Audit committee effectiveness: did the blue ribbon committee recommendations make a difference?

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Abstract: Several years prior to the 2002 passage of the Sarbanes-Oxley Act (SOX), SEC Chairman Arthur Levitt, identified problems regarding audit committee effectiveness. In response, in September 1998 the Blue Ribbon Committee (BRC) on Audit Committee Effectiveness was established jointly by the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD). The BRC issued its recommendations regarding the appropriate make-up and function of the audit committee on February 8, 1999. The current study attempts to measure the change in audit committee behaviour (and presumably effectiveness) subsequent to implementing the BRC recommendations.

Keywords: audit committee; corporate governance; blue ribbon committee.

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1 Introduction

Several years prior to the 2002 passage of the Sarbanes-Oxley Act (SOX), SEC Chairman Arthur Levitt, identified problems regarding audit committee effectiveness. In response, in September 1998 the Blue Ribbon Committee (BRC) on Audit Committee Effectiveness was established jointly by the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD). The BRC issued its recommendations regarding the appropriate make-up and function of the audit committee on February 8, 1999. However, questionable accounting practices and major corporate failures of 2001 and 2002, notably Enron and Worldcom, resulted in federal legislation, SOX, to regulate auditing and corporate financial reporting (Smith, 2003). Perhaps the BRC was too little too late.

The question addressed by this study is to what extent did BRC recommendations affect public companies regarding function of their audit committees. The current study attempts to measure the change in audit committee behaviour (and presumably effectiveness) subsequent to implementing the BRC recommendations and prior to enactment of SOX. The frequency of audit committee meetings has an important effect on the internal control and evaluation function of a company (Al-Mudhaki and Joshi, 2004).

The investing public and government regulators have been comforted somewhat by the BRC recommendations and by passage of SOX. The stock market is considerably higher today than in 2002. However, many are still concerned about the effectiveness of boards of directors and audit committees of publicly traded companies. In recent years, the Securities and Exchange Commission and related parties (SEC) have worked to address accounting and reporting issues, changing audit methodologies, and monitoring of corporate governance.

The governance structures of companies should provide assurance to the stakeholders that management is being monitored and should act in the interests of the stakeholders (DeZoort, 1997; English, 1994). Much has been written on the structures of corporate boards including the structure of audit committees. In recent years audit committees in particular have been the subject of some scrutiny. Some of the past attention given to this subject in the USA was from the Blue Ribbon Committee on Audit Committee Effectiveness (BRC), whose report was issued in early 1999 (BRC, 1999). The report makes ten recommendations for improving the effectiveness of audit committees.

The recommendations of the BRC were made in an effort to improve effectiveness and remedy these problems. The NASD, NYSE, and SEC quickly adopted the recommendations. Virtually all publicly listed firms implemented the recommendations of the BRC by 2001. Whenever policies are changed, they should be evaluated within a reasonable time period after implementation to ensure that the changes have had the desired effect, which is what this study attempts to do.

Audit committees, like other committees of the Board of Directors (the Board), are designed to make the duties of the Board more efficient. The creation of specific committees allows the Board to better address specific issues and let those with expertise in an area, provide the most value to the Board (Menon and Williams, 1994). Ideally, the members of any committee would be able to address the issues of their specific area more efficiently because they are a smaller subset of the overall Board and they also have much needed specific knowledge of that particular area (English, 1994). With this in mind, one might expect the audit committee of a company to consist of a portion of the Board membership that has expertise in finance and accounting. This may not be the case, however. Previous research has found that audit committees perceive their duties differently than what they actually are, that members often feel they are lacking in appropriate skills, and that outside auditors perceive weaknesses in the skill of the audit committees with whom they work (DeZoort, 1997).

The remainder of this paper is organised as follows. First, there is a discussion of other literature regarding the BRC, its recommendations, and definitions of the new requirements. Next, there is discussion of the research hypothesis and the model. This is followed by a description of the methodology employed in the study. The results of the analysis are discussed and interpreted. Finally, this paper concludes with implications of the findings and ideas for possible future research in this arena.

2 Literature review

Research about audit committees and corporate governance has taken place in the USA and other countries including the UK, Canada, and Australia. The research in all of these countries has been in reaction not only to stakeholder needs, but also due to the involvement of regulators in mandating change and additional requirements for audit committees. The main focus of much of this research includes the independence of the members of the audit committees, the experience level of these members, and the perceived vs. actual responsibilities of the audit committee.

Although there has been some research regarding the effectiveness of audit committees subsequent to the BRC report (Joshi and Wakil, 2004; Raghunandan et al., 2001; DeZoort and Salterio, 2001), most studies have not examined the direct impact of the BRC recommendations. Joshi and Wakil (2004) examined the functioning of audit committees of 30 companies listed on the Bahrain stock exchange. The study focused on the extent to which companies in Bahrain responded to the recommendations and guidelines of the BRC. Findings were that size, type of auditors, and industry type affect establishment of audit committees in Bahrain.

The Raghunandan study (Raghunandan et al., 2001) used surveys sent to internal auditors to determine if those companies with 'grey directors' on the audit committee are more or less effective than those companies with independent directors. 'Grey Directors' are those that have been employed by the company in the last five years, but are not currently employed by the company. In the Raghunandan study, the measure of effectiveness is the number and length of meetings between the internal auditor and the audit committee. The Raghunandan study focuses specifically on audit committee interaction with internal auditors and while the findings support the actions of the BRC, the study does not measure whether the BRC recommendations have had an impact on the actions of audit committees subsequent to the implementation of the requirements.

DeZoort and Salterio (2001) use a case about disputes between the external auditor and management to determine if financial savvy and director independence are related to whom the committee member ultimately defends. The results of DeZoort and Salterio also support the recommendations of the BRC by showing that independence is related to audit committee member support for the external auditor in accounting disputes, although the financial expertise factor was not shown to be a significant factor in that study. The DeZoort and Salterio study was based on the results of a case study sent to audit committee members of the 500 largest companies in Canada.

The contribution of the current study is that it specifically examines the effects of the actions of the BRC pertaining to changing audit committee compositions, responsibilities, and the awareness of these responsibilities. This paper will extend the current literature about the effects of the BRC recommendations by using publicly available information about audit committees to determine if audit committees are, in fact, more effective (based on measures of effectiveness established by prior research).

3 Background

During his term as chairman of the SEC, Arthur Levitt set out to bring change to the business community by focusing attention to areas that he felt were not adequately addressed by current accounting and reporting practice. One area of focus for Mr. Levitt was audit committee oversight. In response to Mr. Levitt's concerns, the BRC was formed in September 1998. The BRC was established jointly by the NYSE and NASD to make recommendations to the companies on their respective stock exchanges regarding the appropriate make-up and function of the audit committee. The committee was made up of 11 members and was led by John Whitehead and Ira Millstein. John Whitehead was the former deputy Secretary of State and Senior Partner of Goldman, Sachs & Co. Ira Millstein was a Senior Partner of Weil, Gotshal & Manges LLP and corporate governance expert.

The recommendations of this panel were released on February 8, 1999 and included three major areas that comprised a total of ten recommendations. The major areas covered by the BRC recommendations are audit committee membership requirements, audit committee structure and function, and audit committee communications with the outside auditor and with management. The following are the ten recommendations of the BRC.

Membership requirements

- revise the definition of independent director
- require a completely independent audit committee
- require three members (based on size) who are financially literate and one member must have accounting or related financial management expertise.

Committee structure

- require a written charter of duties and responsibilities
- require annual disclosure of audit committee activities.

Committee communications

- the outside audit engagement is the responsibility of the audit committee
- require discussion of outside auditor independence by written statement
- require discussion of the Quality of Financial Reporting with outside auditor
- require annual letter to stockholders from the audit committee
- require SAS 71 Interim Financial Reviews at each quarter.

Specific areas affected by the BRC recommendations are described below.

First, the definition of an independent director was revised. The new definition is

> "Members of the audit committee shall be considered independent if they have no relationship to the corporation that may interfere with the exercise of their independence from management and the corporation." (BRC, 1999)[1]

In addition, the BRC recommends that all of the committee members meet these independence requirements.

Defining the financial literacy requirements of the recommendations, the BRC states that listed companies should ensure that each audit committee member is

> "financially literate or becomes financially literate within a reasonable period of time after his or her appointment to the audit committee, and further that at least one member of the audit committee have accounting or related financial management expertise." (BRC, 1999)

For purposes of defining 'financially literate' and 'accounting … expertise', the BRC says that literacy

> "signifies the ability to read and understand fundamental financial statements including a company's balance sheet, income statement, and cash flow statement." (BRC, 1999)

They further describe expertise as

> "past employment experience in finance or accounting, requisite professional certification in accounting, or any comparable experience or background which results in the individual's financial sophistication, including being or having been a CEO or other senior officer with financial oversight responsibilities." (BRC, 1999)

Committee structure recommendations will require the committee to have both a formal written charter that is reevaluated on an annual basis and that the committee notify the shareholders of the adoption of the charter as well as whether they have satisfied the responsibilities as they are defined in the charter. The charter will specify the responsibilities of the committee, the structure of the committee, processes, membership and how the committee should carry out its responsibilities.

The last five recommendations are to improve the communications of the audit committee with management and external auditors. These recommendations outline the duties of the committee members in regard to financial reporting procedures and communications with all relevant parties.

4 Research model

The BRC focused on two main requirements for ensuring audit committee effectiveness through membership: Independence and Financial Knowledge. Understanding the reasons why these two areas are so critical to the effectiveness of an audit committee is an important consideration. As noted above, part of the advantage of having an audit committee is improving the overall effectiveness and efficiency of the Board of a firm (English, 1994; Menon and Williams, 1994). The audit committee is responsible for communicating with the internal and external auditor, monitoring management, and understanding the controls and procedures developed by management to ensure proper financial reporting.

Independence is a key issue for audit committees because they should act as a control mechanism over the actions of management (Menon and Williams, 1994). They should also be available to listen to the concerns of internal and external auditors regarding management's control structure, accounting methods, and any concerns of fraud or material weaknesses. Including management on the audit committee may limit the auditor's ability to bring these matters to the attention of the Board. This may happen either because the auditors feel that they cannot communicate these concerns to the audit committee, whose members could be implicated, or the audit committee may choose not to further deliver this information to the Board if it puts any of its members in an uncomfortable position.

A concern that has been stated is having an audit committee with insiders may actually be worse than not having an audit committee at all because the committee is no longer an objective monitoring control over management (SEC, 1980). Other support for this supposition includes evidence that audit committees with independent directors spend more time understanding the results and the plans of the internal audit as well as spending more time (both in frequency and length of meetings) in private meetings with internal auditors (Raghunandan et al., 2001). Further, as discussed above, DeZoort and Salterio (2001) find that in disputes between auditors and management, inside directors are much more likely to side with the view of management than directors that are independent and have relevant financial knowledge.

Financial knowledge is the next attribute of audit committees that should be considered. It is important that audit committee members be able to appropriately process and assess the information that they are provided by management, internal auditors, and external auditors. Having an independent audit committee will be ineffective unless the membership has the tools to understand accounting and reporting issues and related implications, and can intelligently discuss these issues with all interested parties. This seems logical, but DeZoort finds that many audit committee members believe that they do not have the requisite skills and expertise to effectively carry out their duties. What is more concerning is that while committee members feel their knowledge is lacking, a study of public accounting firms found that external auditors ranked their perception of audit committee member knowledge even lower than the audit committees ranked themselves (DeZoort and Salterio, 2001).

In addition to the changes in membership discussed above, other areas of recommendations should also improve effectiveness. Menon and Williams (1994) discuss how many firms in the US form audit committees because of the ‘image value’ that it has in America. Firms in other countries, where audit committee formation is voluntary and lack high ‘image value’, will be much less likely to form audit committees than those countries where the ‘image value’ is high. Menon and Williams go on to say that while many US companies may form committees, they will not use the committees to monitor management or carry out duties of the Board, as might be expected. The BRC recommendations for committee structure and committee communications should remedy these problems.

The committee structure recommendations require the creation of a charter for the audit committee and that the members of the committee report to stockholders regarding fulfilment of responsibilities of the committee as defined by the charter. This serves the purpose of clearly defining for committee members their purpose and responsibilities. As described above, this has previously been an area that members felt were unclear or that external auditors felt members did not understand. Second, this requires that committees evaluate how they fulfilled these obligations. The fact that members now know that the committee must report may make each member take his or her responsibilities more seriously and pursue them more diligently.

The committee communications recommendations should further develop the effects of the second requirement in the above paragraph. The recommendations make the external auditors responsible to report to the Board and Audit Committee, not to management. This requirement may make Audit Committee members want to meet more often with the external auditor and not hear reports only from management. Consequently, the audit committee members will ensure that they receive an annual letter from the external auditors, which in turn facilitates monitoring the nature and extent of the external auditor services. This could help audit committees identify possible independence issues. Other recommendations include discussions between the external auditor and audit committee regarding the quality of the company's financial reporting and the results of the quarterly reviews. Finally, the audit committee must report to the stockholders of the company its activities including those described above and additional requirements regarding the 10 K report and related disclosures. These additional requirements will likely add additional workload and meetings to many audit committees.

Audit committee effectiveness can be a difficult variable to measure; however, frequency and length of meetings have previously been used to define effectiveness (Raghunandan et al., 2001). While the number of meetings of the audit committee offers only a rough estimate of the activity of the audit committee, it may provide some insight into its monitoring effectiveness. Logically, if an audit committee is actually being used to monitor management, rather than just for image value, the committee would meet during the year at least enough times to understand the audit plan, then subsequently evaluate the results of the annual audit.

An audit committee exhibiting genuine monitoring behaviour would be expected to meet periodically throughout the year to review the reports of internal audit and discuss the results of quarterly reviews with external auditors. Thus audit committees would likely meet three to six times per year. The Institute of Internal Auditors has suggested that audit committees meet with the Chief Internal Auditor of the company at least four times per year to be effective (Raghunandan et al., 2001). Levitt (1998) has noted that audit committees that meet as many as 12 times per year are not meeting too frequently.

> "ACs (Audit Committees) which do not meet or meet only once are unlikely to be effective monitors. Several AC meetings would generally indicate a more serious effort to monitor management." (Menon and Williams, 1994)

Thus for purposes of this study, audit committees meeting once or not at all in a year will be considered ineffective, and those that meet more than once per year will be considered effective, with the ideal number of meetings being once per quarter or four times per year.

Based on the above, if indeed BRC recommendations have made audit committees more effective and therefore better monitors of management, we would expect the number of meetings of the audit committee meetings to increase subsequent to the implementation of these new requirements. Our hypothesis is stated formally below.

H1: The implementation of BRC requirements will increase the number of annual meetings of the audit committees of a firm compared to the number of annual meetings prior to the BRC requirements.

The hypothesis will be tested through the following model:

$$\mu_{\text{prior}} - \mu_{\text{subsequent}} < 0.$$

where

μ_{prior}: The number of meetings during the companies fiscal year ended prior to implemenation of BRC requirements.

$\mu_{subsequent}$: The number of meetings during the company's fiscal year ended subsequent to implementation of BRC requirements.

5 Methodology

Two hundred firms were selected from the NASDAQ exchange listing posted on www.nasdaq.com using a random number generator. NASDAQ firms are used in this study as NYSE firms have had stronger audit committee requirements since the 1970s and therefore are likely be less effected by the BRC recommendations (Raghunandan et al., 2001). Only firms that had data available from 1999–2001 were used for the sample; any firms without adequate data were replaced. The year in which the change is reflected in the proxy relates to both the fiscal year end of the company and the timing of issuing the proxy. All of the changes were reflected in the period between 1999–2001. For each year, the annual proxy statements were consulted to determine the number of meetings of the audit committee for that year. This data was compiled into data sheets for each firm and then used to create a database. The data was tested using matched-pair *T*-tests.

6 Results

The results of this analysis support the research hypothesis. Table 1 panel 1 shows the frequency distributions of the 200 sample companies according to the annual number of audit committee meetings before and after the implementation of the BRC recommendations. Of particular interest was that while 13 companies had committees that did not meet at all prior to the recommendations, only one company did not have an audit committee meeting in the subsequent year.

Table 1 Descriptive statistics for sample firms

Number of annual meetings	*Prior to BRC*	*Percentage prior to BRC*	*Subsequent to BRC*	*Percentage subsequent to BRC*
Panel 1: Frequency distribution for annual number of meetings				
0	13	6.5	1	0.5
1	50	25.0	23	11.5
2	59	29.5	30	15.0
3	27	13.5	32	16.0
4	38	19.0	77	38.5
5	7	3.5	22	11.0
6	5	2.5	10	5.0
7	1	0.5	1	0.5
8	0	0.0	4	2.0
Total	200	100.0	200	100

Table 1 Descriptive statistics for sample firms (continued)

Change in meetings held annually	*Frequency*	*Percentage*
Panel 2: Frequency distribution of change in number of meetings		
–2	1	0.5
–1	12	6.0
0	72	36.0
1	46	23.0
2	37	18.5
3	19	9.5
4	7	3.5
5	5	2.5
6	0	0
7	1	0.5
Total	200	100

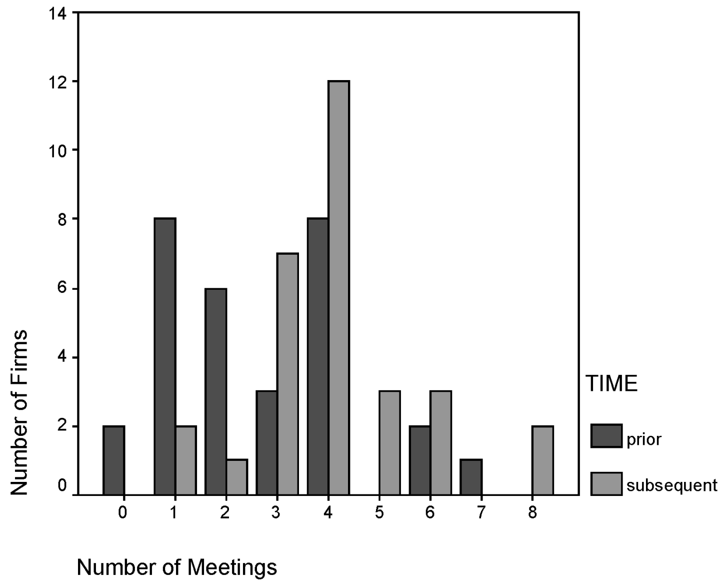
Prior to the implementation of the recommendations the number of meetings ranged from 0 to 7 with an average of 2.37 annual meetings. Subsequent to the implementation of the new committee requirements the meetings ranged from 1 to 8 with an average of 3.48. If we consider the standard imposed by Menon and Williams (1994) discussed above, where those committees meeting 0–1 times are mostly for image value and those meeting more than one time per year are likely to be effective monitors, then while only 68.5% are meeting regularly enough to perform effective monitoring prior to the BRC recommendations, 88.0% are doing so subsequent to the implementation.

The findings in graph form are shown in Figure 1. This graph clearly depicts not only increases, but an overall shift in the distribution of the meetings. Fifty-five percent of the companies are meeting four or more times a year after the BRC recommendations are implemented (most likely representing quarterly activity), and only 24 of the committees (12%) are meeting only once per year or not at all.

Panel 2 of Table 1 represents the change in meetings held by the sample companies between the year before and the year of implementation of the BRC recommendations. Fifty-eight percent of the sample companies increased the number of audit committee meetings in the year of the BRC changes, and 35% of these companies increased the number of meetings by two or more. Of the 13 companies that decreased the number of audit meetings held, six of those decreased from greater than one meeting to one meeting per year. The other companies all had at least three meetings in the year subsequent and still appear to be carrying out adequate monitoring duties.

Seventy-two companies maintained the same number of audit committee meetings as in the previous year, and all but 13 of these companies had more than one meeting a year, and would likely be less affected by efforts to improve their monitoring. Twenty-five of these companies had four meetings in both years and another five companies had more than four meetings in the subsequent year. Finally, of the 115 companies that increased their number of meetings, 49 of them (42.6%) went from having 0 or 1 meeting per year to having more than one meeting per year. Twenty-five of these 49 firms (51%) all had at least four audit committee meetings in the subsequent year.

Figure 1 Annual meetings of audit committees prior and subsequent to BRC recommendations



The results of the matched-pair *T*-tests, pertaining to the research hypothesis, are shown in Table 2. An overall test was performed for all of the companies in the sample. The results of this test show that the average number of annual audit committee meetings subsequent to the implementation of the BRC standards (3.48 per year) are significantly greater than those prior to the implementation (2.37 per year) at all normal levels of significance; thus, the hypothesis was accepted. For the companies that showed an increase, the prior average of 1.91 was significantly less than the subsequent average of 3.97 at the normal significance level. Analysis on the companies that did not have change was unnecessary, although the average number of meetings per year shows that these committees were already performing at an adequate level.

Table 2 Results of paired *T*-test for comparison of mean annual meetings

	Number of companies	*Average meetings prior to BRC*	*Average meetings subsequent to BRC*	*T statistic*
All companies	200	2.37	3.48	–10.8754*
Increased meetings	115	1.91	3.97	–18.5066*
Same meetings	72	2.86	2.86	N/A
Decreased meetings	13	3.62	2.54	14.000

*Significant at $\alpha = 0.000$.

7 Conclusions

The results of this study imply that the implementation of the BRC recommendations have improved audit committee effectiveness. Audit committees are more likely to more seriously monitor management when they are actively involved with reviews, meetings with internal and external auditors, and when they are independent. Increasing the frequency of audit committee meetings, the subject of this study, is one step toward more effective monitoring. Questionable accounting practices and major corporate failures of 2001 and 2002, notably Enron and Worldcom, led to federal legislation, SOX, to regulate auditing and corporate financial reporting. Perhaps the BRC was too little too late, and SOX would have been necessary even if the BRC recommendations had been implemented years earlier. Even after BRC and SOX, there will likely be additional stories of failed companies and ineffective or uninformed audit committees in the future, but perhaps they will be fewer than without BRC or SOX.

The importance of this first step by the BRC should not be overlooked as it forced board members to scrutinize performance, prepare guidelines for action, and report actions to the stockholders of the company. Future studies could consider audit committee behaviour in additional time periods, such as after passage of the Sarbanes-Oxley Act and compare that to the pre-BRC and post-BRC data provided in this study. Another extension of this research would be to examine additional disclosures by or changes to the composition of audit committees.

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Note

[1]Examples of relationships that are not considered independent are:

- a director being employed by the corporation or any of its affiliates for the current year or any of the past five years
- a director accepting any compensation from the corporation of any of its affiliates other than compensation for board service or benefits under a tax-qualified retirement plan
- a director being a member of the immediate family of an individual who is, or has been in any of the past five years, employed by the corporation or any of its affiliates as an executive officer
- a director being a partner in, or a controlling shareholder or an executive officer of, any for-profit business organisation to which the corporation made, or from which the corporation received, payments that are or have been significant to the corporation or business organisation in any of the past five years
- a director being employed as an executive of another company where any of the corporation's executives serves that company's committee (BRC, 1999).