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Audit Committees Effectiveness: A Qualitative Study of Latvian and Lithuanian Listed
Companies

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Abstract

The authors research the characteristics of audit committees in Latvian and Lithuanian listed companies. Having reviewed the relevant literature, including practical guidelines and regulation in the USA and the EU, a set of criteria referred to as better practice recommendations is devised. The authors carry out semi-structured interviews with three parties involved the most in the audit committee work to acquire data – the external auditors, the heads of internal audit and chairpersons of the audit committees. The results show that the audit committees in Latvia and Lithuania to some extent comply with the recommendations, but lag behind in fulfilling such criteria as financial flexibility and involvement with the external auditor. The authors believe that this research can be continued by increasing the sample size and can be transplanted to other settings.

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Glossary

8th Directive - European Union's, European Parliament's and European Council's 8th Directive

AC - Audit Committee

BRP - Blue Ribbon Panel

CC - Cadbury Committee

CG - Corporate Governance

EA - External Auditor

IA - Internal auditor

NYSE - New York Stock Exchange

TSE – Toronto Stock Exchange

1 Introduction

Large shareholders can improve corporate governance in companies where ownership is concentrated since they have both the authority and incentives to discipline the management (Schleifer & Vishny, 1997). However, beyond some level of ownership the latter can result in minority shareholder expropriation. This effect has been observed particularly in countries with weak minority shareholder protection. Another potential hazard in corporate governance theory is entrenchment by the management that in the case of dispersed ownership can lead to expropriation of the whole shareholder body (Schmidt, 1997, p. 85).

Among others, one piece that can enhance the protection of major and minor shareholders, especially in turbulent times is an efficiently working audit committee – a part of supervisory board¹ that ultimately assists the ongoing monitoring process and adds to the credibility of what the company discloses.

The necessity of ACs was first pointed out by the NYSE in 1939, by endorsing the concept of audit committee. Furthermore in 1978 the NYSE made a listing requirement for the companies to have an audit committee (Knapp, 1987).

Corporate governance scandals (e.g. Enron, Ahold, etc.)² have triggered the need for improving the requirements for this committee. Extensive research has been carried out studying ACs in many countries and vast set of practical guidelines and laws have been developed. However, in Eastern Europe there has not been done any prior research studying this phenomenon.

As in Latvia and Lithuania ACs for listed companies have been established already for some time it is of our interest to examine ACs effectiveness in these countries and try to understand whether these committees contribute to better CG, is there a place for improvement, or are these committees established just for the sake of fulfilling a recommendation.

Currently neither the Latvian and Lithuanian stock exchanges nor the respective regulatory institutions explicitly require the listed companies to have ACs. In the corporate governance recommendations the stock exchanges suggest to found such committees or give an explanation why the company deemed audit committees unnecessary (NASDAQ OMX Vilnius, 2009; NASDAQ OMX Riga, 2008).

¹ Supervisory board in most of the European countries, including Latvia, Non-executive board in the US and Lithuania

² Corporate Governance scandals are going to be discussed in greater detail in section 2.2

In this paper we (hereinafter: the authors) will examine the prevalence and characteristics of this entity (AC) in Latvian and Lithuanian listed companies and will try to get a better understanding of how corporate governance is affected by the committees. In particular the authors want to investigate conditions, processes, and factors which affect audit committee daily work and how do those aspects correspond to the better practice recommendations. Hence, our research question is: **To what extent are the Audit Committees in the companies listed in the Latvian and Lithuanian Stock Exchanges operating according to the better practice recommendations?**

Via stratified sampling method the authors will create a representative sample from the population of interest and will investigate the research question using better practice recommendations.

The better practice recommendations are derived from practical guidelines developed in the UK and the USA and from the European Commission's 8th directive. The recommendations are summarized in seven criteria that are acknowledged by authors and legislators as the most important characteristics of a well functioning AC.

The authors limit their study to those two Baltic countries and do not take Estonia into consideration since at the time of the study no listed company in Estonia had an AC.

A qualitative research will be carried out. A three way collaboration platform will be examined, where the involved parties are Audit Committee, Internal audit and External Auditors. The instrument used in the research will be semi-structured interviews.

The paper is structured as follows: firstly the authors look at corporate governance hierarchy and how audit committees fit into the big picture, and why they are important. This is followed by the review of the academic work as well as legislative norms and practical guidelines with regard to audit committees. In the next section the authors will present the methodology that they use to answer their research question. The following part overviews and discusses the empirical findings. The last part of the paper concludes.

2 Background

2.1 Audit Committee in Corporate Governance Hierarchy

Although there is no single definition of CG as it covers large variety of different perspectives, high quality CG can be defined as a continuing set of procedures which stimulate the overall performance of a corporation. Those processes include a systematic analysis and management of a vast range of issues that surround a company. An interactive management of

all internalities and externalities is the prime objective of a well functioning CG. In turn, this aim serves as an accelerator for enhanced internal performance and better relationships with the main stakeholders, namely, customers, investors, shareholders, partners, regulators, employees, and others (Mazuollo, 2009). Mazuollo (2009) summarizes the issue the following way - CG is an interactive framework in which an organization is governed and controlled.

In order to monitor management activities and its functioning so that they behave in the best interest of shareholders, control instruments are implemented within a company.

Those control mechanisms often are constructed in a form of committees (Soltani, 2005). AC among others can have a great impact on decreasing the discrepancies between management's action's and shareholder's interests.

In Latvia AC is a committee subordinated to the supervisory council which is elected by the shareholder annual general meeting and which oversees the work of the management board between the shareholder meetings (see Figure 4). Despite the fact that in Lithuania AC consists of the non-executive board members, in general this is very similar to Latvia because the actual functions are the same. Internal audit department is an entity in a company that continuously monitors business processes and the financial operations. In large listed companies it usually accounts to the AC of the board (KPMG, 1999).

In both countries the role of an AC is to supervise internal auditing, corporate reporting and to a smaller extent managerial activities. For instance, it is under care of AC to anticipate financial risks, ensure that a company pursues appropriate accounting practices, encourage productive discussions with external auditors, and guarantee the stakeholders to receive true, accurate financial disclosure. A good and well-functioning AC can improve accountability and transparency within a company.

2.2 Corporate Governance Failures

Swaying arguments for why an AC that works according to the better practice recommendations is of a high importance can be found in the largest corporate governance failures that have taken place worldwide during the last decade. In all these cases the negligence or the lack of scrutiny or reliability of the AC contributed to misleading of the investors or even the bankruptcy of the company. Although the audit committees cannot be directly held responsible for misdeeds, due to the lack of focus the ACs failed to prevent the management from misleading the shareholders.

Further the authors will look closer to three cases where different aspects of AC malfunctioning have accompanied the respective corporate governance failures.

Probably the most well known CG failure is the Enron scandal in 2002 because of being the first of such scale at that time, and which was the last straw for the need of SOX establishment (Barret, 2005). Enron's fall can be looked from various perspectives - poor decisions made by the governing bodies, the usage of off-balance sheet items, too risky projects undertaken, earnings overstatement, etc. However, the malfunctioning of Enron's AC is of a particular interest since it has been mentioned by many scholars and other sources as one of the pivotal amplifiers of the collapse (Sridharan, Dickes & Caines, 2002; Barret, 2005).

.." The experts criticized the Enron Audit Committee for inadequate oversight to ensure the independence and objectivity of Andersen in its role as the company's outside auditor. The evidence suggests that the Audit Committee did not probe the independence issue, nor did it initiate the type of communications with Andersen personnel that would have led to its discovering Andersen concerns with Enron accounting practices. The Audit Committee had very limited contact with Andersen, essentially communicating with Andersen personnel only at Board meetings" (U.S. Senate 2002, 57).

Despite the fact that members of the AC were financially literate, they failed to fulfill their prime objective - the oversight of the management board, internal risks, and external auditors. Besides, the lack of communication between the EA (Arthur Andersen) and the AC clearly added to the severity of the consequences (Barret, 2005).

A different example of an ineffective work of an AC is the CG failure of Royal Ahold - a Dutch based supermarket chain giant in 2003 that has been called the Europe's Enron (The Economist, February 27, 2003). Many acquisitions undertaken by the company eventually turned out not to be profitable - they increased the current earnings but destroyed the future growth opportunities of the whole company; these investments were negative net present value projects. The management board grabbed the ultimate decision making power into their own hands and left the supervisory board, as well as the AC apart. The AC turned out not to be an independent committee and did not carry out its most important function adequately - giving the shareholders a fair look at the financial situation (De Jong, Rosenboom, Merten & De Jong, 2005).

Another pan-European case from 2003 is the one of Parmalat - a multination food corporation based in Italy. This case shows that improper composition of an AC can also cause a CG crash. The AC did not include any external members that would have a fresh and independent look on the current operations. The fact that the composition was not optimal as argued by researchers caused the lack of scrutiny in the audits carried out. The company was found to have committed corporate fraud in form of concealment of losses and to have excessively used derivatives to hide these deficits (Melis, 2005).

The described cases show the importance of AC working according to, as the authors define, the better practice recommendations. An AC can and should prevent the previously described fraudulence issues, at least to some extent. This in turn would increase the overall quality and reliability of the company's CG that can be a particularly important today where investors' confidence can be a decisive factor (Warren, 2009).

3 Literature Review

3.1 Agency Theory

Managers need to make choices from a set of alternatives in a manner that eventually would make the best use of available resources and, consequently, maximize wealth of both decision-maker and principal whom this agent is liable to. Contracts are made in order to define positions and responsibilities. However, sometimes it is hard to determine the best way to make decisions, to define whether a particular judgment was the most appropriate, and complicated to prove if an agent has been performing well (Jensen & Meckling, 1976). As Stiglitz (1987) has elaborated further, incomplete contracts create place for principal-agent issue.

This study on ACs focuses particularly on shareholder (principal) and manager (agent) problem which arises when managers do not act in the best interest of shareholders. Often this can be seen as moral hazard – situation when managers gain from acting contrary to the rules set in agreement. This also is referred to as information asymmetry – when the insiders (managers) know more than the outsiders (shareholders) (Stiglitz, 1987).

Remedies, including stock options, established supervisory board, large owners that monitor the management excessively, minimize the possible problems but not entirely (Aseff & Santos, 2005).

3.2 Previous research

The research on AC effectiveness has gained an increasing popularity among scholars around the globe particularly since the big scandals of CG failures. The number of publications

in the largest accounting journals in the last seven years listed on the Social Sciences Citation Index³ has been on average 12 per annum (Bedard & Gendron, 2009). This is evidence for the growing interest as well as the dispersed views on this topic. Most of the previous research has been carried out in Anglo-Saxon countries, first of all on US firms and to lesser extent on UK and Australian corporations. Some scholars also have studied the emerging Asian countries. Rather little evidence can be obtained from studies on AC in the EU context and none researching companies in the Central and Eastern Europe (Soltani, 2005, Bedard & Gendron, 2009).

The effectiveness of AC has been measured by various data gathering techniques. They range from descriptive such as surveys, and exploratory – interviews; however, most of them are relational where available archival information is being investigated. Most of the previous studies are carried out from legal and economics perspectives (Bedard & Gendron, 2009).

Further the authors will provide information about of previous scholars' works from each of the previously used data gathering methods and an overview of how effectiveness has been measured. Besides, as the results of previous studies are rather complicated to compare since the approaches differ a lot and are difficult to put in a reasonable comparative framework, previous researchers are presented according to data gathering methods. The authors provide reasoning for choosing interviews and why this method is the most appropriate to tackle the effectiveness issue and try to open the "black box" of CG in the companies of interest. Papers where interviews were used as the fundamental research tool will be discussed in detail as well.

3.2.1 Quantitative studies

Most of the quantitative papers focus on financial reporting as an essential dimension that explains AC effectiveness (Bedard & Gendron, 2009). For instance, Yang and Krishnan, (2005) claimed that ACs have power to minimize company board's excessive incentives in earnings management, and they showed certain prevailing characteristics of AC in this context. After regressing several AC characteristics on quarterly earnings accruals, they found that if an AC member has previously worked in other company's AC, this statistically significantly lowers the accruals of the company the person is involved currently. Interestingly, a similar study in the EU context carried out by Piot and Janin (2007) demonstrated evidence that in France purely the presence not the independence of AC improves the management of earnings effectiveness.

³ An academic citation index

However, both studies relied on accruals as a proxy for effective work of an AC which to some extent as externally observable data is rather arguable measurement of this internal efficiency (Kalbers & Fogarty, 1998).

Another study of Zhang, Zhou and Zhou (2006) applied statistical analysis in order to find if there is some relationship between the quality of internal audit and the independence of the external auditor. They conclude that there is a tie between the bodies and that both financial and accounting expertise are crucial determinants of internal control quality. Stewart and Kent (2006) showed the link between AC meetings' frequency and the fees to external auditors. The paper showed that frequent AC meetings and large utilization of IA resources drives up external audit fees which by this and many other scholars is considered an indicator of an effective work of the AC. However, they also found that the absence of the listed prerequisites still can be associated with higher audit fees if level of AC members' financial expertise is high.

3.2.2 Qualitative studies

Surveys

Surveys have been used to determine what could be the pivotal drivers for efficiency of AC. Muhamad, Zulkarnain, Mohamad and Nassir (2006) after describing variability among the investigated variables found that the surveyed AC chairmen, in general, perceive accounting literacy, appropriate manner of financial statements review and internal control as essential elements of an effective AC.

Contrary, Saad, Evans, Sori and Hamid (2006) surveyed senior managers. According to their opinions, AC effectiveness would be enhanced if it had more power with respect to external auditors, namely, appointment, review of fees and appraisal. However, survey approach in general has a weakness because the questions are structured thus denying room for flexibility and providing imperfect information about ACs.

Interviews

Interviews are used an alternative approach in measuring AC effectiveness. Usually the better practice recommendations that have been put forward by experts and legislators are considered as the basic framework for these kind of exploratory studies where the main objective is to find answers to "how" questions. By "how" it can be understood – how AC operates in respect to external auditors and IA, how much power AC actually has in the company, how much informal communication is carried out, etc. As noted before quantitative studies have many boundaries examining the actual relationship between AC characteristics and thus have limited value (Bedard & Gendron, 2009).

Many papers, including Turley and Zaman (2004, 2007), Bedard and Gendron (2009), Sarens and De Beelde (2006) and other, suggest that getting closer to AC and collection of primary data via interviews has a great potential, despite to the limitations that arise due to the accessibility of the people in question.

The sub-areas of efficiency from a large sample of the previous interview based studies from the last two decades can be divided into four sections: composition, authority, resources, and process (Bedard & Gendron, 2009). Composition has mostly looked at the degree of independence of the members and their financial and managerial skills and knowledge. Authority relates to the oversight of IA and EA. Resources is seen as the number of AC members and the informational and monetary resources they are entitled to. Process in some sense comprises the latter dimensions and adds meetings and intra-relationships among the parties involved in the work of AC. Our aim is to take all those dimensions into account.

Studies that have taken a similar approach to the authors of this paper are to be described. Those researchers also take a stance that qualitative interviews do provide the author with valuable insights in the company operations.

Spira (1998) was one of the pioneers in examining AC activities through interviews. She conducted interviews with AC chairpersons, financial directors, IA and EA members in UK publicly listed companies. The results were inconclusive, although the approach is noteworthy as it was arguably innovative.

Gendron and Bedard (2006) studied effectiveness of AC in three companies listed in the Toronto Stock Exchange. From the interviews they found that the frequency of internal AC meetings and other activities as meetings with the external auditor play a significant role on the effectiveness of AC.

Cohen, Krishnamoorthy and Wright (2009) interviewed thirty external audit managers and found that management has too much power in determining EA which in turn decreases the authority and usefulness of ACs in those firms.

Sarens' and De Beelde's (2006) study of 6 Belgian listed companies also used semi-structured interviews as their primary qualitative assessment; however, they also studied publicly available information and internal documents of the respective companies in order to have more reliable conclusions and to increase validity of the research. They conducted interviews with AC chairpersons and IA chairpersons and their primary objective was to understand the relationships

between the both parties. Their main conclusion can be described that internal audit and audit committees could cooperate better.

Turley and Zaman (2007) studied the potential effectiveness of AC looking at the parties that are involved in the work of AC, namely, IA and EA. This was carried out as a case study of one company included in FTSE-100. Their findings mainly concentrate on the fact that informal processes as, say discussions over lunch or extra - working hours' communication is of great importance. Also they found that historical development and power of AC are determinants of its efficiency.

The authors believe that qualitative approach in this area of research provides an in-depth analysis of the internal operations of the company which are not available publicly. Besides, in order to assess the interaction between the stakeholders associated with AC, exactly semi-structured interviews in hand with additional available sources of information are considered to have great potential. Informal processes and behavioral effects might have a crucial effect on governance outcomes (Turley & Zaman, 2004). Those are the main reasons when determining the choice of instruments for this research. Furthermore as Cohen et al. (2009), Vera-Munoz (2005) and De Zoort, Hermanson, Archambeult and Reed (2002) claim that the Cadbury Committee and Blue Ribbon Panel reports summarize the better practices very well, those recommendation sets are used in the methodology. The authors also take in account the findings of Soltani (2005) that the AC structure and better practices in the EU converge to the ones in the USA to account for the potential bias of irrelevance of the American recommendations in the European context.

3.3 Legislative norms

Legislation has been created that deals with this topic around the world. The first regulation that also dealt with the requirements for audit committees was the Sarbanes- Oxley act in the U.S.A. Legislative piece that deals with those issues in the European Union is the European Commission's 8th directive. Latvia and Lithuania falls in the jurisdiction of the 8th directive, so has to implement the requirements from the directive. However the Latvian legislation includes a clause that if the company has an entity that approximately carries out the tasks of an AC, the company can be exempt from the requirement to found a committee (Law of Financial Instrument Markets, 2010).

3.3.1 *The EUs 8th Directive*

The directive states that public interest companies (definitely but not exclusively companies that are traded on stock exchanges) shall have an audit committee. The 8th directive puts forward four actions that have to be taken by the audit committee:

- a) monitor the financial reporting process;
- b) oversee the internal control, risk management and where applicable the internal audit and the effectiveness of those functions;
- c) oversee the auditing of the annual accounts;
- d) review the independence of the external auditor, particularly in regard with additional services provided to the company. (European Union, European Parliament and European Council, 2006).

3.3.2 *Sarbanes – Oxley act*

The Sarbanes - Oxley act regulates the corporate governance in the U.S.A. It does not introduce any brand new concepts from the ones discussed above, however it does state for example that an audit committee is completely responsible for setting remuneration for any outside accounting companies and that outside auditors have to report directly to the committee. The law also states that an independent member of the Board of Directors cannot receive any remuneration from the company or its affiliation (Sarbanes - Oxley Act, 2002).

Also the institutions that monitor the operations of the companies in our population the NASDAQ OMX Baltic stock exchanges in Riga and Vilnius have issued corporate governance guidelines and recommendations about implementing them. However they are on a comply or explain basis, meaning that they do not force the companies to fulfill any of the points. This recommendation set deals with all aspects of CG, composition of the board, council, and the hierarchy of CG and founding of committees, including an audit committee (NASDAQ OMX Riga, 2008; NASDAQ OMX Vilnius, 2009).

3.4 *Practical Guidelines*

3.4.1 *Cadbury Committee*

The report titled Financial Aspects of Corporate government was published in 1992. It got its name from the person chairing the committee - Adrian Cadbury who was the chairman of Cadbury Schweppes for 15 years and has also been a director for IBM and The Bank of England. The committee was established by the Financial Reporting Council, The London Stock Exchange in May 1991.

As the report states in the preface its purpose is to produce a code that being followed would result in a responsible corporate behavior. By adhering to the code produced by the committee listed companies are to maintain trust among the auditors, shareholders and the management - an evasive goal which is considered to be one of the most important issues in corporate governance. The authors believe that if such a code had been already implemented several failures could have been avoided as signs of fraud or mismanagement would have earlier received appropriate attention. The authors claim that the corporate governance is sound in the UK, and that the code actually reflects the best practices which are prevalent in British companies (Cadbury, 1992).

An important point is that controlling all the aspects of corporate governance by law would unnecessarily restrain companies and decrease the competitiveness; ergo a code that would be embraced by the general business public is more useful. By pressurizing the management the shareholders can achieve the management to comply to a generally accepted code. However the authors believe that some legislation might be implemented to control for some of the issues identified by the report (Cadbury, 1992).

The authors also recommended companies to mention in their reports if they comply with the code or to explain why they don't comply. The paper starts with laying down the basic recommendations about the responsibilities and structure of the board and the executive and non - executive directors.

Audit committees have been proven useful as even if they have been established to fulfill the listing requirement, they have proved to have influence over the management and the quality of reporting in the US. During the time the report was written approximately two thirds of top 250 listed UK companies had incorporated an audit committee and the report encourages all the companies to establish one. Also it is mentioned that the London Stock Exchange plans to require the listed companies to comply with the Code (Cadbury, 1992) (see Appendix A)

3.4.2 The Blue Ribbon Panel

The Blue Ribbon committee worked exclusively on coming up with suggestions for audit committees. The authors write that the boards of directors in companies should not only consider operating within the legal framework, but also how to voluntarily include measures to improve accountability and reporting quality.

As the report points out the first step in developing an audit committee is to recognize the need and usefulness of one throughout the organization. Although it is not the responsibility of the committee itself to perform the financial reporting, the function of oversight in reliance with

the senior management and external auditors is very important. As the authors put it, the three parties - the board, the management and the external auditors should form a “three legged stool” that supports responsible accounting (Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committee, 1999).

The main recommendations stem from two principles, firstly the audit committee should reflect the professionalism and the performance of the board and that there should be a legal, regulatory and self-regulatory framework that encourages good reporting and transparency (Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committee, 1999).

The paper summarizes its message in 10 recommendations (see Appendix B)

As it can be seen both the sets of recommendations are fairly similar and more or less deal with the same issues. The Audit committees should have clearly stated responsibilities and duties. The members of the committees have to be to some extent independent and oversee the communication and actions of the external auditor. Both the panels recommend that their sets of recommendations should be implemented by the respective national stock exchanges although the American one - Blue Ribbon Committee also specifically recommends amending regulations concerning filing annual statements.

4 Theoretical Framework

As already pointed out in the literature review, having reviewed previous academic studies the authors have deemed qualitative interviewing as the most appropriate.

The authors have come to the conclusion that people from three positions should be interviewed - the chairperson of the AC, the head of the internal audit department and an external auditor. Those are also the parties that are involved in the auditing processes the most.

The questions are engineered to correspond to the recommendations put forward by the sets of recommendations described in the literature review part (see appendices 4, 5, 6). To answer the research question, to what extent are the audit committees operating according to the best practices seven criteria are devised.

Firstly ACs should have **articles** that clearly state the duties, responsibilities and accountability of the committee. Those articles have to be approved by the board. The necessity of clarifying the duties and responsibilities of a committee is put forward in Cadbury Committee and Blue Ribbon Panel reports and in the European Commission's 8th directive. It could be more beneficial to analyze what the articles say, however that is not public information in all the cases

and goes beyond our scope. Interpreting the legal aspects of articles in the sample companies would take the authors to quantify or discuss in detail the wording and the thoroughness. In that case the conclusions still wouldn't be that solid as the requirements and stipulations might not be carried out, however the mere presence of *clearly* written articles signals dedication.

Another recommendation univocal in all the reports is that an audit committee should have at least **three members** as that is perceived to be the minimum number of people that could deal with the duties. Although the company size is not taken into account, both the reports and the 8th directive deal with companies that should be of significant size.

The importance of **financial literacy** is discussed in both the reports and the 8th directive. The European Commission's 8th Directive states that at least one member of the committee has to have competence in accounting and / or auditing (European Union, European Parliament and European Council, 2006). However both the Cadbury Committee and Blue Ribbon Panel reports recommend all the members of the committee to be familiar with accounting and auditing. The education and / or extensive experience in the field therefore are looked at as very important conditions for the AC members

Having executive directors⁴ in the audit committee is viewed as a potential risk in both the practical guidelines documents. As the AC's purpose is to supervise the accounting and auditing processes of the company, to ensure credibility for the shareholders, the executive directors theoretically are the ones who the shareholders have to be 'protected from'. Thus the fourth criterion is that **executive directors** should not be included in ACs.

Also a point that The Cadbury Committee report, Blue Ribbon Panel report and the 8th Directive discuss is that the AC has to have a significant role in choosing the auditor. All the documents state that the **EA** should be chosen based on the recommendation of the AC. The AC has to assure a selection of an independent external auditor. As well the AC has to monitor the work of the external auditor to assure that it is carrying out its duties properly. In case of misunderstandings or limitations in the work the EA should contact the AC and most of the communication in general should be done between those two parties.

Accounting practices can be different in companies. The way the assets are valued in books can be influenced by the CFO. However for public interest companies the stakeholders have to have a clear picture of the situation in the company. According to the three Cadbury

⁴ Executive directors are senior managers in the company

committee and Blue Ribbon Panel reports and the European Commission's 8th directive, the AC should discuss and voice their opinions about the **accounting practices** of the company. The Cadbury Committee and Blue Ribbon Panel reports deal directly with this issue but the European Commission's 8th directive states that the committee has to monitor financial reporting.

Lastly, ACs should be able to access the necessary **resources** and information to fulfill their duties. If IA division is subordinated to the AC, then it has to have sufficient budget. Expenses may arise from different sources as hiring outside advisors and remunerating effort. As a rule of thumb the authors inspect whether company's AC has a budget appropriated and whether it has some elasticity in acquiring resources as the AC should be able to hire necessary consultants if such a need occurs.

Also the power that can be exercised by the committee is a resource appropriated by the owners of the company. In Figure 1 the better practice recommendations and the sources are summarized.

Criterion	Source
Clearly documented articles	BRP, CC
Three members	The EUs 8th Directive, BRP, CC,
Financial literacy	The EUs 8th Directive, BRP, CC
No executives	BRP, CC
Dealing with the EA	The EUs 8th Directive, BRP, CC
Monitoring of accounting practices	BRP
Resource availability	CC

Figure 1 – The better practice criteria. Source: made by authors based on BRP, CC, and the EUs 8th Directive

5 Methodology

The companies were contacted via official channels as indicated in their websites and interviews later arranged with the people of our interest. To ensure that the interviewees are clear

about what the authors want to find out, general list of questions (see appendices 4, 5, 6) was sent in advance. Although this might result in preparing ‘the right’ answers, in most cases the authors received requests to send the questions in advance. The questions for the internal auditors and external auditors were slightly changed to gain the information about the same issues.

Having collected the data it is analyzed to come up with conclusions whether the audit committees in the Latvian and Lithuanian listed companies operate according to the principles of better practice and with several recommendations of how to improve the situation via legislation or stock exchange recommendations / requirements.

Although the interpretation of the results is subjective the authors believe that it is valid and yields realistic conclusions. For the purpose of comprehensible visualization of the results also a checklist – a table depicting whether companies partly comply, fully comply or do not comply with the criteria – is created.

5.1 Data description

According to the publicly available information on the NASDAQ OMX Riga, NASDAQ OMX Vilnius, and NASDAQ OMX Tallinn, out of 89 companies listed only 17 have and AC - 5 companies in Latvia and 12 in Lithuania. At the start of our research no publicly listed companies in Estonia had an AC. Although in 2008 the regulatory body in Latvia - The Financial and Capital Markets commission made a requirement for all the companies listed in NASDAQ OMX Riga to have an AC, this requirement in such form was abolished. From an interview with the CFO of SAF Tehnika it was revealed that AC is looked at as an unnecessary body for small companies (Interview with Aira Loite, 2010). The authors delimit the previously mentioned 5 in Latvia and 12 in Lithuania companies and their respective ACs as our population of interest.

The stratified sample consists of 6 companies that were selected according to the following criteria. The authors included companies with different characteristics in terms of capitalization (as of September 1, 2009), age of AC, and industry where the particular company operates in. By doing this the authors create a rather representative sample, taking into account that ACs in both the countries is fairly recently developed mechanism. This, similarly to the previous studies, would help to develop more reasonable conclusions about the population (Saarens & De Beelde, 2006). An investigation of all the companies of the interest would create a descriptive paper and would diminish the scientific nature of the research in its fundamentals.

What is more, the latter would reduce the place for authors' argumentation in the analysis part hence one third of the whole population is a fairly reasonable sample.

The capitalization of the sample companies ranged from around 12 mln EUR to 125 mln EUR. All the companies have fairly concentrated ownership structure that is a characteristic feature of Latvian and Lithuanian listed companies in general. However, within the sample there are companies with one major shareholder with more than 51% of voting rights and also companies where there are a few majority shareholders who own a bit more than 20% in the company. The sample consists of firms that operate both in manufacturing and service industries. All the corporations also run their business internationally.

5.2 Coding

The authors code all the companies in the form Company *X* and interviewees with abbreviations AC *X*, IA *X* and EA *X*, meaning audit committee, internal audit and external auditor. In the paper AC 1 corresponds to the *audit committee of company 1*.

5.3 Reliability and Validity

In a qualitative study, contrary to a quantitative, reliability and validity are often seen as one component (Golafshani, 2003). Many scholars, including Seale (1999), redefine the terms and admit that in a qualitative research it is fundamentally important to explain transferability, trustworthiness, and credibility – elements that make a good quality paper, components which “persuades the audience that research findings are worth paying attention to” (Lincoln & Guba, 1985, p. 290).

Further the authors will argue why this study has the respective features, what limitations it might have, and what maximizes the degree of the reliability and the validity.

As mentioned before, the semi-structured questionnaire was derived from Blue Ribbon Panel, Cadbury Committee, and the EUs 8th Directive which are acknowledged practical guidelines and legislative norms and that to large extent have influenced the latest corporate governance requirements for AC worldwide (Soltani, 2005). What is more, almost all the listed companies around the globe that have an AC also have an IA and EA. This makes it possible to conduct the interviews with all those parties that take part in the work of AC. Besides, the questions of this research for all three persons are not strictly structured which leaves place for inquiring some other study specifics. To sum up, as the authors provide justification on where the questionnaire comes from, why the exact persons were interviewed, and how in particular the interviews were

conducted, this research as Ary, Jacobs, Razavieh and Sorensen (2000, p.501) have said is “descriptively adequate” and to large extent can be replicated to other settings.

An official agreement was signed where the authors stipulated to disclose neither the participants’ nor the companies’ names. The questionnaires were sent in advance so that no misunderstandings occur. Additionally, the transcripts of the interviews were later sent to the interviewees so that they could agree upon what has been released. All the interviewed persons were interviewed alone so that none of the involved parties within one company could possibly be afraid in some sense to release the true information of the particular company. The interviewees could trust the interviewers, which is very important in data gathering process so that the data received is trustworthy.

5.4 Data triangulation

The logic of this strategy grounds on two assumptions. Firstly, interviewing only one source of data might lead to potential biases. Second of all, data triangulation which from Jick’s (1983) viewpoint “purports to exploit the assets and neutralize, rather than compound, the liabilities” should make more sense of what is studied via incorporating the possible inconsistencies, and contradictions or cancel the biases out which would lead to convergence to a ‘true result’. Although convergence is the most commonly assumed outcome of data triangulation, it is not always the case; a pure convergence is very rare. Convergence in general means that after triangulating the data sources it would be possible to come up with a single proposition of the studied population. Convergence is researcher-friendly because it reveals more straightforward explanations. Our strategy might lead also to inconsistencies in the data which is very common. In this case there is quite a lot of place for arguing what might be the right answer to the studied phenomena. The method also might disclose contradictions within the data sources that would make it incommensurable. It is realistic to assume that not all of the questions of the authors’ interest would lead to one easy answerable explanation. However this, in turn, implies the greatest value from applying sources’ triangulation since it presents evidence of which type of the previously described outcomes are observed in the data and the way they have to be explained (Mathison, 1988).

6 Empirical Findings and Discussion

Having interviewed the relevant personnel from two companies in Latvia and four in Lithuania, the authors have acquired data to be presented in this section. The authors have observed occurrences of ACs that take an active part in overseeing auditing, the operations and

communicating with the supervisory council and committees that are created mostly for the sake of fulfilling a recommendation in the corporate governance guidelines issued by the local stock exchanges.

The main source of information in our report is semi-structured interviews. Our goal was to interview a member of the AC and the head of the IA that turned out to be not that simple as due to great differences in the size of the companies, not all of the companies are structured in the same manner i.e. not all the companies have an internal audit department.

The findings are going to be presented according to the criteria developed in the methodology part (See Figure 3).

6.1 Clearly Documented Articles

In order to clarify whether the company fulfills the requirements most of the questions deal specifically with our matter of interest. All the companies have clear definition of purpose stated in the articles, instated at the foundation of the committee. All the interviewees from the 6 companies of the sample claimed that their duties are clearly stated, although the scope of the duties differed. Also the EAs that were interviewed acknowledged the importance of a clear purpose of the AC. However a different finding is that in one of the companies the duties of the AC chairperson overlap with the duties as an economic analyst (AC 3 member, personal communication, February 4, 2010). This implies that the division of tasks in the company does not fully function. Another interesting point is that in one of the companies the AC has grown and developed over time as the articles have been adjusted since the time of instating them (AC 1 member, personal communication, January 29, 2010).

Although the literature suggests definite tasks for ACs the authors find that adding to the classic duties, the committees also take up other tasks as in one case the committee is also mentioned in it's charter as a moderator between different parties when it comes to auditing the company (AC 4 member, personal communication, February 10, 2010)

To summarize, all the companies have clearly written articles, which state the responsibilities and duties of the AC. As those articles are not public information the authors cannot analyze them more thoroughly to find out the quality of them. Although it was found out that in one of the companies the functions inside the company overlap, this criterion is fulfilled and five out of six companies fully comply with the criterion.

6.2 Three Members

Reviewing the appropriate literature, the authors have found that three members is the commonly accepted minimum amount of members. The authors found that all the companies in our sample had at least three members and one of the companies AC had four members (AC 4 member, personal communication, February 10, 2010) Although the authors acknowledge that other companies' ACs that are not in our sample might not satisfy this condition, the authors deem this recommendation fulfilled and that ACs in Latvian and Lithuanian companies fully comply to the criterion. It would add value to find out what motivated the Company 4 to assign more people to the audit committee than the commonly accepted minimum. Probably it was decided to do so to increase the quality of the operations. To find whether the increase in number adds value an inter-temporal analysis of a given company should be done.

6.3 Financial Literacy

Importantly the authors found out that companies in our sample usually appoint people with financial expertise, as one of our interviewees noted:

“For the person to be elected in the committee he has to satisfy three requirements. Understanding of financial reporting, accounting and the specific business.”

AC 1 chairman

The most stringent requirement the authors stumbled upon was in Company 5 - the requirement for financial expertise is quantified - the nominee has to have at least 5 years experience in the field of accounting / auditing (AC 5 member, personal communication, March 18, 2010). However the degree of expertise varies among members as usually at least some of the members are chosen from the supervisory council, for example in one of the Lithuanian companies this is a prerequisite that all the AC members have to be in the supervisory council⁵ (IA 2, personal communication, February 2, 2010). This requirement does not exclude the possibility of financial literacy, however can cause unfitting people to be appointed. However this was the only such case and all the other interviewees claimed that the members have to be and are financially literate i.e. in one of the companies a member of AC was dismissed due to lack of financial expertise (AC 3 member, personal communication, February 4, 2010). Another

⁵The Lithuanian corporate law does not require companies to have a two tier system. Meaning that instead of supervisory council with non - executive members and management board with executive members there is only one body with executive and non - executive members.

interviewee also noted that the understanding of the industry is a ‘must’ (AC 2 member, personal communication, February 2, 2010). Also the EA informed the authors that ACs in listed companies mostly consist of people familiar with the duties they are performing (EA 1, personal communication, February 22, 2010).

A problem pointed out by AC 1 member was that the turnover of the members decreases the operating capabilities as the newly appointed members have to acquire the know-how. In all the companies the authors found out that at least one member changes every year and in order to fulfill his or her duties time has to be spent to become familiar with the way things are done. On the other hand, however being the chairman of the AC might cause one to lose perspective (AC 1 member, personal communication, January 29, 2010). Although the authors do not focus on this issue, the turnover of the AC members might be a good topic for further research.

Financial literacy is very important so that the members of AC are able to understand the financial reports and whether they are depicting the real situation in the company. Interviews reveal that the companies in our sample do appoint people who are fitting for the position. Although in some cases problems are identified as the requirement for a member to be in the council or the fact that one of the companies employed a person without proper background to the committee, authors believe that this criterion in Latvian and Lithuanian listed companies’ ACs is fulfilled.

This should result in an AC that properly can follow the financial actions and reporting of the company. Furthermore having educated people in the AC ought to reinforce investors’ confidence in the corporate governance mechanism in a given company.

6.4 No Executives

Neither of the companies that were included in our sample had an executive director in the AC. Supervisory council members, internal auditors and independent professionals were appointed to the AC. Although this is not very common that the head of internal audit division is appointed as a member of AC it still can function properly (AC 2 member, personal communication, February 2, 2010).

A noteworthy observation is that the criterion of no executive directors can be rendered irrelevant in the case of concentrated ownership. As AC 3 chairperson pointed out a major shareholder who is also the CEO holds significant decision - making power.

“The CEO who is also a direct representative of a major shareholder has the most power in choosing the EA and the members of AC”

AC 3 member

Although the situation is justifiable as major shareholders tend to exercise more control over the company, the fact that minor shareholders can be expropriated is a concern.

This is a very important criterion as AC is supposed to be a management overseeing entity in order to guarantee that the shareholders receive financial figures that are not malevolently tampered with by the management that would like to exhaust private benefits of control. Despite to the fact that in several cases insiders of the company are appointed to the AC the authors believe that the structure is not compromised and in general the ACs in Latvian and Lithuanian companies comply to this criterion.

6.5 Dealing with the EA

A question to which very different answers were received was what the main duties of the committee members / committee chairman are. The answers differed from being very vague as over-seeing accounting to specific like checking the validity of the audit reports presented to them. However the intention of this question was to find out to what extent are the ACs involved in the communication with the EA that is put forward as one of the main duties in the BRP, and CC recommendation sets.

Surprisingly only one of the interviewed AC members mentioned communication with EA as one of the main duties (AC 2 member, personal communication, February 2, 2010). The external auditors interviewed admitted that the communication with the AC is not exceptionally good. Most of the communication is done with the management. Although the AC might be present in the meeting, there are not many meetings only with the EA and the AC present (EA 1, personal communication, February 22, 2010; EA 2, personal communication, March 10, 2010). The nature of communication however is most commonly presentations and ensuing discussions, as said by EA and AC members (AC 5 member, personal communication, March 18, 2010; EA 1, personal communication, February 22, 2010). The convergence of answers shows that although the phenomenon does not necessarily prevail throughout the whole sample the EA's answer describes the situation well as even if the company 5 has been a client of the EA interviewed, the EA claimed that presentations and discussions can be generalized as the main communication tool for the whole population.

A troubling finding was that even if the communication with the EA is good to begin with, it can decrease in quality over time.

“Cooperation with the external auditor has decreased since the founding of the committee. We used to have more meetings without the presence of the management board.”

AC 4 member

This shows that if the company just employs theoretical concepts and does not adjust them to the situation and the specific company, the operation of the AC can arguably decrease in quality over time. An inconsistency according to the triangulation method was due to the fact that EA 1 claimed that the situation has not changed significantly over the last years (EA 1, personal communication, February 22, 2010).

Another aspect that is of our interest in regard with AC and EA interaction is to what extent the AC has a say in choosing the EA. Although the final say always belongs to the shareholders as the hiring of an EA is voted for in general meetings, the proposal is seriously influenced by the AC only in two companies (AC 1 member, personal communication, January 29, 2010; AC 5 member, personal communication, March 18, 2010). In this case the answers by the IA and the AC converge, as the interviewed IA representatives say that the AC has expertise and its recommendations are taken into account (IA 1, personal communication, January 29, 2010; IA 5 member, personal communication, March 18, 2010).

In one of the companies a committee that oversees procurement procedures and is comprised of supervisory council members nominates the EA and in the other four the nomination is put forward by the management.

In conclusion the ACs in Latvian and Lithuanian listed companies do not comply with this point. As discussed in the methodology part the AC should be the party that the EA communicates with the most. As pointed out by EA 1 in the situation where the management chooses the auditor and in fact determines the pay, the external service provider also feels more responsible to the management, namely the CFO and in most cases also communicates with it the most. Although the final vote is casted by the shareholders, the management that is given in most cases extensive power has too much influence in the process that is supposed to give an independent view on the company - audit.

The authors believe that one change should be made with respect to those findings. The AC should be given the power to choose the EA. This way the EA would feel more responsible to the AC and would also communicate with it to a greater extent, resulting in more effective CG mechanism

6.6 Monitoring of Accounting Practices

The authors found out that all the ACs are in a way responsible for overseeing accounting practices but are involved with this matter to a different extent. For example in one of the companies that has had an AC for just under a year, the operations have not yet been fully developed as the committee is overseeing their first audit (AC 3 member, personal communication, February 4, 2010). Contrastingly a major Latvian company's AC meets on a monthly basis and oversees all the internal financial and operational audits of the company that are later communicated to the supervisory council and / or the management board (AC 1 member, personal communication, January 29, 2010). In general the main duty of AC's members is to communicate the level of financial credibility to the supervisory council (shareholders in Lithuanian case, as two tier system is not mandatory in Lithuania).

The EAs interviewed admitted that accounting practices are discussed with the AC, except for the case of banks where such a discussion due to stricter regulation would be obsolete (EA 1, personal communication, February 22, 2010). EA interviewed also noted that if the company offering external auditing services has a plan, such a discussion cannot be avoided (EA 2, personal communication, March 10, 2010).

As pointed out before the monitoring of accounting practices is a crucial part of the AC's responsibilities. Although the ACs in our sample do follow the guidelines of the better practice recommendations there is still some place for improvement.

6.7 Resource Availability

Also a very important prerequisite for an effective operation of an AC is the availability of the necessary resources. Although the remuneration or the way the budget is spent was not discussed, the interviewees claimed that they have free access to all the relevant information. The company where the AC has been operating only for about a year does not appropriate any budget for the committee; the others' budget is incorporated in the internal audit's budget.

The power constituted to the AC is very important as in many situations management can find itself in a conflict with the AC. The authors look at the power the committee is given as a resource as well. If the AC finds some practices not appropriate it does not have the executive power to overturn the decisions directly. However in all the companies according to the interviewees a substantial level of respect is enjoyed by the AC as either the person works in internal audit or in supervisory council that is the direct link to the owners of the company. In Company 1 the chairman of the AC, who is also the deputy chairman of the supervisory council,


said that management effectively cannot ignore the AC as it has to report and is chosen by the shareholders that is represented by the supervisory council (AC 1 member, personal communication, January 29, 2010).

As for the resources the authors have come to a conclusion that AC has to have an appointed budget with some level of flexibility. If this requirement is fulfilled the AC can have some degree of freedom. The degree of freedom is necessary if the audit committee deems it necessary to have some outside consultants involved in the auditing process.

Figure 2 is a visual representation of the results the authors acquired through the interviews with AC members. As the paper takes a qualitative approach to the issue researched, the authors do not quantify the results for the purposes of answering the research question, but use a comprehensible table to summarize the results for the reader's convenience.

Criterion / Company	1	2	3	4	5	6
Clearly Documented Articles	3	3	2	3	3	3
Three Members	3	3	3	3	3	3
Financial Literacy	3	3	2	2	3	2
No Executives	3	3	3	3	3	3
Involvement with the EA	2	2	1	1	2	2
Acc. Practices Monitoring	3	2	3	3	3	3
Resource Availability	2	1	1	1	1	1

Figure 2 – Summary of the results. Source: made by authors based on personal communication

Fully Comply –  – 3

Partly Comply –  – 2

Does Not Comply –  – 1

7 Conclusions

The authors attempt to answer the research question: To what extent are the Audit Committees in the companies listed in the Latvian and Lithuanian Stock Exchanges operating according to the better practice recommendations? It is done by interviewing audit committee members, chiefs of internal audit departments in the companies that are included in the sample, and external auditors in Latvia and Lithuania that recently have audited companies within the

sample. A total of six companies are included in the sample that is approximately one third of the researched population.

The authors do not try to reveal the best performer or look at any single AC in depth, but try to come up with propositions that can be generalized for all the Latvian and Lithuanian listed companies with ACs. The stratified sample is representative of the whole market in its diversity of industries, size and age.

As seven criteria are devised and triangulation method is employed, the information acquired in some places is contradicts which creates caution that the authors take into account.

The most important points, judging from the sample researched are that in general the ACs in Latvian and Lithuanian companies comply with the requirements/criteria of sufficient size, absence of executive directors, clarity of articles and involvement in monitoring the accounting practices within the company. A problematic point is the requirement of financial literacy as although all the interviewed AC members and IA representatives claimed that in their respective companies members of the audit committees are sufficiently literate in the matters of auditing and financial reporting, several problems were identified. The interviews revealed that in one case a member was terminated the membership due to lack of experience in the field and in another two cases being a member of the supervisory council is a requirement to be nominated for the committee.

The criteria for which the lowest levels of compliance with were found are the financial flexibility (resource availability) and involvement with the EA. Generally the audit committees are not appropriated a budget, so in situations when deemed necessary, the committee can not hire outside consultants or do extra financial revisions. The authors believe that this is a major divergence from internationally acclaimed better practice recommendations and that either the legislators should enforce some provision making or the respective local stock exchanges should be more aggressive in promoting those aspects of corporate governance. Also the involvement with the external audit suppliers is not satisfactory. In five out of the six companies, the AC does not have sufficient power given to influence the choice of the EA. This also dampens the communication between the EA and the AC, resulting in reinforced threats of the management expropriating shareholders.

The authors come up with two recommendations for the national stock exchanges and/or legislators - committing themselves to the realization of those proposals. Firstly, the audit committees should have appropriated budget for their working expenses and secondly they

should be given considerably more power to influence the choice of deciding the EA for the company. This might be achieved by either the stock exchanges or the local governments requiring the companies to mandate the ACs the choice of external auditor.

As the AC is an entity that represents the shareholders' interests it has to communicate more with the external auditor that supplies a service for assuring the stakeholders trustworthy and transparent financial reporting. This would also probably increase the costs of operation slightly; nevertheless, in case of large companies the benefits would outweigh the costs.

For further research the authors have several suggestions. With more resources and time the sample can be increased and more people from the companies could be interviewed, as representatives of the management for example. More detailed criteria could also be added. Another interesting path of research is quantifying the characteristics and looking for relations with some measure of quality as discussed in literature review. Quantitative research on the same population could look at the same issues from another perspective. Moreover, a comparison between listed and non-listed companies with similar characteristics could be done or future researches could try to find if the presence of an AC generates abnormal returns.

All in all the authors find that despite to the fact that ACs do partly comply with most of the better practice recommendations, there is place for improvement. Pursuing the enhancement of the flawed features of Latvian and Lithuanian ACs would improve the overall corporate governance situation in the respective companies. Given the return of confidence in financial markets, according to Berglund (2010), this could generate competitive advantage for local companies in the EU context.

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Appendices

Appendix A - Summary of Cadbury Committee report (Cadbury, 1992)

The committees should be constituted to ensure that they have clear links with the board to they are accountable for. Audit committees should have written charter that deal with the responsibilities, power and membership. The committee should normally meet twice a year

The committee should consist of at least three members. The membership should not be available to the executive directors of the company and the majority should be non - executive directors.

The external auditor should attend the committee meetings together with the finance director. Because the board is the one responsible for the reports it should also be allowed to attend the meetings. However, at least once a year the committee should meet the external auditors without the board's presence.

The committee should have the power to execute it's functions as stated in the charter and should have the necessary resources at hand. The committee should also have access to all the relevant information

The company should appoint duties to the committee according to the company's needs, however they should include recommending the board the services of an external auditors and their remuneration review of semi - annual and annual reports before submitting them to the board coordinating external auditors on the scope and nature of audits to be carried out review of external auditor's management letter committee should also review the internal control systems statement before it's approved by the board if a company has internal audit, the committee should ensure that the internal audit has sufficient power and resources. If such a department exists, it's head should attend committee's meetings the chairman of the committee should answer questions addresses at him at the Annual General Meeting.

The Committee should consist of people familiar with the functions it performs and also should be allowed to invite outside professionals.

Appendix B - Summary of Blue Ribbon Panel recommendations

(Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, 1999)

The New York Stock Exchange (NYSE) and the National association of Securities Dealers should adopt a definition of independence for audit committee members. “Members of the audit committee shall be considered independent if they have no relationship to the corporation that may interfere with the exercise of their independence from management and the corporation”.

The audit committee should consist only of independent directors.

The audit committee should consist of at least three directors and they all have to be financially literate, meaning that they have to be familiar with the financial reporting and financial accounting.

Audit Committees should have a written charter approved by the full board, that specifies, the responsibilities, duties, membership requirements and structure of the committee.

The reports from a company should include a statement whether the audit committee has a written charter and whether it has performed its duties to a satisfying extent according to the charter which is to be disclosed to the shareholders.

It should be specified in the charters of audit committees that the external auditor is responsible to the board of directors and audit committee and that the audit committee’s responsibility is to select and when necessary replace the external auditor.

The audit committee has to assure that the outside auditor is completely independent from the relevant company and that the external auditor’s objectivity is not challenged.

The Generally Accepted Auditing Standards should require that the outside auditor and the auditing committee discuss not only the legality or acceptability of the company’s accounting practices, but should also discuss the aggressiveness or conservatism of the company’s accounting principles and other underlying estimates.

The companies should include the following statements when submitting annual reports to the SEC: whether management together with the auditing committee has reviewed and discussed the report, including the content of the discussion about accounting principles employed whether the external auditors have discussed the judgments of the accounting principles’ quality with the audit committee whether the members of audit committee have discussed among themselves the information in the report and whether it is reliable whether the audit committee

believes that the information in the report is fairly presented and corresponds to the Generally Accepted Accounting Principles in all material respects.

The external auditors should perform a SAS 71 Interim Financial Review before the company files its Form 10-Q. Also the SAS 71 should be amended so that the external auditor has to discuss the matters described in AU Section 380 before filing the form 10-Q.

Appendix C - Vilnius Stock Exchange corporate governance guidelines
(The relevant part)

(NASDAQ OMX Vilnius, 2009)

4.14. Audit Committee.

4.14.1. Key functions of the audit committee should be the following:

- 1) Observe the integrity of the financial information provided by the company, in particular by reviewing the relevance and consistency of the accounting methods used by the company and its group (including the criteria for the consolidation of the accounts of companies in the group);
- 2) At least once a year review the systems of internal control and risk management to ensure that the key risks (inclusive of the risks in relation with compliance with existing laws and regulations) are properly identified, managed and reflected in the information provided;
- 3) Ensure the efficiency of the internal audit function, among other things, by making recommendations on the selection, appointment, reappointment and removal of the head of the internal audit department and on the budget of the department, and by monitoring the responsiveness of the management to its findings and recommendations. Should there be no internal audit authority in the company, the need for one should be reviewed at least annually;
- 4) Make recommendations to the collegial body related with selection, appointment, reappointment and removal of the external auditor (to be done by the general shareholders' meeting) and with the terms and conditions of his engagement. The committee should investigate situations that lead to a resignation of the audit company or auditor and make recommendations on required actions in such situations;
- 5) Monitor independence and impartiality of the external auditor, in particular by reviewing the audit company's compliance with applicable guidance relating to the rotation of audit partners, the level of fees paid by the company, and similar issues. In order to prevent occurrence of material conflicts of interest, the committee, based on the auditor's disclosed inter alia data on all remunerations paid by the company to the auditor and network, should at all times monitor nature and extent of the non-audit services. Having regard to the principals and guidelines established in the 16 May 2002 Commission Recommendation

2002/590/EC, the committee should determine and apply a formal policy establishing types of non-audit services that are (a) excluded, (b) permissible only after review by the committee, and (c) permissible without referral to the committee;

6) Review efficiency of the external audit process and responsiveness of management to recommendations made in the external auditor's management letter.

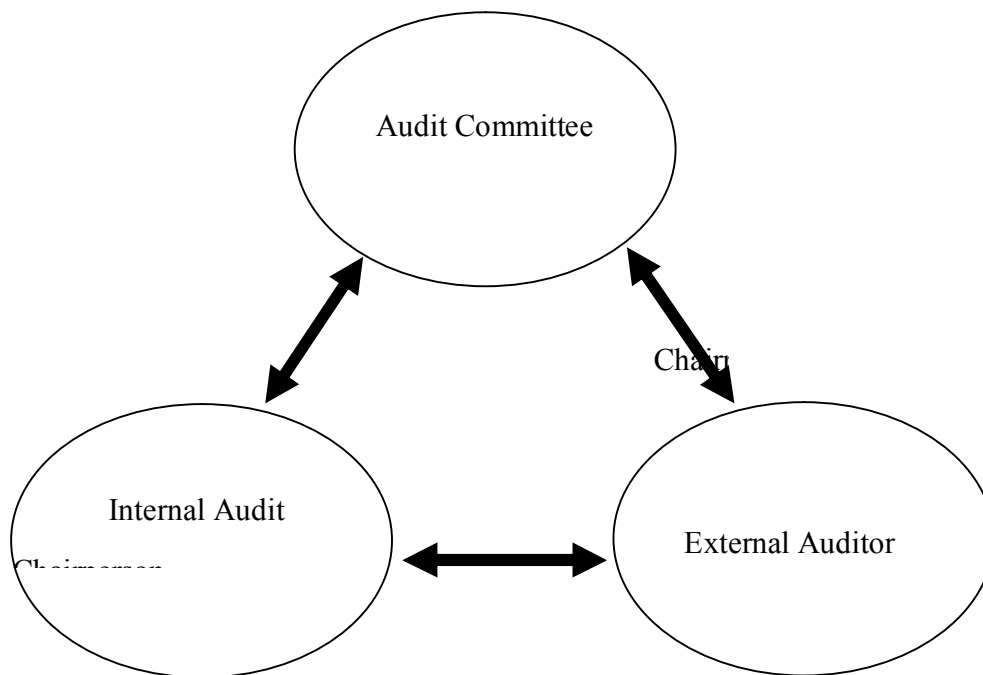


Figure 3 – Triangulation method. Source: made by authors

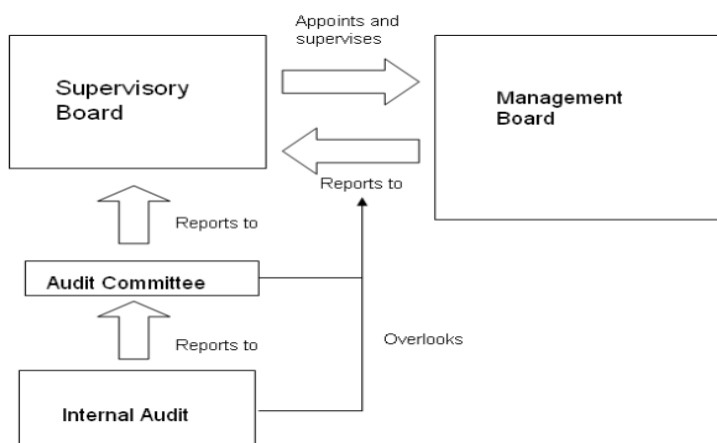


Figure 4 – Corporate Governance system. Source: made by authors

Appendix D - The Questionnaire for audit committee



RĪGAS EKONOMIKAS AUGSTSKOLA
STOCKHOLM SCHOOL OF ECONOMICS IN RIGA

B.Sc Thesis
Miks Miķelsons
Pēteris Miķelsons

Semi - structured interview (for the members of audit committee)

A general list of question and topics to be discussed

1. How long have you worked in the company?
2. What is your position in the company?
3. Does the audit committee have articles?
4. What are the duties of the members and the chairperson of the committee?
5. What power does the audit committee members and the chairperson have?
6. How many members are there in the audit committee?
7. What are the requirements / limitations to be elected to work in the audit committee?
8. How is the budget for the audit committee appropriated?
9. Does the audit committee discuss the accounting practices of the company?
10. Who has the biggest influence over choosing the external auditor?
11. What are the common topics discussed in audit committee meetings?
12. How would you describe interaction between the audit committee and the management.

It is preferred that the questions would not be discussed among colleagues.

Appendix E - The Questionnaire for internal auditor



RĪGAS EKONOMIKAS AUGSTSKOLA
STOCKHOLM SCHOOL OF ECONOMICS IN RIGA

B.Sc Thesis
Miks Miķelsons
Pēteris Miķelsons

Semi - structured interview (for the members of internal audit)

A general list of question and topics to be discussed

1. How long have you worked in the company?
2. What is your position in the company?
3. How would you describe your interaction with the audit committee?
4. If any, what are your responsibilities in respect to the audit committee?
5. What power does the audit committee members and the chairperson have ?
6. What are the requirements / limitations to be elected to work in the audit committee?
7. Do the internal auditors have official meetings with the audit committee?
8. Who has the most influence over the accounting practices?
10. Who has the biggest influence over choosing the external auditor?
11. How would you describe interaction between the audit committee and the management.

It is preferred that the questions would not be discussed among colleagues.

*Appendix F - The Questionnaire for external auditor***A General list of questions and topics to be discussed**

- How long have you worked in the company?
- What is your position in the company?
- What are the requirements / limitations to be appointed to the audit committee?
- What are the topics most often to be discussed with members of audit committees?
- How often do you meet with audit committees?
- Are the audited financial statements submitted firstly to the audit committee?
- How long have you worked as an external auditor for companies with audit committees?
- What power is given to the audit committees you have encountered?
- Do you believe that audit committees add value to the company?

Appendix G - Riga Stock Exchange Corporate Governance guidelines

(The relevant part)

(NASDAQ OMX Riga, 2009)

12. Audit Committee

The Audit Committee shall be established by a resolution of the Issuer's shareholders' meeting, and its operations and scope of responsibilities shall be set as guided by the legislation.

12.1 The functions and responsibility of the Audit Committee should be specified in the regulation of the committee or a comparable document.

12.2 To assure an efficient functioning of the Audit Committee, it is recommended that at least three of its members have adequate knowledge in accounting and financial reporting, because issues related to the Issuer's financial reports and control are in the focus of the

Audit Committee's operations.

12.3 All Audit Committee members shall have access to the information about the accounting principles practiced by the Issuer. Board shall advise the audit Committee as to the approaches to significant and unusual transactions, where alternative evaluations are possible, and shall ensure that the Audit Committee has access to all information that has been specified in the legislation.

12.4 The Issuer shall ensure that its officials, board members and staff release the information to the Audit Committee that is necessary for its operations. The Audit Committee should also be entitled to carry out an independent investigation in order to identify, within its scope, any violations in the Issuer' activities.

12.5 Within its scope, the Audit Committee shall adopt resolutions, and is accountable to the shareholders' meeting for its operations.

Appendix H - The Confidentiality Agreement

RĪGAS EKONOMIKAS AUGSTSKOLA
STOCKHOLM SCHOOL OF ECONOMICS IN RIGA

Stokholmo Aukštoji Ekonomikos Mokykla Rygoje ♦ Stockholmi Kõrgem Majanduskool Riias

Riga, January 11, 2010

Information for Bachelor Thesis

Students at the Stockholm School of Economics in Riga (SSE Riga) have just started working on theoretical and applied research to develop their bachelor thesis. In their bachelor thesis writing to support theoretical studies with practical applications, students should base their research on facts, surveys and interviews. Please, consider an opportunity for the SSE Riga students **Miks Miķelsons** and **Pēteris Miķelsons** to interview corresponding professionals at your company in order to collect qualitative data for their bachelor thesis on „Audit committee effectiveness: a qualitative study of Baltic listed companies.”

In accordance with the SSE Riga Regulations and procedures, the collected information will not be publicly disseminated or used for commercial purposes. If you require special confidentiality terms, for example, not to reveal the company name, etc., then it is subject to agreement between the students and the company.

If you have any further queries or clarifications related the particular bachelor thesis topic, please contact the authors:

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