Audit Committee *Brief*

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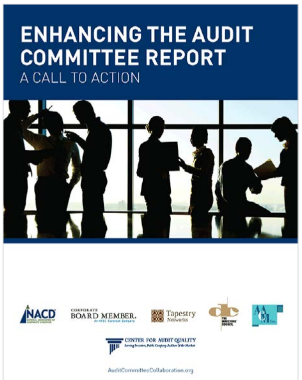
A new era in audit committee reporting

Regulators, investor advocates, and other stakeholders have increasingly called for companies to build trust with investors in recent years. Much of this attention has focused on the audit committee's role in supporting investor interests. For example, many of the approaches to supporting and enhancing auditor independence, objectivity, and professional skepticism that were outlined in the PCAOB's August 2011 *Concept Release on Auditor Independence and Audit Firm Rotation*[1] highlighted the role of the audit committee in supporting the work of the outside auditor. The focus on the role of the independent audit in enhancing investor trust has continued recently with the August 2013 PCAOB Release No. 2013-005,[2] which proposes sweeping changes to the independent auditor reporting model and new standards for auditor responsibilities for other information in the annual report. If adopted, these changes would, among other things, require the auditor to disclose critical audit matters in the audit report.

1 PCAOB Release No. 2011-006, *Concept Release on Auditor Independence and Audit Firm Rotation*, August 2011.

2 PCAOB Release No. 2013-005, *Proposed Auditing Standards – The Auditor's Report on an Annual Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion; The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report; and Related Amendments to the PCAOB*, August 2013.



Outside the regulatory arena, organizations such as the Council of Institutional Investors (CII) and the Center for Audit Quality (CAQ) have led the charge to enhance investor confidence and public trust. The CII recently approved an expansion of its policies on corporate governance to identify how audit committees can use their authority to promote auditor independence and audit quality. Likewise, the CAQ, along with several governance organizations, formed the Audit Committee Collaboration,[3] which released a report titled *Enhancing the Audit Committee Report: A Call to Action* on November 20, 2013, to encourage enhanced audit committee disclosures.

The calls for increased transparency in the oversight of the independent auditor and other key audit committee duties will likely continue to grow, and audit committees can respond by providing more meaningful disclosures that increase awareness of their responsibilities and how individual committees carry them out. This *Audit Committee Brief* provides an overview of SEC requirements for audit committee reports and highlights an analysis Deloitte completed in 2013 that took a deeper look at the language audit committees use in their reports in their effort to be more transparent.

Required elements of an audit committee report

Under SEC rules,[4] the audit committee report in a company's annual proxy statement must, at a minimum, state whether the audit committee has:

- Reviewed the audited financial statements with management
- Discussed with the independent auditor the required communication matters under applicable standards
- Received independence disclosures from the auditor as required under applicable standards
- Recommended to the board of directors that the audited financial statements be included in the company's Form 10-K.

In Deloitte's 2013 analysis, there was essentially[5] 100 percent compliance with these required elements; in a similar analysis conducted in 2011, there was 100 percent compliance with all required disclosures.

Analysis of S&P 50 and 100 companies

In 2011, Deloitte analyzed the audit committee reports of the 43 S&P 50 companies that had filed their proxy statements as of May 31, 2011. The analysis revealed that not only were required SEC disclosures addressed, but also some audit committees were providing additional information to investors to enhance the transparency of the committee's activities.

Deloitte performed a more detailed analysis in 2013 that expanded on both the audit committee report considerations and the population of companies reviewed; the analysis included audit committee reports of the 83 S&P 100 companies[6] that had filed proxy statements as of May 31, 2013. The analysis in this *Audit Committee Brief* is focused on the disclosures in the audit committee report itself. Although additional information about audit committee activities and composition, both required and voluntary, may be

3 The following groups are members of the Audit Committee Collaboration: Association of Audit Committee Members, Center for Audit Quality, Corporate Board Member, The Directors' Council, Independent Directors Council, Mutual Fund Directors Forum, National Association of Corporate Directors, and Tapestry Networks.

4 http://www.sec.gov/rules/final/34-42266.htm.

5 One out of 83 companies did not disclose in 2013 whether its audit committee received the written independence disclosures from their independent auditor as required under applicable standards. The other three required SEC disclosures were disclosed by all companies analyzed.

6 S&P 100 listing as of March 1, 2013.

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included elsewhere in the proxy statement, it was not considered in the analysis.

The following sections elaborate on important areas of consideration regarding audit committee disclosure, including the committee's role and composition, and how the committee works with the independent auditor and internal audit function.

Audit committee role

Consistent with the 2011 analysis, all the audit committee reports analyzed in 2013 clearly disclosed the audit committee's role or areas of responsibility. NYSE listing standards require that audit committees establish and maintain a charter that outlines the responsibilities of committee members. The charter can help investors understand the scope of the committee's work and is an effective tool to help set its agenda. Due to requirements and leading practices, the charter should be reviewed at least annually.[7]

Sixty-four percent of audit committee reports analyzed disclosed the existence of an audit committee charter. However, a written audit committee charter is a standard listing requirement for all publicly traded companies,[8] and the SEC requires companies to disclose in their proxy statements whether their audit committees are governed by a charter. If so, they must either post a copy of the charter on their website and reference the posting in the proxy statement, or include a copy of the charter as an appendix to the proxy statement at least once every three years.[9] Given the importance of the audit committee charter in providing insight into the responsibilities of the committee, Deloitte recommends disclosing the existence of a charter in the audit committee report or providing a reference in the report to another section of the proxy statement that does provide that disclosure.

Audit committee composition

The topic of board composition has risen to the top of the agenda for many investors. Membership on the board and its committees gets to the heart of governance, and having the right mix of directors and committee members can be a strategic differentiator. Regulatory requirements dictate that audit committee members must be independent and financially literate, and they encourage, though do not require, that there be at least one member who is a designated financial expert.[10] Deloitte's analysis showed that only a limited number of audit committee reports touched on financial literacy, the presence of financial experts on the committee, or the independence of committee members. While such disclosures are not required in the audit committee report, investor trust can be enhanced by validating such skillsets in the report.

Audit committee report disclosure	Percentage of S&P 100 companies disclosing
Mention of financial literacy or financial expert	34%
Independence of audit committee members	55%

Deloitte recommends that the audit committee report include not only required information on committee composition, such as independence and financial literacy requirements, but also broader composition elements, such as industry background and credentials. The report could also provide a reference to the director qualification section of the proxy statement for detailed board composition information. Such disclosures help investors understand

7 NASDAQ Corporate Governance Rule 5605(c)(1).

8 NYSE *Listed Company Manual* Section 303A.07(b) and NASDAQ Equity Rule 5605(c).

9 The requirement appears in Item 407 of SEC Regulation S-K.

10 See *Commentary to NYSE Listed Company Manual* Section 303A.07(a); NASDAQ Equity Rule 5605(c)(2)(A); NASDAQ IM-5605-4.

the composition and qualifications of audit committee members to fulfill their responsibilities. SEC rules do not require disclosure of why certain board members are selected to be on particular committees, but adding details in the audit committee report regarding composition could be looked on favorably by investors.

Requirements for audit committee independence emphasize the importance of the committee acting impartially and objectively and avoiding conflicts of interest. Section 301 of the Sarbanes-Oxley Act mandates and defines independence for the audit committee. All listed companies must comply with the disclosure requirements in Item 407 of Regulation S-K, which call for extensive disclosure concerning director independence, with some specific references to the audit committee. In Deloitte's analysis, slightly more than half of the audit committee reports reviewed (55 percent) included disclosure regarding audit committee independence. Again, such qualifications could have been included elsewhere in the proxy statement, but including broad composition information, along with a cross-reference to the relevant section of the proxy statement for detailed composition information, could be valued by investors. Such language could demonstrate impartiality in the audit committee's various oversight roles and provide confidence that the investor's best interests remain a focus.

Independent auditor disclosures

Since the passage of Sarbanes-Oxley, the audit committee has been responsible for overseeing the independent auditor and confirming the auditor's independence. These responsibilities extend to the auditor's appointment, termination, compensation, and retention. The audit committee not only has authority to approve the independent auditor, but also must review and approve all non-audit services performed.[11]

In Deloitte's 2013 and 2011 audit committee report analyses, the independent auditor's independence[12] was disclosed in all audit committee reports. However, the disclosures noted below regarding the audit committee's oversight activities could better inform investors of the committee's responsibilities related to the independent auditor and emphasize the direct reporting relationship between the independent auditor and the audit committee.

Audit committee report disclosure	Percentage of S&P 100 companies disclosing
Selection of independent auditor	42%
Selection of the independent auditor's lead engagement partner	1%
Review or approval of independent auditor fees	30%

Selection of independent auditor

Forty-two percent of the reports analyzed disclosed that the audit committee is responsible for selecting or reappointing the independent auditor. The PCAOB's concept release on auditor independence, objectivity, and professional skepticism has brought renewed attention to this core duty and has increased the focus on the committee's responsibility to regularly and objectively assess the independent auditor.

11 The federal securities laws recognize the importance of independent auditors. See, for example, Items 25 and 26 of Schedule A of the Securities Act and Sections 12(b)(1)(J) and 13(a)(2) of the Exchange Act [15 U.S.C. 78l(b)(1)(J) and 78m(a)(2)]. See also Title II of the Sarbanes-Oxley Act [Pub. L. 107-204, Title II, 116 Stat. 771-75], and Release No. 33-8183 (January 2003).

12 Independence is defined in ET Section 101 of the AICPA Code of Conduct Professional Conduct located at http://www.aicpa.org/Research/Standards/CodeofConduct/Pages/et_101.aspx#et_101.

The Audit Committee Collaboration launched its External Auditor Evaluation Tool in 2012 to help audit committees perform an annual evaluation of the independent auditor and make an informed recommendation to the board regarding reappointment. The tool contains sample questions to gauge the quality of services and sufficiency of resources provided by the auditor; communication and interaction with the auditor; and the auditor's independence, objectivity, and professional skepticism.

Informing investors and other stakeholders about how the audit committee selects the auditor provides transparency about the auditor-audit committee relationship and helps increase confidence in the efficacy of the process. Therefore, audit committees should consider providing additional information about the steps they undertake to evaluate the independent auditor and how often they perform such an assessment, whether through the above-referenced tool or by other means.

Selection of lead engagement partner

Sarbanes-Oxley put in place enhanced requirements for audit partner rotation. The selection of a new lead independent audit engagement partner when rotation is required is rarely discussed in the audit committee report. However, providing a description of the committee's participation in the selection process could provide investors with an appreciation for the diligence that goes into this important activity and emphasize the direct reporting relationship between the auditor and the audit committee. Though only 1 percent of the audit committee reports analyzed included such a disclosure, this area presents an opportunity for companies to enhance disclosures in future audit committee reports.

Independent auditor fees

Another important element in the audit committee's assessment of the independent auditor is reviewing, understanding, and approving the auditor's fees. As part of this process, audit committees can assess changes in audit scope, audit team skills and knowledge, fee levels for audit and non-audit services, and other areas. While a company's proxy statement includes a separate analysis of audit fees, providing highlights of the audit committee's responsibility with respect to fees in the audit committee report can be informative. However, 70 percent of audit committee reports analyzed did not address the audit committee's responsibility for reviewing or approving the independent auditor's fees. This aspect of the audit committee's responsibility has received attention from regulators recently, with Paul Beswick, the SEC's chief accountant from the Office of the Chief Accountant, stating in a recent speech, "I worry that audit committees may be focusing too much on the amount of the fee and not focusing enough on the expected audit quality. This is not to say that audit committee members should not focus on making good business decisions. But I believe focusing on audit quality is completely consistent with making good business decisions."[13] Disclosures about the committee's involvement in discussions about the auditor's fees are one way to demonstrate a conscientious and careful consideration of these various factors.

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13 Remarks at the AICPA 2013 Conference on Current SEC and PCAOB Developments can be accessed at: http://www.sec.gov/News/Speech/Detail/Speech/1370540488257#.Ussy9_RDv_E.

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Internal audit

The audit committee's oversight of the internal audit function has evolved significantly over the past few years. Committees are increasingly taking an active role in reviewing the internal audit team's audit plan, competencies, and budget. Further, the plan and scope of work of the internal audit group frequently align with significant risk areas that have been identified through the risk management process. To strengthen the ties between the audit committee and internal audit, it has become more common for the chief audit executive to report directly to the audit committee. However, only 34 percent of the audit committee reports analyzed disclosed the committee's responsibility with respect to the internal audit scope, plan, or responsibilities. Moreover, of the reports analyzed, only 2 percent highlighted the audit committee's oversight of the internal audit function's budget, and only 4 percent disclosed the audit committee's oversight of internal audit staffing levels. As internal audit's role evolves, transparency by the audit committee regarding its relationship with and responsibility to the internal audit function could offer valuable insight to stakeholders and help confirm that the committee's responsibilities are being executed effectively.

Conclusion

Audit committees today are faced with competing priorities in light of rapidly changing regulatory and governance landscapes. Committees should consider how additional transparency with regard to their role, composition, and oversight of the independent auditor can enhance marketplace confidence. Clear, concise, and thorough disclosures of the committee's activities help provide investors with insight into the job the audit committee is doing to protect investor interests. Thus, audit committees may wish to consider the content of their current audit committee reports to determine whether additional disclosures may be useful to investors.

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