WHAT DISTINGUISHES AUDIT COMMITTEE FINANCIAL EXPERTS FROM OTHER AUDIT COMMITTEE MEMBERS?

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ABSTRACT

Since 2003, public companies have been required to disclose whether any "financial experts" serve on their audit committees. Almost immediately after the implementation of this requirement, researchers have investigated the characteristics of those designated as financial expert. A limitation of much of this research has been its focus on financial experts only, to the exclusion of other audit committee members. Although the characteristics of audit committee financial experts may be better known, the extent to which they differ from non-experts has been largely unaddressed.

This study extends prior research by investigating which factors distinguish financial experts from others on the audit committee. The backgrounds of 766 audit committee members of 200 public companies are examined. A logistic regression model reveals that experience as a CEO or CFO, professional certification such as a CPA, and service on the audit committees of other boards all significantly increase the probability of being designated a financial expert. Although small and large sample firms appear to value different attributes in selecting audit committee members, the only difference observed in their naming of financial experts was experience as CEO, which was not significant for small firms.

INTRODUCTION

The Sarbanes-Oxley Act of 2002 (SOX) greatly altered the landscape of corporate governance. In addition to more familiar sections of the Act dealing with issues such as internal control, Section 407 of SOX required the Securities and Exchange Commission (SEC) to implement a rule requiring firms to disclose whether their audit committees included at least one "financial expert." Although there was no explicit requirement that firms have such an expert, any public company lacking one would be required to explain the reasons why.

Researchers have since documented the importance of financial experts in the financial reporting process. Krishnan (2005) found fewer internal control problems among firms whose audit committees had more financial expertise. Similar findings were reported by Mustafa and Youssef (2010), who discovered a negative correlation between asset misappropriation and audit committee financial expertise. Bedard, Chtourou, and Courteau (2004) found that the presence of a financial expert on the audit committee reduced aggressive earnings management by firms. Barua, Rama, and Sharma (2010) observed that firms with an expert on the audit committee tended to spend less on their internal audit function, suggesting the existence of substitution effects between audit committee financial expertise and investment in internal auditing.

Given the important role played by financial experts, an understanding of the characteristics of those audit committee members selected to serve as experts is critical. Most prior research (e.g. Williams, 2005) into this issue has examined the background of those designated as financial experts by their firms. Although yielding valuable insights, this approach overlooks audit committee members *not* designated as experts. This leaves largely unaddressed the important question of which director attributes are significant in the decision to name an audit committee member as an expert. What characteristics distinguish experts from non-experts? This study seeks to address this concern and extends prior research by examining both financial experts *and* audit committee members who are not so designated. Only by including both experts and non-experts in the analysis can distinctions between the two be drawn. Sample subsets of large and small firms are also analyzed separately to ascertain the impact of firm size on the financial expert designation.

The remainder of the paper is divided into four sections. The first section discusses the SEC rule regarding audit committee financial experts and reviews some selected research into the characteristics of those selected as experts. The second section discusses factors that might affect the financial expert designation decision and presents a logistic regression model to test them. Data selection and results are described in the third section. The paper closes with a summary and discussion of the results.

THE SEC RULES AND PRIOR RESEARCH

In their Final Rules, the SEC (2003) defined the attributes of an audit committee financial expert and described the experiences that might enable a person to attain those 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; and*
- *An understanding of audit committee functions.*

Under the final rules, a person must have acquired such attributes through any one or more of the following:

(1) Education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor or experience in one or more positions that involve the performance of similar functions;

(2) Experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions;

(3) Experience overseeing or assessing the performance of companies or public accountants with

respect to the preparation, auditing or evaluation of financial statements; or

(4) Other relevant experience.

Shortly after the implementation of these rules, researchers began investigating the characteristics of audit committee financial experts. Williams (2005) found that the most common (47.9%) expert characteristic was experience as a CEO. Explicitly financial backgrounds such as CFO experience (13.3%) and CPA certification (16.4%) were much less common. She also found differences between large and small firms in the backgrounds of their financial experts.

Carcello, Hollingsworth, and Neal (2006) also examined financial expert characteristics. They found that 69% of audit committee financial experts had CEO experience, while CFO experience was noted for only 20% of their sample. Another 12% had auditing experience.

A limitation of these lines of research is their exclusive focus on those already designated as financial experts. Other members of the audit committee may have CEO experience or be CPAs, yet are not named financial experts. One of the few studies to investigate the characteristics distinguishing those designated as financial experts from those not so named is Iyer, Bamber, and Griffin (2013). They found that accounting certification and service on other audit committees were positively associated with being named a financial expert, while prior CEO experience was negatively associated with such a designation.

Iyer et al. (2013) based their findings on the self-reported characteristics of 167 survey respondents. They did not address the effects of firm size on their results. This study extends their research in two ways. First, the analysis is based on the publicly available information of 766 audit committee members of 200 public companies. Second, the data are examined separately for both the large and small firms in the sample.

FACTORS AFFECTING THE FINANCIAL EXPERT DESIGNATION

The SEC rules delineating the qualities and experiences needed to be an audit committee financial expert provide some guidance about the factors that would increase the likelihood of a director being named an expert. Prior or current experience as a company CEO should meet the criterion regarding "experience overseeing . . . the performance of companies." Surprisingly, however, Iyer et al. (2013) found that CEO experience *reduced* the chances of being designated an expert.

"(E)xperience overseeing . . . the performance of companies" could be extended to other attributes. Directors actively serving on more than one board committee may gain a more in-depth knowledge of their firm's operations that would enhance their value as financial experts. Similarly, directors serving on the boards of other firms might be able to bring that experience to a company and so qualify as financial experts. This rationale would be even stronger if a director also served on the audit committee of another firm.

The SEC also states that "education and experience as a principal financial officer, . . . public accountant or auditor" would be a qualification for serving as a financial expert. Thus audit committee members with experience as CFOs would be strong candidates to serve as financial experts. Also, CPAs and holders of other professional certifications would appear to easily meet this criterion.

Finally, The SEC cites having “other relevant experience” as a path to qualify as a financial expert. Rather than speculate about the potential backgrounds that might satisfy this criterion, it may be assumed that older directors would have had more opportunities to gain such experience. Similarly, directors with more years of experience serving on the board might use that background to qualify as an expert.

Based on the above, the following logistic regression model was formulated:

Expert = *f*(CEO, CFO, Certification, Other Comm, Other Boards, Other AC, Age, Tenure)

where:

Expert	= 1 if the audit committee member has been designated as an financial expert, else 0.
CEO	= 1 if the audit committee member has current or prior experience as a CEO of a company, else 0.
CFO	= 1 if the audit committee member has current or prior experience as a CFO of a company, else 0.
Certification	= 1 if the audit committee member has a CPA/CIA/CMA certification, else 0.
Other Comm	= 1 if the audit committee member serves on other committees of the firm’s board, else 0.
Other Board	= 1 if the audit committee member serves on the boards of any other publicly held firms, else 0.
Other AC	= 1 if the audit committee member serves on the audit committees of any other publicly held firms, else 0.
Age	= the age of the audit committee member.
Tenure	= the number of years the audit committee member has served on the firm’s board.

A random sample of 100 firms was drawn from companies included in the S&P 500 Index. To provide a comparison with smaller firms, another 100 companies were randomly selected from the Russell Microcap Index, an index designed to track the smallest publicly traded companies in the United States. Information regarding each firm's audit committee members was obtained each firm's most recent proxy statement available as of January 2014. Where necessary, additional data about audit committee member backgrounds were obtained from publicly available online sources, such as *Businessweek* or *Forbes*. Data were obtained for 766 audit committee members. Of this number, 412 had been designated as financial experts by their firms.

Selected descriptive information about the sample's audit committees and number of experts is provided in Table 1. The average audit committee has 3.90 members. Audit committees of S&P 500 firms were somewhat larger (4.45 members) than were those of Microcap firms (3.35 members). The larger size of S&P audit committees appears to provide them the opportunity to designate more financial experts (2.73) than their Microcap counterparts (1.43). As Table 1 indicates, S&P firms are also more likely to name multiple financial experts – 72 of the 100 sample S&P companies have more than one financial expert, while 72 of the 100 sample Microcap firms have only one designated expert. Only two firms, both Microcap companies, did not designate any of their audit committee members as financial experts.

Table 1
AUDIT COMMITTEES AND FINANCIAL EXPERTS

	Total	S&P 500	Microcap
Audit Committee Size:			
Mean	3.90	4.45	3.35
Max	9	9	6
Min	1	3	1
Financial Experts:			
Mean # of Experts	2.08	2.73	1.43
firms with 0 experts	2	0	2
firms with 1 expert	100	28	72
firms with 2 expert	31	20	11
firms with 3 expert	30	19	11
firms with >3 experts	37	33	4

Table 2 provides a summary of the frequency with which the model variables appear in the sample. As the Table indicates, approximately 42% of audit committee members have experience as a CEO. Interestingly, S&P 500 firms are significantly more likely to utilize audit committee members with CEO experience than are Microcap firms.

For the sample as a whole, 24% of audit committee members had experience as CFOs. Approximately 18% of sample directors had CPA/CMA/CIA certification. Audit committee members of Microcap firms were significantly more likely to be certified than were those of S&P 500 companies. Table 2 makes clear that service on multiple board committees is the norm for corporate directors, as over 88% were on at least one other committee in addition to their audit committee service. A significant disparity was observed in the percentage of audit committee members serving on other corporate boards – 62.4% of S&P 500 directors were currently serving on at least one other board, compared to only 27.8% of Microcap directors. This difference extended to service on other audit committees, with S&P 500 audit committee members reporting significantly more such activity than their Microcap counterparts. Finally, S&P 500 audit committee members were slightly but significantly older than Microcap directors, although there was no significant difference in years of service on the board. In total, Table 2 provides evidence that audit committee members of large firms have significantly different characteristics than do those of smaller firms.

Table 2
MODEL VARIABLES

		Total (n=766)	S&P 500 (n=431)	Microcap (n=335)
CEO	#	323	212	111
	%	42.2%	49.2%	33.1%***
CFO	#	184	102	82
	%	24.0%	23.7%	24.5%
Certification	#	135	57	78
	%	17.6%	13.2%	23.3%***
Other Comm	#	675	391	284
	%	88.1%	90.7%	84.8%**
Other Board	#	362	269	93
	%	47.3%	62.4%	27.8%***
Other AC	#	247	179	68
	%	32.2%	41.5%	20.3%***
Age (years)	Mean	62.4	63.1	61.5**
	Min	30.0	30.0	34.0
	Max	86.0	84.0	86.0
Tenure (years)	Mean	8.2	8.29	8.09
	Min	1.0	1.0	1.0
	Max	43.0	42.0	43.0

***Difference between S&P 500 and Microcap firms significant at *p <.01*

**Difference between S&P 500 and Microcap firms significant at *p <.05*

Results of the logistic regression model are presented in Table 3. The regression model was estimated for the sample as a whole and then separately for S&P 500 and Microcap firms. For all three model estimations, the models were significant (p=.000) with classification accuracy ranging from 68.4% to 74.6%.

For the sample as a whole, experience as a CEO was significantly associated with the probability of being named a financial expert. This result appears to be driven entirely by S&P 500 firms, as the variable was not close to significance (p=.693) among Microcap companies.

Consistent with prior research, audit committee members with CPA/CMA/CIA certification or with experience as a CFO were significantly more likely to be designated as financial experts, while service on other board committees appeared to play no significant role.

Table 3
LOGISTIC REGRESSION RESULTS

Expert = f(CEO, CFO, Certification, Other Comm, Other Board, Other AC, Age, Tenure)

	Full Sample			S&P 500 Firms			Microcap Firms		
	Coeff.	Wald	Sig	Coeff.	Wald	Sig	Coeff.	Wald	Sig
Intercept	16.807	0.37	.543	60.194	2.23	.135	-37.828	0.77	.378
CEO	0.446	7.14	***.008***	0.674	9.32	***.002***	-0.110	0.15	.693
CFO	1.333	37.31	***.000***	1.409	20.85	***.000***	1.169	13.17	***.000***
Certification	1.858	44.56	***.000***	1.585	12.89	***.000***	2.202	37.40	***.000***
Other Comm	-0.271	1.00	.317	-0.433	1.11	.291	-0.117	0.09	.759
Other Board	0.411	3.06	.080	0.261	0.77	.380	-0.218	0.17	.676
Other AC	0.723	8.65	***.003***	0.681	5.70	***.017***	1.304	5.30	***.021***
Age	0.007	0.45	.501	-0.001	0.00	.972	0.008	0.28	.595
Tenure	0.009	0.43	.509	0.030	2.32	.128	-0.018	0.77	.378
Model χ^2		164.92	***.000***		71.74	***.000***		100.19	***.000***
Nagelkerke R^2		0.26			0.21			0.35	
Classification accuracy		69.3%			68.4%			74.6%	

Audit committee members serving on more than one board of directors were no more or less likely to be considered financial experts. However service on the audit committees of other boards was significantly and positively associated with the probability of being named a financial expert. Finally, director age and tenure were not significant variables in the models. The results from Table 3 indicate that, although the audit committee members of S&P 500 and Microcap firms may have different characteristics, there is a great deal of similarity in the factors leading to designation as a financial expert.

SUMMARY AND CONCLUSIONS

This study identified characteristics of audit committee members that would lead their boards of directors to designate them as financial experts. A logistic regression model was estimated, using a sample of 200 firms, half drawn from the S&P 500 and half from the Russell Microcap Index.

The results revealed that some factors play an insignificant role in the decision to name someone a financial expert. Characteristics such as age and tenure were not significant in the model. A director’s service on other committees or on other boards also did not influence the financial expert decision. However, service on other audit committees did positively increase the chances of being named a financial expert.

The two factors that were most significant in determining if someone were named a financial expert were certification as a CPA/CMA/CIA and experience as a CFO. The results also indicated that experience as a CEO significantly increased the probability of being designated a financial expert. This result runs counter to the finding reported by Iyer et al. (2013), and, surprisingly, held for only the S&P 500 firms in the sample. Service as a CEO appeared to play no role in naming financial experts for Microcap firms.

Although several prior studies have profiled the characteristics of audit committee financial experts, their focus has been primarily on only the experts themselves. The characteristics of audit committee non-experts have not been included in the analyses, leaving any distinctions between the two groups unaddressed. This study contributes to the literature and extends prior research by examining all audit committee members, both expert and non-expert. This allows identification of the characteristics distinguishing financial experts from other audit committee members.

The results of this study provide evidence that the factors significantly associated with financial expert designation (Certification, CFO or CEO experience, service on other audit committees) track with the qualities and experiences established by the SEC when the rules regarding financial experts were issued in 2003. Other characteristics less directly linked to SEC guidance (Age, Tenure) did not play a significant role. In making the decision to designate a financial expert, firms appear to be closely following the criteria established by the SEC.

Potential areas for further research include identification of additional factors driving the financial expert designation decision. Also, the differing profiles of audit committee members between S&P 500 and Microcap firms suggest that further analyses take size and other firm specific variables into account when investigating this issue.

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