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Audit Committee Analysis 2001-2010

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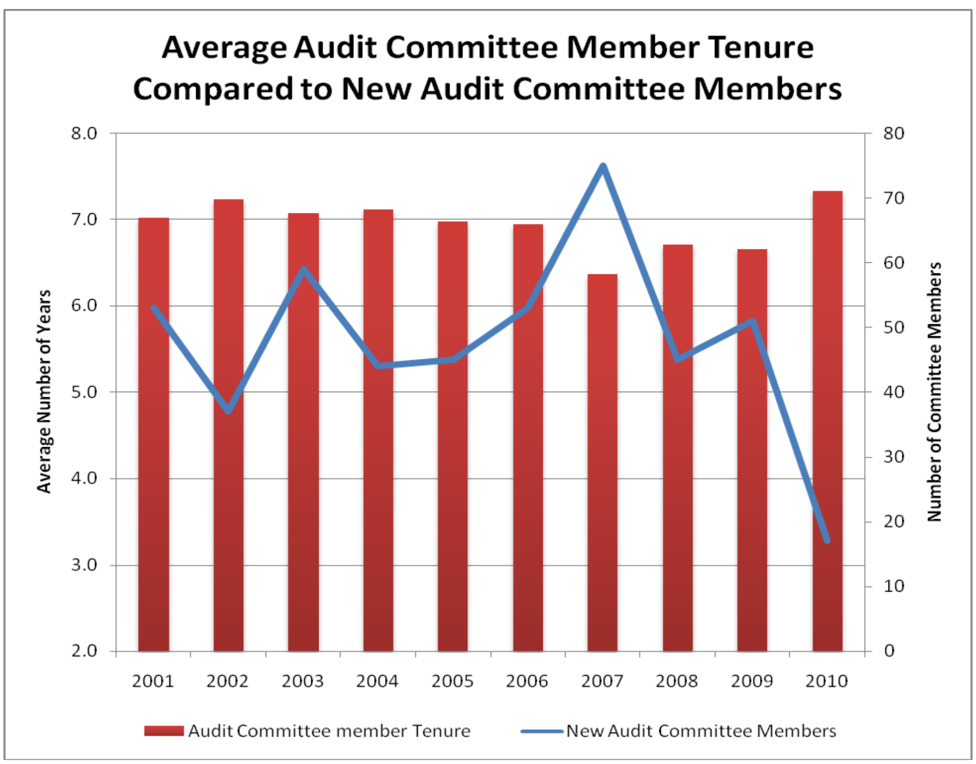
The Sarbanes-Oxley Act (*S-OX*) of 2002 has had a profound impact on corporate boards, and has increased Audit Committees' responsibilities and authority. The introduction of S-OX raised Audit Committee membership requirements, imposed rules on the disclosure of financial experts on boards, and demanded increased director independence. In addition, new rules and regulations governing the Audit Committee were adopted by securities regulators and stock markets around the globe. As of 2011, Audit Committees have come a very long way from when the New York Stock Exchange (*NYSE*) first endorsed the Audit Committee concept back in 1939. This article examines trends we have identified among Audit Committees of corporations that were listed on the S&P/TSX Composite Index during the decade of September 1, 2001 to August 31, 2010, relating to changes in committee member tenure, size and composition and annual Chair retainers.

Committee Member Tenure

In 2001, the average tenure of an Audit Committee member was about 7 years (**Figure 1**). By 2007, average tenure had declined to 6.3 years. However, in 2010 directors' average Audit Committee service is 7.3 years; the longest it has been since 2001. The increase in the average Audit Committee member tenure is consistent with average non-committee director tenures on Boards, which increased by an average of 1 year between 2001 and 2010, to a little more than 10.2 years.

Figure 1.



Size and Composition

Between 2001 and 2010, Audit Committee size has remained constant. The biggest year-over-year percentage change in Audit Committee size was -4.5% between 2009 and 2010 (**Figure 2**). Although Committee size is stable, financial expertise of Audit Committee members has progressively increased: in 2001 the average Audit Committee had on average less than 1 member with a formal financial or accounting designation (0.77), compared to a little more than 1.2 financial experts per committee in 2010 – which represents an increase of over 56%.

CCBE's definition of financial expert is limited to directors with a formal accounting designation, and, as such, is an indication of professional financial expertise rather than financial literacy. So defined, these financial experts exceed the regulatory requirement for all Audit Committee members to be financially literate, as outlined in the National Instrument 52-110 (NI 52-110). According to NI 52-110, "a director is financially literate if he or she has the ability to read and understand a set of financial statements that present a breadth and level of complexity of accounting issues that are reasonably comparable to the breadth and complexity of the issues that can reasonably be expected to be raised by the issuer's financial statements."

Financial experts have similar lengths in tenure to other Audit Committee members. Furthermore, the proportion of financial expert membership on the Audit Committee has risen in recent years. Financial experts represented 29% of Audit Committee members in 2010, which is an increase from 18% representation in 2001 (**Figure 2**). In 2003, 42% of new Audit Committee members on the S&P/TSX Composite Index were financial experts (**Figure 3**), representing the highest percentage year-over-year increase of 23%.

Figure 2.

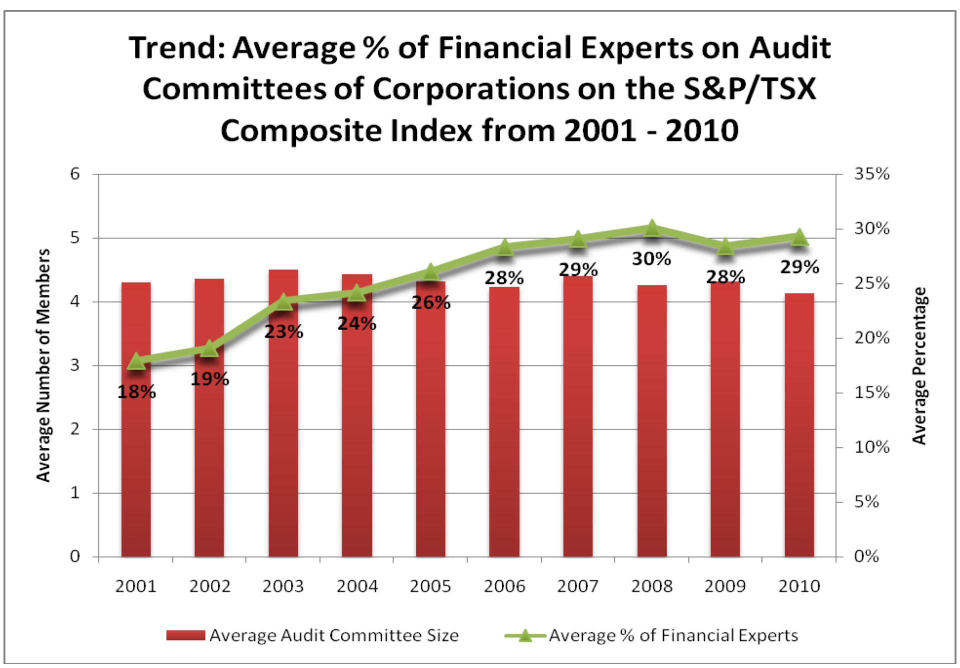
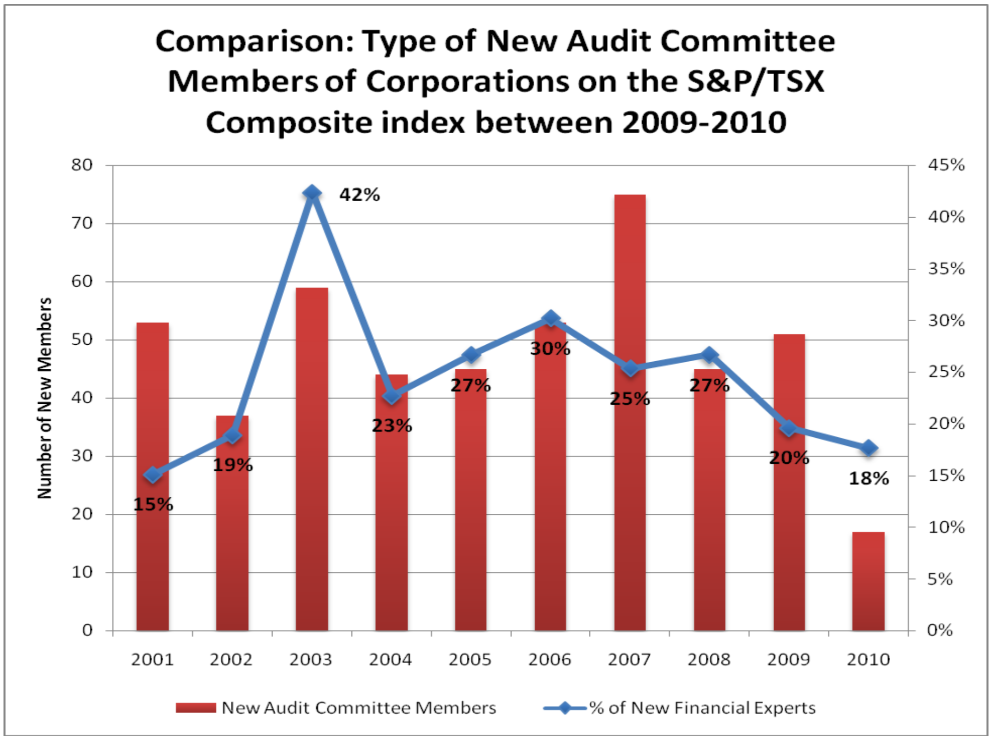


Figure 3.



Throughout our observation period, Audit Committees have consistently added new members at a rapid pace. In 2004, the percentage of new Audit Committee members on the S&P/TSX Composite Index that were financial experts dropped to 23%, but the average number of financial experts on Audit Committees continued to increase (**Figure 3**). The rate of appointment of financial experts to Audit Committees peaked in 2003 with 25 corporations in our sample electing new experts to their committees (**Figure 4**). Since then, the change in expert representation on Audit Committees is inconsequential (**Figure 2**). This may be a symptom of Audit Committees becoming satisfied, in recent years, with their mix of financial experts and financially literate members.

Figure 4.

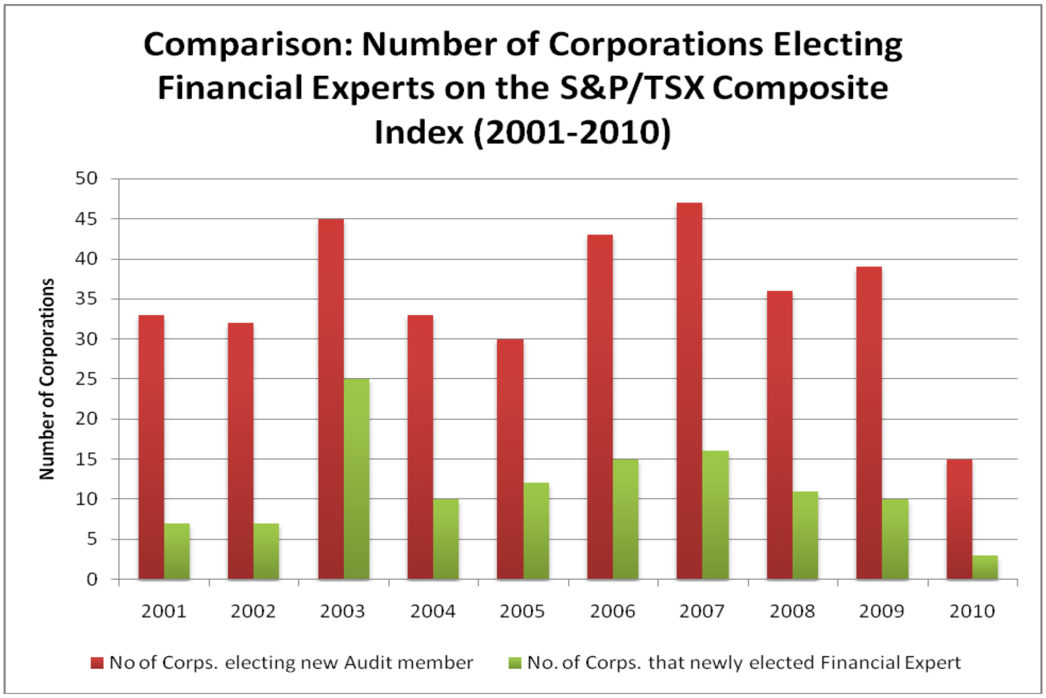
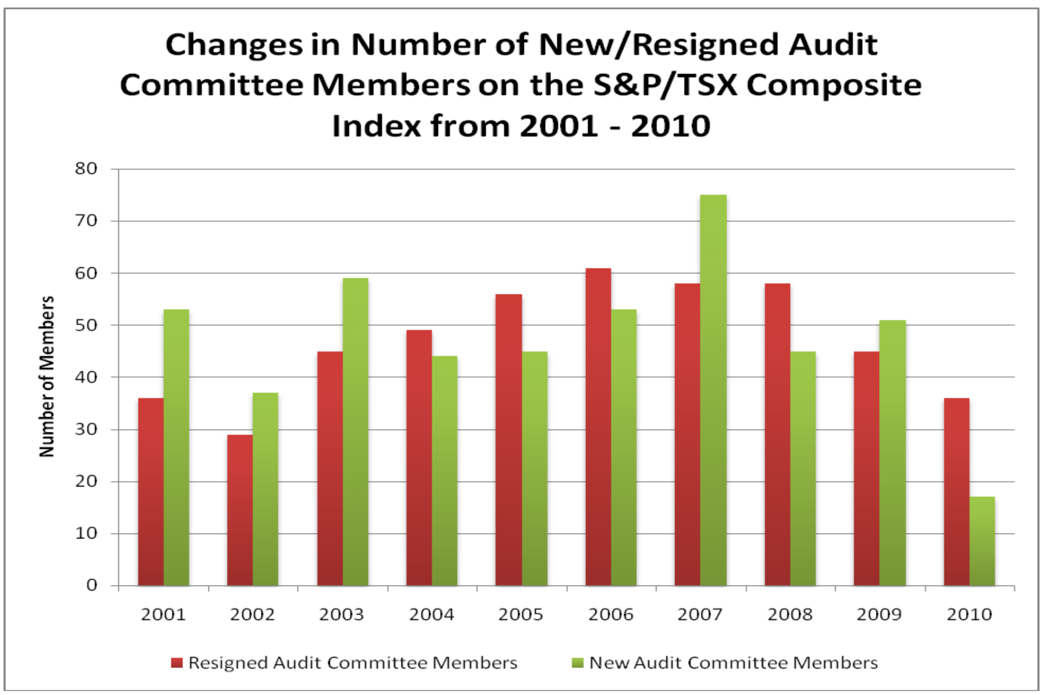


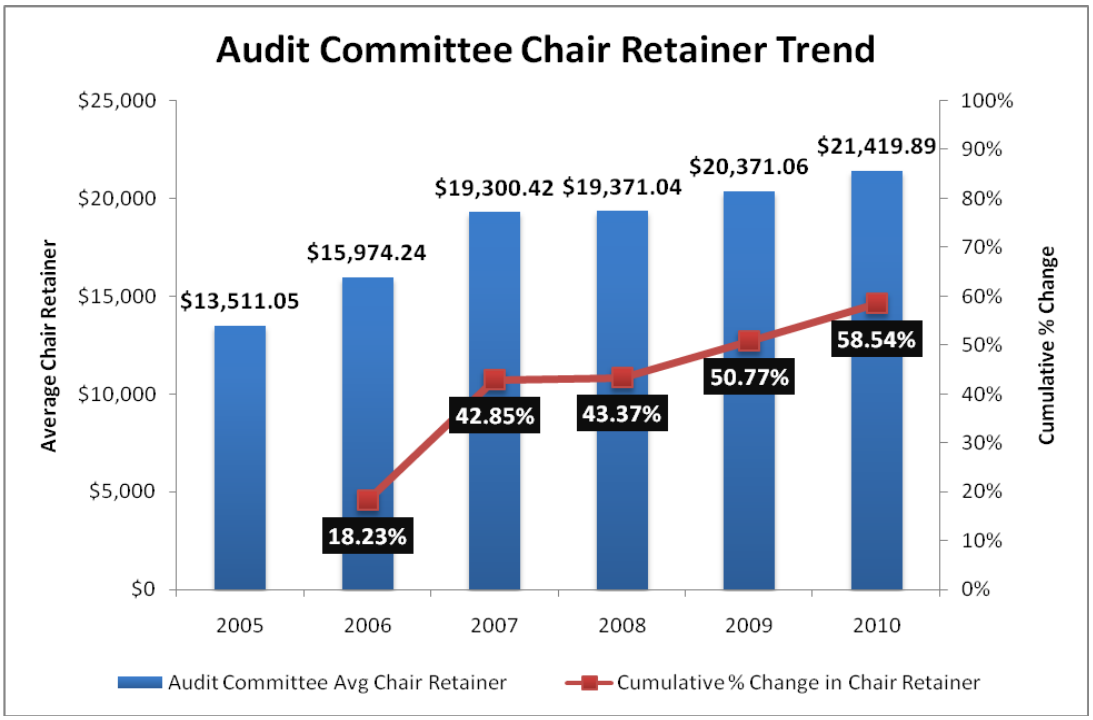
Figure 5.



Annual Audit Committee Chair Retainer

In the post S-OX economic environment, it is even more critical that Boards attract and retain an effective Audit Committee Chair due to the increased responsibilities associated with the role. In 2010, the average annual Audit Committee Chair retainer ($21,420) was almost 1.7 times that of Compensation Committee Chair ($13,027), the next highest paid committee Chair. The average annual Board retainer in 2010, which includes cash and deferred share units (DSU), was $105,342 - an increase of 86.5% since 2005. Compensation Committee Chairs experienced the highest average increase in remuneration during the same period, increasing by a little more than 108%. Comparatively, Audit Committee Chairs' average percentage increase in their remuneration was a little more than 58% since 2005. However, the average Audit Committee Chair retainer remains 61% higher in 2010, than the next highest paid committee Chair.

Figure 6.



Conclusion

Following the high profile corporate meltdowns of the early 2000s, boards faced increased scrutiny from investors, regulators and media. With the introduction of S-OX in the United States, Audit Committees were the first board structure to be subject to major regulatory change. Expectations of independence, financial literacy and expertise increased dramatically and as a result, the composition of the committees has changed to meet these expectations. Audit Committees have increased fees paid to their members and have succeeded in attracting and retaining sophisticated financial experts. As a result, Canadian boards may be better equipped, going forward, to maintain alignment with the expectations of regulators and other stakeholders. We will revisit these trends in upcoming years to determine whether this approach will continue to successfully attract and retain financial experts on Canadian boards.