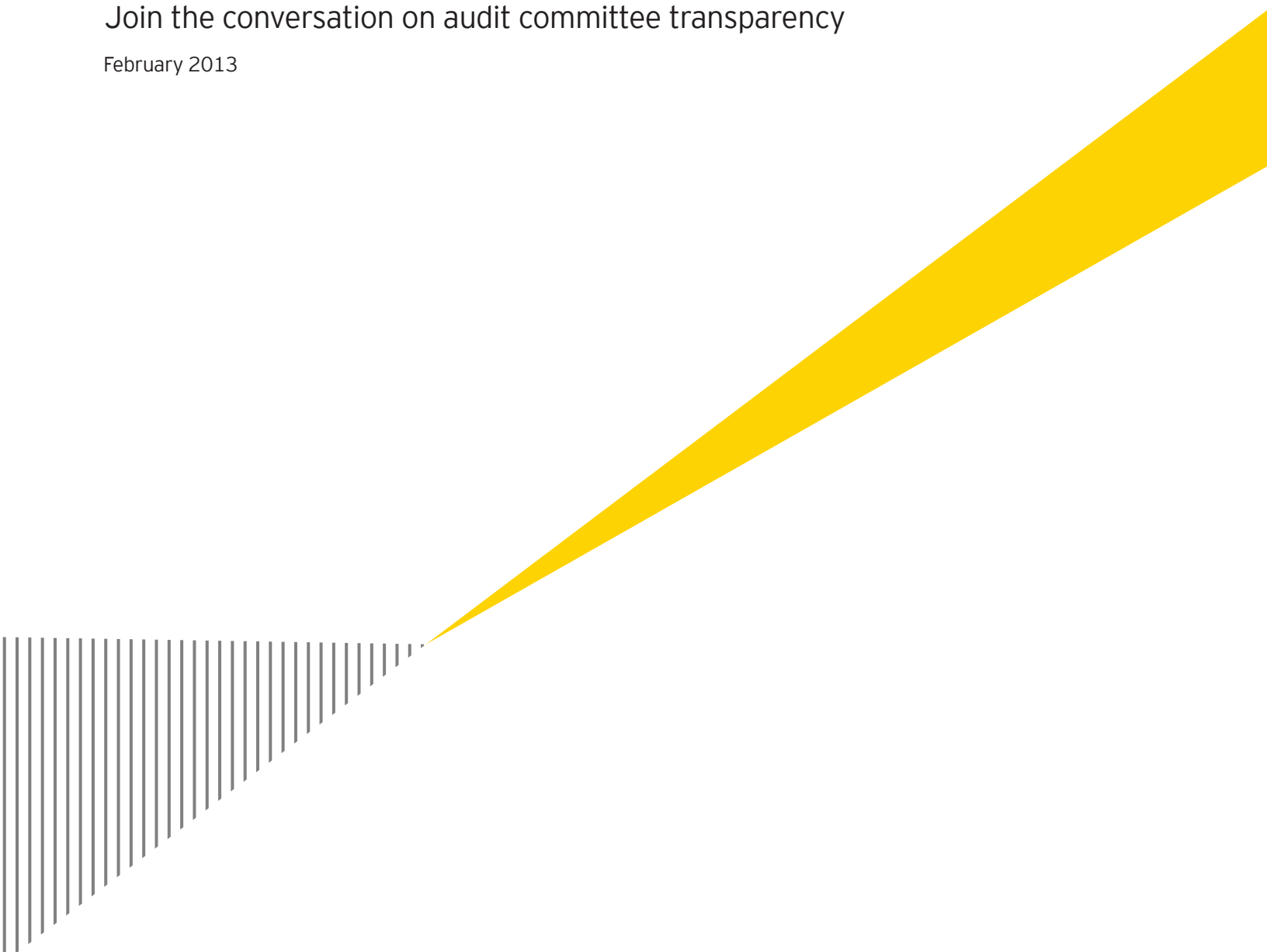


# Audit committee reporting to shareholders: going beyond the minimum

Join the conversation on audit committee transparency

February 2013



Ernst & Young supports effective audit committees and believes that audit committee transparency can promote greater investor confidence in financial reporting. A number of companies currently disclose more information about their audit committees than is required under relevant rules. With this document, we seek to alert audit committees and other stakeholders to current disclosure practices, and also to proposals that have been made for additional disclosures, in order to facilitate consideration and discussion.

# Audit committee reporting to shareholders

## Going beyond the minimum

### Audit committee transparency

In general, investor demand and regulatory changes are driving boards of directors of public companies to be more transparent about their activities.<sup>1</sup>

More specifically, investor interest - and policy debate around the role of audit committees and auditor independence - are generating discussion about audit committee disclosures that go beyond the minimum requirements. For example:

- ▶ In August 2011, the US Public Company Accounting Oversight Board (PCAOB) issued its Concept Release on Auditor Independence and Audit Firm Rotation, in which it sought comments on ways to improve auditor independence, objectivity and skepticism, including mandatory audit firm rotation.<sup>2</sup> While most respondents opposed mandatory firm rotation, they also offered alternatives to address concerns about auditor independence. These included greater transparency about the audit committee's oversight of the audit engagement, in light of the audit committee's role in overseeing the audit process.<sup>3</sup>
- ▶ During the 2012 and current 2013 proxy seasons, the pension funds of the United Brotherhood of Carpenters have sought enhanced disclosures from some companies regarding the audit committee's ownership and oversight of the audit relationship, and many companies are responding by providing such disclosures.<sup>4</sup>

Greater audit committee transparency is also a theme in a series of recent policy initiatives, comment letters and other policy responses relating to audit committee oversight of the auditor. These include:

- ▶ Audit Committee Annual Evaluation of the External Auditor,<sup>5</sup> produced by a collaboration among the Association of Audit Committee Members, Inc., Center for Audit Quality, Corporate Board Member/NYSE Euronext, Independent Directors Council, Mutual Fund Directors Forum, National Association of Corporate Directors and Tapestry Networks
- ▶ Enhancing Audit Quality: Canadian Perspectives, a collaborative project of the Canadian Public Accountability Board and the Canadian Institute of Chartered Accountants<sup>6</sup>
- ▶ UK Corporate Governance Code, updated in 2012 by the UK Financial Reporting Council<sup>7</sup>
- ▶ Ernst & Young Point of View on enhancing transparency of the audit committee auditor oversight process<sup>8</sup>

These resources generally support expanding audit committee disclosures of certain committee-related information and activities for the benefit of investors and other stakeholders.

### Current disclosure practices of US Fortune 100 companies

A review by Ernst & Young's Corporate Governance Center found that expanded audit committee disclosure has already been embraced by a number of public companies.<sup>9</sup> This review, which examined audit committee-related disclosures by the US Fortune 100 companies,

showed that many companies exceed the minimum disclosure requirements, although the nature and manner of these disclosures varied significantly from company to company. The review also observed the significant variation in where and how disclosures are made. Audit committee disclosures are often located in several places in proxy statements and annual reports, as well as on corporate web sites. For example, the following audit committee-related disclosures are typically found in different places in company proxy statements and presented in different formats:

- ▶ The audit committee must provide a separate report in the proxy statement indicating whether it has discussed certain matters with the auditor, including overall audit strategy, matters significant to the financial statements and auditor independence.
- ▶ The company must also disclose in the proxy statement the audit committee's pre-approval policies for services from, and the amount of fees paid to, the external auditor, but these disclosures are not required to be located with the audit committee report or with other auditor-related information.
- ▶ Audit committees of listed companies are required to have charters identifying the committee's purpose and responsibilities among other things, but these could be located in one of several places, depending on the listing rules that apply to the company.<sup>10</sup>
- ▶ In addition to the required disclosures previously mentioned, more than 90% of companies seek annual shareholder ratification of the auditor chosen by the audit committee. These companies frequently provide information about the auditor in the proposal section to ratify the auditor, which can be separate from other audit committee and audit fee-related disclosures.
- ▶ Also, the section of the proxy statement related to board composition and membership usually includes disclosures regarding the identities of members of the audit committee, whether they are independent, functions of the committee, and whether the committee has a financial expert.

### Disclosure comparison

To further audit committee reporting considerations and discussion, the following table summarizes certain current disclosure requirements relating to the audit committee's membership, role and responsibilities; relationship with the independent auditor<sup>11</sup>; and oversight of non-audit services and charter. It also includes a list of additional disclosures in each area that go beyond minimum requirements, with accompanying data provided regarding the percentage of Fortune 100 companies that are already disclosing certain information. These additional disclosures are provided by some Fortune 100 companies today and/or are proposed in the referenced policy initiatives, comment letters and other policy responses.

Select current disclosure requirements <sup>12</sup>	Additional disclosures	
<b>Audit committee membership and oversight of the audit engagement</b>		
<ul style="list-style-type: none"> <li>▶ The name of each audit committee member, whether each member is independent and the number of audit committee meetings held during the last fiscal year</li> <li>▶ Description of the functions of the audit committee</li> <li>▶ Whether the audit committee has a member that is considered a financial expert; if so, the name of the person and whether he or she is independent<sup>13</sup></li> <li>▶ If an audit committee member simultaneously serves on the audit committees of more than three public companies, the board's determination that such simultaneous service would not impair the ability of the member to effectively serve on the company's audit committee</li> <li>▶ The name of the auditor that has been selected or is recommended to security holders for election, approval or ratification for the current year, as well as last year's auditor, if different</li> <li>▶ Statement by the audit committee regarding whether it has: <ul style="list-style-type: none"> <li>▶ Discussed with the auditor matters required to be discussed by US auditing standards, including the responsibilities of the independent auditor in relation to the audit, the overall audit strategy and timing of the audit, and timely observations arising from the audit that are significant to the financial statements and to internal control over financial reporting</li> <li>▶ Received the written disclosures and letter from the independent auditor pursuant to PCAOB requirements regarding independence-related communications by the auditor with the audit committee, and discussed the auditor's independence with the auditor</li> <li>▶ Based on the review and discussions referred to above, recommended to the board that the audited financial statements be included in the company's annual report</li> </ul> </li> <li>▶ If greater than 50%, the percentage of hours expended on the independent auditor's engagement to audit the company's financial statements that were attributed to work performed by persons other than the auditor's full-time, permanent employees</li> </ul>	<ul style="list-style-type: none"> <li>▶ Statement by the audit committee that it conducts a periodic evaluation of the independent auditor and the process used in the evaluation</li> <li>▶ The audit committee's rationale for recommending the retention or replacement of the independent auditor, including the quality of services and sufficiency of resources provided by the independent auditor <ul style="list-style-type: none"> <li>▶ The belief of the board and audit committee that the selection (or continuance) of the independent auditor is in the best interests of the company and its investors</li> <li>▶ The measures employed by the audit committee to reach this conclusion</li> </ul> </li> <li>▶ An explanation by the audit committee of how it carries out its responsibility for compensation of the independent auditor, including determining the appropriate audit fee</li> <li>▶ An explanation by the audit committee of how it promotes the independent auditor's independence and skepticism relative to management of the issuer</li> <li>▶ Statement by the audit committee in the proxy statement that the audit committee is responsible for the appointment, compensation and oversight of the independent auditor<sup>14</sup></li> <li>▶ Length of tenure of the independent auditor</li> <li>▶ Disclosure regarding the types of information discussed with the independent auditor</li> <li>▶ The audit committee's role in selecting the independent auditor's lead engagement partner at the five-year mandatory rotation period</li> </ul>	<p>15% of reviewed companies disclose factors the audit committee considers in its process for the evaluation of the quality and qualifications of the independent auditor; 6% provide this information in the audit committee report, and 9% provide it elsewhere in the proxy statement</p> <hr/> <p>2% of reviewed companies stated that the continued retention of the auditor was in the best interest of the company and investors</p> <hr/> <p>1% of reviewed companies stated that the audit committee is responsible for audit fee negotiations</p> <hr/> <p>32% of reviewed companies disclose information about the audit committee's oversight role of the independent auditor beyond the required minimum (monitoring and overseeing); 28% report this information in the audit committee report, and 4% elsewhere in the proxy statement</p> <hr/> <p>Auditor tenure has previously been disclosed by 52% of reviewed companies, with 32% percent doing so in 2012; 1% disclose this information in the audit committee report, and 31% elsewhere in the proxy statement</p> <hr/> <p>4% of reviewed companies provide detailed information about the topics discussed with the independent auditor</p> <hr/> <p>1% of reviewed companies disclose that the audit committee and chairperson are directly involved in the selection of the auditor's lead engagement partner</p>

Select current disclosure requirements	Additional disclosures
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**Oversight of non-audit services**

<ul style="list-style-type: none"> <li>▶ The audit committee's pre-approval policies and procedures for audit and non-audit services</li> <li>▶ Aggregate fees billed by the independent auditor in each of the last two fiscal years for:             <ul style="list-style-type: none"> <li>▶ Audit fees</li> <li>▶ Audit-related fees</li> <li>▶ Tax fees</li> <li>▶ All other fees</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>▶ The type and extent of non-audit services being provided by the independent auditor and why the audit committee concluded these were appropriate to obtain from the independent auditor</li> <li>▶ A statement regarding whether the audit committee considered the impact of fees for non-audit services on the independent auditor's independence</li> </ul>
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25% of reviewed companies disclose that the audit committee pre-approves non-audit services provided by the independent auditor in the audit committee report, while the rest disclose it elsewhere in the proxy statement

67% of reviewed companies disclose that the committee considers the impact of fees for non-audit services on the external auditor's independence; 52% provide this information in the audit committee report, and 15% disclose it elsewhere in the proxy statement

**Audit committee charter**

<ul style="list-style-type: none"> <li>▶ The audit committee charter must be made available on or through the company web site.<sup>15</sup> The charter must contain the following:             <ul style="list-style-type: none"> <li>▶ The committee's purpose, including assisting board oversight of the integrity of the listed company's financial statements and the independent auditor's qualifications, independence and performance</li> <li>▶ The audit committee's responsibility for the appointment, compensation and oversight of the independent auditor</li> <li>▶ Statement regarding annual performance evaluations of the committee<sup>16</sup></li> <li>▶ The duties and responsibilities of the audit committee, including reviewing a report by the independent auditor describing:                 <ul style="list-style-type: none"> <li>▶ The firm's internal quality control procedures</li> <li>▶ Any material issues raised by the most recent internal quality control review or peer review of the firm, or by any inquiry or investigation by governmental or professional authorities within the past five years relating to audits and any steps taken to deal with such issues</li> <li>▶ All relationships between the independent auditor and the company for purposes of assessing the auditor's independence</li> </ul> </li> </ul> </li> </ul>	
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All reviewed companies provide a link in proxy statements to the audit committee charter; 42% provide the link in the audit committee report and 58% provide it elsewhere in the proxy statement.

- ▶ 7% link to the actual charter
- ▶ 21% link to the company's general investor relations page
- ▶ 27% link to the company's corporate governance page
- ▶ 45% link to the company's main web site

**Location of disclosures regarding the independent auditor and audit committees**

<ul style="list-style-type: none"> <li>▶ Companies disclose information relating to the audit engagement and audit committee in several places throughout the proxy statement, as well as in annual reports and corporate web sites</li> </ul>	<ul style="list-style-type: none"> <li>▶ To the extent possible, information regarding the audit engagement and the audit committee's role in overseeing the independent auditor should be contained in the audit committee report, elsewhere in the proxy statement in connection with the discussion of the audit committee's activities, or available via hyperlinks from the audit committee report</li> </ul>
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## Share your views

This document is intended to inform and stimulate discussion regarding audit committee transparency by and among audit committees, corporate management, corporate counsel, auditors, investors, policy-makers and other interested parties. At Ernst & Young, we would welcome input regarding this document and hope it will be useful in efforts to identify and advance audit committee disclosures.

To share your views or obtain more information regarding the Ernst & Young's efforts in this area, please contact Ruby Sharma, Americas Leader, Audit Committee Center of Excellence, Ernst & Young LLP at [ruby.sharma@ey.com](mailto:ruby.sharma@ey.com); +1 212 773 0078; or Allie Monaco Rutherford, Corporate Governance Center, Ernst & Young LLP at [allie.rutherford@ey.com](mailto:allie.rutherford@ey.com) or +1 202 327 7026.



### Enhancing transparency of the audit committee auditor oversight process

To promote investor confidence in auditor independence and objectivity, Ernst & Young believes there should be greater transparency of the audit committee's auditor oversight process so that shareholders have the information they need to properly evaluate an audit committee's decision to retain or change the auditor. To this end, we believe that shareholders should receive a report from the audit committee on a periodic basis detailing its oversight of the auditor and the audit process. Read more in our [Point of View](#).

## End notes

- 1 For example, many compensation committees are now providing an executive summary of their activities to shareholders at the beginning of the Compensation Discussion & Analysis in the proxy statement. In addition, some boards have begun to provide executive summaries or letters to shareholders at the beginning of proxy statements to highlight key governance activities.
- 2 This concept release is available at <http://pcaobus.org/Rules/Rulemaking/Pages/Docket037.aspx>.
- 3 See, e.g., statement by Michelle Edkins, Managing Director, Global Head of Corporate Governance and Responsible Investment, BlackRock at the PCAOB meeting on auditor independence, objectivity and professional skepticism on 18 October 2012, available at [http://pcaobus.org/Rules/Rulemaking/Docket037/ps\\_Edkins.pdf](http://pcaobus.org/Rules/Rulemaking/Docket037/ps_Edkins.pdf).
- 4 The United Brotherhood of Carpenters sent letters to a number of Fortune 100 companies requesting additional audit committee- and audit-related disclosures in the 2012 and 2013 proxy seasons. For a description of the disclosures that were requested, see transcript testimony of Edward J. Durkin, Director, Corporate Affairs, United Brotherhood of Carpenters, before the Public Company Accounting Oversight Board (PCAOB) at the Public Meeting on Auditor Independence and Audit Firm Rotation on 21 March 2012, available at [http://pcaobus.org/Rules/Rulemaking/Docket037/2012-03-21\\_Transcript-Notice.pdf](http://pcaobus.org/Rules/Rulemaking/Docket037/2012-03-21_Transcript-Notice.pdf).
- 5 Available at <http://www.theqaq.org/resources/pdfs/AuditorAssessment.pdf>.
- 6 Available at <http://www.cica.ca>.
- 7 Available at: <http://www.frc.org.uk/getattachment/a7f0aa3a-57dd-4341-b3e8-ffa99899e154/UK-Corporate-Governance-Code-September-2012.aspx>.
- 8 Available at: [http://www.ey.com/Publication/vwLUAssets/Auditor\\_reporting\\_November\\_2012\\_\(Point\\_of\\_view\)/\\$FILE/EY%20Point%20of%20view%20auditor%20reporting%20November%202012.pdf](http://www.ey.com/Publication/vwLUAssets/Auditor_reporting_November_2012_(Point_of_view)/$FILE/EY%20Point%20of%20view%20auditor%20reporting%20November%202012.pdf).
- 9 This review was conducted by Ernst & Young LLP's Corporate Governance Center, which looked at the disclosures of the 89 public companies that are included in the Fortune 100 list holding an annual meeting in 2012.
- 10 SEC regulations require that if the company does not make the audit committee charter available on its website, it must include it as an appendix to its proxy or information statement once every three years. If not included as such an appendix in a given year, the company must identify the year in which the audit committee charter was included, unless it is available on the company website. 17 CFR §229.407(d). While New York Stock Exchange (NYSE) Rule 303A.07 requires companies to place audit committee charters on their website, Nasdaq rules do not specify a location for the charter.
- 11 The term "auditor" is used in this table to refer to public accounting firms registered with the US PCAOB that audit the financial statements of SEC-registered issuers pursuant to the Securities Act of 1933, the Securities Exchange Act of 1934, and the Sarbanes-Oxley Act of 2002. These firms are referred to by different names in US federal statutes and regulations, as well as stock exchange listing rules, including "independent public accountant," "registered public accounting firm," "independent auditor," and "outside auditor."
- 12 The selected disclosure requirements in this column are drawn from SEC laws and regulations and New York Stock Exchange and Nasdaq listing rules. 15 USC 78j-1(h), (k), (m); 15 USC 7407; 17 CFR§ 229.407; 17 CFR § 240.14a-101; Nasdaq Rule 5605(c); New York Stock Exchange Rules 303A.06 and 303A.07.
- 13 Under NYSE rules, audit committees members must be financially literate (or become financially literate), as defined by the board. In addition, the audit committee must have one member that has accounting or related financial management expertise, as defined by the board. (NYSE Rule 303A.07) Under Nasdaq rules, audit committees must have at least three members, each of whom must be able to read and understand fundamental financial statements, including a company's balance sheet, income statement, and cash flow statement. Additionally, each company must certify that it has, and will continue to have, at least one member of the audit committee who has past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities. (Nasdaq Rule 5605(c)(2)(A)).
- 14 This information is currently required to be included in the audit committee charters of companies listed on the New York Stock Exchange and Nasdaq. NYSE Rule 303A.07 and Nasdaq Rule 5605(c).
- 15 This is required by NYSE Rule 303A.07(b)(ii) but is not required by Nasdaq rules; see endnote x above.
- 16 This is required by NYSE Rule 303A.07(b)(ii) but is not required by Nasdaq rules.



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Score no. CF0039

BSC no. 1301-1007226

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