SOX's Financial-Expert Requirement 15 Years Later

Many companies are missing an audit-committee disclosure opportunity.

By Ann C. Mulé

In the 15 years since the Sarbanes-Oxley Act of 2002 (SOX) was passed, large institutional investors have been "finding their voice" and sharing their views of board expectations with regard to composition, accountability and transparency.

One of the most important aspects of the legislation was that it added additional requirements for the audit committee — the board's financial-oversight lynchpin — in an effort to strengthen it.

SOX required an annual disclosure of whether or not the board of directors had at least one audit committee financial expert (ACFE) on its audit committee, and if so, the expert's name and whether or not they were independent of management.

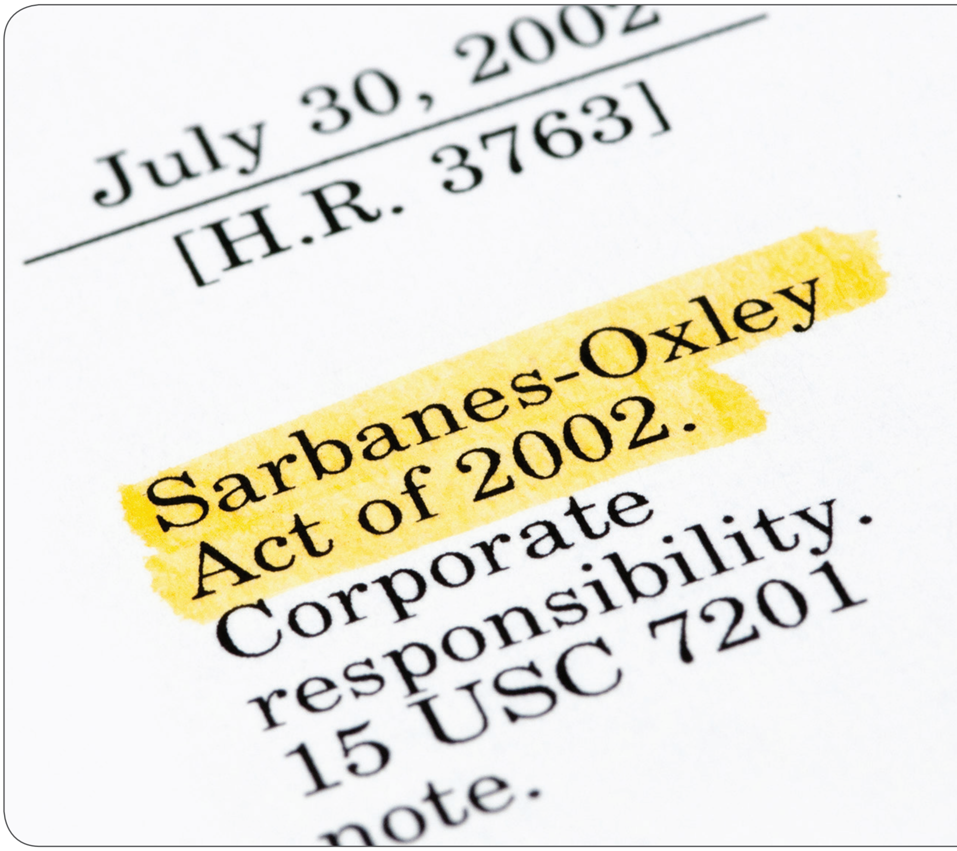
Part of the reasoning underlying this new disclosure requirement was that someone who possessed the skills and experience to be qualified as an ACFE, would ask more challenging questions and, as a result, more effective financial oversight would occur.

SOX was specific as to the skill sets the designated ACFE should possess, and also how the ACFE acquired these skill sets. [See Box.]

While there has largely been consensus that individuals who possess deep accounting, auditing, or corporate finance expertise have the skill sets to qualify, there has been disagreement and confusion over whether or not an individual is qualified to be designated as an ACFE if she or he held a supervisory role over someone with these skill sets. Investors may differ as to which particular ACFE skill sets they want to see on the audit committee. However, are companies missing an opportunity to make the ACFE disclosure more transparent and easy to understand for investors?

Our exclusive review of the 2017 proxy statements of the Fortune 100 companies found the disclosure determining why an ACFE qualified was largely lacking.

Here is what we found:



Under SEC rules, an ACFE is defined as an individual possessing all of the following attributes:

- An understanding of GAAP and financial statements;
- The ability to assess the general application of GAAP to accounting for estimates, accruals and reserves;
- Experience preparing, auditing, analyzing or evaluating financial statements of a breadth and level of accounting complexity generally comparable to the company's financial statements (or experience actively supervising others engaged in such activities);
- An understanding of internal control over financial reporting;
- An understanding of audit committee functions.

  To qualify, an individual must have gained the foregoing attributes through any of the following means:
- Education and experience 1) in a position as a principal financial or accounting officer, controller, public accountant or auditor, or 2) in a position involving similar functions;
- Experience in actively supervising a principal financial or accounting officer, controller, public accountant or auditor (or an individual performing similar functions);
- Experience in overseeing or assessing companies or public accountants in the preparation, auditing or evaluation of financial statements;
- Other relevant experience.

Over the last 15 years, most experts have been in general agreement that an ACFE whose education and experience as a principal financial officer, principal accounting officer, controller ("Preparer ACFE"); public accountant or auditor ("Auditor ACFE"); or experience in one or more positions that involve the performance of similar functions; or an ACFE whose experience comes from analyzing or evaluating financial statements, such as an investment banker or as a financial analyst or venture capitalist ("Evaluator ACFE") are qualified to be designated as an ACFE.

The area where experts have often disagreed as to whether or not an individual is qualified to be designated as an ACFE is one whose experience comes from "actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions…" ("Supervisory CEO ACFE").

In the adopting release, the SEC noted, "The term 'active supervision' means more than the mere existence of a traditional hierarchical reporting relationship between supervisor and those being supervised. The supervisor should have the experience that contributed to the general expertise necessary to prepare, audit, analyze or evaluate financial statements that is at least comparable to the general expertise of those being supervised. A principal executive officer should not be presumed to qualify. A principal executive officer with considerable operations involvement, but little financial or accounting involvement, likely would not be exercising the necessary active supervision. Active participation in, and contribution to, the process, albeit at a supervisory level, of addressing financial and accounting issues that demonstrates a general expertise in the area would be necessary." — *Ann C. Mulé*

1. It was a difficult and time consuming task to determine the reason why an audit committee member qualified as an ACFE because very few companies have voluntarily disclosed this information within the language of the actual ACFE designation disclosure. Five companies that did disclose the ACFE qualifications within the context of the actual ACFE designation were The Travelers Companies, Inc., Johnson & Johnson, Marathon Petroleum Corporation, Best Buy and Target Corporation. Their disclosures were transparent and easy to follow because all of the information was contained in one place in the proxy statement. Such disclosures enable an investor to easily ascertain the diversity of ACFE skill sets present (or lack thereof) among the ACFEs as a whole.

As an example, Travelers designation disclosure reads as follows: "The Board also has determined that Mr. Dasburg's experience with KPMG Peat Marwick from 1973 to 1980, his service as a KPMG Tax Partner from 1978 to 1980, his experience as Chief Financial Officer of Marriott Corporation, as Chief Executive Officer of Northwest Airlines, Burger King Corporation and ASTAR and his service on the audit committees of other public companies qualify him as an audit committee financial expert, and he has been so designated. In addition, the Board designated Mr. Kane as an audit committee financial expert after considering his extensive experience as an audit partner with Ernst & Young for 25 years."

2. Some companies clearly disclosed the specific reasons why an ACFE was designated within their director biographies in the proxy statement. Twelve companies took this approach: McKesson Corporation, United Technologies Corporation, Tyson Foods, Inc., Publix Super Markets, Inc., General Dynamics Corporation, CVS Health Corporation, Lockheed Martin, The Home Depot, Inc., Anthem, Inc., Walgreen Boots Alliance, Inc. and

AmeriSourceBergen Corporation. Marathon Petroleum Corporation explicitly disclosed the reasons why each ACFE qualified both in the designation and in the director biographies.

3. In many companies, it was not easy to determine the reason why one or more of the designated ACFE's qualified either from the actual ACFE designation disclosure or from the director biographies. In this case, one had to spend time carefully reading the director biographies to try to determine what experience or skill sets might qualify the individual as an ACFE.

4. To complicate things further, there were two companies that had only "Supervisory CEO ACFE's" as designated ACFE's on their audit committees. In other words, neither of these companies had a designated ACFE with deep accounting, auditing and/or corporate finance expertise on their audit committees (i.e., no "Preparer ACFE" "Auditor ACFE," or "Evaluator ACFE.") However, after spending the time to do a further analysis of the background and skill sets of the audit committee members who were not designated as ACFEs, it was determined that each company had a non-designated member(s) who possessed either deep accounting or corporate finance expertise on the committee.

5. Regardless of one's position with regard to the merit/value of the "Supervisory CEO ACFE," another relevant question that investors should be asking is whether or not some companies may be incorrectly designating a CEO as an ACFE who does not technically meet the necessary "active supervision" requirement as per the SEC's adopting release. In some cases, it was impossible to determine if this was the case through reading the proxy disclosures.

6. Numerous organizations track the absolute number of ACFE's on audit committees and the absolute number has trended upward over time. This implies that the financial expertise of the audit committee as a whole has been increasing, which is a good trend. However, in some cases, simply tracking the numbers may lead to an incomplete picture. For example, with regard to a specific company, if the absolute number of ACFE's has increased numerically but all of them are "Supervisory CEO ACFE's" (i.e., none of whom have deep accounting, auditing and/or corporate finance expertise), shouldn't this information be readily available to investors so that they can independently decide whether or not that particular audit committee is "fit for purpose" with respect to financial oversight? (Or, at least whether or not there is a need to perform a more detailed review to see what other financial oversight skill sets may or may not be present in the non-designated members?)

Since the audit committee is charged with critical financial oversight responsibilities, investors should be able to easily understand what financial oversight skill sets are possessed by the directors on the board committee as a whole. They should also, as an important first step, understand WHY the board determined that the audit committee member qualifies as an ACFE.

It is important to note that boards and companies are already doing the due diligence work internally to make the judgment call as to whether or not an audit committee member qualifies as an ACFE, and why. Why not clearly share this important information with investors as way to assist and engage with them? ■

***Ann C. Mulé** is the Associate Director of the John L. Weinberg Center for Corporate Governance at the University of Delaware where she oversees and manages all of the professional, public service and academic outreach activities of the Center.*

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