

7-11-2011

Audit Committee Director Turnover

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DOI: 10.25148/etd.FI11080202

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FLORIDA INTERNATIONAL UNIVERSITY

Miami, Florida

AUDIT COMMITTEE DIRECTOR TURNOVER

A dissertation submitted in partial fulfillment of the requirements for the degree of

DOCTOR OF PHILOSOPHY

in

BUSINESS ADMINISTRATION

by

MEGHNA SINGHVI

2011

To: Dean Joyce Elam
College of Business Administration

This dissertation, written by Meghna Singhvi, and entitled Audit Committee Director Turnover, having been approved in respect to style and intellectual content, is referred to you for judgment.

We have read this dissertation and recommend that it be approved.

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Florida International University, 2011

DEDICATION

I would like to dedicate this dissertation to my parents who have worked very hard and scarified enormously to see this day and have loved me unconditionally. My parents have become role models in Udaipur (the city of my birth) where they encourage other parents to provide education to their daughters. My sister, Ankita and I are very lucky to be blessed with such wonderful parents. I truly believe that it was my 'karma' that brought me to Florida International University and helped me accomplish my dreams under the supervision of Dr. Raghunandan and Dr. Rama. I will be eternally grateful to Dr. Raghunandan and Dr. Rama for changing my life. I also would like to thank my husband for his encouragement and his positive attitude. This dissertation is also dedicated to my sister, brother-in-law and my in-laws who have been my strength and my support. Lastly, I would like to thank all my teachers especially Mrs. Sunderajan and Dr. Peter Theuri who inspired me to follow my dreams and who gave me the gift of academia. I feel very fortunate and I will continue to do good deeds for all.

ACKNOWLEDGMENTS

I would like to thank the members of my committee for their time, support and guidance: Dr. Abhijit Barua, Dr. Suchismita Mishra, Dr. Kannan Raghunandan and Dr. Dasaratha Rama. I would like to express my gratitude to my co-major professors: Dr. Kannan Raghunandan and Dr. Dasaratha Rama for their gentle support, useful comments and tireless supervision.

ABSTRACT OF THE DISSERTATION
INTERNAL CONTROL REPORTING BY NON-ACCELERATED FILERS

by

Meghna Singhvi

Florida International University, 2011

Miami, Florida

Professor Dasaratha Rama, Co-Major Professor

Professor Kannan Raghunandan, Co-Major Professor

Actions by both private sector organizations and legislators in recent years have highlighted the importance of the audit committee of the board of directors of corporations in the financial reporting process. For example, the Sarbanes Oxley Act of 2002 has multiple sections that deal with the composition and functioning of audit committees. My dissertation examines multiple issues related to the composition of audit committees.

In the first two parts of my dissertation, I examine the stock market reactions to disclosures of audit committee appointments and departures in the 8-Ks filed with the SEC during 2008 and 2009. I find that there is a positive stock market reaction to the appointment of audit committee directors who are financial experts. The second essay investigates the cumulative abnormal return to departure of audit committee directors. I find that when an accounting expert leaves the audit committee, the market reaction is significantly negative. These results are consistent with regulators' concerns related to having directors with audit, accounting and other financial expertise on corporate audit committees.

The third essay of my dissertation examines the changes in audit committee composition in the last decade. I find that while the increase in audit committee size is relatively modest, there has been a significant increase in the number of audit committee experts and the frequency of audit committee meetings over the past decade; interestingly, such increase in the number of meetings has persisted even after the media focus on the auditing profession, in the immediate aftermath of the Enron and Andersen failures, have waned. My results show that audit committee composition and its role continues to evolve with regulatory and other corporate governance related changes.

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I: INTRODUCTION

In the modern corporation, owners (i.e., shareholders) and managers are distinct. Agency theory suggests that there is a difference in the interests of managers and owners [Fama (1980), Fama and Jensen (1983)]. Hence, there is a need for monitoring the financial statements issued by management.

The board of directors provides the primary monitoring role in the context of public companies. However, consistent with the trend towards specialization, boards of directors have formed sub-committees of the board that deal with diverse functions. The audit committee is a sub-committee of the board of directors. The principal function of the audit committee is to oversee management and external auditors in the financial reporting process. The committee thus serves to protect the interest of the shareholders by providing an oversight over management's presentation of the financial statements.

The role of audit committees has been discussed since the early 1940s by regulators and others interested in strong corporate governance. The Securities Exchange Commission (SEC) and other auditing/corporate governance proponents have had a continued interest in the formation and effective functioning of audit committees, and many regulatory changes have shaped the changes related to audit committees over the years.

In 2002, after the demise of Enron and Worldcom, and the failure of Andersen, Congress enacted the Sarbanes Oxley Act (SOX 2002). SOX further emphasized the role of audit committee directors. Although SOX has had a very significant impact on the role and functioning of audit committees, there were several legislative and

regulatory reports prior to SOX, such as the Treadway Commission (1987) and the Blue Ribbon Panel (1999), which emphasized on the composition, independence and expertise of audit committee members. Arthur Levitt, former Chairman of the Securities Exchange Commission (SEC), in his speech at New York University (Levitt 1998), emphasized that the financial reporting process was facing turbulent times and that there had been gradual erosion in the quality of financial reporting. He pointed out that audit committees need to improve their oversight function and called for “strengthening of the audit committee process” (Levitt 1998, 12). In response to Levitt’s speech which called for a more vigilant audit committee, the Blue Ribbon panel, convened by the SEC, New York Stock Exchange (NYSE) and the National Association of Security Dealers (NASD) released recommendations on improving the role of audit committee members in the financial reporting process.

One of the key recommendations of the Blue Ribbon Panel (1999) was to recruit audit committee members who are fully independent of the company. Another recommendation was that all NYSE and NASD firms with a market capitalization of more than \$200 million must have - a fully independent audit committee, an audit committee size of at least three directors: each of whom is a financial literate and that at least one member must possess accounting or financial management expertise. Other recommendations made by the Blue Ribbon Panel suggested that each audit committee member of a listed company must adopt a formal charter that is approved by the board of directors and which specifies the scope of the member’s responsibilities, and that each audit committee disclose in the company’s proxy statement whether it has adopted a formal written charter and if it has satisfied its

responsibilities during the year in compliance with the charter. The panel also recommended increased communication of audit committees with internal auditors and external auditors.

More recently, SOX (2002) has formalized the role of audit committees in the financial reporting process. Multiple sections of SOX deal with the composition and functioning of audit committees. Section 301 of SOX mandates all publicly-listed companies to have fully independent members preside on the audit committees. An independent audit committee will serve as effective monitors of management; this in turn will improve the quality of financial reporting. Section 407 of SOX requires a company to disclose whether its audit committee includes at least one member who is designated as the audit committee financial expert. A company that does not have a designated financial expert on its audit committee must explain why it does not have such an expert.

Regulators and standard-setters have demanded increased communication between audit committee directors and external auditors. The standard-setters have also encouraged for a more two-way communication between audit committees and external auditors. SEC (2000) states in its final rules that companies disclose in their proxy statements whether their audit committee is governed by a charter, and if so, include a copy of the charter as an appendix to the proxy statement at least one every three years. This new requirement was promulgated to provide information to the shareholders which they can use to assess the role and responsibilities of the audit committee. The SEC also encouraged companies to personalize their charters and stay away from using a “boiler plate” template. The SEC’s purpose in mandating the

publication of the audit committee charter and audit committee report was to promote transparency of the role and actual functioning of the audit committee which in turn would allow the investors to assess the efforts of the audit committee.

Carcello et al. (2002) conduct study to examine a random sample of 150 proxy statements filed in Spring 2001. They find that there is a disparity in what audit committees state they are doing and what is stated in their charters; such variations are associated with firm size, exchange listing, and the composition of audit committees.

Prior research has examined some issues related to the presence of financial experts on audit committees. Subsequent to the implementation of SOX Section 407, Williams (2005) investigates characteristics of financial experts. She finds that most companies were able to identify a financial expert and that several companies had more than one financial expert on their audit committees.

Davidson et al. (2004) and DeFond et al. (2005) provide empirical evidence to show that companies that hire audit committee directors with financial expertise are rewarded by the market. DeFond et al. (2005) study a sample of 702 newly appointed outside directors to audit committees from 1993 to 2002. They find a positive market reaction when accounting financial experts are appointed to the audit committee. Davidson et al. (2004) use a relatively smaller sample because they limited their sample selection to those firms that had press releases and public announcements. Both of the above mentioned studies use data from the pre-SOX period. More importantly, both studies examine market reaction to the appointment of different types of audit committee directors.

In my dissertation, I examine the market reaction to audit committee appointments and departures in the post SOX period. I study the cumulative abnormal return (CAR) using a 3-day and a 5-day window to examine market reaction to news of appointments and departures.

In the first part of my dissertation, I explore the market reaction to audit committee director appointments. Under Section 407 of SOX, each firm is required to disclose in its proxy statement the name of the audit committee financial expert. Throughout my dissertation, I refer to such an expert as a company designated audit committee financial expert. Using a sample of 360 audit committee director appointments (single-director appointments) during 2008, I find that the overall market reaction to the appointments of audit committee directors is not significant. I focus on single-director appointments because I want to control for other confounding factors that could be associated with multiple appointments.

I find interesting results after partitioning the sample by audit committee directors' expertise. I divide audit committee directors into three groups of experts – the first is an *Audit/CPA* expert who is either a Certified Public Accountant (CPA) or has been an audit manager or partner with an auditing firm; the second is an *Accounting/Finance* expert who has prior experience as a CFO, Treasurer, Vice President – Finance, etc.; the last category of *Other* expert comprises of all directors classified audit committee financial experts by the company. I find that when an *Audit/CPA* expert is hired to serve on the audit committee the market reacts positively (significant at 10%) even when the director is not a designated audit committee financial expert. In a sub-sample of 30 events, I find that firms that have four or more

audit committee financial experts present on the audit committee after the new appointment had a positive market reaction of 3% (significant at 1%). This result shows that presence of a team of audit committee financial experts is viewed positively by the market.

The second part of my dissertation investigates the market reaction to audit committee director departures. I have a total of 881 events of director departures. However, I am able to obtain the market reaction for only 300 events because most of the firms in my sample are relatively small. My final sample, after eliminating observations with other contemporaneous events, consists of 229 instances of audit committee director departures. I find that the departure of an accounting expert is perceived negatively by the market; the average market reaction for such events is -3.1% (significant at 5%). These results provide support to the notion that accounting experts are valued on audit committees and the news of their exit can adversely impact the market value of a firm.

The second part of my dissertation also addresses an ongoing debate regarding audit committee director tenure. The proponents for long tenure state that an audit committee director who has served a long period is more knowledgeable and hence a valued member of the board. On the other hand, some members of the business community believe that is a need for a “fresh set of eyes” and that periodic rotation of audit committee members is required. I partition my sample based on director tenure and find that there is a significant negative reaction when a short tenure (0-3 years) and medium tenure director departs from the audit committee. Further, I run several analyses on sub-samples of my data based on ‘busyness’ of a director (measured by

the number of other boards a director serves on), strength of audit committee (measured by the number of audit committee financial experts post departures), age of directors and whether the director was appointed to the audit committee from within the board or (s)he was appointed from outside.

In the aftermath of Enron, as Congress was debating the Sarbanes-Oxley Act, there were many concerns about the lack of individuals with the necessary expertise to serve as audit committee members. Many critics noted that it will be difficult to find people to serve as audit committee members (Dunham 2002). Multiple stories in the media noted that directors who possessed financial expertise such as those who had served as CFOs were even more difficult to recruit because of increased responsibilities (Lavelle 2002, Maher 2002). The vice chairman of an executive recruiting firm estimated that many director candidates were likely to turn down invitations to serve on boards due to litigation risks (Dunham 2002). Glater and Treaster (2002) note that the big insurance companies had significantly reduced director coverage and had even asked some members to share the expense of settlements. Such actions further drove directors away from accepting directorships that could possibly adversely affect their personal pockets. Hennessey and Whitman (2002) cite that increased workload discouraged directors from serving on boards; the burden of additional meetings and decrease in insurance coverage were one of the two most dominant factors driving directors away.

Thus, many critics suggested during the immediate aftermath of the Enron and Andersen failures that the changed corporate governance environment allegedly made it difficult to recruit competent individuals to serve as board members and audit

committee members. This provides the motivation for the third part of my dissertation, where I analyze the metamorphosis of audit committees nearly a decade after the Enron. I provide an overview of the incoming and outgoing directors. I find that directors with *Audit/CPA* and *Accounting/Finance* experience are highly sought after and most firms continue to add more and more audit committee financial experts to their audit committees. I also find that there was a sharp increase in the number of meetings in the immediate aftermath of Enron; interestingly, this has not reversed as we move further away from the tumultuous period of the Enron and Andersen failures.

The remainder of this dissertation is organized as follows: Chapter II discusses the background and related research on audit committees, followed by Chapter III which examines market reaction to audit committee director appointments. Chapter IV investigates the market reaction to audit committee director departures. Chapter V discusses changes in the composition and diligence of audit committees over the past and Chapter VI provides a summary and conclusion.

II: BACKGROUND AND RELATED RESEARCH

The role of audit committees in ensuring high quality financial reporting has long been recognized by regulators. For example, the SEC (1999b) noted:

“Audit committees play a critical role in the financial reporting system by overseeing and monitoring management's and the independent auditors' participation in the financial reporting process. An audit committee can facilitate communications between a company's board of directors, its management, and its internal and independent auditors. A properly functioning audit committee helps to enhance the reliability and credibility of financial disclosures. ...

Audit committees oversee and monitor management and the independent auditors in the financial reporting process, and thereby play a critical role in assuring the credibility of financial reporting. Audit committees can facilitate communications between a company's board of directors, its management, and its internal and independent auditors on significant accounting issues and policies. They can provide a forum separate from management in which auditors can candidly discuss any concerns. By effectively carrying out their many functions and responsibilities, audit committees help to enhance the reliability and credibility of financial reports.”

The Commission noted that it had a long tradition of encouraging the formation of effective audit committees. In the same rule proposal cited above, the SEC noted:

“Since the early 1940s, the Commission, along with the auditing and corporate communities, has had a continuing interest in promoting effective and independent audit committees. It was, in large measure, with the Commission's encouragement, for instance, that the self-regulatory organizations first adopted audit committee requirements in the 1970s. In 1974 and 1978, the Commission adopted rules requiring certain disclosures about audit committees. In 1980, the Commission issued a staff report on corporate accountability that addresses some of the issues underlying today's proposals. Former SEC Commissioner James Treadway led the National Commission on Fraudulent Financial Reporting that issued recommendations on corporate audit committees in 1987.”

In 1987, the National Commission on Fraudulent Financial Reporting (NCFRR) recommended to the SEC that it mandate all public companies to form audit committees comprised exclusively of independent members. It is important to note

that, despite the SEC's periodic exhortations to have effective audit committees, independent and effective audit committees were quite uncommon until late 1970s.

Pincus et al. (1989) study the voluntary formation of audit committees by NASDAQ listed firms, and find that firms with lower managerial ownership were more likely to have an audit committee. These results support the notion that the higher the agency costs of equity, the more incentive a company has to form an audit committee. Pincus et al. (1989) also find that NASDAQ firms that voluntarily formed audit committees were firms that were large, had higher proportion of outside directors and had a big eight auditor.

In a similar vein, Bradbury (1990) relies on agency theory to analyze the voluntary formation of audit committees. However his findings are different from those of Pincus et al. (1989). He uses a sample of 135 firms listed on the New Zealand Stock Exchange and finds that that voluntary formation of audit committees is neither related to auditor variables nor to agency cost variables. Instead, he finds a relationship between directors' incentives and voluntary formation of audit committees. He cites several reasons to support his findings one of which is that the demand for audit committees in New Zealand may be lower due to the presence of a low-litigation environment.

McMullen (1996) conducts a study to investigate if the presence of an audit committee has an impact on the financial reporting quality of a company. Her sample is divided into five treatment groups. The first group consists of companies with shareholder litigation due to fraud and errors in the financial statements. Her sample is for the years 1984-1988 and she has 96 firms in the first treatment group. In the

second group, she has 69 firms that restated quarterly earnings for the years 1982-1988. In the third group, she refers to Accounting and Auditing Enforcement Releases errors to identify 62 firms that violated SEC regulations during 1982-1988. The fourth group comprises of 82 firms that committed illegal acts during 1984-1988 and finally the fifth group consists of 67 companies that switched auditors when there was a disagreement between management and the predecessor auditor during 1984-1988. She measures (the lack of) high quality financial reporting by the incidence of errors, irregularities and illegal acts; she uses shareholder litigation alleging fraudulent financial reporting, corrections of reported quarterly earnings, SEC enforcement action, illegal acts and auditor turnover involving a client-auditor disagreement as proxies to measure financial reporting quality. McMullen (1996) finds that the presence of an audit committee is associated with reduced likelihood of shareholder lawsuits, restatements, enforcement actions and auditor turnover following disagreement between auditor and client.

In 1998, the then SEC Chairman, Arthur Levitt, gave a well-publicized talk titled “The Numbers Game” in which he discussed the role of audit committees in ensuring financial reporting quality. Spurred by this speech, two private sector organizations set up task forces which then issued their reports about the formation of effective audit committees among public companies. The *Report of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees* (BRC 1999) and the National Association of Corporate Directors’ *Report of the NACD Blue Ribbon Commission on Director Professionalism* (NACD 2000) presented various

recommendations to improve audit committee effectiveness in response to the changing business environment.

During the period from 1999 to 2003, the SEC acted on multiple occasions to strengthen the composition and functioning of audit committees. The Commission proposed, and later adopted a rule, “to improve disclosure relating to the functioning of corporate audit committees.” The SEC’s (1999b) new rules require that:

- companies include reports of their audit committees in their proxy statements; in the report, the audit committee must state whether the audit committee has: (i) reviewed and discussed the audited financial statements with management; (ii) discussed with the independent auditors the matters required to be discussed by Statement on Auditing Standards No. 61, as may be modified or supplemented; and (iii) received from the auditors disclosures regarding the auditors' independence required by Independence Standards Board Standard No. 1, as may be modified or supplemented, and discussed with the auditors the auditors' independence (see Section III.B below);
- the report of the audit committee also include a statement by the audit committee whether, based on the review and discussions noted above, the audit committee recommended to the Board of Directors that the audited financial statements be included in the company's Annual Report on Form 10-K or 10-KSB (as applicable) for the last fiscal year for filing with the Commission (see Section III.B below);
- companies disclose in their proxy statements whether their Board of Directors has adopted a written charter for the audit committee, and if so, include a copy of the charter as an appendix to the company's proxy statements at least once every three years (see Section III.C below);
- companies, including small business issuers, whose securities are quoted on Nasdaq or listed on the American Stock Exchange ("AMEX") or New York Stock Exchange ("NYSE"), disclose in their proxy statements whether the audit committee members are “independent” as defined in the applicable listing standards, and disclose certain information regarding any director on the audit committee who is not “independent”; require that companies, including small business issuers, whose securities are not quoted on Nasdaq or listed on the AMEX or NYSE disclose in their proxy statements whether, if they have an audit committee, the members are “independent,” as defined in the NASD's, AMEX's or NYSE's listing standards, and which definition was used.

Later, in November 2000, the SEC issued a comprehensive rule on auditor independence. While the rule was primarily related to the supply of non-audit services by auditors to their SEC registrant clients, one part of the rule also dealt with disclosures by audit committees. Specifically, the SEC (2000) noted that:

“We have modified the proposed disclosure to require disclosure only of whether the audit committee considered whether the principal accountant's provision of the information technology services and other non-audit services to the registrant is compatible with maintaining the principal accountant's independence. ... we believe that companies will be providing useful information to investors under the modified requirement. Investors will be aided by knowing whether the company's audit committee considered whether the provision of non-audit services by the company's principal accountant is compatible with maintaining the accountant's independence. We are requiring issuers to disclose only whether the audit committee considered whether the principal accountant's provision of non-audit services is compatible with maintaining the principal accountant's independence.”

The regulators, standard-setters, academics and the business community continued to lobby for more effective audit committees emphasizing the independence, expertise and responsibilities of audit committee members. The fall of Arthur Anderson and Enron provided further impetus to legislators and regulators to further strengthen the role of audit committees in the financial reporting process. This culminated in the Sarbanes Oxley Act of 2002; SOX has multiple sections that deal with the composition and functioning of audit committees, as discussed in more detail below.

Independence of Audit Committees

Since 1978, the New York Stock Exchange (NYSE) has required listed companies to have audit committees comprised of wholly independent directors. NYSE rules prohibited officers, employees and affiliates of the company from serving as audit committee members. However, the corporation's board of directors have the authority to appoint audit committee members and may appoint "grey" directors. Vicknair et al. (1993, 53) note that "These 'grey' directors include relatives of management, consultants, interlocking directors retired executives of the firm". Such a process diminishes the independence requirement and hence may reduce the effectiveness of audit committee members. Vicknair et al. (1993) find the presence of "grey" directors to be quite common in their sample; 74 percent of the audit committees in their sample had at least one "grey" director and, somewhat surprisingly, "grey" directors constituted a majority in 26 percent of their sample.

As noted above, the SEC issued rules in 1999 that required registrants to indicate if any member of the audit committee was not independent. However, the definitions of independence were dependent on the listing rules of the NYSE, AMEX, and NASDAQ. As noted in Raghunandan and Rama (2007), there was substantial variation among the listing requirements; in addition, there were many instances when firms stated that their members were independent, yet disclosed transactions between the firm and the audit committee director(s) under the "Certain Relationships" section of the proxy statement. Further, it is important to note that the SEC's 1999 rules did

not mandate that the audit committee directors be independent; the rules only required disclosure about the (lack of) independence of audit committee directors.

Section 301 of SOX (2002) is titled “Public Company Audit Committees” and states as follows:

“(m) Standards Relating to Audit Committees.--

“(1) Commission rules.--

“(A) In general.--Effective <<NOTE: Deadline.>> not later than 270 days after the date of enactment of this subsection, the Commission shall, by rule, direct the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that is not in compliance with the requirements of any portion of paragraphs (2) through (6).

“(B) Opportunity to cure defects.--The rules of the Commission under subparagraph (A) shall provide for appropriate procedures for an issuer to have an opportunity to cure any defects that would be the basis for a prohibition under subparagraph (A), before the imposition of such prohibition.

“(2) Responsibilities relating to registered public accounting firms.--The audit committee of each issuer, in its capacity as a committee of the board of directors, shall be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or related work, and each such registered public accounting firm shall report directly to the audit committee.

“(3) Independence.--

“(A) In general.--Each member of the audit committee of the issuer shall be a member of the board of directors of the issuer, and shall otherwise be independent.

“(B) Criteria.--In order to be considered to be independent for purposes of this paragraph, a member of an audit committee of an issuer may not, other than in

his or her capacity as a member of the audit committee, the board of directors, or any other board committee--

``(i) accept any consulting, advisory, or other compensatory fee from the issuer; or

``(ii) be an affiliated person of the issuer or any subsidiary thereof.

``(C) Exemption authority.--The Commission may exempt from the requirements of subparagraph (B) a particular relationship with respect to audit committee members, as the Commission determines appropriate in light of the circumstances.

Pursuant to Section 301 of SOX, the SEC issued a proposal and then the final rules relating to audit committee director independence in 2003. The final SEC (2003) rules state as follows:

(i) The rules of each national securities exchange or national securities association meeting the requirements of this section must be operative, and listed issuers must be in compliance with those rules, by the following dates:

(A) July 31, 2005 for foreign private issuers and small business issuers (as defined in § 240.12b-2); and

(B) For all other listed issuers, the earlier of the listed issuer's first annual shareholders meeting after January 15, 2004, or October 31, 2004.

(ii) Each national securities exchange and national securities association must provide to the Commission, no later than July 15, 2003, proposed rules or rule amendments that comply with this section.

(iii) Each national securities exchange and national securities association must have final rules or rule amendments that comply with this section approved by the Commission no later than December 1, 2003.

(b) Required standards.

(1) Independence.

(i) Each member of the audit committee must be a member of the board of directors of the listed issuer, and must otherwise be independent; provided that, where a listed issuer is one of two dual holding companies, those companies may designate one audit committee for both companies so long as each

member of the audit committee is a member of the board of directors of at least one of such dual holding companies.

(ii) Independence requirements for non-investment company issuers. In order to be considered to be independent for purposes of this paragraph (b)(1), a member of an audit committee of a listed issuer that is not an investment company may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee:

(A) Accept directly or indirectly any consulting, advisory, or other compensatory fee from the issuer or any subsidiary thereof, provided that, unless the rules of the national securities exchange or national securities association provide otherwise, compensatory fees do not include the receipt of fixed amounts of compensation under a retirement plan (including deferred compensation) for prior service with the listed issuer (provided that such compensation is not contingent in any way on continued service); or

(B) Be an affiliated person of the issuer or any subsidiary thereof.

In summary, the independence requirement for public companies has slowly evolved over time, starting from the 1940s. In the post-SOX period, subject to certain exceptions (such as, those for registrants following an initial public offering), public company audit committee directors are expected to be independent. However, the caveat is that the detailed independence rules themselves are based on exchange listing requirements, and these requirements vary across stock exchanges.

Expertise of Audit Committees

The SEC and private sector organizations have also stressed the importance of financial literacy and expertise for audit committee members. The Blue Ribbon Committee (1999) noted the need for presence of financial literates on the audit committee. According to the report “literacy signified the ability to read and

understand fundamental financial statements, including a company's balance sheet, income statement and cash flow statement".

Unlike with independence, the SEC refrained from any rules related to mandating the presence or disclosure of financial literacy or expertise for audit committee directors. This situation changed with the enactment of SOX. Section 407 of SOX is titled "Disclosure of Audit Committee Financial Expert" and reads as follows:

(a) Rules Defining "Financial Expert".--The Commission shall issue rules, as necessary or appropriate in the public interest and consistent with the protection of investors, to require each issuer, together with periodic reports required pursuant to sections 13(a) and 15(d) of the Securities Exchange Act of 1934, to disclose whether or not, and if not, the reasons therefor, the audit committee of that issuer is comprised of at least 1 member who is a financial expert, as such term is defined by the Commission.

(b) Considerations.--In defining the term "financial expert" for purposes of subsection (a), the Commission shall consider whether a person has, through education and experience as a public accountant or auditor or a principal financial officer, comptroller, or principal accounting officer of an issuer, or from a position involving the performance of similar functions--

(1) an understanding of generally accepted accounting principles and financial statements;

(2) experience in--

(A) the preparation or auditing of financial statements of generally comparable issuers; and

(B) the application of such principles in connection with the accounting for estimates, accruals, and reserves;

(3) experience with internal accounting controls; and

(4) an understanding of audit committee functions.

(c) Deadline for Rulemaking.--The Commission shall--

(1) propose rules to implement this section, not later than 90 days after the date of enactment of this Act; and

(2) issue final rules to implement this section, not later than 180 days after that date of enactment.

Pursuant to the requirements of Section 407, in October 2002, the SEC proposed rules related to the disclosure of audit committee financial experts. The initial proposal defined the term “financial expert” as follows: (SEC 2002a)

“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
- An understanding of audit committee functions.”

The above definition of “audit committee financial expert” received huge backlash from the corporate community. Many commenters viewed the definition to be too restrictive. The SEC (2003b) noted that “Several expressed concern that many companies, especially small ones, would have a difficult time attracting an audit committee member who would qualify as an expert under the proposed definition.” Many critics also expressed concerns that companies may have to let go their current directors who do not fit the SEC definition of an audit committee financial expert. There were many comments emphasizing that the role of audit committee members

was one of oversight rather than “direct involvement in the company’s accounting functions.”

It was not surprising that the business community reacted strongly to the proposed definition of who is an audit committee financial expert. Under the proposed definition, financial luminaries such as Warren Buffet and Alan Greenspan also did not adequately fit the definition of an audit committee expert, since none of them were actively engaged in preparation of financial statements. (AABD 2002, Bryan-Low 2002). In a letter to the SEC, the Executive Vice President, General Counsel and Secretary of AmSouth Bancorporation expressed concerns stating that the proposed definition “unnecessarily limits the universe of persons who might be effective members of an audit committee” (AmSouth Bancorporation 2002).

Based on the response of numerous comments from the business community, the SEC revised the definition of an audit committee financial expert. The final rules (SEC 2003a) define an audit committee financial expert as a person who understands GAAP; has an ability to assess the application of GAAP in association with estimates, accruals and reserves; has experience in the preparation, audit, analysis and evaluation of financial statements or has experience in active supervision of such a person; has an understanding of internal controls and an understanding of the audit committee functions. The SEC implementation of the rule for Section 407 is for fiscal years ending on or after July 15, 2003.¹

¹ Small business issuers were required to comply with the audit committee financial expert disclosure requirements in their annual reports for fiscal years ending on or after December 15, 2003.

The SEC defines an Audit Committee financial expert (ACFE) as an individual who has an understanding of financial statements and generally accepted accounting principles. An audit committee financial expert must also possess a thorough understanding of internal controls and procedures for financial reporting and must understand the functions of the audit committee. The SEC rules indicate that the above mentioned attributes of an audit committee financial expert may be acquired through education and experience of having served as a controller, chief-financial officer, principal accounting officer, auditor or having supervised a principal financial officer or through other relevant experience (SEC 2003a). Importantly, if a company discloses that it does not have an audit committee financial expert, it must also explain why it does not have such an expert. The SEC Chair, William H. Donaldson noted the importance of disclosures to the investing community in a testimony before the Senate Committee on Banking, Housing and Urban Affairs. (Donaldson 2003). He stated that “These disclosures will improve transparency to investors in evaluating the experience of the audit committees of companies in which they invest.”

As mentioned earlier, the SEC revised the definition of an audit committee financial expert several times prior to reaching the final version. Many critics had suggested that there will be a shortage of such experts in the market making it difficult for corporate boards to fill their seats.

Williams (2005) investigates the audit committee financial expert disclosure requirement under Section 407 of SOX (2002). She finds that there is no shortage of experts who qualify as audit committee financial experts and in fact some firms in her sample had more than one designated audit committee financial expert. She also finds

that there is no increased liability for directors who are identified as financial experts indicating that safe harbor provisions may have mitigated such worries. Specifically, based on proxy information for 489 firms (370 S&P 500 firms, with the remaining being small firms) for the first annual meeting following the effective date of the required disclosure - she finds that 98 percent of S&P 500 firms in her sample disclose the name of at least one audit committee financial expert compared to 96 percent for small firms. She also finds that 46 percent of the sample discloses the presence of two or more financial experts. Her results are interesting because there was a significant amount of resistance from the business community as evidenced in the SEC comment letters citing the dearth of expert directors.

While the SEC has required disclosures about audit committees, the level of disclosures varied among companies. On one hand, some firms provided detailed explanations with regard to their financial experts but on the other hand others were more concise in their explanations. Carcello et al. (2006) examine a sample of 400 companies with fiscal year-ends between July 15, 2003 and December 31, 2003. They examine the proxy statements to view disclosures (location of disclosure, level of detail, number of experts named) related to audit committee financial experts. They find that 98 percent of the companies in their sample made the required financial expert disclosure and almost 30 percent of their sample companies had an increase in the number of experts since the passage of SOX. They also examine the details of the disclosures made by each company. Using a logistic regression model, they find that company size is positively associated with designation of an audit committee financial expert. They also find that companies that operate in a high litigious environment and

those companies where the audit committees met at least 4 times a year were more likely to make disclosures of financial experts.

In order to provide more detail on which firms were more likely to hire more than one financial expert, Krishnan and Lee (2009) study the determinants of firms' choices of accounting and non accounting financial experts. They study a sample of 802 firms (3,218 audit committee directors) and their financial data relates to the fiscal year ended after July 15, 2003 because their primary focus is on the presence of audit committee financial expertise after the effective date of Section 407 of SOX. They find that 59 percent of their sample firms has one or more accounting financial experts on their audit committee and that firms that operate in a high-litigation environment were more likely to have accounting financial experts on their audit committees provided they had a strong corporate governance model.

In summary, the presence of experts (in some cases two or more) and the level of such disclosures in the company's proxy statements signaled the presence of a good governance model to the investing community.

In the next sub-section, I examine the consequences of having independent audit committee members and financial experts on the audit committee. Given below is an overview of academic literature that has examined the association between audit committee composition and (a) audit committee interaction with external auditors, (b) audit committee interaction with internal auditors, and (c) quality of financial reporting.

Consequences of Audit Committee Composition

Audit Committee Composition and Interaction with External Auditors

The role of audit committee members is one of overseeing a company's financial statements and financial reporting quality. To fulfill these responsibilities, audit committees must maintain effective communication with external auditors.

Some studies have examined the association between audit committee characteristics and their interaction with external auditors.

Carcello et al. (2002) note that audit committees bear the responsibility of recruiting an external audit firm to deliver a high quality audit. Since audit committee members face increased exposure in terms of reputational capital and legal liability, they are further inclined to protect shareholder interests. These interests can be protected by facilitating a high quality audit which would lead to higher audit fees being paid to the external auditors. Carcello et al. (2002) send a questionnaire to controllers for all Fortune 1000 companies and request them to provide the external audit fees for the period April 1992 and March 1993. They find a significant positive relationship between audit fees and board independence, diligence and expertise. They also find that audit committee variables such as audit committee independence and expertise also have a positive relationship with audit fees.

Abbott et al. (2003) examine audit committee characteristics such as independence, financial expertise and number of meetings in association with audit fees. They find that audit fees are higher for firms that had fully independent audit committees. Their results indicate audit committees that have only independent members and have members with financial expertise are more likely to demand

increased scope of auditing services from their external auditors, hence driving the audit fees upwards. The results support the notion that members with financial expertise and 100 percent independence act as good governance tools, as intended by the BRC and ISB in their recommendations (BRC 1999, ISB 1999).

DeZoort et al. (2003) conduct an experiment using audit committee members' judgment and attitudes in instances of auditor-management disputes. More specifically, they study if auditor's materiality justification and the precision of the accounting issue impacts audit committee members' level of support for the external auditor in case of an auditor-management dispute. They find that audit committee members provide more support for the external auditor when the auditor's materiality decisions are deduced using both quantitative and consequences-oriented factors. They also find that audit committee members supported the auditor when the accounting issue demanded precise measurement. Additionally, they find that audit committee members with CPA experience are more likely to support external auditors in such disputes with management.

Goodwin-Stewart and Kent (2006) uses a sample of 401 firms to examine whether the presence of an audit committee, as well as specific audit committee characteristics, are associated with higher audit fees. She collects information on internal audit activities by sending a questionnaire to all companies listed on the Australian Stock Exchange in October 2000 (approximately 1,400 companies). She finds that audit committee expertise is associated with higher audit fees when independence and meeting frequency is low.

Hoitash and Hoitash (2009) collect data audit committee and board characteristics during fiscal 2004 for a sample of 2,393 firms. They find that a strong audit committee often demands a higher level of assurance and is less likely to dismiss its auditors. Overall, their results indicate that the role of audit committees and independence of audit committee members reflects on high audit quality and auditor independence.

Robinson and Owens-Jackson (2009) study audit committee characteristics and investigate if they are related to external auditor changes. The auditor change is subsequent to events such as: disagreement with management, resignation of the auditor, disagreement over audit fees, and qualified audit opinions. They use a sample of firms (that appear simultaneously on Auditor-Trak and the NYSE, ASE or NASD) that switched auditors from 1993-2001 because of one of the following: a disagreement between management and the external auditor; auditor resignations from the audit engagement due to independence issues; audit fee disputes and receipt of a qualified opinion. Their final sample is reduced to 60 firms because of lack of financial data. Their results show that an external auditor is more likely to be supported by an audit committee that is more independent, has more financial expertise and more firm specific knowledge. These findings suggest that the increased scrutiny of audit committee members has made them more effective in the likelihood of an unfavorable event such as those mentioned in this study.

Audit Committee Composition and Interaction with Internal Auditors

Another important element in the corporate governance mosaic is internal auditing. Effective communication with internal auditing can lead to better monitoring by audit committee members. Both are involved in monitoring of internal controls and deterrence of wrongdoing and false financial reporting, albeit to a different degree. Although the powers and the roles differ significantly, their goals overlap and one of their main objectives is to promote accurate financial reporting.

Scarbrough et al. (1998) investigate the association between audit committee composition and the level of interaction with internal auditing. They use several measures in their study such as (1) role of the audit committee in decisions leading to dismissal of the chief internal auditor, (2) meetings between the audit committee and the chief internal auditor and (3) review of the internal auditing program and results by the audit committee. They conduct a survey of chief internal auditors of Canadian manufacturing companies. They find that the audit committee was involved in the dismissal of the chief internal auditor in 48 percent of the respondents' companies. Their results also show that the level of interaction between audit committee members and internal auditing was low. Sixty nine percent of audit committees reviewed the internal auditing program and results and only 59 percent of the audit committees had regular meetings with the chief internal auditor.

Raghunandan et al. (2001) gathered responses from chief internal auditors of public companies and find that only 68 percent had audit committees without inside or gray directors and with at least one member with an accounting or finance background. Their findings also indicate that audit committees that did not have inside

or gray directors and had at least one member with accounting or finance expertise are more likely to (a) have longer meetings with the chief internal auditor, (b) provide access to the chief internal auditor and (c) review the internal audit program and review management's interaction with internal audit.

Barua et al. (2010) study the association between audit committee characteristics and investment in internal auditing. They use a sample of 181 firms that have an active internal audit function for the fiscal years ending between August 1, 2001 and July 31, 2002. They find that companies that had long-tenure audit committee members and had an auditing expert on the audit committee spent less resources on internal auditing. This study shows that an auditing expert coupled with long tenure directors may be able to substitute for internal auditing to some extent. They also find that the investment in internal auditing is positively related to the number of audit committee meetings.

Abbott et al. (2010) document the association between audit committee characteristics and internal audit. They conduct a survey of 134 chief internal auditors from Fortune 1000 firms investigating resources allocated to internal audit activities during fiscal year 2005. They obtain data to measure the relative control of audit committee over the internal audit function using three components of the audit committee/internal audit relationship: reporting duties, termination rights, and budgetary control. The authors hypothesize that the audit committee's objective to avoid a financial misstatement is positively associated with an increased internal audit focus on internal controls. They find that audit committees that have a greater oversight role over the internal audit function allocate a larger proportion of the

internal audit hours towards internal controls.

In summary prior research has examined a variety of issues related to the interaction between internal auditing and audit committee composition. In general, the evidence from prior studies suggests that audit committees that have solely independent directors are more likely to have a higher quality interaction with internal auditing.

Audit Committee Composition and Financial Reporting

Accruals

McMullen and Raghunandan (1996) examine companies with two types of financial reporting problems (SEC enforcement actions and material restatements of quarterly earnings) and compared them to those that did not have any financial reporting problems. In their survey, they examine 51 companies with either an SEC enforcement action and/or material restatements of quarterly earnings financial reporting problems for the period 1985-1989. Their results indicate that companies that had problems did not have audit committees comprising solely of outside directors. Problem companies were also more likely to have no CPAs on their audit committees compared to no problem companies. Lastly, they also find that only 23percent of the problem companies held regular audit committee meetings.

DeZoort and Salterio (2001) examine how 68 Canadian audit committee members react to a dispute between the auditor and management over a material accounting issue. The study is conducted as an experimental task and is created with the help of audit partners, a national office accounting consultation partner, a corporate director and accounting professors. The authors find that audit committee

members who are independent and possess prior audit experience will be more likely to advocate a “substance” approach in an accounting policy dispute with management.

Klein (2002) examines if the magnitude of abnormal accruals is associated with audit committee independence. Her sample comprises of S&P 500 firms, and her analysis covers the years 1991-1993. Her results show that abnormal accruals are high for companies where the majority of audit committee directors were not independent. The results are more significant when there was a reduction in independence level (from majority-independent to minority-independent) either on the board or on the audit committee. Her findings provide evidence that earnings management is negatively associated to independent boards and audit committees.

Bedard et al. (2004) find that the presence of a financial expert is negatively associated with annual discretionary accruals. They use a matched pair design; one group had a high level of abnormal accruals and the other a relatively low level of abnormal accruals in the year 1996. They find that earnings management is less pronounced in firms where audit committees comprised of independent members and financial experts. They also find that a formalized charter empowers audit committee members with the required skills to mitigate aggressive earnings management.

Krishnamoorthy et al. (2002) conducted a survey which was sent to audit partners and managers to study their perception of financial reporting quality and to identify factors that impact audit committee effectiveness. 48 percent of the respondents stated that audit committee members lacked the financial acumen which is required to obtain a high financial reporting quality. Several respondents expressed concerns such as the lack of audit committee willingness to support external auditors

in case of a disagreement with management. The respondents mentioned that the audit committees were not strong enough to curtail financial misstatements and deter fraud.

Yang and Krishnan (2005) examine the association between earnings management and several audit committee characteristics such as independence, frequency of meetings, financial expertise, stock ownership, outside directorships, tenure and size of the audit committee. Their sample comprises of 896 firm-year observations for the years 1996-2000. They find that the number of outside directorships held by audit committee directors is negatively associated with quarterly discretionary accruals. They also find that stock ownership in a company can erode independence of audit committee members as evidenced by presence of earnings management. Lastly, they find that average tenure is negatively associated with quarterly earnings management.

In summary, prior studies have examined many different time periods and samples to examine the association between the composition of audit committee members and the quality of financial reporting. The evidence from such studies indicate that audit committee member characteristics (as measured by level of independence, presence of experts, number of meetings, presence of an audit committee charter etc.) can impact the quality of financial reporting.

Restatements

The quality of financial reporting can also be measured by the number of restatements and internal control weakness disclosures. Abbott et al. (2004) study a group of companies that restated their financial statements at least once during 1991 to 1999 (88 firms) and compare them to a control group of companies that did not restate

(88 firms). They find that the likelihood of a restatement is lower for those firms where the audit committee is comprised of fully independent members and/or includes at least one financial expert. They also find that companies that had active audit committees had lesser restatements compared to the control group. Their findings echo the recommendations of the BRC and others who have argued for independent audit committees, presence of at least one member with financial expertise, and more audit committee meetings—all of which lead to effective monitoring by audit committees.

Agrawal and Chadha (2005) provide empirical evidence between audit committee composition and the likelihood of a misstatement. They examine 159 U.S. public companies that restated their earnings in 2000 or 2001 and identify a sample of 159 firms that did not restate (control group). They find that the probability of a restatement is lower in companies where audit committees have presence of independent directors with financial expertise; however the probability is higher for companies where the CEO belongs to the founding family. Their results suggest that independent directors who possess financial expertise are value-adding members that provide effective monitoring over the company's financial reporting.

Internal Control Reporting

DeZoort (1998) conducts a study by contacting board chairpersons from a random sample of 100 companies listed on the NYSE, ASE and NASDAQ National Market System. Each board chairperson is requested to encourage their audit committee members to participate in the study. Their final sample consists of 87 respondents to analyze if experience has an effect on audit committee member's oversight judgment. These respondents complete an internal control oversight task and

their judgments are evaluated by the author. This study uses an analysis-of-variance approach to test for differences among inexperienced audit committee members, audit committee members with auditing experience and external auditors. The author finds that audit committee members who have domain and task specific knowledge, i.e. those that have prior experience in auditing and internal controls made similar judgment decisions as external auditors in the evaluation of internal controls compared to their counterparts who did not have such prior experience.

Krishnan (2005) conducts a study to analyze the association between audit committee composition and internal control reporting. She uses a matched-sample design and identifies companies that disclose internal control problems in Form 8-Ks and had a change in auditor (1994-2000); for the control group she uses companies that changed auditors but did not have an internal control issues. Her final sample comprises of 128 firms that have internal control problems and 128 control firms that did not have such problems. She finds a negative association between the presence of independent members on the audit committee and occurrences of internal control weaknesses. Additionally, she also finds that presence of experts (financial expertise) and internal control problems are also negatively associated with each other. Her findings indicate that presence of experts seems to matter and have an influence on financial reporting quality.

Krishnan and Visvanathan (2007) identify 90 companies that reported internal control weaknesses between November 15, 2004 and March 1, 2005. Their control group includes companies in the same industry that did not report any deficiencies in internal control. They find that companies with internal control weaknesses were less

likely to have financial experts on the audit committee. They also find that frequent audit committee meetings were related to timely reporting of internal control weaknesses.

Zhang et al. (2007) identify 208 firms with material internal control problems under SOX 302 or 404 from November 15, 2004 to July 31, 2005. These problems are disclosed in the firms' 8-K, 10-Q and 10-K. They use a matched-pair design in their study and collect data for 208 firms without internal control weaknesses. In their univariate analyses they find that 75 percent of the audit committee members of the sample firms are financial experts whereas 83 percent of the audit committee members in the control sample are financial experts. These differences are statistically significant (1%) and indicate that firms with audit committee financial experts are less prone to have internal control problems. Their multivariate tests indicate that firms with internal control problems have more frequent board meetings and presence of experts (both accounting and non-accounting financial experts) helps in improved monitoring.

Goh (2009) investigates if audit committee characteristics are associated with a company's timeliness in the remediation of material weaknesses in internal control. This study finds that firms with larger audit committees and greater proportion of nonaccounting financial expertise will take steps to remediate problems related to internal controls in a timely manner. These results suggest that size of the audit committee does matter and even nonaccounting financial expertise is useful because it assists in a timely remediation of internal controls.

Naiker and Sharma (2009) conduct a study to examine the influence of affiliated former audit partners and unaffiliated former audit partners on the audit committee and internal control deficiencies that require adequate disclosures. They posit that audit committee members who have been audit partners on the engagement in their previous roles would be more effective monitors of internal control weaknesses compared to their counterparts. Their sample comprises of 1,225 firms that make SOX 404 disclosures for the 2004 fiscal year ending on or after November 14, 2003. They find that presence of such expertise (prior audit partners) was associated with lower number of reported internal control deficiencies.

In summary, the above mentioned studies show that audit committee characteristics such as the presence of financial experts are important in the internal control reporting framework. Section 404 of the Sarbanes Oxley Act requires that internal control weaknesses be disclosed in reports by management in a timely manner. Audit committee members can play a crucial role in effective monitoring of internal controls and financial reporting by maintaining constant communication with management, external auditors and internal auditors.

Diligence of Audit Committee Members

The investing community and standard-setters have called for presence of more diligent audit committees. One measure of audit committee diligence is the number of meetings held by audit committees. Frequent meetings allow for a smoother communication between audit committees and others, such as external and internal auditors.

Levitt (1998) notes that “qualified, committed, independent and tough-minded audit committees represent the most reliable guardians of the public interest”. He also cited that there were too many instances where audit committees did not exert their roles as effective monitors. He gives an example of a company where the audit committee meets only twice a year, for fifteen minutes just before the board meeting; he contrasted this with the audit committee of another company that meets twelve times a year before each board meeting. While I expand on the determinants and consequences of audit committee meeting frequency in Chapter 5 of this dissertation, I briefly describe some of the studies associated with audit committee meetings.

Raghunandan and Rama (2007) examine 319 firms to ascertain the determinants of audit committee diligence. They find that there is a higher frequency in the number of meetings of audit committees of firms that are larger, have higher outside block-holding, operate in a litigious environment and have more board meetings. Prior research shows that more frequent audit committee meetings are associated with reduced probability of financial reporting problems (McMullen and Raghunandan 1996), fraud (Beasley et al. 1999), sporadic auditor changes that are deemed suspicious (Archambeault and DeZoort 2001) and restatements (Abbott et al. 2004). Raghunandan et al. (2001) surveyed chief internal auditors (CIA) and find that audit committees that were fully independent tended to have longer meetings with CIAs and were more likely to provide access to CIAs and review internal audit proposals and results.

In summary, audit committees constitute an important element in the corporate governance mosaic. An effective audit committee is more likely to be associated with

higher quality financial reporting. This in turn suggests that the appointment and exit of audit committee directors will be of interest to investors and other financial statement users. I examine these issues in greater detail in the next two chapters.

III: MARKET REACTIONS TO APPOINTMENT OF AUDIT COMMITTEE DIRECTORS

The previous chapter discussed the notion of audit committees as an integral part of the corporate governance system, and the role of the committee in the financial reporting process. As also discussed in the previous chapter, issues related to the composition of the audit committee have attracted significant attention from legislators and regulators. Such attention is supported by empirical evidence from numerous academic studies suggesting that the composition of the audit committee is associated with a variety of processes and outcomes related to financial reporting.

Hence, it is likely that any changes in the composition of the audit committee would be of interest to financial statement users. Recognizing the importance of directors in general in the monitoring process, the SEC requires that any appointment or exit of a director be reported promptly in a Form 8-K to the Commission.

Companies use Form 8-K to disclose certain corporate events that occur between the filings of the 10 Q. In 1977, when the SEC established the filing of the 8-K, corporations were given five business day and 15 calendar day deadlines and SEC had to consider problems associated with paper filing of the 8-K. However, since the advent of the internet and EDGAR electronic filing, it has become easier for corporations to file as soon as the event occurs.

The SEC proposed in June of 2002 that companies file 8-Ks “within two business days after the occurrence of a triggering event.” SEC (2002b) The SEC’s move towards a more spontaneous filing emphasizes the importance of real-time disclosures to investors and the business community. The SEC also proposed adding

items that needed to be reported in the 8-K such as disclosure about the resignation of a director.

“Finally, we propose to expand the current Form 8-K item that requires disclosure about the resignation of a director to also require disclosure regarding the departure of a director for reasons other than a disagreement or removal for cause, the appointment or departure of a principal officer, and the election of new directors.”

Under the old rules, Item 6 of the 8-K required disclosure only if there is a director departure as a result of disagreement with management. The burden of such a disclosure was entirely on the exiting director, who needed to provide a letter to the company discussing the disagreement. The proposed rules also cited a disclosure in the 8-K when a corporate appoints certain new officers and directors. The SEC (2004) noted as follows:

“This proposed item also would require disclosure if the company appoints a new principal executive officer, president, principal financial officer, principal accounting officer, principal operating officer, or person serving an equivalent function. If such an event occurs, proposed Item 5.02(c) would require the company to disclose the officer's name, position, the date of the appointment, a brief description of any arrangement or understanding pursuant to which the officer was selected as an officer, the information required regarding the officer's background and certain related transactions with the company, and a brief description of the material terms of any employment agreement between the company and that officer. In addition, if a new director is elected to the board, except by a vote of security holders at an annual meeting, proposed Item 5.02(d) would require disclosure of the new director's name, the election date, a brief description of any arrangement or understanding pursuant to which the new director was selected as a director, any committees to which the new director has been, or at the time of the disclosure is expected to be, named, and information regarding certain related transactions between the new director and the company. Certain information required to be disclosed regarding new officers and directors would be permitted to be filed by amendment after the company determines this information.”

Effective, August 23, 2004, SEC adopted the final rules surrounding disclosures made in the 8-K. The SEC states that issuers subject to the reporting requirements of Section 13(a) and Section 15(d) of the Exchange act were required to file Form 8-K within four business days of a triggering event. Paragraph (c) of Item 5.02 requires (SEC 2004):

“disclosure if the company appoints a new principal executive officer, president, principal financial officer, principal accounting officer, principal operating officer or person performing similar functions. The company must disclose the officer's name, position, the date of the appointment, information regarding the background of the officer and certain related transactions with the company, and a brief description of the material terms of any employment agreement between the company and the officer.”

In this part of my dissertation, I investigate if there is a market reaction to the appointment of audit committee directors disclosed in Form 8-K filings with the SEC. There have been only two studies have looked at market reaction to appointment of audit committee members, but both of the studies examine audit committee appointments the pre-SOX period. I extend prior research in this area by examining the market reaction to the appointment of audit committee directors in the post-SOX period.

Related Research and Hypotheses

Davidson et al. (2004) hypothesize that the market will react more positively to the appointment of a director with financial expertise. They examine a sample of 136 voluntary appointment announcements from 1990-2001 and find that investors seem to reward firms who hired audit committee directors with financial expertise.

Davidson et al. (2004) had a relatively smaller sample because they limited their sample selection to those firms that had press releases and public announcements.

DeFond et al. (2005) study a sample of 702 newly appointed outside directors to audit committees from 1993 to 2002. The authors find a positive market reaction when accounting financial experts are appointed to the audit committee. They also test if appointment of an expert when there is no existing expert on the audit committee leads to a positive market reaction. In addition, they study the reaction of the market when the number of experts increases on the audit committee. They expect the market to reward firms that attempt to increase their monitoring by appointment of an expert in both cases: when an expert is present prior to the new appointment and when an expert is not present. As expected, they find that the cumulative abnormal return is 1.7% (significant at 5%, two-tailed) when there is an increase in the number of experts. This finding resonates with market belief that increasing the strength of experts on the audit committee will lead to effective monitoring.

Both of the above studies use data from the pre-SOX period. In the post-SOX environment, there are two different arguments about the market reaction to the appointment of expert directors to the audit committee.

One argument is that there is heightened awareness of the need for good audit committees given the emphasis placed by the legislators and the SEC on the composition of audit committees. Hence, the market reaction to the news of an audit committee director with financial expertise will be more positive than in the pre-SOX period.

The counter argument is that in the post-SOX period all listed corporations are required to have at least one financial expert present on the audit committee. Hence, the appointment of another audit committee director with financial expertise may not matter as much compared to the pre-SOX period.

Thus, there are differing arguments about the effects of an expert director to the audit committee in the post-SOX period. Ultimately, this is an empirical question about which I seek to provide some empirical evidence.

Similar to Davidson et al. (2004) and DeFond et al. (2005), I divide my sample into three categories of experts. *Audit/CPA* experts are those directors who have audit experience in a public accounting firm and/or are professionally qualified such as Certified Public Accountants (CPA), Chartered Accountants (CA) and Certified Financial Analysts (CFA). The second category of experts is *Accounting/Finance* which encompasses all those directors who have had finance or accounting backgrounds. For example, a Chief Financial Officer (CFO), Chief Accounting Officer (CAO) Treasurer, or Vice President-Finance would fall under this category. Lastly, *Other* experts are those that are neither *Audit/CPA* nor *Accounting/Finance* experts. If the first of the two arguments discussed above is valid, then the appointment of an *Audit/CPA* expert should elicit the most positive market reaction, followed by the appointment of an *Accounting/Finance* expert; the appointment of *Other* expert should have the least positive market reaction. If the second argument discussed above is valid, then there should be no significant differences in the market reaction to the different types of experts; a stronger form of the hypothesis would also suggest that there will be no positive market reaction to the appointment of any type of expert.

Thus, my first hypothesis, stated in the null form is:

H₀₁: The market reaction to the appointment of audit committee directors with and without financial expertise will not be significantly different.

I also examine if the market reaction to the appointment of audit committee experts varies depending on the number of experts already present in the committee. Here again, there are two arguments. The first argument states that there is a premium for hiring more than one audit committee financial expert. The counter argument is that, given that there is already one or more experts present, the addition of yet another expert would not be deemed to be valuable by the market. Therefore, similar to DeFond et al. (2005), I calculate the number of audit committee financial experts prior to the new appointment to check if the increase in the number of experts post appointment has any differential impact on the market. Thus, my second hypothesis, in the null form, is:

H₀₂: The market reaction to increase in strength of the audit committees will not differ based on the number of experts already present on the audit committee.

The number of board memberships held by directors has come under increased scrutiny in recent years. Some have argued that the number of board memberships is a positive signal about the quality of a director. This argument holds that the reward for good performance by a director comes in the form of additional board memberships; hence, multiple board memberships is a market-based proxy measure for the quality of

a director. In this view, a director who serves on other boards is considered an asset on the audit committee because serving on other boards is perceived as an indicator of a high quality director. Therefore, when a 'busy' director is appointed to the audit committee, the market will react positively.

Ferris et al. (2003) investigate the number of external appointments held by corporate directors. Their sample consists of those firms with at least \$100 million in total assets at the beginning of 1995 for which the director data is available. The final sample comprises of 5,979 directors (653 firms). The mean (median) number of directorships held per director is 1.60 (1.40). They conduct additional analyses and find positive market reaction to announcements of appointments of director who serve on multiple boards. Their results indicate that the historical performance of a firm tends to follow the director and affects the number of directorships held by the director, and his ability to attract other board appointments in the future. They refer to this phenomenon as the reputational effect in the market for corporate directors.

The counter argument is that multiple directorships imply a busy director; this also means that there is less time available for monitoring a company, and hence the quality of monitoring will be adversely affected (U.S. Senate 2002). Under this view, appointing a director with other board memberships is negative. This view may be particularly relevant in the post-SOX period, given the heightened expectations from directors in general and audit committee directors in particular.

The above discussion leads to my third hypothesis. In the null form, my hypothesis is:

H₀₃: The market reaction to appointment of a director will not be related to the number of other board memberships held by a director.

SAMPLE AND DATA

I begin with a list of audit committee director appointments that were disclosed in Form 8-K filings with the SEC firms between January 1, 2008 and December 31, 2008 per the *Audit Analytics* database. As shown in Table 1, from this initial list of 1,351 audit committee director appointments, I delete 3 duplicate observations where the same director appointment was reported twice. I also delete 114 audit committee departures from foreign firms, because there are significant institutional differences between the USA and other countries; the focus of my study is on the USA only. I then delete 348 appointments where there were multiple audit committee directors appointed at the same time; this is because in such instances it is difficult to isolate the effects associated with a specific director. Next, I delete 115 appointments that were accompanied by audit committee director departures, again because it is difficult to disentangle the departure news from the appointment news. Another 231 appointments are deleted because of missing permno (CRSP identifier) and ticker information. After such deletions, I have 540 director appointments with relevant data. I further delete 180 observations where there are other news announcements contemporaneous with audit committee director appointment. My final sample comprises of 360 single director audit committee appointments.

RESULTS

In Table 2, Panel A, I present descriptive statistics for the sample of audit committee director appointments. I note that the mean (median) total assets is 10,576.13 (884.75) million, total revenues is 4,515.34 (392.37) and market value is 4,191.43 (318.24). The size of firms in my sample is similar to Defond et al. (2005) where the mean (median) total assets is 10,317.35 (1,223.00). In Panel B of Table 2, I segregate the sample by industry using the industry classifications provided by Dr. French. I find that excluding the other category; high-tech industry had the largest appointments (22 percent) followed by healthcare (13 percent) and manufacturing (9 percent).

I conduct further analysis to study the market reaction to appointment of experts. I first identify those who are classified as an “audit committee financial expert” by the company, based on subsequent proxy statement disclosures. I also obtain data about the audit committee director from the brief biographical information available in proxy statements. Using such information, I classify audit committee directors as either as *Audit/CPA expert*, *Accounting/Finance Expert* or *Other expert*.

I obtain the 3-day (-1 to + 1) and 5-day (-2 to +2) cumulative abnormal return (CAR) with value-weighted market adjustment from *Eventus*. The estimation period ends on day -10 relative to the announcement date; the minimum and maximum estimation periods are 100 and 255 days, respectively. I selected CRSP Value weighted market index and the benchmark for the estimation of the abnormal returns used is the market model. I calculate the statistical significance of the cumulative abnormal returns using T-tests and median tests.

I am able to obtain CAR data for 540 of the 1,351 audit committee director appointments for 2008; however I deleted 180 observations because there were some other contemporaneous news announcements surrounding the 8-K date. If an event occurred within 5 days of the 8-K filing, I consider it as a concurrent event. This yields a final sample of 360 single-director appointments to the audit committee. One-hundred and sixty eight of the 360 (47 percent) appointments are of expert directors. I compare the proportion of audit committee financial experts to prior research and find that Davidson et al. (2004) have 64 percent accounting experts and DeFond et al. (2005) have 74 percent accounting experts. I conducted the binomial proportions test to check if the proportion of experts is significantly different from the hypothesized value of 50% and I find no such difference.

In Table 3, I provide market reaction to the full sample of 360 audit committee director appointments. As seen in Panel A of Table 3, for the total sample of 360 observations, neither the 3-day nor the 5-day mean CARs are significant. Fifty-one percent of the sample has a negative 3-day CAR, while the proportion is 50 percent for the 5-day CAR.

Panel B of Table 3 shows that the CARs when the sample is partitioned based on the type of incoming audit committee director. For the 168 expert director appointments, the mean 3- day and 5-day CARs are -0.006 and -0.005, respectively; neither is statistically significant at conventional levels. Fifty percent of the expert sample has a negative 3-day CAR, while the proportion is 52 percent for the 5-day CAR. For the 192 expert director appointments, the mean 3- day and 5-day CARs are

0.001 and 0.000, respectively; again, neither is statistically significant at conventional levels. Fifty-one percent of the non-expert sample has a positive 3-day CAR, while the proportion is 48 percent for the 5-day CAR.

In Table 4, I provide a detailed analysis of the market reaction associated with incoming directors that are *Audit/CPA* experts, *Accounting/Finance* and *Other* experts. As seen in Table 4, there are 168 audit committee financial experts and 192 not-audit committee financial experts. Of the 168 audit committee financial experts, 67 percent are classified as *Audit/CPA* experts; 32 percent are *Accounting/Finance* experts.

Based on results from Davidson et al. (2004) and DeFond et al. (2005), one would predict the market will react positively to the news of appointment of an audit committee financial expert, and that the reaction would be more positive when a director is *Audit/CPA* expert. However, the results do not support such predictions. For the 113 *Audit/CPA* expert director appointments, the mean 3- day and 5-day CARs are -0.005 and -0.011, respectively; neither is statistically significant at conventional levels. Forty-eight percent of the *Audit/CPA* expert sample have a negative 3-day CAR, while the proportion is 58 percent for the 5-day CAR.

Interestingly, I find that 60 of the 192 (31 percent) of audit committee directors, not classified as audit committee financial experts are *Audit/CPA* experts. The mean 3-day CAR associated with such appointment is 2.2 %, which is statistically significant. This reaction suggests that the market is rewarding firms for hiring *Audit/CPA* experts even when such experts do not ultimately earn the title of “audit committee financial experts”. This result shows that presence of a director who possesses such expertise is valued by the market. However, why should the market

reward the appointment of experts when they are not classified by the firm as an audit committee financial expert but not when they are so classified? I do not have an answer to this question, other than to say that the results are what they are.

Nevertheless, it is worth noting that even for this group of audit committee financial expert appointments, the 5-day CAR is not statistically significant. In addition, the median tests also are not significant, for either the 3-day or 5-day CAR.

I also find that an additional 17 of the 192 (9 percent) of audit committee directors, not classified as audit committee financial experts are *Accounting/Finance* experts. The mean 3-day and 5-day CARs associated with such appointment are not statistically significant; similarly, the median tests also indicate that the market reaction is not statistically significant.

Before I move on to the analysis of other experts, it is interesting to note that 77 of the 192 appointments of audit committee directors who are not classified as audit committee financial experts by the company can in fact be deemed to be appointments of auditing or accounting experts. Why do the firms not classify such directors as experts? This is an interesting issue for future research. In this context, it is interesting to note that Carcello et al. (2006) who examine disclosures of 400 companies (100 Fortune 500 and 300 drawn randomly from NYSE, Nasdaq National Market System and Nasdaq National Dealer Quotation) find that a very high number of firms (98 percent) comply with the SEC disclosure requirement concerning financial experts, however, the extent of the disclosure varied across the sample. For example, only 5 percent of their sample provide a significant discussion concerning financial experts. They also find that most designated audit committee financial

experts do not have accounting or finance backgrounds. The authors speculate that firms' failure to appoint an audit committee financial expert with an accounting or finance background may mitigate the financial reporting benefit derived from the presence of such experts. Lastly, they find that firms that were large, operated in a litigious environment and have active audit committees were more likely to have a designated audit committee financial expert.

Finally, 115 of the 192 (60 percent) of audit committee directors, not classified as audit committee financial experts, are neither *Audit/CPA* nor *Accounting/Finance* experts. The mean 3-day and 5-day CARs associated with such appointments are not statistically significant; similarly, the median tests also indicate that the market reaction is not statistically significant for such appointments.

Market Reaction: Partitioned by Number of Experts present on the audit committee post appointment

In Table 5, I partition the sample by the number of experts present on the audit committee post appointment. DeFond et al. (2005) find that an audit committee financial expert is more likely to succeed in a strong corporate governance environment. My results reinforce such views, as I find that the market reacts positively (and significant) to the news of appointment of audit committee financial expert when two or more such directors are already present on the audit committee.

It is evident in Table 5 that when there are four or more audit committee financial experts present on the audit committee post the new appointment, the market reacts positively. The 3-day and 5-day CARs when the new appointment results in the

audit committee having four or more experts are 3.0% (significant at $p < .01$) and 3.1% (significant at $p < .10$), respectively. In contrast, neither the 3-day nor the 5-day CAR are significant when there is only one or no expert on the audit committee after the appointment of the director to the audit committee.

Market Reaction: Busy Director Appointment

Table 6 presents the market reaction to the number of other boards a new director serves on. There are 213 audit committee directors who do not serve on any other board, while 147 serve on one more other company boards. The 3-day and 5-day CARs for those appointments where the appointee does not serve on any other board is -0.005 and -0.007, respectively; neither is significant at conventional levels. The corresponding CARs for those appointments where the appointee serves on one or more other boards is 0.002 and 0.004, respectively; again, neither is significant at conventional levels.

In Table 7, I provide additional information about the market reaction to the appointment of different types of directors. I partition the sample based on whether or not the director appointed to the audit committee was already a member of the company's board (i.e., an internal appointment) or if such a person was appointed a member of the board only while simultaneously being appointed to the board (i.e., a new external appointment). I also partition these two categories by the type of expert. As seen in the Table 7, in none of the partitions is the market reaction statistically significant.

SUMMARY

This part of my dissertation examines the market reaction to audit committee director appointments. I find that overall there is no significant market reaction to the full sample of single-director appointments. I also find that, surprisingly, the market does not react positively to the news of appointment of an audit committee financial expert when a director is either *Audit/CPA* expert or *Accounting/Finance* expert. However, I find that 31 percent of audit committee directors not designated as an audit committee financial expert can nevertheless be classified as *Audit/CPA* experts; the market reaction to the appointment of such experts is positive and significant. Even here, it is only the mean 3-day CAR that is significant; the 5-day CAR is not significant, nor are results from the median test with either the 3-day or 5-day CAR. Taken together, the results suggest that the market does not react as strongly in the post-SOX period to the appointment of an audit committee expert as in the pre-SOX period.

This chapter focused on the appointment of audit committee directors. In the next chapter, I examine market reaction to departure of audit committee directors.

IV: MARKET REACTIONS TO DEPARTURE OF AUDIT COMMITTEE DIRECTORS

As noted in Chapter 2, starting since the 1940s the Securities and Exchange Commission has emphasized the role of independent audit committees in ensuring high quality financial reporting (SEC 1999). Chapter 2 also provides a detailed discussion of the many regulatory and legislative actions in recent years that have focused on the composition of audit committees, including specific provisions of the Sarbanes-Oxley Act (SOX) of 2002. In Chapter 3, I provide a summary of prior research related to the composition of audit committees and the many consequences associated with variations in audit committee composition. Yet, as noted in Chapter 3, there is a paucity of research related to the appointment and, more importantly, the departure of audit committee directors.

Recent actions by the SEC reinforce the idea that the departure of directors could be value-relevant to investors and other financial statement users. In August 2004, the SEC (2004) made a final rule change to 8-K filings. Item 5.02 – *Departure of Directors or Principal Officers; Election of Directors; Appointment of Principal Officers* notes as follows:

“Under the revised item, if a director has resigned or refuses to stand for re-election to the board of directors since the date of the last annual meeting of shareholders because of a disagreement with the company, known to an executive officer of the company, on any matter relating to the company's operations, policies or practices, or if a director has been removed for cause from the board of directors, the company must disclose:

1) the date of the director's resignation, refusal to stand for re-election or removal;

2) any positions held by the director on any committee of the board of directors at the time of the director's resignation, refusal to stand for re-election or removal; and

3) a brief description of the circumstances representing the disagreement that management believes caused, in whole or in part, the director's resignation, refusal to stand for re-election or removal.”

Such actions by the SEC to provide more timely and real-time disclosures regarding director departures motivates this part of my dissertation. In this part, I examine the market reaction to audit committee director departures.

Related Research and Hypotheses

I first examine prior research on director departures in general. I then discuss prior research related to departures of audit committee directors.

Outside-Director Turnover

Gupta and Fields (2009) empirically examine board member resignation and the importance of such resignations in light of the firm's governance structure. Their study seeks to examine investors' perceptions of the importance of changes in board independence. They use a sample of 744 director resignation announcements from 1990-2003 and find that an outside director resignation led to, an average, a loss of 1.22% in market value over a three day period surrounding the announcement. These results were statistically significant at the 1% level. They also find that when there is a net decrease in board independence within a one year period following board of director resignation, the market reaction is -1.17%. Their results indicate that investors' perceive a loss in value when an outside director resigns and use this

information to evaluate the strength of the board. Their results hold good after controlling for firm performance.

Dewally et al. (2009) examine the announcements of outside director resignations. While some directors leave quietly, there are some that criticize the firm and publicly disclose their reasons for exit. Some directors may be motivated to publicly criticize their firms at the time of exit to protect their own reputation. Their sample consists of director resignations that were publicly announced in the Wall St. Journal and Lexis/Nexis database from 1990 to 2003. Their final sample consists of 69 director resignations for 52 separate announcements for 49 firms. They also find that resignations of directors due to conflicts with management often result in various internal changes within management and positive stock market reactions. Overall, their study indicates that director resignation (with or without conflict) forces the board to rethink and analyze their corporate governance model and can help protect shareholders' interests.

Asthana and Balsam (2010) provide evidence to suggest that corporate directors are more likely to exit when firm performance declines and the firm becomes more risky (for example, a higher chance of bankruptcy). Their sample comprises of 51,388 observations (13,084 directors) who served 1,065 firms during the period 1997-2004. They also provide evidence showing that directors may pre-empt the decline of their firms and exit in advance of such performance, thus protecting their wealth and reputation. Their results hold good in a multivariate model after controlling for director age, tenure, gender and firm size.

The above studies look at departure of board members in general and the impact of such resignations on firm performance. However, there is little research on the departure of audit committee members. In the next sub-section, I provide an overview of three academic studies pertaining specifically to audit committee director turnover.

Audit Committee Director Turnover

Srinivasan (2005) investigates a sample of 409 companies that restated their earnings from 1997 to 2000 to examine repercussions for audit committee directors after restatements are announced. He finds that subsequent to a restatement, director turnover is 48 percent for income-decreasing restatements and 28 percent for income-increasing restatement. He concludes that penalties in terms of the labor market are highest for outside-directors who are associated with an income-decreasing restatement. His results show that directors associated with restating firms lose more directorships (at other firms) compared to the control sample. There are also legal ramifications for this sample; the SEC issued an AAER against 65 of these 409 companies. This study also finds a negative market reaction to appointment of a director who concurrently presides on the board of a restated firm. The firms that share directors with restating firms experience a cumulative abnormal return of -0.24% (significant at the 10% level) and the cumulative abnormal return was -1.41% when the CEO served as a director in a restating firm. These results suggest that the market is skeptical about hiring directors who are associated with “tainted” firms and the market reaction is stronger for a shared CEO/director because of the increased role of the CEO in the management process.

As noted in the previous chapter, Davidson et al. (2004) examine 136 audit committee director appointments during 1990-2001 and find that investors reward firms that hired audit committee directors with financial expertise. Davidson et al. (2004) hypothesize, and find, that the market will react more positively to a company that appoints a director with financial expertise. DeFond et al. (2005) study a sample of 702 newly appointed outside directors to audit committees from 1993 to 2002, and find a positive market reaction when accounting financial experts are appointed to the audit committee.

In summary, while regulators and legislators have long shown an interest in the functioning of audit committees, there is limited research related to the departure of audit committee directors. Two prior studies show that the appointment of an audit committee expert director is associated with a positive market reaction. Both of these two studies examine the pre-SOX period. I extend the literature on audit committees by first providing descriptive evidence about audit committee director turnover and then examining the market reaction to the departure of different types of directors in the post-SOX era.

There are two different arguments related to expectations about the market reaction to the departure of expert directors from audit committees in the post-SOX period. One argument is that the relative importance of expert directors is higher in the post-SOX period, so the departure of an expert director will elicit a negative market reaction. The counter argument is that in the post-SOX period all companies are expected to have at least one expert director, so even if one expert leaves it is likely that there will soon be another expert director appointment to the audit committee.

Under this latter view, it is not a significant event if an expert director departs from the audit committee; so, there will not be a negative market reaction to departures of expert directors from audit committees.

While there are arguments on both sides, given the prior research evidence, I make a directional prediction in my next hypothesis. In light of the evidence in Davidson et al. (2004) and DeFond et al. (2005), my hypothesis is:

H₀₄: The departure of an Accounting Expert director from the audit committee will elicit a significantly negative market reaction.

Director tenure is an issue that has started to receive attention from good governance advocates and others. During the Enron hearings held by the U.S. Senate's Committee on Governmental Affairs (U.S. Senate 2002) one of the issues that was raised was whether the audit committee directors had been on the audit committee for too long, and hence were too close to management. While increased director tenure may lead to better knowledge of the company and perhaps contribute to enhanced monitoring, others argue that too long a tenure leads a director to become complacent (Kesner 1988; Vafeas 2003). A survey by Heidrick and Struggles (2006) finds 22 percent of companies have term-limits for their directors, and that this proportion has more than doubled since 2000. KPMG's Audit Committee Institute recently released a report (KPMG 2009) which states the ten to-do's for audit committees in 2010, one of the points emphasized leadership of audit committee members and to evaluate if there is a need for a "fresh set of eyes". A similar report on audit committees by Deloitte

and Touche (2010) states that audit committees must periodically evaluate its members' expertise and knowledge.

Directors & Boards (2008) invite a panel of experts who mention interesting points such as how long does it take for directors to become complacent and if term limits are a necessity or do they backfire and cause inefficiencies in the performance of the board. The proponents for long tenure state that an experienced director has better knowledge of the company and thus contributes to improved monitoring. On the other hand, those against long tenure state that audit committee members who have been on the board for too long are no longer independent of management.

Heidrick and Struggles (2006) conduct a study national survey of corporate directors to evaluate what makes board of directors effective and how their current practices continue to evolve in response to the environment. They find that 22 percent of their respondents have imposed term-limits for their directors. Although term-limits are not a common phenomenon, the number of boards imposing such limits has more than doubled from 9 percent in 2000. It also emphasizes that companies need to strike a balance between experienced members and new members to maintain the effectiveness of the audit committee. The report supports change in the composition of audit committee members but also states that too much turnover can cause inefficiencies.

Lapides et al. (2007) list 21st Century *Governance* Principles for U.S. Public Companies and recommend that the board should consider rotation of audit committee members and impose term-limits which will limit the number of years a member can serve on the audit committee. The NACD in its 1996 Report on Director

Professionalism pioneered in the field of term-limits for board directors. Recently, H&R Block announced in a press release dated June 17, 2008 that the company had decided to impose a term-limit of limit of 12 years for members of the board of directors. The company's initiative indicates that it is important to have a "periodic infusion of fresh thinking" by adding new board members and an adequate level of turnover among board members promotes the effectiveness of the board. (Drysedale and Rauber 2008) Audit committee related reports issued by KPMG (2009) and Deloitte (2010) note the need for audit committees to have "fresh set of eyes."

In the context of audit committees, the departure of a director with long tenure may be viewed less negatively if investors believe the departure is part of the normal rotation and bringing in "fresh set of eyes." Conversely, the departure of a director who has been on the audit committee for only a short period of time may raise more concerns.

For example, two directors submitted their resignations from St Joe Co. merely six weeks after they joined. Such news led to a decline in the stock price of 2.4%. The board members said that they were resigning because they did not agree with management on several issues. (WSJ, Feb 15, 2011). In another instance, there was an announcement of the exit of Dynegy's chief executive and chief financial officers who submitted their resignation on February 21, 2011. In addition, five of the six board members also announced that they will be resigning in June at the company's annual meeting. The top officers and board members cited that the lack of shareholder approval for a potential buyout had caused frustration among directors and management. (WSJ, February 22, 2011).

The above discussion leads to my next hypothesis, focusing on the association between audit committee director tenure and departure. My hypothesis is:

H₀₅: The market reaction to the departure of an audit committee director is more negative if the director is a short-tenured director.

Some have argued that serving on too many boards spread a director thin, and thus reduces the quantity and/or quality of the oversight provided by the director (NACD 1996; Council of Institutional Investors 1998; U.S. Senate 2002). The National Association of Corporate Directors (1996) suggests that corporate directors who have full-time jobs should prohibit themselves from serving on more than three or four other boards. The counter argument is that the number of other board memberships may be viewed as a signal of the market's assessment about a director (Fama 1980; Fama and Jensen 1983).

During the Enron hearings (U.S. Senate 2002), the Senators posed the following question to some witnesses:

“Some directors of the Enron Board have been criticized for their membership on numerous boards, calling into question their ability to dedicate time and focus to issues at Enron. Would you be in favor of limiting the number of corporate boards an individual may serve simultaneously?” (U.S. Senate 2002)

If a busy director resigns, then the negative reaction may be tempered by the fact that the person serves on many boards; the counter-argument is that if multiple board service is viewed as the market-based reward for an effective director, then the resignation of such a director may elicit a more negative reaction.

In my next hypothesis, I posit that market reaction to the exit of a ‘busy’ director will be negative because a ‘busy’ director is known to add value to the audit committee because of the broad array of experiences he brings to the table.

H₀₆: The market reaction to the departure of a ‘busy’ director will be negative.

One measure used to calculate the strength of an audit committee is the number of audit committee financial experts on the audit committee. In Chapter 2, I noted comments from companies and others that there has been an acute shortage of qualified directors who will agree to serve as audit committee financial experts due to increased legal liability and reputational concerns. Therefore, when more than one audit committee financial expert is present on the audit committee, it may be perceived that the board of directors has taken measures to hire the most proficient directors who serve as overseers of management on behalf of the shareholders. In such cases, when the strength of the audit committee declines as a result of a departure, it is likely that the market will react negatively because of the loss of an expert. Consistent with this argument, DeFond et al. (2005) measure the strength of the audit committee prior to a new appointment and find that the market reacts favorably when a financial expert is added to an already existent strong corporate governance structure.

Conversely, if more than one expert is present on the audit committee, then the departure may not elicit a negative market reaction. This is particularly the case in the post-SOX period.

My next hypothesis examines the association between the market reaction to the departure of an audit committee directors and the presence of other experts on the audit committee.

H₀₇: The market reaction to the departure of an audit committee director will be more negative when there are zero experts on the committee post-departure.

SAMPLE AND DATA

I begin with a list of audit committee director departures that were disclosed in Form 8-K filings with the SEC firms between January 1, 2007 and December 31, 2008 per the *Audit Analytics* database. As shown in Table 8, from this initial list of 1,059 audit committee director departures, I delete 16 duplicate observations where the same director departure was reported twice. I also delete 76 audit committee departures from foreign firms yielding a sample of 967 audit committee director departures for 746 firms.

When two or more directors exit on the same day, I code it as a single event. As seen in Table 9, the 967 audit committee director departures encompass 881 unique events. In 818 of the 881 instances, only one audit committee director departed. In 46 events, two directors departed simultaneously; there were another 17 instances with simultaneous departures of three or more audit committee directors. Thus, the overwhelming majority of audit committee director turnover is characterized by the departure of one director at a time.

Davidson et al. (2004) and DeFond et al. (2005) exclude from their primary analyses audit committee director appointments that were concurrent with the departure of a director. Rosenstein and Wyatt (1990) suggest that replacement announcements are noisier than board expansion announcements. They note that such (replacement) appointments with concurrent departures must be treated differently from appointments without a concurrent departure. Following the same logic, I partition my sample of audit committee director departures based on whether or not there was a concurrent appointment of another audit committee director. I define 'concurrent' as appointment of an audit committee director within 5 days of the departure of a director.

Table 9 shows that 73 percent of the 818 single director exit events occurred without a concurrent appointment. With two exceptions, there was a concurrent appointment of another single director in the remaining single director exit events. In contrast to the above, a majority of the events with two audit committee directors exiting have concurrent appointment of at least one audit committee director. Also, eight of the 17 events with three or more audit committee director exit events include the concurrent appointment of at least one new audit committee director.

I use the 8-K filing date as my event date. I obtain the 3-day (-1 to + 1) and 5-day (-2 to +2) cumulative abnormal return (CAR) with value-weighted market adjustment from *Eventus*. The estimation period ends on day -46 relative to the announcement date; the minimum and maximum estimation periods are 3 and 255 days, respectively. I am able to obtain CAR data for 280 of the 818 single director

exits. Of these 280 events, 67 had other contemporaneous news events (earnings release, proxy statement release, other press releases or news announcements) in the five days surrounding the director departure disclosure date. In another 80 instances, there was a concurrent appointment of another audit committee director. After deleting such observations, my final sample for market reaction analyses includes 133 single director exit events.

In Table 12, I provide descriptive data about the market-reaction sample. The mean (median) total assets of the sample firms is \$1,344 (\$478) million, indicating that the sample is skewed. Similarly, the average annual revenues (market value) for the sample firms is \$846 (\$891) million, while the median value is \$231 (\$358) million. While I do not show descriptive statistics for the 16 multiple director events with available data, T-tests indicate that the multiple directors exit group is significantly ($p < .01$) smaller than the single director exit group in terms of total assets and revenues.

RESULTS

In Table 13, I partition the single director exit sample by expert status. Of the 133 single director departures with no concurrent appointments, 48 are for those classified as “audit committee financial experts.” I read through the biographies of the departing directors, and classified 20 of them as “Accounting experts” (i.e., those with experience as an auditor, or as a Chief Financial Officer, Chief Accounting Officer, or other senior executive positions in accounting or finance, such as Vice-President—Finance). The remaining 28 are classified as other financial experts; these members

are designated audit committee financial experts but do not have a background in auditing/accounting.

Audit committee directors who possess accounting and financial expertise are valued members of the audit committee. These members are diligent and well versed with finance and accounting nuances and their contribution helps the audit committees. Therefore, in H_{04} , I posit that the departure of such a director is deemed negative by the market. As seen in Table 13, there are 20 director departure events where the departing director is an accounting expert. There is a significant ($p < .05$) negative market reaction to such events, with average 3-day and 5-day CAR values of -3.1% and -4.0%. In contrast, the average 3-day CAR for the departure of the 28 non-accounting financial experts is -1.3%; this is marginally significant in a T-test ($p < .10$), but the median value of -0.6% is not significant in a non-parametric test; the 5-day CAR is not significant in either parametric or non-parametric tests. Finally, the mean market reaction to the departure of the 85 non-experts is not significant when considering the 3-day or 5-day CAR, using either parametric or non-parametric tests.

Overall, the results indicate that only the departure of accounting experts elicits a significant adverse reaction from the market. These results are consistent with the findings of Davidson et al. (2004) and DeFond et al. (2005) related to the appointment of different types of audit committee directors, as also the results from other recent studies that show differences in various financial reporting measures based on differences in the types of audit committee experts (Yang and Krishnan 2005; Krishnan and Viswanathan 2008; Krishnan and Lee 2009; Dhaliwal et al. 2010).

Departures partitioned by director tenure

In panel A of Table 14, I partition the departure of non-expert directors based on the tenure on the audit committee of the departing director. I categorize tenure as short (0-3 years), medium (4-6 years) and long (7 years or more). Overall, the market reaction is not significantly different from zero in any cell, when I consider the sample of non-expert directors.

Panel B of Table 14 examines the market reaction to the departure of expert directors, when partitioned by the tenure of the director. In this group, the 3-day and 5-day CARs for the departure of the director is significantly negative for both short and medium-tenured directors; however, the reaction is not significant for the departure of long-tenured directors. The evidence suggests that the market may view the departure of an expert director less negatively if that director had a long tenure. This evidence is consistent with calls to ensure that audit committee directors do not serve for too long a period.

As part of my sensitivity analysis, I tried using the following cutoff points to split the sample into two groups in each instance: five years or more, seven years or more, and ten years or more. In each such partition, I obtain results that are substantively similar to those reported in the paper—namely, the departure of expert directors with shorter tenures elicits a negative market reaction, but the departure of expert directors with long tenure does not elicit a negative market reaction.

Busy Director Exits

Panel A of Table 15 partitions the sample by whether the exiting director serves on at least one other public company board; there are 36 directors who serve on at least one other board at the time of their departure, while the remaining 49 have no other board service. The data show that neither group of director exits elicits a significant market reaction.

Panel B of Table 15 provides the market reactions for the departures of expert directors, partitioned by the number of other public company board directorships. There are 30 directors with no other board memberships, while 18 directors have one more other board memberships. For both groups of departing directors, there is a significant negative market reaction.

As part of my sensitivity analysis, I used two or more other board memberships to define a busy board member. With this cutoff, there are 11 busy directors each in the expert and non-expert groups. In the non-expert group, as before, there is no significant market reaction to the departure of busy or non-busy directors. In the case of expert directors, for the 37 events where the departing expert had one or no other board memberships, both the 3-day and 5-day CARs are significantly negative; for the 11 events where the departing director had two or more other board memberships, the 3-day CAR is marginally negative.

Overall, the results suggest that—unlike the case with director tenure—there are no significant differences in the market reaction based on whether or not the departing audit committee director serves on other boards. While some good governance advocates have called for restricting the number of board memberships,

usually such calls seek to restrict the number of other board memberships at three or more. I am unable to perform meaningful statistical analysis with a cutoff of three because only five directors from the sample of 133 departing audit committee directors served on four or more other boards.

Audit Committee Strength: Post Departure

As seen in Table 18, there is significant reaction to 33 events where there are zero experts remaining on the audit committee post departure. The results are negative and significant in both the 3-day window and the 5-day window. The results obtained from my study support my hypothesis. When the number of experts remaining is zero, I find that the 3-day CAR is -2.2% and the 5-day CAR is -2.5%. As the number of experts remaining on the audit committee increases from zero to two, I note a positive market reaction. These results show that the departure of an expert, especially when there are no other experts remaining on the audit committee is perceived negatively by the market and could be potential bad news for the future.

Regression Analysis

The evidence presented above pertained to analyses conducted in a univariate setting. I now provide results of multivariate tests performed using ordinary least square regression.

I perform four different multiple regressions, using the (a) 3-day or 5-day market reaction as the dependent variable, separately for (b) expert and non-expert director departures (thus, the $2 \times 2 = 4$ regressions). In each regression, the

explanatory variables are (a) long tenure or not, and (b) whether or not the departing director had membership in other public company boards. As seen in Table 16, in the expert director departure regressions the *Tenure* variable is significant indicating that the market reacts negatively to the departure of an expert who has served for less than seven years; but the *OtherBoard* variable is not significant. However, neither of the two regressions examining the departure of non-expert directors is significant.

Departures with Specific Reasons Given

In some instances, the departing directors provide specific reasons for their departure. My sample of single director exits without a concurrent appointment includes five instances where the directors note that they are leaving due to *disagreement with management*. The mean (median) 5-day CAR is -7.5% (-4.5%) for such departures; the 5-day CAR is significant ($p < .05$ for mean, $p < .10$ for median). There are 14 instances where the departing director specifies *too many commitments* as the reason; the market reaction to the departure of directors that list too many commitments as the reason is not statistically significant.

SUMMARY

In this part of my dissertation, I examine market reaction to audit committee director departures. I find that Audit committee directors who possess accounting and financial expertise are valued members of the audit committee. My results show that when the departing director is an accounting expert, there is a significant ($p < .05$) negative market reaction to such events, with average 3-day and 5-day CAR values of

-3.1% and -4.0%. In contrast, the average 3-day CAR for the departure of the 28 other financial experts is -1.3%; this is marginally significant in a T-test ($p < .10$), but the median value of -0.6% is not significant in a non-parametric test. Overall, the results indicate that only the departure of accounting experts elicits a significant adverse reaction from the market. These results are consistent with the findings of Davidson et al. (2004) and DeFond et al. (2005) related to the appointment of different types of audit committee directors, as also the results from other recent studies that show differences in various financial reporting measures based on differences in the types of audit committee experts (Yang and Krishnan 2005; Krishnan and Viswanathan 2008; Krishnan and Lee 2009; Dhaliwal et al. 2010).

I also examine market reaction to audit committee director departure partitioned by tenure. In this group, the 3-day and 5-day CARs for the departure of the director is significantly negative for both short and medium-tenured directors; however, the reaction is not significant for the departure of long-tenured directors. The evidence suggests that the market may view the departure of an expert director less negatively if that director had a long tenure. This evidence is consistent with calls to ensure that audit committee directors do not serve for too long a period.

V: AUDIT COMMITTEE COMPOSITION AND FUNCTIONING

POST-ENRON

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 (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.

As discussed in more detail in Chapters 2 and 3, one of the important changes brought forth by SOX was to require 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 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 examine the evolving composition of audit committees during the decade from 2000 to 2009. Specifically, I examine the number of directors on audit committees as well as the proportion of audit committee directors who could be characterized as an audit committee financial expert.

In this chapter, I also focus 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 examine 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 will be hard to recruit directors to serve as audit committee members because of the increase in 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 will be very difficult in specialized industries such as insurance, stating “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 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 will 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 leads to the following hypothesis (stated in the null form):

H₀₈: The number and proportion of audit committee financial experts did not change between 2000 and 2009.

Another issue related to audit committees that has 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.

Menon and Williams (1994) examine 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 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 indicate that larger firms have more active audit committees.

Collier and Gregory (1999) use 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 consists of 167 companies of which 142 were usable replies. They find that audit committee diligence (measured by audit committee activity) is positively associated with a high quality external auditor (Big Six). They also find that the CEO-Chair duality reduces audit committee meeting frequency. Collier and Gregory (1999) also show that when the audit committee includes insiders such as executive directors, the frequency of audit committee meetings is lower.

Lapides et al. (2007) recommend that audit committee members must meet more frequently for extended period of time and should have unrestricted access to information. Specifically, they recommend 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) study the determinants of audit committee meeting frequency in New Zealand which has voluntary requirements for audit committee formation, composition and responsibilities. Their sample comprises of 96 firms that were listed on the main board of the NZX in fiscal 2004 and 2005. Their results show that high-growth firms had fewer audit committee meetings, and firms with high

managerial and institutional ownerships have more frequent audit committee meetings.

Raghunandan and Rama (2007) examine 319 firms with a December 31 fiscal year end in the S&P 600 index. They concentrate on small firms because large firms most likely have other governance mechanism in place such as a larger analyst following. They find that the number of audit committee meetings increases 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 seek to answer this question, and examine the changes in the frequency of audit committee meetings from 2000 to 2009. This leads to the following hypothesis (stated in the null form):

H₀: The number of audit committee meetings per year did not change between 2000 and 2009.

SAMPLE AND DATA

I begin with a sample of S&P 500 firms as of December 31, 1999. I delete firms that are not present in years 2000-2002 and 2008-2009. My final sample comprises 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 collect audit committee

member names, age, and tenure. I also collect the number of audit committee meetings each firm has in each of these years. I am 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 provides me names of ‘incoming’ audit committee directors and ‘outgoing’ committee directors. By reading each proxy statement, I am able to collect biographical information for each incoming and outgoing director and identify their expertise as *Audit/CPA*, *Accounting/Finance* or *Other*.

RESULTS

Table 21 provides empirical evidence about the size of audit committees in various years. The data show that the average size of audit committees increases from 4.27 in FY 2000 to 4.41 in 2001, and has a slight decrease to 4.38 in 2002. The average audit committee size is 4.47 (4.55) in fiscal year 2008 (2009). The proportions in Table 21 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 are 187 firms that have four or less than four directors on their audit committees. However, this number drops down steadily and only 153 firms have four or fewer directors in year 2009.

I also compare the number of audit committee members between 2000 and 2009. Because the sample firms are the same for both years, I use a paired-sample T-test and found that $T = -3.19$ (0.0016). The results indicate that the mean size of audit

committees differs 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 that it would become harder to find directors willing to serve on audit committees.

Table 22 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 also is 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 23, 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 use my own definition to describe an *Audit/CPA* expert, *Accounting/Finance* expert and *Other* expert.

The data show that the proportion of *Audit/CPA* and *Accounting/Finance* type of experts account for 20.5 percent of incoming experts in 2001, and 25.5 percent in 2002; by contrast, these two types of experts account 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 24, I partition my sample based on strength of audit committee prior to the appointment of a new director. Similar to Defond et al. (2005), I combine *Audit/CPA* and *Accounting/Finance* categories into one single group. In the year preceding SOX (2002), there was no requirement for presence of a financial expert on the audit committee; therefore there were no designated ‘audit committee financial experts’ in the years 2000-2002. Hence, I use my own judgment and rely on prior literature to define the category of accounting experts. I conduct univariate analysis and find 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 have just one audit committee that has 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 appear to be more likely to be appointed in firms already have more than two such experts on the committee.

In Table 23, I divide the incoming and outgoing audit committee financial experts into the following three categories: *Audit/CPA*, *Accounting/Finance* and Other. I find that there is a significant increase in the number of *Accounting/Finance* experts. Approximately 34 percent of the incoming directors in fiscal year 2009 are *Accounting/Finance* experts compared to *Audit/CPA* experts who constituted only 7 percent of the incoming members. The interesting part here is that even many of those not formally classified as an “audit committee financial expert” by the company have

the qualifications which enable me to classify them as *Audit/CPA* or *Accounting/Finance* experts. Why, then, do the firms resist so classifying such a director as an “audit committee financial expert?” This is an interesting question for future research.

Audit Committee Meetings

Table 26 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 jumps 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 reject 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 enable me to answer the question posed in Raghunandan and Rama (2007), namely, 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. The answer is that the frequency of audit committee meetings appear to have increased significantly as we move further away from the 2001-2002 period.

VI: SUMMARY AND CONCLUSIONS

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 this dissertation, I examine three issues related to the composition of audit committees. In the first part of my dissertation, I explore market reaction to audit committee director appointments. Using a sample of 360 audit committee single-director appointments during 2008, I find that the 3-day cumulative abnormal returns surrounding the announcement of appointing an *Audit/CPA* to serve on the audit committee is positive even though the director is not a designated audit committee financial expert; however, when a designated audit committee financial expert is hired, there is no significant market reaction. Thus, my results provide partial support to the hypothesis that hiring an *Audit/CPA* expert to the committee is viewed positively by the market. However, I do not find support to the hypotheses that the market reaction will differ based on the number of experts already present on the audit committee or the holding of other board memberships by the director.

The second part of my dissertation investigates the market reaction to audit committee director departures. My sample consists of 133 audit committee director departure events during 2007 and 2008. I find the news about the departure of an expert director from the audit committee elicits a significant negative market reaction. Additional analysis reveals that the 3-day and 5-day CARs for the departure of the director is significantly negative for the departure of short and medium-tenured directors; however, the reaction is not significant for the departure of long-tenured directors.

Taken together, the above results suggest the appointment and departures expert directors to the audit committee are value relevant to the market. The findings provide empirical support to legislative and regulatory actions related to audit committee financial experts. In this context, it is interesting to note that while SOX mandates that all audit committee directors must be independent it only requires disclosure if the audit committee has at least one expert. The evidence also suggests that the market may view the departure of an expert director less negatively if that director had a long tenure; this finding is consistent with calls from governance experts to ensure that audit committee directors do not serve for too long a period.

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 the third part of my dissertation I analyze the change in audit committees a decade after Enron and passage of SOX. I find 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 the SOX related requirements would make it difficult to find audit committee financial experts willing to serve on audit committees. In the third part of my dissertation, I also examine 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 if audit committee behavior would revert back once the “bright lights” associated with the Enron and Andersen failures dimmed. However, I find 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. First, I only examine audit committee appointments during 2008 and audit committee departures during 2007 and 2008. This period coincides with the global economic downturn precipitated by the financial market crises, and it is not clear if the same findings would be obtained in other (less turbulent) periods. Second, 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.

Table 1
Audit Committee Director Appointments: Sample Selection

Initial Sample

Audit Committee Director Appointments during 2008 per <i>Audit Analytics</i> :	1351
Less: Duplicate observations (same appointment reported twice)	<u>3</u>
	1348
Less: Foreign firms	<u>114</u>
	1234
Less: Multiple appointments	<u>348</u>
	886
Less: Departures that were concurrent	<u>115</u>
	771
Less: Missing permno and ticker	<u>231</u>
	540
Less: Companies with other contemporaneous news	<u>180</u>
	360
Total Number of Events	360

Table 2
Audit Committee Director Appointments (n=360)

Panel A: Descriptive Statistics

	Mean	S.D.	25th percentile	Median	75th percentile
Total Assets	10576.13	37282.49	142.63	884.75	3949.46
Revenues	4515.34	13469.54	80.06	392.37	3025.76
Market Value	4191.43	13482.05	71.48	318.24	1524.52

Note: All numbers presented above are in millions.

Panel B: Composition of Sample by Industry

Category	Number of Firms	Percentage of Total
NonDurables	17	4.7%
Durables	7	1.9%
Manufacturing	34	9.4%
Energy	21	5.8%
High-Tech	80	22.2%
Telecom	11	3.1%
Shops	23	6.4%
Healthcare	45	12.5%
Utilities	18	5.0%
Other	104	28.9%
Total	360	100.0%

Note: I use the ten industry groups, as defined by Dr. French; the classifications are available at

http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html

Table 3
Market Reaction to Audit Committee Director Appointments

Panel A: Single Director Appointment

Number of Events	-1 to +1 CAR	-2 to +2 CAR
360	-0.002 (0.000) 51%	-0.002 (0.000) 50%

Note: In each cell, the first (second) number represents the mean (median) value for the value-weighted market-adjusted return, while the number in the last row represents the percent of observations with a negative market-adjusted return. ** and * = significant at $p < .05$, and $p < .10$, respectively.

Panel B: By Expert Status

Type of Incoming Director	-1 to +1 CAR	-2 to +2 CAR
Expert (n=168)	-0.006 (0.000) 50%	-0.005 (-0.005) 52%
Not Expert (n=192)	0.001 (-0.001) 51%	0.000 (0.002) 48%

Note: This table presents cumulative abnormal return to appointment of audit committee financial experts and non-experts. Expert (Not Expert) refers to appointments where the incoming director is (not) an audit committee financial expert. In each cell, the first (second) number represents the mean (median) value for the value-weighted market-adjusted return, while the number in the last row represents the percent of observations with a negative market-adjusted return. * Significant at $p < .10$.

Table 4
Audit Committee Director Appointments (Year 2008)

Panel A: Types of Directors

Audit Committee Financial Expert (n=168)			NOT Audit Committee Financial Expert (n=192)			
Audit/ CPA	Accounting/ Finance	Other	Audit/ CPA	Accounting/ Finance	Other	Total
113 (67.3%)	55 (32.7%)	0 (0.00%)	60 (31.3%)	17 (8.9%)	115 (59.9%)	360

Panel B: Market Reaction by Expert Status

Type of Director	Type of Expert	-1 to +1 CAR	-2 to +2 CAR
Audit Committee Financial Experts (n=168)	Audit/CPA (n=113)	-0.005 (0.001) 48%	-0.011 (-0.009) 58%
	Accounting/Finance (n=55)	-0.008 (-0.001) 55%	0.007 (0.007) 42%
NOT Audit Committee Financial Experts (n=192)	Audit/CPA (n=60)	0.022* (0.006) 48%	0.018 (0.009) 43%
	Accounting/Finance (n=17)	-0.034 (-0.015) 71%	-0.012 (0.005) 47%
	Other (n=115)	-0.005 (0.000) 50%	-0.008 (0.000) 50%

Table 5
Market Reaction to Appointment of Audit Committee Financial Expert
Partitioned by Number of Experts Post-Appointment

Number of Experts on Audit Committee Post-Appointment	Number of events	-1 to +1 CAR	-2 to +2 CAR
0-1	201	-0.001 (-0.003) 52%	-0.005 (-0.002) 52%
2-3	129	-0.012** (-0.002) 52%	-0.005 (0.000) 50%
4 or more	30	0.030*** (0.018) 37%	0.031* (0.026) 37%

Note: This table presents cumulative abnormal return to appointment of audit committee financial experts, when partitioned by the number of experts on the audit committee (following the appointment of the new director). In each cell, the first (second) number represents the mean (median) value for the value-weighted market-adjusted return, while the number in the last row represents the percent of observations with a negative market-adjusted return.
 ** Significant at $p < .05$.

Table 6
Number of other Directorships of Appointed Director and Market Reaction

Number of other boards served	Number of directors appointed	-1 to +1 CAR	-2 to +2 CAR
0	213	-0.005 (-0.005) 51%	-0.007 (-0.006) 49%
1 or more	147	0.002 (0.002) 50%	0.004 (0.004) 52%

Note: This table presents cumulative abnormal return to departures of audit committee directors without a concurrent appointment, when partitioned by the number of other boards served on by the departing director. In each cell, the first (second) number represents the mean (median) value for the value-weighted market-adjusted return, while the number in the last row represents the percent of observations with a negative market-adjusted return.

Table 7
Market Reaction to New outside director appointment or appointment to Audit Committee from the Board

Type of appointment	Type of Expertise and number of directors appointed	-1 to +1 CAR	-2 to +2 CAR
From board (n=31)	Audit/CPA (n=10)	-0.035 (0.017) 40%	-0.048 (0.000) 50%
	Accounting/Finance (n=11)	0.019 (0.003) 46%	0.035 (0.029) 27%
	Other (n=10)	0.007 (-0.005) 60%	-0.004 (0.011) 40%
From outside (n=329)	Audit/CPA (n=163)	0.007 (0.001) 49%	0.002 (-0.005) 53%
	Accounting/Finance (n=61)	-0.020* (-0.007) 61%	-0.004 (0.005) 46%
	Other (n=105)	-0.007 (0.001) 49%	-0.008 (0.000) 51%

Note: This table presents cumulative abnormal return to appointments of audit committee directors, when partitioned by a new appointment from outside or an appointment from within the Board. In each cell, the first (second) number represents the mean (median) value for the value-weighted market-adjusted return, while the number in the last row represents the percent of observations with a negative market-adjusted return.

Table 8
Audit Committee Director Departures: Sample Selection

Initial Sample

Audit Committee Director Departures during 2007-2008 per <i>Audit Analytics</i> : 1059	
Less: Duplicate observations (same departure reported twice)	<u>16</u>
	1043
Less: Foreign firms	<u>76</u>
Total Director Departures	967
Total Number of Events	881
(Note: When multiple directors depart on the same day, I code it as a single event)	
Total Number of firms	746

Table 9
Audit Committee Director Departures: With and Without Concurrent
Appointments

Departure of Single Director:	
With No Concurrent Appointments	601
With One Concurrent Appointment	215
With Two or More Concurrent Appointments	<u>2</u>
	818
 Departure of Two Directors:	
With No Concurrent Appointments	20
With One Concurrent Appointment	10
With Two or More Concurrent Appointments	<u>16</u>
	46
 Departure of Three or More Directors	
With No Concurrent Appointments	9
With One Concurrent Appointment	4
With Two or More Concurrent Appointments	<u>4</u>
	17
 Total number of events	 881

Table 10
Audit Committee Director Departures

Sample for Market Reaction Analyses

Number of audit committee directors exiting	Initial Sample of audit committee director departures	Events with data to calculate cumulative abnormal returns	Events without other contemporaneous news	Events without concurrent appointment
1	818	280	213	133
2	46	19	15	6
3 or more	17	1	1	0

Note: The table above presents the overall sample of audit committee director departures. The first column shows the number of directors exiting; for example there were 17 firms where three or more audit committee directors resigned on the same date.

Table 11
Market Reaction to Single Director Exit, No Concurrent Appointment
Descriptive Analysis
(n=133)

	Mean	Standard Deviation	25th percentile	Median	75th percentile
Total Assets	1344.01	2304.40	88.09	478.23	1219.02
Revenues	845.79	1551.12	58.10	231.43	839.38
Market Value	890.91	1383.43	84.27	357.86	898.95

Note: All amounts are in millions of dollars.

Table 12
Market Reaction to Audit Committee Director Departures

Panel A: Single Director Exit

Type of Event	Number of Events	-1 to +1 CAR	-2 to +2 CAR
Number with no concurrent appointments	133	-0.007 (-0.004) 54%	-0.004 (-0.003) 50%
Number with 1 concurrent appointment	80	-0.007 (-0.005) 59%	-0.015 (-0.009) 59%

Panel B: Two or more Directors Exit

Type of Event (n=number of directors exiting)	Number of Events	-1 to +1 CAR	-2 to +2 CAR
Number with no concurrent appointments (n=12)	6	-0.147 (-0.042) 67%	0.006 (0.019) 50%
Number with 1 or more concurrent appointments (n=21) ²	10	0.067 (0.017) 44%	0.078** (0.022) 25%

Note: In each cell, the first (second) number represents the mean (median) value for the value-weighted market-adjusted return, while the number in the last row represents the percent of observations with a negative market-adjusted return. ** and * = significant at $p < .05$, and $p < .10$, respectively.

² I had 10 events where two audit committee directors quit on the same day and 1 event where three directors quit on the same day.

Table 13
Market Reaction to Audit Committee Director Departures: By Expert Status

Type of Outgoing Director	Number of events	-1 to +1 CAR	-2 to +2 CAR
Accounting Expert	20	-0.031** (-0.022)** 75%	-0.040** (0.000)** 75%
Other Financial Expert	28	-0.013* (-0.006) 57%	-0.011 (0.000) 54%
Non-Expert	85	0.000 (0.004) 47%	0.008 (0.007) 44%

Note: This table presents cumulative abnormal return to departure of audit committee financial experts and non-experts, when an audit committee director resigns without a concurrent appointment of another director to the audit committee. “Accounting Expert” refers to directors who are audit committee financial experts with experience in the field of accounting and/or auditing; “Other Financial Expert” refers to directors who are designated “audit committee financial experts” but do not have accounting and/or auditing experience. Non-Expert refers to departing directors who are not designated as experts.

In each cell, the first (second) number represents the mean (median) value for the value-weighted market-adjusted return, while the number in the last row represents the percent of observations with a negative market-adjusted return. ** Significant at $p < .05$; * Significant at $p < .10$.

Table 14
Departing Director Tenure and Market Reaction

Panel A: Non-Expert Director Departures

Tenure of departing director	Number of directors exiting	-1 to +1 CAR	-2 to +2 CAR
0-3 years	24	-0.012 (-0.004) 55%	-0.004 (0.004) 48%
4-6 years	22	-0.005 (-0.004) 56%	-0.008 (-0.026) 64%
7 or more years	39	-0.005 (-0.004) 53%	-0.001 (0.007) 44%

Panel B: Expert Director Departures

Tenure of departing director	Number of directors exiting	-1 to +1 CAR	-2 to +2 CAR
0-3 years	18	-0.035*** (-0.026)** 78%	-0.037* (-0.017)** 72%
4-6 years	14	-0.022** (-0.020)* 71%	-0.039*** (-0.036)*** 86%
7 or more years	16	0.001 (0.001) 44%	0.002 (0.012) 31%

Note: This table presents cumulative abnormal return to departures of audit committee directors without a concurrent appointment, when partitioned by the audit committee tenure of the departing director. In each cell, the first (second) number represents the mean (median) value for the value-weighted market-adjusted return, while the number in the last row represents the percent of observations with a negative market-adjusted return. ***, **, and * = Significant at $p < .01, .05, \text{ and } .10$, respectively.

Table 15
Number of other Directorships of Departing Director and Market Reaction

Panel A: Non-Expert Director Departures

Number of other boards served	Number of directors exiting	-1 to +1 CAR	-2 to +2 CAR
0	49	0.000 (0.004) 47%	0.005 (0.007) 43%
1 or more	36	-0.001 (0.001) 50%	0.012 (0.007) 44%

Panel B: Expert Director Departures

Number of other boards served	Number of directors exiting	-1 to +1 CAR	-2 to +2 CAR
0	30	-0.021** (-0.016)* 63%	-0.023* (-0.014) 60%
1 or more	18	-0.017** (-0.017) 67%	-0.027** (-0.020) 67%

Note: This table presents cumulative abnormal return to departures of audit committee directors without a concurrent appointment, when partitioned by the number of other boards served on by the departing director. In each cell, the first (second) number represents the mean (median) value for the value-weighted market-adjusted return, while the number in the last row represents the percent of observations with a negative market-adjusted return. ** and * = Significant at $p < .05$ and $.10$, respectively.

Table 16
Regression Results

Variable	Departure of Expert Directors (n=48)		Departure of Non-Expert Directors (n=85)	
	-1 to +1 CAR	-2 to +2 CAR	-1 to +1 CAR	-2 to +2 CAR
Intercept	-0.0004 (.97)	0.0057 (.74)	-0.0084 (.38)	-0.0094 (.74)
Tenure	-0.0287 (.07)	-0.0452 (.03)	-0.0087 (.46)	0.0270 (.16)
OtherBoard	0.0059 (.73)	0.0085 (.70)	0.0189 (.26)	0.0003 (.99)
	F = 1.17 p = .19 Adj.R.sq.= .03	F = 2.46 p = .09 Adj.R.sq.= .06	F = 0.92 p = .40 Adj.R.sq.= .00	F = 1.00 p = .37 Adj.R.sq.= .00

Note: This table presents the results from four regressions, where the dependent variable is the 3-day or 5-day cumulative abnormal market reaction surrounding the announcement of the departure of an audit committee director. The variables are defined as follows: *Tenure* = 1 if the departing director served on the audit committee for less than seven years, else 0; *OtherBoard* = 1 if the departing director served on at least one other public company board, else 0. The values in the cells represent the regression coefficient (*p*-value).

Table 17
Market Reaction to Audit Committee Director Departure: By Reasons Given
Single Director Exit

Reason	Concurrent appointment (n = Number of directors exiting)	-1 to +1 CAR	-2 to +2 CAR
Disagreement with management	No Concurrent appointments (n=5)	-0.030 (-0.045) 60%	-0.075* (-0.045) 100%
Too many commitments	No Concurrent appointments (n=14)	0.060 (0.003) 50%	0.016 (-0.003) 57%
All other reasons	No Concurrent appointments (n=114)	-0.011* (-0.005) 53%	-0.003 (0.003) 47%

Table 18
Market Reaction to Departure of Audit Committee Financial Expert: Partitioned
by Number of Experts Post-Departure

Number of Experts Still on Audit Committee Post- Departure	Number of events	-1 to +1 CAR	-2 to +2 CAR
0	33	-0.022*** (-0.018)* 64%	-0.025** (-0.012) 61%
1	79	-0.006 (0.000) 52%	0.002 (0.004) 48%
2 or more	21	0.011 (0.000) 48%	0.010 (0.008) 43%

Note: This table presents cumulative abnormal return to departure of audit committee financial experts, when partitioned by the number of experts still on the audit committee (following the resignation of the expert director). In each cell, the first (second) number represents the mean (median) value for the value-weighted market-adjusted return, while the number in the last row represents the percent of observations with a negative market-adjusted return.
 ** Significant at $p < .05$.

Table 19
Market Reaction by Age of Directors

Age	Number of directors exiting	-1 to +1 CAR	-2 to +2 CAR
<55 years	69	-0.006 (-0.005) 54%	-0.024* (-0.012) 59%
55-64 years	60	0.005 (-0.006) 58%	0.006 (-0.013) 58%
65-69 years	44	0.001 (-0.002) 52%	0.017 (0.007) 41%
>=70 years	40	-0.003 (-0.002) 53%	-0.004 (0.002) 45%

Note: This table presents cumulative abnormal return to departure of audit committee directors, when partitioned by the age of the departing director. In each cell, the first (second) number represents the mean (median) value for the value-weighted market-adjusted return, while the number in the last row represents the percent of observations with a negative market-adjusted return.
** Significant at $p < .05$.

Table 20
Market Reaction to Complete Exit from the Board or Position Change within the company

Type of exit	Type and number of directors exiting	-1 to +1 CAR	-2 to +2 CAR
From board (n=105)	Out Financial expert n=14	-0.031 (-0.020) 79%	-0.039 (-0.028) 71%
	Out Non Financial Expert n=23	-0.012* (-0.011) 57%	-0.021** (-0.005) 57%
	Out Non Expert n=68	0.003 (0.004) 49%	0.015 (0.005) 46%
From audit committee only (n=28)	Out Financial Expert n=6	-0.031 (-0.021) 67%	-0.043** (-0.034) 83%
	Out Non Financial Expert n=5	-0.009 (-0.005) 60%	0.024 (0.017) 40%
	Out Non Expert n=17	-0.013 (0.004) 47%	-0.019 (0.011) 35%

Note: This table presents cumulative abnormal return to departures of audit committee directors without a concurrent appointment, when partitioned by complete exit from the firm or exit from audit committee only (i.e., continue to be on the board, but not as audit committee member). In each cell, the first (second) number represents the mean (median) value for the value-weighted market-adjusted return, while the number in the last row represents the percent of observations with a negative market-adjusted return.

Table 21
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 22
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 23
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 24
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
Year 2000-2001 n=138	0	77 (113)	23	90
	1	37 (53)	12	41
	2	19 (23)	5	18
	3 or more	5 (6)	0	6
Year 2001-2002 n=155	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
	0	68 (96)	24	72
	1	60 (79)	21	58
	2	19 (23)	8	15
	3 or more	8 (10)	2	8
Year 2008-2009 n=98	Number of Experts on Audit Committee before Appointment	Number of Firms (Number of Directors)	Number of Audit Committee Financial Experts	Number of NOT Audit Committee Financial Experts
	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 25
Changes in Audit Committee Financial Experts (Year 2008-2009)

Incoming Directors (n=138)	Audit Committee Financial Expert (n=69)			NOT Audit Committee Financial Expert (n=69)		
	Audit/ CPA	Accounting/ Finance	Other	Audit/ CPA	Accounting /Finance	Other
	7 (10.1%)	35 (50.8%)	27 (39.1%)	3 (4.3%)	12 (17.4%)	54 (78.3%)
Outgoing Directors (n=116)	Audit Committee Financial Expert (n=57)			NOT Audit Committee Financial Expert (n=59)		
	Audit/ CPA	Accounting/ Finance	Other	Audit/ CPA	Accounting /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 26
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 number of meetings	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.

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