

**2007 Audit Committee
Research Report**

A Huron Consulting Group Report



Huron's Audit Committee Research report analyzes patterns of Audit Committee composition over a five-year period from 2002 to 2006.

The number of audit committee chairpersons who are accountants has risen dramatically, while their numbers on committees has remained stable in 2006.

The number of audit committee members who we identified as accountants doubled from 6% to 12% over the five-year period from 2002 to 2006. There was a similar increase in the number of audit committees with at least one “accountant” – from 21% in 2002 to 40% in 2006. However, the majority of companies (98 companies) in our sample did not have an “accountant” on their audit committee in 2006.

Audit Committee charters vary from company to company but usually include the following three fundamental duties, which are in tandem with Section 404 of the Sarbanes-Oxley (SOX) Act:

- Reviewing and monitoring the annual and quarterly financial statements and other financial reports;
- Evaluating and monitoring the internal accounting controls; and
- Overseeing the audit scope and adequacy of the independent public accountants’ audit plans and results.

The Rules and Recommendations

The U.S. Securities and Exchange Commission (SEC) and the major U.S. exchanges all introduced new rules over the past several years regulating the selection and disclosure of audit committee members. Section 407 of the Act required the SEC to issue rules requiring each issuer to disclose that it has at least one “financial expert” on its audit committee or, otherwise, to explain why it does not. In January 2003, the SEC issued such a rule requiring issuers to disclose “audit committee financial expert” information in annual reports filed for fiscal years ending on or after July 15, 2003. The SEC identified the following attributes that define an audit committee financial expert according to the SEC:

- An understanding of generally accepted accounting principles and financial statements.
- The ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves.
- Experience preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally

comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the registrant’s financial statements, or experience actively supervising one or more persons engaged in such activities.

- An understanding of internal controls and procedures for financial reporting.
- An understanding of the audit committee function.

Additionally, both the NYSE² and NASDAQ³ established listing requirements with member companies. While these exchange requirements fall short of requiring audit committees to have a “financial expert,” they do require each audit committee to have at least one member with experience in accounting or finance in order to analyze how organizations are adapting to the rules and recommendations.

Audit Committee Financial Experts

Huron’s study makes some interesting observations about the companies and their boards with regard to the SEC “audit committee financial expert” disclosure rules. In 2006, for the second year in a row, all companies in

our study designated one or more audit committee financial experts; however, only 22% of the designated financial experts had biographies indicating they had accounting backgrounds. This represents a negligible change from our findings for 2005. On the other hand, audit committee financial experts categorized as “finance professionals” have climbed to 44% in 2006, up from 41% in 2005, bringing the total percentage of “finance professionals” and individuals with an accounting background designated as financial experts to 66%.

Consequently, 34% of audit committee financial experts appeared to lack either an accounting or finance background in 2006. However, our study does identify a noteworthy decline in the number of companies that do not have an audit committee financial expert with either an accounting or finance background from 18% in 2005 to 13% in 2006.

Consistent with last year’s report, it is unclear whether the low percentage of accountants results from a broad interpretation of background qualifications of audit committee members by companies and their boards, incomplete disclosure qualifications, or a combination thereof.

While the SEC provides a clear definition of the attributes of an “audit committee financial expert,” the board of directors, not the SEC, determines and selects the designated “audit committee financial expert(s)” for the company. Additionally, while the SEC lists several ways in which the audit committee member must acquire such attributes, the SEC gives companies significant latitude in interpreting whether an audit committee member qualifies as a “financial expert” by stating that such designees may have acquired attributes via “other relevant experience.”⁴

Audit Committee Members

Despite the increase in the number of audit committee members who are “accountants” over the period, they still lag behind other categories of professionals. Moreover, the increase in their participation in prior years appears to have leveled off between 2005 and 2006. Huron’s report showed that 34% of audit committee members are “finance professionals” in 2006, compared to 12% who are “accountants” (see Figure 1). While the number of audit committee members considered either “accountants” or “finance professionals” in our study increased from about 34% in 2002 to about 47% in 2006, audit committee members in the “other” category still account for more than half of all audit

committee members in 2006. Although audit committee members with accounting or finance backgrounds represent less than half of the audit committee members in the study for each year, there is at least one “accountant” or one “finance professional” on 92% of the audit committee boards in 2006 (up from 84% in 2002).

Audit Committee Chairperson

During the five-year period covered by our study, audit committee chairpersons described as having accounting backgrounds increased from less than 10% in 2002 to 23% (see Figure 2) in 2006, while the number of audit committee chairpersons considered “finance professionals” remained flat from 2002 to 2006 at approximately 40%. Based on these results, it appears that boards of directors have been increasingly inclined to designate an “accountant” to serve as audit committee chairperson. Further, it appears that boards of directors tend to designate “finance professionals” rather than “accountants” as audit committee financial experts (see *Audit Committee Financial Experts Section*).

Other Major Observations

Audit Committee Meetings – From 2002 to 2006, the average annual number of audit committee meetings

doubled from about five to ten meetings during the period. The average number of audit committee meetings in 2005 was also ten, indicating that frequent meetings seem to be the norm as companies continue to deal with Sarbanes-Oxley regulations, greater oversight from the audit committee, and increasingly complex accounting pronouncements:

- 60% of companies held nine or more meetings in 2006, up from 7% in 2002
- 3% of companies held four or fewer meetings in 2006, down from 44% in 2002

Retirees – The percentage of audit committee members who were employed full time remained relatively constant, at about 64%, from 2002 to 2006.

Audit Committee Size – The average size of the audit committee remained constant, at about four audit committee members per company during the period covered by the study.

Age – The ages of audit committee members throughout the study ranged between 33 and 85 years old. The average age of audit committee members increased from 60 in 2002 to 61 in 2006.

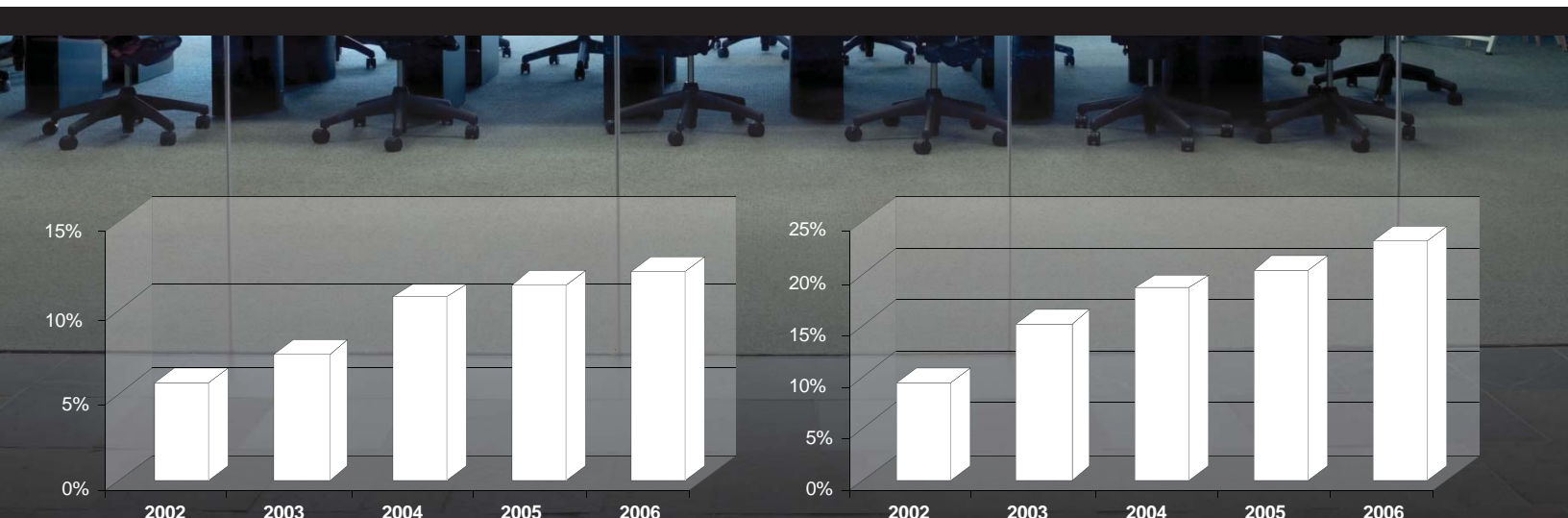


Figure 1: “Accountants” as a Percentage of Audit Committee Members

Figure 2: Percentage of Audit Committee Chairpersons that are “Accountants”

For the second consecutive year, Huron Consulting Group Inc. (NASDAQ: HURN), a leading provider of financial and operational consulting services, analyzed the biographies of more than 670¹ audit committee members at 164¹ public companies from the NASDAQ 100 and Fortune 100 listings (audit committee data was captured and analyzed for companies with publicly available financial statements from 2002 to 2006).

The purpose of the study was to identify characteristics of the committees, compare and contrast audit committee composition to governing rules and regulations from the SEC, NYSE and NASDAQ, and analyze significant trends based upon the audit committees studied.

To accomplish this, Huron analyzed the background data and categorized the experience of audit committee members into groups and determined whether the audit committee member was either:

- an “accountant” by training and experience (this category included CPAs, controllers, accounting professors and those who served on accounting standards or other oversight similar boards); or
- a “finance professional,” such as a chief financial officer, treasurer, or finance professor.

Those individuals who did not fall into either of these categories were grouped in an “other” category.

1. Huron's inaugural Audit Committee report last year had a sample of more than 700 audit committee members at 178 companies from the NASDAQ 100 and Fortune 100 listings. The decrease in the sample size is attributable to mergers and acquisitions among the 178 companies within the sample, as well as delays in filings because of stock option investigations.
2. Commentary to the NYSE Corporate Governance Rules that were approved by the SEC on November 4, 2003 states, "...at least one member of the audit committee must have accounting or related financial management expertise, as the company's board interprets such qualification in its business judgment. While the Exchange does not require that a listed company's audit committee include a person who satisfies the definition of audit committee financial expert set out in Item 401(e) of Regulation S-K, a board may presume that such a person has accounting or related financial management expertise."
3. Commentary to the NASDAQ Corporate Governance Rules that were also approved by the SEC on November 4, 2003 states, "...Companies will still be required to have at least one member on the audit committee that has past employment experience in finance or accounting, requisite professional certification in accounting or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities. NASDAQ has withdrawn a previous proposal to require one member of the audit committee to meet the SEC's definition of a financial expert, although a person meeting that definition would also satisfy NASDAQ's rule."
4. The SEC final rule with regards to "Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002" (*approved by the SEC on January 24, 2003*). Under the final rules, a person must have acquired such attributes through any one or more of the following:
 - (a) Education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor or experience in one or more positions that involve the performance of similar functions;
 - (b) Experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions;
 - (c) Experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements; or
 - (d) Other relevant experience.



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