

# NON-EXECUTIVE DIRECTORS AND THE CHANGING NATURE OF AUDIT COMMITTEES: EVIDENCE FROM UK AUDIT COMMITTEE CHAIRMEN\*

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## Abstract

In this paper we provide a descriptive summary of a postal survey of FT 500 UK company audit committee chairman on the operations of UK audit committees. The survey represents an “insider view” of the activities of audit committees and the characteristics of non-executive directors and contributes to the continuing debate on corporate governance reforms. In particular we report on company boards and their composition, audit committee chairman and their outside directorships, financial literacy and remuneration and various aspects of audit committee activity. Our survey shows that UK audit committees and corporate boards have undergone many changes in the last decade since the last comprehensive survey reported in Collier (1992). Our study on the current level of activity within major UK corporate audit committees deepens understanding of the roles and characteristics of non-executive directors and the operation of UK audit committees. In particular our survey shows that there is a significant shift in audit committee activities from the traditional financial reporting role to a greater focus on internal control and risk management. Independence is overwhelmingly seen as the most significant attribute of an audit committee member. Lack of time is perceived to be the greatest impediment to audit committee effectiveness but pressure from executives and an unclear remit are surprisingly prevalent problems even after ten years of corporate governance reforms.

**Keywords:** non-executive directors; audit committees; director fees; financial literacy

## Introduction

Over the last two decades, non-executive directors (hereafter NED) have attracted a great deal of attention from different quarters of the academic community and from corporate governance reformers. The current revival of interest is partly caused by the demise of Enron and World.com, amongst others, and partly reflects the on-going public debates on the role of non-executive directors. In the UK, beginning with the Cadbury Report (1992), six regulatory and advisory reports have been published, the most recent of which is the Smith Report (2003). A similar trend can be observed on the other side of the Atlantic. In particular, the Blue Ribbon Committee (1999) has re-emphasized non-executive directors' monitor

ing roles and put forward radical recommendations with reference to director independence, financial literacy and interlocking directorate.

Despite these recent academic debates, our knowledge of how non-executive directors carry out their monitoring roles remains fragmentary. In this paper, we provide new evidence on director independence, financial literacy, monitoring activities, remuneration and document the views of audit committee chairman on these issues.

The structure of this paper is as follows. Firstly, we present a brief review of the literature on director effectiveness with particular reference to audit committees. This is followed by a short section which

\* Financial support from Napier University Business School and UWA University Research Fund are gratefully acknowledged. Early versions of the paper have been presented at BAA 2001 Conference in Nottingham and a School seminar at The University of Wales, Aberystwyth, January 2002. We thank the participants for their interest and suggestions. We are most grateful to FT 500 audit committee chairpersons for their participation in this project. Finally, we wish to thank Eileen Fairgrieve for her administrative assistance. We are solely responsible for all errors and misinterpretations.

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describes our survey design and responses. We then report our findings from a postal survey of FT 500 audit committee chairmen, focusing on board independence, director characteristics such as financial literacy, outside directorships, their monitoring activity and their remuneration. Some tentative conclusions are drawn in the final section of the paper.

### Previous surveys on UK audit committees

From the literature it is possible to identify three basic approaches to audit committee research which may be classified as perception-based approaches, activity-based approaches and benchmarking approaches.

The perception-based approach asks relevant parties to rank certain effectiveness indicators. Kalbers and Fogarty (1993) adopt this approach. They maintain that audit committee effectiveness is a function of its power in the broad sense. Kalbers and Fogarty (1993) decompose power into six dimensions: legitimate, sanctionary, institutional support, expert, referent and diligence. They found that the organisational aspect of power is crucial for ensuring audit committee effectiveness. In particular, Kalbers and Fogarty (1993) argue that the audit committee needs a strong organisational mandate to be effective. This stronger mandate may be achieved by a well-articulated charter and sufficient informal recognition by other internal organisations and agents, especially from directors. Financial literacy and diligence are also perceived to be important determinants of audit committee effectiveness.

More broadly, Porter and Gendall (1998) elicit views of external and internal auditors, company and public sector chairmen and financial statement users. They found that each of these groups consider that the effectiveness of audit committees could be improved by ensuring they have clearly defined written terms of reference; by routinely providing all relevant parties with minutes of audit committee meetings; and by disclosing the existence, membership and objectives of audit committees in corporate annual reports.

Activity-based approaches, as adopted by Menon and Williams (1994), Lee and Stone (1997), and Collier and Gregory (1999), use meeting frequency to measure director monitoring activity. Menon and Williams (1994) show that audit committee meeting frequency may be affected by company size and board composition. Collier and Gregory (1999) extend this methodology and include audit committee meeting duration as an additional measure of its activity. Collier and Gregory (1999) claim that dominant chief executives may be associated with less audit committee activity and leverage is positively correlated with audit committee activity. They also report that the inclusion of inside directors reduces audit committee activity. Lee and Stone (1997) introduce the issue of financial literacy and found that only a limited number of audit committee members

have requisite qualifications. Lee and Stone (1997) document that more than half of US audit committee chairmen had previous experience as executive directors.

The benchmark-based approach of Beasley (1996), Carello and Neal (2000) in the US and Peasnel *et al* (2000) and Song and Windram (2000) in the UK use established reporting standards as a yardstick and compare actual performance of financial reporting to the yardstick. These authors treat any failure to comply with these standards as an indicator of audit committee ineffectiveness. This approach is consistent with the organisational effectiveness model of Cameron (1986). Beasley (1996) investigates whether there is any link between financial reporting fraud and the existence of audit committees and finds that companies subject to SEC investigations differ from companies that have not been subject to the adverse rulings. Peasnell, *et al* (2000) and Song and Windram (2000) report similar results for UK companies that have been subject to adverse rulings by the Financial Reporting Review Panel (FRRP). All of these authors find that director independence increases audit committee effectiveness in financial reporting. In addition, Song and Windram (2000) also suggest that active audit committees and financially literate audit committees may reduce the likelihood of financial reporting malpractices. However, Song and Windram (2000) found no evidence to support the claim that director equity ownership may increase their effectiveness as monitors of financial reporting. Interestingly they indicate that non-executive directors with outside directorships may in fact increase audit committee effectiveness in financial reporting. This is consistent with a recent US study by Ferris, *et al* (2003). For a thorough review of the literature on audit committee effectiveness, we refer interested readers to DeZoort, *et al* (2003). To facilitate readers outside the UK, we should mention briefly previous surveys on UK audit committees. In their first surveys carried out in the 1970s, Tricker (1978), and Chambers and Snook (1979) reported that very few UK companies had had an audit committee. This was consistent with the finding of the Accountants International Study Group (1977). Subsequent surveys by Marrian (1988) and Collier (1992) reveal that by the late 1980s, about half top industrial firms in Times 1000 had an audit committee. Collier (1995), Conyon and Mallin (1998) and Young (2000) report that over 80 percent of large UK companies has an audit committee in late 1980s. The focus of our survey of 2000-2001 is different from these earlier studies. Instead of documenting the institutionalisation of audit committees, we obtain "inside information" on boards of directors, audit committees, and important personal characteristics such as their financial literacy, outside directorships and remunerations. This additional information enables us to further investigate the effectiveness of non-executive directors in general and audit committees in particular.

## Survey design

Our survey focuses on the FT (Financial Times) 500 companies, as at April 2000. A questionnaire was designed to ascertain information on the operation of UK audit committees and the roles of non-executive directors in their capacity as audit committee chairman. We focus specifically on audit committee chairman for a number of reasons. Firstly, these chairpersons are often designated as senior independent directors. They comprise of a significant proportion of outside/non-executive directors across all FT 500 companies. These directors sit on the main board and therefore represent an important force at the board level, indeed many of them also serve as board Chairman, as we shall document later in this section.

In addition, audit committee chairmen often serve on other board sub-committees, such as remuneration and nomination committees. Thus, although audit committee chairman is only one of a number of all non-executive directors, they clearly play a major role as non-executive directors. However, perhaps the most exciting aspect of seeking the views of audit committee chairmen is their "insider knowledge" of the activities described above.

The questionnaires were sent directly to audit committee chairmen of all FT500 companies at April 2000. The survey comprised a number of questions of different styles and offered opportunities for further comments where appropriate. After second re-

quests, 200 questionnaires were returned. This response rate is quite satisfactory for this type of research. The questionnaires were analysed and various statistical test were carried out. The results were very interesting and further data is now being collected on the companies in the sample. Many of the descriptive statistics were particularly striking and this paper reports on these results.

## Results

Specifically, our analysis addresses the following aspects relating to non-executive directors and audit committees: features of the main board: its size, composition and meeting frequency; audit committee meetings: their frequency, duration and preparation time; time allocated in meetings between different functions of the audit committee; profile of audit committee chairmen: outside directorships, fees and financial literacy; links between director pay and personal characteristics; perceptions about the key attributes of NED's and significant impediments to their effectiveness.

### Main board characteristics

Statistics on the size and composition of the main board are displayed in Table 1. Preliminary analysis, not presented here, reveals that board size is closely correlated with firm size as measured by market capitalisation.

**Table 1.** Main board features

Variable	Mean	Minimum	Maximum	StDev
Size (number)	10	5	23	3.46
Composition (%)	47	0	90	14.9
Meetings (p.a.)	8.7	4	12	2.09

It is noticeable that chairman and CEO duality is not an issue in our sample, as only 3.5% of the directors combine the roles of chief executive and board chairman. It is significant that on average non-executive directors comprise about 50% of the main board. The majority of boards meet more than eight times during the year. Our survey suggests a non-linear relationship between board composition and meeting frequency: when fewer non-executive directors sit on the board, board meeting frequency is high; as the number of non-executive directors increases, the board meets less frequently; when the board is dominated by non-executive directors, meeting frequency rises again. Smaller boards do not

necessarily have more meetings. Yermack (1996) indicates that companies with smaller boards have higher market values than those with larger boards. This suggests that board meetings may be driven by other factors such as company performance.

### Audit committee meetings: frequency, duration and preparation time

Four questions of the survey address audit committee meetings: annual meeting frequency, meeting duration, meeting preparation time and time spent at meetings on the audit committee's three major roles. The results are reported in Tables 2 and 3.

**Table 2.** Audit committee meetings

	Mean	Min.	Max.	StDev
Meeting frequency (p.a.)	3.26	1	6	0.85
Meeting duration (mins)	121	40	260	40.68
Meeting preparation (mins)	294	180	960	149.0

About half of the audit committees meet three times a year, higher than that recommended by the Cadbury Committee (1992) and that reported in Collier (1992), and in line with the recommendations of the Blue Ribbon Committee (1999).

Meeting duration and time spent preparing for meetings exhibit more variation, however. The standard deviation of 149 for meeting preparation is par-

ticularly striking. 160 of the audit committees met on average between 1.5 and 2 hours. The majority of audit committee chairmen spend three to five hours preparing for each audit committee meeting. We also found that audit committee chairmen with relevant accounting qualifications spent more time preparing for audit committee meetings.

**Table 3.** Roles of audit committees

Variable	Mean	Min.	Max.	StDev
Financial reporting (time %)	46.05	7.69	87.95	0.1423
Audit (time %)	11.55	0.00	46.15	0.0745
Risk and control (time %)	42.40	10.95	80.00	0.1377

As discussed above, apart from their traditional supervisory role in financial reporting, audit committees are also responsible for auditor appointments and fee determination, and internal control and risk management issues. Of these three major functions the audit committee spends the least time on issues relating to external auditors. Over 60% of our audit committees spent less than 10 minutes at their meetings on the appointment, renewal and remuneration of external auditors. This raises questions about the sort of relationship which the audit committee has with the auditor, in particular, the issue of external auditor independence.

Our audit committees spent only about 12% of their meeting time on audit appointment and fees issues. These statistics indicate that audit committees spend as much time on internal control and risk management issues as on financial reporting matters. Although there is no substantial evidence from previous research, it is fairly well accepted that audit committee activity has traditionally been dominated by its role of monitoring corporate financial reporting. Thus our survey reveals for the first time a significant shift of UK audit committees, therefore providing empirical support for the Turnbull Report (1999) which focuses on risk management and internal control.

### Profile of AC chairmen

This sub-section reports on outside directorships, director's fees and financial literacy.

### Outside directorships

Our survey results show that on average, audit committee chairmen hold between 3 and 4 outside directorships. Further analysis reveals that one third of audit committee chairmen serve as executive directors of another company. It is noticeable that of these serving as executive directors, approximately half have accounting qualifications. Only 10 percent of audit committee chairmen serve one board.

Audit committee chairmen seem to fall into three groups. The first group consists of directors serving as NEDs for one company only; the second group of directors serve one company as an executive director as well as non-executives for more than one company. The last group serves solely as non-executive directors on a number of companies.

### Fees

Information about fee paid to audit chairmen is presented in Tables 4 and 5. Several patterns emerge.

First, the group of chairmen combining executive and non-executive roles generally receives the lowest fees for their NED roles. Second, average fees rise as outside directorships increase. Third, there does not seem to be a premium for financial literacy: as a group, directors with accounting qualifications do not earn more on average than those without. Audit committee chairmen with no executive role and with no formal accounting qualification receive the highest fees on average. Finally, there seems to be an inverse U-shaped relationship between remuneration and outside directorships. This non-linearity merits further investigations.

**Table 4.** Fees, outside directorships and executive role

Average Fee (£)	Number of outside directorships								
	0	1	2	3	4	5	6	8	Average
If serve as executive									
No	27105	24200	29444	31176	35500	30416	35714	31555	30167
Yes		31363	25000	25909	19285	36666	30000	25000	26393
Average	27105	26741	27285	29107	31296	31666	34444	29370	28968

**Table 5.** Fees, financial literacy and executive role

Average Fee (£)		Financial Literacy		
If serves as exec.		No	Yes	Average
No		31182	29434	30167
Yes		28225	24500	26393
Average		30116	27907	28968

**Financial literacy**

The Blue Ribbon Committee (1999) recommended that every audit committee member should be financially literate or becomes so in a reasonable period of time after their appointment. The Committee also required that at least one audit committee member should have relevant financial qualifications and/or experience. Only half of our survey respondents had a formal accounting qualification. Of those audit

committee chairmen with accounting qualifications, 30 serve as executive directors of another company. On the other hand, of all those serving also as executive directors, about half had accounting qualifications.

Overall, audit committee chairmen with qualifications are more active and spend more time on meeting preparation than those with no qualifications (see tables 6, 7 and 8).

**Table 6.** Qualifications, outside directorships and executive role

Sum of qualifications	Number of outside directorships								
If as executive director	0	1	2	3	4	5	6	8	Total
No	12	12	9	7	10	9	3	15	77
Yes		5	6	4	5	3	2	5	30
Total	12	17	15	11	15	12	5	20	107

**Table 7.** Executive directorship, outside directorship and financial literacy

If serving as executives	Number of outside directorships								
Qualification	0	1	2	3	4	5	6	8	Total
No	0	6	11	7	2	0	0	4	30
Yes	0	5	6	4	5	3	2	5	30
Total	0	11	17	11	7	3	2	9	60

**Table 8.** Audit committee activity (in minutes)

AC activity	Qualifications		
Outside directorships	No	Yes	Average
0	777	814	800
1	727	963	709
2	643	744	686
3	605	764	667
4	611	780	705
5	530	674	645
6	622	782	711
8	645	689	676
Average	656	734	700

Table 8 shows that activity measured as the total of annual meeting time and preparation time, is not constrained by other directorships: audit committee activity falls marginally as outside directorships in-

crease. On the other hand, director fees appear to be highly correlated with audit committee activities. The table also clearly shows that directors with a financial qualification spend more time on their duties as NED.

**Table 9.** Audit committee activity and director's fees

Activity	Director fee (£000)									
	8	9	15	20	25	35	40	50	60	Average
(minutes)	900	570	637	450	697	743	1100	740	818	700

The fact that some NEDs serve as executives of other companies is interesting. Booth and Deli (1996) suggests that CEO's holding outside directorships serve as a kind of bonding. They claim that companies engage in bilateral trades in an in-kind market for directors. A separate analysis, not reported in this paper, indicates that audit committee chairmen sitting on the main board of a large company are less likely to serve as executive directors for other companies. Directors with relevant qualifications and more active audit committees are less likely to hold executive directorships.

### Director Fees

As NED remuneration is starting to attract more attention, it is important that we report on this issue as well. Our results show that the average fee paid to NED serving as audit committee chairmen was £28,888 in 2000-2001. However, there is a great variation with a high of £60,000 and a low of £8,000.

As indicated earlier in this section, financial qualification does not appear to be correlated with NED fees. Directors with a formal accounting qualification and an executive directorship of another company earn the least. Directors without an accounting qualification and with no executive directorship earn the most. Given the descriptive nature of the present paper, we do not intend to report more results on NED pay. Given the limited scope of the present paper, we report detailed analysis of this important issue in another paper.

### Important audit committee characteristics and constraints

As part of the survey, audit committee chairmen were asked to give their views on key factors affecting audit committee effectiveness. Firstly respondents were asked to identify the most important attribute of an audit committee member. The results are shown in table 10 below (148 audit committee chairmen responded definitively to this question).

**Table 10.** Most important attribute of an audit committee member

Relevant industry experience	6	4.0%
Financial literacy	39	26.4%
Time and commitment	13	8.8%
Independence	90	60.8%
Total	148	100%

It is clear from the table that audit committee chairmen regard independence as the most important attribute of an audit committee member. This is consistent with professional guidance, academic writing and agency theory in particular. More than a quarter of our respondents rank financial literacy as being most important (two-thirds of these directors have accounting qualifications). However, of all AC chairmen with accounting qualifications, only a quarter considered financial literacy to be most important. On the other hand, 41% of the directors with qualifications rank independence as being most important.

Audit committee chairmen were also asked to identify the greatest impediment to audit committee effectiveness. The results are shown in table 11 below. The group of audit committee chairmen who also serve as executive directors with another company are likely to face acute time constraints. More than one third of the 131 audit committee chairman, who expressed a definitive view on the major impediment to audit committee effectiveness, regarded

the lack of time as being the most important factor. Although this is a concern it is perhaps not surprising. Of much more significance is the fact that just over one-third claims that pressure from the executives is the greatest impediment and 22% rated an unclear remit to be the most significant hindrance. Pressure from executive directors is a direct challenge to non-executive director independence and the strength of feeling shown by our results illustrates a serious potential threat to audit committee integrity from aggressive executive directors. The overwhelming importance given to independence as the most significant attribute of an audit committee further demonstrates this problem. It would appear that despite corporate governance reforms significant pressure continues to be applied to non-executive directors in the boardroom. It is also disturbing to note that more than one fifth of audit committee chairmen state that an unclear remit is the greatest impediment to audit committee effectiveness. Given the almost universal existence of audit committees in the UK and multiple professional guidance pronouncements

in this area, one would have thought that the audit committee remit was now widely established.

**Table 11.** Most significant impediment to audit committee effectiveness

Pressure from executives	38	29.0%
Lack of time	45	34.4%
Poor remuneration	1	0.8%
Lack of training	18	13.7%
Unclear remit	29	22.1%
Total	131	100%

### Concluding remarks

In this paper we present a descriptive analysis of the latest survey of UK audit committee chairmen with particular reference to the characteristics of audit committees and characteristics of non-executive directors such as the operations of the main board and audit committees, director financial literacy, outside directorships and remuneration.

This research reveals that corporate boards of the largest UK companies now comprise approximately equal numbers of executive and non-executive directors. Audit committee meeting frequency has increased over the last twenty years but meeting duration and preparation time exhibit large variations. The audit committee meeting agenda has experienced a considerable shift towards internal control and risk management activities and less time is spent than in the past on the traditional financial reporting role.

A large proportion of audit committee chairmen hold outside directorships, only 10 percent of our respondents serve one company only. More than half of the audit committee chairman in our sample has accounting qualifications. Compared to their peers, those with accounting qualifications earn less if they also serve as executives of another company. The market seems to reward dedication and loyalty rather than qualification. NED remuneration would appear to be related to board and audit committee meeting activities. Audit committee chairman with accounting qualifications spend more time preparing for meetings. It appears that board size, financial literacy and audit committee meeting frequency may reduce the probability of holding executive directorship. Those non-executive directors with financial qualifications are more likely to hold multiple directorships.

In light of recent world-wide corporate governance reform pronouncements, it is interesting to note that a vast majority of audit committee chairmen rank independence as the most important attributes of a NED with a significant minority giving precedence to financial literacy. The views of audit committee chairmen regarding the most significant impediment to audit committee effectiveness were perhaps the most striking findings. Over one-third of chairmen ranked time constraints as the greatest im-

pediment to audit committee effectiveness but almost 30% stated pressure from executives was most significant and 22% believed an unclear remit was their greatest impediment.

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