

# Convergence in European Corporate Governance: the audit committee concept

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This paper analyses recent corporate governance codes issued by 20 countries for evidence of convergence in corporate governance systems in Europe. The analysis shows that there has been a degree of convergence towards an Anglo-Saxon model of corporate governance as the audit committee concept is widely accepted in countries with both unitary and two-tier governance systems. Further, the latest audit committee recommendations in countries that have issued several governance codes show a strengthening of the recommendations for an audit committee over time in line with the Anglo-Saxon audit committee concept and convergence with the debate in the US and UK on issues such as the independence and financial expertise of members. However, consistent with the literature on the convergence of European corporate governance systems, at an operational level there is limited consistency in the recommended structure and role of audit committees.

**Keywords:** Corporate governance, convergence, Europe, audit committees, governance codes

## 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, such as separation of the role of board chairman and chief executive, appointment of non-executive directors and formation of board subcommittees. The audit committee concept – defined for the purpose of this paper as the existence of a subcommittee of the main or supervisory board comprised mainly or wholly of non-executive or independent directors with responsibility for oversight of auditing activities (Birkett, 1986; Cadbury Committee, 1992; Collier, 1992) – has been the subject of considerable attention following both past and recent corporate scandals. Early recommendations for the voluntary adoption of audit committees made in North America were followed by proposals for

extending their use in many countries (see, for example, Collier, 1992; Turley and Zaman, 2004).

For countries in the European Union, the European Commission has been active in promoting the audit committee concept within its brief to create a fair internal market. The European Commission's Green Paper noted "audit committees have developed into essential committees of boards of directors" (1996, p. 5). Subsequently, the European Commission stated that "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" (2003, p. 15). This position is repeated in European Commission (2004a, pp. 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

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audit committee or equivalent body (s.2.2.4), and in European Commission (2004b, pp. 70–71) which attributed responsibility for audit to the non-executive/supervisory board directors, and recommended an audit committee should usually be set up for this purpose.

This paper seeks to contribute to the literature on audit committees by examining the extent to which audit committees appear in corporate 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 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 because, first, 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” (EU Institutions Press Release, IP/03/716 21 May 2003). 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; Collier, 1996) and were extremely rare within Europe prior to the early 1990s (Vanasco, 1994, p. 23). They are becoming widely accepted internationally (Turley and Zaman, 2004). Audit committees are expected to have a key role in ensuring high standards in financial reporting that underpin confidence in financial markets (see, for example, European Commission, 2003) and have also been extremely topical following recent corporate scandals such as Enron, WorldCom, Parmalat and Hollinger International.

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 and a section defining the data source and population. 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 (b) recommendations concerning audit committee

membership, expertise and independence and audit committee activity and roles. A further section analyses changes to 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 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, p. 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 for 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, pp. 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).

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

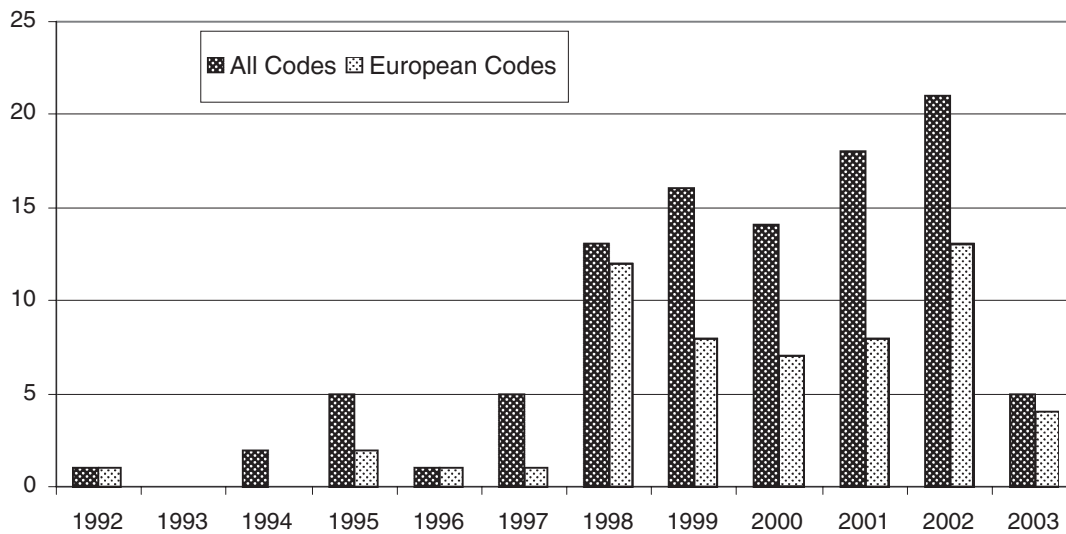


Figure 1: Number of governance codes issued by year

and principles (94 codes, excluding 5 undated, from 35 countries and 7 pan-national) from across the world 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 the 20 European countries included in this study are shown separately (see Appendix 1). Figure 1 reveals a concentration of developments with 73 per cent of all codes issued in or after 1999. The position for European countries is similar with 70 per cent of codes issued in this period. 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" model, with its emphasis on shareholder 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 Mayer, 1996; Moerland, 1995).

A number of researchers have examined this question (see, for example, Rhodes and van Apeldoorn, 1998; Deeg and Perez, 2000; Cernat, 2004) in the context of Europe where, in response to historic and cultural developments, countries have a variety of different corporate governance approaches within the framework corresponding either to the Anglo-

Saxon or Continental model (for example, Issakson 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 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 that domestic elites are not prepared to see their power and positions undermined by changes and will therefore champion continuity and adjustment in response to external pressures rather than 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, p. 161) suggested 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 observed that "they do not have audit committees in Europe: perhaps they are not necessary with alternative forms of governance" (1978, p. 28). 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, p. 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, pp. 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 per cent of the companies had audit committees with adoption rates highest in the UK (100 per cent), 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, p. 20) in France, the 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 international market forces, the interest of the authorities and regulators in governance issues, and their adoption in the UK, France and the Netherlands will increase the significance of audit committees in Europe and their inclusion in national code recommendations would grow. This paper demonstrates that this has been the case.

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 gover-

nance procedures will often differ from those countries that have broad liquid stock markets. The EASD (2000, p. 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 per cent; whereas, in Austria, Belgium, Germany and Italy over half of listed companies have a 50 per cent plus beneficial owner.

This European approach is in contrast to the pan-national codes from the Commonwealth Association for Corporate Governance (1999, p. 12) or the ICGN (1999, pp. 4, 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. The 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, p. 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, which includes a number of members who were involved in the early promotion of audit committees (for example: the UK, Canada, South Africa and Singapore) 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 analyses 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 on the ECGI web site (<http://www.ecgi.org>)

as at 1 April 2003. The web site has academic integrity and the ECGI is a not for profit organisation, whose primary role is to undertake, commission and disseminate research on corporate governance, governed by a board in which academics comprise a majority. The data source contains a fairly comprehensive list of codes and principles, many in English; information on the date posted; and, importantly, details of their provenance. Twenty European countries had one or more code or principle 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. Eleven of the 20 countries covered had more than one code or guideline.<sup>1</sup> 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 convergence towards acceptance of the audit committee concept.

Appendix 1 shows that the codes and principles are predominantly derived from commissions set up by stock exchanges (11 countries – 55 per cent). However, in a further seven countries (35 per cent) the recommendations were generated by 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 countries (80 per cent), 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 departures (see, for example, the UK Combined Code (Financial Reporting Council, 2003)).<sup>2</sup> The disclosure recommendations were predominantly for companies to comply or explain (ten countries) or to disclose the extent

of compliance (four countries), but no guidance was given in four countries.

### *The recognition of audit committees in national corporate governance codes*

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

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, the Norby Committee (2001, p. 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, p. 35) indicated that the supervisory board might form an audit committee. The Commission of the Stock Exchange (1999, p. 9) in Portugal recommended the formation of internal committees but did 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) left 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,<sup>3</sup> the recommendations are similar to Cadbury (1992), while the Irish guidelines (Irish Association of Investment Managers, 1999, p. 1) endorse the provisions of the UK Combined Code (Committee on Corporate Governance, 1998) without reservation. However, in France the Vienot Report II (1999, s.23) recommended that only a minimum of one third of the audit

Table 1: Governance structure and audit committee recommendation in Codes

	Unitary (%)	Two tier (%)	Total (%)
Audit committee	11 (79)	5* (83)	16 (80)
No audit committee	3 (21)	1 (17)	4 (20)
Total	14 (100)	6 (100)	20 (100)

\*Peters Committee (1997, s.3.2, p. 11) only requires the supervisory board to consider forming an audit committee and the Austrian Working Group on Corporate Governance (2002, p. 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.

committee should be comprised of independent directors, although the Bouton Committee (2002, p. 12) increased the proportion. In Italy both the Preda Code (Preda Committee, 1999, s.5.4.3) and Committee for Corporate Governance of Listed Companies (2002, p. 14) refer to an internal control committee with many audit committee functions. In countries that have a predominantly two-tier board structure, the audit committee is appointed by and reports to the supervisory board.<sup>4</sup>

Thus in 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 the 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.

##### *Audit committee size*

For the audit committee to be effective it is generally recognised that it should comprise a number of outside directors. In the UK the Cadbury Committee (1992, s.4.35, pp. 28–29) recommended that established audit committees should have a minimum of three members and membership be confined to non-executive directors. This minimum size was supported by the subsequent Smith Report (2003) and incorporated in the Combined Code (Financial Reporting Council, 2003). Table 2 Panel A below shows that, 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, p. 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 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” (1940, p. 7). 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.

Panel B in Table 2 indicates that in a majority of 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 per cent 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 per cent specified a degree of independence in the membership. In the Netherlands the Peters Committee (1997, s.2.3, p. 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, pp. 10–11) required audit committees to be wholly independent,<sup>5</sup> and provisions in the Sarbanes-Oxley Act 2002 legislated to this effect (s.301). Similarly, the UK Smith (2003) and Higgs (2003) reports stressed the importance of the independence of non-executive directors and required audit committees to be comprised of wholly independent directors. This is also consistent with the European Commission (2004a) recommendation that the audit committee should be

Table 2: Audit committee composition

	No.	%	Countries
<i>Panel A: Minimum size</i>			
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
Total	16	100	
<i>Panel B: Independence</i>			
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
Total	16	100	
<i>Panel C: Financial expertise</i>			
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	
Total	16	100	

\*In Spain and Sweden they are referred to as outside directors. \*\*Bouton Committee (2002, s.IV, p. 13) refers to two-thirds independent with no corporate officers eligible for audit committee membership.

composed exclusively of non-executive or supervisory directors, of whom the majority should be independent. However, the earlier clarity of the Belgium Commission for Corporate Governance (1998) recommendations is worthy of note. It defined non-executive direc-

tors as those who "do not perform any management functions within the company or any of its subsidiaries" (s.1.4, p. 4) and independent directors as "independent of executive management and of dominant shareholders and free from any business or other relation-

ships which could interfere with their independent judgement apart from their remuneration and shareholding in the company" (s.22, p. 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, p. 12) recommended not only that every member should be financially literate, but also 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 Report (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). 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 European Commission (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 Report (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 per cent and 10.2 per cent 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 below shows that European codes and principles are largely silent on this impor-

*Table 3: Audit committee activity*

Minimum number of recommended meetings	No.	%	Countries
Two	2	13	Cyprus, 2003; and Greece, 1999
Three	1	6	UK, 2003
Four	1	6	Czech Rep., 2001
Not specified	12*	75	Austria, 2002; Belgium, 1998; 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 Belgium, which requires one meeting per year, between the audit committee and the external and internal auditors, and the Netherlands, which specifies one meeting a year between the supervisory board and the external auditors.



tant issue, with almost 75 per cent not specifying the minimum number of audit committee meetings. The highest minimum number of meetings is four per year, as 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, p. 2), and in the UK, three meetings (Smith Report, 2003).

#### *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, 2003).

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 4 was just below four. Oversight of internal and external audit is almost universally seen as the central function of audit committees, while there is least agreement on explicit responsibility for financial reporting, although to an extent this may be implicit within the oversight of the external audit role. 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 per cent) 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.

This section has shown that the audit committee concept has been accepted in many European countries. It was also found that the formation of an audit committee is 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**

In accordance with the globalisation contentions of Monks and Minow (2001, pp. 249–251), major economic powers were the first to introduce codes on corporate governance. By the end of 1998, Belgium, France, Germany, Italy, the Netherlands, Spain and the UK<sup>6</sup> had introduced national codes in advance of pan-national guidance from the OECD (1999a), 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 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 direc-

*Table 4: Audit committee role*

Roles specified in codes	No.	%
Oversight of external audit	16	100
Oversight of internal audit	15	94
Involvement in external auditor selection or dismissal	11	69
Oversight of risk/internal control reporting by the board	10	62
Oversight of financial reporting quality	9	56

tors 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 Report was moved towards the Cadbury report position by the Bouton Committee (2002, p. 12) recommendation that two-thirds of the membership of the audit committee should be independent and must not include any 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.

In the Netherlands, the Peters Committee 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), only required that supervisory boards should consider setting up audit committees and permitted 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 Tabaksblat Committee (2003) cited the audit committee as a "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, that only one non-independent member may be included on the committee, that at least one supervisory board member must have financial expertise and that the scope of the audit committee includes internal control and risk management (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 Commission 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 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, pp. 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, p. 25) moved to reverse the Norby Committee's (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 a number of European countries demonstrates 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. For example, 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.

## Discussion and conclusion

This paper has examined the development of the audit committee concept in Europe. The results show that, despite an absence of support from pan European codes, a recommen-

dition for an audit committee was present in 16 (80 per cent) of the countries covered. The corporate governance codes were not consistent in the specification of audit committee structure concerning membership, independence, financial qualification and frequency of meetings. Similarly, the audit committee's wider role in financial reporting, external auditor selection and internal control and risk assessment was not always explicitly stated.

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 system, 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.

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 van Apeldoorn (2003), who argued that there will be adjustment at the margins rather than 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; 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. The Green Paper (European Commission, 1996) saw audit committees as essential committees of the board. More recently, the European Commission (2003, p. 5) acknowledged that standards were being set at an international level but suggested that 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). In discussing the role of non-executive directors on main and supervisory boards, the European Commission stressed their audit committee role (European Commission, 2004a, pp. 70–71). 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 for a well-articulated corporate governance model to be adopted (Cernat, 2004).

This paper has a number of limitations. First, it examines the audit committee concept rather than audit committee practices and their enforcement, which is a major area for further research. The European Commission 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" (2002, pp. 70–75). 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. Second, the coverage in this paper is limited to what is observable through that part of the governance context captured in what is stored on the ECGI web site rather than the full national corporate governance context. However, we believe requirements for audit committees are unlikely to be contained outside the codes covered.

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 the literature on convergence of corporate governance systems that suggests there will be convergence at the margins but that 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 mixed literature on their effectiveness in practice (see, for example, Kalbers and Fogarty, 1993; Wolnizer, 1995; Collier, 1996; Spira, 2002; Turley and Zaman, 2004) 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 – that regardless of its efficacy it may signal that regulatory and professional bodies (issuing the national codes) have addressed concerns about weaknesses in governance? These questions have been outside the scope of this paper, but are worthy of investigation to enhance understanding of convergence in corporate governance mechanisms and their effects in practice.

## Notes

1. See Appendix 1 for a list of the countries and the code or principles on which the analysis is based.
2. Germany (Article 161 of the Stock Corporation Act 2002, Cromme Committee, 2003), Italy (Law of Measures to Reform the Financial System, article 47 of Law 44/2002, Olivencia Report, 1998) and Spain (Legislative Decree 58 of 24 February 1998, Article 148, Draghi Report, 1997) gave legal force to aspects of the Code.
3. For example, Belgium (Belgium Commission for Corporate Governance, 1998), Greece (Committee on Corporate Governance in Greece (1999), Spain (Olivencia Report, 1998) and Switzerland (Swiss Stock Exchange, 2002).
4. Austria, Czech Republic, Germany, the Netherlands, Poland and Slovakia are examples of countries with two-tier board structures. See the Peters Committee report (1997, s.3.2) and the German Panel on Corporate Governance (2000, p. 10), for example, on the appointment by and reporting to supervisory boards.
5. Independence was defined as having no relationship to the corporation that may interfere with the exercise of their independence from management and the corporation.

6. Federation of Belgium Companies (1998), Vienot Report (1995), Federal Ministry of Justice (1998), Draghi Report (1997), Peters Committee (1997), Madrid Stock Exchange (1996) and Cadbury Committee (1992) respectively.

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### Appendix 1: 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) and 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

*Appendix 1: Continued*

Country	Code reference	Instigator	Status	Disclosure	Scope
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 and 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 (2000)	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