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Audit committees of publicly traded US companies are subject to SEC rules and listing standards of the exchange on which the company’s securities are listed (i.e., the NYSE or NASDAQ). Some of these rules and standards relate to committee composition, the charter, committee evaluations, and member education. These topics, as well as advice on how to run effective audit committee meetings, are covered in this section.

Composition

The audit committee should consist of three or more directors who are “independent,” as determined by the board based on the requirements discussed below. All members must comply with the financial literacy requirements of the relevant securities exchange. Although audit committees are not required to include an “audit committee financial expert,” as defined by the SEC, it is considered beneficial for at least one member to qualify as an expert to avoid having to disclose the reasons why there is none.

Audit committees should review their composition periodically to confirm that members have the knowledge and experience they need to be effective. In addition to industry knowledge, members should have a strong grasp of internal control over financial reporting and financial reporting and accounting issues such as revenue recognition, pensions and other post-employment benefits, financial instruments, and critical accounting policies.

Independence and qualifications of members

Audit committee members must be independent directors, and their independence should be continuously maintained and reviewed at least annually. Listed companies should have policies in place to allow timely identification of changing relationships or circumstances that may affect the independence of
audit committee members. Companies generally require directors to complete questionnaires when joining the board and each year thereafter and to notify the company of any changes that may affect independence. For audit committee members, these questionnaires should be tailored to reflect the independence criteria of either the NYSE or NASDAQ. Companies may want to involve legal counsel in assessing the independence of directors.

Having appropriate and relevant skills on the audit committee is increasingly important. I'm constantly challenging the composition. Do we have the right competencies on the audit committee? Are there skills we need to add?

Audit Committee Chairman

SEC requirements. Section 10A of the Securities Exchange Act of 1934 specifies general criteria for audit committee independence. Under these criteria, an audit committee member is permitted to receive compensation such as director fees, retainers, and meeting fees for serving on the board, the audit committee, or another committee, but may not:

- Accept any other consulting, advisory, or compensatory fee from the company or any subsidiary
- Be affiliated with the company or any subsidiary, as discussed below.

Prohibited compensation includes that received for services rendered by a law firm, accounting firm, consulting firm, investment bank, or similar entity in which the audit committee member is a partner, executive officer, or the equivalent. Prohibited compensation also includes payments to spouses, minor children or stepchildren, and adult children or stepchildren who share a home with the audit committee member.

Whether a person is “affiliated” with the company or a subsidiary depends on the circumstances. Under the SEC rules, a person will be affiliated if he or she is an executive officer or both a director and employee, general partner, or managing member of a company or another entity that controls, is controlled by, or is under common control with the company. “Control” is defined as “the power to direct or cause the direction of...management and policies..., whether through the ownership of voting securities, by contract, or otherwise.” Under the SEC rule, a director is considered independent to serve on an audit committee if he or she is neither an executive officer nor a holder of 10 percent or more of the entity’s shares. The rule provides limited exceptions.

NYSE and NASDAQ requirements. The NYSE and NASDAQ listing standards incorporate the SEC’s independence requirements, but each has its own additional requirements.

NYSE listing standards state that an audit committee member is not independent if any of the following applies:

- He or she is an employee or an immediate family member1 is or was an executive officer of the company during the past three years.
- He or she or an immediate family member received more than $120,000 in direct compensation from the company in any 12-month period during the previous three years, except for director fees and other permitted payments.
- He or she or an immediate family member is a current partner of the company’s internal or independent auditor; he or she is a current employee of such a firm; he or she has an immediate family member who is a current employee of such a firm and personally works on the company’s audit; he or she or an immediate family member was, but is no longer, a partner or employee of such a firm and personally worked on the company’s audit during the previous three years.
- He or she is a current employee, or an immediate family member is a current executive officer, of another company that made payments to, or received payments from, the listed company for property or

\[1\text{ A person’s spouse, parents, children, siblings, mothers- and fathers-in-law, sons- and daughters-in-law, brothers- and sisters-in-law, and anyone other than domestic employees who shares such person’s home. (NYSE listing standards)\]
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services in an amount that, in any one of the previous three fiscal years, was in excess of the greater of $1 million or 2 percent of the other company’s consolidated gross revenues.

NASDAQ listing standards state that an audit committee member is not independent if any of the following applies:

- He or she is an employee or a family member is or was an executive officer of the company during the previous three years.
- He or she or a family member\(^1\) accepted compensation in excess of $120,000 from the company in any 12-month period during the previous three years, except for director fees and other permitted payments.
- He or she or a family member is a partner of the company’s independent auditor or was a partner or employee of the company’s independent auditor and worked on the company’s audit during the previous three years.
- He or she or a family member is a partner, controlling shareholder, or executive officer of another organization that received from, or made payments to, the listed company for property or services in an amount in excess of the greater of 5 percent of the recipient’s gross revenues or $200,000, or did so during the previous three years (with certain limited exceptions).

**Director qualification disclosure requirements.** The SEC requires proxy disclosures about the qualifications of directors and the nomination process. The disclosure includes information about the experience, qualifications, and attributes considered in the nomination process and the reasons why individuals should serve on the company’s board. Disclosures regarding individual board committee qualifications are not required, but companies may want to consider including such qualifications as a part of the overall board qualification disclosure.

**Financial literacy and expertise**

**SEC requirements.** The SEC requires an issuer to disclose whether at least one “audit committee financial expert” serves on the audit committee, and if so, the name of the expert and whether he or she is independent of management. The SEC defines the term as an individual who the board determines to possess all the following attributes:

- An understanding of financial statements and generally accepted accounting principles (GAAP)
- An ability to assess the general application of GAAP in connection with accounting for estimates, accruals, and reserves
- Experience preparing, auditing, analyzing, or evaluating financial statements that present a breadth and level of complexity of accounting issues generally comparable to what can reasonably be expected to be raised by the company’s financial statements, or experience actively supervising those engaged in such activities
- An understanding of internal control over financial reporting
- An understanding of the audit committee’s functions.

The rule indicates that the attributes may be acquired by any of the following:

- Education and experience as a principal financial officer, principal accounting officer, controller, public accountant, or auditor, or experience in positions that involve similar functions
- Experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor, or someone performing similar functions
- Experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing, or evaluation of financial statements
- Other relevant experience.

Disclosure of whether at least one audit committee member is an audit committee financial expert is required in the annual report, usually by reference to the proxy statement. If the committee does not have at least one audit committee financial expert, the company must explain why it does not. The SEC also requires disclosure of the financial expert’s name and whether he or she is independent of management. The company may choose to disclose whether more than one audit committee member is an audit committee financial expert, but the names of any additional experts need not be disclosed.

The SEC rule states that designation as a financial expert does not imply that an individual is an expert for any purpose under the Exchange Act or otherwise. Furthermore, it does not elevate the duties, obligations, or liabilities of that member or lessen those of other board and audit committee members.

\(^1\) A person’s spouse, parents, children and siblings, whether by blood, marriage, or adoption, or anyone residing in such person’s home. (NASDAQ listing standards)
**NYSE requirements.** The NYSE requires all audit committee members to be “financially literate” as interpreted by the company's board, or to become financially literate within a reasonable period after being appointed to the committee.

In addition, at least one member must have “accounting or related financial management expertise,” again as interpreted by the board. Although the NYSE listing standards do not require the audit committee to include a person who satisfies the SEC’s definition of a financial expert, a person who satisfies the SEC’s definition also satisfies the NYSE requirement.

**NASDAQ requirements.** NASDAQ listing standards require all audit committee members to be able to read and understand financial statements at the time of their appointment to the committee. NASDAQ also requires at least one audit committee member to be “financially sophisticated.” Financial sophistication may be obtained through employment experience in finance or accounting, professional certification in accounting, or any comparable experience, including current or past employment as a chief executive officer, chief financial officer, or other senior officer with responsibility for financial oversight. Like the NYSE, NASDAQ does not require a financial expert on the audit committee, but if the board determines an individual to be a financial expert, he or she will also be deemed financially sophisticated.

**Common practices and considerations.** In designating an audit committee financial expert, the board should abide by the SEC rules and applicable listing requirements noted above, and may wish to consult with legal counsel when doing so. Given the complex issues audit committees often address, many are choosing to have more than one financial expert.

According to Deloitte’s latest proxy statement analysis, Audit Committee Disclosure in Proxy Statements – 2017 Trends, 86 percent of the S&P 100 disclosed that their audit committees have more than one financial expert. In making this determination, the board may have audit committee members complete a questionnaire or use the American Institute of Certified Public Accountants’ decision tree to evaluate whether an individual meets the criteria.

Although financial expert status does not change over time, it is important that audit committee members invest the effort needed to understand the latest developments in financial reporting and auditing standards. Many boards have a process for reconfirming the financial literacy of their audit committee members and revisiting the financial expert designation periodically. It is also important for the board and the audit committee to consider financial literacy and expertise during succession planning.

### Questions for audit committees to consider

**Composition**
- Does the nominating and governance committee maintain a matrix that incorporates the skills and attributes needed on the audit committee?
- Does the audit committee periodically assess its composition to confirm its members collectively have the skills and experience (e.g., industry, business, leadership) needed to fulfill the committees’ duties? Are any gaps discussed with the nominating and governance committee chairperson?
- When assessing committee composition, does the committee consider attributes such as diversity, tenure, and experience?
- Do the audit committee members meet the requirements for financial expertise and financial literacy?
- Are training and education programs available to help audit committee members maintain their financial knowledge?
One of the audit committee’s biggest challenges is to keep discussions relevant to their responsibilities and leave broader topics for the full board. Without the charter’s guideposts, the committee may lose its way.

Audit Committee Chairman

Charter

Both the NYSE and NASDAQ outline minimum requirements for the content of the audit committee charter. Additional detail on these responsibilities is included in the sample audit committee charter template in Appendix A.

NYSE requirements. The NYSE requires the audit committee charter to include oversight of:

- The integrity of the company’s financial statements
- The company’s compliance with legal and regulatory requirements
- The independent auditor’s qualifications and independence
- The performance of the company’s independent auditor and internal audit function.

Charters of NYSE-listed companies also must set forth the audit committee’s responsibility to discuss policies with respect to risk assessment and management; discuss the company’s earnings press releases and information provided to analysts and rating agencies; meet in executive sessions with management, internal audit personnel, and the independent auditor; assess the audit committee’s performance annually; comply with Section 10A of the Securities Exchange Act of 1934; and various other responsibilities specified by the NYSE listing standards (NYSE 303A.07).

NASDAQ requirements. Under NASDAQ standards, the charter should include the audit committee’s purpose of overseeing the company’s accounting and financial reporting processes and the audits of its financial statements. The charter should also address the scope of its responsibilities and how the committee carries out those responsibilities, including structure, processes, and membership requirements. The responsibilities in the charter must include all of the following:

- Obtaining a written statement from the independent auditor delineating all relationships between the auditor and the company, consistent with PCAOB Ethics and Independence Rule 3526
- Communicating with the independent auditor with respect to any relationships or services that may affect the auditor’s objectivity and independence
- Overseeing the independence of the auditor.

Common practices and considerations. An annual review of the charter is recommended for all audit committees and is required for NASDAQ-listed entities. Some factors that may render updates necessary are:

- Changes in regulatory or legal requirements, including new disclosure requirements within the purview of the committee
- The board’s delegation of new responsibilities to the committee or reassignment of certain responsibilities that are not required of the audit committee by law or regulation
- Changes in the company’s bylaws that affect the composition of the committee or how members are appointed
- Identification of practices the audit committee wants to formalize and include among its responsibilities.
In addition to addressing responsibilities prescribed by rules and listing standards, the charter should set forth the audit committee's recurring responsibilities, as well as its responsibility for overseeing significant transactions and unusual events. The charter should allow the committee to meet outside the official calendar when needed. Concurrent with the charter review, the committee can examine its calendar of meetings and consider if modifications are needed.

When updating the charter and calendar, it may be helpful to consult with legal counsel, management, the internal auditors, and the independent auditor.

SEC rules require the proxy statements of public companies to disclose whether the board has adopted a written charter for the audit committee. If so, the statement must disclose whether a copy of the charter is available on the company’s website and provide the address.

Tools and resources

Deloitte has developed a template for an audit committee charter based on those of a variety of companies and the requirements of the SEC, the NYSE, and NASDAQ. See Appendix A or a sample audit committee charter for US public companies. The charter can be used with the calendar planning tool in Appendix B.

Right to engage independent counsel

The NYSE, NASDAQ, and the SEC all authorize the audit committee to engage and compensate independent counsel and advisers. The audit committee may use the same counsel and advisers as management, but circumstances may warrant otherwise. Lawyers are the outside advisers most often engaged by audit committees and may be engaged to advise on areas such as legal proceedings, corporate governance issues, whistleblower inquiries, fraud concerns, and SEC matters. The services may be investigative, or they may be used to identify potential process improvements.
Meetings
Audit committees should consider ways to implement or enhance practices that will help them conduct effective meetings. Each committee should consider what is most effective for its circumstances, but certain practices are valuable for most.

Calendar. As noted above, audit committees can use the charter to create a calendar outlining what will be covered during each meeting over the course of a year. This can help confirm that required matters are addressed and allow the chairman to determine whether meetings are frequent and long enough to cover the necessary topics.

Meeting agendas. Once the annual calendar is established, the chairman and management can create meeting agendas that focus on critical risks and priority areas. The agendas should be flexible enough to address any issues that may arise during the year and allow time for critical discussion by committee members. The chairman should consider how to prioritize agenda items so the committee allocates appropriate time to high-priority topics. A well-planned and -managed agenda will help the committee stay focused.

Consider allocating time on the agenda for educational topics or more in-depth discussions to help committee members stay informed of risks and issues affecting the company. These educational sessions can be led by management or involve external specialists.

Meeting materials. As the demands on audit committees increase, it is important for meeting materials to contain information that facilitates discussion and effective decision making. Advance materials should be provided to the audit committee well ahead of meetings and include executive summaries that help members understand risks and issues. Materials should clearly identify the actions to be taken by the committee.

Meeting attendees and discussions. The chairman should work with management to determine who should attend each meeting. Although it is important to have the right subject-matter resources in attendance, the chairman should keep the meetings small enough to encourage candid discussions. Each attendee should have a role and contribute to the overall goals of the meeting.

Critical discussion and engagement in meetings should be encouraged by the chairman and members should come prepared, having read all advance materials and prepared questions for management. The chairman should keep the discussion focused on important topics and reprioritize the agenda if necessary.

Executive sessions. Executive sessions allow the audit committee to meet privately with key members of executive management (e.g., the CEO and CFO), the independent auditor, the internal auditors, and the general counsel or chief legal officer. They provide an opportunity to discuss sensitive issues that may not be appropriate in a larger meeting. Executive sessions often occur after regular business portion of the meeting and should be held even if there are no specific topics to discuss. This practice helps keep the lines of communication open between the audit committee and its stakeholders. Some audit committees also meet privately in advance of meetings, to discuss the agenda and priorities, and after meetings and executive sessions to debrief, outline actions, and consider future agenda topics.

Average director time commitment for the audit committee:

| Number of in-person meetings per year | 5.5 |
| Average in-person meeting length (hours) | 2.6 |
| Number of meetings conducted remotely via telephone or other electronic means | 3.2 |

Source: 2017–18 NACD Public Company Governance Survey, National Association of Corporate Directors
Evaluation and self-assessment

The NYSE listing standards require audit committees to perform an annual performance evaluation, and this responsibility must be set forth in the audit committee’s charter. The SEC and NASDAQ listing standards do not require audit committees to assess their performance, but all audit committees should consider how performance assessments could provide information they can use to enhance their performance and processes.

Factors often considered when evaluating the audit committee’s effectiveness include:

- Independence of the audit committee members from management
- Fulfillment of the audit committee’s role, including what is outlined in its charter
- Articulation of the committee’s responsibilities and the degree to which they are understood by management, the independent and internal auditors, and the committee
- Interaction among the committee and the independent auditor, the internal auditors, and senior financial executives
- Whether the committee raises the right questions with management and the independent and internal auditors, including questions that indicate the committee’s understanding of critical accounting policies and judgments and that challenge management’s judgments and conclusions
- Whether the committee has been responsive to issues raised by the independent and internal auditors.

Because there are no specific requirements for how to assess an audit committee’s performance, directors have the benefit and the burden of collaborating on an appropriate process. This can be done in consultation with legal counsel, the independent auditor, or third-party facilitators. There are several considerations in shaping the assessment process.

**Conducting the assessment.** The assessment can be led by a variety of parties, including the committee itself, the entire board or its nominating/governance committee, or the general counsel or corporate secretary. Some audit committees find it useful to engage an objective third party to assist with the evaluation process, or a combination of these options may prove optimal. For example, a committee may choose to engage a third party every two or three years and facilitate the process internally in other years.

**Format and documentation.** The format may consist of evaluation forms, interviews, or both. The party leading the evaluation may also consider soliciting information from individuals who have significant interaction with the audit committee, including management. The committee may want to consider changing the process periodically to keep it fresh.

Because the evaluation may contain information that is critical of the committee or its practices, committees should consult with counsel about the level of documentation that should be provided and retained.

**Addressing the results.** The results should be presented in a private session limited to audit committee members. This allows the committee to discuss the findings and develop a plan for improvement, which is the ultimate objective of the assessment. A performance evaluation may highlight the need to examine issues such as the audit committee’s composition and qualifications, information related to critical financial reporting areas, members’ understanding of complex accounting and financial reporting issues, and meeting agendas.

As part of its procedures to test internal control over financial reporting, the independent auditor considers the effectiveness of the audit committee’s oversight of financial reporting. The results of the audit committee’s self-assessment can support those procedures.
Benefits of conducting an annual performance evaluation

A well-crafted performance assessment process can provide a number of benefits to the audit committee, including:

• Prioritizing agendas and the meeting structure to focus on the most critical issues
• Considering the committee’s composition in the context of its current and future needs and challenges
• Revisiting the timing of delivery, level of detail, and quality of materials provided by management
• Identifying future agenda items and continuing education topics.

Tools and resources

See Appendix C for a sample self-assessment that audit committees can use to evaluate their performance.
Education

NYSE listing standards require board education to be addressed in the company’s corporate governance guidelines. The audit committee should embrace a continuing education program to address emerging issues, knowledge gaps, and leading practices using a needs-based approach to determine the content, nature, and frequency. Various types of education programs can be implemented:

- **Public forums on corporate governance.** These programs are offered by many professional services firms, universities, and not-for-profit organizations. Public forums offer the opportunity to meet with peers and share experiences, and these programs can be invaluable for gaining knowledge from experts on trends in corporate governance. Forums often feature speakers who would not be available otherwise. However, boards should be careful not to rely completely on public programs designed for a broad audience, because they may not address the dynamics of a specific company and its industry.

- **Customized continuing education program.** An increasingly popular option is a customized program of continuing education focused on topics relevant to the audit committee, the specific company, or its industry. These topics could encompass audit committee roles and responsibilities, including internal control over financial reporting and risk oversight; accounting issues such as revenue recognition, pension and other post-retirement employment benefits, and critical accounting policies; industry trends and developments; and regulatory updates. Customized sessions can address subjects relevant to the company’s needs and incorporate company-specific policies, processes, and objectives.

It is important for audit committee members to participate in activities that help them stay educated on relevant trends and developments. We find it helpful to include different educational topics on the agendas one to two times per year.

**Audit Committee Chairman**

When designing an education program, management and the audit committee should consider the risks and complex issues facing the organization. Once a curriculum is set, the board, the audit committee, and management can assess the resources available to create and deliver the program. The program can feature a mix of individuals: some within the organization and others who can provide an external perspective. Sessions can be delivered during regularly scheduled audit committee meetings or in special sessions.

As part of this program, audit committees often benefit from periodically inviting subject-matter specialists to participate in audit committee meetings to enhance the members’ knowledge. For example, specialists in cyber risk, international tax, governance, or a particular industry can provide valuable insight in identifying and addressing risks or new requirements. Independent auditors or outside consultants can assist in identifying appropriate specialists.

**New member onboarding.** In addition to continuing education, the board, in collaboration with management, may consider conducting one or more onboarding sessions for new audit committee members. Sessions can be tailored to the new member’s background and experience but can include an overview of the company, including its history and operations; company policies and the code of ethics; major business and financial risks; corporate governance requirements and practices; audit committee responsibilities, including oversight of accounting policies and practices; and industry trends. Onboarding sessions may include other audit committee members, the CEO, the finance team, internal audit, and the independent auditors.

**Tools and resources**

Deloitte’s Board and Audit Committee Director Development publication provides a list of education topics that can be customized for audit committees seeking additional education.
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