



On the board's agenda | US

Trends in audit committee reporting

For the past several years, various governance groups and investors have encouraged audit committees to disclose more information on how they execute their duties. As recently as November 2016, the United Brotherhood of Carpenters' Pension Fund announced that it would send letters to 75 companies encouraging their audit committees to enhance auditor independence disclosures in 2017 proxy statements—a request they have been making since 2013. The SEC weighed in on the discussion when it issued a request for public comment on this topic in a July 2015 concept release titled *Possible Revisions to Audit Committee Disclosures*.

While the SEC has not yet changed disclosure requirements as a result of such requests from governance groups

and investors, there has been increased voluntary disclosure by audit committees, as evidenced in Deloitte's latest proxy statement study, in which we reviewed the proxies of S&P 100 companies¹, as we did in 2015. While our review confirms that voluntary disclosure is increasing, a year-over-year comparison of disclosures suggests that the pace of change is slow and steady rather than dramatic.

Disclosure in three areas increased by more than 10 percent in 2016: the number of financial experts on the audit committee, the audit committee's role in reviewing earnings or annual report press releases with management and the independent auditor, and the audit committee's role in approving audit engagement fees. Most

other disclosures fluctuated by 3 percent or less.

For the 2016 disclosure review, we analyzed some additional areas, including the audit committee's role in overseeing risk. We found that nearly every filer included some level of disclosure on this topic, with most including details on the extent of the audit committee's responsibilities. Most notable was the acknowledgement that more than half of S&P 100 audit committees play a key role in overseeing risk beyond the traditional areas of financial reporting, internal controls, and compliance. ➤



Audit committee composition

The majority of audit committee disclosure requirements, principally found in *Item 407 of the SEC's Regulation S-K*, were adopted in 1999. Since then, there have been enhancements to audit committee disclosures arising from the Sarbanes-Oxley Act of 2002.

Companies are required to disclose whether their audit committee has at least one financial expert. Given the complex issues many audit committees oversee today, many are choosing to have more than one financial expert on the committee. Eighty-eight percent of the S&P 100 disclosed that their audit committees have more than one financial expert, a 12 percent increase from 2015.

While the New York Stock Exchange Listed Company Manual requires each member of the audit committee to be financially literate², only 63 percent of the companies in our analysis disclosed this, up 4 percent in 2016.

Appointment and evaluation of the independent auditor

Fifty-nine percent of S&P 100 companies, 2 percent less than in 2015, explicitly disclosed that the audit committee evaluates the independent auditor. Factors considered in those evaluations included the independent auditor's qualifications, performance, independence, and tenure.

We observed a 7 percent increase, to 42 percent, in the number of companies that disclosed the reasons for retaining the incumbent independent auditor. While some merely stated that retention was in the best interest of the company, a number included additional insight into the factors considered in making this determination. The reasons cited most often were quality and performance, including the results of PCAOB and peer reviews, tenure of the relationship, and the audit team's knowledge of and experience with the industry and the company's operations. Some companies also cited the appropriateness of fees, both on an absolute basis and as compared to peer firms.

Our review indicates that S&P 100 companies uniformly comply with required disclosure requirements related to the audit committee, which are summarized in the appendix. We therefore focused our review on disclosures that either expanded on or went beyond those required elements, especially in the areas of oversight of the independent auditor, oversight of the financial reporting process, and other oversight responsibilities.

Oversight of the independent auditor

The Sarbanes-Oxley Act of 2002 recognized the importance of independent audit committees to the audit process through explicitly mandating that the audit committee be directly responsible for the appointment, compensation, and oversight of the independent auditor. As a result, many audit committee-related proxy statement disclosures focus on these key responsibilities. Consistent with what we saw in 2015, all the S&P 100 company audit committees disclosed information about their roles and responsibilities, including their oversight of the independent auditor.

Compensation of the independent auditor

While only 21 percent of audit committees disclosed that they are responsible for negotiating fees, a 2 percent decrease from 2015, there was a significant increase in more general disclosures around the audit committee's role in reviewing and approving the audit engagement fees. In fact, this disclosure saw the largest increase in disclosure by S&P 100 companies in our analysis—jumping from 40 percent to 65 percent. In addition to disclosing the audit committee's responsibility for reviewing and approving the independent auditor's fees, some companies also disclosed that the audit committee established preapproval policies related to all audit and non-audit services provided by the independent auditor. ➤

¹ Our review included all sections of the most recent annual proxy statements filed as of October 1, 2016, for the companies that were included in the S&P 100 index as of August 1, 2016. Because the composition of the S&P 100 changes annually, the companies analyzed in 2015 and 2016 differed; 16 of the companies in the 2016 analysis were not in the S&P 100 in 2015.

² NYSE Listed Company Manual Section 303A.07(a).

Discussions around the auditor's responsibilities

Sixty-nine percent of S&P 100 companies provided disclosures regarding the responsibilities of the independent auditor, only a 1 percent increase over 2015. Responsibilities mentioned frequently included:

- Performing an audit of, and expressing an opinion on, the company's financial statements and its internal control over financial reporting
- Discussing with the audit committee any matters deemed appropriate.

Additionally, 67 percent of the S&P 100 disclosed that the audit committee has separate meetings with the independent auditor, and 63 percent disclosed that they discussed the overall scope of and plans for the audit with the auditor. Both disclosures only fluctuated by 1 percent from 2015.

While only 6 percent of companies disclosed that they discussed issues encountered during the audit with the independent auditor, we expect this may change if the PCAOB adopts a new standard on the auditor's reporting model. See additional information on the expected rule below/on the right.



New auditor's reporting model and its potential effect on audit committee disclosures

The PCAOB repropoed an auditing standard in May 2016 that would substantially expand the auditor's report. The PCAOB states that the proposed standard is intended to increase the informational value, usefulness, and relevance of the auditor's report. As proposed, the new form or report will retain the current pass/fail approach, while proposing a significant new section in the auditor's report describing critical audit matters (CAMs). CAMs are certain matters that were communicated or are required to be communicated to the audit committee that relate to accounts or disclosures material to the financial statements and involve especially challenging, subjective, or complex aspects of the audit.

Although it is not clear what changes will be made to finalize the proposal and when the standard will become effective, auditors, management, and audit committees should be considering and discussing the potential effects.

Read more about the feedback received on the proposal.

Oversight of the financial reporting process

While some companies simply noted that one of the audit committee's responsibilities was to oversee the financial reporting process, many others provided additional details. Eighty-eight percent of S&P 100 companies discussed their audit committees' role in overseeing internal control over financial reporting, with approximately half noting that they discussed the evaluation of the company's internal controls and the overall quality of the company's financial reporting, and approximately one-quarter disclosing the committee's oversight of certain areas of legal and regulatory compliance.

An increased number of companies noted that their audit committees review the earnings/annual report press releases with management and the independent auditor



Non-GAAP measures

The SEC is taking a hard look at non-GAAP measures due to concerns about their increased use and prominence. As a result, companies and audit committees should consider reexamining their use of non-GAAP measures and related controls and procedures for disclosure of such measures. Consider reviewing Deloitte's roadmap to non-GAAP financial measures, which combines the SEC's guidance with Deloitte's interpretations and examples, and includes questions for companies to consider when disclosing these measures. Also refer to Deloitte's *Heads Up* for questions audit committee members can consider related to non-GAAP measures.

prior to their release. Disclosure in this area increased to 30 percent from 20 percent, and it may increase further given the SEC's recent focus on non-GAAP measures. Slightly more companies—21 percent, up from 18 percent—said their audit committees discuss the financial statements in advance of earnings announcements.

Disclosures related to the audit committee's review of significant accounting policies were up 9 percent, to 56 percent in 2016. Additionally, 59 percent of companies disclosed information about their audit committees' review of management judgments and/or accounting estimates, versus 55 percent in 2015. ➔

Other oversight responsibilities

In addition to their responsibility for overseeing the independent auditor and financial reporting process, many audit committees also discussed other oversight responsibilities. Our 2016 analysis was expanded to consider disclosures about the audit committee's oversight of areas such as risk, internal audit, and cybersecurity.

Role of the audit committee in overseeing risk

The role of the board and its committees in overseeing risk continues to be a hot topic. Ninety-six percent of S&P 100 companies disclosed the role of the audit committee in overseeing risk. The level of responsibility assigned to the audit committee, however, differed from company to company.

Sixty-nine percent of companies disclosed that the audit committee was responsible for overseeing risks associated with traditional areas such as financial reporting, internal controls, and compliance, while 61 percent noted that the audit committee's role in risk oversight extended beyond these areas. The extent of additional responsibility varied, with most saying that the committee was responsible for reviewing the guidelines and policies governing management's process for risk assessment and risk management, either alone or in coordination with other committees. About one-quarter of these companies noted that the audit committee is responsible for overseeing the enterprise risk management program for the board.

In most instances, the disclosures also noted that the audit committee was responsible for discussing the results of their risk oversight with the full board.

Fourteen percent of S&P 100 companies disclosed that the audit committee is responsible for overseeing cybersecurity risk.

Role of the audit committee in overseeing internal audit

Eighty-five percent of companies discussed the audit committee's role in overseeing the internal audit function. Disclosures often noted the audit committee's role in the following areas:

- Assisting the board of directors in fulfilling its oversight responsibility with respect to the qualifications and performance of the internal audit function and internal auditors
- Meeting regularly with internal audit to review and discuss the internal audit scope and plan and the results of internal audit activities
- Overseeing the appointment, removal, performance, and compensation of the chief audit executive

Other topics discussed by the audit committee

All the S&P 100 companies disclosed at least some topics of discussion between the audit committee and management, the independent auditor, internal audit, or others. Most companies limited this disclosure to the five items required by *Item 407 of the SEC's Regulation S-K*³. Those companies that identified additional topics of discussion generally limited their disclosures to the topics covered and did not include details from the discussion. The topics listed most commonly were:

- The audited financial statements, results, and/or performance, including the quality and acceptability of the accounting principles and clarity of the disclosures in the financial statements
- The evaluation of the company's internal controls and overall quality of the company's financial reporting
- The policies and procedures with respect to the company's risk assessment and risk management. ➤



The role of the board in risk oversight

The SEC issued rules in 2010 requiring disclosure in proxy statements about the board's role in risk oversight. Deloitte conducted an analysis of risk-related disclosures several years after the rules were passed. See *Deloitte's Risk Intelligent Proxy Disclosures: 2013* for the results of that analysis.

³ *Item 407 of Regulation S-K*. See a list of these required disclosures in the appendix.

Conclusion

Deloitte continues to believe that transparency into the audit committee's oversight activities and performance can provide investors with a better understanding of both the audit committee's performance and the audit process. While it is not necessary, or possible, to disclose everything an audit committee does each year in fulfilling its duties, providing additional insight into the structure and key activities of the audit committee can help increase investor confidence in both the audit committee and the company as a whole.

Based on our analysis of the S&P 100's audit committee-related proxy disclosures, the calls for transparency seem to be leading companies to continue expanding disclosures beyond what is currently required. This is encouraging, but from our day-to-day interactions with audit committees, we know that many of them are doing much more to fulfill their responsibilities than they disclose.

Disclosures that emphasize the direct reporting relationship between the audit committee and the independent auditor, and provide insight into the audit committee's assessment of audit quality and independence, could be valuable to investors in assessing the audit committee's performance of its Sarbanes-Oxley duties. These could include disclosures that give a clearer picture of the level and extent of communication between the independent auditor and the audit committee, beyond the fact that the communications required by PCAOB audit standards and listing requirements occurred. Additionally, disclosures that give insight into the audit committee's process and rationale for appointing the independent auditor can provide important insight into not only the auditor's qualifications but also the audit committee's level of engagement and oversight.

Expanding these disclosures could further enhance investors' confidence in the audit committee's oversight role and reduce the need for additional mandated disclosures.

Appendix

Required disclosures related to the audit committee

SEC rules and regulations require that certain information about the audit committee be disclosed. Most companies include all the required disclosures in their annual proxy statement. *Item 407 of Regulation S-K* requires:

- Disclosure of whether the company has an audit committee, and if it does, the names of the members, the number of times the committee met in the past year, certain information about member attendance at these meetings, and a brief description of the functions performed.

- Disclosure of whether the audit committee is governed by a charter and, if so, whether a current copy of the charter is available on the registrant's website or included as an appendix to the proxy or information statement that it is provided to security holders at least once every three fiscal years (or sooner if the charter has been materially amended).
- If the board of directors appoints a director to the audit committee who is not independent, as defined in the applicable listing standards⁴, disclose the nature of the relationship that makes the individual not independent and the reasons for the board of director's determination.
- Disclosure of whether the audit committee has at least one financial expert, and the name (and in some cases attributes) of the expert(s).
- An audit committee report that states whether the audit committee has:
 1. Reviewed and discussed the audited financial statements with management
 2. Discussed the required communication matters under applicable auditing standards with the independent auditor
 3. Received the required written independence communications from the independent auditor as required by the rules of the PCAOB and discussed the independent auditor's independence with the independent auditor
 4. Recommended to the board of directors that the audited financial statements be included in the company's annual report on Form 10-K.
- The name of each member of the audit committee must appear below these required disclosures.

The SEC's regulations pertaining to the preparation of a company's annual proxy statement (Schedule 14A, Item 9) also require that the company disclose the audit committee's policies and procedures regarding the preapproval of fees paid to the independent auditor.

In addition to the disclosures required by the SEC, *New York Stock Exchange Listed Company Manual Item 303A.07* requires that public companies disclose whether any audit committee member serves on the audit committee of more than three public companies, and if so, why the board determined this was appropriate.

⁴ Director independence disclosures are also required under *NYSE Listed Company Manual Section 303A.02(a)* and *NASDAQ Listing Rule 5605(b)(1)*.

Summary results of analysis

Disclosure in the proxy statement	Percent of S&P 100 companies that included related disclosures in their proxy	
	2016	2015
Disclosure related to the composition of the audit committee		
1. Audit committee has more than one financial expert	88%	76%
2. Financial literacy of audit committee members	63%	59%
Disclosure related to the role of the audit committee		
3. Roles and responsibilities of the audit committee	100%	100%
4. Information about the charter beyond its existence	71%	77%
5. Topics of discussion for the audit committee	100%	100%
Disclosure related to the oversight of the financial reporting process		
6. Audit committee review of significant accounting policies	56%	47%
7. Additional disclosure about significant accounting policies	27%	28%
8. Discussion of management judgments and/or accounting estimates	32%	28%
9. Audit committee review of the earnings/annual report press release with management and the independent auditor	30%	20%
10. Audit committee discussions about the financial statements before earnings announcements	21%	18%
Disclosure related to the oversight of the independent auditor		
11. Audit committee evaluates the independent auditor	59%	61%
12. Why the audit committee decided to reappoint the independent auditor	42%	35%
13. Audit committee or its chair is involved in the selection of the auditor's new lead engagement partner	73%	71%
14. Tenure of the independent auditor	67%	64%
15. Retention of the incumbent independent auditor is in the best interest of the company and its investors	79%	73%
16. Audit committee consideration of changing or regularly rotating the independent auditor	75%	74%
17. Steps to be taken if the majority of shareholders do not ratify the independent auditor	78%	80%
18. Audit committee compensates the independent auditor	80%	77%
19. Audit committee approves the audit engagement fees	65%	40%
20. Audit committee is responsible for audit fee negotiations	21%	23%
21. Audit committee sets the compensation for the independent auditor	6%	7%
22. Responsibilities of the independent auditor	69%	68%
23. Audit committee discussion with the independent auditor regarding the scope of and plans for the audit	63%	62%
24. Discussion of issues encountered during the audit	6%	7%
25. Separate meetings between the audit committee and the independent auditor	67%	68%
Disclosure related to the responsibilities of the audit committee		
26. Audit committee is responsible for the oversight of risk	96%	N/A
27. Discussion of the audit committee's oversight of the company's financial reporting process	88%	N/A
28. Discussion of the audit committee's role in the oversight of cybersecurity	27%	N/A
29. Discussion of the audit committee's role in overseeing the internal audit function	85%	N/A
30. Discussion of the actions the audit committee has taken during the prior year	43%	N/A

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