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SŁOWO WSTĘPNE

Sektor małych i średnich przedsiębiorstw klasyfikowany jest jako jeden z kluczowych. Podmioty wchodzące w skład sektora MŚP odgrywają bardzo ważną rolę w rozwoju gospodarki. Jednak są to często podmioty mające problemy kapitałowe, technologiczne i rynkowe. Wzrost znaczenia sektora MŚP w gospodarce jest, jak wskazują badania, ściśle związany z postępem technologicznym i rozwojem cywilizacyjnym. Podmioty MŚP należą do najbardziej elastycznych, a równocześnie szczególnie dynamicznych podmiotów gospodarczych.

Istotnym problemem zgłaszanym przez właścicieli i zarządzających firmami z sektora MŚP jest brak kapitału. Problemy z finansowaniem działalności mogą być w części przezwyciężane większą skłonnością przedsiębiorców do inwestowania. Kapitał własny przedsiębiorców jest jednak zwykle ograniczony, stąd potrzeba sięgania po dodatkowe źródła. Naprzeciw tym potrzebom wychodzą m.in. inicjatywy związane z rozwojem rynku kapitałowego, w tym tworzenie segmentów rynku dedykowanych dla mniejszych podmiotów. Taką inicjatywę podjęto w Polsce, gdzie w sierpniu 2007 roku utworzono New Connect – czyli tzw. Alternatywny System Obrotu na GPW. Jest to rynek przeznaczony dla małych firm, przede wszystkich w początkowej fazie rozwoju.

Finansowanie MŚP wiąże się ściśle z rozwojem różnych form wsparcia, między innymi w formie pożyczek, poręczeń, factoringu, leasingu. Ogromną rolę we wspieraniu rozwoju MŚP pełnią fundusze Unii Europejskiej. Ważne jest także wsparcie dla inicjatyw regionalnych w zakresie działalności innowacyjnej w ramach tworzonych parków przemysłowych i technologicznych.

Wspomniane wyżej zagadnienia dotyczące finansowania i wspierania MŚP stanowią wiodącą tematykę zamieszczonych w niniejszym opracowaniu artykułów. Niniejsza publikacja zawiera artykuły naukowe z obszaru zarządzania finansami, które zostały opracowane i w większości zaprezentowane przy okazji dziewiątej Międzynarodowej Konferencji „Zarządzanie Finansami" zorganizowanej w kwietniu 2008 roku przez Zakład Inwestycji i Wyceny Przedsiębiorstw Uniwersytetu Szczecińskiego. Oprócz zagadnień bezpośrednio związanych z finansowaniem MŚP, w opracowaniu zamieszczono artykuły poświęcone: kreowaniu wartości, efektywności inwestycji, fuzjom i przejęciom, mierzeniu i ocenie wyników przedsiębiorstw, nadzorowi korporacyjnemu, planowaniu finansowemu, wycenie przedsiębiorstw, finansom i gospodarce publicznej.

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Streszczenie

Przedmiotem opracowania jest wpływ struktury własności na efektywność funkcjonowania przedsiębiorstw. Wyniki dotychczas prowadzonych badań w tym zakresie, zarówno na świecie jak i w Polsce, wskazują na często przeciwstawne zależności począwszy od pozytywnej korelacji między koncentracją własności a wartością przedsiębiorstwa, po negatywne zależności między koncentracją własności a efektywnością przedsiębiorstwa.

INFLUENCE OF THE STRUCTURE OF SHAREHOLDERS ON EFFICIENCY OF COMPANIES

Summary

The subject of this paper is influence of the ownership structure on efectiveness of the companies. Results of studies in this area worldwide and in Poland until now indicate contrary relations, starting from positive correlation between concentration of ownership and value of the companies, ending at negative relation of concentration and companies' performance.

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AGNIESZKA HERDAN

THE RELATIONSHIP BETWEEN AUDIT COMMITTEES AND INTERNAL AUDIT FUNCTION: EVIDENCE FROM UK

1. Introduction

Corporate governance is defined as a system by which companies are directed and controlled. In recent years, concern has arisen at the way some companies have been managed and how shareholders interests have been neglected, especially after the collapse of Enron, problems with Xerox or Parmalat. It has become a main discussion in business at both academic and practitioner levels, how to better govern the activities of a company. As a result the Codes of Good Corporate Governance have been implemented for listed companies in many countries around the World.

There are many mechanisms that have been used to enforce and encourage management to act in the best interest of shareholders. These are: legal and regulatory frameworks, external and internal controls, disclosures and many more. Amongst them, internal control is believed to play an important role in monitoring the activities of managers. Internal control includes the responsibilities of an audit committee in overseeing the financial reporting process, monitoring the choice of accounting policies and principles, monitoring internal control processes, and overseeing the hiring and performance of external auditors.

2. The Role of an Audit Committee and Internal Audit in Corporate Governance

An audit committee is a sub-committee to The Board of Directors. It is responsible to oversee matters relating to financial reporting, internal control and audit activities. An effective audit committee is generally recognised as an essential corporate governance mechanism[1]. An audit committee should act independently from the executive, to ensure that the interests of shareholders are well protected.

[1] L.F. Spira: *Ceremonies of Governance: Perspectives on the role of the audit committee.* "Journal of Management and Governance" 1999, Vol. 3, pp. 231–260.

Internal audit should be an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It should help an organisation to accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes[2]. Internal auditors are also considered add value to a firm because their analyses and suggestions for improvement are objective. Internal audit function is to ensure that an organisation's operations are conducted effectively, efficiently and economically and with compliance to laws and regulations. Strong internal control leads to a lower risk score and hence a lower level of regulatory intervention[3].

The role of an audit committee and its internal audit function can be well-established as an oversight mechanisms for The Board to ensure that good corporate governance processes are effective, in particular the composition of independent non-executive directors in the audit committee, as well as increasing the reliability of financial information.

The role of non-executive director is considered to contribute significantly to the efficiency of The Board of Directors. An independent director (non-executive director) is defined as not having a relationship which would interfere with the exercise of independent judgement in carrying out the functions of the committee[4].

A non-executive director as not involved in the day-to-day activity of the business and can often see risks and opportunities that can be sometimes overlooked by the executive management. It is significantly important when the Chairman or Chief Executive Officer of a company is especially entrepreneurial or overbearing.

The non-executive directors can also act as a buffer between the executive directors and shareholders. They monitor executive actions and question executive decisions[5]. Their role is to ensure that the company is acting in a responsible way and in the best interests of shareholders and stakeholders.

Non-executive directors, who have essential qualities such as specialised commercial and technical expertise, can bring to The Board an independent perspective.

[2] Institute of Internal Auditors, *Definition of Internal Auditing*. Altamonte Springs, Florida: The Institute of Internal Auditors, London 1999.

[3] J. Tiner: *Financial services sector regulation and internal audit*. Speech at Risk Conference, 22 September 2005, available from: http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2005/0922_jt.shtml (August ,2007).

[4] J. Goodwin, T.Y. Yeo: *Two factors affecting internal audit independence and objectivity: evidence from Singapore*. "International Journal of Auditing" 2001, Vol. 5, No. 2, pp. 107–125.

[5] C. Pass: *Corporate governance and the role of non-executive directors in large UK companies: an empirical study*. "Corporate Governance" 2004, Vol. 4, No. 2, pp. 52–63.

3. The Relationship Between an Audit Committee and Internal Audit Functions

The relationship between audit committees and internal audit functions is an increasingly important issue for all organisations. The effectiveness of internal audit is the basis and solid principles of the audit committee process as they strengthen each other's function.

Scarbrough[6] reported that audit committees comprising solely of non-executive directors had more frequent meetings with the chief internal auditor than those committees consisting of executive directors. They were also more likely to review the internal audit program and the results of internal auditing.

According to the Institute of Internal Auditors[7], a strong working relationship between internal auditing and the audit committee is essential for each to fulfil its responsibilities. An effective audit committee can strengthen the position of the internal audit function by acting as an independent forum for internal auditors to have regular and confidential access to the committee[8].

At the same time, internal audit can assist the audit committee in its oversight of reporting, risk management and control[9]. In particular, internal audit can help an independent audit committee overcome the problem of information asymmetry as they do not have direct access to the same level of information as management.

4. Regulation of UK Audit and Corporate Governance

In the UK, the financial regulatory framework under the UK Financial Services and Market Act 2000 requires banks and other authorised financial firms to establish internal systems of control, compliance, and reporting for senior management and other key personnel[10]. The Financial Services Authority has the power to review and sanction banks and financial firms regarding the types of internal control and compliance systems they adopt. These systems must be based on recognised principles and standards of good governance in the financial sector.

These regulatory standards place responsibility on the senior management of firms to establish and maintain proper systems and controls, to effectively oversee the different aspects of their business.

[6] D.P. Scarbrough, D.V. Rama, K. Raghunanda: *Audit committee composition and interaction with internal auditing: Canadian evidence*. "Accounting Horizons" 1998, Vol. 12, No. 1, pp. 51–62.

[7] Institute of Internal Auditors Practice Advisory: *Relationship with the Audit Committee*, Altamonte Springs, FL: The Institute of Internal Auditors, London 2000.

[8] J. Goodwin, T.Y. Yeo: *op.cit.*

[9] W.G.III Bishop, D.R. Hermanson, P.D. Lapides, L.E. Rittenberg: *The year of the audit committee*. "Internal Auditor" 2000, Vol. 57, No. 2, pp. 46–51.

[10] Financial Services and Market Act 2000 http://www.opsi.gov.uk/acts/acts2000/ukpga_20000008_en_1 (accessed January 2008).

The companies' listed on the London Stock Exchange are, therefore, required to comply with the Listing Rules of the Combined Code of Corporate Governance set out in the listing rules of the Financial Services Authority. The new Combined Code introduces a number of key principles of compliance with regard to the roles of a company's chairperson and chief executive, the composition of the Board of Directors and the three main committees: Nominations, Remuneration, and Audit committees.

The UK Combined Code 2003 recommends that an effective audit committee should include at least three members, all of whom should be independent non-executive directors. They should be financially literate or at least one of them should have accounting or financial management expertise. A financial background is defined as past employment experience in accounting or finance, a professional certification in accounting or comparable experience[11]. Such expertise helps the audit committee to carry out its role effectively.

Additionally, it is recommended that there should be as many meetings as the audit committee's role and responsibilities require, but no fewer than three meetings per year. In addition, no one other than the audit committee's chairman and members is entitled to be at the meeting. The Code also emphasises under the Code's "comply or explain" philosophy, that listed firms are also required to provide an appropriate explanation for why they have not fully complied with a provision of the Code[12].

5. Data – Information Sources

The data used for this paper has been obtained from reports of audit committees and internal auditors as well as internal controls available on company websites – the investor relations section or by annual company reports. A pivot table was drafted to centralise and summarise all the questions and answers, and then used for the analysis.

The Data sampled are companies that are fully listed on the London Stock Exchange, but only within the banking-financial services sector.

The paper observes how the audit committees of those listed firms discharged their responsibilities during the period of investigation 1st January 2006 to 31st March 2007.

Analysis of the findings is based upon Smith's guidance on the Combined Code and on the role and responsibilities of an audit committee in connection with internal auditing and the recommendations about the conduct of audit committees' and their relationship with the internal auditors[13].

[11] UK Combined Code 2003 – http://www.shef.ac.uk/cuc/pubs/CHEMS_Higgs_Code.pdf (January 2008)

[12] C. Pass: *op.cit.*

[13] Audit Committee Combine Code Guidance, http://www.football-research.org/docs/smithreport-30-01-03.pdf (January 2008).

The following questions were considered:

- Does the organisation have an audit committee?
- How many times does the audit committee meet during the examined period?
- Does the organisation have an internal audit function (regardless of in-house or outsourced)?
- How many members are in the audit committee?
- How many members of the audit committee are independent non-executive directors?
- How many members of the audit committee have an accounting or finance background?
- Does the audit committee review internal audit proposals related to programs or plans, budget, and co-ordinate with external auditors?
- Does the audit committee review the results of internal auditing related to financial reporting, internal control, compliance with laws/ regulations?
- Does the audit committee review management responses to internal auditing findings/suggestions?

6. Methodology and variables

The study applies a multiple regression model, using the general form of a linear regression model. In the study, the independence of an audit committee is considered as a dummy variable and scores 1 if the audit committee is fully independent, if not this variable is 0. The independence variable is calculated by the number of members in the audit committee minus the number of independent directors in the committee. If the result equals 0 then the independence variable of the observation will be 1, which means the whole committee is independent. On the other hand, if the result is 0 which means the audit committee contains some executive directors, the independence variable will be 0.

Furthermore, private meetings were also considered as a dummy variable so if there are private meetings between audit committees and internal audit, a score of 1 or 0 was used.

Variables:

- The independent variables are:

  X1: The size of the audit committee.

  X2: The number of independent non-executive directors in the audit committee

  X3: The number of audit committee members with financial or accounting knowledge

  X4: The number of meetings held by audit committees with the presence of a chief internal auditor.

  D1: if the audit committee has private meetings with an internal auditor, score equals 1 or otherwise 0.

  D2: if the audit committee is fully independent it scores 1 or otherwise 0.

. ne dependent variable is:

Y: The amount of work that an audit committee does reviewing internal audit functions.

The amount of work that an audit committee reviewing internal audit functions is the dependent variable, as the study tries to find the relationship between an audit committee in relation to an internal audit function. It is therefore dependant on how big it is, its composition, the number of audit members with financial expertise, the number of meetings held between the audit committee and the chief internal auditor, if these meetings are organised privately or not, and if the audit committees are fully independent or not.

The amount of work is the total work that was done by an audit committee during the investigated period and was calculated as the sum of all following elements:

- If an audit committee reviews internal auditor's proposal relating to programs or plans, it scores 1, if not it scores 0.
- Similarly, if an audit committee reviews internal auditor's proposal relating to budget, it scores 1, if not it scores 0.
- If an audit committee reviews internal auditing related to co-ordination with external auditor, it scores 1, if not it scores 0.
- If an audit committee reviews internal auditing results related to financial reporting, it scores 1, if not it scores 0.
- If an audit committee reviews internal auditing results related to internal control, it scores 1, if not it scores 0.
- If an audit committee reviews internal auditing results related to compliance with laws or regulations, it scores 1, if not it scores 0.
- If an audit committee reviews the arrangement of management in responding to internal auditor's findings and suggestions, it scores 1, if not it scores 0.

The regression for the relationship is:

$$E(Y) = a + b1\ SIZE + b2\ NON\text{-}EXE + b3\ ACCOUNTING + b4\ MEETINGS + \\ + b5\ PRIVATE + b6\ INDEPENDENCE + e$$

7. Findings

From 103 companies listed on London Stock Exchange in the financial institution sector, only 57 companies had been selected as the others didn't have an audit committee nor an internal audit function, or did not disclose information about the existence of such a committee.

Audit committees with four members were in the highest proportion with 21 companies (36.8%), 17 companies had three members (29.8%) and 14 entities had five members on their committees (24.6%). The overall mean number of members is 3.96. This number is

actually lower than the results of New Zealand (4.61) and Australia (4.58) found in Goodwin's research (2003). However, the result from UK audit committee is higher than the result of those in Singapore with 3.71[14].

Table 1

The size of the audit committee

Members		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	2	3	5.3	5.3	5.3
	3	17	29.8	29.8	35.1
	4	21	36.8	36.8	71.9
	5	14	24.6	24.6	96.5
	6	1	1.8	1.8	98.2
	9	1	1.8	1.8	100.0
	Total	57	100.0	100.0	

According to the guidance of the Combined Code, the Board of Directors should establish an audit committee of at least three members, or two members if the company is smaller in size[15]. In general, the size of companies in the UK meets this requirement as they have an average of 3.96 members on their audit committee.

The majority of financial companies listed on the London Stock Exchange have fully independent audit committees, 51 entities out of the 57 sampled have 100% independent non-executive directors (89.47%) (see table 2). 6 out of the 57 companies were not fully independent, 5 companies had one or more executive directors on their audit committee board, and only one company did not have non-executive directors in its audit committee.

In response to both the Cadbury and Hempel Committee reports, which recommended that non-executive directors should be "independent" of the board to ensure objectivity, many companies listed in the UK market recognised the current trend towards having a majority of independent directors on their boards.

One example is Canaccord Capital Inc. The company believes that having mainly independent directors on their board will adequately reflect the perspectives and interests of their minority shareholders[16]. Old Mutual plc is also committed to achieving high standards of corporate governance by using mainly non-executive directors on its board[17].

14 J. Goodwin: *The Relationship between the Audit Committee and the Internal Audit Function: Evidence from Australia and New Zealand.* "International Journal of Auditing" 2003, Vol. 7, pp. 263–278.
15 Audit Committee Combine...
16 Canaccord Capital Inc, Annual Report 2007, p. 85.
17 Old Mutual plc, Annual Report 2006, p. 46.

Table 2

The independence of audit committees in the sample

Percentage independence	Frequency	Percentage
100%	51	89.47%
75–99%	3	5.26%
50–74%	2	3.51%
25–49%	0	0.00%
0–24%	1	1.75%
Total	57	100.00%

But, many other companies seem to have different opinions, such as the board of Charles Stanley Group Plc whose board is only composed of executive directors on its audit committee[18].

Although the Combined Code requires all members of the audit committee to be independent non-executive directors, the results show that only 51 entities amongst 57 complied with this regulation. However, the descriptive statistics relating to the independant financial companies listed in the UK shows a very high level of independent non-executive directors existing within their audit committees at 95.97%, compared to 74% in the U.S. sample reported by Raghunandan[19].

According to the Smith guide[20], audit committee members are not only expected to be independent, but also need to be financially literate as well as have recent and relevant corporate finance expertise. An audit committee structure, therefore, requires the inclusion of at least one financially qualified member.

The survey shows that 1.26 members of the audit committees have financial experience. As presented in table 3, there are only 3 companies (5.26%) in which all members have financial knowledge in their audit committees. Most of them have a percentage of financial expertise ranging from 25% to 49% (28 entities). On average, UK audit committees have a lower percentage of financial experts (33.47%) compared to those from Australia (57.2%) and New Zealand (62.7%)[21]. However, while most of the companies have one member on their audit committee with relevant financial expertise, there were still 9 companies that did not have any member with accounting experience on their audit committees.

[18] Charles Stanley group plc, Annual Report 2006, p. 26.

[19] K. Raghunanda, W.J. Read, D.V. Rama: *Audit committee composition, 'gray directors', and interaction with internal auditing.* "Accounting Horizons" 2001, Vol. 15, No. 2, pp. 105–118.

[20] Audit Committee Combine...

[21] J. Goodwin: *op.cit.*

Table 3

The expertise of audit committees in the sample

Percentage with expertise	Frequency	Percentage
100%	3	5.26%
75–99%	1	1.75%
50–74%	10	17.54%
25–49%	28	49.12%
0–24%	15	26.32%
Total	57	100.00%

Table 4

Frequency of audit committee meetings

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	2	1	1.8	1.8	1.8
	3	8	14.0	14.0	15.8
	4	14	24.6	24.6	40.4
	5	15	26.3	26.3	66.7
	6	9	15.8	15.8	82.5
	7	3	5.3	5.3	87.7
	8	5	8.8	8.8	96.5
	9	2	3.5	3.5	100.0
	Total	57	100.0	100.0	

The Smith guidance (2003) recommends that there should be as many meetings as the audit committee's role and responsibilities require, but there should be no fewer than three meetings per year[22]. The reviewed audit committees held between 2 and 9 meetings with internal auditors per year (see Table 4). Companies with 5 meetings per annum took up the highest percentage.

The average frequency of audit committee meetings is around 5.09 times, which is higher than the frequency of meetings in Australia (4.14 times) and New Zealand (4.25 times)[23]. The finding shows that on average UK audit committees comply with the Combined Code in relation to meeting frequency.

[22] Audit Committee Combine...

[23] J. Goodwin: *op.cit.*

8. Conclusion

The conducted research demonstrates that:

- On average, UK audit committees consist of 4 (3.96) members.
- The majority of financial companies listed on London Stock Exchange have fully independent audit committees.
- 51 out of 57 entities have 100% independent non-executive directors.
- On average only 1 (1.26) member of an audit committee has a background or some expertise in finance.
- An audit committee usually meets 5 times per year.
- Audit committees and internal audit functions have a strong relationship with each other.
- The size of an audit committee, the accounting experience of its members as well as their level of independence and the number of meetings held by an audit committee has a significant effect on the amount of work that an audit committee can carry out on an internal audit function. Within those, the accounting expertise and independence of an audit committee plays the most important role.

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Summary

One of the most important elements of corporate governance is strong internal control. Internal control includes the responsibilities of an audit committee in overseeing the financial reporting process, monitoring the choice of accounting policies and principles, monitoring internal control processes, and overseeing the hiring and performance of external auditors.

The aim and objective of this report is to examine the relationship of audit committees and internal audit functions within financial institutions listed on London Stock Exchange. Also the compliance with the Combined Code 2003 will be analyzed.