

CONVERGENCE IN EUROPEAN GOVERNANCE CODES: THE AUDIT COMMITTEE CONCEPT

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ABSTRACT

In response to corporate failures in many countries both regulatory and professional bodies have widely promoted audit committees. This paper seeks evidence from an examination of the most recent corporate governance codes issued by 20 countries of convergence in corporate governance systems in Europe by examining the extent to which the audit committee concept (with its Anglo-Saxon origin) has been adopted in Europe.

The analyses show that there has been a degree of convergence towards an Anglo-Saxon model of corporate governance as the audit committee concept is widely accepted. However, consistent with the literature on the convergence of European corporate governance systems, the recommendations of the governance codes are not consistent in the specification of a number of factors that contribute to their effectiveness – membership, independence, financial expertise, and roles. A further analysis of the changes in the codes in a number of the countries examined over a period of time revealed a gradual move towards the Anglo-Saxon model. In particular, there was evidence of the recent inclusion in the codes of a number of European countries of a number of the recommendations of the Blue Ribbon Committee (1999) and Higgs Report (2003), which envisage a proactive rather than passive role for audit committees.

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INTRODUCTION

A significant feature of the corporate environment during the last two decades has been increasing conformity internationally in the models and mechanisms relied on for corporate governance. The globalisation, interpreted here as a comprehensive spread of a phenomenon (Braithwaite and Drahos, 2000: 8), of corporate governance involves the spread of some set of regulatory norms but it does not mean that regulation has necessarily been harmonised. It is a process of degrees, of intensification, the more convergent the phenomenon in question, the stronger the globalization. Corporate governance mechanisms such as separation of the role of board chairman and chief executive, appointment of non-executive directors and formation of board subcommittees, such as audit, remuneration, nomination and risk management and internal control committees are now increasingly common in many countries.

A mechanism of corporate governance that has been the subject of considerable attention, following both past and recent corporate scandals, is that of the corporate audit committee. Originally voluntary structures used by a minority of corporations especially in the US, more recently numerous official professional and regulatory committees have recommended their more universal adoption by corporate enterprises. Early recommendations for the adoption of audit committees made in the US (Treadway Commission, 1987) and MacDonald Commission (1988) have been followed by proposals for extending their use in many countries (Cadbury Committee, 1992; Centre for European Policy Studies, 1995; European Commission 1996; see also Porter and Gendal, 1998 and Morse and Keegan, 1999). Accompanying their widespread adoption, expanded roles for audit committees have been advocated and/or stipulated (see for example: AICPA, 1999; Auditing Practices Board, 2000; Blue Ribbon Committee, 1999; ISB, 2000; KPMG 1999; Public Oversight Board, 2000; Securities and Exchange Commission, 2000).

For countries in the European Union, the European Commission has been active in promoting the audit committee concept with its brief to create a fair internal market. As early as 1996, the European Commission's Green Paper (European Commission 1996: 5) stated that "audit committees have developed into essential committees of boards of directors". More recently, the European Commission (2003: 15) recommended "In view of recent accounting scandals, special emphasis will be placed on the audit committee (or equivalent body) with a view to

fostering the key role it should play in supervising the audit function”. A position repeated in European Commission (2004a: 8-9), which stated where executive directors have a conflict of interest, as with the audit of the accounts, decisions should be made exclusively by non-executive or supervisory board directors through an audit committee or equivalent body (s. 2.2.4), and European Commission (2004b: 70-71) which attributes responsibility for audit to the non-executive/supervisory board directors, and recommends an audit committee should usually be set up for this purpose. This position was also supported by the European Federation of Accountants (2003: 15) who opined that the audit committee was key to investor confidence and that all listed companies should form one.

This paper seeks to contribute to the literature on audit committees by examining the extent to which audit committees appear in governance codes and principles issued by 20 European countries, the consistency of their recommended structure and the extent to which they conform to current norms required for effective audit committees. The paper also aims to contribute to the debate on the convergence of corporate governance systems by examining evidence for convergence in European corporate governance systems around the audit committee concept.

Europe is chosen for analysis first, because it has countries with varying traditions of corporate governance, and, second, the European Commission has been actively addressing the issue with an Action Plan aimed at delivering "the integrated and modern company law and corporate governance framework which businesses, markets and the public are calling for"¹. The audit committee concept is chosen for analysis for the following reasons:

- audit committees are demonstrably an Anglo-Saxon corporate governance mechanism (see Birkett (1986) or Collier (1996) for information of their origins in the US and UK respectively);
- audit committees were extremely rare within Europe prior to the early 1990s (Vanasco, 1994: 23).
- audit committees are becoming widely accepted internationally²;

¹ EU Institutions press release, IP/03/716 21 May 2003

² The International Corporate Governance Network (ICGN, 1999: 4 and 9) states audit committees composed wholly or predominantly of independent non-executives should be established. Further, corporate governance codes recommending audit committees are to be found in countries as diverse as Japan (Japan Corporate Governance Committee, 2001), Brazil (Securities and Exchange Commission of Brazil, 2002), Indonesia (National Committee on Corporate Governance, 2001), and Pakistan (Securities and Stock Exchange of Pakistan, 2002).

- the audit committee has a key role in ensuring high standards in financial reporting, which are essential for confidence in financial markets – a position recognised by the European Commission in its Action Plan (European Commission, 2003); and
- audit committees have been extremely topical following recent corporate scandals such as Enron, WorldCom, Parmalat and most recently Hollinger International whose audit committee resigned following reported accounting failures³.

A major limitation of the paper is that it examines the audit committee concept rather than audit committee practices and their enforcement, which is a topic for further research. The European Commission (2002: 70-75) noted the paucity of current evidence in this area and observed “monitoring evidence indicates, companies in Member States appear to be responding in varying degrees to code recommendations”. Overall, they concluded that codes reflect aspirations and that translation into practice may be slow especially where the recommendations differ from current practices but that over time institutional investor pressure for change will ensure compliance.

This paper is structured as follows. The next section outlines the increasing attention that has been devoted to the promotion of corporate governance internationally. It is followed by a discussion of the acceptance of the audit committee concept in Europe. The following section defines the data source and population being examined. Thereafter an analysis of European governance codes is presented. The analysis focuses on the extent of convergence in governance codes in particular the consistency of their recommended structure and the extent to which they conform to current norms required for effective audit committees. Specifically, the codes are examined for their (a) acceptance of the audit committee concept, and recommendations concerning (b) audit committee membership, expertise and independence and (c) audit committee activity and roles. The recommendations of the UK Smith Report (2003), and where relevant of its predecessor the Cadbury Committee (1992), are used as a benchmark for comparison. Both these reports were heavily influenced by North American developments (Treadway Commission (1997) and MacDonald Commission (1998) for the former, and the Blue Ribbon Committee (1999) and the debates following the failure of Enron and WorldCom for the latter) and there provide a reasonable approximation of the audit committee concept and how it should be applied. A further section analyses changes to

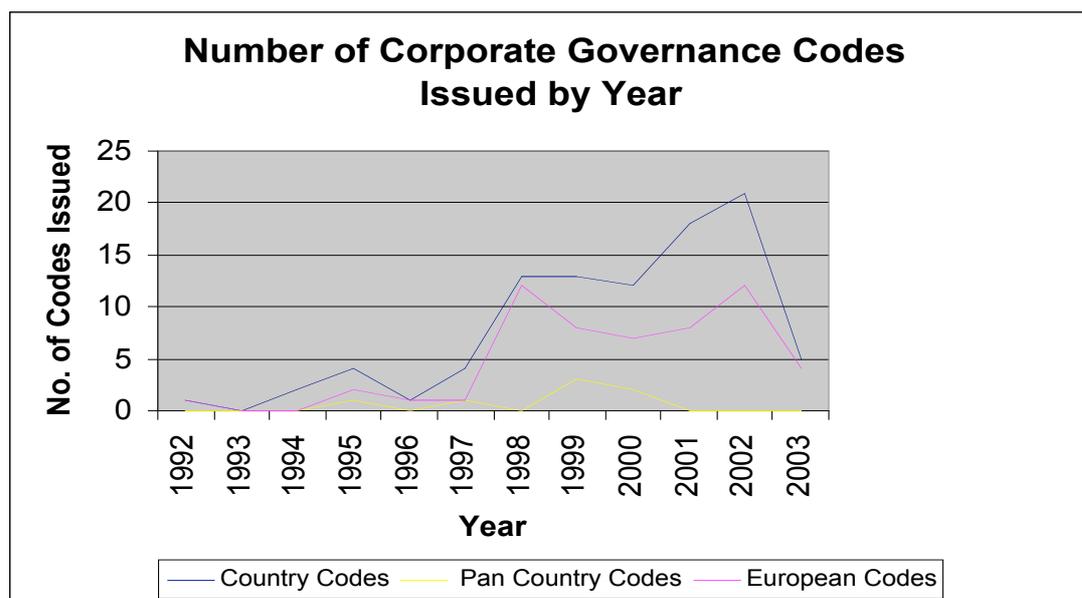
³ See Accountancy, December 2003: 18.

corporate governance codes in various European countries over the last ten years to ascertain where there is evidence for convergence on the audit committee concept. The last section contains discussion and conclusions.

INTERNATIONAL CONVERGENCE AND PROMOTION OF GOVERNANCE CODES

Over the last few years, a number of international bodies have been active in promoting co-operation in the area of corporate governance. In 1998, the Organisation for Economic Co-operation and Development (OECD) established a task force with a membership including representatives of the 29 OECD governments, the EU commission, the World Bank, International Monetary Fund, the Bank for International Settlements, business, labour and the investment community to propose principles of corporate governance. The Principles (OECD, 1999a), which represent the first inter-governmental attempt to develop international standards, are not prescriptive about board structure and operation, but rather provide a framework to assist countries in developing approaches to corporate governance that reflect their own, legal, institutional and regulatory environment (Fredrick, 1999: 27). In June 1999 (OECD, 1999b), the OECD and the World Bank agreed to co-operate on the improvement of corporate governance through a range of initiatives including an annual Global Corporate Governance Forum and Policy Dialogue, and Development Round Tables. In another international initiative, the Commonwealth Association for Corporate Governance in 1999 produced "Principles of Corporate Governance in the Commonwealth" which, as with the OECD, were generic rather than specific and intended to assist with the development of national strategies for the promotion of good corporate governance (Armstrong, 2000: 58-63). At a non-governmental level, the International Corporate Governance Network (ICGN) formed in 1995 brought together key international investors to facilitate international dialogue on the development of global corporate governance practices which resulted in a statement on global corporate governance principles (ICGN, 1999).

Figure 1



Alongside pan-national pronouncements on corporate governance, there has been an expansion in corporate governance codes and principles issued by individual countries. Figure 1 shows the issue dates of the 101 codes and principles (94, excluding five undated documents, from 35 countries and 7 pan-national) extant on the European Corporate Governance Institute (ECGI) web site on 1 April 2003. With reference to the topic of this paper, details of the year of issue for the 57 codes issued by 20 European countries⁴ are shown separately. Figure 1 shows a concentration of developments in recent years with 71% of pan-national documents issued in 1999 or 2000 and 73% of country codes and principles issued in or after 1999. The position for European countries is similar with 70% of codes issued in or after 1999.

This codification activity in corporate governance can be attributed to the globalisation of the international economy and choices in codes reflect the debates regarding the international competitiveness of different financial systems and whether these pressures will lead to convergence to an optimum approach (Berger and Dore, 1996; Mayer 1997). In particular, there has been discussion on whether the outcome of this globalisation process will lead to the global dominance of the Anglo-Saxon 'outsider' model⁵ with its emphasis on shareholder

⁴ See appendix I for a list of the countries

⁵ Deeg and Perez (2000: 122) "On balance the received wisdom is that international financial integration forces compliance with the standards of the equity market and tends to undermine the "insider" model of corporate governance".

rights and transparency over the Continental 'insider' model with typically fewer listed companies and a remarkable concentration of ownership either in families or other companies (Franks and Meyer, 1995; Moerland, 1995).

A number of researchers have examined this question (see for example Rhodes and van Apeldoorn, 1998; Deeg and Perez, 2000; or Cernat, 2004) in the context of Europe where countries in response to historic and cultural developments have a variety of different corporate governance approaches within the framework corresponding either to the Anglo-Saxon or Continental model (for examples of differences in the European countries, see for example, Isaksson and Skog, 1994). This diversity has led the European Commission to attempt the harmonisation of corporate finance and governance practices for a number of years (European Commission, 2003). The combination of globalisation and European Commission pressure for harmonisation suggests that convergence, if any, towards the Anglo-Saxon model of corporate governance should be most evident in Europe. However, despite the pressures, the evidence in the literature for any such convergence is weak. Rhodes and van Apeldoorn (1998) suggest domestic elites are not prepared to see their power and positions undermined by changes and will therefore champion continuity and adjustment to the external pressures rather than the transformation to a dominant Anglo-Saxon corporate governance model. Similarly, Deeg and Perez (2000) contend that the politics of financial reform are likely to differ from those postulated in market-driven models of regulatory change, and observe that countries are susceptible to international pressures in different ways. Most recently, Cernat (2004: 161) contended that there is an absence of convergence in Europe because the two models of corporate governance are hard to reconcile, and the European Commission is poorly equipped to advance a well-articulated corporate governance model.

AUDIT COMMITTEES IN EUROPE

The above discussion of international convergence has focused on the overall corporate governance system. This section outlines the move towards acceptance of one corporate governance device in the region that is the subject of this paper. The literature indicates that audit committees were not present widely in Europe, apart from the UK, before the 1990s. Tricker (1978: 28) observed that "they do not have audit committees in Europe: perhaps they are not necessary with alternative forms of governance". Van Hoek (1988) noted that, while audit committees were relatively unknown in Europe, there were isolated instances in

companies in Italy and Sweden. Vanasco (1994: 23) noted that audit committees are rare in continental Europe, perhaps with the exception of France. However, audit committees gained greater acceptance in continental Europe from the mid-1990s onwards. Keegan and Degeorge (1998: 116-117) reported in a survey of 65 major companies based in eight European countries (Belgium, France, Germany, Italy, Spain, Sweden, Switzerland and the UK) that 60% of the companies had audit committees with adoption rates highest in the UK (100%), France and Switzerland and lowest in Sweden and Italy. The change towards acceptance of the audit committee concept is in line with recommendations from governance committees set up in various countries, for example, the Vienot Report (1995: 20) in France, the subsequently issued Peters Committee (1997) report from the Amsterdam Stock Exchange, or the Cardon Report (Belgium Commission for Corporate Governance, 1998) in Belgium. In a review of audit committees in Europe a Price Waterhouse (1997) survey noted that as leading companies in UK, France and the Netherlands implement recommendations concerning audit committees, and the twin pressures of international market forces, and the interest of the authorities and regulators in governance issues expand, the significance of audit committees in Europe and their inclusion in national code recommendations will grow. This has been proved correct with audit committee recommendations being made in West European countries like Germany, Greece and Portugal and East European countries like Slovakia, Czech Republic and Romania.

Promotion of the audit committee concept has been less prominent in pan-European codes. The three earliest codes, Centre for European Policy Studies (1995), European Bank for Reconstruction and Development (1997) and European Shareholders Association (2000), did not mention audit committees and made recommendations at a higher level. Similarly, the European Association of Securities Dealers (EASD, 2000) failed to recommend the formation of audit committees despite proposing board committees with a balance of executive and non-executive membership for nominations and remuneration purposes. Although it is not specifically articulated, the reasoning for this approach may be the view that European corporate governance procedures will often differ from those countries that have broad liquid stock markets. The EASD Corporate Governance Committee (1997: 7) cites research showing that more than half of the New York Stock Exchange and NASDAQ listed companies have no single beneficial owner with a holding of greater than 5%; whereas, in Austria, Belgium, Germany and Italy over half of listed companies have a 50% plus beneficial owner.

This European approach is in contrast to the pan-national codes from the Commonwealth (Commonwealth Association for Corporate Governance (1999: 12) or the International Corporate Governance Network (ICGN, 1999: 4 and 9) both of which recommend audit committees. The latter stressed the importance of the audit committee as a means of avoiding conflicts of interests that might arise for executive directors, and ensuring that independent business judgement is focused on this important area. However, the Organisation of Economic Co-operation and Development (OECD, 2004) failed to recommend the formation of audit committees but did acknowledge their possible role with respect to internal and external auditors (pp. 55-56). This position is an advance on the previous position (OECD, 1999a: 9) which, although recognising the importance of ensuring the integrity of the organisation's accounting and financial reporting system, including independent audit and internal control and risk management, merely stated in annotated notes (pp. 24-25) that boards may consider establishing specific committees with independent members to consider questions where there is a potential conflict of interest.

The dichotomy of support for audit committees in pan-national codes reflects the strength of influence of countries where audit committees are established. Thus, the ICGN, which was set up by interest groups in the US and the UK, and the Commonwealth influenced by the UK, Canada, Australia, South Africa, Singapore and other supporters of audit committees are positive, whereas the OECD, with a wider constituency, and other pan-European codes are more equivocal.

AUDIT COMMITTEES IN EUROPEAN GOVERNANCE CODES

The following sections outline the methodology for determining the current level of acceptance of the audit committee concept in European countries and the extent to which there is any convergence on their structure and operation.

The approach taken was to examine the recommendations in the codes and principles issued by European countries. The source used for accessing the relevant codes and principles for European countries was the ECGI web site⁶ as at 1 April 2003. This data source was chosen

⁶ <http://ecgi.org>

because it has academic integrity⁷ and contains: a fairly comprehensive⁸ list of codes and principles (see Figure 1 for details), many in English; information on the date posted; and importantly details of their provenance. Twenty European countries had one or more codes or principles posted on the web site. Where more than one code had been posted for a country, the analysis was based on the most recent code or principles with an English version at the set date on the grounds that this best reflects the current position. Eleven of the twenty countries covered had more than one code or guideline (see appendix 1 for a list of the countries and the code or principles on which the analysis is based). As a second stage, an overview of the changes that had occurred in countries that had issued a series of codes was undertaken to determine whether there was a convergence towards acceptance of the audit committee concept.

Appendix 1 shows that the codes and principles predominantly derived from commissions set up by stock exchanges (11 countries – 55%). However, in a further seven countries (35%) the recommendations derived from other bodies, for example the Financial Reporting Council in the UK or business associations in France, and in Germany and Spain the recommendations were made by government commissions. The scope of the codes and principles was limited to listed companies in 16 (80%) countries but in the remaining four, as well as being recommended for this category, all companies were encouraged to adopt them. The codes and principles were uniformly voluntary, although in several instances stock exchange requirements enforced disclosure of the extent of compliance with an explanation of departures⁹, and Germany, Italy and Spain gave legal force to aspects of the Code.¹⁰ The disclosure recommendations were predominantly comply or explain (ten countries) or disclose the extent of compliance (four countries) but no guidance was given in four countries.

⁷ The European Corporate Governance Institute (ECGI) is a not for profit organization, whose primary role is to undertake, commission and disseminate research on corporate governance. The ECGI is governed by a Board in which academics comprise a majority.

⁸ There are a number of gaps, for example, Finland (Ministry of Trade and Industry, 2000) has not been posted on the web site at 1 April 2003.

⁹ For example, the Combined Code (Financial Reporting Council, 2003) in the UK.

¹⁰ Respectively: Article 161 of the Stock Corporation Act 2002 (Cromme Committee, 2003); Law of Measures to Reform the Financial System, article 47 of Law 44/2002 (Olivenciai Report, 1998), dated 22 November; and Legislative Decree 58 of 24 February 1998, Article 148 (Draghi Report, 1997).

The recognition of audit committees in national corporate governance codes

Table 1 shows that despite the weak guidance in Pan European codes discussed above, audit committees are widely recommended in European codes and guidelines irrespective of whether the predominant corporate governance structure is unitary or two-tier.

Table 1: Predominant governance structure and presence of an audit committee recommendation in Codes

	Unitary (%)		Two tier (%)		Total (%)	
Audit committee	11	(79)	5*	(83)	16	(80)
No audit committee	3	(21)	1	(7)	4	(20)
	14	(100)	6	(100)	20	(100)

**Peters Committee (1997, s.3.2: 11) only requires the supervisory board to consider forming an audit committee and the Austrian Working Group on Corporate Governance (2002: 19) noted that if the supervisory board has six or fewer members, the functions of the audit committee may be taken by all board members.*

The four countries without an audit committee recommendation in the latest code or guidelines were: Denmark; Poland; Portugal; and Romania. In the case of Denmark (Norby Committee, 2001: 13) indicated that the majority of company boards are not so large as to require board committees to manage their tasks. For Poland, responsibility for the audit is given to the supervisory board (Best Practices Committee at the Corporate Governance Forum, 2002), however, the earlier Polish Corporate Governance Forum (2002: 35) indicated that the supervisory board may form an audit committee. The Commission of the Stock Exchange (1999: 9) in Portugal recommends the formation of internal committees but does not mention the audit as a focus for such committees or indicate where responsibility for audit committee functions might lie, and the Romanian code (Strategic Alliance of Business Associations, 2000) leaves responsibility for these matters to the main board.

The audit committee concept does not always conform to the Anglo-Saxon model. In several countries where unitary boards prevail (for example, Belgium, Greece, Spain and Switzerland¹¹) the recommendations are similar to Cadbury (1992); while the Irish guidelines (Irish Association of Investment Managers, 1999: 1) endorse the provisions of the UK

¹¹ See Belgium Commission for Corporate Governance (1998), Committee on Corporate Governance in Greece (1999), Olivencia Report (1998) and Swiss Stock Exchange (2002))

Combined Code (Committee on Corporate Governance, 1998) without reservation. However, in France the Vienot II (1999: s.23) recommended that only a minimum of one third of the audit committee should be comprised of independent directors, although this was increased by the Bouton Committee (2002: 12). In Italy both the Preda Code (1999: s.5.4.3) and Committee for Corporate Governance of Listed Companies (2002: 14) refer to an internal control committee with many audit committee functions. In the countries that have a predominantly two-tier board structure (Austria, Czech Republic, Germany, Netherlands, Poland and Slovakia), the audit committee is appointed by and reports to the supervisory board¹².

Therefore, in mainland Europe, there has been a widespread move to include recommendations on a form of audit committee within the corporate governance codes and principles especially where there are unitary board structures. Where two tier structures exist, audit committees are recommended without equivocation in Germany, the Czech Republic and Slovakia but Netherlands only specified that consideration should be given to forming an audit committee and Austria recognises their infeasibility when the size of the supervisory board is small.

Audit committee structures – size, membership and expertise

Following the finding in the above section that audit committees are now widely recommended in the governance codes of European countries, this section focuses on the extent of convergence in the recommended audit committee structures.

The later Higgs Report (2003) endorsed the Smith Report (2003) recommendation on the need for some degree of expertise among members. In the US listed companies are required to have an audit committee comprising a minimum of three directors, all of whom are to be financially literate and at least one of whom must have accounting or related financial management expertise.

Audit committee size – For the audit committee to be effective it is generally recognised that it should comprise of a sufficient number of outside directors. In the UK the Cadbury Committee (1992, s.4.35: 28-29) recommended that established audit committees should

¹² See for example the Peters Report (1997: s.3.2) and the German Panel on Corporate Governance (2000:10)

have a minimum of three members, membership confined to non-executive directors and this minimum size has been supported by the subsequent Smith Report (2003) and incorporated in the Combine Code (Financial Reporting Council, 2003). Table 2 panel A below shows, although a minimum number of audit committee members were only specified in a half of the governance codes, when they were recommended a minimum of three members was applicable to all but Cyprus, where the minimum membership was two, perhaps reflecting small board size. In the case of the Czech Republic, the recommendation of the Czech Securities Commission Code (2001, s.5.8.1: 18) of a minimum of three members was extended to 'three to five' in specimen terms of reference (p. 28).

Audit committee independence – From the early days of their development, a fundamental aspect of audit committees was that they should be composed solely of outside directors. The US Securities and Exchange Commission (1940) recommended that a committee of independent directors should nominate the auditors and arrange the details of the engagement and the New York Stock Exchange (1940: 7) stated "where practicable, the selection of the auditor by a special committee of the board of directors composed of directors who are not officers of the company appears desirable". This position was reflected in the recommendations of the Treadway Commission (1987), MacDonald Commission (1988) and Cadbury Committee (1992). The persistence of corporate failures in companies with an audit committee, highlighted by Verschoor (1989, 1990) in the US and Campbell (1990) in Canada, led to a focus on the independence of audit committee members. In particular, Vicknair et al (1993) identified the problem of 'grey area' directors who despite appearing to be independent have some connection with the company or board that undermines the independence of the audit committee.

Table 2: Audit Committee Composition

Panel A: Minimum size	No	%	Countries
Two	1	6	Cyprus, 2003
Three	8	50	Belgium, 1998; Czech Rep., 2001, Ireland 1999; Greece, 1999, Slovakia, 2002; Spain, 1998; Sweden, 2001; and UK, 2003
Not specified	7	44	Austria, 2002; France, 2002; Germany, 2002; Italy, 2002; Malta, 2001; Netherlands, 1997; and Switzerland, 2002.
<i>Total</i>	<i>16</i>	<i>100</i>	
Panel B: Independence			
One Tier			
Non-executive directors*	4	25	Greece, 1999; Spain, 1998; Sweden, 2001; and Switzerland, 2002
Non executive directors with the majority independent**	5	32	Belgium, 1998; Cyprus, 2003; France, 2002; Ireland, 1999; and Italy, 2002.
Non executive directors with the majority independent including the chair	1	6	Malta, 2001
Independent non-executive directors	1	6	UK, 2003
Two tier			
Members of the supervisory board	1	6	Netherlands, 1997
Members of the supervisory board and the chair not a former member of the management board	2	13	Austria, 2002; and Germany, 2002.
Majority independent members of the supervisory Board	1	6	Czech Rep., 2001
Independent members of the supervisory board	1	6	Slovakia, 2002
<i>Total</i>	<i>16</i>	<i>100</i>	
Panel C: Financial expertise			
Chair financially literate or experienced in accounting or financial policy	1	6	Cyprus, 2003
Sufficient expertise	1	6	Germany, 2002
Majority including the chair financially literate	1	6	Switzerland, 2002
At least one with significant, recent and relevant financial expertise	1	6	UK, 2003
Not specified	12	76	
<i>Total</i>	<i>16</i>	<i>100</i>	

* in Spain and Sweden they are referred to as outside directors.

** The Bouton Committee (2002, s. IV: 13) refers to two thirds independent with no corporate officers eligible for audit committee membership.

Panel B in table 2 indicates that in a majority country codes and principles the concept of independent audit committee membership is recognised. In the case of unitary structures, all called for non-executive (outside) directors and 64% of the codes and principles specify a degree of independent membership, while in the case of two tier boards, all are to be appointed from supervisory board members and 80% specified a degree of independence in the membership. In the Netherlands the Peters Committee (1997, s.2.3: 11), although not

mentioning an independent element in audit committee membership, requires all members of the supervisory board to operate independently of each other and the board of directors.

The recent recommendations on audit committees in the US and the UK suggest an evolution towards tighter definitions of independence. For example in the US, the Blue Ribbon Committee (1999: 10-11) required audit committees to be wholly independent, (independence was defined as having "no relationship to the corporation that may interfere with the exercise of their independence from management and the corporation"); and provisions in the Sarbanes-Oxley Act 2002 legislated to this effect (s. 301). Similarly in the UK, the Smith (2003) and Higgs (2003) reports have stressed the importance of the independence of non-executive directors and require audit committees to be comprised of wholly independent directors (Turley and Zaman, 2003a). This is also consistent with the European Commission (2004a) recommendation that the audit committee should be composed exclusively of non-executive or supervisory directors, of whom the majority are independent. However, the earlier clarity of the Belgium recommendations (Belgium Commission for Corporate Governance, 1998) are worthy of note. They defined non-executive directors as those who "do not perform any management functions within the company or any of its subsidiaries" (s. 1.4: 4) and independent directors as "independent of executive management and of dominant shareholders and free from any business or other relationships which could interfere with their independent judgement apart from their remuneration and shareholding in the company" (s. 22: 5).

Audit committee expertise – Another recent focus of attention for improving the effectiveness of audit committees has been the expertise of the membership in accounting and financial reporting matters. For example, the Blue Ribbon Committee (1999: 12) recommended not only that every member should be financially literate but that at least one member should have accounting or related financial management expertise, and the Sarbanes-Oxley Act (2002: s.407) specified that at least one member should be a financial expert. In parallel, the Smith Committee (2003) in the UK required at least one audit committee member to have significant, recent and relevant financial expertise, a position endorsed by the Higgs Report (2003). Table 2 Panel C shows that this requirement is only included in the codes of four countries (Cyprus, Germany, Switzerland and the UK) reviewed. The four codes were all issued in either in 2002 or 2003. The inclusion in only the most recent codes and principles probably reflects the influence of the US debate following Enron and WorldCom. Further

evidence of whose impact is seen in the recent EC (2004b) recommendation that (a) at least one audit committee member must have recent and relevant experience which results in a sophisticated knowledge of finance and accounting, and (b) all other members of the audit committee should be able to read and understand financial statements at the time of their appointment.

Audit committee activity and roles

Audit committee meetings – The number of meetings that an audit committee should have in a year has not always been clearly specified in codes and principles, for example, the Cadbury Committee (1992) did not suggest a minimum number of meetings even though the duties set out in section 4.35(e) require at least two or three meetings to fulfil. Nevertheless, it is widely accepted that audit committees will not be effective unless they are active (Menon and Williams, 1994). In the UK, the Smith Committee (2003) recommended that the audit committee chairman, in consultation with the company secretary, should decide the frequency and timing of its meetings. It is recommended that there should be not fewer than three meetings during the year, held to coincide with key dates within the financial reporting and audit cycle. No one other than the audit committee's chairman and members is entitled to be present at a meeting of the audit committee.

When audit committees are first established they take a passive cosmetic role and a failure to meet frequently enough may well exacerbate this tendency (Spira, 1998). A position supported by Menon and Williams (1994) and Lennox (2003) who showed that in both voluntary and mandatory situations 6% and 10.2% of audit committees respectively do not meet in the course of a year. This situation has been reflected in the increase in minimum number of meetings per year in the US codes rising from two (American Bar Association, 1978) to four per annum (Blue Ribbon Committee, 1999).

Table 3: Audit Committee Activity

Minimum number of meetings	No	%	Countries
One	1	6	Belgium, 1998
Two	2	13	Cyprus, 2003; and Greece, 1999.
Three	1	6	UK, 2003
Four	1	6	Czech Rep. 2001
Not specified	11*	69	Austria, 2002; France, 2002; Germany, 2002; Ireland, 1999; Italy, 2002; Malta, 2001; Netherlands, 1997; Spain, 1998; Sweden, 2001; Slovakia, 2002; and Switzerland, 2002.
Total	16	100	

* includes the Netherlands which specifies one meeting a year between the supervisory board and the external auditors.

Table 3 shows that European codes and principles are largely silent in this important area with almost 69% offering no advice on the minimum number of audit committee meetings. The maximum number of four meetings per year is recommended by the Czech Republic (Czech Securities Commission, 2001), which acknowledges influence from the OECD and the UK Combined Code (Committee on Corporate Governance, 1998: 2), and the three meetings country is the UK (Smith Committee, 2003). The minimum of one is a reference in the Belgian Code (Belgium Commission for Corporate Governance, 1998, s.4.3c: 7) to a requirement of one meeting per year, between the audit committee and the external and internal auditors, from which executive directors may be excluded.

Audit committee role – Corporate governance codes issued in the UK and the US have over time expanded the role of the audit committee. In the UK for instance the publication of the Turnbull Report (1999) by the Institute of Chartered Accountants in England and Wales has widened their responsibilities in respect of internal controls and risk management (Zaman, 2001). The recently published Smith Report (2003) also expands the duties of audit committees concerning financial reporting and external audit, bringing the UK policy on audit committees a step closer to that of the US (see Turley and Zaman, 2003b).

Table 4: Audit Committee Role

Roles specified in codes	No.	%
Oversight of external audit	16	100
Oversight of internal audit	15	88
Involvement in external auditor selection or dismissal	11	62
Oversight of risk/ internal control reporting by the board	10	62
Oversight of financial reporting quality	9	56

Table 4 shows the number of codes that specified that the role of the audit committee should include responsibility for the above areas. It shows broad acceptance of these major areas with all areas being mentioned by a majority of country codes. The mean number of the five roles mentioned in Table 5 was just below four. Oversight of internal and external audit is almost universally seen as the central purpose of audit committees with financial reporting the role on which there is least agreement. The countries that specified the fewest of the functions were Belgium and Greece at two but Cyprus, Romania and Sweden only listed three. In contrast, France, Ireland, Spain and the UK recommended all the roles in their codes and principles.

The formalisation of the roles of the audit committee in written terms of reference was recommended by only nine (56%) of the 16 governance codes. The countries where no mention of the terms of reference were made were Austria, Germany, the Netherlands, Spain, Sweden and Switzerland, although by implication the supervisory board or main board will delegate duties and powers. Italy recommends that the internal control committee is a formally constituted body but does not expand further.

The section shows that the audit committee concept had been accepted in many European countries. It has also found that the formation of an audit committee was widely recommended in current codes and principles issued by European countries and that their structure and role, although reflecting national characteristics, is reasonably compatible with the Anglo-Saxon model in countries with both a unitary and two-tier corporate governance structure.

DEVELOPMENTS OF CODES IN SPECIFIC EUROPEAN COUNTRIES

Spira (1998) contended that audit committees within firms evolve from a passive to a proactive role. Consistent with this, given the maturity of the audit committee concept in the US, Deloitte Touche (2003) surveying the views of US practitioners reported a consensus that the focus of the audit committee had shifted since the early 1990s from compliance issues and the reporting function (where audit committees were largely observers who did not actively participate in the governance process), to a position where audit committees were integrated in the governance process. This move, which reflects the impact of the Blue Ribbon Committee recommendations (Blue Ribbon Committee, 1999), has been reinforced by Higgs (2003) and the Sarbanes-Oxley Act 2003, to the produce the expectation that audit committees will be actively involved in the audit process, make independent judgements and not solely rely on recommendations from management and the external auditors.

Within Europe, a number of countries have developed corporate governance codes through a number of iterations and it may be expected that views on the need for audit committees and their structure and role have also evolved. Table 5 below provides information from postings on the ECGI web site by European country on the year that the first code or principle was issued, the number subsequently issued and the year of the last code or principle issued

The sequence matches the globalisation contentions of Monks and Minnow (2001: 249-251) with the major economic powers being the first to introduce statements on corporate governance well in advance of pan-national guidance from the OECD (1999), EASD (2000) or other bodies. A review of these and subsequent codes shows that the position of the audit committee in European corporate governance codes has strengthened over time. This has occurred most markedly in the UK where the Higgs Report (2003), has enhanced the Cadbury Committee (1992) recommendations especially in terms of the independence of the membership and in specifying that at least one member should have relevant financial expertise. However, in continental Europe there are similar examples among countries that issued early codes. In France, the Vienot Report (1995) strengthened the Cadbury report's definition of non-executive directors to directors without any interests that may affect their impartiality. However, it only recommended that one third of the audit committee should comprise such directors, whereas the Cadbury report specified that the membership should be wholly composed of non-executive directors. This position of the Vienot reports was moved towards the Cadbury report position by Bouton (Bouton Committee, 2001: 12) that

recommended that two-thirds of the membership of the audit committee should be independent and with no corporate officer as a member. In Spain, the initial recommendations for an audit committee in the Madrid Stock Exchange (1996, para. 2.12, p. 12) was endorsed in the Olivencia report (1998) and legislated for in 2002 (Law of Measures to Reform the Financial System, article 47 of Law 44/2002, dated 22 November.) The latest Aldama report (2003) strengthens the definition of independent directors and states that in appointing members of the audit committee account must be taken of their knowledge and professional experience.

Table 5: Initial and subsequent issue of governance codes

Year – initial code	Country	Number of subsequent codes	Year – latest code
1992	UK	14	2004
1995	France	6	2004
1996	Spain	3	2003
1997	Netherlands	5	2003
1998	Belgium	5	2004
	Germany	8	2003
	Italy	3	2002
1999	Greece	3	2002
	Ireland	0	
	Portugal	0	
2000	Romania	0	
2001	Czech	0	
	Denmark	2	2003
	Malta	0	
	Sweden	2	2003
2002	Austria	0	
	Cyprus	0	
	Poland	0	
	Slovakia	0	
	Switzerland	0	

In the Netherlands the Peters Report (1997) which responded to the internationalisation of the Dutch economy and increasing international attention on the position of shareholders (para. 1.1, p.6), was weak in its recommendations for audit committee only requiring that supervisory boards should consider setting up audit committees with the alternative of leaving its function to the supervisory board (para. 3.2, p. 15). The code also did not give detailed information on the number of members, require written terms of reference, specify the independent status of members or extend the role to internal controls and risk

management. In contrast, the recently published draft Tabaksblat Committee (2003) cited the audit committee as 'key' committee and specified that one shall be appointed by the supervisory board (para. II.4, p.16). Further, it recommended that: there be written terms of reference; only one member cannot be independent; at least one supervisor board member must have financial expertise (relevant knowledge and expertise of financial administration and accounting for listed companies or other large organisations, para. II.21, p. 14) and the scope of the audit committee includes internal risk management and control (para. II.4.6, p.16).

Similar weak positions on audit committees in Belgium and Germany were strengthened in later documents. In the former, early recommendations (Federation of Belgium Companies, 1998), despite citing the Cadbury Report as its model, only stipulated that companies may set up an audit committee (para. 4.3, p.16) but this was reversed to a positive recommendation later in the year by the Belgium Committee for Corporate Governance (1998: para.4.3, p.7). In Germany the summary of the 'Law on Control and Transparency in Business' (Federal Ministry of Justice, 1998) acknowledged the pressures for reform from the globalisation of financial markets and the internationalisation of shareholding in German companies and transferred responsibility for the external audit to the supervisory board but only indicated that an audit committee may be formed by the supervisory board in pursuance of this responsibility. However, the Berlin Initiative Group (2000) took a stronger position and the Cromme Code (2002) required the formation of an audit committee and identified the need for members to have sufficient expertise (para. 5.3.2, p. 11).

In Italy the response to the Draghi proposals (Draghi Report, 1997) led to legislation (Legislative Decree 58 of 24 February 1998, Article 148.) for a board of auditors to supervise the external audit. The Italian Stock Exchange (Committee for Corporate Governance of Listed Companies, 2002) following the Preda Committee (1999: 45-46) recommended the establishment of an internal control committee, but strengthened it by requiring a member of the board of auditors to be a member. This remains a country specific approach but is closely linked to the conventional audit committee (para, 12, p.14). Finally, in Denmark the Copenhagen Stock Exchange Committee on Corporate Governance 2003, VIII, 7: 25) moved to reverse the Norby Committee (2001) rejection of audit committees by stating that in "complex accounting and auditing conditions the supervisory board should consider whether to establish an audit committee".

This overview of the changes to successive codes and principles in European countries that have issued a number of such documents shows, first, that there has been growing acceptance of the audit committee concept as a key component in a corporate governance system; and, second, that the evolution in a number of countries is towards a more proactive role, which mirrors developments in the UK and US.

DISCUSSION AND CONCLUSION

This paper has examined the development of the audit committee concept in Europe, where evidence suggests that they were rare prior to the early 1990s (Vanasco, 1994). The paper approached this in two stages: first, a survey of the latest European corporate governance in codes in 20 countries; and second, an overview of how the audit committee concept had developed in countries that had issued multiple codes. The results show that, despite an absence of support from pan European codes, a recommendation to the effect that an audit committee should be formed was present in 16 (80%) of the countries covered.¹³ The corporate governance codes were not consistent in the specification of audit committee structure concerning membership, independence, financial qualification, and frequency of meetings. Similarly, there was less consensus on the audit committee's role in financial reporting, external auditor selection and internal control and risk assessment.

The development of audit committee recommendations in countries that had issued several governance codes showed a strengthening of the recommendations for an audit committee over time in line with the Anglo-Saxon audit committee concept. It was also noted that a few more recent codes revealed examples of convergence with the debate in the US and UK on issues such as the independence and financial expertise of members. Overall, the audit committee concept has gradually gained broad acceptance in European governance codes in countries with both a one-tier corporate governance systems, where it is a sub-committee of the main board, and in countries with a two-tier corporate governance system, where it is a sub-committee of the supervisory board assisting this board in its oversight role. However, at an operational level there is limited consistency in the recommended structure and role of audit committees.

¹³ Denmark has now stated that audit committee formation should be considered in more complex situations (Copenhagen Stock Exchange, 2003).

The findings of broad acceptance of the audit committee concept but only gradual convergence in recommended audit committee practices are consistent with the arguments of commentators who contend that, despite pressures for the convergence towards an Anglo-Saxon model of corporate governance from globalisation, there are other forces which mitigate changes. The adoption of the audit committee concept, while retaining a two-tier structure, could be seen as supporting Rhodes and Apeldoorn (2003) who held that there will be adjustment at the margins rather than the transformation to a dominant Anglo-Saxon corporate governance model as domestic elites will not be prepared to see their power and positions undermined by changes and will therefore champion continuity. Similarly, the findings are consistent with the view that globally there is a move towards convergence in national systems or principles of corporate governance (Cuervo, 2002 and Mallin, 2002). However, the findings do suggest that for the audit committee concept, the position differs from the broad overview of Deeg and Perez (2000) that there is no clear convergence toward either the Anglo-Saxon model of corporate governance or the continental system in Germany, France, Spain and Italy, and Cernat (2004) who argued that despite globalisation and pressure for a single European market from the European Commission there will not be any convergence of national corporate governance systems in Europe because the Anglo-Saxon and continental models of governance are difficult to reconcile. For countries within the European Union, pressure from the European Commission may be one reason for the spread of the audit committee concept.

For countries within the European Union, pressure from the European Commission may be one reason for the spread of the audit committee concept. The Green paper (European Commission, 1996) saw audit committees as essential committees of the Board. More recently, the European Commission (2003: 5) acknowledged that standards were being set at an international level but suggested the European Union must define its own European corporate governance approach, tailored to its own cultural and business traditions. It also opined that “A common approach should be adopted at European Union level with regard to a few essential rules and adequate co-ordination of corporate governance codes should be ensured” including the formation of audit committees (p.15). European Commission (2004a) in discussing the role of non-executive directors on main and supervisory boards stressed their audit committee role (p.70-1). The failure to enforce the 1996 recommendations is consistent with the view that, given the diversity of approaches among member states,

European decision making procedures are insufficiently strong to for a well-articulated corporate governance model to be adopted (Cernat, 2004).

In conclusion, the audit committee concept has been widely adopted in the governance codes of European countries, including those with a two-tier governance structure but the recommendations in codes and principles do exhibit a degree of variation. The findings are consistent with literature on convergence of corporate governance systems that suggests there will be convergence at the margins but embedded interests in Europe will prevent convergence to one corporate governance model. Audit committees were introduced as a reaction to corporate failures in the US (Birkett, 1986). Their widespread acceptance by European countries including those with two tier boards has occurred despite the mix literature on their effectiveness in practice (see for example Kalbers and Fogarty, 1993; Wolnizer, 1995; Collier, 1996; and Turley and Zaman, 2001) begging the question – why is the audit committee concept so attractive to regulators and professional bodies? Could it be that the adoption of the concept has symbolic value – regardless of its efficacy it signals that regulatory and professional bodies (issuing the national codes) have addressed concerns about weaknesses in governance?

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APPENDIX I

References to the governance codes, principles and reports that formed the basis of the survey at April 2003

Country	Code reference	Instigator	Status	Disclosure	Scope
Austria	Austrian Working Group on Corporate Governance (2002)	Representatives of accountants, investment analysts, listed companies and investors	Voluntary	Public declaration of commitment to code and extent of compliance	Listed companies
Belgium	Belgium Commission for Corporate Governance (1998)	Belgium Stock Exchange and Banking and Finance Commission	Voluntary	Comply or explain	Listed companies: encouraged for all
Cyprus	Cyprus Stock Exchange (2002)	Cyprus Stock Exchange	Voluntary	Comply or explain	Listed companies
Czech Republic	Czech Securities Commission (2001)	Czech Securities Commission		Comply or explain	Listed companies: encouraged for all
Denmark	Norby Committee (2001)	Danish Stock Exchange	Voluntary	Account for use of Board committees	Listed companies: encouraged for all

France	Bouton Committee (2002)	Association of private sector companies (AFEP – AGREF) & Association of major French corporations (MEDEF)	Voluntary	No	Listed companies
Germany	Cromme Committee (2003)	Government Commission on Corporate Governance	Voluntary	Comply or explain	Listed companies: encouraged for all
Greece	Committee on Corporate Governance in Greece (1999)	Capital Markets Commission	Voluntary	Comply or explain	Listed companies
Ireland	Irish Association of Investment Managers (1999)	Irish Association of Investment Managers	Voluntary	Comply or explain	Listed companies
Italy	Committee for Corporate Governance of Listed Companies (2002)	Italian Stock Exchange	Voluntary	No	Listed companies
Malta	Malta Stock Exchange (2001)	Malta Stock Exchange	Voluntary	Extent of compliance	Listed companies
Netherlands	Peters Committee (1997)	Stock Exchange, Association of Securities Dealers, Issuing Companies & Investors	Voluntary	Existence in Supervisory Board report and extent of compliance	Listed companies
Poland	Best Practices Committee at the Corporate Governance Forum (2002)	Stock Exchange and business	Voluntary	Extent of compliance or explain	Public companies
Portugal	Commission of the Stock Exchange (1999)	Stock Exchange	Voluntary	Extent of compliance	Listed companies
Romania	Strategic Alliance of Business Associations (2002)	Strategic Alliance of Business Associations	Voluntary	Report to Stock Exchange on observance	Listed companies and others
Slovakia	Bratislava Stock Exchange (2002)	Bratislava Stock Exchange	Voluntary	Comply or explain	Listed companies
Spain	Olivencia Report (1998)	Government Commission	Voluntary	No	Listed companies
Sweden	Swedish Shareholders Association (2001)	Swedish Shareholders Association	Voluntary	No	Listed companies
Switzerland	Swiss Stock Exchange (2002)	Swiss Stock Exchange	Voluntary	Comply or explain	Public limited companies
UK	Smith Report (2003)	Financial Reporting Council	Voluntary	Comply or explain	Listed companies