Audit Committee Financial Experts: Leveraging Their Information Advantage in Accounting, Auditing, and Corporate Governance

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To enhance financial reporting quality through increased oversight, the Sarbanes–Oxley Act (SOX) Section 407 mandates that firms disclose whether their audit committee includes a financial expert or explains the absence of such an expert. The definition of a financial expert has been broadened to encompass not only accounting knowledge but also finance or supervisory experience. Financial experts on audit committees possess an advantage in information access due to their role on the committee and an advantage in information processing because of their superior skills. This combination of skills and access to private information enables audit committee financial experts to achieve superior performance. We review articles that show audit committee financial experts leveraging their information advantage in accounting to improve financial transparency, in auditing to maintain audit integrity, and in corporate governance to enhance monitoring effectiveness.

audit committee financial expertise | Sarbanes–Oxley Act (SOX) Section 407 | accounting | auditing | corporate governance

In this entry, we review research on audit committee financial experts. Financial experts on audit committees possess an advantage in information access due to their role on the committee and an advantage in information processing because of their superior skills [1]. Audit committee effectiveness has been a significant issue in corporate governance since the Blue Ribbon Committee (BRC) released its report in February 1999. The BRC recommended enhancing audit committee independence, improving their effectiveness, and increasing accountability among audit committees, outside auditors, and management. Specifically, audit committees should have at least three members, each financially literate, meaning that they can read and understand financial statements. Moreover, at least one member should possess accounting or financial management expertise, demonstrated through past employment, professional certification, or comparable experience, such as serving as a corporate officer with financial oversight responsibility [2][3].

These recommendations led to significant rule changes by the New York Stock Exchange (NYSE), National Association of Securities Dealers (NASD), American Stock Exchange (AMEX), Securities and Exchange Commission (SEC), and American Institute of Certified Public Accountants (AICPA); and were later incorporated into Section 407 of the Sarbanes–Oxley Act in 2002 [4]. SOX Section 407 mandates firms to disclose in periodic reports whether a financial expert serves on the firm’s audit committee and, if not, to explain why not. Audit committee members, responsible for reviewing financial statements, face civil and potentially criminal liabilities for violations of the Securities and Exchange Act of 1934 Section 10(b) and Rule 10b-5 [5]. They are more likely than other independent directors to be named as defendants in securities lawsuits [6].

The SEC defines a financial expert as an individual with an understanding of financial reporting and related internal controls [7]. A financial expert can be an accounting financial expert with experience as “a principal financial officer, principal accounting officer, controller, public accountant or auditor” [7]. A financial expert can also be a non-accounting financial expert with supervisory responsibilities (e.g., chief executive officer, president, or chairman of the board) or finance experience (e.g., a managing director, partner, or principal in venture financing, investment banking, or money management) [8][9]. Relative to their non-financial expert counterparts, audit committee financial experts profit more from insider purchases because they have not only an information access advantage but also superior information processing skills [1]. Initially, the definition of a financial expert was narrow, focusing on accounting-related experience. Critics argued that this would reduce financial reporting quality, as non-accounting financial experts are more likely to raise concerns about salient issues that receive press attention [10]. In response, the SEC broadened the definition to include individuals with supervisory or finance experience, thus expanding the scope beyond just accounting knowledge [7]. In support of this broader definition, Cohen et al. found that audit committee members with both accounting and industry expertise outperform those with only accounting expertise [11].

One caveat is that companies often do not designate all qualifying audit committee members as financial experts because such disclosure may expose designated financial experts to legal liabilities [12][13]. Exploring the link between litigation risk and the designation of financial experts, Krishnan and Lee found that firms facing higher litigation risk are more likely to appoint financial experts, especially when corporate governance is strong [14]. These studies underscore the complexity of the financial expert designation process, which is shaped by both the demand for expertise and the legal liabilities associated with the role.

The main objective of our entry is to provide readers with a comprehensive review of extant research evidence on how audit committee financial experts help improve financial transparency, maintain audit integrity, and enhance monitoring effectiveness. Specifically, we review the roles of audit committee financial experts in financial reporting, auditing, and corporate governance. This body of literature has significant implications for corporate stakeholders, regulators, and researchers.

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