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Meet the Experts

Susan Perry Williams

INTRODUCTION

Recent business failures and fraudulent financial reporting provided an impetus for corporate reform and regulation. In response to the possible erosion of investor confidence, the U.S. Congress enacted the Sarbanes-Oxley Act of 2002 (the Act). The Act creates new requirements for executives, boards of directors, and audit committees of public corporations required to file financial reports under the Securities Exchange Act of 1934. Specifically, the Act provides regulations designed to hold executives accountable for financial statements, to provide investors with greater transparency, and to enhance the quality and independence of corporate audits.

While the Act may provide reassurance to investors, many of its provision have been controversial due to cost and time demands, as well as potential liability for individuals and corporations. Perhaps most contentious or problematic are:

- Sections 302 and 906, which require that the CEO and CFO take personal responsibility for financial statements;
- Section 404, which compels assessment of internal control and auditors' reports on those assessments; and
- Section 407, which directs firms to disclose whether the audit committee has a "financial expert." A financial expert is not required, but if the firm does not designate a financial expert, then the reason for this absence must be explained.

The focus of this paper is the audit committee "financial expert" disclosure requirement under Section 407 of the Sarbanes-Oxley Act of 2002. It is based upon an examination of audit committee financial experts identified by firms in their proxy statements during the first year of implementation of the requirement (after March 2003 when the Act became effective). This study contributes to our understanding of the financial expert reporting requirement in four ways. First, contrary to the expectations of some corporate critics of the requirement, the evidence suggests that the pool of qualified financial experts for public firms is more than adequate. Almost all of the firms in the sample designated a financial expert, and many firms designated multiple experts. Second, some advocates of stricter regulation worried that allowing firms the option of not naming a financial expert would result in limited implementation of the financial expert disclosure. My findings suggest that

Susan Perry Williams is a Professor at the University of Virginia.

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Corresponding author: Susan Perry Williams
Email: sep4v@virginia.edu

this concern was greatly overstated as almost all firms identified a financial expert. Apparently firms did not want to risk the possible consequences of being labeled a "non-designator." Third, during the comment period, firms expressed concern that board members designated as financial experts would be subject to increased liability. The findings show that a significant number of firms name multiple financial experts, suggesting that safe harbor provisions may have allayed these fears. Finally, the profile of the financial experts described in this paper can help in assessing the effectiveness of the financial reporting requirement.

BACKGROUND

The Act calls for sweeping reforms to provide shareholder accountability by public firms and their auditors, including a general mandate to disclose information about audit committee financial experts. A brief review of the controversy surrounding the adoption of a "financial expert" rule by the SEC provides a useful context for understanding and evaluating the requirement after its first year of implementation.

In October 2002, the SEC issued a Proposed Rule containing, among other things, specific guidance regarding disclosures about financial experts. The Proposed Rule led to concerns that the requirements were too restrictive and would make it difficult to identify and retain a financial expert on the audit committee. The SEC responded by changing and broadening the requirements prior to final adoption in March 2003. As with most compromises, some dissatisfaction with the Rule remains.

The Final Rule requires public companies to disclose whether the audit committee of their board of directors has at least one "financial expert." The requirement includes disclosure of the name of the expert and whether the expert is independent of management. If the registrant does not identify a financial expert on its audit committee, then it must explain why it does not have such an expert on the committee. The disclosure requirement applies to public company annual reports for years ending on or after July 2003.

The sections of the Proposed Rule relating to audit committee financial experts were challenged on grounds that (1) the definition of a financial expert was too limited and requirements for familiarity with the industry were too narrow; (2) the degree and type of experience was unduly restrictive; and (3) individuals designated as financial experts would be subject to greater liability exposure. Comment letters to the SEC suggested that the proposal went beyond the requirements of Section 407 of the Act and expressed fear that these restrictive requirements, coupled with expanded liability, would make it difficult to identify and retain financial experts on the audit committee. The SEC response to each of these concerns is discussed briefly below.

Definition of a Financial Expert

Item 401(h)(2) of Regulation S-K defines an "audit committee financial expert" to mean a person who has all five of the following attributes:

1. an understanding of generally accepted accounting principles (GAAP) and of financial statements;
2. an ability to assess the general application of such principles in connection with the accounting for estimates, accruals, and reserves;
3. experience in 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 company's financial statements, or experience actively supervising one or more persons engaged in such activities;
4. an understanding of internal controls and procedures for financial reporting; and
5. an understanding of audit committee functions.

The SEC's final definition of an audit committee financial expert is less restrictive than originally proposed in October 2002. The change of emphasis from *experience* to *ability and understanding,* while subtle, is more consistent with the focus of the audit committee and undoubtedly enlarged the pool of potential financial experts.

Degree and Type of Experience

Item 401(h)(3) of Regulation S-K explains that a person shall have acquired the attributes of a financial expert through one of the following means:

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.

This revised set of experience alternatives eliminated a requirement in the Proposed Rule that the financial expert must have gained experience with a public firm filing reports with the SEC.

Liability Concerns

Legal liability is a major concern for any member of the board of directors. However, additional concerns surfaced regarding the increased personal liability brought about by the disclosure requirement. One critical issue is whether the designation "financial expert" subjects the director to increased liability. In response, the SEC included a safe harbor from liability for audit committee financial experts. Item 491(h)(4) of Regulation S-K provides:

1. A person who is determined to be an audit committee financial expert will not be deemed an "expert" for any purpose, including without limitation for purposes of Section 11 of the Securities Act, as a result of being designated or identified as an audit committee financial expert pursuant to the new disclosure item;
2. The designation or identification of a person as an audit committee financial expert pursuant to the new disclosure item does not impose on such person any duties, obligations, or liability that are greater than the duties, obligations, and liability imposed on such person as a member of the audit committee and board of directors in the absence of such designation or identification; and
3. The designation or identification of a person as an audit committee financial expert pursuant to the new disclosure item does not affect the duties, obligations, or liability of any other member of the audit committee or board of directors.

While the SEC efforts may provide some degree of comfort, particularly for SEC actions, only time will tell whether the courts hold financial experts to higher standards in litigation cases. Typically audit committee financial experts are covered by director indemnity agreements and insurance policies, and additionally some may elect to provide themselves with supplemental insurance coverage.

PROFILE OF AUDIT COMMITTEE FINANCIAL EXPERTS

The SEC changes to the Proposed Rule were designed to, among other things, expand the pool of qualified audit committee financial experts. The Final Rule tried to strike a balance between specific and general relevance of financial experts' qualifications. Recent proxy statements filed by public companies provide information on the initial group of designated financial experts. This research provides a profile of some of the attributes of these individuals and the firms they are serving.

Sample Selection

I collect the proxy statement for the first annual meeting following the effective date of the required disclosures for all available S&P 500 firms and a random sample of 125 smaller firms. To address the concern that compliance is overly burdensome for small firms, the non-S&P 500 firms are required to have assets of less than $400 million. I examine proxy statements for 489 firms with 370 (75.7 percent) coming from large (S&P 500) firms and 119 (24.3 percent) from small firms.[1] Nine firms in the sample do not designate a financial expert, and 183 firms designate two or more financial experts.

The final sample for the descriptive analysis includes 821 designated audit committee financial experts in 480 firms. Biographical information in the proxy for each expert is used to provide descriptive statistics. Summary information is provided in Table 1. By design, mean assets and sales are significantly different for the small firms relative to the large firms. This disparity in size should allow me to detect different responses to disclosure requirements, if they exist.

Who Are the Financial Experts?

Contrary to concerns about the ability to identify audit committee experts, 98.0 percent of the firms in the sample disclose the name of at least one financial expert in their first proxy statement following the effective date of the disclosure rule. A slightly lower percentage of small firms (95.8 percent) identify a financial expert (t-statistic 1.62). Given the concerns about expanded legal liability, it is perhaps surprising that 38.1 percent of the firms in the sample disclose two or more financial experts. This phenomenon is much more apparent in the large firms where 46.0 percent of the firms designate two or more financial experts, for an average of 1.95 financial experts per firm (t-statistic 8.79). Fifty-three large firms designate the entire audit committee as financial experts. This is perhaps surprising since under the Rule, the board has no obligation to disclose more than one expert. Only 12.8 percent of the small firms designated more than one financial expert. Overall, the findings suggest that identifying at least one financial expert is not overly difficult for the firms in this sample. Further, since this rule is only a disclosure requirement and audit committee financial experts are not required, the proportions suggest that the lack of an expert may be perceived to be sufficiently negative that it motivates the firm to designate a financial expert.

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[1] At the data collection date for this study, only 370 S&P 500 firms had proxy statements available. The 119 smaller firms represent a random sample. To ensure that the S&P firms are representative, I checked a random sample of the later filings for S&P firms. They appear to be consistent with the initial sample.

TABLE 1
Financial Experts Summary Statistics

	All Firms (n = 480)		Small Firms (n = 114)		Large Firms (n = 366)		Significance
	Mean	**Median**	**Mean**	**Median**	**Mean**	**Median**	**t-test[f]**
Panel A: Firm Financial Data							
Mean Assets (millions $)	33,184	5,863	70	61	44,094	11,344	−6.60***
Sales (millions $)	11,345	4,446	72	62	15,059	7,091	−9.38***
Panel B: Audit Committee Characteristics							
	Number	**% of Sample**	**Number**	**% of Sample**	**Number**	**% of Sample**	**t-test[g]**
Boards with a Financial Expert	480	98.0[d]	114	95.8[e]	366	98.9[e]	1.62
Boards with Multiple Experts	183	38.1	14	12.8	169	46.0	8.79***
Financial Expert is Chair of Audit Committee[a]	212	44.2	81	71.0	131	35.8	−9.83***
Panel C: Source of Experts							
	n = 821	**% of Sample**	**n = 131**	**% of Sample**	**n = 690**	**% of Sample**	**t-test[g]**
Experts Added to Boards[b]	236	28.7	44	33.6	192	27.8	−1.43
Experts Previously on Board	585	71.3	87	66.4	498	72.2	
Total Financial Experts	821		131		690		
Financial Experts are Retired Executives	353	43.0	40	27.4	313	45.4%	6.12***
Panel D: Characteristics of Experts							
	n = 821		**n = 131**		**n = 690**		**t-test[f]**
Female/Male	88/733		6/125		82/608		3.24***
Average Age	60.0 years		58.2 years		60.5 years		3.55***
Average Years on Current Board	6.51 years		5.62 years		6.72 years		1.47
Average Other Board Appointments[c]	2.15 boards		1.27 boards		2.34 boards		6.75***

[a] Not all firms designate a chair of the Audit Committee.
[b] Experts added to boards are those appointed since 2003.
[c] Other board appointments are outside the firm.
[d] This percentage is based on 489 firms for which proxies were examined. The balance of the analysis is based on the 480 firms with financial experts on their boards.
[e] Percentages are based on 119 small firms and 370 large firms for which proxies were examined. The balance of the analysis is based on the number of firms with financial experts on their boards—114 small firms and 366 large firms.
[f] Two-sided t-tests of mean differences between large and small firms. *** Denotes significance at < .001.
[g] Two-sided t-tests of differences between large and small firms' percentages. *** Denotes significance at < .001.

All financial experts in the sample sit on the audit committee of the board, and 44.2 percent of the firms in the sample report that a designated financial expert is the chair of the audit committee.[2] Surprisingly, the smaller firms more often (71.0 percent versus 35.8 percent) appoint a financial expert to the position of audit committee chairman (t-statistic –9.83). Perhaps large firms select audit committee chairs with a broader executive and operational perspective. Whatever the reason, a few additional major financial frauds could induce more large firms to place control of the audit committee in the hands of a designated financial expert, if only for legal defense reasons.

Most designated financial experts are already in position as directors on the board. Two hundred thirty-six (28.7 percent) financial experts are new to the board of directors (since 2003), while 585 (71.3 percent) were existing board members when named as an audit committee financial expert. Small firms may have a greater burden in meeting the requirement as 33.6 percent of their financial expert appointments came from new board members. However, the difference between large and small firms is not statistically significant.

The biographies of 43.0 percent of the financial experts state they are retired from their primary profession. However, many are still engaged in a variety of professional activities. For example, a number of former CEOs and board chairmen currently are self-employed as consultants. Thus, the "retired executive" category includes men and women with multiple types of professional responsibility. Fewer small firm financial experts are retired (27.4 percent) compared to the large firm financial experts (t-statistic 6.12).

Individual Characteristics

Most financial experts are male (89.3 percent), and the small firms (95.4 percent male) name significantly fewer female financial experts than do large firms (88.1 percent male, t-statistic 3.24). On average, the financial experts are 60 years old, and have served on the current board for 6.51 years. In addition to this board of directors' position, on average these financial experts serve on the boards of 2.15 other firms. Significant differences between small and large firms (t-statistics 3.55 and 6.75, respectively) exist for age and appointments on other boards. Financial experts on the boards of smaller firms are significantly younger (58.2 versus 60.5 years), and serve on fewer additional boards (1.27 versus 2.34) when compared to the larger firm financial experts. The younger age is consistent with fewer small firm financial experts being retired from their primary career.

Experience of the Financial Experts

The board of directors can designate a person as a financial expert if, in lieu of experience as a public accountant, the person has experience as principal financial officer, principal accounting officer, controller, or similar expertise and experience. Table 2 shows the prior experience of the audit committee financial experts. Almost half of the financial experts served as a chief executive officer and/or chairman of the board of other firms. Large firms engage a significantly greater number of experienced CEOs and Chairmen than do small firms (t-statistics 4.58 and 9.83, respectively). This may reflect the prestige and the higher compensation associated with large firm boards of directors. Small firms, on average, name significantly more financial experts with experience as a company presidents (45.8 percent versus 25.7 percent) and Chief Financial Officers (26.0 percent versus 10.9 percent).

[2] This percentage is a conservative estimate, because some firms do not disclose their audit committee chair in the proxy statement.

TABLE 2
Professional Experience of Financial Experts

Type of Experience	All Experts (n = 821) %	Small Firm Experts (n = 131) %	Large Firm Experts (n = 690) %	Significance t-test[a]
Chief Executive Officer	47.9	30.5	51.1	4.58***
Chairman	46.0	16.0	51.7	9.83***
President	28.9	45.8	25.7	−4.28***
Exec/Senior Vice President	15.3	17.6	14.9	−.96
Chief Financial Officer	13.3	26.0	10.9	−3.71***
Certified Public Accountant	16.4	30.5	13.8	−3.85***
Chief Operating Officer	7.1	12.2	6.1	−1.07
Other	12.8	22.9	10.9	−6.23***

[a] Two-sided t-tests of differences between large and small firms. *** Denotes significance at < .001.
Prior experience includes multiple positions as listed in the biography in the Proxy statement. The "Other" category includes academics, venture capitalists, lawyers, independent consultants, private investors and family founders, among others.

In 2003, 135 CPAs (106 are retired partners from the major public accounting firms) served as a financial expert on the audit committee. Almost two-thirds of these CPAs have joined the board since Sarbanes-Oxley was enacted. Small firms have been particularly successful in recruiting former CPAs from public accounting firms, as 30.5 percent of their financial experts are CPAs (t-statistic –3.85).

The "other category" includes academics, venture capitalists, lawyers, independent consultants, and private investors. Many experts have multiple prior professional experiences. Clearly, the broadening in the SEC financial expert criteria (to *an understanding* rather than actual *experience*) greatly reduced the burden of designating a financial expert.

Financial Expert Remuneration

Board compensation takes a variety of forms. Some firms compensate board members with a flat cash retainer, while others offer a fixed retainer plus cash compensation for each board meeting and committee meeting attended. Firms that do not pay a per-meeting fee often provide a fixed payment for committee member assignments. Given the recent increase in audit committee meetings, a per-meeting fee tends to generate greater compensation than the fixed fee. In addition, chairing a committee often provides additional compensation.

Most firms also use stock or stock options to compensate board members. The value of this form of compensation often equals or exceeds the cash remuneration. Several small firms provide no cash compensation and use only stock or stock options as board remuneration.

I collect compensation data for a subsample of 314 firms (200 are S&P 500 firms, see Table 3). Not surprisingly, on average, compensation for a board member serving on the audit committee is considerably greater for large firms when compared to small firms. Most large firms in this sample have an annual retainer for all board members. Only 80.7 percent of the small firms provide an annual retainer and the average retainer is significantly less

TABLE 3
Board Compensation for Financial Experts

	Participation Percent				Means			
	All Firms (n = 314)	Small Firms (n = 114)	Large Firms (n = 200)	t-test[a]	All Firms (n = 314)	Small Firms (n = 114)	Large Firms (n = 200)	t-test[b]
Annual Retainer	92.4	80.7	98.9	4.84***	$36,441	$15,708	$45,778	10.93***
Fee per Board Meeting	64.0	66.7	67.8	.24	$1,630	$1,645	$1,621	−.16
Fee per Committee Meeting (other than Audit)	57.3	50.9	66.6	2.75***	$1,061[c]	$773	$1,192	6.35***
Fee per Audit Committee Meeting	57.6	51.7	67.8	2.88***	$1,168[c]	$921	$1,281	3.94***
Annual Retainer for sitting on Committee (other than Audit)	14.0	13.2	14.4	.31	$4,083[d]	$3,650	$4,625	.41
Annual Retainer for sitting on Audit Committee	24.7	25.4	24.4	−.18	$6,480[d]	$4,414	$7,714	3.03***
Annual Retainer for Chairing a Committee (other than Audit)	60.9	39.5	83.3	8.31***	$6,485[e]	$4,911	$6,912	2.18**
Annual Retainer for Chairing the Audit Committee	66.6	38	86.7	9.45***	$10,831[e]	$7,666	$11,657	2.40**
Board Meetings in 2003	NA	NA	NA		8	7	8	1.88*
Audit Committee Meetings in 2003	NA	NA	NA		8	6	10	5.36***
Stock or Stock Options	96.0	89	100	3.81***	NA	NA	NA	NA

[a] ***, **, * Denote significance at the <.001, .05, and .10, respectively for tests of percentage differences between large and small firms' participation.
[b] ***, **, * Denote significance at the <.001, .05, and .10, respectively for tests of mean differences between large and small firms' compensation.
[c] The difference between average committee meeting fees for audit committees compared to other committees is statistically significant (t-statistic 2.89, $p < .001$).
[d] The difference between average annual retainers for audit committee assignments compared to other committee assignments is statistically significant (t-statistic 5.83, $p < .001$).
[e] The difference between average annual retainers for audit committee chairs compared to other committee chairs is statistically significant (t-statistic 7.39, $p < .001$).
Board Compensation data are based on a subsample of 314 firms (200 S&P and 114 small firms).
Participation percents are the percentages of firms with each attribute.

for the small firms relative to the large firms ($15,862 versus $45,034, t-statistic 10.93). Fees for committee meetings attended are also significantly less for small firms when compared to large firms. About one fourth of the firms also provide an annual retainer for audit committee members. Again, the annual retainer is significantly less for the small firm relative to the large firm ($921 versus $1,218, t-statistic 3.03). And serving as the chairman of the audit committee on average commands an additional premium of $7,666 for small firms compared to large firm premiums of $11,657 (t-statistic 2.40).

None of the proxies indicate an incremental amount paid specifically for serving as the designated audit committee financial expert. However, audit committee members on the board typically receive a higher rate of compensation relative to other committee members. For firms paying per-meeting compensation for committee meetings, audit committee meetings garner on average a $1,168 per meeting fee compared to $1,061 on average for other committee meetings (t-statistic 2.89). For firms that compensate committee members with a fixed payment, the assignment to the audit committee tends to be, on average, about $1,400 higher than that for other committee retainers (t-statistic 5.83). Finally, chairs of committees other than the audit committee are paid $4000–$5,000 annually less than their audit committee chairmen counterparts (t-statistic 7.39). However, drawing general inferences on financial expert compensation is difficult for several reasons: the financial expert is not always the audit committee chairman, not all firms designate an audit committee chairman, and the financial expert sometimes sits on other committees. Whatever the current level, anecdotal data suggests that compensation to audit committee members may increase dramatically next year. A number of current proxies discuss next year's compensation increases for the audit committee and the audit committee chairman. This could potentially create a future burden for small firms to find and retain financial experts.

Industry Analysis

I analyze board and individual characteristics for five industries (see Table 4). These industries (two-digit SIC) include:

- Manufacturing
- Transportation and Public Utilities
- Retail Trade
- Finance, Insurance, and Real Estate
- Services

These five industries represent almost 90 percent of the firms and 95 percent of the financial experts in this sample. Across industry analysis of financial experts reveals no statistically significant differences. New board members were named the financial experts in all industries and represent from 22.7–32.3 percent of designated experts. Average age (58–61.7 years) and gender representation (84.7–93.1 percent male) is similar across industries.

The Manufacturing and Services industries appear to name the financial expert as audit committee chairman more often than other industries (Chi-square 3.52). Given that more small firms appoint the financial expert as audit committee chair, this may reflect the impact of smaller firms, which are disproportionately represented in these two industries. No other results appear to be driven by industry effects.

SUMMARY AND IMPLICATIONS

The Sarbanes-Oxley Act of 2002 called for sweeping reform to provide shareholder accountability by public firms and their auditors. One controversial aspect of this reform is

TABLE 4
Industry Analysis

Firms	**Manufacturing (n = 216 firms)**	**Transportation (n = 56 firms)**	**Retail Trade (n = 32 firms)**	**Finance, Insurance, Real Estate (n = 62 firms)**	**Services (n = 58 firms)**
Financial Expert as Chair of the Audit Committee (% of firms)	110 (50.9)*	18 (32.1)	11 (34.4)	24 (38.7)	29 (50.0)*
Financial Experts	**n = 388 experts**	**n = 101 experts**	**n = 59 experts**	**n = 119 experts**	**n = 101 experts**
Experts Added to Boards	116 (29.9)	25 (24.8)	19 (32.2)	27 (22.7)	30 (29.7)
Experts Previously on Boards	272 (70.1)	76 (75.2)	40 (67.8)	92 (77.3)	71 (70.3)
Total Financial Experts	388	101	59	119	101
Female/Male (% of experts)	42/346 (10.8/89.2)	13/88 (12.9/87.1)	9/50 (15.3/84.7)	13/116 (10.9/89.1)	7/94 (6.9/93.1)
Average Age	59.5 years	61.7 years	58.0 years	60.0 years	61.0 years

* Denotes significance at .10 level for a Chi-square test of differences between manufacturing and services industries relative to other industries.
These five industries (SIC two-digit) include approximately 90 percent of the firms in this sample and 95 percent of the financial experts.

a requirement that publicly listed firms disclose whether a "financial expert" serves on their audit committee. Disclosure includes the name of the audit committee financial expert and whether the expert is independent of management. The requirement was met with concern that finding and retaining audit committee financial experts would be difficult due to the definition, the required experience, and the potential legal liability.

In this study, I examine a sample of large (S&P 500) and small firms. The findings suggest that many of the initial concerns have proved unfounded. Even though this regulation is a disclosure requirement and companies are not required to have an audit committee expert, almost all firms in the sample designate an audit committee financial expert. Further, many firms designate multiple financial experts. The data are also analyzed by firm size and industry. Both small and large firms have been successful in finding and retaining financial experts. In fact, the majority of firms are able to name a financial expert from their existing board members. I document size-related firm and financial expert differences. Concerns about the burden to small firms appear to be unfounded at the inception date. However, the level of work for these financial experts will undoubtedly result in higher compensation, and small firms may have difficulties finding and retaining financial experts without a substantial financial cost. In summary, this study provides a profile of financial experts and will assist in the evaluation and possible modification of the financial expert reporting requirement.

Future research can examine the changes in the compensation structure for audit committee members and financial experts as the increased workload is addressed. Another stream of research can examine the paucity of women as financial experts. Over the last several decades, women have increasingly entered the finance and accounting profession, yet little research has documented their progression in the business world. Research is needed to determine the number of females qualified to serve as financial experts, and whether this pool of experts is underutilized.