

COMPLIANCE WEEK

Audit Committee Financial Experts, One Year Later

By Susan Schott Karr — September 21, 2004

A study released on Sept. 7 by GovernanceMetrics International reported that 95 percent of U.S. companies now say they have an independent audit committee financial expert on board, up from 65 percent as reported in 2002.

The increase shouldn't be a surprise, as on July 15 we hit the one-year anniversary for the SEC's "audit committee financial expert" rule, which was promulgated under Section 407 of The Sarbanes-Oxley Act.

According to the rule, public companies must disclose annually whether they have at least one audit committee financial expert on their audit committee. If so, a company must state the name of the audit committee financial expert and also whether this expert is independent of management.

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A company that does not have an audit committee financial expert is required to disclose this fact and explain why it has no such expert.

The final rules permit, but do not require, a company to disclose that it has more than one audit committee financial expert on its audit committee.

A Matter Of Quality

At the time the rules was proposed, many commented that the requirement would cause compliance problems due to the subjectivity of the "expert" nomenclature. Others argued that the strict definition would disqualify many academics and financial gurus who simply lacked required hands-on experience.

And many, like Emerson Electric general counsel and corporate secretary W. Wayne Withers, wanted their own boards to use their best judgment. In an SEC comment letter, Withers wrote that "we recommended that the SEC allow the board of directors of each company to determine, based on the Act's guidance, whether members of the audit committee possess the requisite education, experience and expertise to effectively serve on the audit committee."

But one year later, the real question is: Has having such an expert made any difference in the quality of the audit committee?



Katzen

"Absolutely, yes," says Larry R. Katzen, a director since 2003 at Kellwood Company in St. Louis, Mo. Katzen now serves as the audit committee financial expert as well as the chairman of Kellwood's audit committee. He is also a retired Arthur Andersen managing partner, and his views reflect his experience from the "inside" and the "outside."

Katzen believes that, given a higher level of knowledge of the audit committee and additional years of experience, a designated "expert" will have the ability to ask more insightful questions and use a higher level of intuition about an institution. "Clearly, knowledge is power. More knowledge is better," Katzen says.

Most assuredly, this knowledge can prove a boon when setting the audit committee's meeting agendas.



Hirth

According to Robert Hirth, managing director at the independent risk consulting firm, Protiviti, one positive outcome is that audit committee agendas have become more rigorous, as audit committees have taken more seriously the issues that the audit committee needs to address.

"Incrementally, [the rule] has better focused who was eligible to be audit committee members and therefore those who do participate on the audit committee," says Kenneth A. Goldman, senior vice president, finance and administration, and chief financial officer of Siebel Systems.



Goldman

Overall, the move has been positive, says Hirth. "Whether it's enough, we'll see. In any case, it has strengthened the committees and bolstered the agendas and the focus of the work they need to do."

The Best Number Of Experts

But recently, governance watchdogs have begun asking whether one expert is enough. Should all members of the audit committee be deemed financial experts?

"One is better than not having one at all," says Hirth. "It's heresy to think there are no experts at some companies. What does that say about governance at these companies?"

Hirth says his clients have all met the regulation. Most of the clients he's served already had a member who would qualify as an expert. Some had two, others three.

However, Hirth asks, "Why wouldn't a company want three? Why wouldn't we want all of them to be good at what they do?"

According to Katzen, this isn't necessary. However, he does suggest that a company may want to have two, in case one leaves the committee.

Katzen's logic is as follows: "Some companies do have two, but it's not necessary for everybody to have that depth of knowledge. It's also good to have breadth of knowledge on the audit committee. Some members may have a broader experience level, say for example, more of an operating slant; they know the business from a different perspective."

Katzen adds, "It's the skill level you have and experience you bring that count. It's a matter of breadth versus depth of experience."

More Liability, Pressure?

Since the SEC announced its rule, there has been talk about higher risks and more liability for the person serving as expert.

In comments to the SEC about the rule, opposition stemmed from a fear that the designation of an audit committee financial expert may inappropriately suggest that the expert bears greater responsibility, and therefore is subject to a higher degree of liability than other audit committee members for audit committee decisions. Some commenters thought that identification of the audit committee financial expert in the company's annual report would exacerbate that problem and discourage qualified persons from serving as such experts.

To the extent that there were liability concerns, the SEC tried to address them by the inclusion of a safe harbor in the rules.

Nonetheless, even though the designation as expert may not appear to subject one to more risk, there is the unresolved, nagging question of whether having additional subject matter expertise would expose the audit committee financial expert to more risk in the courtroom, given the implicit fiduciary duty to the company and its shareholders.

The bottom line, according to Goldman: "You're more liable if you don't take the time and take your fiduciary responsibilities on the audit committee—or frankly on the board itself—seriously."

But while liability may not have increased, many feel the pressure has. According to Hirth, many candidates say no to filling the expert's shoes. For those who are asked to fill this role, they are often also asked to chair the committee. "Yes, they feel more pressure. There is the perceived liability of taking on more risk."

"In addition to this perceived liability for being the 'expert,' a higher percentage of audit committee financial experts, by nature, have taken the responsibility very seriously, and this self-generated seriousness has imposed more pressure on them," adds Hirth.

Katzen, however, says he doesn't feel the pressure. He's applying his experience, which he's accumulated over a lifetime. In fact, Katzen says he feels less pressure now as an audit committee financial expert and as the chairman of the audit committee than he did as a partner at Arthur Andersen.

Goldman concurs. He doesn't think there is more pressure. However, he admits that the position most certainly calls for more time, effort, and responsibility. It's a big commitment.

According to Hirth, in speaking to likely candidates for the financial expert role, having the time to do the job—given all of its requirements—seems daunting. Many would never do it, given the combination of the workload and the liability they perceive.

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