AUDIT COMMITTEE COMPOSITION AND FUNCTIONING POST-ENRON

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Abstract

The role of audit committees is crucial in the financial reporting process. I studied a sample of 288 S&P 500 firms from the period 2000-2002 and 2008-2009 to identify changes in audit committee composition. I found that directors with *Audit/CPA* and *Accounting/Finance* experience are sought after and most firms continue to add audit committee financial experts to their audit committees; in many instances, such additions happen in companies that already have multiple audit committee financial experts. This suggests that although it is challenging to find audit committee financial experts it is not impossible as some critics may have suggested in the past when the definition of who is an audit committee financial expert was under debate. I also examined the frequency of audit committee meetings in 2000-2002 and 2008-2009. It was important to look at changes in audit committee meetings in the post-Enron period because companies were likely to revert to reducing costs and reduce audit committee meetings. However, I found that the number of audit committee meetings has continued to increase, contrary to concerns that audit committees would become less diligent with the passage of time.

The first decade of the 21st century has witnessed some dramatic events that have significantly altered the landscape of corporate governance. The Enron and WorldCom failures, along with the failure of the Big 5 audit firm of Arthur Andersen, led to the enactment of the Sarbanes-Oxley Act (SOX) (2002), which brought sweeping reforms in the corporate governance structure of U.S. publicly held companies. SOX is deemed to be one of the most significant legislative actions related to the regulation of public companies since the Securities and Exchange acts of 1933 and 1934. SOX (2002) tightened the rules for audit committees of public companies and strengthened their roles.

One of the important changes brought forth by SOX was requiring companies to disclose in their proxy statements if the audit committee had an audit committee financial expert. The definition of "audit committee financial expert" was very controversial. The initial Security and Exchange Commission (SEC) rule proposal was quite narrow, and following a storm of criticism the SEC changed the definition by relaxing the requirements. As discussed in more detail below, many critics suggested that it would be very difficult to obtain qualified audit committee directors, particularly those willing to be characterized as an audit committee financial expert. Given such arguments, I examined the evolving composition of audit committees for selected years during the period 2000 to 2009. I limited my data to selected years because all the audit committee characteristics were hand-collected. Specifically, I examined the number of directors on audit committees as well as the proportion of audit committee directors who could be characterized as audit committee financial experts.

I also focused on a second topic of interest to regulators and other good governance advocates. Given the intense media focus on corporate governance in general, and audit committees in particular, in the immediate aftermath of Enron and WorldCom, it was natural that there would be significant changes in the functioning of audit committees. However, would the changes persist once the "bright lights" of the media and legislators dimmed with the passage of time? In other words, were the changes that occurred post-Enron and WorldCom merely temporary blips, or more permanent? I examined this issue by focusing on the frequency of audit committee meetings.

BACKGROUND AND HYPOTHESES

Audit committees continue to be an important element of the corporate governance structure. Since the board of directors delegates the overseeing of the financial reporting process to audit committees, it must ensure that this duty is delegated to the right set of individuals. Since the passage of SOX (2002), there has been a lot of discussion with regard to composition and functioning of audit committees. During the period surrounding the enactment and implementation of SOX (2002), there was significant criticism from the business community that it would be hard to recruit directors to serve as audit committee members because of the increased risk and liability (Kirk 2000, Olson 1999).

The SEC's proposed definition of the term "financial expert" was as follows:

> "We proposed to define the term "financial expert" to mean a person who has, through education and experience as a public accountant, auditor, principal financial officer, controller or principal accounting officer, of a company that, at the time the person held such position, was required to file reports pursuant to Section 13(a) or 15(d) of the Exchange Act, or experience in one or more positions that involve the performance of similar functions (or that results, in the judgment of the company's board of directors, in the person's having similar expertise and experience),the following attributes:
>
> > (1)An understanding of generally accepted accounting principles and financial statements;
> >
> > (2) Experience applying such generally accepted accounting principles in connection with the accounting for estimates, accruals, and reserves

> that are generally comparable to the estimates, accruals and reserves, if any, used in the registrant's financial statements;
>
> (3) Experience preparing or auditing financial statements that present accounting issues that are generally comparable to those raised by the registrant's financial statements;
>
> (4) Experience with internal controls and procedures for financial reporting; and
>
> (5) An understanding of audit committee functions." SEC (2003b)

This definition elicited much criticism. For example, the Vice President and Controller of Aetna Inc. expressed his concerns stating that it is too "restrictive" and may result in some unfavorable consequences for public companies. He noted that the availability of qualified directors would be very difficult in specialized industries such as insurance, stating that, "we support disclosure of whether a financial expert serves on a company's audit committee. However, we are concerned that identifying, by name, the person that the board of directors has determined to be the financial expert serving on the company's audit committee may cause qualifying candidates to decline to serve, due to the actual or perceived additional risk of personal liability" (Aetna 2002).

The American Association of Bank Directors (AABD 2002) urged the SEC to expand the definition of a financial expert and noted that for many bank holding companies that are listed on NASDAQ, it is a burdensome task to persuade a qualifying person to serve as an audit committee financial expert because the task can be "overwhelming, if not impossible". The letter also noted that persons who are qualified to serve in such capacities may not agree to do so because of the increase in liability.

Similarly, another letter was sent to the SEC by Maine Bankers Association expressing similar concerns such as, lack of such experts within geographical limits and higher costs to recruit out of state directors. The President of Maine Bankers Association (2002) stated that, "a strict reading of the proposed definition would make it extremely unlikely that a financial expert, willing to serve on the Audit Committees of our registrant members, could be identified within the Companies' service areas, or in the entire State of Maine. The most likely candidates meeting the definition would be expensive, professional Board members from other regions of the United States."

The General Counsel of AmSouth Bancorporation urged the SEC to expand the definition of a financial expert because it would be difficult to find qualified candidates to fit the proposed definition of a financial expert. He noted that, "limiting candidates to those persons with experience in the same or similar industry would work a substantial hardship on many companies as they attempt to select persons who satisfy the 'financial expert' definition." (AmSouth Bancorporation 2002). He further expressed the concern that the proposed definition, "unnecessarily limits the universe of persons who might be effective members of an audit committee and who should qualify as financial experts. We are also concerned about the negative perceptions of investors resulting from disclosures that only one, or for many companies, none, of the directors on the audit committee can be deemed a financial expert under the Commission's definition."

In summary, there were several critics that vehemently opposed the proposed definition of a financial expert. A common theme of such criticism was that it would be very difficult to obtain qualified audit committee directors, particularly "audit committee financial experts." This lead to the following hypothesis (stated in the null form):

H_{01}: The number and proportion of audit committee financial experts did not change between 2000 and 2009.

Another issue related to audit committees that have attracted significant attention in recent years is diligence. It is not enough for an audit committee to exist; to be effective, it must be diligent. Prior researchers have focused on the frequency of audit committee meetings as a measure of diligence. This is perhaps because the number of meetings is the only publicly available data about the functioning of audit committees. DeZoort et al. (2002) summarize studies that examine diligence of audit committee members. Beasley et al. (2000) examined number of meetings of audit committee members and found that fraud companies met only once a year compared to no-fraud companies that met two or three times. Abbott et al. (2000) indicated that firms with audit committees that met at least twice per year had lesser instances of SEC sanctions.

Menon and Williams (1994) examined factors associated with frequency of audit committee meetings. One interpretation of audit committee meetings is that those that do not meet or meet only once are unlikely to be effective monitors of management. On the other hand, a higher frequency of audit committee meetings is a sign of the audit committee's diligence in effective monitoring of the financial reporting process. Their sample consists of 200 randomly selected over-the-counter firms that that have active audit committees for the period 1986-1987. The authors find that board composition has an impact on the frequency of audit committee meetings; as the proportion of outside directors on the board increases, the frequency of audit committee meetings increases. In addition, the results indicated that larger firms have more active audit committees.

Collier and Gregory (1999) used a sample of major UK companies listed on the London Stock Exchange. Their sample is gathered from the results of a survey by Collier (1992) who examined companies in the top 250 of the Times 1000 for 1989-1990. Their final sample consisted of 167 companies of which 142 were usable replies. They found that audit committee diligence (measured by audit committee activity) is positively associated with a high quality external auditor (Big Six). They also found that the CEO-Chair duality reduces audit committee meeting frequency. Collier and Gregory (1999) also showed that when the audit committee includes insiders such as executive directors, the frequency of audit committee meetings is lower.

Lapides et al. (2007) recommended that audit committee members must meet more frequently for an extended period of time and should have unrestricted access to information. Specifically, they recommended that face-to-face meetings should occur quarterly and each meeting should hold an executive session. They also recommend that the committee should meet in separate sessions of management, the external auditor, the internal auditor, legal counsel and other advisors.

Sharma et al. (2009) studied the determinants of audit committee meeting frequency in New Zealand, which had voluntary requirements for audit committee formation, composition and responsibilities. Their sample comprised of 96 firms that were listed on the main board of the NZX in fiscal 2004 and 2005. Their results showed that high-growth firms had fewer audit committee meetings, and firms with high managerial and institutional ownerships had more frequent audit committee meetings.

Raghunandan and Rama (2007) examined 319 firms with a December 31 fiscal year end in the S&P 600 index. They concentrated on small firms because large firms most likely had other governance mechanisms in place such as a larger analyst following. They found that the number of audit committee meetings increased with the higher proportion of accounting experts on the audit committee.

Raghunandan and Rama (2007) also state that, "it is an empirical question whether the frequency of audit committee meetings will increase, remain unchanged, or decrease as we move further away from the spotlight on audit committees in the immediate aftermath of Enron, WorldCom, and other failures that culminated in the enactment of SOX". I sought to answer this question, and therefore examined the changes in the frequency of audit committee meetings from 2000 to 2009. This lead to the following hypothesis (stated in the null form):

H_{02}: The number of audit committee meetings per year did not change between 2000 and 2009.

SAMPLE AND DATA

I began with a sample of S&P 500 firms as of December 31, 1999. I deleted firms that were not present in years 2000-2002 and 2008-2009. My final sample was comprised of 288 S&P firms that have publicly accessible proxy information for years 2000-2002 and 2008-2009. For each of these 288 firms, I collected audit committee member names, age, and tenure. I also collected the number of audit committee meetings each firm had in each of these years. I was able to collect changes in audit committee member composition by comparing audit reports of 2001 with 2000; 2002 with 2001; and 2009 with 2008. This provided me names of 'incoming' audit committee directors and 'outgoing' committee directors. By reading each proxy statement, I was able to collect biographical information for each incoming and outgoing director and identify their expertise as *Audit/CPA*, *Accounting/Finance* or *Other*. All the data for audit committee members was hand-collected as a result this data covers selected years 2000-2002 and 2008-2009. I understand that this may be a limitation of this paper.

RESULTS

Table 1 provides empirical evidence about the size of audit committees in various years. The data show that the average size of audit committees increased from 4.27 in fiscal year 2000 to 4.41 in 2001, and had a slight decrease to 4.38 in 2002. The average audit committee size was 4.47 and 4.55 in the fiscal year 2008 and 2009, respectively. The proportions in Table 1 also show that fewer companies have three or fewer audit committee members in 2009 than in 2000; in fact, there appears to be a steady decline in the percent of audit committees with three or fewer audit committee members during the period from 2000 to 2009. In addition, in the year 2000 there were 187 firms (64.93%) that had less than four directors on their audit committees. However, this number dropped steadily and only 153 firms (53.12%) had four or fewer directors in year 2009.

I also compared the number of audit committee members between 2000 and 2009. Because the sample firms are the same for both years, I used a paired-sample T-test and found that T= -3.19 (0.0016). The results indicated that the mean size of audit committees differ significantly between 2000 and 2009. These results suggest that audit committees have increased in size over the years. This evidence is at variance with suggestions from many critics, who suggested, that it would become harder to find directors willing to serve on audit committees.

Table 2 provides descriptive evidence about changes in audit committee composition across the years examined. One notable feature is that a much higher proportion of firms experienced no changes in audit committee composition in 2008-09, compared to the turbulent period of 2001-02; it is also interesting to note that the number of firms with no changes in 2008-09 is significantly more than the number of such firms in 2000-01.

In Table 3, I provide an overview of incoming audit committee directors who possess audit and accounting expertise. My data examines changes in audit committee composition for the years 2000-2002 and 2008-2009. Since there was no SEC rule regarding experts on audit committees in years 2000-2002, I used the following definition to describe an *Audit/CPA* expert, *Accounting/Finance* expert and *Other* expert. Directors who had auditing/CPA experience were *Audit/CPA* expert; Directors who had experience in accounting and/or finance such as Controller, VP-Finance were *Accounting/Finance* experts and those that did not fit in these two categories were *Other* experts.

The data showed that the proportion of *Audit/CPA* and *Accounting/Finance* type of experts accounted for 20.5 percent of incoming experts in 2001, and 25.5 percent in 2002; in contrast, these two types of experts accounted for 41.3 percent of the incoming experts in 2008-09. A chi-square test rejects the null hypothesis of no difference across the years (Chi-sq = 22.1, d.f. = 4, p <.001). These results are again contrary to the concerns voiced by the critics at the time SOX was being debated in Congress, and later when the SEC was implementing the rules pursuant to SOX.

In Table 4, I partition my sample based on strength of audit committees prior to the appointment of a new director. Similar to Defond et al. (2005), I combined *Audit/CPA* and *Accounting/Finance* categories into one single group. In the year preceding SOX (2002), there was no requirement of a financial expert on the audit committee; therefore there were no designated 'audit committee financial experts' in the years 2000-2002. Hence, I used my own judgment and relied on prior literature to define the category of accounting experts. I conducted univariate analysis and found that an audit committee that lacked experts (zero experts on the audit committee before appointment) was more likely to appoint directors without accounting expertise.

In the years 2008-2009, six years after the advent of SOX (2002), not surprisingly, I had just one audit committee that had zero experts on its audit committee prior to a new appointment. This is in striking contrast with the number of firms that had no such experts in 2001 or 2002. Interestingly, audit committee accounting experts appeared to be more likely to be appointed in firms that already had more than two such experts on the committee.

In Table 3, I divided the incoming and outgoing audit committee financial experts into the following three categories: *Audit/CPA*, *Accounting/Finance* and *Other*. I found that there was a significant increase in the number of *Accounting/Finance* experts. Approximately 34 percent of the incoming directors in fiscal year 2009 were *Accounting/Finance* experts compared to *Audit/CPA* experts who constituted only 7 percent of the incoming members. The interesting part here is that many of those not formally classified as an "audit committee financial expert" by the company had qualifications which enabled me to classify them as *Audit/CPA* or *Accounting/Finance* experts. Why, then, do the firms resist to classifying such a director as an "audit committee financial expert?" This is an interesting question for future research.

Audit Committee Meetings

Table 6 provides empirical evidence about the number of audit committee meetings for each of the years 2000-2002 and 2008-2009. The results show an increase in the number of meetings from 2000 to 2001; however, since I do not know the exact dates of the meetings, and since the Enron problems came to light in October of 2001, I cannot rule out the possibility that some of the increase in audit committee meetings occurred in late 2001.

The results show a dramatic increase in the number of audit committee meetings in 2002. The mean number of audit committee meetings jumped from 5.09 in 2001 to 7.36 in 2002. The differences are indeed striking: only 17 of the 288 firms had less than four meetings in 2002, compared to 58 firms in 2001 and 88 firms in 2000. Both a T-test and a chi-square test rejected the null hypothesis of no difference in the frequency of meetings across the three years, 2000 to 2002. Such empirical evidence supports claims made in both prior academic research and in the popular press that audit committees have become more diligent in the aftermath of the Enron, WorldCom and Andersen failures.

More interesting is to observe the number of audit committee meetings in 2008 and 2009. The results do not support the conjecture that once the bright lights of the media faded with the passage of time, audit committees would revert back to how they were prior to SOX. In fact, the average number of meetings is more in 2008 than in 2002 (8.74 versus 7.36). A paired T-test rejects the null hypothesis of no difference in favor of the alternative that the meetings are more frequent in 2008 ($p < .05$). However, there is no significant difference in the number of audit committee meetings between 2008 and 2009. Taken together, my data enabled me to answer the question posed in Raghunandan and Rama (2007), namely, whether the frequency of audit committee meetings would increase, remain unchanged, or decrease as we moved further away from the spotlight on audit committees in the immediate aftermath of Enron, WorldCom, and other failures that culminated in the enactment of SOX. The answer is that the frequency of audit committee meetings appears to have increased significantly as we move further away from the 2001-2002 period.

SUMMARY AND CONCLUSION

Audit committees have long been an important element in the corporate governance framework. The SEC has long promoted the formation of independent audit committees that would be diligent in providing oversight of the financial reporting process. Starting from around 1998, the pace of regulatory, legislative and private sector initiatives related to audit committees has quickened. Such activities culminated in the enactment of the Sarbanes-Oxley Act in 2002. Multiple sections of SOX deal with the composition and functioning of audit committees. Yet, there has been very little published research related to the appointment and departures of audit committee directors.

In the aftermath of Enron, as Congress was debating the Sarbanes-Oxley Act, there were many critics who expressed fears that the requirements of SOX would make it difficult to hire of individuals with the necessary expertise to serve as audit committee members. There is little empirical evidence to support—or, refute—such assertions. In this paper, I analyzed the change in audit committees several years after Enron and passage of SOX. I found that directors with *Audit/CPA* and *Accounting/Finance* experience are sought after and most firms continue to add audit committee financial experts to their audit committees; in many instances, such additions happen in companies that already have multiple audit committee financial experts. Hence, the evidence does not appear to support the claims of critics who submitted to the SEC that SOX related requirements would make it difficult to find audit committee financial experts willing to serve on audit committees. In this paper, I also examined the frequency of audit committee meetings in 2000-2002 and 2008-2009. While prior research has noted that the frequency of audit committee meetings increased in the immediate aftermath of SOX, researchers and others have questioned whether audit committee behavior would revert back once the “bright lights” associated with the Enron and Andersen failures dimmed. However, I found that the number of audit committee meetings has continued to increase, contrary to concerns that audit committees would become less diligent with the passage of time.

As with empirical research in general, my study is subject to some limitations. My sample is restricted to US firms. It is not clear if similar results would be obtained in other countries, given significant differences in governance mechanisms. These limitations also represent avenues for further research.

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Table 1
Audit Committee (AC): Size
(n=288)

Number of AC Members	2000	2001	2002	2008	2009
Only 2	9 (3.1%)	2 (0.7%)	2 (0.7%)	0 (0.0%)	0 (0.00%)
Only 3	89 (30.9%)	80 (27.8%)	76 (26.4%)	60 (20.8%)	51 (17.7%)
Only 4	89 (30.9%)	91 (31.6%)	96 (33.3%)	98 (34.0%)	102 (35.4%)
Only 5	50 (17.4%)	65 (22.6%)	67 (23.3%)	84 (29.2%)	85 (29.5%)
6 or more	51 (17.7%)	50 (17.4%)	47 (16.3%)	46 (16.0%)	50 (17.4%)
Total Number of AC Members	1230	1270	1262	1287	1309
Average Size of AC	4.27	4.41	4.38	4.47	4.55

Note: The sample includes 288 S&P 500 firms with a December 31 fiscal year end and with all available data for the fiscal years 2000-2002 and 2008-2009. Each cell indicates the number of firms with percentage in parentheses.

Table 2
Changes in Audit Committee Composition

Year	0,0	-1,+1	-2,+2	-1,0	0,+1	Other	Total
2000-2001	119 (41.3%)	44 (15.3%)	11 (3.8%)	29 (10.1%)	42 (14.6%)	43 14.9%)	288
2001-2002	101 (35.1%)	56 (19.4%)	15 (5.2%)	27 (9.4%)	40 (13.9%)	49 (17.0%)	288
2008-2009	160 (55.5%)	29 (10.1%)	5 (1.7%)	28 (9.7%)	33 (11.5%)	33 (11.5%)	288

Note: The sample includes 288 S&P 500 firms with a December 31 fiscal year end and with all available data for the fiscal years 2000-2002 and 2008-2009. Each cell indicates the number of firms for each type of change in audit committee composition, where X, Y indicates that the number of outgoing and incoming directors were X and Y respectively. Thus, for example, the -1, 1 cell for 2000-2001 indicates that between years 2000-2001, there were 44 cases where there was one outgoing member and one incoming member. The number in parentheses is the percentage of firms out of 288.

Table 3
Changes in Audit Committee Composition by Type of Director

Panel A: Directors with Accounting and Finance Experience Incoming)

Year	Audit/CPA	Accounting/Finance	Other	Total
2000-2001	8 (4.1%)	32 (16.4%)	155 (79.5%)	195
2001-2002	18 (8.7%)	37 (17.8%)	153 (73.5%)	208
2008-2009	10 (7.2%)	47 (34.1%)	81 (58.7%)	138

Panel B: Directors with Accounting and Finance Experience (Outgoing)

Year	Audit/CPA	Accounting/Finance	Other	Total
2000-2001	3 (2.0%)	14 (9.0%)	138 (89.0%)	155
2001-2002	4 (1.8%)	38 (17.6%)	174 (80.6%)	216
2008-2009	8 (6.9%)	26 (22.4%)	82 (70.7%)	116

Note: In this table, I present the number of directors (incoming and outgoing) and their expertise. The sample includes 288 S&P 500 firms with a December 31 fiscal year end and with all available data for the fiscal years 2000-2002 and 2008-2009.

Table 4
Strength of Audit Committee before Appointment of New Director

Year	Number of Experts on Audit Committee before Appointment	Number of Firms (Number of Directors)	Number of Directors with Accounting Expertise	Number of Directors without Accounting Expertise
2000-01 (n=138)	0	77 (113)	23	90
	1	37 (53)	12	41
	2	19 (23)	5	18
	3 or more	5 (6)	0	6
2001-02 (n=155)	0	68 (96)	24	72
	1	60 (79)	21	58
	2	19 (23)	8	15
	3 or more	8 (10)	2	8
2008-09 (n=98)	0	1 (1)	0	1
	1	31 (41)	11	30
	2	32 (50)	28	22
	3 or more	34 (46)	30	16

Note: The sample includes 288 S&P 500 firms with a December 31 fiscal year end and with all available data for the fiscal years 2000-2002 and 2008-2009.

Table 5
Changes in Audit Committee Financial Experts (Year 2008-2009)

	Audit Committee Financial Expert (n=69)			**NOT Audit Committee Financial Expert (n=69)**		
Incoming Directors (n=138)	Audit/ CPA	Account / Finance	Other	Audit/ CPA	Account / Finance	Other
	7 (10.1%)	35 (50.8%)	27 (39.1%)	3 (4.3%)	12 (17.4%)	54 (78.3%)
	Audit Committee Financial Expert (n=57)			**NOT Audit Committee Financial Expert (n=59)**		
Outgoing Directors (n=116)	Audit/ CPA	Account / Finance	Other	Audit/ CPA	Account / Finance	Other
	7 (12.3%)	17 (29.8%)	33 (57.9%)	1 (1.7%)	9 (15.3%)	49 (83.0%)

Note: The sample includes 288 S&P 500 firms with a December 31 fiscal year end, and with all available data for the fiscal years 2000-2002 and 2008-2009.The above table reflects the number (and type) of incoming and outgoing audit committee directors.

Table 6
Audit Committee: Number of Meetings
(n=288)

Number of AC Meetings	2000	2001	2002	2008	2009
< 4	88 (30.6%)	58 (20.1%)	17 (5.9%)	1 (0.3%)	0 (0.00%)
4-8	187 (64.9%)	213 (74.0%)	187 (64.9%)	140 (48.6%)	145 (50.3%)
9-12	13 (4.5%)	14 (4.9%)	73 (25.4%)	123 (42.7%)	119 (41.3%)
12 or more	0 (0.0%)	3 (1.0%)	11 (3.8%)	24 (8.4%)	24 (8.4%)
Average	4.50	5.09	7.36	8.74	8.64

Note: The sample includes 288 S&P 500 firms with a December 31 fiscal year end and with all available data for the fiscal years 2000-2002 and 2008-2009. Each cell indicates the number (percentage) of firms with the specified number of audit committee meetings during that year.