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Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, DC 20006-2803

Rulemaking Docket No. 37

Board Members:

I appreciate the opportunity to comment on the PCAOB’s Concept Release on “Auditor Independence and Audit Firm Rotation.” My comments are primarily from the perspective of having chaired audit committees of five large public companies over the past ten years. Before that I spent twenty-six years on the other side of the table as a partner with the accounting firm now known as Ernst & Young. These comments are solely my own and should not be attributed to any other entity.

The press release that announced the Concept Release said that the Board was soliciting comments “… on ways that auditor independence, objectivity and professional skepticism can be enhanced, including through mandatory rotation of audit firms (emphasis added).” Thus, I was somewhat surprised to see that the entire Release covered audit firm rotation and not the broader topic of auditor independence. As Chairman Doty noted in that same press release, “One cannot talk about audit quality without discussing independence, skepticism and objectivity.” I fully agree, but would have expected that the Board would consider those important topics with a much broader look, rather than what many may feel is a myopic focus on audit firm rotation.
The Summary to the Release says the Board’s objective is “... to solicit public comment on ways that auditor independence, objectivity and professional skepticism could be enhanced.” But given Chairman Doty’s words above as well as the actual contents of the Release, a more accurately worded objective should be “to solicit public comment on whether a mandate for audit firm rotation would actually improve audit quality.”

Those who favor mandatory audit firm rotation apparently feel that a change in audit firm increases independence, objectivity, and skepticism while somehow not sacrificing any of the quality side of the equation. Or they implicitly are willing to sacrifice some measure of performance quality in exchange for what they believe will be improved independence, objectivity, and skepticism. However, I believe the opposite is true: little will be gained in the way of independence, objectivity, and skepticism with a good chance of a loss in quality. Further, the direct and indirect costs of such a requirement would be substantial.

I was pleased to see Board Member Ferguson’s statement at the Open Board Meeting that emphasized, “…in this as in all other instances where we consider regulatory change, we take seriously the Hippocratic maxim, that has application to anyone attempting to ameliorate anything, of ‘first, do no harm.’” Obviously, mandating audit firm rotation would be very costly and not something that would be easy to undo once started. So the Board is certainly correct in first seeking comments on a Concept Release before even considering the possibility of a standard. And I strongly agree with page 17 of the Release where it says, “The Board is interested in comment on whether mandatory auditor rotation would significantly enhance auditors’ objectivity and ability and willingness to resist management pressure (emphasis added.)” In the Concept Release there are arguments that at least some parties find reasonable on both sides of this issue. But in order to make a case for significant enhancement of quality – not just independence, objectivity, and skepticism – and to overcome the obvious harm of high costs and disruption to reporting companies, there should be compelling and not just reasonable arguments to support change.

The Concept Release in Perspective

The PCAOB’s responsibility, of course, runs to the regulation of auditors of entities reporting to the SEC. Thus, this project relates to the topic of audit firm rotation and whether that might improve audit quality. But I think it’s important to keep in mind that investors don’t invest in audit firms – they invest in corporations. So investors’ principal concern ought to be whether any PCAOB action would
have the effect of improving the quality of the information they receive from corporations. I think the PCAOB should have a similar objective. You should consider not only would mandatory rotation of auditors significantly improve the quality of audits, but would such improvement in audits actually improve the quality of information provided to shareholders?

You may balk at such an obligation but it's exactly the one that audit committees have at present. Audit committees have numerous statutory and regulatory responsibilities including hiring, compensating, and overseeing external auditors; a similar role for internal auditors; oversight of risk management and whistleblower hotlines; etc. However, oversight of the company's financial reporting is by far the most important responsibility of audit committees. Most of the other duties relate to activities that help assure that the financial reporting system is producing reports to shareholders that are in compliance with GAAP and are as transparent as possible. Because of this principal responsibility, audit committees are most interested that their companies have all of the following:

Sufficient, highly capable finance personnel who are knowledgeable about GAAP and SEC reporting matters

A system of internal controls over financial reporting that produces accurate information that is summarized into appropriate reporting formats

Accounting policies that are most appropriate for the company's circumstances without biasing reporting in any way

Footnote and other disclosure practices that emphasize transparent, excellent communications with users of the company's financial reports

Internal audits that are seen as helping ensure that the company is accomplishing its objectives, rather than simply trying to catch mistakes

External audits that independently challenge all of the above and provide investors with reasonable assurance that the efforts of management and the audit committee have been successful

The above items are not necessarily listed in order of importance. But it should go without saying that the system wouldn't work very well if corporate accounting and controls were generally poor with poor audit committee oversight and the system was relying mainly on external audits to somehow shore things up. That
can work for certain audits on the margin or for certain issues for individual companies. But management and the audit committee generally must do their job in a near zero defect manner else the overall system is fatally flawed.

The above is not intended to say that the external audit is unimportant. Rather, as noted in my listing above, I believe it is an integral part of the system that shareholders and our overall capital markets heavily rely on. Much of our democratic system is built on checks and balances or “trust but verify,” and the role of the external audit brings an independent point of view to financial reporting that helps make our public markets continue to be arguably the most credible in the world.

I think it is also important to note that independence, objectivity, and skepticism are qualities that audit committee members insist upon in Chief Financial Officers, Controllers, Chief Accounting Officers, Chief Audit Executives, and other senior finance leaders with whom they work directly. Obviously, these terms would not be applied in exactly the same way as for external auditors. A CFO, for example, receives compensation from the company and wouldn’t meet an external auditor’s definition of independence. However, the audit committee expects that the CFO’s communications to them are independent of his/her personal interests in the company or responsibilities to the CEO, for example. Providing incomplete or incorrect information to the audit committee, or worse yet, withholding information, would be grounds for dismissal for a CFO.

Thus, as an experienced audit committee chairman, the above observations greatly influence my consideration of the Concept Release. As noted, I find myself asking not just about auditor independence, objectivity, and skepticism, but whether mandatory rotation would significantly improve audit quality. And the more important question in carrying out my responsibilities to shareholders and other users of the company’s public reports is whether mandatory auditor rotation would somehow improve those reports. My conclusion is “no” for both of those questions and it is based on the comments in the following section.

Audit Firm Quality Today – An Audit Committee Chairman’s Observations

Audit firms are subject to numerous internal and external quality control measures at present including permanent and temporary PCAOB standards on auditing, quality control, and independence and ethics. Several of these standards require the audit firm to discuss matters with the audit committee, which would decide whether any “exceptions” reported represent matters that significantly detract from
the quality of the audit and raise questions about the retention of the incumbent firm. (See later comments about annual evaluation of the audit firm and consideration for reappointment.)

For example, PCAOB Ethics and Independence Rule 3526 requires the audit firm to annually provide information to the audit committee that could reasonably bear on independence prior to the committee’s decision whether to reappoint the firm as auditors. And for New York Stock Exchange listed companies, the audit firm is required annually to provide to the audit committee a report describing the firm’s quality control procedures, any material issues raised by internal or external quality control reviews or external investigations, and all relationships between the audit firm and the company.

Audit firm independence and objectivity are also bolstered by rules dealing with relationships between firms and their clients such as prohibitions on providing certain services and limits on when certain firm personnel are able to go to work for clients. (For large public companies that often use professional services of other of the Big 4 accounting firms in addition to their auditors, this can become somewhat problematic. For Legg Mason, one of my public board companies, we presently have a policy that requires that we will specify one firm for which we will be sure not to use professional services that could possibly raise any independence issues just so we keep our rotation options open.)

Audit committees are also well aware of the effect of the PCAOB’s inspection program. The audit engagement for one of my board companies underwent a very comprehensive inspection a few years ago, including several inspectors visiting a U.K. location. I understand that inspection resulted in no findings of consequence.\(^1\) For another of my board companies, the PCAOB inspections staff performed a more limited review and again had no significant findings. From my discussions with the engagement partners, and with accounting firm leaders in general, it’s my impression that the firms take these inspections very seriously. I understand that financial penalties are assessed against partners who are subject to poor inspection reports and an individual’s career can be significantly impaired if not destroyed by an extremely poor report. In short, I believe the PCAOB has truly

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\(^1\) My understanding is that there is presently no requirement for an audit firm to share the results of an inspection with the company whose audit is being inspected. While I believe that firms generally do notify their clients and audit committees when an inspection is being performed, they may not always share the results of the inspection. The PCAOB should consider requiring that this be done.
put the "fear of God" into the accounting firms with respect to making every effort to improve their quality controls.

At the same time, it's important to recognize that few, if any, audits are perfect and in looking at thousands of them over a period of time it is inevitable that the PCAOB will find fault with some. At least some of the issues identified by the PCAOB inspectors will be matters of judgment – differences of professional opinion – as often commented on by the firm in the response to the public inspection reports. Other issues will be omissions or mistakes as is likely in any human enterprise. However, care should be taken in how these matters are reported to the public. In Chairman Doty’s Statement at the August 16th open meeting he suggested the possible need for mandatory rotation in part because “... our inspectors have identified hundreds of audit failures (emphasis added).” To the average reader that may sound like hundreds of Enrons, WorldComs, etc. – a statement of alarming consequences. Board Member Ferguson used more neutral language in mentioning “… a troubling number of audit deficiencies in many areas....” Surely, the vast number of these issues did not result in restatements of the audited financial statements. Thus, while the auditing can certainly be improved, investors or other users of those statements were not seriously harmed.

Please do not interpret the above comments as a lack of concern about the deficiencies identified by the PCAOB inspection process. The accounting profession can and should strive for zero defects in performance. And while I have general concern about these matters as a long-time professional accountant, I would be particularly concerned if any of these deficiencies were identified for the companies for which I serve as audit committee chairman.

Page 7 of the Release quotes phrases that apparently came from proposals to potential audit clients from one of the largest audit firms. Those phrases are troubling indeed, as they certainly imply – if not directly indicate – a predisposition toward a lack of independence. And by using the word “proposals” in the text, I assume the inspections team found that this wasn’t a one-time occurrence. However, I would hope that the absence from the Release of several other examples indicates that this was still a relatively isolated situation. Rather than penalizing all registrants by forcing them to make a change in audit firm periodically, wouldn’t it make more sense for the PCAOB to sanction firms that violate the spirit if not the letter of independence rules in cases like this?

Frankly, this particular example strikes me as more due to overly exuberant marketing people rather than necessarily an indication of lack of controls around
the audit. If mandatory rotation were implemented, marketing functions would become even more paramount as firms would need to sell new work to replace the existing work that is scheduled to go away regularly. This would seem to encourage exactly the mindset that the PCAOB is trying to eliminate!

In addition to the built-in quality controls of the audit firms through mandated professional standards and otherwise, and in addition to the effective PCAOB inspections program, I believe audit partner rotation brings a great deal of independence, objectivity, and professional skepticism to the process. The Release, of course, discusses this in some detail. However, the Release does not seem to fully acknowledge the comprehensive scope of partner rotation—not just limited to the engagement and concurring partners—for larger companies. Let me illustrate this with my two current public board audit committees.

For Fannie Mae (Fortune 5), there are a total of 18 Deloitte & Touche partners who are required to rotate off of the engagement after either five years or seven years (mostly the latter). While we don’t have perfect symmetry, if we did, on average there are two or three partners who play an important role in the engagement rotating every year.

For Legg Mason (Fortune 579 - 2010), there are 10 PricewaterhouseCoopers partners who are subject to similar rotation rules so there are one or two rotations per year on that audit on average.

This results in fresh views being brought to the audit but it also brings discontinuity of experience and understanding.

And that brings me to the issue of quality. Mandated audit firm rotation would lead to at least some degree of increased independence in the first year or two after a change. However, whether that degree of increased independence increases audit quality, and whether mandated rotation increases objectivity and skepticism are more problematic. As discussed at length above, audit committees generally demand and receive independent, objective, and skeptical service from their current firms. Otherwise, they would move to replace the current firm with another firm that did provide such service (see further comments below).

For a large, complex company, it is very difficult for a brand new audit team to fully understand and address all of the audit risks in the first year. I found this in my own experience in public accounting and I’ve certainly found it when I joined new audit committees. While certainly not a perfect analogy, I liken this to a
newly hired full Professor at the University of Georgia who is assigned to teach the Advanced Accounting class using a textbook with which she is not familiar when she has previously taught only Intermediate Accounting classes. She is a well qualified instructor and can certainly follow the textbook and can even use the lecture notes and ask questions of last year’s instructor. But there will still be a significant learning curve for her the first year and she is likely to miss certain subtleties in the subject matter that come only from the experience of having taught the class several times before.

In a similar vein, audit committees look for continuity in their external audit relationships in most cases as it generally enhances an understanding of the business which leads in turn to a quality audit. Further, excessive turnover can be very costly (see below) in terms of the audit firm wasting time on matters that are not important and in terms of having to train audit firm personnel in basic company operations.

In my view, therefore, there is little indication that mandated audit firm rotation will result in increased audit quality. And there is particularly no indication that investors would receive better financial information as a result. But I believe such a mandate would create inefficiencies that have a good chance of actually reducing audit quality.

As a final observation as an audit committee chairman, an annual evaluation of the audit firm’s performance is an important committee responsibility. This would focus largely on matters such as:

Having an outstanding understanding of the business

Communicating effectively with management and the audit committee

Bringing any new issues to the company’s attention promptly (and anticipating problems before they arise)

Resolving technical issues in an effective and timely manner

Performing as a well-functioning and cohesive team throughout the world

This process allows the audit committee to provide feedback to the audit firm to improve performance in the future. However, it is also used as the basis for determining whether to reappoint the firm as auditors for the coming year (and
whether to ask shareholders to ratify that appointment, as many companies do). Thus, audit committees go through an annual process of evaluating the performance of their audit firm and deciding whether to continue the engagement or to seek proposals for a possible new auditor. For larger companies, the latter step is relatively uncommon because a change is costly and disruptive. Also, sometimes a change in auditors is viewed as a negative by stock analysts. But audit committees take this responsibility very seriously and will consider a change when they feel the current firm, or the team it has deployed, is not up to the standards they demand.

The Cost of Mandatory Rotation

As noted in the above section of my letter, I am satisfied that current audit and related standards, the PCAOB inspection program, and mandatory partner rotation, among other quality control measures, lead to generally very high quality public company audits at present. There’s no reason for me to believe these audits would be significantly enhanced by mandatory auditor rotation. When exceptions are found by the PCAOB they should be sanctioned, but it is inappropriate to impose mandatory audit firm rotation on all public companies because of the faults of the relatively few.

Equally important, I believe there would be significant costs imposed by such a requirement that cannot be justified, particularly in light of the lack of any real benefit.

In a mandatory rotation environment, the costs of change no doubt would include actual higher audit fees for the first year or two as the new firm would need to perform some procedures with respect to earlier balances and transactions. And it would be in a learning curve mode for a period of time. At present, when audit firm changes take place, the new firm often offers a lower fee as it is willing to reduce its profits in the short run in order to gain a potential long-term client. In a mandatory rotation environment, there would be less incentive for firms to do so, particularly for the largest companies that have only a few real choices anyway. Further, near the time a firm knew it was going to be rotated off of the engagement, there would be a natural incentive to over audit in order to avoid any second guessing by the new audit firm.

As noted in the Release, the most important costs of mandatory rotation would not be those fees but the tremendous time and effort involved in having to train new people to understand a company’s business and become capable of performing a
satisfactory audit. For example, for the latest audit period approximately 180 total Deloitte & Touche personnel (including partners) worked on the Fannie Mae engagement for 100 hours or more. For Legg Mason, about 70 PricewaterhouseCoopers people were involved in the audit for 100 hours or more. Fannie Mae is an entirely domestic audit but Legg Mason has operations in several international locations. As noted earlier, each of these companies is quite large and their operations are also complex. (I’m sure that quite a few other large public audits involve many more total audit personnel.)

As mentioned earlier, a certain number of partners have to rotate off of these engagements each year. And other personnel change because of promotions, terminations, reassignments, and other reasons. So there is already a certain amount of turnover and resulting disruption that occurs each year on any good sized audit. But mandatory rotation would mean the entire team would leave at once and company personnel would need to teach the auditors how the company operates.

To build on my accounting professor example above, she will probably spend a little extra preparation time the first semester. But she doesn’t have to worry about legal liability, PCAOB inspections, audit committee expectations, or similar considerations. About the worst that can happen are some poor student evaluations and those most often have almost no real negative effects!

The audit firm, on the other hand, recognizes that its inexperience will expose it to the types of consequences mentioned above. And it knows that reading the former auditors’ working papers is no substitute for actually performing the work for several years. So it will tend to be very careful the first year or two and compensate for its lack of experience with the company by spending more time in sensitive areas. In many cases this will include unnecessarily challenging areas that weren’t considered high risk by the former auditors or unnecessarily challenging accounting that had been previously been considered acceptable.

At least some of these education or learning curve costs may well be included in the direct costs mentioned in the first part of this section. And they also relate to my earlier comments about audit quality as any decline in understanding of the company’s business certainly affects audit quality. But the costs mentioned above refer mainly to those of the audit firm and not the company. There will also be substantial company personnel time incurred to educate and continually communicate with auditors.
A more subtle cost is the potential for an impairment of the relationship between the audit engagement partner and other key partners with the audit committee. Having gone through engagement partner rotation a few times, I can tell you that process is highly disruptive to the company, to the audit committee, and, obviously, to the partner involved. Focusing only on the audit committee role, it takes a fair amount of time to build a relationship with a new engagement partner after that person is selected. To greatly over-simplify things, it seems as though it takes the engagement partner the first two years to develop a good understanding of the company (and build a relationship with the audit committee during that time), the next two years to do a highly effective job, and then his/her final year preparing to move on and breaking in the replacement. Audit committees usually try to gain exposure to other members of the audit team such as the concurrence partner, tax partner, IT partner, partners in charge of key locations or activities, etc. However, there is only so much time available at regular committee meetings so most of the committee’s interaction is naturally going to be with the engagement partner and perhaps with a senior advisory partner.

Audit committees accept engagement partner rotation over such a short period as a necessary evil given the realities of the regulation of the accounting profession. However, moving to mandatory firm rotation would greatly exacerbate the situation and likely diminish the effectiveness of the relationship between the engagement partner and audit committee.

The last thing that audit committees want in the audit team serving them is “yes men.” But we do want a team that is fully knowledgeable about the company’s business, handles sensitive issues constructively and proactively, and communicates timely and effectively. On balance, those skills improve with experience.

The costs of change would also be those involving the substantial investments that audit firms make to build expertise in geographic locations or in industry knowledge for multinational or more specialized type companies. Firms may be willing to absorb these costs under current conditions when they recognize the need to develop expertise in many foreign locations for a very large company. This could involve transferring in personnel from the U.S. or other locations with the necessary knowledge to develop the local people over several years. Even the largest firms simply don’t have outstanding resources or the right specialized knowledge in every location in the world or even in the U.S. Thus, required rotation will not only be costly it can result in at least temporary weak points in audit coverage.
In summary, the direct and indirect costs of changing audit firms are substantial. Audit committees take their responsibility for the evaluation and reconsideration of the independent audit firm very seriously. And in appropriate circumstances, a committee will make the judgment that a change is necessitated. But mandating a change in the interest of unproven increases in audit quality would be a poor policy decision by the PCAOB. Little if anything would be gained from such a change and much would be lost.

Other comments

I have one idea that may not fit in this project but is something that the PCAOB should consider in concert with the SEC at some point as it could improve audit oversight. That is to revisit the rules on who qualifies as an “Audit Committee Financial Expert.” When the SEC initially proposed those rules pursuant to Sarbanes-Oxley, they were met with significant opposition. The result was very watered down final rules that allow individuals who served in senior executive positions to qualify even when they have very little actual accounting or auditing experience. I’ve always thought that at least one member of the audit committee ought to be able to “speak GAAP and GAAS” in order to effectively interact with financial management and the outside auditors, etc. This is an important issue but it doesn’t have any traction at the SEC because of Dodd-Frank and many other priorities. I refer you to the attached article.

Question 6 of the Release asks, “Should the Board consider requiring rotation for all issuer audits or just for some subset, such as audits of large issuers?” The Release suggests that applying a requirement only to the largest companies might preserve much of the benefits of a rule while reducing market-wide implementation costs. For the largest companies, there is already a great deal of audit partner rotation as exemplified by Fannie Mae and Legg Mason. On the other hand, for medium or small companies, there may be only a handful of partners in a local firm. While I’m not advocating firm rotation, it could be more logical to require rotation for smaller firms than larger ones on the basis of objectivity, etc. of the individuals involved.

As a member of the PCAOB Standing Advisory Group, I was somewhat surprised that the Board chose not to review this important topic with SAG before developing the Concept Release and issuing it for public comment. As noted in the Release, the Board did seek the views of its Investor Advisory Group. But SAG represents a much broader cross section of the Board’s constituents and could have
provided more balanced input prior to seeking public comment. Also, at least a few members of IAG were already on record on audit firm rotation as noted in the Release and its footnotes, so the information provided by that Group might well have been predicted.

Summary

In summary, I do not support mandatory audit firm rotation and believe the PCAOB should discontinue work on this particular project. Of course, a broader project on independence, objectivity, and professional skepticism is worthwhile and should be pursued in due course.

I would be pleased to provide further comments if you have any questions about my letter.

Sincerely,

Dennis R. Beresford
Ernst & Young Executive Professor of Accounting

Attachment – “How ‘Expert’ is Your Financial Expert?”
How “Expert” is Your Financial Expert?

By Dennis R. Beresford and Joseph Hinsey

“My background easily makes me a financial expert as determined by the boards on which I serve, even though today’s accounting pronouncements are beyond my comprehension,” observes former Federal Deposit Insurance Corporation Chairman L. William Seidman in a column he wrote for a recent issue of Bank Director magazine. Mr. Seidman’s observation points up a dilemma facing many boards and individual directors these days; that is, which directors serving on the audit committee should be -- or, perhaps more realistically, can be -- designated as an “audit committee financial expert” (“ACFE” or “financial expert”) under the Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley” or “Act”) and the implementing regulation adopted by the Securities and Exchange Commission (“SEC”).

Public companies are not actually required to have a so-called “financial expert” serving on their audit committees. However, if they do, they must state who the ACFE is. AND if they do not, they must disclose that fact and provide the reason(s) why. Most issuers have stated that, pursuant to their board’s determination under the regulatory scheme, they do have one or more such experts serving on their audit committees.

Section 407 of Sarbanes-Oxley provided the general framework that Congress envisioned for a “financial expert” (per 407, a term to be defined by the SEC through rulemaking). The Act contemplated that such a person would have an
understanding of generally accepted accounting principles ("GAAP"), financial statements and audit committee functions. The Act indicated, as further considerations for the SEC’s rulemaking, that a "financial expert" should have experience with the preparation or auditing of financial statements of generally comparable issuers, and an ability to assess the application of GAAP to accounting for estimates, accruals, and reserves.

That Congressional guidance suggests the Act’s intention to set a fairly high standard for financial experts. Section 407 listed public accountants, auditors, chief financial officers, controllers, and principal accounting officers as examples of persons who might qualify, through their education and experience, as financial experts. As an alternative, the Act suggested that others might qualify "from a position involving the performance of similar functions." Given the general framework provided by the Act, the SEC proceeded to develop an implementing regulation for the "financial expert" term. Its initial proposal was a fairly strict interpretation of Section 407; however, a flood of comment letters caused the Commission to moderate the final rule (e.g., with reference to internal controls, "understanding" was substituted for the term "experience").

To qualify as a financial expert under the final rule, an audit committee member is required to have: (1) an understanding of (i) GAAP and (ii) financial statements; (2) an ability to assess GAAP’s application re accounting for estimates, accruals and reserves; (3)(i) experience “preparing, auditing, analyzing or evaluating”
financial statements presenting accounting issues that are generally comparable to those raised by the issuer’s financial statements or (3)(ii) experience "actively supervising" others engaged in such activities; (4) an understanding of (i) internal controls and (ii) financial reporting procedures; and (5) an understanding of audit committee functions. [emphasis supplied to indicate moderating adjustments made in the final rule]

SO, the defined term includes not just those who have had direct involvement in preparing or auditing financial statements but also those who have “analyzed or evaluated” those statements. AND, ACFE designees can also include those with experience actively supervising others engaged in the preparation, analysis, audit or evaluation of financial statements. Notwithstanding the fact that an ACFE designee must satisfy all five of the above requirements in order to qualify as a financial expert, current practice appears to approach the designation process as if it involves “multiple choice” (i.e., tapping candidates who meet some requirements but not all five). (Moreover, while supervisory experience may qualify, it must be “hands-on” and in the SEC’s view a CEO role, without more, would be insufficient.)

Accordingly, current and former CEOs and other executives, having had only a traditional hierarchical reporting relationship supervising financial statement preparation and/or having only a general knowledge of GAAP and related financial accounting matters, are thought to be eligible for designation as a financial expert. In fact, we can speculate that a very large percentage of all
those who have been designated as ACFEs to date satisfy only such general standards.

Actually, those more general qualifications are probably more than adequate for many of the mandated duties of audit committees. For example, the following tasks should require only a fairly basic financial expertise:

- engaging the independent auditor and arranging compensation for that firm;
- approving any proposed non-audit services to be provided by such firm to ensure that they do not impair its independence;
- reviewing reports by internal auditors to management; and
- establishing a procedure for anonymous (and confidential) submissions of employee complaints about accounting or auditing matters.

However, there are other mandated duties that arguably require more than a basic or general knowledge of GAAP and similar matters. For example, wouldn’t a more specific understanding of GAAP be needed to evaluate whether management has properly considered and applied a new pronouncement that affects the company’s basic revenue recognition practices? This is admittedly a fine line, for we can’t (and shouldn’t) expect audit committees to micro-manage the accounting and reporting practices of their companies. BUT if the board has designated an ACFE, shouldn’t shareholders be entitled
to expect that audit committee member to be able to evaluate the reasonableness of accounting judgments made (such as the one just mentioned) – not to mention the reasonableness of estimate-accrual-reserve determinations made by management?

Some of the other audit committee duties that may be problematic for an ACFE who lacks a more in-depth understanding of GAAP, etc., are:

- overseeing the resolution of any disagreements between management and the independent auditors;
- reviewing any alternative treatments of GAAP that have been considered by management; and
- reviewing any changes in the selection or application of accounting principles.

In short, boards may want to be sure that the person they identify as an ACFE can actually "speak accounting." This would include relatively specific knowledge of GAAP, SEC accounting regulations, and auditing standards. AND that knowledge should be current – a retired financial executive or auditor, undertaking the ACFE responsibilities, must keep up with new pronouncements and other unfolding developments to maintain relevancy.

Most boards, if questioned today, would presumably profess satisfaction with their ACFE determinations. However, if Mr. Seidman's candid personal assessment is shared by other ACFEs, it may be appropriate for both the board and its designated financial experts to rethink the matter. Aside from the
uncertainty as to what exactly is an ACFE’s role on the audit committee, an imponderable facing the boardroom community involves the proper interpretation of each of the five qualifications (skill sets and/or experience) that are requirements under the SEC’s final rule for ACFE designation. For example, how “actively” must a candidate have been involved when supervising the preparation of financial statements, how “comparable” must those financials have been to the issuer’s current financial statements, and how recent must that “supervision” have been?

One solution, of course, is to recruit new board members with the requisite qualifications. Some companies have done this but the addition of qualified financial reporting experts to corporate boards can probably be described more as a trickle than a flood. Qualified individuals may well be available but, as a generalization, new board memberships continue the familiar pattern of adding more CEO’s and other senior general managers.

Another solution is for the audit committee to engage consultants to help with the tasks that require more specialized knowledge. Sarbanes-Oxley makes clear that audit committees have the right to do so and at least some committees now ask other accounting firms or individual experts (e.g., academics) to assist them. However, “outsourcing” these important responsibilities seems to defeat the purpose of having qualified and experienced board members providing appropriate oversight.

When the SEC issued its implementing regulation, it tried to make clear that the financial expert designation is not intended to
create new responsibilities or greater liability for that person or for
the audit committee (or board) as a whole. However, that
disclaimer has not been tested in court and no one knows whether
ACFEs will ultimately be held to a higher standard than other
directors. Certainly we can anticipate an attempt by the class
action bar to hold ACFEs to a higher standard – and perhaps even
to assert, in securities litigation, that the listing of unqualified
ACFEs in the issuer’s disclosure documents involves a material
misrepresentation! At a minimum, there probably will be
embarrassing moments for at least some ACFEs when they are
required to testify in securities litigation and have to admit that
they didn’t actually understand some complex accounting matter
(that conceivably precipitated the restatement of the issuer’s
financials) or, perhaps more fundamentally, have to acknowledge
that they do not meet all five requirements – the necessary skill
sets and experience -- for ACFE designation.

Determining whether the audit committee includes a financial
expert is an important judgment for all corporate boards. Taking
steps to add expertise to the board or engage consultants may be
appropriate actions. OR, in the alternative, it may be appropriate to
recognize that the committee’s membership does not include the
specified expertise. Otherwise, many board members may find that
their situation is as Mr. Seidman explained in that same article:
“For me, the answer is to do the best job on the audit committee
that I can do, and then hope and pray that the system will provide
reasonable latitude in judging performance.”
Dennis R. Beresford is the Ernst & Young Executive Professor of Accounting at the University of Georgia. Joseph Hinsey is the H. Douglas Weaver Professor of Business Law, Emeritus, at the Harvard Business School. All rights reserved.