Let’s talk: governance

Audit committee reporting to shareholders
2014 proxy season update

August 2014
Issue 8

Audit committees continue to enhance voluntary disclosures

Executive summary
This 2014 proxy season update is EY’s third report on the topic of audit committee reporting. Beginning with February 2013’s Audit committee reporting to shareholders: going beyond the minimum and continuing with September 2013’s Audit committee reporting to shareholders 2013 proxy season update, EY has sought to advance discussion among audit stakeholders by providing data-driven insights into current audit-related disclosure practices. Our research shows a consistent movement by Fortune 100 companies to enhance the depth and scope of audit committee-related disclosures. Top companies are progressively supplementing mandatory disclosures with additional voluntary information sought by investors.

The 2014 proxy season saw significant growth in audit committee transparency. Continuing the trend of the past several years, an increased number of Fortune 100 companies are going beyond the minimum disclosures required. These disclosures are also more robust – providing valuable perspectives on the activities of audit committees, including their oversight of external auditors. This conclusion is based on a review of companies in the Fortune 100 in 2014 that filed proxy statements for three consecutive years as of 15 August (80 companies in total). This data is based on the EY Center for Board Matter’s proprietary database, which covers more than 3,000 public companies listed in the US.

Context
The recent movement toward increased audit committee transparency has been encouraged by a variety of factors and entities. In addition to the ongoing disclosure effectiveness review by the US Securities and Exchange Commission (SEC) involving a holistic review of the US corporate disclosure regime, audit committee disclosures are receiving significant attention from a variety of stakeholders. These stakeholders include US and non-US regulators, investors, and policy organizations. Reasons for supporting greater audit committee transparency include enhancing investor confidence in the important oversight work performed by audit committees; improving communication with investors about audit committee responsibilities including their oversight of external auditors; and better informing shareholders in their consideration of auditor ratification proposals.
The audit committee plays a critical role in financial reporting oversight, and investors have expressed interest in increased transparency into the audit committee’s activities. The audit committee reporting requirements have not changed significantly in a number of years and it is time to take a look at whether improvements can be made.”

20 May 2014 — Mary Jo White, SEC Chair

“The Center for Audit Quality, Enhancing the Audit Committee Report: A Call to Action, broadened their letter-writing campaign in 2014 to include nearly 100 large companies. This campaign, which asks audit committees to enhance their disclosures, has met with success in many cases.

The Audit Committee Collaboration, made up of governance and policy organizations that support high-quality audits and corporate governance, published Enhancing the Audit Committee Report: A Call to Action in November 2013 to urge audit committees to reassess their current disclosures and consider proactively strengthening their public disclosures to more effectively convey key elements of their critical work to investors and stakeholders.

In summer 2014, proxy advisory firm Institutional Shareholder Services (ISS) issued a policy survey for the 2015 proxy season to seek feedback on potential changes to its voting policies, including whether the policies should examine companies’ transparency with regard to the audit. Investors were asked to rate the importance of disclosures, such as how the audit committee oversees the auditor and its considerations when selecting or reappointing the auditor.

Enhanced audit committee reporting has received attention outside the US as well. For example, in the UK, the UK Corporate Governance Code was updated in late 2012 to provide for enhanced disclosure on how the audit committee discharges its responsibilities. In late 2013, the UK Competition Commission recommended that the Code be further amended to require a shareholder advisory vote regarding the sufficiency of the disclosures contained in the audit committee report. The UK Financial Reporting Council, which has authority over the Code, is considering whether and how to incorporate this recommendation into the Code.

2014 highlights

This report carries on past efforts to examine voluntary audit committee-related disclosures found in the proxy statements of Fortune 100 companies. Beginning with the 2012 proxy season and comparing year-over-year disclosures, the 2014 proxy season saw audit committee reporting remain a significant area of change for companies and their audit committees. In this regard, several companies expanded their disclosures in key ways.

Examples include:

- SEC Chair Mary Jo White made a speech in May 2014 noting investors’ interest in increased transparency around the audit and her intention to explore whether disclosures can be improved in this area. Also in 2014, SEC Chief Accountant Paul Beswick gave remarks emphasizing that the audit committee report is an opportunity to explain the committee’s process for overseeing the auditor. He also encouraged audit committees to consider adding information to their report that would help shareholders with auditor ratification votes.

- The pension funds of the United Brotherhood of Carpenters broadened their letter-writing campaign in 2014 to include nearly 100 large companies. This campaign, which asks audit committees to enhance their disclosures, has met with success in many cases.

- The Audit Committee Collaboration, made up of governance and policy organizations that support high-quality audits and corporate governance, published Enhancing the Audit Committee Report: A Call to Action in November 2013 to urge audit committees to reassess their current disclosures and consider proactively strengthening their public disclosures to more effectively convey key elements of their critical work to investors and stakeholders.

This report shows that audit committees are continuing to go beyond basic requirements to provide more relevant, useful information.

Some audit committees are centralizing their disclosures as part of efforts to communicate more effectively: Audit-related disclosures increasingly are consolidated in an “audit-related” section of the proxy statement or placed in the audit committee report. Reducing the dispersion of audit-related disclosures throughout the proxy statement can make it easier for readers to synthesize all available information.

Some companies are improving the accessibility of the audit committee charter: Audit committee charters detail the responsibilities and duties of the committee based on company-specific circumstances. By providing investors with a direct link to the charter, companies make it easier for investors to quickly learn about the committee’s designated responsibilities — without having to navigate the company website. Nearly 15% of companies provided a direct link to the audit committee charter in the proxy statement this year, more than twice the 6% level of two years ago.

Audit committees are increasingly open about how they oversee their external auditors: As investors seek further clarity on the audit committee oversight and decision-making process, a growing number of companies are responding by providing additional information (refer to the table on page three for three-year comparisons).

Disclosures related to the audit committee’s review and evaluation of external auditors:

- 65% of companies specified that the audit committee is responsible for the appointment, compensation and oversight of the auditor, compared to 40% in 2012.
- 46% of companies explicitly state their belief that their selection of the external auditor is in the best interest of the company and/ or shareholders, up from 4% in 2012.
- 44% of companies disclosed that the audit committee was involved in the selection of the audit firm’s lead engagement partner. In comparison, only 1% of companies did this in 2012.
- 31% of companies explained the rationale for appointing their auditor, including the factors used in assessing the auditor’s quality and qualifications. Only 16% percent of companies did this in 2012.
- 8% of companies disclosed the topics that the audit committee discussed with the auditor — beyond matters required to be discussed under regulatory rules.
Disclosures related to the audit committee’s authority to approve all audit engagement fees and terms:

- 80% of companies noted that they consider non-audit services and fees when assessing the independence of the external auditor.
- 19% of companies disclosed that the audit committee was involved in the auditor’s fee negotiations, up significantly from just 1% in 2012.
- 8% of companies acknowledged a change in fees to the external auditor and explained the circumstance for the change, doubling the percentage of companies that did so in 2012.

Disclosures related to the tenure of their external auditors:

- Auditor tenure was disclosed by half of reviewed companies, an increase from 26% in 2012.
- 28% of companies disclosed that the audit committee considers what would be the impact of rotating their external auditor, up from 3% in 2012.

<table>
<thead>
<tr>
<th>Category</th>
<th>Disclosure</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Disclosures in the audit committee report</td>
<td>Statement that the audit committee is independent</td>
<td>58%</td>
<td>55%</td>
<td>59%</td>
</tr>
<tr>
<td></td>
<td>Name of audit firm included in audit committee report</td>
<td>71%</td>
<td>71%</td>
<td>71%</td>
</tr>
<tr>
<td>Audit committee composition</td>
<td>Audit committees with one financial expert (FE)</td>
<td>33%</td>
<td>30%</td>
<td>33%</td>
</tr>
<tr>
<td></td>
<td>Audit committees with two FEs</td>
<td>16%</td>
<td>24%</td>
<td>14%</td>
</tr>
<tr>
<td></td>
<td>Audit committees with three or more FEs</td>
<td>51%</td>
<td>46%</td>
<td>54%</td>
</tr>
<tr>
<td>Audit committee responsibilities regarding external auditor</td>
<td>Statement that the audit committee is responsible for appointment, compensation and oversight of external auditor</td>
<td>40%</td>
<td>53%</td>
<td>65%</td>
</tr>
<tr>
<td>Identification of topics discussed</td>
<td>Topics discussed by the audit committee and external auditor</td>
<td>8%</td>
<td>8%</td>
<td>8%</td>
</tr>
<tr>
<td>Fees paid to the external auditor</td>
<td>Statement that the audit committee considers non-audit fees/services when assessing auditor independence</td>
<td>79%</td>
<td>79%</td>
<td>80%</td>
</tr>
<tr>
<td></td>
<td>Statement that the audit committee is responsible for fee negotiations</td>
<td>1%</td>
<td>10%</td>
<td>19%</td>
</tr>
<tr>
<td></td>
<td>Explanation provided for change in fees paid to external auditor</td>
<td>3%</td>
<td>5%</td>
<td>8%</td>
</tr>
<tr>
<td>Assessment of the external auditor</td>
<td>Disclosure of factors used in the audit committee’s assessment of the external auditor qualifications and work quality</td>
<td>16%</td>
<td>19%</td>
<td>31%</td>
</tr>
<tr>
<td></td>
<td>Statement that the audit committee is involved in lead partner selection</td>
<td>1%</td>
<td>18%</td>
<td>44%</td>
</tr>
<tr>
<td></td>
<td>Disclosure of the year the lead audit partner was appointed</td>
<td>3%</td>
<td>3%</td>
<td>6%</td>
</tr>
<tr>
<td></td>
<td>Statement that choice of external auditor is in best interest of company and/or shareholders</td>
<td>4%</td>
<td>24%</td>
<td>46%</td>
</tr>
<tr>
<td>Tenure of the external auditor</td>
<td>Disclosure of the length of the external auditor tenure</td>
<td>26%</td>
<td>31%</td>
<td>50%</td>
</tr>
<tr>
<td></td>
<td>Statement that the audit committee considers the impact of changing auditors when assessing whether to retain the current external auditor</td>
<td>3%</td>
<td>16%</td>
<td>28%</td>
</tr>
<tr>
<td>Accessibility of audit committee charts from proxy statements</td>
<td>Company provides a direct link to the charter</td>
<td>6%</td>
<td>9%</td>
<td>14%</td>
</tr>
<tr>
<td></td>
<td>Link to charter goes to the company’s main website</td>
<td>43%</td>
<td>39%</td>
<td>38%</td>
</tr>
<tr>
<td></td>
<td>Link to charter goes to the company site for investor relations</td>
<td>26%</td>
<td>28%</td>
<td>28%</td>
</tr>
<tr>
<td></td>
<td>Link to charter goes to the company site for corporate governance matters</td>
<td>25%</td>
<td>25%</td>
<td>21%</td>
</tr>
</tbody>
</table>

The reviewed companies had an average of 2.8 financial experts, up from 2.7 in both 2012 and 2013.

Beyond required discussion items, reviewed companies indicated that the audit committee raised these topics, among others, with their external auditors: risk controls and compliance, integrated audit plan, income tax strategy and risks, ethics and compliance program, risk management initiatives and controls, and cybersecurity.

Most companies provide an explanation for the types of services included within each fee category. The companies highlighted here specifically acknowledge a change in fees from the prior year and explain the circumstances for the change.

Reviewed companies indicated they based these assessments on criteria such as the independence and integrity of the external auditor and its controls and procedures; performance and qualifications, including expertise and global reach relative to the company’s business; quality and effectiveness of the external auditor’s personnel and communications; appropriateness of fees; and Public Company Accounting Oversight Board reports on firm and peers.

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Let’s continue the conversation.

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Endnotes

3 The organizations composing the Audit Committee Collaboration are the National Association of Corporate Directors, Corporate Board Member/NYSE Euronext, Tapestry Networks, the Directors’ Council, the Association of Audit Committee Members, Inc., and the Center for Audit Quality.
5 Final Report, Statutory audit services for large companies market investigation (October 2013) (available at https://assets.digital.cabinet-office.gov.uk/media/5329db35ed915d0e5d00001f/131016_final_report.pdf). The UK Competition Commission was replaced by the UK Competition and Markets Authority in 2014.

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