The role of audit committees in Barbados

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Abstract

Purpose – *The purpose of this paper is to examine the role and function of audit committees in public companies in Barbados since the corporate scandals of Enron and WorldCom in the USA.*

Design/methodology/approach – *The study used a mixed-methods approach of self-administered questionnaires, interviews with directors, audit committee members and auditors, and a content analysis of the published annual reports.*

Findings – *There was no full-scale adoption of audit committees. Membership in audit committees tended to vary between three and four, and audit committees met on average four times a year. There were mixed views on audit committees having broader roles such as business strategy, assessment and management of risks. There were also excellent working relationships among audit committees, internal and external auditors. The independence of audit committees was questionable.*

Research limitations/implications – *The concept of audit committee is relatively new in Barbados. Further, there are Boards dominated by directors with major shareholdings. This study also relied heavily on US-centric literature and the perceptions of audit committee members. These factors are likely to limit its usefulness to other non-US countries. Future research can measure stakeholders' perceptions of the role of audit committees.*

Practical implications – *This study is important to academics and practitioners in understanding the role and function of audit committees in a small country.*

Originality/value – *This study sets out a best practice model for the adoption of audit committees in small countries like Barbados.*

Keywords *Audit committees, Corporate governance, Barbados, Internal auditing, External auditing*

Paper type *Research paper*

Introduction

The past 20 years have witnessed audit committees becoming more globally important and prevalent. Historically, audit committees have always been associated with the roles of overseeing and monitoring management and the external auditor, and achieving proper corporate governance and accountability in companies. However, recent scandals such as Enron and WorldCom have questioned the role and function of audit committees (Rezaee *et al.*, 2003). Media coverage has heavily debated the ineffectiveness of the audit committees in overseeing the financial reporting process and the audit function. As a result, considerable attention has been drawn to audit committees from various regulatory bodies.

This paper investigates the extent to which audit committees are utilized by companies in a small island developing state in Barbados, and the related role and function of such committees. Audit committees have their origins and further development in the developed countries of the USA and the UK. Much of the literature has been written about audit committees in these countries (Vanasco, 1994; Goddard and Masters, 2000). Academically, there has been limited research on audit committees, especially in the small emerging market, similar to Joshi and Wakil's (2004) study in Bahrain, and none has been done in

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Barbados in particular. To this end, this paper is important to inform academics and practitioners about the operation of audit committees in a small country like Barbados.

The paper is structured as follows: Section 2 deals with a review of previous research on audit committees. Section 3 examines the research setting of Barbados and is followed by section 4 on the research methodology. Then, the fifth section presents and discusses the results. Section 6 concludes the study.

Previous research

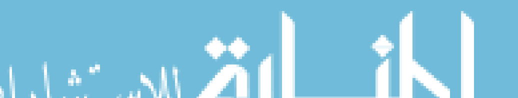
A company's audit committee is appointed by the Board of Directors and is responsible for recommending the selection of external auditors to the Board, receiving, reviewing, and forwarding to the Board the annual financial report of the external auditors, and generally dealing with other financial matters that arise. In summary, the primary responsibility of the audit committee is the oversight of the firm's financial reporting process (BRC, 1999, p. 7). The concept of an audit committee was first proposed by the Securities and Exchange Commission (SEC) in 1940 in the US, following the McKesson and Robbins case (Vanasco, 1994; Goddard and Masters, 2000).

However, it was not until the 1960s and 1970s that any significant progress was made. In fact in 1974, the New York Stock Exchange (NYSE) stated that a strong audit committee could stimulate improvements in financial reporting and control and strengthen the credibility of corporate reports. In 1978, the NYSE required the establishment of audit committees composed of independent directors for its listed companies. Since then, the establishment of audit committees has escalated worldwide. Development has varied from country to country and has been largely attributed to the large number of business failures and corporate malpractice (Goddard and Masters, 2000, p. 358). For example, in the UK, the Cadbury Committee (1992) was established in response to high profile corporate failures such as Polly Peck and BCCI (Laing and Weir, 1999, p. 457). In Canada, the collapse of Atlantic Acceptance Corporation Limited in the 1960s propelled the adoption of audit committees (Vinten, 1998).

Formation of audit committees

The audit committee must be independent of the organization's management to fulfill the oversight role and protect shareholders' interests. It may be argued that if the members of an audit committee are independent from management and owners of the organization, then they should be able to deter management from manipulating financial results. BRC (1999) recommends that the audit committee be composed only of directors who have no relationship with the firm that may interfere with their independence. Beasley (1996) found that the likelihood of financial reporting fraud is a decreasing function of the average tenure of outside directors. Beasley (1996) also found that the incidence of financial fraud is negatively associated with the independence of the Board of Directors. However, in Korea, Choi et al. (2004, p. 56) found that where ''. . .members of the committee own shares in the firm, the negative relationship between earnings management and the inclusion of members having experience in financial institutions and professors disappear.''

Menon and Williams (1994) concluded that companies in the USA did not appear to rely on audit committees and implied that the audit committees were established for appearance rather than because companies relied on them. Goddard and Masters (2000) argued that audit committees were more likely to be found in large companies with a high proportion of non-executive directors. Knapp (1987) argued that audit committees were more inclined to support the external auditors rather than management when there are disputes. Kaplan (1985) found that when the effectiveness of the internal control system deteriorates, planned audit time increases. Kalbers (1992) found that the importance of audit committees in the financial reporting process varies among companies. Members of audit committee rated themselves as effective in their functions, whilst auditors rated them significantly lower.



The effectiveness of audit committees

The focus on corporate governance and accountability has created considerable interest in audit committees. There has been limited research on the effectiveness of audit committees, and their perceived role can be viewed as ''vaguely unsuccessful, yet meritorious, endeavours to create a more level playing field for external and internal auditors, *vis-à-vis* operating management'' (Pomeranz, 1997, p. 281). An audit committee represents a standing committee of the Board of Directors, which is responsible for dealing with audit-related concerns and should assist in resolving disputes between the auditor and management. Pomeranz (1997) argued that the effectiveness of audit committees could not be judged by the mere comparison of companies with audit committees to companies that do not have them.

The qualifications of audit committee members

The responsibilities of audit committees include the assessment and evaluation of the corporate ethical environment, financial information, regulatory compliance, internal control and information systems. Obviously, audit committee members should have the requisite qualifications and expertise to discharge these responsibilities. Consequently, audit committee members without accounting or finance knowledge may not be qualified to be audit committee members. BRC (1999) recommends that at least one member should have accounting or related financial management expertise. Expertise is defined as ''past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a CEO or other senior officer with financial oversight responsibilities'' (BRC, 1999, p. 25). Pomeranz (1997, p. 283) cited that 35 per cent of audit committees did not include an accountant, while a third of audit committees lacked a lawyer. The Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991, passed by the US Congress in response to the then savings and loan scandals, requires that audit committees in banking institutions should have at least 2 members with banking or related financial management expertise and have access to outside legal counsel (McMullen, 1994).

Activity of audit committees

The effectiveness of audit committees is not only guaranteed by the composition of independent and competent directors, but also by the activity of the audit committees. An actively functioning audit committee should have a greater likelihood of detecting problems than an inactive one (Choi *et al.*, 2004). Activity can be interpreted to mean the duties the audit committee has to perform, the frequency of meetings and its size. BRC (1999) and Verschoor (1993) identified responsibilities and duties to include oversight of the financial statements, external audit and internal control system. The audit committee's role has been widened to look not only at the financial reporting process, but also the assessment of risks faced by companies which including competition, environmental, financial, legal, operational, regulatory, strategic and technological responses (Pomeranz, 1997; KPMG, 1999; NACD, 2000). A functioning audit committee must maintain a constant level of activity. In a study of European companies, PricewaterhouseCoopers (1999) found that audit committees met on an average of three to four times a year. Menon and Williams (1994) found that 57 per cent of the audit committees did not meet or only met once a year. Best practices suggest three or four meetings a year (Cadbury Committee, 1992).

Best practices also suggest that the audit committee should include at least three members to provide the necessary expertise for the oversight function (Cadbury Committee, 1992; BRC, 1999; KPMG, 1999). Archambeault and Dezoort (2001) found that companies, who had suspicious switches of external auditors, were the ones who had fewer audit committee members with experience in accounting, auditing or finance than their non-switching counterparts.

Selection of auditors

Audit committees are expected to choose the external auditors, by making recommendations to the Board of Directors who usually have the final say. It is also expected that the external auditor should report any problems to the audit committee. Thus, it is implied that independence is created and enhanced if the external auditor is chosen by the audit committee. The audit committee should act on behalf of the shareholders to maintain the integrity of the auditing process rather than allowing opportunistic management to select their own auditor. Research has found relatively little impact from the audit committees in the selection of auditors (Vanasco, 1994; Vinten, 2003). Kalbers (1992) reported that both audit committee members and auditors believed that the audit committee had an important influence on auditor choice. Abbott *et al.* (2000) found that companies with active and independent audit committees were more likely to hire industry-specialist auditors.

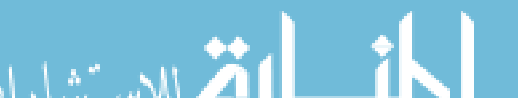
The inclusion of the board

Pomeranz (1997) argued that auditor independence could be achieved by a good link between the entire board of directors and the external auditor with the use of an audit committee. There must be a full involvement of the audit committee, external auditor and the Board of Directors in such issues as understanding threats, risk management, review of the audit process, fraud prevention and compliance with corporate ethics policies (Pomeranz, 1997; KPMG, 1999). Full integration should ensure all parties' efforts are harmonized to achieve accountability and corporate governance in companies.

The Treadway Report

In 1987, the Treadway Report in the USA (known as the Report of the National Commission of Fraudulent Financial Reporting), offered 11 recommendations to enhance the effectiveness of audit committees, which were to be the foundation of corporate financial governance (Vanasco, 1994; Vinten, 2003, p. 452):

1. Audit committees should have adequate resources and authority to discharge their responsibilities.
2. Audit committees should be informed, vigilant, and effective overseers of the company's financial reporting process and its internal control system.
3. Audit committees should review management's evaluation of the independence of the company's public accountants.
4. Audit committees should oversee the quarterly as well as the annual reporting process.
5. The SEC should mandate the establishment of an audit committee composed solely of independent directors in all public companies.
6. The SEC should require audit committees to issue a report describing their responsibilities and activities during the year in the company's annual report to shareholders.
7. A written charter for the audit committee should be developed. The full board should approve, review, and revise it when necessary.
8. Before the beginning of each year, audit committees should review management's plans to engage the company's independent public accountant to perform management advisory services.
9. Management should inform the audit committees of second opinions sought on significant accounting issues.
10. Together with top management, the audit committee should ensure that internal auditing involvement in the entire financial reporting process is appropriate and properly co-coordinated with the independent public accountant.
11. Annually, audit committees should review the programme that management establishes to monitor compliance with the company's code of ethics.



Vinten (2003, p. 453) argued that ''most audit committee chairs commend the recommendations as having exerted a positive influence on corporate reporting and internal controls.''

The Cadbury Code

Vanasco (1994, p. 24) stated that in December 1992, the Cadbury Committee recommended that audit committees in the UK should have the following responsibilities:

- Provide recommendations to the board of directors on the appointment of the external auditors, the audit fee, and any matters of resignation or dismissal.
- Review annual financial statements.
- Discuss the nature and scope of the audit with the external auditor.
- Review the management letter from the external auditor.
- Review the company's statement on internal control.
- Review any significant findings of internal investigations.
- Review the internal audit programme.

Blue Ribbon Committee

In 1999, the Blue Ribbon Committee (BRC) in USA addressed the role of corporate governance, and suggested, *inter alia*, that an audit committee report should be included annually in the proxy statement (Rezaee *et al*., 2003). The report should deal with whether the audit committee has reviewed and discussed the audited financial statements with management and the external auditors (BRC, 1999). The aim of the BRC is to improve oversight responsibility by forging working relationships with audit committees, Board of Directors, management, internal auditors and external auditors.

Recent developments

Financial reporting improprieties and business failures in companies such as the Enron, WorldCom and Adelphia have brought audit committees of corporate boards of directors under increased scrutiny. Enron filed for Chapter 11 protection in early December 2001 after a collapse of an empire built upon weak financial foundations and fraudulent financial reporting, major confidence crisis, staff and investors losing retirement savings and investments, and resulting bankruptcy (*Strategic Direction*, 2003, p. 10). Enron has become a by-word for ''corporate irresponsibility. thus creating a need for good corporate governance and a commitment to corporate social responsibility (Kelly, 2002). At the same time, Arthur Andersen, one of the then leading accounting firms, was closed down as a result of the scandal for lack of independence and conspiring to hide information from regulators.

WorldCom reported US$16 billion in earnings to its shareholders but reported less than US$1 billion in profits to the tax authorities between 1996 and 2000 (Shaikh and Talha, 2003). In the UK, Ernst & Young is currently being heavily criticized by the accountancy profession's disciplinary body (The Joint Disciplinary Scheme) for its role in the near collapse of Equitable Life. Ernst & Young is being accused of failing to act objectively and independently, and of rubber stamping the company's accounts which were later found not to be providing a true and fair view of the company's financial position (Parkinson, 2004). These corporate misconducts have caused users to query, ''where was the audit committee?'' The widespread coverage by the media of these events has gained the attention of the stock exchanges, regulatory bodies and the accounting profession worldwide.

The Sarbanes-Oxley Act

As a result of the scandals in the USA, there was the enactment of the Sarbanes-Oxley Act of 2002, which resulted in considerable revamping of corporate governance and disclosure law. The Sarbanes-Oxley Act was created to protect investors by improving the accuracy and reliability of corporate disclosures. The Act requires companies to make new disclosures on internal controls, ethics codes and the composition of their audit committees

on annual reports. Thus, these stringent requirements will force companies to be more thorough about ensuring the validity of their financial reporting process.

Under the Act, a new five member board will oversee auditors, accounting firms will not be allowed to provide other services to companies whose accounts they audit, and independent directors must sit on companies' audit committees. The Act states that an audit committee is a committee established by and amongst the board of directors of a company for the purpose of overseeing the accounting, financial reporting process and audits of the financial statements. Interestingly, while the Act does not require a company to maintain an audit committee, it provides that the entire board of directors may serve as the audit committee where one does not exist.

Rezaee *et al.* (2003, pp. 532-3) stated that the Sarbanes-Oxley Act enacted the following six requirements for audit committees:

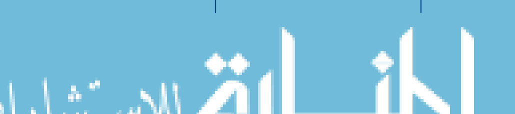
1. the audit committee should be composed entirely of independent members of the board of directors;
2. the audit committee should be directly responsible for the appointment, compensation and oversight of the work of external auditors;
3. the audit committee should have authority to engage advisors;
4. the audit committee should be properly funded to effectively carry out its duties;
5. the auditors must report to the audit committee all ''critical accounting policies and practices'' used by the client; and
6. the SEC should issue rules to require public companies to disclose whether at least one member of their audit committee is a ''financial expert.''

The recent publicized disclosures of alleged accounting irregularities have obviously raised valid concerns about other possible improper corporate accounting practices. The revised role and function of audit committees has raised concerns and challenges. The mandatory requirement for audit committee members to have financial and accounting expertise may limit companies in their choice of directors since they may not have the necessary qualifications or expertise. This can inappropriately infringe on shareholders' rights to elect directors of their choice. Another concern relates to the dual role that non-executive directors who serve as board members must perform. A potential conflict of interest could arise when persons are expected to work with management on the one hand, to maximize shareholders' wealth, whilst at the same time, serving as members of the audit committee, and are expected to act independently of management to achieve sound corporate governance and accountability. Readers are invited to read Vanasco (1994), Pomeranz (1997) and Vinten (2003) for excellent expositions on audit committees and corporate governance.

Research setting

Barbados is an island in the Caribbean, which is 166 square miles in size with a population of approximately 260,000 persons. As a previous British colony, it has a stable democratic political system and has very strong ties to the UK and the USA. It is a small open economy with the key productive sectors of tourism, agriculture, manufacturing and offshore financial services. By the end of December 2003, the gross domestic product was US$2.7 billion with a growth rate 2.2 percent. Total exports and imports of goods and services were US$246 million and US$1,165 million respectively (Central Bank of Barbados, 2004).

The Barbados Stock Exchange (BSE), originally the Securities Exchange of Barbados, was established in 1987 under the Securities Exchange Act, Cap 318A of 1982. There were 26 local public companies, comprising eight main categories of four financial institutions (banks), two conglomerates, two insurance companies, seven manufacturers, one tourism company, five retailers, three utility companies and two other companies. By the end of 2004, the total market capitalization of these companies was US$5,241.7 million and total trading volume was 120.9 million shares (BSE, 2005). The stock exchange aims to protect investors' investments, by ensuring that good practices and good corporate governance is



maintained. By international standards, the BSE is small, but there ought to be a great emphasis on high standards and good corporate governance as a basis for acceptance and registration on the stock exchange.

In addition, the financial services sector is represented by international, regional and local commercial banks totaling six, as well as many credit unions. There are audit firms of varying sizes in Barbados, including the four major international accounting firms of PricewaterhouseCoopers, KPMG, Ernst & Young and Deloitte. Research in a small island developing state is necessary to find out how public companies have responded adequately in the aftermath of the international scandals with respect to the role and function of audit committees.

The Barbados Companies Act, Cap 308, 1982-1997 (Government of Barbados, 2001), regulates Barbadian companies. The Act stipulates that the directors of a company must direct the management of the business and affairs of the company (section 58 (1b)) and act honestly and in good faith with a view to the best interests of the company (section 95 (1)). Section 150 states that the directors must approve the financial statements. Barbados has always been influenced by the practices of the developed countries (Alleyne, 2002). This influence has been also culturally transmitted through the structure of professional accounting associations. While there is no legislation similar to Sarbanes-Oxley Act in place, it has been widely accepted by the local accounting body (The Institute of Chartered Accountants of Barbados) that adoption of this legislation is critical to Barbados, given the significant amount of trade with the USA, and more importantly, the thriving offshore business sector.

Research methodology

A self-administered questionnaire was mailed to the 26 local public companies. The sample of respondents included either the chairman, members of the Board of Directors or audit committee members of these public companies. Respondents were asked 21 questions, of which 16 questions required either a ''yes. ''no. ''not sure. or ''won't say'' response. Their responses are outlined in Table I. The other five questions were open ended and required comments. These questions covered the reasons for needing an audit committee, selection criteria for appointment of members, frequency of meetings, number of members and the relationship with external and internal auditors. A limitation to the questionnaire method is that it does not provide a richer source of insights to questions under investigation as face-to-face interviews would provide (Strauss and Corbin, 1998).

To this end, the use of a qualitative research method as a form of triangulation to support a quantitative analysis was used to understand the issues underlying audit committees in Barbados. The questionnaire had asked respondents to indicate their willingness to be interviewed later. The second phase of the study involved interviews with directors or audit committee members of ten organizations, as such interviews were obtained to assist in finding out what is happening and to ask questions (Saunders *et al.*, 2003). These directors were also chosen from the sample used in the questionnaire phase of this research. The use of several methods allows one to fully explore the issues. The interview schedule replicated the questionnaire phase and interviewees were allowed to discuss any issues.

In addition, interviews were obtained from the three partners or audit managers in audit firms who had experience in auditing the above sample. The audit respondents were asked to share their views and experience on the issues outlined in the survey instrument. Each interview lasted approximately 1 hour. Finally, a content analysis was done on the annual report and financial statements for the organizations to determine the extent of disclosures as it pertains to audit committees (Rezaee *et al.*, 2003).

Results and discussion

Sample profile

The quantitative survey resulted in a sample population comprising 25 public companies in Barbados, which represented a 96.2 per cent response rate. The respondents comprised

Table I Summary of frequencies for responses

Questions	*N*[a]	*Yes*	*No*	*Not sure*	*Won't say*
		Frequencies (%)			
Does your company have an audit committee?	25	64	36	0	0
Do you think there is need for an audit committee?	25	88	12	0	0
Does your audit committee meet regularly?	16	87.5	12.5	0	0
Are you aware of the issues of Enron/WorldCom?	25	88	8	4	0
Are you aware that a question was raised ''Where was the audit committee'' in the Enron/WorldCom cases?	25	56	28	12	4
Does your audit committee have clear terms of reference?	16	87.5	12.5	0	0
Should an audit committee have broader roles such as business strategy, and assessment and management of risks?	25	52	20	28	0
Are the members independent – no financial ties?	16	37.5	37.5	12.5	12.5
Are members financially literate?	16	81.25	6.25	6.25	6.25
Do you have an internal audit department?	25	76	24	0	0
Is there a good relationship between the external auditor and the audit committee?	16	81.25	18.75	0	0
Is there a good relationship between the internal auditor and the audit committee?	16	93.75	6.25	0	0
Is there regular, effective and fair communication with shareholders?	25	92	4	4	0
Do you encourage greater shareholder participation at AGMs?	25	92	4	4	0
Does your external auditor provide non-audit services?	25	48	32	12	8
Is approval sought from the audit committee on provision of non-audit services?	16	25	68.75	6.25	0

Note: [a]full sample was 25; however, 16 respondents indicated that they had audit committees consequently, certain questions would only pertain to them hence $n = 16$

companies in the following categories: four financial institutions, two conglomerates, two insurance companies, seven manufacturers, one tourism company, three utility companies, five retailers and one other company. The results of the quantitative survey are illustrated in Table I. The interview phase with the directors or audit committee members resulted in a 40 per cent response rate, based on their indication on the questionnaire of their willingness to be interviewed. The sample of respondents from these interviews comprised four financial institutions, one insurance company, two conglomerates, one utility company and two retailers. In addition, interviews were obtained from three audit partners/managers who had an average of 18 years experience in the audit field.

Formation of audit committees

The extent to which there was use of audit committees is reflected by only 64 per cent of the respondents indicating that their company had audit committees. It can be easily seen that there is no full-scale adoption of audit committees. However, the majority of the respondents (88 per cent) felt that there was a need for audit committees; 33 per cent of the respondents who indicated that their companies did not have audit committees were of the opinion that there was no need for such a committee. Pearson chi-square statistical test was employed to measure the relation between the variables ''Do you have an audit committee?'' and ''Do you think there is need for an audit committee?'' The test revealed that the two variables are not independent (chi-square $= 6.061$, df $= 1$, $p < 0.05$).

Of the ten companies interviewed, six had audit committees, which amounted to 60 per cent of the sample of interviewees. These six companies believed there was a need for audit committees, since audit committees formed a major component of the corporate governance framework, viewed policies and procedures from a different perspective from the day-to-day staff, and ensured independent flow of management information, unbiased by reporting lines. One director commented that:

> Their function could result in reductions in the cost of external audit procedures and can function as some kind of check point to ensure that the company is following the International Accounting Standards.

One of the companies that did not have an audit committee saw no need for its implementation since ''it was a relatively small company and the Board of Directors carried out the audit committee's role.'' The three auditors stressed that there was a definite need for audit committees. The interviews corroborated the results from the quantitative survey. While international regulators required audit committees as part of the corporate governance structure, it was also interesting to note that there was no mention of audit committees within the Barbados Companies Act. This may partly explain why there is no full-scale adoption of audit committees in Barbados, which similar to the findings of Joshi and Wakil (2004) in Bahrain.

Awareness of issues surrounding Enron/WorldCom

The majority of the respondents (88 per cent) indicated that they were aware of issues surrounding Enron and WorldCom. Fifty-six percent (56 per cent) of the respondents were aware that a question was raised ''Where was the audit committee''? These results showed that while there was a general awareness of the Enron/WorldCom issues, just over half were aware of the specifics. This finding indicated that a significant number of audit committee members were unaware of the Enron or WorldCom scandal, and may not be able to reap the benefits of learning from such experiences, which may inform best practices in Barbados.

The role of audit committees

Of the 16 companies who reported having audit committees, 87.5% of the respondents purported that their committees had clear terms of reference. The quantitative survey further revealed that just over half of the companies (52 per cent) felt that audit committees should have broader roles such as business strategy. 50 per cent of the audit committee members interviewed agreed with the view that the role of the audit committee should be broadened. This finding showed the sample population is relatively divided on this issue. Further research may consider investigating reasons for this division. Current literature has purported the broadening of the role of audit committees (Pomeranz, 1997; NACD, 2000).

One of the auditors interviewed, disagreed that audit committees should have broader roles such as business strategy, assessment and management of risks. The response of this auditor was that ''this is ultimately the responsibility of the Board of Directors, which may be delegated to subcommittees of the board.'' Another auditor's response to this question was ''to some extent.'' These results showed that there were mixed views on expanding the role of audit committees.

Selection criteria

Respondents from the questionnaire phase suggested that the selection criteria used to recruit members included factors such as knowledge of the organization's line of business, experience, integrity, financial management expertise, and accounting knowledge. The interviewees supported this finding. However, one company director pointed out that the reality was that audit committee members are recruited on the basis of ''whom the members feel to elect.''

Composition of the audit committee

There was a mean score of 3.63, with a standard deviation of 2.634, for the sample population on the question of ''How many members does your committee have?'' A one-sample *t*-test was computed with test value equal three members, as the hypothetical population mean, to investigate whether the sample mean and hypothesized population mean is the same. There was a mean difference of 0.63. However, *t*-test indicated that there was no statistically significant difference as ($t = 1.162$, df $= 23$, $p = 0.257$). These results showed that membership varied between 3 and 4, and provided support for findings from PricewaterhouseCoopers (1999) and the recommendations for best practices by BRC (1999).

Frequency of meetings

Ninety-two percent (92 per cent) of the respondents reported that there was regular, effective and fair communication with shareholders and also that their companies encouraged greater shareholder participation at annual general meetings (AGMs); 87.5 per cent of the public companies with audit committees reported that their committees met regularly. These findings showed that the audit committees were generally well organised. There was a mean score of 4.09, with a standard deviation of 3.048, for the sample population on the question of ''How often does the audit committee meet annually?'' A one-sample *t*-test was computed with test value of three times per annum, as hypothetical population mean. There was a mean difference of 1.09. However, *t*-test indicated there was no statistically significant difference as ($t = 1.187$, df $= 10$, $p = 0.263$).

Interviews with directors confirmed that three companies with audit committees followed the requirement of meeting on average four times a year. These findings supported the best practice guidelines advanced by Cadbury Committee (1992) and BRC (1999). Content analysis of the annual reports further revealed that disclosure of frequency of meetings was minimal with only three companies reporting.

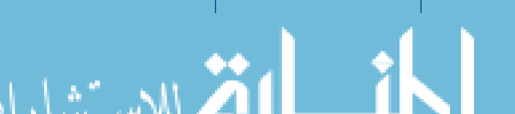
The auditors unanimously supported the fact that audit committees needed to meet to discuss, address and approve financial and audit related areas, more often than currently obtained in Barbados. They argued that audit committees should meet regularly. One audit partner's response was that ''the frequency of meetings varies . . . they should meet as often as required.'' All the auditors agreed that no noteworthy changes, with respect to audit committees' role and function, had taken place in Barbados, since the Enron scandal.

Independence

When questioned about the independence of members (those with no financial ties or personal relationships), 62.5 per cent of these respondents divulged that the members comprising their audit committees were not independent. Most of the audit committees comprised both non-executives and executives who are members of the Board of Directors. Joshi and Wakil (2004) argued that, in small countries like Bahrain, it might be difficult to find fully independent non-executive directors, so there may be a relatively high percentage of ''grey'' directors. An interviewee pointed out that some of the members in the audit committee had some financial relationship in his company. In particular, there was a committee member who was a former external auditor. However, one director argued that in another company, a shareholder pointed out that a member of the committee was not independent because the company also employed the member as a financial consultant. He was subsequently removed from the audit committee to comply with the independence requirement. This decision demonstrated that shareholders are becoming more knowledgeable in corporate governance. Nevertheless, this finding raises some concerns, as it goes counter to the international prescription of members being independent, which is the theoretical justification for the creation of audit committees. Thus, audit committee members who are not independent may compromise their unbiased opinion and thus, reduce the committee effectiveness (Vicknair *et al.*, 1993; Verschoor, 1993).

Non-audit services

Twenty five percent (25 per cent) of the 16 respondents (who had audit committees) indicated that approval is sought from the audit committee for the provision of non-audit services, while a significant percentage (68.75 per cent) reported that approval is not sought from the audit committee. Four organizations, representing about 40 per cent of those interviewed, sought the approval of the audit committee on selecting the external auditor and provision of non-audit services. At the same time, the quantitative phase revealed that 48 per cent of the total respondents divulged that their external auditors provided non-audit services. Whilst this is less than half, a source of concern is that the provision of non-audit services is being argued as compromising independence, as was the case in Enron. Enron's auditor, Arthur Andersen, was paid US$25 million for auditing services and US$27 million for



non-auditing services which created an economic bond and conflict of interest issues between auditor and auditee (Alleyne, 2002).

Internal and external auditors

Table I revealed that, of the 16 respondents who had audit committees, 81.25 per cent reported that there was a good relationship between the external auditor and the audit committee. For example, discussing the progress of audit, reviewing management letter and internal control. The vast majority of these respondents (93.75 per cent) reported that there were also good relationships between internal auditors and audit committees. These findings augured well for the companies, as a good relationship ought to produce good results. On the other hand, other stakeholders may argue that such familiarity may breed a lack of independence, thus creating a fertile climate for the manipulation of results (fraudulent financial reporting).

Seventy-six percent (76 per cent) of the respondents indicated they had internal audit departments, which were viewed as an integral part of any company. In the interview phase, the six companies, which had audit committees, also had internal audit departments. It was pointed out that internal auditors tended to report to the President, CEO, or Finance Manager rather than to the audit committees. However, these companies supported the quantitative findings that there were good working relationships among the audit committees, external and internal auditors, as one director commented that:

> . . . good relationship reduces the amount of conflict within the organization and it improves the flow of information between managers and shareholders.

One director was not sure of the relationship of the audit committee with the external auditor because the financial controller was usually the liaison. Another director supported this by stating that:

> . . . there is no relationship (as far as I can see) because the audit committee is not involved with the external audit team but deals predominately with the internal auditor.

Two auditors stated that the relationship between audit committees and themselves (the external auditors) was excellent.

In one financial institution, the external auditor attended meetings of the audit committee. The interviewee indicated that the majority of the audit committee's time is spent, reviewing reports by the internal and external auditors. However, he emphasized that the audit committee had a very limited impact on overall board decisions. Three members of the Board sat on the audit committee and one was the Chairman of the Board of Directors. The Financial Controller of the bank, his deputy, or the Vice President is occasionally invited to attend meetings.

Financial literacy of the members of the audit committee

In the quantitative analysis, the financial literacy of the audit committee members was strongly supported by the majority of the respondents (81.25 per cent). Interviews with directors further corroborated this finding that audit committees had financially literate members. A content analysis of the annual reports of the public companies revealed that eight of these companies had audit committees. However, in general, the disclosure of information was insufficient, as it did not reveal qualifications, composition and reports of the audit committees. There was partial disclosure in only three companies. For example, one company's annual report revealed that three members of the Board of Directors were also members of the company's audit committee and these three members were financially literate since they possessed accounting qualifications. Of the three companies who disclosed any information, there were reports from the audit committees of only two companies. One may conclude that there is a possibility that there were no major problems to be reported, or perhaps such information was not deemed necessary to be published.

Yet, the annual reports disclosed the qualifications of the Board of Directors. Some members of boards were financially literate in terms of qualifications and experience. Although some

of these board members may be also members of the audit committee, it was not easy to discern who formed part of the audit committees. These findings demonstrated that the members had the experience and professional qualifications to interpret the financial statements, and satisfy the criteria of ''professional expert'' and ''financially literate''. Additionally, they would be able to contribute more than just a ''rubber stamp'' to the financial statements.

All three auditors agreed that audit committee members should possess some financial or accounting knowledge. One audit partner pointed out that:

> . . . many audit committee members do not indeed possess the necessary skills and knowledge to effectively perform their duties.

Another auditor supported this by arguing that:

> The concern here lies in the fact that if these committees are not financially literate, they will be unable to recognize any significant issues or matters relating to the financial reporting process.

However, one auditor noted that while audit committee members were generally able to read financial statements, many were not familiar with audit procedures. These results supported the best practice recommendations by BRC (1999) to have financial literate members in the audit committee.

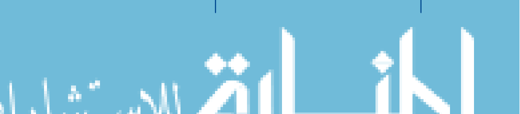
Conclusions: towards a ''best practice'' model for Barbados

This study found that while there was no full-scale adoption of audit committees, 88 per cent of the respondents felt that there was a need for audit committees and 56 per cent of the respondents were aware of the specifics of the issues surrounding Enron and WorldCom. It was also found that 53 per cent felt that audit committees should have broader roles such as business strategy, and assessment and management of risks, rather than just examining financial information; 87.5 per cent agreed that their audit committees had clear terms of reference. Membership of audit committees tended to vary between three and four. While 87.5 per cent of the respondents argued that audit committees met regularly, the meetings tended to average four times a year.

It was also found that 62.5 per cent of the respondents argued that the members of the audit committees were not independent. The findings also showed that only 25 per cent of the 16 who had audit committees indicated that approval is sought from the audit committee for the provision of non-audit services. The selection of audit committee members was based on knowledge of the organization's line of business, experience, integrity, financial management expertise and accounting knowledge. There were good working relationships between audit committees, external and internal auditors. Audit committee members were generally financially literate. It was also found that there was minimal disclosure of composition, qualifications and reports of audit committees in the annual reports of these public companies.

This study shows the following guidelines for best practice in Barbados:

- Audit committee members should be composed solely of independent outside directors.
- The audit committee should meet independently with the internal auditor and the external auditor to review the audit process.
- The audit committee should have clear written terms of reference to guide their activities.
- The external auditor should be accountable to the audit committee and to the Board of Directors, and not to management.
- An audit committee should comprise not less than three individuals.
- An audit committee should meet at least four times per year.
- The audit committee should broaden its role to include the oversight of the financial reporting process, as well as the assessment and management of risks.



- Members of the audit committee should be financially literate. Furthermore, at least one member of the audit committee should have accounting or financial management expertise.
- The organization should disclose particulars on the composition of the audit committee, as well as include an audit committee's report on the financial reporting process and operations for the year under review in the annual report.

Since, in Barbados, audit committees are not mandatory for public companies, the BSE finds no urgency to include their governance in statute. In spite of the highly publicized demise of many international corporate giants, the findings show that the corporate sector in Barbados are satisfied with the status quo and maybe believe that what happened in the USA may not happen in Barbados. Thus, the companies are comfortable with their current arrangements.

Several caveats need to drawn here. First, audit committees are in their infancy in Barbados, and are not as developed as in the USA and UK. Second, there are boards dominated by directors with significant shareholdings that could hamper the performance of these audit committees, which is similar to a point made by Choi *et al.* (2004) in Korea. Third, there was extensive reliance on the US-centric literature. Fourth, the study measured the perceptions of audit committee members and auditors. These caveats may limit the study's usefulness elsewhere. Future research can seek to measure other stakeholders' perceptions of what is expected from audit committees. This study is important because investors in small countries should be granted adequate oversight protection with respect to a reliable financial reporting process.

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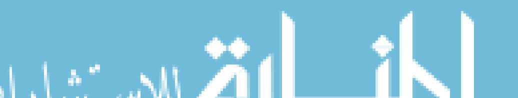

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