AUDIT COMMITTEES IN WEST INDIAN STATES

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Abstract

This study describes the regulatory framework governing audit committees (AC) of publicly traded companies in the West Indies and examines the extent to which the provisions of these AC regulations are similar to the International Federation of Accountants guidelines for AC. Also, it examines the actual AC policies of publicly traded West Indian firms and determines whether they vary systematically with industry affiliation or firm size. The sample comprised companies traded on Barbados, Jamaica Stock Exchange, and Trinidad and Tobago Stock Exchanges in 2002. Larger companies and those in the financial industry provided better audit committee disclosures than their smaller counterparts and those in non-financial industries.

Keywords: Audit Committee, Corporate Governance, West Indies

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Introduction

The western world has recently experienced several major corporate scandals and business failures involving hitherto leading organizations such as Enron and Vivendi. Additionally, there has been an increase in the frequency of financial restatements by public companies. These events have been attributed to, among other things, weaknesses in, and abuses of existing corporate governance systems (Ruder, 2002; Walker, 2004). According to Monk and Minow (2004: pp. 2) "a corporate governance system is composed of structures intended to ensure that the right questions get asked," at the appropriate times, "and that checks and balances are in place to ensure that the answers reflect what is best for the creation of long-term, sustainable value." The likelihood of divergence between the interests of managers and other organizational stakeholders increases when corporate governance systems fail. This exposes the organization and the wider community to dysfunctional managerial behavior, economic losses and ultimately corporate scandals and failures (Jensen and Meckling, 1976).

The audit committee of the board of directors (BOD) is the element of the corporate governance system that received much of the scrutiny and criticism in the aftermath of the recent corporate scandals (Abbott, Parker and Peters, 2004; IFAC, 2003). An audit committee is a sub-committee of the BOD usually comprising non-officer, and preferably outside, directors that is created to help the BOD discharge its fiduciary responsibilities (see endnote 1) (KPMG, 1999). It was asserted that in the run-up to the recent corporate scandals audit committees were given too few resources and tended to act too passively in the discharge of their duties (Felo, Mahoney and Solieri, 2002).

There were also calls for corporate audit committees to receive adequate amounts of high quality resources, and for them to play a more proactive and hands-on role in the governance of their organizations (Sweeney, and Waller Vallario. 2002; Turner, 2001). Shortly thereafter, in several countries, including the USA, the UK and Canada, audit committee responsibilities and resources were enlarged (Ascarelli, 2003; Felo, Mahoney and Solieri, 2002) and the likely sanctions for breach of those duties were made more stringent (Felo, Mahoney and Solieri, 2002).

Recognizing that corporate scandals and failure are not unique to any one country and that similar factors have been identified as contributors to such events across countries, the International Federation of Accountants (IFAC) formulated a set of international best practices of corporate governance, including audit committee requirements. The guidelines are voluntary in nature and draws heavily on the practices of the developed western states. Many of the IFAC's member countries and several multilateral agencies have endorsed the IFAC corporate governance guidelines.

However, the countries in the West Indies (WI), which have to date been spared the occurrence of a major corporate scandal, are yet to endorse the guidelines (see endnote 2). This despite calls for them to do so by the Inter-American Development Bank and other supra-national institutions because of the presence of lax control environments and ineffective corporate governance systems. For instance, Staking and Schulz (1999) suggested that substantial improvements must be made to the corporate governance systems in West Indian states if their capital markets are to operate efficiently and firms are to get access to financing on competitive terms.

West Indian governments and regulators apparently prefer to treat the matter as an internal issue to be addressed by individual firms as they strive for international competitiveness in the increasingly open global economy (see endnote 3, 4). This laissez faire approach to corporate governance has been attributed, in part, to a recognition by W.I. states that regulation may inhibit the development of their corporate sector by imposing generic requirements which ignore the specific circumstances of individual firms (see endnote 5).

This study has two primary purposes. First, it describes the regulatory framework governing audit committees (AC) of publicly traded companies in the West Indies and examines the extent to which the provisions of these AC regulations are similar to the International Federation of Accountants (IFAC) guidelines for AC. Secondly, it examines the actual AC policies of publicly traded West Indian firms and determines whether they vary systematically with industry affiliation or firm size. The study is important given the critical role assigned to AC in financial oversight of publicly listed companies and the dearth of empirical research on the topic in the WI. It will provide a better understanding of what audit committees are currently doing and how this varies across settings (firm size, industry affiliation and country). This study also has the potential to improve the transparency of AC oversight of the financial reporting process by alerting them that their work is open to public scrutiny. This awareness, in turn, may provide additional motivation for AC members to demonstrate that they have discharged their duties effectively.

The remainder of this paper is organized as follows: section two describes the nature and purpose of ACs and the theoretical arguments underpinning their existence. Section three articulates the theoretical arguments regarding the relationship between industry affiliation and firm size with the quality of AC disclosures. In section four we describe the research methodology. Section five discusses the nature of IBP on AC and assesses the extent to which the AC requirements of WI states are similar to IBP on AC. Section six presents the findings of the hypothesis testing regarding the quality of AC disclosures. The paper concludes with a discussion of the findings.

Nature and purpose of the audit committee

ACs are a key element of the corporate governance infrastructure in many states with market-based economic systems. Anglo-American corporate governance systems in general, and audit committees in particular, are intended to resolve or mitigate problems of coordination and control caused by the separation of ownership and control in the modern corporation and to protect the interest of owners and other stakeholders (Jensen and Meckling, 1976). The cost of designing and administering these systems and the value lost because of the remaining self-interested opportunism by agents that cannot be eradicated are the “agency cost” that rational investors must take into account when pricing the securities of companies. From this perspective the primary purpose of corporate governance is “to create cost-effective monitoring, bonding and incentive systems that will reduce the amount of foregone value associated with the separation of ownership from control” (Kester, 1996: pp. 118).

This need for shareholder protection has traditionally been explained using Agency Theory (see endnote 6). According to Jensen and Meckling (1976: pp. 305) “agency theory views an organization as the nexus of contracts among owners of the factors of production” (and customers). These contracts specify the rights and responsibilities of each agent in the organization and the performance criteria on which agents are evaluated. They also endow common shareholders with the rights to the net cash flows of the organization. In this context it is argued that the separation of ownership from the control (decision making) function in corporations creates the potential for conflict of interest between owners and managers if the goals of the respective groups are not properly aligned. Also, it is asserted that information asymmetry between owners and managers make it relatively attractive for managers to seek their own interest at the expense of owners (see endnote 7). Therefore, owners incur costs to structure and monitor contracts and to bond managers to keep them from taking actions contrary to the best interest of owners (see endnote 8). One of the key strategies employed by owners to reduce the probability of such opportunistic behavior by managers is the separation of the ratification and monitoring of decisions (a function of the BOD) from the initiation and implementation of decisions (an executive management function).

According to this strategy, while individual decision agents may be involved in the management of some decisions and the monitoring or ratification of others, they should not exercise exclusive management and control rights over the same decisions. Separation of decision management from decision control at all levels of the organization helps to control agency problems by limiting the power of individual agents to expropriate the interests of shareholders. Without such separation, owners have little protection against potential opportunistic actions by decision agents and would risk lower returns on their investment. Appropriately constituted ACs enhance the separation of decision control and ratification functions. It has also been suggested that given the attention focused on the AC as one of the key mechanisms available to promote good corporate governance firms can gain legitimacy by establishing them and disclosing their process and performance.

The presumed benefits of audit committees are frequently attributed to the operation of two forces. First, they provide a forum for concentrated attention to be devoted to issues that are challenging to the full board of directors, many of whom are not financially literate (Walker, 2004). Secondly, audit committees enable the non-executive directors to contribute their independent judgment to the board of directors and offer the auditors a direct link with non-executive directors (Cadbury, 1992).

From its inception in the late 1930's regulators have viewed the AC as a major mechanism for safeguarding the public's interest in commercial enterprises by promoting reliable financial reporting and generally protecting shareholders (and other stakeholders) from the potentially devastating economic, social, and political consequences associated with major corporate financial scandals (Birkett, 1986; Goddard and Masters, 2000; Walker, 2004). Initially ACs were expected to meet with, and focus on matters raised by, the external auditors. However, the responsibilities of ACs have evolved to include the oversight of many aspects of the management of public companies (Walker, 2004).

These responsibilities are usually accomplished by having the AC oversee the financial reporting of firms, assessing processes related to the company's risks and control environment and evaluating the internal and independent audit processes (KPMG, 1999: p. 5). The specific approach used by an AC to discharge its mandate, and its success in so doing, varies according to the clarity of its mission, the knowledge, skills and abilities (tough-mindedness, inquisitiveness, commitment, independence, technical expertise) of its members, and the tone at the top of the corporate governance structure (KPMG, 1999).

Theory and hypotheses

Industry affiliation and audit committee practices

According to Kerr (2005) corporate governance development in the financial sector has outpaced that elsewhere in Caribbean economies in response to international and regional (read Jamaican) financial crises, and concerns about money laundering and terrorist financing. As a result, the international financial community has mandated timely compliance with international banking standards. These standards have been implemented via updated financial legislation (by regional governments) and better regulation and supervision by regional central banks. These initiatives, while not mandating the adoption of IBP on AC, may have created an environment that is more conducive to its voluntary implementation.

Another incentive for better AC disclosure among companies in the financial industry may be the relatively greater effectiveness of monitoring and enforcement mechanisms and the more severe penalties they are likely to face for not adopting IBP (Accountancy, 2001). Companies operating in the financial industry are subjected to two independent supervisory processes while other firms are only subjected to one supervisory process. Similar to other publicly listed companies, the Securities and Exchange regulators supervises financial firms. However, unlike the other publicly traded firms, financial institutions also report to their respective Central Banks. Furthermore, this additional level of monitoring is more frequent, ongoing and comprehensive than that provided by the Securities and Exchange regulators (Kumar 2004). For example, in Trinidad and Tobago (T&T), it was noted that the Central Bank has more, and a higher quality of, monitoring resources than the Securities and Exchange regulators (Bowrin 2007). Regional Central Banks are also likely to be more alert to the need to effectively discharge their responsibilities than securities industries regulators, because the IMF, World Bank and international financial community in turn more closely scrutinize them.

Additionally, by tradition, Central Banks have greater power to impose penalties on the companies under their jurisdiction (financial institutions) than do Securities and Exchange regulators, which must rely on the threat of fines and delisting to motivate compliance by firms under their jurisdiction. For instance, unlike the T&T Securities and Exchange Commission, the T&T Central Bank can also impose strategic and operating sanctions to correct deficiencies discovered during the monitoring process. These arguments are supported by Carcello, Hermanson and Neal (2002) who reported a greater incidence of voluntary disclosure of AC activities among financial institutions than other publicly traded US firms.

The following hypothesis is proposed based on the above arguments and empirical findings:

H1: Firms in the financial industry will provide better (more) audit committee disclosures than firms in other industries

Firm Size and Financial Reporting Quality

The organizational studies literature also suggests that firm size is positively associated with financial reporting quality. See for example, Knechel and Payne (2001) – USA; Bamber, et al (1993) – USA; Ashton et al (1989); Newton and Ashton (1989) – (Canada); Carslaw and Kaplan (1991) – New Zealand; Abdulla (1996) – Bahrain; Simnett et al. (1995) – Australia); all of which suggest that financial reporting quality, including reliability, is better among larger firms than their smaller counterparts. Similarly, Tan and Tower (1999) found that company size was positively related to the degree of compliance with accounting standard in both Singapore and Australia. Based on these findings one may expect a positive relationship between firm size and AC disclosures which can be regarded as a dimension of financial reporting quality.

This relationship is probably due to the greater economic and political visibility of larger firms relative to their smaller counterparts (Alchian and Kessel, 1962; Watts and Zimmerman, 1986; Tosi, Mero and Rizzo, 2000).The greater visibility of large(r) firms stems from the fact that events in, and outcomes of large(r) firms tend to have a more significant impact on the overall economic system and its constituents. This visibility leads to heightened scrutiny for large(r) firms. This is exemplified by the greater attention paid to the regulation of large(r) firms in the corporate governance literature (Alchian and Kessel, 1962; Jensen and Meckling, 1976). It is also demonstrated by the recent decision of the UK government to remove the requirement for small(er) firms to have their financial statements audited and the general tendency of governments in outsider-dominated equity based financial systems (Nobes, 1998) to impose stricter reporting requirements on large(r) companies than on smaller ones.

If we assume that larger firms are aware of their greater visibility and scrutiny, which increase the likelihood that deviations from regulations and best practices will be detected, then we can expect larger firms to be more likely than their smaller counterparts to comply with financial reporting requirements (Watts and Zimmerman 1986).

This expectation is supported by the findings of Carcello et al. (2002) that there was a greater incidence of voluntary disclosure of AC activities among larger firms than among their smaller counterparts. The following hypothesis is based on the abovementioned arguments and findings:

H2: Large(r) firms will provide better (more) audit committee disclosures than smaller firms.

Methodology

Selection of companies and years examined

All companies listed on one of the four West Indian (W.I.) stock exchanges were considered for inclusion in the study. However, the sample was eventually restricted to companies listed on the Barbados Stock Exchange (BSE), the Jamaica Stock Exchange (JSE), and the Trinidad and Tobago Stock Exchange (TTSE). This decision was taken because the Eastern Caribbean Stock Exchange only commenced operation in November 2001 and only two companies were listed in 2002. The list of the 81 companies listed on the BSE, JSE and TTSE in 2002 was obtained from the websites of the exchanges and used to contact the firms and the exchanges to obtain their annual reports. The final sample comprises 68 companies. Seven of the remaining 13 firms were listed on more than one stock exchange. The remaining three firms were excluded after several attempts to secure a copy of their annual report proved futile. The year 2002 was chosen because at the commencement of the study it was the latest year for which annual reports were available.

Procedure used to determine audit committee requirement

The audit committee requirements for firms in the W.I. were determined by reviewing the Companies Acts of Antigua-Barbuda, Barbados, Grenada, St. Lucia and Trinidad and Tobago and the Securities Industry Acts of Barbados, Trinidad and Tobago and the Eastern Caribbean.

Procedure used to determine actual audit committee practices

Data was collected primarily from the 2002 annual reports of the sample companies that were filed with the three West Indian stock exchanges. Some data also came from the websites of sample companies.

Two researchers independently read a clean copy of the entire annual report of each company and highlighted all information relating to audit committees. Next, the highlighted information was examined to determine which of the IBP each firm adopted. Each researcher coded each occurrence of an IBP in the annual report. Later, the findings of both researchers were compared for consistency. Both researchers reviewed each discrepancy uncovered during this comparison and reached a common position. Next, the AC practices noted for W.I. firms were compared with the IBP guidelines to determine the extent to which they are similar. Finally, the AC disclosures noted for each firm were used to test the research hypotheses.

Operationalization of variables

Firm size was operationalized using the value of total asset (Carcello et al. 2002) and sample firms were segregated at the median value. Firms were segregated based on industry affiliation into "financial" and "other" categories. The AC disclosure score was computed by summing the number of IBP disclosures provided by each firm.

Data analysis and findings

The preliminary data analysis was primarily restricted to the tabulation of audit committee practices and the comparison of the resulting frequency counts and percentages. The information obtained in this process was critically assessed to determine whether the research hypotheses were supported. The hypotheses were tested using independent-samples t-tests.

Description of sample

The average firm in the sample (n=68) had gross revenues of TT$609.05M (Median = TT$242.55M; SD TT$867.09M; and average total assets of TT$2,918.54M (Median = TT$224.03M; SD = TT$8,733.55M). There were eleven firms in the financial industry and fifty-seven firms in "other" industries.

Findings - international best practice guidelines for audit committees

The following description of International Best Practice (IBP) guidelines on audit committees are based on the recommendations contained in the report of the IFAC Task Force on Rebuilding Public Confidence in Financial Reporting (2003). The recommendations were developed by the IFAC task force after reviewing regulatory requirements and reports issued by national and international bodies and proposals that have been adopted or are being considered in Australia, Canada, France, Japan, the United Kingdom and the United States. The Task Force also considered developments from international bodies such as the Financial Stability Forum, the International Organization of Securities Commissions (IOSCO), the European Commission, the International Accounting Standards Board (IASB) and IFAC.

The IBP guidelines on AC are presented in column 1 of Tables I – IV. They address a myriad of issues that are likely to impact on the effectiveness, efficiency, accountability and transparency of corporate entities. The guidelines span the following areas: responsibilities, criteria for membership, processes (meetings, reviews, etc), remuneration, resources (budgets), and sanctions (including legal liability). Overall, 35 IBP guidelines were examined.

Insert Table I about here

General guidelines

As shown in Table I IBP guidelines provide that all publicly listed firms must have an AC. The AC is required to meet regularly i.e., at least as frequently as the firm is required to publish financial information and to devote sufficient time to perform its role effectively. The AC is also required to have a formal charter that is approved by the full board of directors. The AC charter must specify its structure, the nature and scope of its responsibilities, criteria for membership and the processes to be used to discharge its responsibilities. The AC charter should also be reviewed for adequacy and revised, if necessary, by the BOD annually. The specific IBP requirements in the areas of AC responsibilities, composition competence, and procedures will be highlighted as we compare them with the requirements for West Indian firms in the next section.

Compliance of West Indian audit committee regulatory requirements with IBP (see endnote 9)

Consistent with the general requirements of the IBP guidelines on AC reported in Table I above, states in the West Indies require all publicly traded companies to have AC. However, this is where the similarity ends as almost no attempt has been made by these states to specify what AC should do or report. As a result, almost no requirements have been established concerning audit committee responsibilities or required disclosures in the W.I.

Firstly, contrary to the IBP guidelines, states in the WI allow publicly traded companies to seek exemption from the requirement to have an audit committee and do not require firms to disclose if they have an audit committee or to explain when they do not have one. Secondly, states in the West Indies do not explicate the need for the AC to meet regularly or to devote sufficient time to perform its role effectively.

Thirdly, in the WI there is no requirement for ACs to have a charter or for their charter to specify the scope of their responsibilities and how they are to be discharged. Also, the BOD is not required to approve, review or periodically assess the adequacy of terms governing the operation of the AC as is required under IBP guidelines.

Fourthly, unlike the IBP guidelines, which provide specific guidance on the structure, processes and responsibilities of the AC, as well as the disclosures it must provide, the regulatory framework in the WI is largely silent on these issues. The specific findings of our review of the regulatory framework in West Indian states are summarized in Tables I – IV and are described below.

Responsibilities – external auditor

As shown in Table II, the only IBP responsibility contained in the AC regulations in the WI is the need for the AC to review the financial statements of the company before the BOD approves them. The regulatory framework is silent on the issue of the responsibilities of AC regarding the external and internal auditors and the frequency of reporting to the full BOD.

Insert Table II about here

Composition and competence

As shown in Table III, the regulatory requirements of states in the WI regarding AC composition are not consistent the IBP guidelines. Whereas the IBP guidelines require all members of the AC to be independent, the WI legislation only require that a majority of AC members be independent. Further, the definition of independence contained in West Indian legislation is much narrower than that suggested by the IBP guidelines. While the West Indian states define independence in term of only being a current employee or officer of the focal company or its affiliates, the IBP definition also includes past employees and officers, persons with current or past material business relationships, persons with family ties to directors, senior employees or advisors, and representatives of significant shareholders. Additionally, unlike the situation, which obtains in the WI, the IBP guidelines explicitly allow the BOD to identify additional threats to independence. The regulatory framework in the WI is silent on the issue of the competence of AC members.

Insert Table III about here

Procedures, reporting and resources

As shown in Table IV, the West Indian AC regulations stipulate that external auditors must be notified of every meeting of the AC and are entitled to attend at the company's expense if requested by an AC member. The regulation is silent about the best practice requirements of whether, and how frequently, the AC meets privately with the external auditors, the Head of internal audit and the Chief Financial Officer (CFO). Also, the West Indian regulations do not require companies to provide any disclosures regarding the existence, structure, procedures, competence, responsibilities, or resources available to the AC. Additionally, there are no provisions for the disclosure of non-audit fees paid to the external auditors. Additionally, companies are not required to disclose any non-compliance with the IBP guidelines.

Insert Table IV about here

The West Indian AC regulations do not provide for the AC to have access to regular reports from management and the auditors concerning areas of dispute, concern or major accounting judgment and estimates. They also do not require companies to provide the AC with access to independent expert advice to facilitate the effective discharge of its responsibilities.

The findings presented above regarding AC regulations in the WI leads one to characterize these states as having a laissez-faire approach to corporate governance. There are at least three possible explanations for this lax state of audit committee regulation in the WI. Firstly, it may be that stakeholders (e.g., legislators, regulators and publicly listed companies) do not fully appreciate the importance of ACs to effective corporate governance. Based on this explanation regulators in the WI may have been responding to the fad of the day when they made it mandatory for public companies to have ACs.

Secondly, it may be that legislators and regulators recognize the importance of audit committee to effective corporate governance in principle, but in their estimation the circumstances in the region is such as to minimize the importance of audit committees, probably because other mechanisms are present to fulfill its role. Thirdly, it may also be the case that regulators in the WI recognize the importance of audit committees for effective corporate governance and are aware of the need for such regulation in the region but are lacking the will and or the resources to implement the reforms that have been identified as IBP. Additionally, it may be that the key stakeholders in West Indian states believe that it is not necessary to legislate/ regulate the specific AC requirements because the forces of globalization would promote the convergence of local practices toward the IBP guidelines.

Researchers may wish to conduct survey-based research with key stakeholders to explore these competing rationales for the lax state of AC regulations in the WI.

Findings - audit committee practices in individual West Indian states

Probably the most significant finding of this study is the low level of disclosure provided regarding the existence of AC, their size, structure responsibilities and practices. Overall, firms listed on the TTSE did a slightly better job than their counterpart listed on the BSE and the JSE of implementing the IBP guidelines on AC. However, in all three jurisdictions the level of audit committee disclosure was very poor and suggests that WI firms are not keeping abreast of IBP on AC.

Barbados

All 23 companies traded on the BSE in 2002, were included in this study. Only seven of the 23 companies disclosed that they had an AC in 2002. Even among the firms that disclosed the existence of an AC, the level of disclosure about the composition, procedures, competence, responsibilities and resources was very low. Of these seven companies, five disclosed the number of members comprising the AC. The AC of these 5 firms had an average of 4.8 members (range 3 -7). All the firms that disclosed the AC size were cross-listed on other stock exchanges, highlighting the poor state of AC disclosure among firms listed only on the BSE. These same five firms were also the only ones that disclosed the number of AC members who were (a) insiders (mean = 1.6; range 1-4) [In one firm the AC chairperson was an insider] and (b) independent (mean = 2.8, range = 1-6). None of the firms disclosed whether the AC had a formal charter. Four firms disclosed the number of outside AC members (mean = 2, range = 1-3).

Only two firms disclosed the number of financially literate AC members (Mean = 4, range = 3-5). The same two firms also disclosed the number of AC members with financial expertise (mean = 4, range 3-5).

The level of disclosure was even sparser in the area of AC procedures and responsibilities. None of the Barbadian companies disclosed the general AC responsibilities or those related to the external auditors (appointment, evaluation, termination, setting compensation, approving non-audit assignments) or executive management. One company indicated that the AC was responsible for reviewing the effectiveness of the internal control system and was consulted on the appointment of the head of internal audit. All the companies were silent on the other recommended AC responsibilities related the internal audit function. Regarding AC procedures, only two companies disclosed the number of AC meetings (Mean = 7.5, range 3-12). One company disclosed that the AC met with the head of the internal audit function and none of the companies disclosed whether the AC met with the chief financial officer or the external auditors. None of the firms disclosed the amount of audit and total (non-audit) fees paid to the external auditors making it difficult to assess whether there was the potential for non-audit relationships between the external auditors and the firms to adversely affect auditors' independence. Similarly, only one firm disclosed whether the Chief Executive Officer was in a position to exerted inordinate/ significant influence over the AC. Additionally, none of the firms disclosed whether the AC had a budget for or access to independent expert advice. Finally, none of the companies listed on the BSE provided disclosures about AC member compensation.

Jamaica

All 27 companies traded on the JSE in 2002, were included in this study. Only six (22%) of the 28 companies disclosed that they had an AC. Of these six companies, five disclosed the number of members comprising the AC. The AC of these 5 firms had an average of 4.4 members (range 3 - 6). Six firms disclosed the number of AC members who were (a) insiders (mean = 0.17; range 0 - 1). Only one firm disclosed the number of independent AC members (3). None of the firms disclosed whether the AC had a formal charter. One firm disclosed the number of outside AC members (3).

Only two firms disclosed the number of financially literate AC members (Mean = 3, range = 2 - 4). The same two firms disclosed the number of AC members with financial expertise (mean = 2, range 0 - 4).

Three companies indicated that the AC was responsible for reviewing the effectiveness of the internal control system. All the companies were silent on the other recommended AC responsibilities related the internal audit function. Regarding AC procedures, only four companies disclosed the number of AC meetings (Mean = 5.25, range 1-12). Two companies disclosed that the AC met with the head of the internal audit function but failed to indicate whether this was done in the absence of executive management, and none of the companies disclosed whether the AC met with the chief financial officer. Only two companies disclosed that the AC met with the external auditors. Twenty-two of the firms disclosed the amount of audit fee but none disclosed either the total fee paid to external auditors or the non-audit fees paid to the external auditors. Similarly, none of the firms disclosed whether the Chief Executive Officer was in a position to exert inordinate/ significant influence over the AC. Additionally, none of the firms disclosed whether the AC had a budget for or access to independent expert advice. None of the companies listed on the JSE disclosed whether the AC was responsible for the appointment of the external auditors or the review of non-audit services provided by the external auditors, or the number of meetings held with the external auditors. Finally, only one of the companies listed on the JSE provided disclosures about AC member compensation.

Trinidad & Tobago

The situation was marginally better among firms traded on the Trinidad & Tobago Stock Exchange, but here too the level of reporting on AC structure and processes was well below that suggested by the IBP guidelines.

Of the 29 companies traded on the TTSE in 2002, twenty-six were included in this study (we were not able to get a copy of the financial statements of the remaining 3 companies). Eighteen of the 26 companies disclosed that they had an AC. Among the firms that disclosed the existence of an AC, the level of disclosure about the composition, procedures, competence, and responsibilities was low but better that that of firms listed on the BSE and JSE. All 18 of these companies also disclosed the number of members comprising the AC. The AC of these 18 firms had an average of 3.5 members (range 3 -7). Fifteen of these eighteen firms disclosed the number of AC members who were (a) insiders (mean = 1; range 1-4) and (b) independent (mean = 2.63, range = 1-6). Eight firms disclosed the number of outside AC members (mean = 2.44, range = 1-4). Further, none of the TT firms disclosed whether the AC had a formal charter.

Thirteen firms disclosed the number of financially literate AC members (Mean = 3.08, range = 1-5) and eight firms disclosed the number of AC members with financial expertise (mean =2.75, range 1-5). The level of disclosure was poorer in the area of AC procedures and responsibilities. Only two companies disclosed the specific AC responsibilities. One firm disclosed that the AC was responsible for the review of non-audit services provided by the external auditors but all the companies were silent regarding whether the AC was responsible for or consulted on the appointment, evaluation, termination, or the establishment of compensation for the external auditors. All the companies were also silent on the responsibilities of the AC regarding executive management including the appointment and termination of the Chief Financial Officer. One company indicated that the AC was responsible for reviewing the effectiveness of the internal control system and two indicated that the AC was consulted on the appointment of the head of internal audit. None of the publicly listed TT companies reported on the other recommended AC responsibilities related the internal audit function.

Regarding AC procedures, only three companies disclosed the number of AC meeting (Mean = 7, range 3-12). Two companies disclosed that the AC met privately with the head of the internal audit function, the external auditors and executive management. One company reported that the AC met privately with the chief financial officer. Also, six firms disclosed the amount of audit fees but all were silent on the amount of total (non-audit) fees paid to the external auditors. Four firms disclosed that the Chief Executive Officer was in a position to exert inordinate/ significant influence over the AC. Additionally, none of the firms disclosed whether the AC had a budget for or access to independent expert advice and only one firm provided disclosures about the compensation of AC members.

Preliminary review of hypotheses

Industry affiliation and audit committee disclosure

The total number of IBP disclosures provided by each firm was calculated to facilitate the testing of the hypotheses. As shown in Table V, industry affiliation was positively correlated with AC disclosure ($r = 0.274$; $p < 0.05$). This finding provide preliminary support for hypothesis one and is reinforced by the comparison of the AC disclosures provided firms in the major functional categories. As shown in Table VI, overall the companies operating in the financial industry provided better disclosures regarding AC existence and size, structure, competence, responsibilities and procedures than companies operating in other industries. For instance, 73% of financial firms disclosed the existence of an audit committee compare to 28% of non-financial firms.

Insert Table V about here

Insert Table VI about here

Similarly, on all three measures of AC structure, financial firms were more transparent than their non-financial counterparts. Sixty-four percent of firms in the financial industry disclosed the number of inside audit committee members compared to only 21% of the firms in non-financial (other) industries. Also, 18% and 27% of firms in the financial industry disclosed the number of independent AC members, respectively, compared to only 12% and 11% for firms in other industries.

The level of disclosure by financial firms was also higher in the area of AC competence. Forty-five percent of firms in the financial industry disclosed the number of financially literate and financially expert AC members on the AC compared with 18% and 11% respectively for non-financial firms.

As was previously noted, the level of disclosure regarding AC responsibilities and procedures was especially poor. Among firms in the financial industry, only 2 (18%) disclosed the responsibilities and procedures of the AC. However, this compares favorably with the level of reporting provided by non-financial firms, only 2 (4%) and 5 (9%) of which disclosed AC responsibilities and AC procedures, respectively. Neither category of firms disclosed the relative amounts paid to the external auditors for audit and non-audit services.

Based on the above findings, it appears that ACs of firms in the financial industry were more transparent than their counterparts in other industries. Hypothesis one is supported. It should be noted however, that the level of disclosure was low and inadequately across both industries.

Firm size and ac disclosure

Table V shows a positive correlation between Firm Size and AC disclosure scores ($r = 0.28$; $p < 0.05$), and provides preliminary support for hypothesis two. This conclusion is reinforced by the comparison of the AC disclosures provided by firms in the major functional categories. Overall, larger firms disclosed more information regarding AC existence and size, structure, competence, procedures and responsibilities than their smaller counterparts. See Table VII. Hypothesis two is supported. However, the level of disclosure by both categories of firms was very poor.

Insert Table VII about here

For instance, as shown in Table VI, 48% and 41% of the larger firms disclosed the existence of an AC and its size, respectively, compared to 24% for smaller firms. Similarly, a greater proportion of larger firms disclosed the number of inside (38%), outside (24%), and independent (18%), AC members than their smaller counterparts.

In terms of AC competence, 32% and 26% of the larger firms disclosed the number of financially literate and financially expert AC members, respectively compared to only 14% for smaller firms. The level of disclosure was particularly poor for AC responsibilities and AC procedures. See Table VI. However, even in this area the larger firms outperformed their smaller counterparts.

Hypothesis testing

Industry affiliation by audit committee disclosure

An independent-samples t-test was conducted to evaluate the hypothesis that financial firms provide more (better) AC disclosures than non-financial firms. The test was significant, $\underline{t}\ (66) = 2.318$, $p = 0.024$, and in the direction predicted. Financial firms ($M = 4.82$, $SD = 3.422$) on average provided more AC disclosures than their non-financial counterparts ($M = 2.16$, $SD = 3.816$). The eta square index indicated that 8% of the variance in AC disclosure was accounted for by the firm's industry affiliation.

Firm size and ac disclosure

An independent-samples t-test was conducted to evaluate the hypothesis that larger firms provide more AC disclosures than smaller firms. The test was significant, $\underline{t}\ (55.363) = 2.371$, $p = 0.021$, and in the direction predicted. Larger firms ($M = 3.59$, $SD = 4.17$) on average provided more AC disclosures than their non-financial counterparts ($M = 1.59$, $SD = 2.607$). The eta square index indicated that 8% of the variance in AC disclosure was accounted for by firm size.

Discussion

AC regulations

The failure of W.I. states to spell out minimum terms of reference for an AC means that W.I. companies have tremendous discretion in determining what their audit committees do and disclose. Further, if the situation presented in the annual reports examined are taken as representative of the true state of affairs (it is possible that firms are simply not disclosing all their AC policies and processes), it suggests that they may not have exercised this discretion in the best interest of stakeholders. This indicates that the W.I. business environment may be more risky than that of other states that have implemented the IBP guidelines on ACs. The low level of disclosures provided by, required of, W.I. firms in almost all areas of ACs make it almost impossible for external stakeholders to adequately assess their independence, competence, the full extent of the purpose served by AC or their procedures, resource endowment and hence effectiveness. It increases the probability that many West Indian ACs may be working ineffectively and serving only as window dressing rather than adding to the substance of the accountability/ transparency processes. This is potentially troublesome given the tendency for the many unsophisticated users in West Indian financial markets to take management representations at face value.

The failure of West Indian states to require adequate disclosure of AC responsibilities and activities is even more troubling in the light of recent international findings that ACs do not always perform the functions assigned to them in their formal charter De Zoort (1997). Unless copies of AC charters are publicly available, and unless annual reports clearly describe the activities undertaken by ACs, investors and other stakeholders will be unable to ask informed questions of ACs and more generally to hold directors accountable. Otherwise, West Indian firms may get the legitimacy benefits associated with properly functioning ACs when they are not warranted (see endnote 10).

Actual AC practices

Audit committees have been assigned a key oversight role in the corporate governance architecture of organizations operating in market-based economies. The small number of West Indian companies indicating the existence of an audit committee (24 of 68) leads one to question whether this role is appropriately recognized by the full BOD in most West Indian companies. Also, the fact that none of the 44 West Indian companies that did not disclose the existence of an AC indicated whether the full board had assumed responsibility for the duties usually assigned to the AC is disconcerting. It hinders users' assessment of whether, and how effectively, those functions are being discharged in these companies.

Additionally, the low level of AC disclosures provided by WI firms, regardless of size or industry affiliation (the average firm provided less than 5 of the 35 IBP disclosures examined in this study), suggests that even the firms that recognize the importance of ACs do a poor job of discharging their role and or communicating their performance. This position is reinforced by the finding that only nine firms disclosed the number of meetings held by AC during the year, a fact that limits the extent to which external stakeholders can assess whether ACs are at least devoting adequate time to the discharge of their responsibilities.

Together these findings indicate a risky West Indian business environment, within which firms may have difficulty attracting capital on favorable terms. For instance, the fact that only 19 of the 68 W.I. firms studied indicated the number of inside directors on their audit committees makes it difficult for external stakeholders to assess the independence of the AC and its ability to ensure proper oversight of financial matters and to act as an arbiter of disagreements between internal managers and the owners of the firm. While this situation was marginally better for firms in the financial industry and larger firms, even these firms represent a more risky proposition than their counterparts in jurisdictions that have adopted and enforced IBP on ACs.

Another cause for concern is the finding that West Indian companies generally did not consult the audit committee on the appointment or termination of either the Head of Internal Audit or the Chief Financial Officer (CFO). This finding increases the probability that these key players in corporate governance may not have the appropriate level of separation from the Chief Executive Officer (CEO) to effectively discharge their duties to shareholders. Similarly, the fact that only 15 and 11 firms reported the number of AC members that were financially literate and experts, respectively, retards our ability to assess the competence of the audit committees. Of equal concern is the finding that not all members of the audit committees of the fifteen firms providing financial literacy disclosures were in fact financially literate. This finding suggests that the competence of W.I. AC members may not be on par with IBP guidelines. Furthermore, the capacity of West Indian stakeholders to assess the capacity of the AC to effectively discharge its responsibility was inhibited because none of the firms in the West Indies disclosed whether the AC had a budget for, or access to, independent expert advice.

It is also difficult to assess the independence of the external auditors of West Indian firms (i.e., the potential for non-audit relationships to influence auditor independence) as only eight firms disclosed the amount of fees paid to external auditors and none of them disclosed either the total fees paid to auditors or the amount of non-audit fees paid to the external auditors. Regulators may need to monitor this situation closely.

Finally, the finding that the CEOs of all four West Indian firms that disclosed whether the CEO was in a position to influence the AC indicated that they were (they were members of the AC) causes one to question whether those ACs could effectively limit the decision discretion of the CEO. This situation contravenes one of the basic tenets of effective corporate governance, the separation of the responsibility for decision making and implementation from that of monitoring and ratification for a given problem or opportunity.

West Indian companies are ignoring many of the IBP guidelines on ACs, probably because they are not legally binding on these companies. As suggested by Walker (2004) this may be due in part to the wariness of directors to voluntarily introduce guidelines that may expose them to claims of negligence, especially in an environment like the W.I. were external stakeholders are either unable or unwilling to detect the shortcoming and penalize firms accordingly.

As it stands now, it appears that users cannot rely on the AC disclosures contained in the annual reports of publicly listed West Indian companies, regardless of their size, industry affiliation or country of registration, to know whether AC are operating effectively or in conformity with IBP guidelines on ACs. This is a most unsatisfactory situation that is made worse by the lack of monitoring provided over this area by regulatory agencies in the WI.

Limitations and implications for future research

There are two major limitations associated with this study. Firstly, by using only one year's AC documentation for sample companies the representativeness of the findings may be called into question. To the extent that companies may have deviated from their usual AC practices in the year chosen, then the findings would be anomalous. Fortunately, we have no reason to believe that this was the case.

Secondly, the fairly low incidence of disclosure by West Indian companies makes it difficult for one to grasp the true nature of AC practices in the W.I. This shortcoming makes it imperative for researchers to undertake survey-based research to gather information on actual audit committee practices directly from key players in West Indian companies.

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Appendices

Table 1. Audit Committee Regulatory Requirements – General Guidelines

General AC Guidelines	Int'l Best Practice	TT and Barbados (Also Grenada; St. Lucia)
Audit committee (AC) required	Yes	Yes
Minimum AC size	No	3
Company may seek exemption from requirement to have AC	No	Yes
AC required to meet regularly	Yes	No
AC required to devote sufficient time to perform its role effectively	Yes	No
Principle based (vs. Rule-based) approach to AC guidelines	Yes	No (seems to be ad hoc, piece-meal, laissez faire) Extremely so!
Formal AC Charter required	Yes	No
AC Charter approved by BOD	Yes	No
AC review and assess adequacy of Charter annually	Yes	No
AC Charter must specify:		
- Scope of AC's responsibilities	Yes	No
- How AC discharges responsibilities (structure, processes, membership requirements)	Yes	No

Table 2. Audit Committee Regulatory Requirements – Responsibilities (External Auditors, Internal Auditors and Financial Statements)

AC Responsibilities – External Auditors	Int'l Best Practice	TT and Barbados (Also Grenada; St. Lucia)
External Auditor (EA) responsible to Board of Directors (BOD)	Yes	No
External Auditor responsible to Audit Committee (AC)	Yes	No
BOD and AC authority and responsibility for hiring EA	Yes	No
BOD and AC authority and responsibility for evaluating EA	Yes	No
BOD and AC authority and responsibility for replacing EA	Yes	No
AC responsible for ensuring that EA periodically submits to the AC a formal written statement of all relationships with the company	Yes	No
AC to recommend audit fee to BOD	Yes	No
AC required to approve non audit services provided by the EA	Yes	No
AC to approve appointment of EA key individuals to company after cooling-off period	Yes	No
AC required to conduct a regular comprehensive review of the total audit relationship, including both costs and quality aspects	Yes	No
AC responsible for assessing the impact of EA – Company relationships that may impair objectivity and independence and recommending appropriate action(s) to BOD	Yes	No
AC responsible for approving non-audit services provided by the External Auditors	Yes	No
AC responsible for approving the appointment of key external auditor personnel to positions in firm (as employees)	Yes	No
AC Responsibilities – Internal Auditors		
AC approves terms of reference/charter of internal audit	Yes	No
AC consulted on appointment of Head of internal audit	Yes	No
AC consulted on termination of Head of internal audit	Yes	No
AC responsible for regularly assessing the appropriateness of resources being devoted to the adequacy and effectiveness of internal controls	Yes	No
AC Responsibilities – Financial Statements		
Review the financial statements of the company before they are approved by the BOD	Yes	Yes
AC report regularly to the full BOD	Yes	Yes

Table 3. Audit Committee Regulatory Requirements – Composition and Competencies

AC Composition	Int'l Best Practice	TT and Barbados (Also Grenada; St. Lucia)
All AC members must be independent (see endnote 11)	Yes	No
Majority of AC members must be independent	No	Yes (may be related to small size of states)
Independence clearly defined	General threats specified	Yes (very narrow definition)
Definition of independence left to the discretion of the BOD	Yes	No
AC Competencies		
All AC members must be financially literate	Yes	No
Financial literacy clearly defined	No	No
Definition of financial literacy left to the discretion of the BOD	Yes	No
All AC members must be financial experts (see endnote 12)	No	No
Majority of AC members must be financial experts	No (but preferred)	No
At least one audit committee member must be a financial expert	Yes	No
Financial expert clearly defined	No	No
Definition of financial expertise left to the discretion of the BOD	Yes	Silent on competence

Table 4. Audit Committee Regulatory Requirements – Procedures, Reporting and Resources

AC Disclosure	Int'l Best Practice	TT and Barbados (Also Grenada; St. Lucia)
BOD to provide annual written affirmation of AC existence, functioning, composition and expertise, independence of directors adequacy of AC charter, literacy of AC, presence of expert on AC	Yes	No
AC responsible for disclosing its approval of the employment by the company of individuals who place a key role on the firm's audit (in the recent past)	Yes	No
Are firms required to disclose non audit fees	Yes	No
Company to disclose detailed background of all AC members to assist in assessment of competence	Yes	No
Company required to disclosure non compliance with best practice	Yes	No
Company required to disclose non audit fees to shareholders	Yes	No
AC Procedures		
AC must hold regular private meetings with EA without management	Yes	No
AC must hold regular private meetings with Head of internal audit without management	Yes	No
AC must hold regular private meetings with CFO without management	Yes	No
Frequency of meetings with External Auditors	At least once per quarter	No
BOD required to devote adequate time to discuss report of AC	Yes	No
CEO and CFO required to prepare a statement to be filed with quarterly and annual financial statements certifying the "appropriateness of the financial statements and disclosures contained in the report, and that those disclosures and financial statements fairly present, in all material respects the operations and financial condition" of the company (USA)	Yes	No (general requirement for directors to sign financial reports)
AC Resources		
AC must have access to advice/expertise to facilitate its role	Yes	No
AC receive regular reports from management and the auditors covering areas of concern or disputes	Yes	No

Table 5. Descriptive Statistics on AC Disclosures

Panel A: Correlation Matrix

	Variables (N = 68)	1.	2..	3.
1.	AC disclosure	NA		
2.	Industry affiliation	0.274*	NA	
3.	Firm size	0.280*	0.359**	NA

* Significant at the 0.05 level (1 – tailed)
** Significant at the 0.01 level (1 – tailed)

Panel B: Audit Committee Disclosure by Industry Affiliation

Groups	Mean	SD
1. Financial firms	4.82	3.422#
2. Other (non-financial) firms	2.16	3.816#

Levene's test for equality of variances indicated that variances are similar ($F = 0.59$, $p = 0.45$). Therefore an equal variance t-test used.

Panel B: Audit Committee Disclosure by Firm Size

Groups	Mean	SD
1. Large(r) firms	3.59	4.170$
2. Small(er) firms	1.59	2.607$

$ Levene's test for equality of variances indicated that variances are different ($F = 7.99$, $p = 0.006$). Therefore an unequal variance t-test used.

Table 6. Audit Committee Disclosure by Industry Affiliation

	OVERALL			
	Financial (11)		Others (57)	
AC EXISTENCE AND SIZE				
Number disclosing existence of an AC	8	73%	16	28%
Number of firms disclosing audit committee size (# members)	6	75%	15	94%
AC STRUCTURE (COMPOSITION)				
Number of firm disclosing # of insider AC members	7	64%	12	21%
Number of firms disclosing # of independent AC members	2	18%	7	12%
Number of firms disclosing # of outside AC members	3	27%	6	11%
AC CAPACITY (COMPETENCE / RESOURCES / ATTRACTIVENESS)				
Number of firms disclosing # of financially literate AC members	5	45%	10	18%
Number of firms disclosing number of financially expert AC members	5	45%	6	11%
AC PROCEDURES				
Number of firms disclosing number of meeting with external auditor only	2	18%	2	4%
Number of firms disclosing number of meetings with management	1	9%	2	4%
Number of firms disclosing number of meeting with head internal auditor only	2	18%	2	4%
Number of firms disclosing # of meeting with CFO only	1	9%	0	0%
Number of firms disclosing whether CEO able to exert inordinate influence on AC	1	9%	3	5%
Number of firms disclosing # of AC meetings	4	36%	3	5%
Mean		17%		4%
AC RESPONSIBILITIES				
Number of firms disclosing AC responsibilities	2	18%	3	5%

Table 7. Audit Committee Disclosure by Firm Size

	Small (n - 34)		Large (n-34)	
	Number	Percent	Number	Percent
AC EXISTENCE AND SIZE				
Number disclosing existence of an AC	8	24%	16	48%
Number of firms disclosing audit committee size (# members)	7	21%	14	41%
AC STRUCTURE (COMPOSITION)				
Number of firm disclosing # of insider AC members	6	18%	13	38%
Number of firms disclosing # of independent AC members	3	9%	6	18%
Number of firms disclosing # of outside AC members	2	6%	8	24%
AC CAPACITY (COMPETENCE / RESOURCES / ATTRACTIVENESS)				
Number of firms disclosing # of financially literate AC members	5	14%	11	32%
Number of firms disclosing number of financially expert AC members	5	14%	9	26%
AC PROCEDURES				
Number of firms disclosing number of meeting with external auditor only	0	0	4	12%
Number of firms disclosing number of meetings with management	0	0	3	9%
Number of firms disclosing number of meeting with head internal auditor only	0	0	4	12%

Number of firms disclosing # of meeting with CFO only	0	0	1	3%
Number of firms disclosing whether CEO able to exert inordinate influence on AC	3	9%	1	3%
Number of firms disclosing # of AC meetings	0	0	7	21%
Mean	1	2%	3	10%
AC RESPONSIBILITIES				
Number of firms disclosing AC responsibilities	1	3%	4	12%
Number of firms indicating AC responsible for internal control	1	3%	2	6%
Mean	1	3%	3	9%

Endnotes

[1] Managers' fiduciary duty comprises two dimensions, a duty of loyalty to shareholders' interests and a duty of care in exercising sound judgment.
[2] Jamaica is the one West Indian island that has experienced major corporate bankruptcies when many firms in its financial sector collapsed in 1996-7 due to financial liberalization, regulatory arbitrage and management and governance failures. The other WI islands have viewed these problems as unique to the Jamaica economy.
[3] This response is consistent with a philosophical preference by states in the West Indies not to regulate the internal functioning or structure of listed companies and is probably a relic of their British colonial heritage and their recent preference for Canadian Corporate Legislation.
[4] Companies' legislation in West Indian states was initially based on the U.K. legislation. More recently most of the West Indian states have upgraded their Companies legislation using the Canadian Business Corporation Act as a model.
[5] The success of this approach is likely to be enhanced if states and the regulators therein, establish the key responsibilities, processes and objectives that are deems necessary for effective corporate governance before allowing firms to choose the approach they considered appropriate to implement those requirements.
[6] Under the agency theory model, the primary reason for managerial inability to achieve the objective of principals is self-serving opportunistic behavior. Factors such as low ability, lack of knowledge and poor information are generally ignored.
[7] According to Fama and Jensen (1983: p. 302) the separation of these functions persist despite agency issues/problems because the benefits of this specialization outweigh the costs allowing large modern organizations to deliver the outputs demanded by customers at the lowest price while covering costs.
[8] Agency costs also include the cost (value) of output lost because the costs of full enforcement of the contracts exceed the benefits.
[9] Dominica, Grenada, St. Lucia and Antigua Barbuda have identical regulatory requirements relating to the ACs of publicly listed firms. These countries are not included in this study because at the time of the study there was no establish market for trading in securities in any of these countries. On the other hand, Jamaica, St. Kitts Nevis and St Vincent and the Grenadines have not enacted legislation concerning ACs.
[10] One reviewer highlighted the possibility that West Indian firms may not have implemented IBP of ACs because of the presumed ineffectiveness of those measures relative to other mechanism that may have been implemented. While this is a possibility, it does not detract from the negative consequences associated with the implementation of improperly constituted ACs. If this is the case stakeholders need to be apprised of the nature of the alternative and effectiveness of the measures and provided with evidence of their ongoing operation in the firm. This possibility will be explored in a follow-up survey-based study.
[11] That is, they should not be past employees or officers, persons with current or past material business relationships, persons with family ties to directors, senior employees or advisors, persons with more than 10 years tenure on the BOD, representatives of significant shareholders (Higgs Report 2003).
[12] This is generally interpreted as follows: past employment experience in finance or accounting, requisite professional certification in accounting, other comparable experience or background which results in the individual's financial sophistication, including past or present as a CEO, CFO, other senior officer with financial oversight responsibilities.