 00	2 50
36	Dawn t l dusk Hold ngs P c	98	5	3	2	0 400	NO	no	YES	N S	N S	YES	NO	N/S	NO	2	NO	1 00	1 00
45	Property Partnersh p P c	98	6	2	4	0 667	YES	yes	YES	N S	N S	YES	YES	IFC	YES	3	y	0 67	1 33
			5 2	2 8	2 4	e 1 ed 4	y=3 5	y 1	y 5 5	y 1	2 5	a	1/5	4/5	4/5	2 2	2 5	0 533	1 767
9	CREOS Internat ona group	99	5	2	3	0 600	NO	yes	YES	N	1	YES	NO	IFC	YES	3	y	1 00	0 00
37	Photob t on Plc	99	5	3	2	0 400	YES	no	YES	N S	N/S	YES	YES	FC	YES	2	NO	1 00	2 50
47	RMS Commun cat ons Plc	99	8	4	4	0 500	NO	yes	YES	YES	N/S	YES	NO	FC	YES	3	NO	0 33	2 00
48	B am P c	99	3	2	1	0 333	NO	no	NO	N A	N/A	YES	NO	N S	NO	N/A	N/A	N/A	N/A
49	Peral el P ctures Group	99	6	3	3	0 500	NO	yes	YES	YES	N S	YES	NO	IFC	YES	3	y	1 00	0 67
50	Total Off ce Group P c	99	4	2	2	0 500	NO	no	YES	N S	N/S	YES	NO	IFC	YES	2	y	1 00	1 50
51	Fu Circ e Industries	99	5	2	3	0 600	NO	yes	YES	N S	2	YES	NO	FC	YES	3	y	0 33	1 00
			5 1429	2 5714286	2 57142857	ne 2 ed=7	y=1 7	y 4 7	y=6 7	y 2/7	1 7	A	1 7	6/7	6 7	2 67	4/7	0 78	1 28
																		0 61	

FIGURE 73 EXCEL SHEET FRP GROUP

Control Group 1	Year end	No of Board	No of exec	No of NED	NED >=3	CEO= Chair	Bal	Audit Comm ✓ X	Terms of Ref ✓ X	No of Meet'ngs	Comp'n ✓ X	IA Dept ✓ X	IFC or IC Scope ✓ X	Ext Audit on CG ✓ X	No of AC Mem s	Qual	Fin Lit	Add Dir Ave
1 Bisichi Mining Plc	95	5	3	2	NO	NO	40%	YES	N/S	N/S	YES	NO	IFC	YES	2	YES	1 00000	1 50
8 Bulgin	95	5	5	0	NO	NO	0%	NO	N/A	N/A	YES	NO	IFC	YES	N/A	N/A	N/A	N/A
10 Bulough	95	6	2	4	YES	NO	67%	YES	N/S	N/S	YES	NO	IFC	YES	5	YES	0 60000	3 40
16 RPC	95	7	4	3	YES	NO	43%	YES	N/S	2	YES	NO	IFC	YES	3	YES	1 00000	1 67
20 Black (Peter) Holdings Plc	95	7	5	2	NO	NO	29%	YES	YES	2	YES	YES	IFC	YES	2	YES	1 00000	2 50
23 Reece Plc	95	5	2	3	YES	NO	60%	YES	YES	2	YES	NO	IFC	YES	3	YES	1 00000	1 33
32 StYESle Holdings Plc	95	8	5	3	YES	NO	38%	YES	N/S	N/S	YES	NO	IFC	YES	3	YES	1 00000	1 00
39 MICE	95	4	3	1	NO	YES	25%	YES	YES	N/S	YES	NO	IFC	YES	2	YES	0 50000	1 50
40 Air Partner Plc	95	4	4	0	NO	NO	0%	NO	N/A	N/A	YES	NO	IFC	YES	N/A	N/A	N/A	N/A
		5 67	3 667	2 00	4/9	1/9	ne=2 ED=7	7/9	3/9	3/9	ALL	1/9	9/9	9/9	2 86	7/9	0 87	1 84
2 Brancote Holdings	96	5	3	2	NO	NO	40%	NO	N/A	N/A	YES	NO	IFC	YES	N/A	N/A	N/A	N/A
17 Lowe (RH)	96	4	2	2	NO	NO	50%	YES	N/S	2	YES	NO	IFC	YES	2	YES	0 50000	3 50
18 Glenmorangie	96	9	5	4	YES	NO	44%	YES	N/S	2	YES	YES	IFC	YES	4	YES	1 00000	2 00
19 Black Arrow	96	8	6	2	NO	NO	25%	YES	YES	2	YES	NO	IFC	YES	2	YES	0 50000	1 50
21 Tepnel Life Sciences	96	5	4	1	NO	YES	20%	YES	YES	N/S	YES	NO	IFC	YES	1	YES	1 00000	2 00
24 AbbeYEScrest	96	6	4	2	NO	YES	33%	YES	N/S	N/S	YES	NO	IFC	YES	6	YES	0 66700	1 50
25 BS Group Plc	96	6	3	3	YES	NO	50%	YES	N/S	N/S	YES	NO	IFC	YES	3	YES	1 00000	1 67
29 Multimedia	96	4	2	2	NO	NO	50%	NO	N/A	N/A	YES	NO	IFC	YES	N/A	N/A	N/A	N/A
33 Partridge Fine Arts	96	8	6	2	NO	YES	25%	YES	N/S	N/S	YES	NO	IFC	YES	2	YES	1 00000	0 00
42 Tom Hoskins Plc	96	5	3	2	NO	NO	40%	YES	N/S	N/S	YES	YES	IFC	YES	3	YES	0 66700	2 67
43 CGU	96	12	5	7	YES	NO	58%	YES	YES	4	YES	NO	IFC	YES	5	YES	1 00000	1 80
		6 5455	3 9091	2 6364	3/9	3/9	NE=1 ED=10	9/11	3/11	4/11	ALL	2/11	11/11	11/11	3 111	9/11	0 815	1 848
3 Firestone Diamonds AVOCET MINING	97	7	2	5	YES	NO	71%	YES	N/S	2	YES	NO	IFC	YES	3	YES	0 75000	3 25
4 Chieftain	97	4	3	1	NO	NO	25%	NO	N/A	N/A	YES	NO	IFC	YES	N/A	N/A	N/A	N/A
5 Utilitec	97	5	3	2	NO	NO	40%	YES	YES	N/S	YES	NO	IFC	YES	2	NO	1 00000	3 00
6 Latham james	97	7	6	1	NO	NO	14%	YES	YES	3	YES	NO	IFC	YES	3	YES	0 33333	2 67
7 UNIDARE	97	5	2	3	YES	NO	60%	YES	YES	N/S	YES	NO	IFC	YES	3	YES	1 00000	5 33
11 Gooch & Housego	97	7	5	2	NO	NO	29%	YES	N/S	2	YES	NO	IFC	YES	2	YES	0 50000	1 00
12 Cirqual	97	5	3	2	NO	YES	40%	YES	N/S	N/S	YES	NO	IFC	YES	2	YES	0 50000	0 60
13 Locker	97	3	2	1	NO	NO	33%	YES	YES	2	YES	NO	IFC	YES	2	NO	0 50000	1 00
22 Sanderson Bramall group	97	8	6	2	NO	YES	25%	NO	N/A	N/A	YES	NO	IFC	YES	N/A	N/A	N/A	N/A
26 Nottingham Forest Plc	97	5	2	3	YES	NO	60%	NO	N/A	N/A	YES	NO	IFC	YES	N/A	N/A	N/A	N/A
27 Digital animations Plc	97	4	4	0	NO	NO	0%	NO	N/A	N A	YES	NO	IFC	YES	N/A	N/A	N/A	N/A
28 Zetters Plc	97	6	4	2	NO	NO	33%	YES	N/S	N/S	YES	NO	FC	YES	6	NO	0 00000	1 33
30 Pearson Plc	97	10	5	5	YES	NO	50%	YES	YES	N S	YES	YES	FC	YES	3	NO	1 00000	3 33
31 Jacques Vert	97	5	3	2	NO	YES	40%	YES	YES	1	YES	NO	IFC	YES	5	YES	0 40000	1 60
38 Ricardo Group	97	6	3	3	YES	NO	50%	YES	YES	2	YES	YES	IFC	YES	3	YES	1 00000	1 67
44 Creston Plc	97	5	2	3	YES	NO	60%	YES	YES	2	YES	NO	FC	YES	3	YES	1 00000	2 33
46 Rodime	97	4	1	3	YES	NO	75%	YES	YES	N/S	YES	NO	FC	YES	3	YES	0 66700	1 33
		5 6471	3 2941	2 3529	7/17	3/17	NE 5 ED-12	13/17	9 17	7 17	ALL	2 17	17/17	17/17	3 0769231	9/17	0 665410256	2 18077
14 Eleco	98	4	2	2	NO	YES	50%	YES	YES	2	YES	NO	IFC	YES	2	NO	1 00000	2 00
15 Br dport	98	6	3	3	YES	YES	50%	YES	N/S	2	YES	NO	FC	YES	3	YES	0 66700	4 00
35 QS Group PLc	98	9	4	5	YES	NO	56%	YES	N S	N S	YES	NO	IFC	YES	4	YES	0 50000	1 00
36 Form nster Plc	98	7	3	4	YES	NO	57%	YES	N/S	2	YES	NO	FC	YES	4	YES	0 50000	0 00
45 CNC Properties	98	7	2	5	YES	NO	71%	YES	N	2	YES	NO	FC	YES	3	YES	0 66700	1 67
		6 6	2 8	3 8	4 5	2 5	NE 3 ED 2	5 5	1 5	4 5	ALL	/5	5 5	5 5	3 2	4/5	0 6668	1 73333
9 Dewhurst Plc	99	6	5	1	NO	NO	17%	YES	N/S	n s	YES	YES	IFC	YES	2	YES	1 00000	1 00
37 W m ngton Group Plc	99	6	5	1	NO	NO	17%	YES	N S	2	YES	NO	FC	YES	2	NO	1 00000	1 50
47 Qua tYES Software Ho d ngs P c	99	5	3	2	NO	NO	40%	YES	YES	2	YES	NO	IFC	YES	2	YES	0 50000	2 00
48 Radiant Meta Fin sh	99	4	2	2	NO	YES	50%	YES	YES	2	YES	NO	FC	YES	2	YES	0 50000	0 00
49 Equator Group	99	6	3	3	YES	YES	50%	NO	N A	N A	YES	NO	FC	YES	N/A	N/A	N/A	N/A
50 EurocopYES plc	99	7	5	2	NO	NO	29%	YES	N S	N S	YES	NO	FC	YES	2	YES	0 50000	0 50
51 Shaw (Arthur) Plc	99	3	2	1	NO	YES	33%	YES	N S	N S	YES	YES	FC	YES	3	YES	0 66700	2 00
		5 2857	3 5714	1 7143	1 7	3/7	NE=0 ED=7	6/7	2/7	3 7	ALL	2/7	7/7	7/7	2 1666667	5/7	0 6945	1 16667

FIGURE 74 EXCEL SHEET CONTROL GROUP 1

INTERVIEW GUIDELINES

	HYPOTHESES	EXPLANATION
1	Companies with financial reporting problems are more likely to have ineffective boards. I.e. where NED's are deemed to be ineffective in that they constitute less than 1/3 of the total	Do you consider that the no. of NED's on the board influences the extent to which they can be effective/ In the past, have there been times where Ned no's have resulted in the inability to make a difference in voting?
2	Companies with financial reporting problems are more likely to have ineffective boards I.e. where there is CEO Chair role duality	Do you agree that the role of CEO and Chair should be split? What problems do you think may occur if they are not split?
3	Companies with financial reporting problems are more likely to have audit committees with less than three NED's	Why do you feel that some co.'s have ac's with less than 3 members? I.e. ignorance, not beneficial. Do you feel that <3 members can be efficient
4	Companies with financial reporting problems are more likely to have audit committees with poor governance procedures	In relation to internal Audit, Audit charter, no of meetings, do you feel that some co.'s are lacking due to ignorance, cost, or time constraints? What are the time constraints that you consider relevant?

	HYPOTHESES	EXPLANATION
5	Companies with financial reporting problems are more likely to have audit committees that are not considered independent. If any member is not independent the whole committee is considered not independent	Do you think independence influences the ability of the audit committee to be effective in discharging their financial reporting role? Would you include a non-independent director on your board and what factors would lead you to this decision?
6	Companies with financial reporting problems are more likely to have audit committees with fewer financially literate members.	Do you consider financial literacy important? How would you define financial literacy? Do you feel that executive mgmt. Listen the ac's opinions?
7	Companies with financial reporting problems are more likely to have audit committees with no technically competent members. One member must be technically competent	Do you consider technical competence important? Do you feel that executive mgmt. Listen the ac's opinions?
8	Companies with financial reporting problems are more likely to have audit committees members who hold additional directorships.	Do you feel that additional directorships impact on the ability of NED's ?

FIGURE 73 INTERVIEW GUIDELINES

SAMPLE LETTER

«FirstName» «LastName»
«Company»
«Address1»
«Address2»
«City»
«Postcode»

Dear Sir

Research Study on Corporate Governance

I am a doctoral student at City University Business School and am currently researching in the area of corporate governance with specific reference to the effectiveness of audit committees in UK.

As part of my research, I will be conducting interviews with non-executive directors in order to:

- Discuss their individual experiences of audit committees.
- Discuss their opinions on the effectiveness and usefulness of corporate governance to the business.

I would be grateful if you would consider being interviewed and I can assure you that all opinions expressed will remain confidential. The interview would last for no longer than forty minutes.

Please indicate a convenient time and date on the card enclosed and I will contact you or your secretary to arrange a location convenient to you for the interview to take place. I enclose a stamped address envelope for your convenience.

In the event that a meeting is not possible, I would be able to conduct the interview by telephone. If this option is preferred, please complete the enclosed card stating your preference and time most convenient to you.

Yours faithfully

Ms. D. O. Dafinone

FIGURE 74 INTERVIEW LETTER

INTERVIEW RESPONDENTS

	Name	Company Name	FRP	NFRP
1	A Skailes	Bulgin PLC		✔
2	A Winter	Bulgin PLC		✔
3	Albert Cheesebrough	Abbeycrest PLC		✔
4	Alex Watson	Locker PLC		✔
5	Fred Shedden	Burn Stewart Distillers PLC		✔
6	G Maddrell	Glenmorangie PLC		✔
7	J M Southworth	Locker PLC		✔
8	J R Featherstone	Abbeycrest PLC		✔
9	J Smith	Bullough PLC	✔	
10	J T Sutcliffe	Abbeycrest PLC	✔	
11	K M Benson	Abbeycrest PLC		✔
12	L Rogers	AIM PLC		✔
13	M C Stoddart	Bullough PLC		✔
14	M N Lever	Abbeycrest PLC		✔
15	Richard Olver	Reuters PLC	✔	
16	Rupert Mark	Pearson PLC	✔	
17	Shaun Bowden	Eurocopy PLC		✔
18	Sir John Craven	Reuters PLC		✔
19	Sir John Pickard	Bullough PLC	✔	
20	Sir Noel Davies	Ricardo PLC		✔
21	T Black	Peter Black Holdings		✔
22	Vernon Sankey	Photo me International PLC		✔

FIGURE 75 RESPONDENTS

BOARD COMPOSITION

Paired Samples Statistics

		Mean	N	Std. Deviation	Std. Error Mean
Pair 1	IMBFRP	41.2531	49	16.5594	2.3656
	IMBCON1	40.0408	49	18.1956	2.5994

Paired Samples Correlations

		N	Correlation	Sig.
Pair 1	IMBFRP & IMBCON1	49	-.095	.515

Paired Samples Test

		Paired Differences					t	df	Sig. (2-tailed)
		Mean	Std. Deviation	Std. Error Mean	95% Confidence Interval of the Difference				
					Lower	Upper			
Pair 1	IMBFRP - IMBCON1	1.2122	25.7435	3.6776	-6.1821	8.6066	.330	48	.743

FIGURE 76 SPSS BOARD IMBALANCE FRPV CONTROL GROUP 1

ROLE DUALITY

Wilcoxon Signed Ranks Test

Ranks

		N	Mean Rank	Sum of Ranks
CEOCON1 - CEOFRP	Negative Ranks	7[a]	9.00	63.00
	Positive Ranks	10[b]	9.00	90.00
	Ties	32[c]		
	Total	49		

a. CEOCON1 < CEOFRP

b. CEOCON1 > CEOFRP

c. CEOFRP = CEOCON1

Test Statistics[b]

	CEOCON1 - CEOFRP
Z	-.728[a]
Asymp. Sig. (2-tailed)	.467

a. Based on negative ranks.

b. Wilcoxon Signed Ranks Test

FIGURE 77 SPSS ROLE DUALITY FRPV CONTROL GROUP 1

Terms of Reference

Wilcoxon Signed Ranks Test

Ranks

		N	Mean Rank	Sum of Ranks
TRECON1 - TREFFRP	Negative Ranks	3[a]	6.00	18.00
	Positive Ranks	8[b]	6.00	48.00
	Ties	20[c]		
	Total	31		

a. TRECON1 < TREFFRP

b. TRECON1 > TREFFRP

c. TREFFRP = TRECON1

Test Statistics [b]

	TRECON1 - TREFFRP
Z	-1.508[a]
Asymp. Sig. (2-tailed)	.132

a. Based on negative ranks.

b. Wilcoxon Signed Ranks Test

Figure 78 SPSS Terms Of Reference FRP V Control Group1

MEETINGS

Paired Samples Statistics

		Mean	N	Std. Deviation	Std. Error Mean
Pair 1	MEETFRP	.7500	28	1.0408	.1967
	MEETCON1	1.0357	28	1.1380	.2151

Paired Samples Correlations

		N	Correlation	Sig.
Pair 1	MEETFRP & MEETCON1	28	-.242	.214

Paired Samples Test

		Paired Differences					t	df	Sig. (2-tailed)
		Mean	Std. Deviation	Std. Error Mean	95% Confidence Interval of the Difference				
					Lower	Upper			
Pair 1	MEETFRP - MEETCON1	-.2857	1.7182	.3247	-.9520	.3806	-.880	27	.387

FIGURE 79 SPSS MEETINGS FRPV CONTROL GROUP 1

INTERNAL AUDIT

Wilcoxon Signed Ranks Test

Test Statistics[b]

	IACON1 - IAFRP
Z	.000[a]
Asymp. Sig. (2-tailed)	1.000

a. The sum of negative ranks equals the sum of positive ranks.

b. Wilcoxon Signed Ranks Test

Ranks

		N	Mean Rank	Sum of Ranks
IACON1 - IAFRP	Negative Ranks	4[a]	4.50	18.00
	Positive Ranks	4[b]	4.50	18.00
	Ties	41[c]		
	Total	49		

a. IACON1 < IAFRP

b. IACON1 > IAFRP

c. IAFRP = IACON1

FIGURE 80 SPSS INTERNAL AUDIT FRPV CONTROL GROUP 1

AUDIT COMMITTEE EXISTENCE

Wilcoxon Signed Ranks Test

Ranks

		N	Mean Rank	Sum of Ranks
ACCON1 - ACFRP	Negative Ranks	7[a]	8.50	59.50
	Positive Ranks	9[b]	8.50	76.50
	Ties	33[c]		
	Total	49		

a. ACCON1 < ACFRP

b. ACCON1 > ACFRP

c. ACFRP = ACCON1

Test Statistics [b]

	ACCON1 - ACFRP
Z	-.500[a]
Asymp. Sig. (2-tailed)	.617

a. Based on negative ranks.

b. Wilcoxon Signed Ranks Test

FIGURE 81 AUDIT COMMITTEE EXISTENCE FRPV CONTROL GROUP 1

AUDIT COMMITTEE MEMBERSHIP

Paired Samples Statistics

		Mean	N	Std. Deviation	Std. Error Mean
Pair 1	ACMEMFRP	2.7419	31	.8932	.1604
	ACMECON1	3.0000	31	1.1832	.2125

Paired Samples Correlations

		N	Correlation	Sig.
Pair 1	ACMEMFRP & ACMECON1	31	.126	.499

Paired Samples Test

		Paired Differences					t	df	Sig. (2-tailed)
		Mean	Std. Deviation	Std. Error Mean	95% Confidence Interval of the Difference				
					Lower	Upper			
Pair 1	ACMEMFRP - ACMECON1	-.2581	1.3897	.2496	-.7678	.2517	-1.034	30	.309

FIGURE 82 AUDIT COMMITTEE MEMBERSHIP FRPV CONTROL GROUP 1

TECHNICAL COMPETENCE

Wilcoxon Signed Ranks Test

Ranks

		N	Mean Rank	Sum of Ranks
QUALCON1 - QUALFRP	Negative Ranks	3[a]	7.50	22.50
	Positive Ranks	11[b]	7.50	82.50
	Ties	17[c]		
	Total	31		

a. QUALCON1 < QUALFRP

b. QUALCON1 > QUALFRP

c. QUALFRP = QUALCON1

Test Statistics[b]

	QUALCON1 - QUALFRP
Z	-2.138[a]
Asymp. Sig. (2-tailed)	.033

a. Based on negative ranks.

b. Wilcoxon Signed Ranks Test

FIGURE 83 TECHNICAL COMPETENCE FRPV CONTROL GROUP 1

FINANCIAL LITERACY

Paired Samples Statistics

		Mean	N	Std. Deviation	Std. Error Mean
Pair 1	LITFRP	.5856	31	.2882	5.177E-02
	LITCON1	.7473	31	.2645	4.750E-02

Paired Samples Correlations

		N	Correlation	Sig.
Pair 1	LITFRP & LITCON1	31	-.028	.882

Paired Samples Test

		Paired Differences					t	df	Sig. (2-tailed)
		Mean	Std. Deviation	Std. Error Mean	95% Confidence Interval of the Difference Lower	95% Confidence Interval of the Difference Upper			
Pair 1	LITFRP - LITCON1	-.1617	.3966	7.123E-02	-.3072	-1.62E-02	-2.270	30	.031

FIGURE 84 FINANCIAL LITERACY FRP V CONTROL GROUP1

INDEPENDENCE

Ranks

		N	Mean Rank	Sum of Ranks
INDCON1 - INDFRP	Negative Ranks	5[a]	4.50	22.50
	Positive Ranks	3[b]	4.50	13.50
	Ties	23[c]		
	Total	31		

a. INDCON1 < INDFRP

b. INDCON1 > INDFRP

c. INDFRP = INDCON1

Test Statistics[b]

	INDCON1 - INDFRP
Z	-.707[a]
Asymp. Sig. (2-tailed)	.480

a. Based on positive ranks.

b. Wilcoxon Signed Ranks Test

FIGURE 85 INDEPENDENCE FRPV CONTROL GROUP 1

Additional Directorships

Paired Samples Statistics

		Mean	N	Std. Deviation	Std. Error Mean
Pair 1	DIRFRP	1.4287	31	1.1579	.2080
	DIRCON1	1.8113	31	1.1633	.2089

Paired Samples Correlations

		N	Correlation	Sig.
Pair 1	DIRFRP & DIRCON1	31	.014	.942

Paired Samples Test

		Paired Differences					t	df	Sig. (2-tailed)
		Mean	Std. Deviation	Std. Error Mean	95% Confidence Interval of the Difference: Lower	95% Confidence Interval of the Difference: Upper			
Pair 1	DIRFRP - DIRCON1	-.3826	1.6303	.2928	-.9806	.2154	-1.307	30	.201

FIGURE 86 ADDITIONAL DIRECTORSHIPS FRPV CONTROL GROUP 1

Summary Analysis (FRP v Control Group 1) Alpha = 1%

Paired Samples Statistics

		Mean	N	Std. Deviation	Std. Error Mean
Pair 1	IMBFRP	41.2531	49	16.5594	2.3656
	IMBCON1	40.0408	49	18.1956	2.5994
Pair 2	MEETFRP	.7500	28	1.0408	.1967
	MEETCON1	1.0357	28	1.1380	.2151
Pair 3	ACMEMFRP	2.7419	31	.8932	.1604
	ACMECON1	3.0000	31	1.1832	.2125
Pair 4	LITFRP	.5856	31	.2882	5.177E-02
	LITCON1	.7473	31	.2645	4.750E-02
Pair 5	DIRFRP	1.4287	31	1.1579	.2080
	DIRCON1	1.8113	31	1.1633	.2089

Paired Samples Correlations

		N	Correlation	Sig.
Pair 1	IMBFRP & IMBCON1	49	-.095	.515
Pair 2	MEETFRP & MEETCON1	28	-.242	.214
Pair 3	ACMEMFRP & ACMECON1	31	.126	.499
Pair 4	LITFRP & LITCON1	31	-.028	.882
Pair 5	DIRFRP & DIRCON1	31	.014	.942

Summary Analysis (FRP v Control Group 1) Alpha = 1% Continued

Paired Samples Test

		Paired Differences					t	df	Sig. (2-tailed)
					99% Confidence Interval of the Difference				
		Mean	Std. Deviation	Std. Error Mean	Lower	Upper			
Pair 1	IMBFRP - IMBCON1	1.2122	25.7435	3.6776	-8.6519	11.0764	.330	48	.743
Pair 2	MEETFRP - MEETCON1	-.2857	1.7182	.3247	-1.1854	.6140	-.880	27	.387
Pair 3	ACMEMFRP - ACMECON1	-.2581	1.3897	.2496	-.9444	.4283	-1.034	30	.309
Pair 4	LITFRP - LITCON1	-.1617	.3966	7.123E-02	-.3576	3.417E-02	-2.270	30	.031
Pair 5	DIRFRP - DIRCON1	-.3826	1.6303	.2928	-1.1878	.4226	-1.307	30	.201

FIGURE 87 SUMMARY ANALYSIS FRP/ CONTROL GROUP 1 ALPHA = 1%

BOARD COMPOSITION

Paired Samples Statistics

		Mean	N	Std. Deviation	Std. Error Mean
Pair 1	IMBFRP	41.2531	49	16.5594	2.3656
	IMBCON2	43.3878	49	16.8087	2.4012

Paired Samples Correlations

		N	Correlation	Sig.
Pair 1	IMBFRP & IMBCON2	49	.041	.781

Paired Samples Test

		Paired Differences					t	df	Sig. (2-tailed)
		Mean	Std. Deviation	Std. Error Mean	95% Confidence Interval of the Difference				
					Lower	Upper			
Pair 1	IMBFRP - IMBCON2	-2.1347	23.1107	3.3015	-8.7729	4.5035	-.647	48	.521

FIGURE 88 BOARD BALANCE FRPV CONTROL GROUP 2

ROLE DUALITY

Wilcoxon Signed Ranks Test

Ranks

		N	Mean Rank	Sum of Ranks
CEOCON2 - CEOFRP	Negative Ranks	6[a]	7.50	45.00
	Positive Ranks	8[b]	7.50	60.00
	Ties	35[c]		
	Total	49		

a. CEOCON2 < CEOFRP

b. CEOCON2 > CEOFRP

c. CEOFRP = CEOCON2

Test Statistics[b]

	CEOCON2 - CEOFRP
Z	-.535[a]
Asymp. Sig. (2-tailed)	.593

a. Based on negative ranks.

b. Wilcoxon Signed Ranks Test

FIGURE 89 ROLE DUALITY FRPV CONTROL GROUP 2

Wilcoxon Signed Ranks Test

Ranks

		N	Mean Rank	Sum of Ranks
TRECON2 - TREFFRP	Negative Ranks	3[a]	7.00	21.00
	Positive Ranks	10[b]	7.00	70.00
	Ties	20[c]		
	Total	33		

a. TRECON2 < TREFFRP

b. TRECON2 > TREFFRP

c. TREFFRP = TRECON2

Test Statistics[b]

	TRECON2 - TREFFRP
Z	-1.941[a]
Asymp. Sig. (2-tailed)	.052

a. Based on negative ranks.

b. Wilcoxon Signed Ranks Test

FIGURE 90 TERMS OF REFERENCE FRP/CONTROL GROUP 2

MEETINGS

Paired Samples Statistics

		Mean	N	Std. Deviation	Std. Error Mean
Pair 1	MEETFRP	.7000	30	1.0222	.1866
	MEETCON2	1.0333	30	1.1290	.2061

Paired Samples Correlations

		N	Correlation	Sig.
Pair 1	MEETFRP & MEETCON2	30	-.230	.221

Paired Samples Test

		Paired Differences					t	df	Sig. (2-tailed)
		Mean	Std. Deviation	Std. Error Mean	95% Confidence Interval of the Difference				
					Lower	Upper			
Pair 1	MEETFRP - MEETCON2	-.3333	1.6884	.3083	-.9638	.2971	-1.081	29	.288

FIGURE 91 MEETINGS FRPV CONTROL GROUP 2

INTERNAL AUDIT

Wilcoxon Signed Ranks Test

Ranks

		N	Mean Rank	Sum of Ranks
IACON2 - IAFRP	Negative Ranks	4[a]	5.00	20.00
	Positive Ranks	5[b]	5.00	25.00
	Ties	40[c]		
	Total	49		

a. IACON2 < IAFRP

b. IACON2 > IAFRP

c. IAFRP = IACON2

Test Statistics[b]

	IACON2 - IAFRP
Z	-.333[a]
Asymp. Sig. (2-tailed)	.739

a. Based on negative ranks.

b. Wilcoxon Signed Ranks Test

FIGURE 92 INTERNAL AUDIT FRPV CONTROL GROUP 2

AUDIT COMMITTEE EXISTENCE

Wilcoxon Signed Ranks Test

Ranks

		N	Mean Rank	Sum of Ranks
ACCON2 - ACFRP	Negative Ranks	5[a]	7.50	37.50
	Positive Ranks	9[b]	7.50	67.50
	Ties	35[c]		
	Total	49		

a. ACCON2 < ACFRP

b. ACCON2 > ACFRP

c. ACFRP = ACCON2

Test Statistics[b]

	ACCON2 - ACFRP
Z	-1.069[a]
Asymp. Sig. (2-tailed)	.285

a. Based on negative ranks.

b. Wilcoxon Signed Ranks Test

FIGURE 93 AUDIT COMMITTEE EXISTENCE FRPV CONTROL GROUP 2

AUDIT COMMITTEE MEMBERSHIP

Paired Samples Statistics

		Mean	N	Std. Deviation	Std. Error Mean
Pair 1	ACMEMFRP'	2.8485	33	1.1489	.2000
	ACMECON2	3.0606	33	1.2485	.2173

Paired Samples Correlations

		N	Correlation	Sig.
Pair 1	ACMEMFRP & ACMECON2	33	.050	.782

Paired Samples Test

		Paired Differences					t	df	Sig. (2-tailed)
		Mean	Std. Deviation	Std. Error Mean	95% Confidence Interval of the Difference Lower	Upper			
Pair 1	ACMEMFRP - ACMECON2	-.2121	1.6537	.2879	-.7985	.3743	-.737	32	.467

FIGURE 94 AUDIT COMMITTEE MEMBERS FRPV CONTROL GROUP 2

INDEPENDENCE

Wilcoxon Signed Ranks Test

Ranks

		N	Mean Rank	Sum of Ranks
INDCON2 - INDFRP	Negative Ranks	5[a]	5.50	27.50
	Positive Ranks	5[b]	5.50	27.50
	Ties	23[c]		
	Total	33		

a. INDCON2 < INDFRP

b. INDCON2 > INDFRP

c. INDFRP = INDCON2

Test Statistics[b]

	INDCON2 - INDFRP
Z	.000[a]
Asymp. Sig. (2-tailed)	1.000

a. The sum of negative ranks equals the sum of positive ranks.

b. Wilcoxon Signed Ranks Test

FIGURE 95 INDEPENDENCE FRPV CONTROL GROUP 2

FINANCIAL LITERACY

Paired Samples Statistics

		Mean	N	Std. Deviation	Std. Error Mean
Pair 1	LITFRP	.5971	33	.2769	4.819E-02
	LITCON2	.7576	33	.2702	4.703E-02

Paired Samples Correlations

		N	Correlation	Sig.
Pair 1	LITFRP & LITCON2	33	-.078	.664

Paired Samples Test

		Paired Differences					t	df	Sig. (2-tailed)
		Mean	Std. Deviation	Std. Error Mean	95% Confidence Interval of the Difference				
					Lower	Upper			
Pair 1	LITFRP - LITCON2	-.1605	.4017	6.993E-02	-.3029	-1.80E-02	-2.295	32	.028

FIGURE 96 FINANCIAL LITERACY FRPV CONTROL GROUP 2

TECHNICAL COMPETENCE

Wilcoxon Signed Ranks Test

Ranks

		N	Mean Rank	Sum of Ranks
QUALCON2 - QUALFRP	Negative Ranks	2[a]	7.50	15.00
	Positive Ranks	12[b]	7.50	90.00
	Ties	19[c]		
	Total	33		

a. QUALCON2 < QUALFRP

b. QUALCON2 > QUALFRP

c. QUALFRP = QUALCON2

Test Statistics[b]

	QUALCON2 - QUALFRP
Z	-2.673[a]
Asymp. Sig. (2-tailed)	.008

a. Based on negative ranks.

b. Wilcoxon Signed Ranks Test

FIGURE 97 TECHNICAL COMPETENCE FRPV CONTROL GROUP 2

ADDITIONAL DIRECTORSHIPS

Paired Samples Statistics

		Mean	N	Std. Deviation	Std. Error Mean
Pair 1	DIRFRP	1.4645	33	1.1053	.1924
	DIRCON2	' 1.7839	33	1.2561	.2187

Paired Samples Correlations

		N	Correlation	Sig.
Pair 1	DIRFRP & DIRCON2	33	-.026	.888

Paired Samples Test

		Paired Differences					t	df	Sig. (2-tailed)
		Mean	Std. Deviation	Std. Error Mean	95% Confidence Interval of the Difference				
					Lower	Upper			
Pair 1	DIRFRP - DIRCON2	-.3194	1.6942	.2949	-.9201	.2813	-1.083	32	.287

FIGURE 98 ADDITIONAL DIRECTORSHIPS FRPV CONTROL GROUP 2

SUMMARY ANALYSIS (FRP V CON 2) ALPHA = 1%

Paired Samples Statistics

		Mean	N	Std. Deviation	Std. Error Mean
Pair 1	IMBFRP	41.2531	49	16.5594	2.3656
	IMBCON2	43.3878	49	16.8087	2.4012
Pair 2	MEETFRP	.7000	30	1.0222	.1866
	MEETCON2	1.0333	30	1.1290	.2061
Pair 3	ACMEMFRP	2.8485	33	1.1489	.2000
	ACMECON2	3.0606	33	1.2485	.2173
Pair 4	LITFRP	.5971	33	.2769	4.819E-02
	LITCON2	.7576	33	.2702	4.703E-02
Pair 5	DIRFRP	1.4645	33	1.1053	.1924
	DIRCON2	1.7839	33	1.2561	.2187

Paired Samples Correlations

		N	Correlation	Sig.
Pair 1	IMBFRP & IMBCON2	49	.041	.781
Pair 2	MEETFRP & MEETCON2	30	-.230	.221
Pair 3	ACMEMFRP & ACMECON2	33	.050	.782
Pair 4	LITFRP & LITCON2	33	-.078	.664
Pair 5	DIRFRP & DIRCON2	33	-.026	.888

Paired Samples Test

		Paired Differences					t	df	Sig. (2-tailed)
		Mean	Std. Deviation	Std. Error Mean	99% Confidence Interval of the Difference Lower	Upper			
Pair 1	IMBFRP - IMBCON2	-2.1347	23.1107	3.3015	-10.9901	6.7207	-.647	48	.521
Pair 2	MEETFRP - MEETCON2	-.3333	1.6884	.3083	-1.1830	.5163	-1.081	29	.288
Pair 3	ACMEMFRP - ACMECON2	-.2121	1.6537	.2879	-1.0005	.5762	-.737	32	.467
Pair 4	LITFRP - LITCON2	-.1605	.4017	6.993E-02	-.3520	3.101E-02	-2.295	32	.028
Pair 5	DIRFRP - DIRCON2	-.3194	1.6942	.2949	-1.1270	.4882	-1.083	32	.287

FIGURE 99 SUMMARY ANALYSIS FRPV CONTROL GROUP 2 ALPHA = 1%

SPSS RAW DATA SHEETS – FRP GROUP

	IMBFRP	CEOFRP	ACFRP	TREFFRP	MEETFRP	IAFRP	ACMEMFRP	QUALFRP	LITFRP	DIRFRP	INDFRP
1	33.3	2	2	1	0	1	3	1	0.33	0.33	1
2	50	1	2	1	0	1	2	1	0.5	1.5	1
3	33.3	1	1	.	.	1	.	.	.	.	.
4	44.4	1	2	1	0	1	3	1	0.67	1.33	2
5	33.3	1	2	1	0	2	3	2	0.33	1.33	1
6	40	2	1	.	.	1	.	.	.	.	.
7	50	1	2	1	0	1	2	2	0.5	1	2
8	29	1	1	.	.	1	.	.	.	.	.
9	88	1	2	2	0	1	7	2	0.71	1.2	2
10	50	1	2	1	0	1	3	2	0.67	1.67	2
11	40	1	2	1	0	2	3	2	0.67	0	2
12	33.3	1	2	2	2	1	2	1	0	1	2

	IMBFRP	CEOFRP	ACFRP	TREFFRP	MEETFRP	IAFRP	ACMEMFRP	QUALFRP	LITFRP	DIRFRP	INDFRP
13	66.7	2	1	.	.	1	.	.	.	.	.
14	0	1	1	.	.	1	.	.	.	.	.
15	44.4	1	2	1	0	1	4	1	0.75	0.8	1
16	25	2	2	1	0	1	2	1	1	1.5	1
17	37.5	1	1	.	.	1	.	.	.	.	.
18	28.6	1	2	1	2	1	2	2	0.5	1.5	2
19	40	1	1	.	.	1	.	.	.	.	.
20	57.1	1	2	2	0	2	4	1	0.75	2.5	2
21	33.3	1	2	1	0	1	2	1	0.5	0.5	2
22	40	1	2	1	2	1	2	1	0.5	2	2
23	28.6	1	2	1	2	1	2	1	0.5	3	2
24	0	1	1	.	.	1	.	.	.	.	.
25	40	2	2	1	2	1	2	2	0.5	0	2
26	62.5	1	2	1	2	1	3	2	0.33	0	2
27	50	1	2	1	2	1	3	1	0.33	0.67	1

	IMBFRP	CEOFRP	ACFRP	TREFFRP	MEETFRP	IAFRP	ACMEMFRP	QUALFRP	LITFRP	DIRFRP	INDFRP
28	50	1	2	1	0	1	3	2	0.33	1.33	1
29	57.1	1	2	2	2	1	4	2	0.75	1	2
30	28.6	1	1	.	.	1	.	.	.	.	.
31	20	1	2	1	0	1	2	2	1	1	1
32	40	1	2	2	0	1	2	2	1	1.5	2
33	53.8	1	2	1	0	2	6	2	1	5.17	2
34	40	1	2	2	2	1	3	2	0.67	3	1
35	41.7	1	2	1	2	2	4	1	0.5	1	2
36	0	1	1	.	.	1	.	.	.	.	.
37	33.3	1	2	1	3	1	3	2	0.67	1	1
38	50	2	2	1	0	1	2	1	0.5	3.5	2
39	28.6	2	2	2	.	1	2	2	0.5	0.5	2
40	50	1	2	1	.	1	2	1	0	2.5	1
41	40	1	2	1	.	1	2	1	1	1	2
42	66.7	2	2	1	0	2	3	2	0.67	1.33	1

	IMBFRP	CEOFRP	ACFRP	TREFFRP	MEETFRP	IAFRP	ACMEMFRP	QUALFRP	LITFRP	DIRFRP	INDFRP
43	60	1	2	1	0	1	3	2	1	0	1
44	40	2	2	1	0	2	2	1	1	2.5	1
45	50	1	2	2	0	1	3	1	0.33	2	2
46	33.3	1	1	.	.	1	.	.	.	.	.
47	50	1	2	2	0	1	3	2	1	0.67	2
48	50	1	2	1	0	1	2	2	1	1.5	2
49	60	1	2	1	2	1	3	2	0.33	1	1

FIGURE 100 SPSS FRP DATA

SPSS RAW DATA SHEETS – CONTROL GROUP1

	IMBCON1	CEOCON1	ACCON1	TRECON1	MEETCON1	IACON1	ACMEMCON1	QUALCON1	LITCON1	DIRCON1	INDCON1
1	40	1	2	1	0	1	2	2	1	1.5	2
2	0	1	1	.	.	1	.	.	.	.	.
3	67	1	2	1	0	1	5	2	0.6	3.4	2
4	43	1	2	1	2	1	3	2	1	1.67	2
5	29	1	2	2	2	2	2	1	0.5	2.5	1
6	60	1	2	2	2	1	3	2	1	1.33	2
7	38	1	2	1	0	1	3	1	0.67	1	2
8	25	2	2	2	0	1	2	2	0.5	1.5	1
9	0	1	1	.	.	1	.	.	.	.	.
10	40	1	1	.	.	1	.	.	.	.	.
11	50	1	2	1	2	1	2	2	0.5	3.5	2
12	44	1	2	1	2	2	4	1	0.75	2	1
13	25	1	2	2	2	1	2	2	0.5	1.5	1

	IMBCON1	CEOCON1	ACCON1	TRECON1	MEETCON1	IACON1	ACMEMCON1	QUALCON1	LITCON1	DIRCON1	INDCON1
14	20	2	2	2	0	1	1	1	0	2	1
15	33	2	2	1	0	1	6	2	0.67	1.5	1
16	50	1	2	1	0	1	3	1	1	1.67	1
17	50	1	1	.	.	1	.	.	.	.	.
18	25	2	2	1	0	1	2	1	0.5	0	2
19	40	1	2	1	0	2	3	2	0.67	2.67	1
20	58	1	2	2	4	1	5	2	1	1.8	2
21	71	1	2	1	2	1	3	1	0.75	3.25	2
22	25	1	1	.	.	1	.	.	.	.	.
23	40	1	2	2	0	1	2	1	1	3	2
24	14	1	2	2	3	1	3	2	0.33	2.67	1
25	60	1	2	2	0	1	3	2	0.67	5.33	2
26	29	1	2	1	2	1	2	2	0.5	1	2
27	40	2	2	1	0	1	2	1	0.5	0.5	2
28	33	1	2	2	2	1	2	1	0.5	1	1

	IMBCON1	CEOCON1	ACCON1	TRECON1	MEETCON1	IACON1	ACMEMCON1	QUALCON1	LITCON1	DIRCON1	INDCON1
29	25	2	1	.	.	1	.	.	.	.	.
30	60	1	1	.	.	1	.	.	.	.	.
31	0	1	1	.	.	1	.	.	.	.	.
32	33	1	2	1	0	1	6	1	0	1.33	1
33	50	1	2	2	0	2	3	1	1	3.33	2
34	40	2	2	2	1	1	5	2	0.4	1.6	1
35	50	1	2	2	2	2	3	2	1	1.67	2
36	60	1	2	2	2	1	3	2	1	2.33	2
37	75	1	2	2	0	1	3	2	0.67	1.33	1
38	50	2	2	2	2	1	2	1	1	2	1
39	50	2	2	1	2	1	3	2	0.67	4	1
40	56	1	2	1	0	1	4	2	0.5	1	1
41	57	1	2	1	2	1	4	2	0.5	0	1
42	71	1	2	1	2	1	3	2	0.67	1.67	2
43	17	1	2	1	0	2	2	2	1	1	1

	IMBCON1	CEOCON1	ACCON1	TRECON1	MEETCON1	IACON1	ACMEMCON1	QUALCON1	LITCON1	DIRCON1	INDCON1
44	17	1	2	1	2	1	2	1	1	1.5	1
45	40	1	2	2	2	1	2	2	0.5	2	2
46	50	2	2	2	2	1	2	2	0.5	0	1
47	50	2	1	.	.	1	.	.	.	.	.
48	29	1	2	1	0	1	2	2	0.5	0.5	2
49	33	2	2	1	0	2	3	2	0.67	2	1

FIGURE 101 SPSS CONTROL GROUP 1 DATA

SPSS RAW DATA SHEETS – CONTROL GROUP 2

	IMBCON2	CEOCON2	ACCON2	TRECON2	MEETCON2	IACON2	ACMEMCON2	QUALCON2	LITCON2	DIRCON2	INDCON2
1	57	1	1	.	.	1	.	.	.	.	.
2	40	1	2	2	2	2	2	2	1	0.5	2
3	67	1	2	1	0	1	5	2	0.6	3.4	2
4	40	1	2	1	2	1	4	2	1	2	2
5	43	1	2	2	2	2	3	2	0.67	2.33	1
6	67	2	2	2	2	1	2	2	1	1.5	2
7	38	1	2	1	0	1	3	1	0.33	1	2
8	40	1	2	2	0	1	3	2	0.33	1	1
9	50	1	2	1	0	1	3	2	0.33	0.67	2
10	40	1	2	1	0	1	2	2	0.5	1.5	2
11	50	1	2	1	2	1	2	2	0.5	3.5	2
12	56	1	2	1	2	2	5	2	0.75	3	1
13	33	1	2	2	2	1	2	2	0.5	1.5	1

	IMBCON2	CEOCON2	ACCON2	TRECON2	MEETCON2	IACON2	ACMEMCON2	QUALCON2	LITCON2	DIRCON2	INDCON2
14	20	2	2	2	0	1	1	1	0	2	1
15	22	1	2	1	0	1	7	2	0.57	1.29	1
16	50	1	2	1	0	1	3	1	0	1.67	1
17	50	1	1	.	.	1	.	.	.	.	.
18	25	2	2	1	0	1	2	1	0	0	2
19	40	1	2	1	0	2	2	2	1	3	2
20	62	1	2	2	4	1	3	2	0.67	1.67	2
21	71	1	2	2	2	1	4	1	0.25	3.25	2
22	25	1	1	.	.	1	.	.	.	.	.
23	40	1	2	2	0	1	2	1	0	3	2
24	14	1	2	2	3	1	3	2	0.33	2.67	1
25	60	1	2	2	0	1	3	2	0.67	5.33	2
26	29	1	2	1	2	1	2	2	0.5	1	2
27	40	2	2	1	0	1	2	1	0.5	0.5	2
28	33	1	2	2	2	1	3	1	0.67	1	1

	IMBCON2	CEOCON2	ACCON2	TRECON2	MEETCON2	IACON2	ACMEMCON2	QUALCON2	LITCON2	DIRCON2	INDCON2
29	25	2	1	.	.	1	.	.	.	.	.
30	60	1	1	.	.	1	.	.	.	.	.
31	0	1	1	.	.	1	.	.	.	.	.
32	33	1	2	2	0	1	6	1	0	1.33	1
33	50	1	2	2	0	2	3	1	1	3.33	2
34	40	2	2	2	1	1	2	1	0	1.5	2
35	50	1	2	2	2	2	3	2	1	1.5	2
36	71	1	2	2	2	1	2	2	1	1.67	2
37	75	1	2	2	0	1	3	2	0.67	1.33	1
38	50	2	2	2	2	1	2	1	0.5	2	1
39	50	2	2	1	2	1	3	2	0.67	5	1
40	56	1	2	1	0	1	4	2	0.5	1	1
41	57	1	2	1	2	1	4	2	0.5	0	1
42	71	1	2	1	2	1	5	2	0.67	1.67	2
43	17	1	2	1	0	2	2	2	0.5	1	1

	IMBCON2	CEOCON2	ACCON2	TRECON2	MEETCON2	IACON2	ACMEMCON2	QUALCON2	LITCON2	DIRCON2	INDCON2
44	17	1	2	1	2	1	2	1	1	1.5	2
45	40	1	2	2	2	1	2	2	0.33	2	2
46	50	2	2	2	2	1	2	2	0.5	0	1
47	50	2	1	.	.	1	.	.	.	.	.
48	29	1	2	1	0	1	2	2	0.5	0.5	2
49	33	2	2	1	0	2	3	2	0.67	2	1

FIGURE 102 SPSS CONTROL GROUP 2 DATA