Audit committees' effectiveness in overseeing the integrity of company's financial reporting in the UK: Auditors view. An exploratory investigation.

Dissertation submitted in partial fulfilment of the requirement for the MSc in Corporate Governance & Business Ethics

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September 2012

Abstract

Purpose – The purpose of this study is to obtain a better understanding of the types of expertise required of AC members and to see whether it is possible to identify the specific areas of expertise required of members of audit committee in monitoring the integrity of financial reporting. The study will also investigate the current level of UK audit committees' members' expertise, attempt to identify "knowledge gaps". The processes related to the oversight of financial reporting will be considered as part of this research.

Design/methodology/approach – The evolving and changing nature of the researched field – the changing roles, regulations, "best practice" – indicate that in order to gain a richer understanding of the factors affecting the efficiency of AC in overseeing the company's financial reporting, an exploratory research is needed. Semi-structured interview was chosen as an appropriate method of gathering information as it allows for some flexibility for interview participants to engage in a dialogue and explore the emerging issues in-depth. Six representatives from six audit firms have been interviewed. Auditors were given preference as a source of information for this research for a number of reasons, but mainly because auditors are in the best position to assess the expertise required of AC members. Additionally, due to their regular communications with AC boards they can provide opinion on the current level of expertise of UK AC members.

Findings – One of the key findings of this research is the growing role of AC members in understanding and reviewing key accounting judgements contained in company's reporting. Other findings include: the lack of UK audit committees' expertise in IFRS, the marked difference in financial expertise between the FTSE 100 and Mid 250 companies. Also this research found that the ability to ask the "right" questions scores highly in the hierarchy of AC skills. In terms of AC processes related to their financial oversight role, it has been found that AC involvement in the process of the annual report preparation (timing of the involvement) raised concerns of auditors. Also respondents' views on the degree of audit committee's reliance on external auditors and the financial management were conflicting, with one respondent stating that currently UK ACs rely too much on the financial management of the company in obtaining information. The research is inconclusive on this. Concerns have been raised about the insufficient discussion during the meeting of AC with auditors of financial reporting issues emerging from audits.

Originality/value – While previous studies have drawn attention to the correlation between AC members' characteristics and effectiveness of audit committees in their financial oversight role, there remains a lack of understanding and consensus on what should constitute financial expertise. There is limited UK-based research on AC literacy, operation and processes compared to the abundance of research in the US. UK Corporate Governance has its unique features and regulation that place some limitations on applicability of US –based research findings in the UK business context. This research explores AC operation in the UK.

Keywords: Corporate governance, Audit committees, Accounting judgement, Financial literacy, Financial expertise, IFRS.

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1. INTRODUCTION

The subprime crisis raised many questions regarding the efficacy of the existing corporate governance systems and was a powerful spur to research on the efficiency of different constituent components of the corporate governance systems.

Audit committees (hereafter referred to as ACs), being a part of the corporate governance system have attracted much attention both from researchers and regulators. One of the primary roles of AC, according to many international and national regulatory requirements, is to monitor the integrity of the financial statements. There is quite extensive research dedicated to AC's effectiveness in this role.

The US and UK codes stipulate that financial expertise is required on AC. The UK corporate governance code requires that at least one member should possess a "recent and relevant financial experience". The requirement was first introduced by the Smith Guidance (currently Guidance on Audit Committees, FRC, 2010b) in the UK in 2003. The US requirement to financial AC members' expertise as enacted by the Securities and Exchange Commission (SEC, 2003) is probably more prescriptive in that it requires the specific attributes/knowledge areas of AC members and even tells how the attributes can be acquired.

One of the criticisms of the regulatory requirements concerns the broad nature of the financial expertise definition which causes lack of agreement on what constitutes financial expertise (e.g. Giacomino, Akers and Wall, 2009a; Barra, 2010; Dhaliwal et al, 2010). Effectively, the regulators while requiring financial expertise on AC boards leave it up to the boards of directors to decide on what may constitute the financial expertise. This approach gives the companies a few advantages. Firstly, companies may select from a larger pool of candidates and secondly they can take into account the specifics of the company's business and risks in describing the candidates' profile. However, this approach bears a risk of employing directors that, while having a broad supervisory or commercial expertise, may lack the expertise required to monitor the integrity of the financial reporting and to challenge the boards appropriately. One of the aims of this research is therefore to get a better understanding of the types of expertise required of AC members in the UK. Particularly there has been little research on the specific areas of expertise that can help AC members to fulfil their role effectively. Some studies indicated this lack of knowledge as a limitation and encouraged further research in this field (Zaman, Hudaib, and Haniffa, 2011).

However, even where AC members are comprised of financially savvy members, there have been incidents of failure of these AC committees in their capacity to ensure the reliability of information released to the public. Some notable examples that were widely covered in the media include Hollinger, Enron, Satyam (Barker, 2011). This may indicate that there are other factors that may play a crucial role in AC effectiveness in their primary oversight role. The interviewees have described some of these factors. One group of these factors may be referred to as processes. Three processes have been identified by interviewees and considered in this research.

Additionally, what we see today is that AC's role in overseeing the financial reporting process is being revisited. This can be considered as a second wave of changes in AC regulation (the post-Enron changes instigated the first wave of regulatory activism in relation to ACs). In April 2012 the Financial Reporting Council (FRC) initiated the Corporate Governance Code review and issued a consultation document: "Revisions to the UK Corporate Governance Code" to generate comments (FRC, 2012a). If the new version of the code is adopted, the AC will be required to produce a separate report to express its opinion on key accounting judgements and to declare whether they consider the whole annual report to be "fair and balanced" in presenting information to the users (FRC, 2012a)..

This research will capture the respondents' views on AC effectiveness in one of its main roles before the above mentioned regulatory changes take place. Further studies may use this research findings as a source of data for further studies and to assess the effectiveness of regulatory initiatives in later research.

The purpose of this study is to better understand what types of expertise are required of AC members and to see whether it is possible to identify the specific areas of expertise required of members of audit committees in monitoring the integrity of financial reporting. And subsequently the study will try to investigate the current level of UK AC members' expertise, attempt to identify "knowledge gaps" and look into other factors that contribute to AC's effectiveness in overseeing the integrity of financial reporting.

Specifically the study will seek to address the following research questions:

in the view of the changing roles/responsibilities of the AC:

A. investigate the requirements to AC members' financial expertise in order for them to effectively fulfil their role of overseeing the company's financial reporting.

B. attempt to identify "knowledge gaps" in the current expertise of AC members on the UK boards.

C. *investigate other possible factors that may affect the AC's effectiveness in its role of overseeing the company's financial statements. And finally:*

D. identify possible avenues for further research by analysing the current literature in the field and making inferences from the above findings (A, B, C).

2. METHODOLOGY

According to Schutt (2009), “the goal [of the social exploratory research] is to learn 'what is going on here?' and to investigate social phenomena without explicit expectations”. The above statement seems to be an appropriate approach for tackling the research questions of this study. The evolving and changing nature of the researched field – the changing roles, regulations, “best practice” – indicate that in order to gain a richer understanding of the factors affecting the efficiency of ACs in overseeing the company’s financial reporting, an exploratory research may be required.

Semi-structured interview was chosen as an appropriate method of gathering information as it allows for some flexibility for interview participants to engage in a dialogue and explore the emerging issues in-depth.

Also, some authors specifically call for audit committee research using the interview method to better understand audit committees' activities. For example, Turley and Zaman (2004) believe that interview and case study methods of gathering information allow one to study how ACs operate and interact (e.g. with external auditors and senior management) in the “organizational and institutional context”. Similarly, Carcello, Hermanson, and Ye (2011) are saying that one of the high potential areas of research is the “exploration of what actions, behaviours, processes, and personality traits contribute to board and audit committee effectiveness” and, in their view, “a holistic approach to examining effectiveness should include interviews with external audit”.

Interviewees

In order to answer the question “Who is in the best position to provide an expert opinion on AC’s financial expertise a few groups have been considered as being most appropriate for obtaining this information, among them:

1. External auditors' engagement partners or senior level employees (partners, directors) whose designated role in the company is to consult on audit committee issues.
2. Audit committee chairmen.
3. Non-executive directors on the boards.

The first group has been given preference due to a number of factors that favoured them among other groups. Firstly, external auditors have a deep knowledge of financial and accounting issues and their primary duty is to provide an opinion on the integrity of the audited financial statements. Due to time/scope limits and impracticality of reviewing all data, auditors have to pay more attention to sensitive accounting/financial issues (more prone to fraud and error). As such, they can probably use this experience to identify the expertise that is required of a person in the conditions of limited time to oversee the integrity of the financial statements.

Secondly, due to the nature of their job, auditors have to liaise with audit committee members. According to the UK Guidance on Audit Committees (FRC, 2010b) meetings should be held between auditors and AC (at least once a year), without executive directors "to discuss matters relating to its remit and any issues arising from the audit" and the AC chairman should maintain a continuous contact with the "audit lead partner". So audit partners may be aware of the current level of AC directors' expertise and areas they need to improve on.

Thirdly, auditors' companies (larger companies) will have dedicated teams and departments that deal with corporate governance related services and that closely follow all the latest developments in the practice and regulation of ACs. Larger audit companies will also comment on FRC consultation papers and proposals. So it is reasonable to expect that larger audit companies will have a good level of knowledge and expertise in the latest corporate governance issues.

In order to make the research manageable it has been decided to limit the data analysis to FTSE 350 companies, since it was feasible to interview the external auditor representatives for FTSE 350. The percentile distribution of FTSE 350 auditors for 2011 is provided in Table 1 (FRC, 2012b). According to this, 96% (335 companies) of FTSE 350 are audited by the firms listed in the table.

Table 1.

Concentration of Listed Companies' Audits – Year Ended 2011 (By Number of Listed Clients – FTSE 100, FTSE 250			
UK Firm Name	**Year End**	**No of FTSE 100 Audit Clients**	**No of FTSE 250 Audit Clients**
PricewaterhouseCoopers	30-Jun-11	39	69
Deloitte	31-May-11	22	64
KPMG	30-Sep-11	21	48
Ernst & Young	30-Jun-11	18	43
BDO	30-Jun-11	1	5
Grant Thornton	30-Jun-11	0	5
Total		**101**	**234**

The rest of FTSE 250 (16 companies) are audited by smaller audit companies.

It was intended to interview and capture experience of FTSE 350 auditors. Due to the impracticalities that would have been associated with interviewing all audit partners that have experience with FTSE 350 there are certain limitations to this research which are described in the "Conclusions" section of this paper.

Six representatives from six audit firms in Table 1 have been interviewed. The candidates for interviews have been selected based on their senior role in corporate governance and/or their previous experience in audit and assurance with FTSE 350 clients. Four of the interviewees were senior partners/partners in charge of corporate governance and risk services and with experience in audit services. Two of the interviewees were senior managers in a similar role.

The Process

A questionnaire has been developed to address the research questions (please see Appendix 1 for the questionnaire). The questionnaire has been piloted with two non-executive directors, both members of NEDA (Non-Executive Directors Association). Both directors have experience in finance and corporate governance. A few comments have been received and incorporated in the final version of the questionnaire.

The questions one to four in the questionnaire give the respondents an option to choose from three types of expertise specified or any other type of expertise (option four). The rationale to include these three specific areas (accounting, finance and industry expertise) was to allow comparison with previous research that used similar categories (e.g. Dhaliwal et al, 2006). The question also includes a definition of each type of expertise in order to facilitate the shared understanding of these dimensions.

The interviews were conducted over the telephone with each interview taking approximately 30 minutes. The interview questionnaire has been e-mailed to the participants in advance with the letter providing the background to the research. Also prior to interviews the interviewees have been briefed about the purpose of research.

The semi-structured type of questionnaire allowed for clarification of the answers along the way. Some questions emerged during the interview and were purported either to clarify the meanings assigned to interviewees' responses or to encourage interviewees to elaborate further on the issues discussed. One additional question (Question 5, Appendix 1) has been included in the questionnaire following the first interview, as the respondent has raised an issue which was considered interesting for further enquiry.

Ethical issues

Each participant has been e-mailed a consent form (Appendix 3) in order to comply with the ethical standards required of any research that involves a contribution from human subjects. The participants have been made aware that their identities will not be disclosed without their permission. The consent form also asked for participants' agreement to recording the interviews. Also prior to tape recording a verbal permission has been additionally sought from interviewees to start the recording. There has been no resistance from the part of interviewees to recording.

The remainder of this paper is divided into 3 sections. Section 3 will look at prior literature and regulation in the area of AC effectiveness in overseeing the financial reporting process, highlighting the trends and main bodies of research. Section 4 will look at research findings and analyse them and provide a comparison with prior research findings. Section 5 will summarise the key ideas and will discuss the possible avenues for further research. Research limitations will also be covered in this section.

3. LITERATURE REVIEW

The literature review will be structured as follows: the first chapter will look at the current regulatory requirements and developments with regard to AC's role in overseeing the financial reporting process. The second chapter will look into the current research in the US and UK related to AC financial expertise and its impact on AC effectiveness. The third chapter will look into the research and literature on AC corporate governance processes and their impact on AC effectiveness.

Most of the research/literature on AC's financial expertise comes from the US, where the history of audit committees is oldest, with proposals to mandate all companies to have one dating to the late 1930s and the requirement for a mandatory AC introduced in 1977 (NYSE, 2007). This research will utilise a number of US-based research and also the available UK research and literature in this field. Both US and UK corporate governance systems follow the Anglo-Saxon corporate governance model (Gourevitch and Shinn, 2005). However, the two systems differ in one respect. The US system of corporate governance is said to be rules based where some corporate governance requirements have a force of law with concomitant criminal and administrative punishment measures. The UK corporate governance system is said to be principles based where the main feature is a "comply or explain" approach. Correspondingly the US requirements to audit committees' oversight role and financial expertise are enforced by law (e.g. Sarbanes-Oxley Act) as well as guidance and soft regulation. In the UK the AC roles and composition are regulated by the UK Corporate Governance Code (subject to "comply or explain" requirements of the London Stock Exchanges' listing rules) and Financial Reporting Council (FRC) guidance (not subject to "comply or explain" requirements).

Corporate governance regulation often experiences periods of change and development in response to corporate failures. As noted by Roberts et al (2005):

"…governance reform has typically followed governance failure" and "through successive rounds of governance failure, the non-executive has been the target of both blame and reform". Following the number of high profile corporate governance failures in 2002, the corporate governance regulation has undergone some significant reforms. In order to restore confidence in capital markets and as a measure to exercise more control, the Smith Guidance in the UK and the SOX legislation in the USA have enhanced requirements to AC independence, financial literacy (Ernst&Young, 2012a).

In the following paragraphs the current regulatory requirements to financial expertise (US and UK) will be considered.

3.1 Regulatory requirements to AC members' expertise

Under the SEC rules (SEC, 2011) every AC should identify at least one member who is a "financial expert". SEC details both the attributes required and the ways the attributes can be obtained. The three types of experience are indicated in the legislation, and they are generally grouped under three headings: accounting (SEC: e.g.: "experience as a principal financial officer, principal accounting officer, controller... or auditor"); financial (SEC e.g.: "overseeing or assessing the performance of companies with respect to the preparation or evaluation of financial statements"); and supervisory experience (SEC e.g.: "experience actively supervising a principal financial officer, principal accounting officer, controller … or auditor").

The UK code requires that at least one member on AC should possess a "recent and relevant financial experience". The code does not specify how this experience should be obtained. The accompanying guidance (which is not subject to "comply or explain" rule) says that the member "should have a professional qualification from one of the professional accountancy bodies" (FRC, 2010).

According to Giacomino, Akers and Wall (2009b) the "current regulation and laws vary as to the meaning of financial literacy and financial expertise". A number of studies point to the lack of consensus on the definition of financial literacy and financial expertise (e.g. Cunningham, 2007; Mustafa and Youssef, 2010; Giacomino, Akers and Wall, 2009a; Barra, 2010; Dhaliwal et al, 2010; DeFond, Hann and Hu 2005; DeFond and Francis, 2005). Giacomino, et al (2009a) in their research on AC's financial literacy conclude: "while financial literacy is important for an audit committee in discharging its duties there is no authoritative guidance or definition and limited empirical research as to what constitutes financial literacy of audit committees…".

Interestingly, both UK and USA regulators attempted to detail the requirements to AC directors. In the UK it was proposed that the Code should provide a clear definition of what constitutes "recent and relevant financial experience" (FRC, 2009). This has, however, been objected by business community. For example, SABMiller (2009) commented on this proposal: "We would not support such a change on the basis that we believe it is preferable for boards to apply their own judgement and form their own view, rather than have yet another judgement forced on upon them by the governance industry – largely because, all companies are different and there is no one size fits all prescription".

Similarly, the initial proposed definition from the SEC was quite specific, and required that AC members need "experience in preparing or auditing financial statements". However, following the criticism that the definition was too narrow and with this requirement it will be a challenge to fill a position of an AC member, SEC extended its initial definition to include supervisory expertise (Dhaliwal et al, 2006).

Currently both UK and US regulators allow a degree of latitude and effectively allow the boards of directors to decide the specific requirements to AC members' financial expertise. The SEC requires companies to disclose whether they have a "financial expert" on the audit committee but allows them to explain the absence of such director (SEC, 2003). Same is true for the UK companies (FRC, 2010a).

One of the reasons to develop a better understanding and a clearer definition of expertise required of AC members is to set the boundaries of their responsibility and accountability. In other words, there should be no confusion over the responsibilities as this may lead to the lack of accountability and eventually in case of failures or malpractice, passing the blame onto others.

Also some research and articles (e.g. Harrington, 2012) refer to an expectation gap related to some of AC functions, for example, their ability to detect fraud. A clearer definition will help to close this gap. Additionally, it would be useful to understand the current level of ACs' expertise and any perceived gaps in their literacy as this may help to understand whether ACs can bear the growing load of responsibilities that they are discharged with.

This research is aimed to contribute to the understanding of definition of financial expertise by capturing auditors' opinion and understanding what kind of expertise they consider relevant and important taking into account the current and expected roles of ACs.

3.2 Latest developments in regulation

The period following the subprime crisis of 2008 has seen the introduction of more codes and regulation pertaining to audit committees. In particular, the AC's responsibilities are being revisited. For example, the proposed EU regulation (Ernst&Young, 2012b) suggests "expanded audit reporting to the AC" and "stronger AC" that will "include at least one [member] with knowledge of audit and another with knowledge of accounting and/or auditing".

FRC has initiated the second post-subprime crisis review of the Corporate Governance code and issued a consultation paper to collect feedback. The 2012 review suggestions place more responsibility on ACs in reviewing the annual report. FRC is collecting comments at this stage. The effective date (if adopted) for the revised code will be October, 1, 2012 (FRC, 2012a).

The FRC consultation paper proposes to extend the remit of the audit committee "to include consideration of the whole annual report, including the narrative report" in order to determine "whether the annual report, viewed as a whole, is fair and balanced". The paper also proposes that ACs should include in their own report "the issues considered in relation to the financial statements, including any key judgements that it made". Previously this requirement was not a part of the code, but a part of an Audit Committees Guidance, which required ACs to "consider significant accounting policies, any changes to them and any significant estimates and judgements". The current version of the Code describes AC roles more broadly: "to monitor the integrity of the financial statements of the company".

It seems that the current move in regulation is towards understanding accounting judgements, estimates, and policies. This is probably due to the fact that there is a room for manipulation when the accounting judgments are involved and the latest corporate failures have shown that management may be employing the accounting practices that are allowable by the accounting regulation and that have been approved by auditors but still fail to reflect the true substance of transactions (e.g. Lehman Brothers' use of "Repo 105" transactions).

Probably in an attempt to address this issue, in August 15, 2012 the PCAOB (Public Company Accounting Oversight Board) has adopted changes to the standard on communications (PCAOB, 2012) with audit committees. The new version of the standard is purported to improve the communication process between AC and external auditors. A range of new requirements to the information communicated to AC has been introduced, among them the external auditor is to communicate to AC: "significant accounting policies and practices, critical accounting policies and practices, critical accounting estimates, significant unusual transactions". The auditors are also required to communicate to ACs among other things, the "alternative accounting treatments".

3.3 Correlational research

There is a whole body of research looking at possible correlations between AC members' characteristics, e.g. type of financial expertise and some AC effectiveness characteristics, proxied by accruals quality, earnings management, misappropriation of assets (e.g. Krishnan and Visvanathan, 2009; Zaman et al, 2011; DeZoort et al, 2008). Carcello et al (2011) refer to these variables as "input governance characteristics" and "accounting and auditing outcomes". Vast majority of this research is based on the US material. Most of the findings in this body of research show that financial and/or accounting expertise is positively associated with AC effectiveness. A number of studies indicate that accounting expertise plays a larger role compared to other types of expertise in AC effectiveness. For example, Krishnan and Visvanathan (2009) having studied the sample of S&P 500 firms' AC members, found that "an audit committee's financial expertise is positively associated with conservatism when financial expertise is defined to include only accounting experts".

Market also seems to value the appointment of AC directors with accounting expertise. DeFond, Hann, and Hu (2005) find that markets react positively to the appointment of an AC member with "accounting financial expertise" and are neutral to the appointment of directors with "non-accounting financial expertise". However, the result is contingent on this member being independent and the company's corporate governance being strong.

The controversy and lack of clarity around the definition of financial expertise have led to researchers coming up with different measures and definitions of financial expertise. Some studies use a SEC definition of AC members' financial literacy, classifying it into accounting, finance and supervisory expertise (e.g. Dhaliwal et al, 2006). Other studies limit the definition of financial literacy to one or two characteristics, e.g. "financial-reporting knowledge" and "audit-reporting" knowledge (DeZoort and Salterio, 2001). Cohen et al (2010a) bring industry expertise to their analysis. There are papers that classify members to accounting financial experts and non-accounting financial experts (DeFond, Hann, and Hu. 2005). Importantly, most of above studies used the available information on directors' background and education to measure the input data (e.g. Coates, Marais and Weil, 2007).

So interestingly, although prior literature affirms that financial and/or accounting expertise does contribute to AC effectiveness, there is no agreement on the measures of financial and/or accounting expertise. Giacomino et al (2009a) suggest that there is a need to develop specific criteria for assessing financial literacy. Until then, he asserts "audit committees and boards will need to use professional judgment in determining the most appropriate way to measure financial literacy considering the composition and expertise of the board members".

Giacomino et al (2010b) describe an experimental research conducted by Weil and Schipper in order to evaluate the AC directors' financial expertise. Weil and Schipper developed a quiz to measure the financial literacy of AC members who attended their executive training classes (1464 directors have been quizzed over the period of 4 years). The questions covered the material of a "basic accounting text for first-year MBA students" (Giacomino et al, 2010b). They found that the average rate for correct answers was 32% for AC members, which was lower than the results shown by MBA students in the same study.

However, one of the main roles of AC members, according to some previous research (Pozen, 2010) and surveys is to ask challenging questions of management and auditors: e.g. in FRC's "Walk the line" survey (FRC, 2012c) one of the AC chairmen claims: "the willingness and confidence to ask questions is seen as perhaps the most important attribute for audit committee members". So the question arises: What should be the AC members' level of expertise that would allow them to do so effectively. Weil (in an interview by Morse,

2004) argues that there is little value in asking questions, unless the answers can be correctly interpreted.

In order to test how well the AC members can interpret the answers and ask appropriate follow-up questions, Weil put together a questionnaire (in Morse, 2004) to "see how well board members could differentiate between CFOs satisfactory and evasive answers". The rate of correct answers to this questionnaire was less than 50%. Weil therefore concludes that it may not be sufficient for AC members to possess enough expertise to "ask the right questions", but they need to understand the answers in order to ask further questions or clarify the answers.

The above-mentioned research results as well Giacomino et al (2009a) experimental study based on the same questionnaire may indicate that even AC directors who meet the *formal* regulatory criteria for being considered "financially literate", still could be missing the essential skills to fulfil their role effectively.

3.4 Research on AC processes

The lack of research on AC processes has been identified as a literature gap by some researchers in the last decade. See for example, Bedard and Gendron (2010): "research on dynamics surrounding audit committee processes is scarce"; Carcello (2011) indicated the "need to address governance processes (what boards and audit committees actually do and how they do it), not just governance characteristics such as independence or financial expertise"; Roberts et al (2005) point at the lack of research on "behavioural processes": "there are calls for greater theoretical pluralism and more detailed attention to board processes and dynamics". Turley and Zaman (2007) highlight the significance of informal processes.

There is scarce literature on AC processes in general, and particularly on the specific processes related to AC's financial reporting oversight role. However, Beasley et al. (2009)

conducted a research looking specifically at processes employed by ACs in this role. The research is interview-based (AC members' interviews). They examine six process areas and investigate the ceremonial aspects and substantive aspects of these processes. They find that AC processes are mainly substantive in nature, but there is also a significant amount of ceremonial action as well. They also find that AC members are not comfortable with the role of assessing the financial reporting fraud risks and consider it to be a domain of external auditors. Also, based on their findings, ACs rely heavily on other parties "primarily auditors and management" in their oversight role.

Gendron et al (2004) conducted research on AC meetings with external auditors and found that the ability to ask challenging questions of auditors and managers is viewed as an important skill on AC board.

One of the recent researches on AC effectiveness includes an investigation by Cohen et al. (2010) of the auditors' experience with audit committees in the US. This study is particularly interesting due to the fact that same researchers conducted a similar study prior to SOX (Cohen et al 2002), so it was possible to assess the effect of SOX on AC's effectiveness in financial reporting oversight role. Overall auditors see a significant change in the post-SOX period and in their view, ACs are "considerably more active and diligent in the post-SOX era". There are some areas of concern though and these include the management playing a primary role in auditor appointment and dismissal. Also less than half of the interviewed thought that audit committees "plays an important role in resolving auditor disputes with management". This concern has also been raised in a research by Beasley et al (2009).

The above papers study the processes at US and Canadian companies. This paper explores the current issues with AC financial oversight role processes in the UK.

4. FINDINGS, ANALYSIS AND DISCUSSION

4.1 Requirements to AC members' financial expertise

According to respondents' views the level of expertise of AC members has increased since 2003 (the year when the requirement of "recent and relevant financial expertise" was first introduced). This is supported by statistical data. For example, according to Grant Thornton annual Corporate Governance Review (2011) the number of companies that were in compliance with this requirement has increased from 76.4% in 2004 to 92.6% in 2011.

When asked about the types of expertise required: accounting, finance and industry expertise (Questions 1), most respondents were of an opinion that financial and accounting expertise were indeed important. Respondents have considered accounting and financial expertise as equally important. The opinions on the level/depth and specific areas of financial and accounting expertise varied among respondents.

One of the respondents suggested that broad, rather than a narrow accounting expertise was desirable:

> "Broad finance expertise in terms of evaluating or dealing with financial statements whether that comes from being a chief executive, a finance director or an auditor is probably a good place to start as opposed to someone with pure accounting expertise".

The same respondent supported his view by pointing at the impracticability of attaining a high level of expertise in a certain area, for example, in International Financial Reporting Standards (IFRS). The view held was that due to the complexity of the IFRS it was not possible to be an expert in IFRS unless you are dealing with it on a day-to-day basis.

Some other respondents expressed similar views:

> "The role of a non-executive director is somewhat amateur. We are not necessarily expecting a particular expertise in a particular area in accounting or finance".

Three respondents pointed at changing demands to AC members' expertise in the context of their changing roles and responsibilities. They indicated that non-executive directors should now be more confident in assessing the key accounting judgements in the company's annual report:

> "Key judgement areas – that's an area that will cause a lot of anxiety amongst ACs – when you have to disclose what the key judgements are".

The respondent explained his understanding and gave some examples of accounting judgments: "Judgements are all areas that are not black and white, but grey: is the provision correct, what is the value of impairment, how much we are likely to recover on this particular debt, etc". In agreement with the above, another respondent suggested that there is "a change taking place" and providing judgements will be a challenge to current non-executive directors.

With regard to the financial expertise, respondents have not considered professional accounting qualification as imperative. Rather, they suggested that experience plays a greater role. As one respondent phrased it:

> "Professional accounting qualification is not something that is absolutely vital. …I would not rule people out just because they don't have it, if they have got the right type of experience".

There is some research in US on accounting qualification effect on AC's judgement. For example, DeZoort, Hermanson and Houston (2008) found that audit committee members who hold a Certified Professional Accountants (CPAs) designation are more likely to support an adjustment suggested by external auditors, i.e. are more conservative in their judgement, than non-CPA members in the post-SOX period. However, authors ask to exercise caution when interpreting these results due to the limitations of their research, namely, the sample size.

Regarding the industry expertise, (Question 1), most respondents expressed the view that whereas industry expertise was indeed important:

> "They need sufficient industry expertise: expertise understanding risks, complexities arising from the industry",

it was possible to acquire the expertise via CPD (Continuous Professional Development), or "learning on the job":

> "I don't think you need a whole career in the industry to start understanding these".

And another respondent suggested: "Industry expertise …can be learnt over time".

Industry expertise was included in the questionnaire due to the possible impact it may have on AC's effectiveness in overseeing the integrity of the financial statements. According to a research by Dhaliwal, Naiker and Navissi (2010) the AC members that possess industry or business specific knowledge can contribute to AC's effectiveness in monitoring the financial reporting process since "the business and industry knowledge possessed by finance experts can complement the domain-specific knowledge of accounting experts to promote accruals quality". We can find a similar idea in Cohen, Krishnamoorthy and Wright (2008): "AC members with industry expertise are likely to have a superior ability to understand, interpret, and assess the quality of financial reports than members with no industry expertise". This view was supported by the respondents, when they acknowledged the importance of this type of expertise.

However, in response to a question (Question 2) on more specific areas of industry expertise respondents struggled to provide a definitive answer. This could be explained by the fact that the industry or business expertise is difficult to generalize. Some respondents suggested that the depth and importance of the industry expertise depends on the industry the company is in. It has been mentioned that some industries will require more of industry-specific expertise than the others. One of the reasons could be that different industries bear different financial reporting risks. For example, some prior research findings on financial statements fraud indicated that (Beasley et al, 2000) "financial statement fraud techniques vary by industry… in technology companies, the most common fraud technique involved revenue recognition, while asset frauds and misappropriation of assets were most common in financial-services companies". The same research refers to the "concentration of frauds" in technology, health care, and financial-services industries.

Another area that emerged during the interviews is respondents' views on how many members should possess the accounting or finance expertise. There were opinions shared by all respondents and some answers/suggestions that stood out. Respondents generally agreed that at least one member should possess the financial reporting experience. Two respondents referred to this member as "an interpreter":

> "There has to be at least one member on the audit committee who has the ability to interpret what they are hearing to provide assistance and guidance to the other members".

It was further emphasized that other members should have "commercial" or "at least some accounting and finance expertise".

The above summarizes the respondents' views on the expertise required of AC members in order for them to effectively fulfil their financial oversight role. The next section will look at the current status of expertise of the UK AC members and provide a further analysis of the findings.

4.2 Audit committee's financial expertise: current level of expertise

The section will look at the current level of expertise of UK AC members and analyse the "literacy gaps" identified by respondents. The one common response worth considering is that in answering the Part 2 of the questionnaire – the current level of expertise – all respondents indicated that there is a marked difference in the financial expertise as well as some other characteristics (such as involvement in auditor-client discussions) between larger and smaller companies, with AC's expertise level showing a considerable decline below the FTSE 100 level. The smaller companies were broadly referred to as those below FTSE 100 level.

> "If you are talking about the FTSE 100 then it would be fairly rare for the calibre of audit committee members not to be quite high. They may not have an in-depth knowledge of IFRS but I think the level of experience for the type of role in the FTSE 100 is generally high".

This was supported by the second respondent: "there are some companies where the expertise on AC is not as strong. That tends to be in the lower end of the FTSE 350". And other respondents observed that "once you get outside the FTSE 100 it [expertise] starts falling away very quickly".

One of the reasons given for this by one of the respondents was the difficulties associated with finding the proper candidates since the position has a "high profile around it" and "has an additional exposure" compared to other directors. But also smaller companies often have "only a couple of non-executive directors" and they "automatically end up on the AC".

Another reason is the level of compensation as some of the non-executive directors feel that they are not "sufficiently well rewarded" according to a survey undertaken by the respondents' company.

No previous UK or US research has been identified that would look at the issues of companies' size (here, the size in terms of market capitalisation) and AC effectiveness. There is, however, statistical data showing that FTSE 100 and FTSE 250 companies perform differently in terms of AC processes and characteristics.[1,2]

Further research may help to better understand the relation between the size of a company, AC characteristics and AC performance.

4.2.1 Accounting and financial expertise

When asked about the accounting and finance expertise (Part 1 of the questionnaire, Appendix 1) three respondents out of six specifically indicated this as a problem. Two of these respondents indicated that AC members lack knowledge of IFRS, with one of them saying that this was a serious knowledge gap (especially for smaller companies). Interestingly, these two respondents clarified that they were not speaking of an in-depth knowledge of accounting standards. As one respondent put it, they "need a good working knowledge of broader rules related to financial reporting", which, according to the respondent, they lacked.

Some respondents explained this gap by the recency of International Financial Reporting Standards (IFRSs) adoption in the UK. IFRS became a mandatory set of reporting standards for EU listed companies in 2005 (European Parliament and Council Regulation No 1606/2002). The worldwide adoption of IFRS really took momentum after 2000. It was in 1999 that IOSCO approved IFRS as a set of standards to be recommended to its member bodies. Two of the respondents mentioned that current non-executive directors weren't

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[1] For example, annual Corporate Governance Review undertaken by Grant Thornton collects some statistical information from FTSE 350 and according to the latest (2011) review the average number of AC meetings, average fees per meeting varied considerably between FTSE 100 and FTSE 250.

[2] A recent survey of Australian companies on the level of financial literacy also showed a degree of variability in literacy between the Top 200 and smaller companies. (available at: http://www.frc.gov.au/reports/other/Financial_Literacy_Survey/downloads/FRC_BETF_final.pdf).

"educated in IFRS", neither have they had "working experience in IFRS, most of their experience, if any, "was with the UK GAAP". Indeed, in case non-executive directors have been occupying their posts for more than 7 years (since the adoption of mandatory IFRS reporting in 2005), then it is very unlikely that they have had any hands-on experience with IFRS.

Another issue mentioned in relation to the knowledge of IFRS is the complexity of the standards, and the fact that they have been evolving, developing and changing so fast in the past years that it makes it difficult for anyone who is not dealing with it on a daily basis to have a good grasp of the IFRS related issues.

A recent survey of Australian companies, conducted by the Australian Government (FRC Australia, 2012), also includes concerns related to the level of board directors' confidence with IFRS: "the increasing complexity of accounting standards is making it more difficult for directors to acquire and maintain the level of financial knowledge needed to sign off on financial statements".

The rest of the respondents were of an opinion that current AC boards possess sufficient accounting and financial expertise.

The one respondent, who pointed at the lack of accounting expertise among the current AC boards, stated that current non-executive directors are ill-prepared to provide their opinion on the key accounting judgments. In case the revised version of the code is issued by FRC this requirement will become part of the new code (FRC, 2012a). The same respondent pointed that at the moment only 9% of FTSE 350 companies provide key judgements in their annual report. This has been described as a "huge area of challenge for ACs".

Analysis/discussion

It is a worrying finding that IFRS accounting knowledge, and more importantly, accounting judgement skills may be missing on AC boards as there is past research suggesting that such knowledge has a significant impact on the quality of the company's financial reporting. Whereas no research looking at the UK AC's accounting expertise specifically has been identified[3], there is a number of US-based research findings indicating that accounting expertise is associated with "better" financial reporting outcomes, measured as "accruals quality" or "accounting earnings management", see for example, Cunningham (2007), Krishnan and Visvanathan (2008).

With the global acceptance of IFRS as a common "language of accounting" and the issuance of IFRS for SMEs one of the possible scenarios could be that UK GAAP will over time be overtaken by IFRS. So knowledge of IFRS on AC board will likely to become more relevant and it is important for AC directors to take this on board.

The non-executive directors' capacity to provide an opinion on key accounting judgements is another area of concern. It is difficult to make any assumptions at this stage of whether the FRC proposal (if implemented) will contribute to improving AC's capacity in this area by requiring ACs to produce their own report on this. Two respondents commented on the Corporate Governance Code revision (there was no specific question on this in the questionnaire). One of the respondents commented that AC members would have to be more "conscious about what they are saying":

> "One thing is to having a discussion in the privacy of audit committee. But once you start putting that in the public domain, then people can challenge it and that makes AC members a lot more conscious about what they are saying".

Another respondent expressed concerns that this extension of AC's remit threatens the unitary structure of the board, since one of the board committees – an AC – will have a disproportionately higher level of responsibilities.

[3] The UK-based research on ACs does not differentiate between finance and accounting expertise, combining them in one category (e.g. Zaman, Hudaib and Haniffa, 2011).

If we draw some parallels with an introduction of management certification of financial reporting in the US, that was introduced by Sarbanes Oxley Act (Sec. 302), the empirical evidence suggests that in the post-SOX period management exercises more conservatism in financial reporting and there is a "significant reduction in discretionary accruals [a measure of accounting conservatism] (Lobo and Zhou, 2006). Also Cohen Krishnamoorthy and Wright et al (2010a) point at a positive effect that the mandatory management certification of the financial statements had on "the integrity of financial reporting".

However, in case of the revised UK code the AC members will not be assigned an individual responsibility. The responsibility will still remain at group level and this will still carry all the drawbacks attached to it.

It would be interesting to see what changes in the work of AC will occur with adoption of a new version of the Code.

4.2.2 Industry and risk management expertise and "other" expertise' role in AC effectiveness

One of the interviewees identified the lack of industry/business expertise on AC board, saying that the industry expertise "gets missed, because various codes rarely talk about industry expertise".

> "Some of the best questions around the audit committee table sometimes come from the least expected area. Often it is not financial or accounting expert that asks that decisive question around off-balance balance sheet financing. Often it's the guy who is perhaps there because he understands the industry, but he asks the "daft laddie" question, the really "silly" question: how does that work, why, how".

Industry expertise was often mentioned in connection with risk management expertise. These respondents considered industry expertise as helpful in identifying the relevant financial reporting risks. This is again consistent with the argument in a research by Cohen, Krishnamoorthy and Wright (2010a): "the strong industry expertise …suggests that members of the audit committee would have sufficient knowledge to assess the business activities and risks for a company to be able to evaluate whether accounting methods properly reflect the economic substance of transactions and whether estimates are realistic, leading to higher quality financial reporting".

4.2.3 Balance/mix of expertise

The discussion of the types of expertise leads to the discussion of the balance or distribution of these types of expertise among the board members, or an optimum mix of expertise.

Between the three types of expertise, financial, accounting and industry, in the questionnaire (Question 1), respondents seemed to agree that it was unlikely that the three types of expertise should reside with one person:

> "Collectively an audit committee should have the right expertise, but obviously that expertise might not reside in any one individual. You are looking for a collective knowledge, skills and experience".

So in fact, respondents are suggesting that it will be very difficult to find one person with a desirable level of expertise in all three areas. Hence the AC members should complement each other and collectively provide the required expertise.

Some researchers in the past expressed concerns that "financial expertise requirements result in ACs being less diversified in terms of membership" (Bedard and Gendron, 2010)". Consistent with these arguments are respondents' (3 respondents) views that too much accounting expertise was not necessarily good.

> "An audit committee needs a balance of expertise. You can't have an audit committee made up of accountants. They need to have a broad set of skills, a lot of it based on experience to be there in the first place".

The reason given by two of the respondents is that "too much" accounting expertise will lead to "too much" discussion of the technical accounting issues. This may have an adverse effect on the effectiveness of AC meetings as some broader picture will be lost behind the technicalities. One of the respondents even suggested that "someone who did not have much background in the industry is ideal".

> "There is a school of thought that says that sometimes somebody who did not have much background in the industry is ideal".

Interestingly, in the previous interview-based research on AC's expertise and composition respondents expressed a similar view (e.g. Cohen et al, 2010b and Bedard and Gendron, 2006). And surveys of AC members and chairs in the UK include similar opinions, e.g., "Walk the Line" (FRC, 2012c) survey interviewed AC chairmen, and one of the responses on the composition of the AC was the following:

> "I will appoint one person because he just comes from a different space intellectually. I'll appoint another because they understand the industry; and another because they understand the broader economics. And then there is the fourth member, the one who doesn't fit any of those moulds. Why do we put him there? For a range of reasons: one because he is left field, and so he asks something different".

So according to the above one of the reasons to appoint someone is that it may bring diversity to the discussion, help to look at issues from a different angle. Another interesting reason, probably more of a psychological nature, rather than a "group dynamic" nature was given by one of the respondents:

> "A human nature is that the person who is perhaps the least expert is best able to ask those questions, whereas the person who is perceived as being the expert, who sort of understands what is being said may be reluctant to question it so as not to embarrass himself".

This "skill" to ask questions, that other board members may feel embarrassed to ask has been mentioned in interviews by some AC chairmen in the past. See, for example, Beasley et al (2009): "audit committees need people willing to ask dumb questions in front of smart peers"; FRC survey (2012c): "audit committee needs someone prepared to ask the 'daft laddie' question". These respondents seem to believe that the person who is in the best position to ask "dumb" questions should come from a completely different background than other AC members (not accounting background). The Smith Guidance (2003) stated specifically: "There may also be advantage in including a member without much financial experience or literacy but with a strong intellect, who can perhaps more easily than others cut through the technicalities and raise the right straightforward questions". Roberts et al (2005) refers to this "skill" as an "experienced ignorance". One of the interviewees in his study noted that "just by asking the idiot-boy questions you can really add value".

Roberts et al (2005) explain this by the fact that there will always be information asymmetry on the board and non-executive directors will be on the unprivileged side of this asymmetry. Therefore, in his opinion: "what a non-executive can bring to the relationship is the objectivity that their relative distance from day-to-day matters allows, along with the experience and knowledge acquired elsewhere".

These opinions may indicate a call for a behavioural research and group dynamics research. Some recent studies also point at the lack of research on "group issues" (Carcello et al, 2011) and the value of behavioural research for better understanding of "governance oversight of the financial reporting process" (Beasley et al, 2009).

Whereas respondents provided their opinion on the expertise, they commented that other factors can have a significant effect on AC's effectiveness in the financial reporting process oversight. The next section will look at processes and how they contribute to AC's effectiveness in their financial oversight role.

4.3 Audit committee financial oversight: processes

Initially the focus of the research was on the expertise required of AC directors in fulfilling their financial oversight role. However, with interviews progressing, it has become clear that respondents are placing importance on other factors, such as processes (both formal and informal), and the company context in which AC operates. Anecdotal evidence also suggests that audit committees fail in their oversight role even when they have directors with the required credentials, background, and financial experience. Beasley et al (2009), for example, gives an example of a Hollinger company; also Enron is notoriously famous for having an audit committee comprised of highly professional individuals (e.g. Louis, 2002).

The next paragraphs will look at the effect of processes on AC effectiveness in overseeing financial reporting. Some previous research specifically pointed at the lack of studies in this field. For example, in his article Verdun (2004) suggests that: "the real value of an effectively operating audit committee arguably lies in its process, namely, the scope of the authority that the audit committee has to undertake its role, the manner in which the audit committee interfaces with the company's financial reporting system…". Similarly, Turley and Zaman (2007) highlight the significance of informal processes in analysing AC effectiveness. And finally, Carcello et al (2011) in a recent literature review research identified this area as one of the "under-researched" areas, requiring further investigation: "need to address governance processes (what boards and audit committees actually do and how they do it), not just governance characteristics such as independence or financial expertise".

There were three specific process areas that were identified during the interviews. The first process relates to the information exchange between the company management and the AC members.

4.3.1 Timeliness of information provided to AC members

One respondent indicated specifically that literacy of AC members was indeed important but even more important were the processes related to their role of overseeing the integrity of financial statements: "Because of the nature of the role of non-executive directors, the problem is not really literacy. I think it's a process issue". The process that this respondent considered to be critical for the AC effectiveness was the timing and level of AC involvement in annual reports preparation. He explained the conditions that may give rise to an insufficient level of oversight:

> "Companies work to a tight reporting timetable and they announce the dates when the financial reporting statements are going to be published. Often there is no choice but for that to happen and that's the perception anyway that it [publishing] must happen on a particular date. What happens in practice is management prepares financial statements and the effectiveness of audit committee members depends a lot on what stage in the process they are brought in. If it's too late in the process, then there is a lot of pressure on boards, but particularly on ACs to just "pass" and not necessarily challenge this deeply. They would have done [challenged] if there had been a better process and more time to do so. But if the first time you saw the set of financial statements was when they were in a final produced draft, then your opportunity to say anything much about it is limited because it's too late".

Another respondent mentioned that these situations (where the AC gets involved at a later stage in the annual report analysis, instead of being there from the beginning) do occur at FTSE 350 audit committees. It is difficult to conclude, given the limitations of this research, whether this issue pertains to only a small number of companies and whether this issue is relevant to the UK ACs only.

Whereas no research has been identified that would look at this particular issue – timing of AC involvement in the oversight of the annual reporting process, there are research findings related to the audit committee meeting processes. Beasley et al (2009) analysed three components of the meeting processes: AC meeting number and length, audit committee meeting agenda setting, communications between meetings and pre-meeting flow of information to the AC. This last component is particularly relevant to the finding of this study. Beasley et al (2009) concludes that "information timeliness can be a significant issue and may reduce the AC to a ceremonial role". The risks may also lie in the agenda setting process, as Beasley et al give a number of examples of corporate governance failures (Enron, WorldCom, Hollinger) where the senior management took control of the agenda and thus was able to control the flow of information to the board and AC.

In accordance with the UK Code, it is the role of the company's chairman to set the agenda and ensure "that adequate time is available for discussion of all agenda items" and ensure "that the directors receive accurate, timely and clear information." Additionally, one of the roles of a chairman is to ensure constructive contribution from all board members, both executive and non-executive directors. Two respondents mentioned the chairman role in this regard: "it is the role of the chairmen in making sure that all voices are heard". One of the respondents mentioned that the AC ought to be using the company secretary in obtaining information: "I think they have a key role to play in the UK in terms of obtaining information. They are a neutral person". According to the UK Corporate Governance Code (FRC 2010a), the company secretary's responsibilities include: "ensuring good information flows within the board and its committees and between senior management and nonexecutive directors".

So further investigation of this issue (maybe as a part of a bigger research on AC processes) will probably help to clarify the roles of chairmen and company secretaries in communicating information to ACs.

4.3.2 Reliance on external auditors and financial management in obtaining information

Turley and Zaman (2007) suggest that "formally the AC is very much a receiving and responding" body and therefore ACs are "very dependent on the manner in which other parties choose to interact with, and provide information" to it. However, with growing responsibilities the ACs may be prompted to take a more active position in financial reporting oversight. The question is: in order for ACs to fulfil their oversight function effectively, should they be more proactive in their role or whether they should remain as "receiving and responding" bodies.

One of the questions (Question 5) in the interview was: "What should be the extent of audit committee's reliance on: **a.** financial management of the company **b.** external auditors in obtaining information required to fulfil their oversight function (financial reporting oversight)?" and "What is the current situation with this in the UK ACs?" The rationale for these questions was to capture auditors' views on the desirable and current degree of reliance.

The answers varied but most respondents were inclined to think that ACs should rely both on financial management and the external auditors to bring any significant issues to their attention.

> "They have a right to rely on financial management to prepare the information in a good way and also to draw to their attention any particular issues. They are not necessarily expected to be detectives to try and work out within a

> whole mass of information what key points are. They should also be able to rely on the external auditors to draw issues to their attention as well. My expectation is that in practice external auditors and financial management would have spoken to each other through the audit process and have come to an agreement of what the key points for the committee to be concerned with. I don't think they should necessarily be looking for new issues that nobody else had raised".

> "An audit committee will develop a good understanding of the business, but they will focus on the matters that are brought to their attention as opposed to maybe searching out other issues. … Audit committees have to rely upon the expertise of financial management of the business supported by auditors".

> "I won't expect the audit committee to look any further than the management and the external auditor to reach its conclusions".

At the same time these respondents highlighted the importance of "trust but verify" approach, stating that AC directors should "maintain a healthy degree of scepticism". Two respondents indicated that ACs should rely on both parties in obtaining information but to do so the AC should be satisfied with the "integrity of management" and "professionalism and competency" of external auditors and "build a relationship where an AC can trust the financial management of the company and the audit partner".

Bedard and Gendron (2006) have interviewed three major Canadian corporations listed on the Toronto Stock Exchange. Their interviewees came up with similar answers, i.e., AC chairmen emphasized that ACs rely on "assessment of management and auditor integrity".

However, there is no fundamental research on how the managements' or external auditors' integrity can be measured. Some previous research touches upon this issue, for example, Beasley et al (2009) had questioned AC chairmen on "how audit committee members assess management's integrity (i.e., "the tone at the top"). The answers included such means as: "evaluate management's body language; observe management's transparency/openness, especially with the board and the audit committee; observe how management reacts in pressure situations; observe if management is defensive" and some respondents said they use "whistleblower hotline". Beasley et al conclude that there is no consistency in the way the managements' integrity was assessed. Taking into account the value of integrity assessment evidenced by interviewees' responses, further research on integrity assessment could help to obtain a better understanding of this process.

Current situation

As of the current situation, most respondents agreed that there is an optimal degree of reliance and these respondents did not think any changes were needed here. However, there was one critical opinion that there is an unacceptable degree of reliance on the financial management of the company. One of the respondents stated that the current UK audit committees are over-relying on financial management and external auditors in obtaining information. This was explained by the lack of financial expertise:

> "They rely on financial controllers rather than CFOs which is a consequence of the fact that financial statements are not intuitive to people who don't happen to be professional accountants".

Interestingly, those respondents that had been satisfied with the level of expertise of AC members stated that AC members should rely on external auditors and the financial management of the company to raise any financial-reporting related issues (Group1). Those respondents that pointed at the lack of accounting and financial expertise also stated that AC members are either over-relying on management and external auditors in obtaining information for their judgement, or get involved too late in the process, suggesting that ACs should take a more proactive role in monitoring the integrity of the financial statements (Group 2).

There is a research suggesting that the lack of expertise leads to reliance on external auditors (Verschoor, 1997). The similar opinion is contained in a report produced by FRC, ICAS and ICAA (FRC, 2012c) based on interviews with AC chairmen. One of the respondents in this report claimed that: “most current non-executive directors were of a generation who were not brought up with International Financial Reporting Standards” and “it made them too reliant on management and the external auditor”.

Another hypothesis can be inferred from respondents’ answers to this question. There are several theories of corporate governance. Under the agency theory the role of the AC will be to monitor the financial reporting process in order to reduce the agency costs to shareholders. It could be that Group 2 respondents identify themselves with the agency theory, whereas Group 1 respondents identify themselves with the stewardship theory as the stewardship theory “asserts the need for collaboration” (Roberts et al, 2005). Carcello et al (2011) in his review of corporate governance research in accounting and auditing observes that “researchers often find that audit committee members interviewed about governance processes provide responses that are consistent with a mix of governance theories”. Non-executive directors’ role assumes that directors are both shareholders’ agents and should monitor directors’ performance but at the same time they should collaborate with directors in achieving the company’s goals (UK Corporate Governance Code, FRC, 2010a) and may assume other roles as well. As Roberts et al (2005) described it, non-executive directors are expected to be ‘engaged but non-executive’, ‘challenging but supportive’ and ‘independent but involved'. One of the respondents describes the two perspectives of the role of a non-executive director:

> "The relationship between AC and management and auditors should not be adversarial. There should be trust. The audit committee should trust the executives, the management, and the auditor to be able to do their job properly. But it's trust with verification. So you can't just rely on trust you have to ask sensible questions. Audit committee will be relying upon management in preparation of financial statements. But it will also be jumping up and down quite hard if management were found to deliver things very late, mislead things in any way".

Maintaining such balance is quite a challenging task and there is little guidance or research on how to achieve this. One of the insights can be found in O'Neill (2002, quoted in Roberts et al, 2005, p. S11) where she warns about creating the "culture of suspicion" which paradoxically can be an unexpected result of increased "transparency". "Well placed trust', she suggests, grows out of active enquiry rather than blind acceptance".

Similarly, Pozen (2010) agrees that whereas directors indeed have to possess the expertise to assess the information they receive in order to ask the right questions, but more importantly, he states "the directors must know what questions to ask about information they are not getting". And to make this task manageable, he suggests that external auditors "should identify any significant accounting policies that depart from standard industry practice or for which the accounting literature allows alternative treatments…and provide the committee with a careful analysis of the risks and benefits of available alternatives". In the USA the changes to the standard on communications have been adopted (PCAOB, 2012). It would be interesting to see how this affects the quality of auditor-audit committee communication, since in the past there were cases where auditors themselves did not consider the accounting practices as being divergent in any way and therefore they did not consider it necessary to bring the issues to the attention of ACs (e.g. Lehman Brothers auditors).

The third process area that will be looked at in this section is related to the way ACs approach any accounting/financial reporting issues raised by the auditors (Question 8).

4.3.3 How ACs discuss the issues raised by external auditors

The third process that was uncovered is the AC involvement in discussing and resolving financial reporting issues that arose during the audit. This relates to the issue of AC's proactivity in their communications with the external auditors.

The current regulation in this field (Guidance on Audit Committees, FRC, 2010b) expects the ACs to discharge the following duties: review with auditors the audit findings, and discuss "major issues" that arose during the audit (both resolved and unresolved issues), "review key accounting and audit judgments" and "review levels of errors identified during the audit". According to the Guidance, the audit committee should also review the representation letters and management letters.

Responses relating to this process have been received both as answers to Question 8 and answers to additional questions. Responses here varied with some respondents saying that audit committees get involved in discussions with external auditors and issues that emerge in the course of audits are discussed between the two parties. Also most respondents said that it was unusual for audit committees to raise any issues. It was more common for external auditors to raise the financial reporting issues (if any) for discussion:

> "If an auditor has a serious issue that might affect the audit opinion – they would put that point across first and make sure the audit committee understood that".

Two of the respondents were of an opinion that the ACs do not always engage in adequate discussion of audit issues:

> “I have had chairmen of audit committees say to me: ‘This isn’t taking long, is it?’ at the beginning of meetings as if it was an obligation that we were putting on them. This was more than on one occasion. Those tend to be smaller companies, though”.

Another respondent said that even on those occasions where auditors raise the issues, they are not always taken on board by the ACs:

> “I definitely have experience of audit committees not necessarily taking all these issues responsibly: you can lead the horse to water but you cannot make it drink”.

The respondent, however, commented further on this by saying that “this happens less in FTSE 100: “the tendency to brush problems under the carpet would happen more often at the smaller companies”.

Some of the reports issued by larger consulting firms on the quality of corporate governance disclosure include a criticism of the lack of disclosure in this area. The joint ICAEW and BDO research (ICAEW, 2011) has come up with a list of key observations that include the following:

> “Very few audit committee reports include any information on reviewing audit representation letters or management’s letters and on management’s responsiveness to the external auditor’s findings and recommendations”.

This may also point at the inadequate level of discussion of the contentious issues and hence a very limited reporting of these issues.

Knapp (1987) argues that AC members “have to have adequate knowledge and expertise” in order to take part in resolving contentious issues between auditors and management: “only data and their literal interpretations are not enough rather they require technical knowledge and wider experience”. This brings us back to the financial expertise of

AC members and their reliance on management and external auditors to resolve any issues between them.

Yet another recent behavioural research by Schöndube-Pirchegger and Schöndube (2011) investigates the rationale for audit committees to agree with auditors' opinion without properly challenging the questionable financial reporting issues and exercising independent judgement. Schöndube-Pirchegger and Schöndube suggest that audit committee members place a great deal of concern on their reputation in the labour market. They find that audit committee members are motivated to agree with auditors' opinion since in case the financial statements are found to be incorrect, they will "share the blame" with auditors. Whereas if the AC were to be in disagreement with the management and the auditors and subsequently the AC was found to be wrong, this would result in a bigger damage to their reputation. Schöndube-Pirchegger and Schöndube refer to this phenomenon as a "herding behaviour". More importantly Schöndube-Pirchegger and Schöndube suggest that their theory "holds even if the audit committee members are held liable for detected failure".

The latter argument questions the efficacy of the new regulation which supposedly increases AC liability by requiring it to produce a separate report and express their opinion on the quality of financial reporting.

4.3.4 Other issues: informal processes, AC personal qualities and culture

In their responses interviewees referred to some other factors that play a role in AC effectiveness financial oversight role. These are informal processes, the integrity of AC directors and the culture of the organization.

Particularly, the interviewees stressed the importance of informal communication and relationships between the AC and other parties:

> "I think it broadly comes down to relationships. I think it's quite a soft issue. The difference between good and bad audit committees is often around those

> softer skills, around the quality of relationships the audit committee has, not just around the committee table and each other, but with management, with internal audit, with external audit".

A similar view is expressed by Roberts et al (2005): "Actual board effectiveness… depends upon the behavioural dynamics of a board, and how the web of interpersonal and group relationships between executive and non-executives is developed in a particular company context". Also, Turley and Zaman (2007) highlight the significance of informal processes. "The effects of the audit committee do not result solely from the existence of formal structures and processes (as tend to be specified in governance codes) but are additionally dependent on informal voluntary interaction with (senior) management and (internal and external) auditors. …Interaction between the audit committee, executive management and the external auditors influences corporate governance outcomes, and some of the strongest evidence of audit committee impact on organizational life comes from outside the formal meetings".

The above opinions indicate that in addition to their professional skills and characteristics and formal processes, directors' personal skills, their integrity their ability to build relationships, deserve equal attention. Some of the respondents questioned the effectiveness of "codification" or increasing corporate governance regulation in response to corporate governance inefficiencies:

> "When we have a crisis like 2008 there is usually a great urge to introduce some sort of new regulation or new rules... Regulators, society, politicians succumbed by the media look to add extra layers around processes, qualifications... These things in my experience tend to be costly, difficult to do and don't really get at the real cause of what the problems are".

The respondent then suggests that the cause to the problems are "the behavioural or soft issues: people behaving badly and people not being as diligent as they ought to be". Peter Verhezen (2010) suggests that whereas formal codes and regulation are necessary it is "informal mechanisms that are based on relationship-building" that will likely inspire moral excellence and integrity. But soft issues, like "integrity", "culture", "ethics" tend to be elusive, mostly invisible and difficult to measure. This is supported by respondent's example from his work practice:

> "I did a piece of work on an audit committee a few months ago. I tried to review how effective they are. I reviewed all the documents, all the publicly available information … all seemed to be very sensible. I sat in the meeting with two audit committee members and an audit committee chairman. Whereas an audit committee chairman had a good dialogue with the auditors and management, the two AC members did not say a word. …Fundamentally that just seems wrong to me. And you can't measure or regulate for people not seemingly being alert, not asking the right questions and pushing the right buttons".

Another respondent pointed at the growing focus on issues, related to culture of the company:

> "There is a growing focus by chairmen on the culture of the organisation. You see a lot of the company failings in the publicity recently. And you see that the inappropriate actions and decisions have been taken not because the rules weren't there, but because the attitude of the people did not reflect what the chairmen or the shareholders wanted… Culture has a pervasive influence over people, management of finance, operation of controls and basically the way business is done. And that's something that an audit committee can't ignore. If

> an audit committee is reviewing the figures and it knows that CEO, for example, is very aggressive … and if the reward and bonus systems encourage rapid growth, then you have to be aware that figures may have been influenced by the bonuses and attitude of CEO".

When asked of the possible ways to improve the AC skills in this area, respondents suggested that more guidelines, professional training would be of benefit to AC directors. One of the respondents indicated some topics in relation to informal communication and processes that deserve attention: "How do you get the financial director on the side? What tricks of the trade does an AC use to ensure that they get the very best information around the organisation? What sort of conversations can ACs have around the table?"

5. CONCLUSION

This study has explored the AC's effectiveness in one particular role – overseeing the integrity of the financial information released by companies to the public. This has been investigated in the context of a changing environment, in the aftermath of the 2008 subprime crisis, in which the regulators, researchers and businesses are looking for the ways to improve the governance mechanisms and rebuild the investors' and the public's trust in corporations. Audit committees play an increasing role in the corporate governance mosaic. Often, in the eyes of the public and investors ACs are associated with corporate failures and they are seen as being partially responsible for the failures. However, they face many challenges in their role as with increasing responsibilities it takes time for ACs to adapt to new regulatory requirements. One of the respondents in this study shared some of the findings of their company's research according to which "it takes 5 years typically for any new guidance to get taken up by the majority of companies".

This research sought to improve an understanding of the factors affecting AC's financial oversight role in the UK companies in this dynamic environment. The exploratory nature of this research allowed to obtain rich information from interviewees, without focusing on any particular theory or hypothesis. One of the insights of this research was the recognition that it is a challenge to single out one factor contributing to AC effectiveness in its financial oversight role as there is an interplay between different factors and the weakness of one characteristic can be compensated by the strength of other factors: be that other processes (formal or informal), AC directors' characteristics or the company context.

There are a number of limitations to this research. Firstly, the study is based on the interviews with larger audit firms. Members interviewed might have exercised some caution in expressing their opinion, despite the assurances of anonymity. There are strict procedures and policies in these firms on sharing information with the public due to reputational concerns and legal obligations related to client confidentiality. This corporate culture might have had an impact on how openly the interviewees have expressed their views.

Secondly, the research aimed at investigating auditors' experience and opinion on FTSE 350 companies. Apparently the interviewees have had experience communicating with a sample of the FTSE 350 companies and the opinions they expressed were based on this experience. A larger sample of interviewees might have helped to be more confident about the representativeness of the research findings. For example Cohen et al (2010b) in an interview-based study of AC effectiveness conducted interviews with 30 external audit (Big4) partners.

Thirdly, as with any questionnaire there is a risk that respondents attribute different meanings to interview questions. As Foddy (1993) notes: "all topics are multidimensional" and he stresses the importance of shared understanding of "what a question is about". A number of measures have been taken to address this. Some of the concepts have been defined in the questionnaire (Question 1). And the semi-structured interview design allows for probing and clarification of answers during the interview process. However, in some instances there was a need to remind the respondents of the research question, when it was clear that interviewees' responses were outside the topic of the research, for example, when interviewees digressed to other AC roles (not the financial oversight role). These were single incidents and overall the rapport with the interviewees was very good.

5.1 Key research findings

Respondents shared their views on what should constitute financial expertise on ACs and whether the UK AC members possess this expertise.

One of the key findings of this research is the growing role of AC members in understanding and reviewing key accounting judgements contained in company's reporting. The latest regulatory initiatives point at the increasing focus at financial reporting areas that are judgemental in nature and where the management has to use estimates or where there are alternative treatments. In the UK this resulted in a proposal to require the ACs to report on the way they assessed the key judgements (FRC, 2012a). In the US the PCAOB (2012) updated their standard on communications with ACs to prescribe that auditors should provide more comprehensive information on available alternative accounting treatments.

The second finding worth considering is the AC's literacy in IFRS. It appears from some of the respondents' perspective that AC members do not possess sufficient level of expertise in IFRS. This is probably more relevant to the UK than to the US audit committees. US companies still apply their local accounting principles, and audit committees in the US are more likely to have members with experience of US GAAP reporting, whereas UK companies have to report under IFRS (group reporting) and this area is new to most non-executive directors.

The third finding is related to ACs of smaller UK companies. Respondents' answers indicate that there is a degree of disparity between the FTSE 100 and Mid 250 companies in terms of AC characteristic, in particular, the financial expertise.

Another finding of this research which is in agreement with the previous research findings is the insight that the ability to ask the "right" questions scores highly in the hierarchy of AC skills. Respondents referred to these questions as "dumb" questions or "daft laddie" questions. Though the ability to ask the "right" questions has been mentioned in previous studies, no research has been identified that would have studied this phenomenon in more detail. An understanding of "how it works" could have helped to clarify the skill requirements to AC members.

One of the dimensions investigated in this study is AC processes. The main findings here include the respondents' concerns about the insufficient degree of AC involvement in the process of the annual report preparation (timing of the involvement) and in particular, the roles of the chairman and the company secretary in this process.

Also respondents' views on the degree of audit committee's reliance on external auditors and the financial management were conflicting, with one respondent stating that currently UK ACs rely too much on the financial management of the company in obtaining information. The research is inconclusive on this. However, the overreliance could be related to the level of AC members' expertise to a certain extent. Also how AC members understand and perceive their role may affect the level of their reliance. Other respondents claimed that the degree of reliance is optimal, but AC members should continuously assess the integrity of the external auditors to make sure they can trust them.

Concerns have been raised about the insufficient discussion during the meeting of AC with auditors of financial reporting issues emerging from audits. Of a particular concern is an observation that ACs of smaller companies do not seem to be taking these discussions seriously. One of the reasons could be AC's motivation to agree with auditors' opinion to reduce the risks to AC members' reputation in case AC proves to be wrong, as suggested by Schöndube-Pirchegger and Schöndube (2011). There could also be a trade-off between the level of AC's expertise and the eagerness and readiness of AC members to engage in discussions. One of the respondents observed that IFRS was not "an exciting topic" for AC members and "if, for example, you start talking to an average audit member about the impairment of intangible fixed assets, they glaze over fairly quickly". The research is inconclusive as to the reasons for the lack of discussion of financial reporting issues with auditors.

5.2 Further research

As a result of this papers' findings, some areas for further research have been identified as being topical.

- Key judgement areas: further research could look at the current processes that ACs engage in to review the judgments, and also investigate the areas where the risks to the integrity of financial reporting that come from management applying judgment are greatest.

- Audit committee training and CPD (Continuous Professional Development): interviewees have been asked about the possible ways to improve the level of financial expertise of audit committee members in the UK (Question 10). Three respondents mentioned the increasing importance of CPD for the AC members to update their knowledge continuously and they noted that the chairman should lead this process. CPD is a requirement of the UK Corporate Governance Code and it is the role of a chairman to "ensure that the directors continually update their skills and the knowledge" (FRC, 2010). Coates, Marais and Weil (2007) found from their interviews of AC board chairmen that no one of them "had any formal process to increase financial literacy of the audit committee members". Further research on the processes related to CPD and the quality of training currently provided by leading suppliers of CPD services for non-executive directors could help to assess the benefits of professional training for AC members.

- It has been emphasised that ACs should exercise a certain degree of scepticism in their role and they should "trust but verify". However, how this should be done in practice, what processes (formal or informal) could be used to strike the right balance between non-executive directors' monitoring and cooperating roles is unclear. One respondent noted that "good boards can do it". So it might be useful to approach AC boards that are effective in this and investigate the processes and "best practice" employed by these boards.

- Research on AC effectiveness in smaller sized companies: a research in this area may help to understand the effectiveness of corporate governance regulation in the companies of smaller size.

- Research on AC's expertise and AC processes: research in this area could help to answer questions: how does AC members' expertise affects their interaction with auditors and management.

- Research on group dynamics of audit committees: the findings of this study indicate that the way AC members interact with each other (e.g. AC members with different background, level of expertise) and with other groups (external auditors, financial management) at formal and informal levels, play a significant role in AC effectiveness. Further research could focus on the behaviour and processes related to AC contribution during the board discussions, the ways to build an effective audit committee team, the personality styles of AC members and their effect on AC performance as a team.

Appendix I. Research questionnaire.

Interview Part 1
1. How would you rate the importance of the following types of expertise for audit committee to effectively fulfil its role of monitoring the integrity of financial statements? a. Accounting expertise - experience preparing or auditing financial statements. b. Finance expertise - experience analyzing or evaluating financial statements. c. Industry expertise - understanding complexities arising from the industry/business the company is operating in. d. Other (please specify)
2. Within each type of expertise could you indicate the knowledge areas that are absolutely essential?
3. How would you evaluate the importance of having a formal qualification for the above types of expertise? Why?
4. How would you evaluate the importance of professional experience for the above mentioned types of expertise? Why?
5. What should be the degree of audit committee's reliance on: a. Financial management of the company b. External auditors in obtaining information required to fulfil their oversight function (financial reporting oversight)? and what is the current situation with this in the UK ACs?
Interview Part 2
6. Taking into consideration the above answers (Part 1) how you would describe the current level of expertise of audit committee members in these areas of expertise?
7. Are there particular literacy gaps among audit committee members in each of the areas of expertise identified in Part 1?
8. In your experience of working with FTSE clients were there any financial reporting – related issues you wished the audit committee should have raised but they didn't.
9. Do you see any new requirements to financial expertise of audit committee members emerging after the 2008 financial crisis?
10. What steps, if any, would you suggest to improve the level of financial expertise of audit committee members in the UK?

Appendix II. Participant's consent form

Insititution: Birkbeck College, University of London
Student name: Gulnaz Khamidullina
MSc Corporate Governance& Business Ethics

Participant's Consent Form

I have had the details of the study explained to me. My questions have been answered to my satisfaction, and I understand that I may ask further questions at any time.

I understand I have the right to withdraw from the study at any time and to decline to answer any particular questions.

I agree to provide information to the researcher on the understanding that my name will not be used without my permission. (The information will be used only for this research and publications arising from this research project.)

I agree to the interview being taped.

I understand that I have the right to ask for the audio tape to be turned off at any time during the interview.

Signed

Name

Date

Appendix III. List of abbreviations:

AC	-	Audit Committee
CPA	-	Certified Public Accountant
CPD	-	Continuous Professional Development
FRC	-	Financial Reporting Council
FTSE	-	A share index of the stocks of the 100 companies listed on the London Stock Exchange
IFRS	-	International Financial Reporting Standards
NYSE	-	New York Stock Exchange
SEC	-	Securities and Exchange Commission
SOX	-	Sarbanes-Oxley Act, USA
UK GAAP	-	United Kingdom Generally Accepted Accounting Principles
US GAAP	-	United States Generally Accepted Accounting Principles

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