A growing body of research is beginning to clarify the impact financial expertise has on audit committee members' judgment and financial reporting. One study examined audit committee members' financial expertise in the period surrounding implementation of Section 407 of the Sarbanes-Oxley Act of 2002. The purpose of the study was to develop a classification system that could be used by analysts to quantify an audit committee's financial literacy. Although prior research highlights the importance of accounting expertise on the audit committee, the final rules implementing Section 407 continue to allow a rather broad definition of financial expertise, including experience in positions such as CEO/President without direct accounting or finance experience. The authors found evidence of strong reliance on the broader definition of financial expertise in order to meet the requirements of Section 407.

Using proxy statement disclosures from 2000 through 2004, the study examined 300 companies, analyzing audit committee members' work experience and backgrounds. Although the study found a significant increase in the level of audit committee members with accounting experience (surrounding the passage of Section 407), there was also a large representation of firms with at least one CEO/President without accounting or finance experience on the audit committee. The authors found that the CEO/President audit committee constituency increased subsequent to the passage of Section 407.

T29: Audit Committee Financial Literacy

Points	4	3	2	1
Description of the Directors' Accounting Experience	Actual experience as a public accountant or controller	Experience in a typical finance area, but with no explicit accounting responsibilities	Experience serving as non-financial executive (including CEO)	Other experience outside of business (no significant finance background)

Source: "Audit Committee Financial Literacy: A Work in Progress", Douglas J. Coates, M. Laurentius Marais, Roman L. Weil, 2005

Financial and accounting expertise of audit committee members is instrumental to the proper execution of their duties. One of the study's authors, Roman Weil, a professor at the University of Chicago Graduate School of Business, states, "Suppose you're on the audit committee of a company that does a lot of foreign-exchange transactions. You wonder, is my company hedging, or are they speculating? How could you tell? You'd have to understand accounting just to think about it."

Notably, the authors found evidence of superior stock market returns to companies who had improved the financial literacy of their audit committees over the last four years. These firms experienced annualized abnormal, excess returns of 4.6 percent per year above those firms which did not improve audit committee financial literacy. The study graded each audit committee in the sample with a three part grade ranging from 111 (lowest) to 444 (highest). If a company had more than three members on its audit committee, the top three scores were used. Similar research by Mark Defond, Rebecca Hann, and Xuesong Hu of the University of Southern California's Marshall School of Business found that companies with accounting experts on their audit committees

The firms with improving financial literacy of audit committees experienced annualized abnormal, excess returns of 4.6 percent per year above those firms which did not improve audit committee financial literacy.

enjoyed an average 1.3 percent stock price premium compared with other lower rated companies.

By any measurement, the new rule has not changed disclosure or improved governance in any meaningful way. According to a review of the proxy statements of Fortune 500 companies by CFO magazine, more than half of the approximately 850 people named as experts were current or former CEOs. Approximately 16 percent were formerly CFOs, eight percent had served as public auditors, and just seven percent (63 individuals) were current or recently retired finance chiefs. An earlier evaluation by Bloomberg examining first quarter 2004 proxy disclosures of S&P 500 companies identified audit committee members (though not categorized as financial experts) including 11 retired generals, 7 British Lords/Ladies, 3 former astronauts, 2 priests and former Mexican President Ernesto Zedillo. The Corporate Library searched the S&P 500 universe for audit committee members categorized as financial experts and the keyword "CPA" in the biographical sections of public filings, and the results produced just 40 individuals out of a total of 943 S&P 500 financial expert directorships (when using the term "accountant" the search produced 60 individuals).

Section 407 of the Sarbanes-Oxley Act of 2002 directed the SEC to require public companies to report annually whether they have an audit-committee "financial expert," a term the SEC also defined. Initially, the SEC opined that an expert should have past experience preparing or auditing financial statements, thereby making CFOs and auditors about the only directors who could meet such criteria. The SEC's final rule, however, stated that an expert must have five attributes, including an understanding of GAAP and the ability to assess the application of its principles and experience "preparing, auditing, analyzing, or evaluating financial statements...or experience actively supervising someone engaged in that activity." These changes represented key departures from the proposed rule, effectively allowing people who were several degrees removed from the actual issuance of financial statements (such as investment bankers, venture capitalists, and CEOs) to meet the requirements. The SEC's final rules absolved companies of having to provide the rationale for financial expert designations, making it relatively easy for companies to follow form without content.

Final SEC rules state specifically that experience as an auditor, CFO, controller, or even chief accounting officer, "does not, by itself, justify the board of directors in deeming the person to be an audit committee financial expert." Additionally, CEOs do not automatically qualify. While a CEO who actively supervised a CFO may seem to qualify, the SEC has cautioned that the term "active supervision" means more than a mere existence of an organizational reporting relationship and that, "a principal executive officer with considerable operations involvement but little financial or accounting involvement likely would not be exercising the necessary active supervision." Some companies designate two or more audit committee financial experts.■

T30: Evolution of the final SEC rule for financial expert classification

Sarbanes-Oxley Act	SEC Proposed Rule	SEC Final Rule
…experienced in the application of GAAP	…experience applying GAAP…	…ability to assess the general application of GAAP…
...experience with internal account controls…	…experiences with internal accounting controls…	…understanding of internal accounting controls…
…experience preparing and auditing financial statements…	…experience preparing and auditing financial statements…	…or experience actively supervising one or more persons engaged in preparing and auditing financial statements…

Source: SEC, Bloomberg