Emerging Markets Queries in Finance and Business

The role of the audit committee in corporate governance – case study for a sample of companies listed on BSE and the London Stock Exchange - FTSE 100

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Abstract

This article proposes a deductive approach - from general aspects to particular aspects - that combines quantitative and qualitative studies. Theoretical knowledge is used for a better understanding of a phenomenon and not for making assumptions (Siti-Nabiha, 2009). Thus, in order to achieve our study, we selected 21 companies listed on Bucharest Stock Exchange (11 companies) and London Stock Exchange (10 companies). Please note that all the companies belong to the main index of these Stock Exchanges (Category 1 – Bucharest Stock Exchange - and FTSE 100 – London Stock Exchange). We mention that all these companies where chosen completely randomly, not using in their selection criteria as stock exchange capitalization, but still taking into account the availability of information. In this study, we tested a lot of statements using “true” or “false”. To obtain the information, we accessed website of each company and annual reports for 2011 and Corporate Governance Regulations of companies in question. Following this study, we concluded that the role of the audit committee is crucial, although some aspects are more or less unevaluated by the companies from the sample on which the study was conducted. As a general conclusion, we can see that the companies listed on Bucharest Stock Exchange are not aware of the significant role of the audit committee in corporate governance, unlike foreign companies, which understand the significant role of this structure.

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1. Introduction

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A group of researchers suggests that the audit committee play a large role in consolidation of financial control within a company (Collier, 1993; Vinten & Lee, 1993). A number of studies have found that inside of companies with an audit committee, particularly when the committee is active and independent, there is less chance for the occurrence of fraud (Beasley et al., 2000; Abbott et al., 2000, McMullen, 1996) and other irregularities reporting (McMullen, 1996).

It also suggests that audit committees are effective in reducing the appearance of errors in earnings management, which may lead to inaccurate financial statements (Defond & Jiambalvo, 1991; Peasnell at al., 2000).

The role of the audit committee as a key corporate governance system is a considerable interest in recent years. Corporate governance committees and regulatory authorities around the world approached the need for an effective audit committee and, moreover, require listed companies to establish an audit committee. Recognizing that the existence of an audit committee does not guarantee his effectiveness, attention shifted to the organization and activities of audit committees. Recommendations focused on the independence and competence of the audit committee members and the frequency of audit committees sittings (Report Smith, 2003; ASX, 2003, NACD, 1999). Researches indicate that there is a significant difference in recommended structure and the role of audit committees. The establishment of an audit committee within a company is a core component of corporate governance.

Nationally, OECD recommendations were taken in the CCG (Code of Corporate Governance) prepared and published by Bucharest Stock Exchange. Thus, the audit committee is permanent, independent, reporting directly to the Board, having an advisory function. The audit committee consists of at least two non-executive members of the Board or the Supervisory Board, as appropriate, or of other representatives appointed by the Annual General Meeting, one of whom shall be chairman.

Also, the Government Emergency Ordinance no. 90/2008 states that „each public-interest company must have an audit committee. Regulators of public-interest companies determine whether the audit committee must be composed of non-executive members of the Board and/or members of Supervisory Board of the audited company and/or the members who are appointed by the Annual General Meeting, complying the law. At least one member of the audit committee shall be independent and shall have expertise in accounting and/or auditing.

The audit committee, among others, the following responsibilities: monitoring the financial reporting process, monitoring the effectiveness of internal control or internal audit, as appropriate, and risk management of the company, monitoring the statutory audit of annual financial statements and the consolidated annual financial statements, monitoring the independence of the statutory auditor of the company and, primarily, the provision of additional services to the audited company.

The audit committee represents a key element in the corporate governance process. The fight for the integrity of information in the financial statements and confidence in them depends on a balance to be achieved between management pressures, regulator, investors and the public interest.

In conclusion, the audit committee plays a large role in the decision making within a company and, at the same time, it helps the Board of Directors, management, internal audit and external audit.

2. Methodological issues regarding to the case study

To achieve the case study on analyzing the role of the audit committee in corporate governance, we chose a sample of 21 companies listed on Bucharest Stock Exchange (11 companies) and London Stock Exchange (10 companies). Please note that the companies listed on BSE belong to the main index of this stock exchange (Category I). Also, the companies listed on LSE belong to the main index of this stock exchange, namely FTSE 100.

To achieve the objectives, we went through following steps: analysis of the implementation guide corporate governance code, selecting the companies, selecting relevant information, defining the method of analysis, the proper analysis and interpretation of the results.

Also, please note that these companies were chosen completely randomly, not using in their selection criteria such as market capitalization, but still taking into account the availability of information. In this study,
we tested a number of statements with „true” or „false”. To obtain this information, we accessed the site of each company and the annual reports for 2011. Plus, we used Corporate Governance Regulations of respective companies.

To achieve the objectives, for each company of the sample, we analyzed a number of relevant issues such as:

- The existence of audit committee;
- The independence of the chairman of audit committee;
- The expertise of the chairman of audit committee;
- The structure of the audit committee;
- The position of the audit committee within the company;
- The independence of the audit committee;
- The expertise of the members of audit committee;
- The responsibilities of the audit committee;
- The number of annual sittings of the audit committee.

3. **Results of the case study**

To represent the results of the analysis as summarily as possible, we considered the structuring of the topics. These topics are presented in the following.

3.1. **The existence of audit committee**

In case of companies listed on BSE, the existence of the audit committee is not found overall. 3 companies (27%) of 11 not have an audit committee, the responsibilities of the audit committee being performed by the Board of Directors (Azomureș, Alro Slatina and Oltchim Râmnicu Vâlcea, which has an audit committee since March 2012). All the companies listed on LSE have an audit committee, the role and responsibilities of this committee being clearly defined.

3.2. **The independence of the chairman of audit committee**

To examine the independence of the audit committee’s chairman, we removed the 3 companies listed on BSE which do not have an audit committee, because we do not want to change the results of the study. Regarding the independence of audit committee’s chairman, there is not available information on this issue in case of 5 companies listed on BSE (Banca Transilvania, BRD Societe Generale, OMV Petrom, Transgaz and SIF Banat Crișană). In case of the other companies (Banca Comercială Carpatica, SIF Oltenia and SIF Transilvania), the chairman of the audit committee is separate and he is not part of executive management as can be seen in Table 1. All the companies listed on London Stock Exchange have a separate audit committee with an independent leader who is not part of the executive management of the company.

<table>
<thead>
<tr>
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<th>BSE</th>
<th>LSE</th>
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<tbody>
<tr>
<td>The audit committee’s leader is independent and is not part of executive management</td>
<td>38%</td>
<td>100%</td>
</tr>
<tr>
<td>There is not available information regarding the independence of the audit committee’s leader</td>
<td>62%</td>
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3.3. **The expertise of the audit committee’s leader**
Nowadays, the need for a financial expert within an audit committee is recognized internationally. This financial expert must have accounting and financial knowledge in order to make connections and to be able to get quick answers to questions (Bockl, 2004 p. 1561). Blue Ribbon report already mentions the need for a financial expert. This recommendation was taken by Sarbanes Oxley after three years. Also, Combined Code (princ. C. 3.1.) makes the recommendation that one member of the audit committee to be a chartered accountant. Only 2 companies listed on BSE (25%) have an audit committee whose leader has financial accounting or auditing expertise. The other 6 companies listed on BSE (75%) do not provide information on this issue in their annual reports or their corporate governance regulations. All the companies listed on LSE have an audit committee whose leader has financial accounting or auditing expertise.

3.4. The structure of the audit committee

In USA and United Kingdom is recommended a minimum of 3 members, although the German corporate governance code does not refer directly to the membership of the audit committee. The most corporate governance codes refer to an optimum number of three to six members (PWC, 2003, p. 20). Bertschinger and Schaad (2003, p.20) believe that the members the of audit committee should not exceed a total of 4 members, except for unusual circumstances. We could say that the number of the members of the audit committee is directly related to the size of the company and to the workload.

Regarding the companies listed on BSE, 2 of them (Transgaz and SIF Banat Crişană) do not publish the structure of the audit committee. Other 5 companies have audit committees consisting of two members and the leader (SIF Transilvania, SIF Oltenia, BRD Societe Generale, Carpathian Commercial Bank and Banca Transilvania) while OMV Petrom has an audit committee consisting of 3 to 5 members and the chair.

Table 2. Structure of the audit committee

<table>
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<th>BSE</th>
<th>LSE</th>
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<tr>
<td>The audit committee includes 2 members and the chairman</td>
<td>62%</td>
</tr>
<tr>
<td>The audit committee includes 3 to 5 members and the chairman</td>
<td>13%</td>
</tr>
<tr>
<td>The audit committee includes more than 5 members and the chairman</td>
<td>0%</td>
</tr>
<tr>
<td>The audit committee’s structure is not published</td>
<td>25%</td>
</tr>
</tbody>
</table>

Of the 10 companies listed on LSE, 6 companies have audit committees consisting of 3 to 5 members plus the chairman (Burberry Group, ARM Holdings, HSBC Holdings, Aviva, Rexam, Vodafone Group), 2 companies have audit committees consisting of 2 members plus the leader (Fresnillo and Vedanta Resources), and the other 2 companies have audit committees consisting of more than 5 members plus the audit committee’s chairman (Experian and GlaxoSmithKline).

3.5. The position of audit committee within the company

Half of the companies listed on BSE do not publish audit committee’s position (Banca Transilvania, OMV Petrom, SIF Oltenia and SIF Transilvania) while the audit committee of the other companies report its activities the Board or Supervisory Board, as appropriate (SIF Banat Crişana, Transgaz, BRD Societe Generale și Banca Comercială Carpația). All the 10 companies listed on LSE have audit committees which report the activities the Board or Supervisory Board.

3.6. The independence of the audit committee
Since the early 90’s, the independence of audit committee members became very important (Böckli, 2004, p.1439). Regarding the independence of the audit committee’s members, requirements vary from one area code to another and also the interpretation may be different.

Blue Ribbon Report contains 10 recommendations regarding audit committees, including a number of recommendations regarding the independence of the audit committee’s members:

1. The members of the audit committee must be independent of the company.
2. The audit committee must be composed only of members who are not part of the management.
3. The audit committee must be composed of at least 3 independent members. They must obtain a deep knowledge in the field of financial accounting.

Two of the companies listed on BSE do not provide information on the independence of the audit committee members (Transgaz and SIF Banat Crișana). Other 3 companies have the audit committee including at least one independent member who is not part of the executive management (Commercial Bank Carpathian, BRD Societe Generale and OMV Petrom), a company have an audit committee whose all members are non-executive (BT), and the other 2 companies have audit committees whose all members are independents and non-executives (SIF Oltenia and SIF Transilvania).

From the companies listed on FTSE 100, only one has published independence criteria of the audit committee members (Fresnillo). In case of 2 companies, the most members of the audit committee are independent and non-executive (Burberry Group and ARM Holdi). The audit committees of the other 7 companies are entirely composed of independent non-executive members.

3.7. The expertise of the audit committee members

It seems that the companies listed on BSE neglect the expertise of the audit committee’s members. Thus, 6 of them (BT, OMV Petrom, Transgaz, SIF Oltenia, SIF Transilvania, SIF Banat Crișana) provide insufficient information on this issue while the other 2 (Carpathian Commercial Bank and BRD Societe Generale) have audit committees within which all members are experienced in financial accounting or auditing.

In case of 2 companies listed on FTSE 100 (Fresnillo and ARM Holdi), at least one member of the audit committee is experienced in financial accounting or auditing. In case of GlaxoSmithKline, most members of the audit committee are experienced in financial accounting or auditing. The audit committees of the other 7 companies listed on FTSE 100 consist only of members experienced in financial accounting or auditing.
One company listed to BSE and component of the sample provides insufficient information related to responsibilities of the audit committee (SIF Oltenia). Please note that all other companies, the audit committee is responsible for monitoring the financial reporting process and conformity of accounting policies, the accuracy of the internal control procedures and statutory audit. In case of OMV Petrom, the audit committee proposes the profit sharing. Carpathian Commercial Bank is the only company in which the audit committee monitors the response of management to internal audit recommendations. There are some aspects neglected by companies listed on BSE, such as monitoring the responses of management to external audit recommendations, monitoring management efforts ensuring compliance with the legal framework, whistle-blowing policy, monitoring audit and non-audit fees that could compromise the external auditor’s independence, reviewing the corporate governance statement issued by management of the company.

In case of companies listed on FTSE 100, the audit committee has the following responsibilities:
monitoring the financial reporting process, the conformity of accounting policies, the accuracy of the internal control procedures, the statutory audit, proposals regarding the appointment or dismissal of the external auditor. Also, all 10 companies support consolidated financial statements, monitor the external auditor’s independence and the fees that could compromise it, supervise the effectiveness of internal control and internal audit, monitor the risk management process. The only issue which is not found in any of the 10 companies’ audit committees is profit sharing.

3.8. **The number of annual sittings of the audit committee**

For a proper performance of duties, it is very necessary to meet members of audit committees in regular sittings. In 1992, Cadbury stated a number of 2 sittings per year (Annex 4, paragraph 6). To meet the requirements of today, it is considered that a total of two sittings per year is too little, considering the amount of work. To emphasize the importance of sittings, Smith Report (Paragraph 2.7) mentions a minimum of three annual sittings: “Audit committee shall meet as often as necessary to discuss the role and responsibilities of the audit committee.” Other authors mention a total of four annual sittings: Zinkin (2005, p.216), Ranzinger and Blies (2001, p.460) and Böckl (2005, p.39).

The last issue that we analyzed in this case study is the number of the audit committee’s annual sittings. In case of the companies listed on BSE, 3 of them (Transgaz, SIF Oltenia and SIF Transilvania) did not publish the number of the audit committee’s annual sittings. One company (BT) has an audit committee which meets less than 2 times within a year. 3 other entities (BRD Societe Generale, OMV Petrom and SIF Banat Crișana) have audit committees that meet from 2 to 4 times per year. Carpathian Commercial Bank has an audit committee which meets more than 4 times per year.

<table>
<thead>
<tr>
<th>Table 3. Number of annual sittings of the audit committee</th>
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<tbody>
<tr>
<td>The number of annual sittings of the audit committee is not published</td>
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<tr>
<td>The audit committee meets less than 2 times annually</td>
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<tr>
<td>The audit committee meets from 2 to 4 times annually</td>
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<tr>
<td>The audit committee meets more than 4 times annually</td>
</tr>
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</table>

All the companies considered and listed on FTSE 100 publish the number of annual sittings of the audit committee. The audit committee of Vodafone group meets less than 2 times annually. Vedanta Resources, Rexam, Experian and Burberry Group have audit committees which meet from 2 to 4 times annually. The other 5 companies considered have audit committees which meet more than 4 times annually.

4. **Conclusions and perspectives**

The study came to the conclusion that the role of the audit committee in corporate governance is essential, although some issues are more or less neglected by the companies from the variety on which the study was conducted.

- The first conclusion we reached is that not all the companies listed on a stock exchange have a separate audit committee, with clearly defined responsibilities. Please note that these companies are listed on Bucharest Stock Exchange. This is a big minus of BSE. In contrast, all the companies selected in the sample and listed on the London Stock Exchange have a separate audit committee, with clearly defined responsibilities. It is obviously
that the managers of Romanian companies do not understand the necessity of an audit committee in corporate governance.

- The independence of the chairman of audit committee is an issue neglected by companies listed on BSE, in contrast with the companies listed on FTSE 100. For being efficient, the audit committee must have an independent chairman. This would help to accomplish the objectives of the company. This independence means the member of the audit committee does not have close relations with the managers or other employees. Also, this member of the audit committee is detached of the activities of the company.

- The companies listed on BSE do not publish information related to expertise of the audit committee. This is another significant minus of Bucharest Stock Exchange.

- 25% of companies listed on BSE which have an audit committee do not publish its composition. All the companies listed on FTSE 100 publish the structure of the audit committee.

- Half of the companies listed on BSE do not publish information about the role of audit committee. This hinders annual statements users understanding the role of the audit committee within the company.

- Regarding the separate of audit committee members, Romanian companies do not provide sufficient information. In some cases, criteria are met a little compared to the companies listed on FTSE 100.

- It is also observed that 75% from the companies listed on BSE which have an audit committee provide insufficient information about the expertise of committee members. The companies listed on FTSE 100 provide this information.

- The responsibilities of the audit committee are met by the companies listed on BSE, as well as by the companies listed on FTSE 100.

- Regarding the number of annual sittings of the audit committee, Romanian companies may classify the practices of the companies listed on FTSE 100 as a good example.

As a general conclusion, it can be seen that the companies listed on BSE are not aware of the significant role of the audit committee within corporate governance, especially for a company listed on a stock exchange. The foreign companies are aware of this issue, whole pages of their annual reports being devoted to audit committee.

For future research, it is very essential to extend the basis of study, to extend the sample. An analysis based on more stock exchanges would be more relevant than this. Also, it is recommended to analyze more significant issues, though taking into account the availability of information.

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