

BEST PRACTICES REGARDING THE ORGANIZATION AND FUNCTIONING OF AUDIT COMMITTEES

**ADRIAN POPA, DRAGOȘ LAURENȚIU ZAHARIA,
ANI DUMITRACHE ***

ABSTRACT: *The article intends to identify best practices regarding the organization and functioning of audit committees in the corporate governance codes, listing requirements of stock exchanges and views of practitioners. The first section is dedicated to the establishment of audit committees, covering the size and composition of the committee and the content of its charter. The second section explains the main attributes of efficient audit committee members (independence, financial literacy and expertise) and the procedures for the nomination and induction of audit committee members. The conduct of meetings is presented in the third section. It also approaches issues such as meeting frequency and self-assessment of the committee's performances. The fourth section details the role and content of the reporting documents prepared by the committee. The last section summarizes the best practices expressed in previous sections.*

KEY WORDS: *audit committee; charter; corporate governance codes; financial reporting.*

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1. ESTABLISHMENT OF AUDIT COMMITTEES

Romanian legislation regulating the organization and functioning of audit committees is rather heterogeneous.

Company law no. 31/1990 provides that boards of directors can create consulting committees comprised of at least two members charged with performing investigations and elaborating recommendations for the board in areas such as audit, remuneration of directors, censors and staff or nominating persons for the board (art.

* *Ph.D. Student, Valahia University of Târgoviște, Romania*
Ph.D. Student, Valahia University of Târgoviște, Romania
Ph.D. Student, Valahia University of Târgoviște, Romania

140¹). Hence, in case of company law the establishment of audit committees appears as a recommendation not an imposition.

Law no. 672/2002 on internal public audit stipulates the obligation of establishing audit committees for central public institutions that carry out during a financial year a budget higher than RON 2 billion (art. 9).

Government Emergency Ordinance no. 90/2008 on statutory audit of annual financial statements and the consolidated annual financial statements and oversight of the accounting profession in the public interest provides that every entity of public interest must establish an audit committee (art. 47). The definitions section shows that entities of public interest are legal persons defined according to the accounting regulations.

According to *Government Emergency Ordinance no. 119/2011 regarding corporate governance of public enterprises*, audit committees are also required for autonomous companies (art. 10) and for state-owned companies (art. 34).

1.1. The resolution to establish the audit committee

The audit committee is constituted formally as a subcommittee of the board of directors. Therefore, it reports regularly and is responsible to the board. Most frequently, boards establish audit committees by board resolution.

According to Futter et al. (2002, p. 139), the board resolution should refer issues such as:

- the creation of the audit committee;
- the number of persons to serve on the audit committee;
- required qualifications for audit committee members;
- the procedure for appointing and replacing audit committee members;
- the duties and responsibilities of the audit committee;
- voting requirements and other requirements for actions by the audit committee;
- the power of the audit committee to retain counsel;
- the reports to be made to the board.

1.2. Size and composition of the audit committee

The corporate governance codes and reports¹ plead that the audit committees comprise a minimum of three members that should be non-executive independents, without setting an upper limit.

Following these recommendations, U.S. stock exchanges² have adopted as a listing condition the requirement that the audit committees of adherent companies be comprised of a minimum of three members.

¹ Treadway Commission (1987, pp. 182–183), Cadbury Report (1992, 4.35 (b)), Smith Guidance (2010, 2.3), King III (2009, Rec. 10), Financial Reporting Council (2010, C.3.1), Business Roundtable (2010, p. 19)

² NYSE (2009, §303A.07(a)); NASDAQ (2009, §5605(c)(2)(A)); AMEX (2008, §803(B)(2)(a))

The corporate governance code of Bucharest Stock Exchange (BSE) does not specify a certain value for the size of the audit committee, mentioning that 'it will be composed exclusively of non-executive directors and it should contain a sufficient number of independent directors' (BSE, 2008, Rec. 29).

Both Law no. 31/1990 (art. 140²(2)) and GEO no. 90/2008 (art. 47(1)) require that all audit committee members be non-executives and at least one must be independent.

The committee should be big enough in order for an equilibrium of opinions and expertise to be assured and small enough as to function efficiently.

Some authors, for example Bragg (2011, p. 121) or Ruppel (2006, p. 18), as well as the guidelines prepared by PricewaterhouseCoopers (2003, p. 20) and American Bar Association (2007, p. 61), consider that the optimal size for the audit committee is 3–5 members. Others, such as Burke et al. (2007, p. 7.01), indicate that, generally, audit committees are composed of 3–6 members.

Ruppel (2006, pp. 17–18) advocates for a number of three to five members, arguing that any figure greater than 5 will probably determine a decrease of the efficiency of the audit committee because the influence of every member would become too diluted and less than three members is not practical since this would generate voting problems.

The size of the audit committee, Burke et al. (2007, p. 7.01) show, is dependent upon the company and its culture, the responsibilities delegated to the committee by the board, board size and its members qualifications.

Regarding the number of members, 69% of the European companies surveyed by KPMG in 2010 answered that their audit committees have 3-4 members while 23% of them reported having 5-6 members. Small audit committees with 'up to 2 members' were found in Russia (18% of companies) and northern countries (16% in Netherlands and 13% in Denmark). Largest audit committees were identified in Austria, 13% of Austrian companies stating their audit committees have more than 8 members (KPMG, 2010, p. 9).

The Korn Ferry Institute found in a study conducted in 2007 that the audit committees of over 800 companies analyzed, scattered through Asia, Pacific, Europe and North America, were comprised, on average, of 4 members, all outside directors (Korn Ferry, 2008, p. 19).

1.3. Audit committee charter

Most corporate governance codes recommend that audit committees should function according to a charter³ and U.S. stock exchanges⁴ require listed companies to adopt a written charter that provides a clear understanding of the committee's role, structure, processes and membership requirements. In order to be made public, it should be posted on the company's website or attached to its annual report.

³ Cadbury Report (1992, 4.35(a)), Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (1999, Rec. 4 și 5), Codul King III (2009, 3.1.3), Financial Reporting Council (2010, C.3.2)

⁴ NYSE (2009, §303A.07 (b)); NASDAQ (2009, §5605(c)(1)); AMEX (2008, §803(B)(1))

The audit committee charter will generally contain the following elements (Ghiță, 2008, p. 323; Lowy, 2003, pp. 51-53; OAGNZ, 2008, pp. 25-26):

- the audit committee scope, the governance framework in which it activates, how it interacts with other governance mechanisms/ committees;
- authority (the power and authority the committee has in order to fulfill its objectives);
- composition (size, member attributes, how are they elected or reelected);
- duties and responsibilities;
- administrative issues (committee meetings, participation, decision making and voting mechanisms, provisions regarding conflict of interests, induction of new members);
- arrangements for self-assessment;
- periodic review of the charter.

Apart from satisfying the listing requirements, there is a series of practical reasons for using a charter (Ruppel, 2006, p. 15; Burke et al., 2007, p. 7.03):

- The board will know what functions the audit committee is assuming, which prevents any misunderstandings regarding the committee's role;
- It confirms the duties and responsibilities delegated to the committee by the board;
- Audit committee members will have a clear understanding of their responsibilities and what is expected from them;
- It allows the committee to compare its effective performances with its duties and responsibilities;
- It helps new audit committee members to better understand their role and responsibilities.

2. AUDIT COMMITTEE MEMBERS

2.1. Attributes of efficient audit committee members

Independence, expertise and financial knowledge represent essential attributes for audit committee members acknowledged by the corporate governance codes and required by listing provisions. All of these conditions will be detailed in the following subsections.

In addition, other attributes considered characteristics of efficient audit committee members, include (PwC, 2011a; PwC, 2011b, p. 19):

- extremely high level of integrity;
- an attitude of mind independent of the company's management;
- healthy skepticism;
- inquisitiveness and independent judgment – asking the right questions and appropriately interpreting the answers;
- an ability to give direct and honest opinions;
- courage to challenge the answers that don't appear right;

- an understanding of the business and its products;
- knowledge of the company's risks and controls;
- ability to offer new perspectives and constructive suggestions.

Burke et al. (2007, p. 8.01) summarize: 'To be an effective audit committee member, an individual should have certain characteristics. First, the individual should have a general understanding of the company's major economic, operating and financial risks. In addition, the individual should have a broad awareness of the interrelationship of the company's operations and its financial reporting, including risks and controls related to financial reporting. An inquiring attitude, independence, a high level of integrity, and sound judgment are essential for a person serving in this important capacity. Further, [...], an audit committee member should understand the difference between the oversight function of the audit committee and the decision-making function of management'.

2.1.1.1. Independence

Futter et al. (2002, p. 140) consider the requirement of independence extremely important in assuring the public that the audit committee can and will objectively review the management's performance. Further, they argue that assurance regarding the independence of the organization's auditors from management is greater if the audit committee is independent and the auditors are responsible to the audit committee.

The criteria recommended by listing requirements to determine whether a director (and implicitly an audit committee member) is independent varies slightly from one stock exchange to another⁵ but, as Futter et al. (2002, p. 141) note, incompatibilities impairing the independence of audit committee's members can be grouped in four major categories:

- employment by the organization;
- employment of a close relative;
- prior employment by the organization;
- substantial business relationships.

Law no. 31/1990 (art. 140²(2)) and GEO no. 90/2008 (art. 47(1)) require that at least one member of the audit committee must be independent.

From the 829 European companies that participated in the KPMG survey, only half of them declared that all their members can be considered independent, while 2% stated that their audit committees comprise of no independent member. Greatest occurrences of all-independent committees were identified in Netherlands (68%) and UK (58%) and the lowest in France, where only 10% of companies have fully independent audit committees (KPMG, 2010, p. 9).

Also, from a sample of 676 companies, 94% consider their financial experts to be independent (KPMG, 2010, p. 9).

⁵ See NYSE (2009, §303A.02); NASDAQ (2009, Rule 5605(c)(2)(A)); BSE (2009, Rec. 16)

2.1.2. Financial knowledge and expertise

NYSE Rule 303A.07 'Audit committee additional requirements' states that audit committees must consist of at least three individuals, all of whom must be financially literate (NYSE, 2009).

Similarly, NASDAQ Rule 5605 provides that audit committee members must 'be able to read and understand fundamental financial statements, including a Company's balance sheet, income statement, and cash flow statement. Additionally, each Company must certify that it has, and will continue to have, at least one member of the audit committee who has past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities' (NASDAQ, 2009).

Law no. 31/1990 (art. 140²(2)) and GEO no. 90/2008 (art. 47(1)) require that at least one member of the audit committee must have experience in applying accounting principles or in financial auditing.

2.1.3. Nominating a 'financial expert'

In addition to the requirement that all audit committee members be financially literate, the SEC requires companies that are USA registrants to disclose whether or not, and if not the reasons why, at least one audit committee member is a 'financial expert'.

It defines the financial expert as a person who has the following attributes:

- an understanding of generally accepted accounting principles and financial statements;
- the ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves;
- experience preparing, auditing, analyzing, or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the registrant's financial statements, or experience actively supervising one or more persons engaged in such activities;
- an understanding of internal controls and procedures for financial reporting;
- an understanding of audit committee functions.

The Commission suggests that companies should use the following guidelines in order to determine whether a person qualifies as a 'financial expert' (SEC, 2003):

- The level of the person's accounting or financial education, including whether the person has earned an advanced degree in finance or accounting;

- Whether the person is a certified public accountant, or the equivalent, in good standing, and the length of time that the person actively has practiced as a certified public accountant, or the equivalent;
- Whether the person is certified or otherwise identified as having accounting or financial experience by a recognized private body that establishes and administers standards in respect of such expertise, whether that person is in good standing with the recognized private body, and the length of time that the person has been actively certified or identified as having this expertise;
- The person's specific duties while serving as a public accountant, auditor, principal financial officer, controller, principal accounting officer or position involving the performance of similar functions;
- The level and amount of the person's direct experience reviewing, preparing, auditing or analyzing financial statements that must be included in reports filed under Section 13(a) or 15(d) of the SEA;
- The person's past or current membership on one or more audit committees of companies that, at the time the person held such membership, were required to file reports pursuant to Section 13(a) or 15(d) of the SEA;
- The person's level of familiarity and experience with the use and analysis of financial statements of public companies; and
- Whether the person has any other relevant qualifications or experience that would assist him or her in understanding and evaluating the registrant's financial statements and other financial information and to make knowledgeable and thorough inquiries whether:
 - The financial statements fairly present the financial condition, results of operations and cash flows of the company in accordance with generally accepted accounting principles; and
 - The financial statements and other financial information, taken together, fairly present the financial condition, results of operations and cash flows of the company.

Analyzing the aggregated answers of 710 European companies regarding the background of their financial experts, KPMG concluded that most of them come from positions of qualified accountant or auditor (55%), while 47% of them held positions such as CFO or Finance Director. Only 19% of them were CEOs (KPMG, 2010, p. 9).

2.2. Appointment of audit committee members

Smith Guidance (2010, 2.4) suggests that the appointments to the audit committee should be made by the board on the recommendation of the nomination committee (where there is one), in consultation with the audit committee chairman.

PwC (2011a, p. 85) highlights that the CEO should have limited involvement in selecting the committee members or its chairman, given the committee's key role in overseeing management judgments.

2.3. Tenure

The audit committee charter must provide fixed periods for members' mandate to assure their rotation over time. Periodic rotation of audit committee members strengthens independence and brings fresh perspectives.

Smith Guidance (2010, Rec. 2.5) considers that appointments should be for a period of up to three years, extendable by no more than two additional three-year periods, so long as members continue to be independent.

2.4. Induction of new members

Once their appointment is confirmed, it is important to provide new audit committee members with relevant background information regarding (PwC, 2011b, p. 33; Burke et al., 2007, p. 8.13; OAGNZ, 2008, pp. 22-23):

- *The company*: Products and services; Foreign and domestic operations; Key areas of risk and how they are managed; Statutory reporting and exchange listing requirements to which the company is subject; Financial and operational controls; Types of budget and management reports; Company's code of conduct and business behavior.
- *The audit committee*: The audit committee's charter; Nature and timing of reports prepared by management for the audit committee; Company staff available to support the audit committee; External advisers available to support the audit committee.
- *Management*: The background and qualifications of senior executives and financial management; Organization chart of reporting lines and responsibilities; The basis on which senior management is remunerated.
- *External auditors*: A copy of the current year's external audit engagement letter; The scope of the external audit, including the current year audit plan; The audit committee's relationship with the external auditor; The types and timing of reports issued by the external auditor; Company policy on engaging the auditor to provide audit and non-audit services.
- *Internal audit*: The responsibilities of the internal audit function; The number of internal auditors and their qualifications and experience; The audit committee's relationship with the internal audit department; The types of reports the audit committee receives from the internal audit department; The current year's internal audit plan.

2.5. The audit committee chairman

One of the audit committee members should be elected as chairman of the committee. Best practice calls for the audit committee chair to be an independent director and should not also be chairman of the board.

Ruppel (2006, pp. 27-28) identifies and discusses two situations: the audit committee members elect the chairman or the board designates the individual that can serve as board chairman. He opts in favor of the latter considering that, given the

rather small number of audit committee members, there are not enough voters to make the process meaningful, especially if more individuals are interested in the position. On the other hand, the board is more suitable to designate the chairman, since he will have an important role in coordinating and motivating the audit committee to execute its responsibilities given the board.

3. AUDIT COMMITTEE MEETINGS

3.1. Meeting frequency

The audit committee charter should mention the number of the meetings that the committee anticipates it will have during the year.

The Smith Guidance (2010, Rec. 2.6) recommends there should not be fewer than three meetings during the year, held to coincide with key dates within the financial reporting and audit cycle.

Recommendation 30 of the Corporate Governance of the BSE suggests audit committees should meet whenever necessary, but not fewer than two times, when it will deal with the half-yearly and yearly results (BSE, 2008).

The audit committees of the 1.146 European companies surveyed by KPMG organized, on average, a number of 6,8 meetings per year; the average length of those meetings was 3,1 hours. The greatest number of meetings was found in Russia (7,7) and the smallest in Austria (3,8).

The survey also shows that the average number of hours spent on board and audit committee matters is 51,8 hours. This includes travel time, the actual meeting and preparation for the meeting. According to the findings of this study, the longest periods of time dedicated to meeting preparation were allocated in the UK (98,2 hours on average) and Russia (79,1 hours on average) while the shortest were in France (only 14 hours on average) (KPMG, 2010, p. 10).

As for the audit committees of U.S. companies, they met 8,7 times on average in 2011, according to study conducted by Spencer Stuart (2011, p. 29).

3.2. Conduct of meetings

Only audit committee members are allowed to participate on the committee's meetings. They will determine whether other persons should attend a meeting or part of a meeting.

Provision 2.7 of the Smith Guidance (2010) explains that: 'No one other than the audit committee's chairman and members is entitled to be present at a meeting of the audit committee. It is for the audit committee to decide if non-members should attend for a particular meeting or a particular agenda item. It is to be expected that the external audit lead partner will be invited regularly to attend meetings as well as the finance director. Others may be invited to attend'.

The committee will conduct its meetings according to a *meeting agenda*. The agenda should be customized considering the committee's activities and the company's specific.

At the moment of their establishment, it is recommended that audit committees should design a less loaded agenda; as time passes and the committees become more experienced, their agendas can be supplemented by assuming new responsibilities.

To document the process followed in discharging their responsibilities and to capture highlights of important discussions and conclusions, audit committees should maintain a record of its activities conducted at its meetings. This is usually accomplished by keeping *minutes of meetings*.

Ruppel (2006, p. 26) notices that there is no unique style for preparing minutes. These vary among two extremes: 'some committees and organizations prefer minutes that summarize their activities at a very high level and may focus on formal resolutions or actions taken by the committee, rather than the discussions that preceded those actions or resolutions. At the other extreme, some audit committees' minutes provide an almost verbatim transcript of the discussions of the committee members, along with the committee's actions and resolutions'.

Regarding the content of the minutes, Burke et al. (2007, p. 15.05) advocate that an equilibrium has to be pursued: 'Minutes should be detailed enough to indicate the matters covered and decision reached, but should not contain exhaustive discussion of all the points that were considered at the meeting. That is, minutes should focus on documenting processes and conclusions and should not be transcripts of the discussions that took place'.

A practice used more often recently in audit committees' activity is starting the meeting *in camera* (i.e. in secret), attended only by committee members. Meetings can take other forms, during which the members meet only with certain persons. For example, the committee can have private sessions with the external auditor. Usually, these take place at the end of the meeting; the executives are asked to leave and the committee begins its dialogue with the external auditor. In some situations, the committee can also meet in camera with the chief of internal audit.

3.3. Assessment of audit committee's performance

Smith Guidance (2010, 3.3 & 3.4) acknowledges two forms of audit committee evaluations: a self-assessment performed within the audit committee and an evaluation performed by the board.

Usually, the assessments are accomplished by using questionnaires or interviews but they can be executed with the aid of an external evaluator.

4. AUDIT COMMITTEE REPORTING

Audit committees prepare three types of reporting documents:

- Reports on their current activities (meeting minutes) – covered in sec. 3.2;
- Annual report to the board;
- Annual report to shareholders.

4.1. Reporting to the board

Because the audit committee is a subcommittee of the board and is responsible to it, there are recommendations of corporate governance codes and listing requirements according to which the audit committee should report annually to the board about its activity.

According to a guideline prepared by Deloitte, the audit committee's report to the board should include the following (Deloitte, 2009):

- Assessment of whether external reporting is consistent with committee members' information and knowledge and is adequate for shareholder needs;
- Assessment of the management process supporting external reporting;
- Procedures for the selection and appointment of the external auditor and the rotation of external audit engagement partners;
- Recommendations for the appointment or removal of an auditor/ internal auditor;
- Assessment of the performance and independence of the external auditors and whether the audit committee is satisfied that independence of this function has been maintained with regard to the provision of non-audit services;
- Assessment of the performance and objectivity of the internal audit function;
- The results of its review of risk management, compliance and control systems.

The audit committee's report is important to the board for these reasons (Braiotta et al., 2010, p. 347):

- It communicates to the board financial, accounting, and auditing matters of particular interest that were noted in the audit directors' reviews and discussions with the internal and external auditing executives and the senior representatives of management, such as the chief financial officer.
- Their report not only contains an independent and objective appraisal of the audit functions but also provides assurance to the board that management is fulfilling its stewardship accountability to its outside constituencies, particularly the stockholders.
- The report calls the board's attention to nonfinancial accounting matters of significance, such as conflicts of interest and other general business practices

4.2. Reporting to shareholders

Rezaee (2007, p. 157) considers that a typical audit committee report should contain five sections with the following content:

- Section 1 – Describes the formation and composition of the audit committee.

- Section 2 – Describes the responsibilities of the company’s management, the independent auditor, and the audit committee pertaining to internal control over financial reporting and the preparation of financial statements.
- Section 3 – States that the audit committee has met with both the company’s management and the independent auditor to discuss the preparation of financial statements in conformity with GAAP and the performance of a financial audit in accordance with PCAOB auditing standards. This paragraph also explains the committee’s communication about accounting, auditing, and internal control issues with both management and the independent auditor.
- Section 4 – Addresses auditor independence, and states that the company’s independent auditor has provided to the audit committee the written disclosures required by the Independent Standard Board Standard No. 1 and has discussed auditor independence with the external auditor. This paragraph also describes provisions of non-audit services that are compatible with maintaining auditor independence.
- Section 5 – States that, based on the audit committee’s discussion with the company’s management and the independent auditor, the committee recommended that the board of directors include audited financial statements in its filings with the SEC on Form 10-K.

The Implementation Guidelines for the Corporate Governance Code of the Bucharest Stock Exchange recommends that companies should disseminate all important issues of their corporate governance policies (BSE, 2010, Rec. 3). In respect with their specialty commissions and committees they should circulate:

- Operating regulation/essential aspects of the Operating regulation of each commission/committee;
- A list containing the members of each commission/committee, indicating which is a member of the board;
- An activity report regarding the meetings of the commission/committee.

5. SUMMARY

- The optimal number of audit committee members, which grants the best results, is between 3 and 5;
- Audit committee members must be non-executive independents.
- At least one member of the audit committee must meet the criteria to be considered ‘financial expert’;
- The committee should meet at least four times a year, or whenever required by unexpected situations;
- Audit committee members should attend all meetings in person; participation via telephone should represent an exception, used only when members are constrained;

- Minutes should be prepared after each meeting of the audit committee. These have to be analyzed and approved by all members of the committee.
- The board should designate a member of the audit committee that will serve as chairman;
- Audit committee members should be appointed for fixed terms, generally of three years, with opportunity for reappointment;
- The audit committee should prepare an annual report of its activities and use the report to perform a review and evaluation of its activities for the preceding year;
- The audit committee should be authorized to hire outside counsel and other advisors to assist it in discharging its responsibilities.

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