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EY Center for Board Matters

Audit committee reporting to shareholders in 2018

The EY Center for Board Matters has reviewed voluntary proxy statement disclosures by Fortune 100 companies relating to audit committees and the audit since 2012. We examine and track these disclosures because of their value in informing investors about the important role that audit committees play in investor protection through their independent oversight of the external audit. This oversight, in turn, enhances investor confidence in financial reporting. Proxy disclosures in 2018 continue to show a year-over-year trend of increasing voluntary audit-related disclosures.

Understanding the context

The Sarbanes-Oxley Act of 2002 created a strong regulatory framework to protect the integrity of financial reporting. One of the primary ways the Act accomplished this was by requiring listed companies to have fully independent audit committees that are responsible for the appointment, compensation and oversight of the external auditor. U.S. Securities and Exchange Commission (SEC) regulations do not require disclosure regarding the full range of an audit committee's activities, which means that

company disclosures often do not provide investors and other stakeholders with a full picture of this important work.

In recent years, investor groups and regulators have encouraged more audit-related disclosure to address this gap. Companies in response have been voluntarily augmenting the information they provide in their annual proxy statements.

What we see in 2018

Although the change in percentage of companies providing these voluntary disclosures is smaller in 2018 than in recent years, there has been a dramatic increase in disclosures in most categories since we began examining these disclosures in 2012. For example:

- ▶ In 2018, 71% of companies disclosed the length of auditor tenure. In 2017, the percentage was 64%, and in 2012 it was 25%.
- ▶ Sixty-two percent of companies disclosed the factors used in the audit committee's assessment of the external auditor qualifications and work quality, while in 2017 and 2012 the percentage was 58% and 18%, respectively.
- ▶ In 2018, the percentage of companies disclosing that the audit committee considers non-audit fees and services when assessing auditor independence increased to 89% from 86% in 2017. In 2012, 12% of companies disclosed this information.
- ▶ The percentage of companies providing an explanation for a change in all fees paid to the external auditor decreased slightly from 45% in 2017 to 44% in 2018, while just 10% of companies made these disclosures in 2012. However, in 2018 only 16% provide an explanation for a change in the audit fee itself.

In the table to the right, we provide further data on these disclosures by Fortune 100 companies.

Outlook on disclosure requirements

Looking ahead, new auditor disclosure requirements could impact decisions regarding voluntary audit committee disclosures over the next several years, including:

- ▶ **Required disclosures by auditors have increased:** In 2016 and 2017, the US Public Company Accounting Oversight Board (PCAOB) issued rules to expand certain disclosures by the auditor. This could encourage companies to expand their disclosures. These new auditor disclosures include:
 - ▶ Lead audit partner's name¹
 - ▶ Identification of the names and locations of other accounting firms that participate in an audit, as well as the extent of their participation²
 - ▶ Length of auditor tenure³
- ▶ **More auditor disclosures are on the way:** The PCAOB also issued a rule to require disclosure of critical audit matters (CAMs) starting in 2019 for some issuers. CAMs are matters communicated or required to be communicated to the audit committee that relate to material accounts or disclosures and involve especially challenging, subjective or complex auditor judgment.⁴ Companies may choose to review their disclosures to make certain the same topics are covered as well.

Trends in audit committee disclosures

Category	Topic
Disclosures in the audit committee report	Statement that the audit committee is independent
	Name of the audit firm is included in the audit committee report
Audit committee composition	Audit committee with one financial expert (FE)
	Audit committee with two FEs
	Audit committee with three or more FEs
Audit committee responsibilities re: external auditor	Explicit statement that the audit committee is responsible for appointment, compensation and oversight of external auditor
Identification of topics discussed	Topics discussed by the audit committee and external auditor
Fees paid to the external auditor	Statement that the audit committee considers non-audit fees/services when assessing auditor independence
	Statement that the audit committee is responsible for fee negotiations
	Explanation provided for change in fees paid to external auditor
	Explanation provided for change in audit fees paid to external auditor
Assessment of the external auditor	Disclosure of factors used in the audit committee's assessment of the external auditor qualifications and work quality
	Statement that audit committee involved in lead partner selection
	Disclosure of the year the lead audit partner was appointed
	Statement that choice of external auditor is in best interest of company and/or shareholders
Tenure of the external auditor	Disclosure of the length of the external auditor tenure
	Statement that the audit committee considers the impact of changing auditors when assessing whether to retain the current external auditor
Accessibility of audit committee charters from proxy statements (link in proxy statement goes directly to)	Audit committee and/or all committee charters
	Company main website
	Company site for investor relations
	Company site for corporate governance

2018	2017	2016	2015	2014	2013	2012
68%	67%	61%	61%	57%	53%	56%
79%	75%	73%	72%	72%	73%	73%
14%	17%	28%	27%	32%	29%	31%
33%	29%	16%	21%	24%	45%	32%
53%	53%	56%	52%	44%	25%	37%
88%	88%	82%	81%	68%	56%	44%
4%	4%	4%	5%	5%	5%	5%
89%	86%	84%	79%	75%	75%	12%
37%	34%	29%	26%	16%	8%	1%
44%	45%	37%	25%	21%	15%	10%
16%	19%	15%	10%	12%	10%	7%
62%	58%	48%	41%	33%	22%	18%
78%	75%	70%	66%	48%	15%	0%
16%	16%	12%	11%	7%	3%	3%
74%	73%	73%	64%	48%	23%	4%
71%	64%	63%	62%	53%	30%	25%
63%	60%	53%	49%	33%	16%	3%
12%	12%	12%	16%	16%	11%	8%
38%	38%	36%	38%	40%	41%	44%
25%	25%	25%	25%	27%	27%	26%
25%	25%	27%	21%	16%	21%	22%

Notes: Percentages based on total disclosures for audit committees each year. Data based on the 73 companies on the 2018 Fortune 100 list that filed proxy statements each year during 2012-2018 and held annual meetings through 15 August 2018.

Disclosure observations and sample language from Fortune 100 proxy statements

Topics discussed by the audit committee and external auditor

Reviewed companies indicated that the audit committee raised certain topics with their external auditors other than those required by regulations.

Sample language

"The Audit Committee met in private sessions as required by its charter with representatives of Audit Firm and members of the Company's management, including the Chief Executive Officer, the Chief Financial Officer, the Controller, the Chief Accounting Officer, the Chief Legal Officer and the Vice President – Corporate Audit. The Audit Committee and other attendees discussed and reviewed the following, among other matters: Company SEC filings; information technology matters; the scope, resources and work of the internal audit function; the financial reporting process; the consolidated financial statements and related notes; the scope and progress of testing of the Company's internal control over financial reporting; management's assessment of the effectiveness of the Company's internal control over financial reporting; enterprise risk management (ERM); legal and regulatory matters; accounting standards; accounting and controls related to specific company functions, strategic investments, subsidiaries and accounts; and tax matters."

Explanation provided for change in fees paid to external auditor

Most companies provide an explanation for the types of services included within each fee category. Reviewed companies explained the circumstances for the change.

Sample language

"The decrease in audit fees in 2017 as compared to 2016 is attributable to the fact that Operating Entity is no longer part of the Company and therefore services related to that entity are no longer included."

Disclosure of factors used in the audit committee's assessment of the external auditor qualifications and work quality

Reviewed companies provided examples of criteria used in auditor assessments.

Sample language

"The Committee annually reviews Audit Firm's performance and independence in deciding whether to retain the Audit Firm or engage a different independent registered public accounting firm. In the course of these reviews, the Committee considers, among other things, the quality and efficiency of the Audit Firm's historical and recent audit plans and performance on the Company's audit; the Audit Firm's capability and expertise in handling the breadth and complexity of the Company's worldwide operations; ..."

Statement that the audit committee considers the impact of changing auditors when assessing whether to retain the current external auditor

Reviewed companies indicated that the audit committee considered alternatives to retaining the external auditor.

Sample language

"The Audit Committee also considers whether, in order to assure continuing auditor independence, there should be regular rotation of the independent registered public accounting firm, which includes consideration of the advisability and potential impact of selecting a different independent public accounting firm. The Committee engages in an annual evaluation of the independent public accounting firm's qualifications, assessing the firm's quality of service, the firm's sufficiency of resources, the quality of the communication and interaction with the firm, and the firm's independence, objectivity and professional skepticism. The Committee also considers the advisability and potential impact of selecting a different independent public accounting firm."

How we see it

A US survey of investors indicates high degrees of confidence in the audited financial information disclosed by public companies.⁵ This confidence aligns with improvements in the quality of financial reporting: in 2017 the number of financial restatements was lower than it has been in 17 years.⁶ Yet, at the same time, there was a slight increase in average votes against ratifying the external auditor in the 2018 proxy season.

This increase suggests that some investors are taking a stricter approach to reviewing the company-auditor relationship. This could encourage companies to provide additional disclosure around the audit committee's selection of an auditor.

Enhancing audit committee transparency can increase investors' confidence in financial reporting and their confidence in the role of the audit committee in overseeing the audit process and promoting audit quality in the interest of investors.

Meaningful disclosure about what audit committees do and how they oversee auditors would provide a window into the important work audit committees perform, as well as the processes in place to protect auditor independence and professional skepticism and further the alignment among auditors, audit committees and investors.

Questions for audit committees to consider

- ▶ How do director qualifications and board composition-related disclosures highlight the expertise, experiences and backgrounds of audit committee members?
- ▶ How has the role of the audit committee evolved in recent years (e.g., oversight of enterprise risk management, cybersecurity risk) - and to what extent are these changes being communicated to stakeholders via the proxy statement?
- ▶ What impact will new auditor disclosure requirements have on audit committee disclosures?
- ▶ What additional voluntary disclosures might be useful to shareholders related to the audit committee's time spent on certain activities, such as company restructuring or financial statement reporting developments?

Endnotes

- 1 PCAOB standard, *Improving the Transparency of Audits: Rules to Require Disclosure of Certain Audit Participants on a New Form and Related Amendments to Auditing Standards*, 15 December 2015, PCAOB website, <https://pcaobus.org/Rulemaking/Docket029/Release-2015-008.pdf>, accessed August 2018.
- 2 Ibid.
- 3 PCAOB standard, *Auditing Standards on the Auditor's Report and the Auditor's Responsibilities Regarding Other Information and Related Amendments*, 1 June 2017, PCAOB website, <https://pcaobus.org/Rulemaking/Pages/Docket034.aspx>, accessed August 2018.
- 4 Ibid. Disclosure of CAMs must be provided in auditor reports relating to audits of large accelerated filers for financial reporting periods ending on or after 30 June 2019. For other public companies, this disclosure will be required for financial reporting periods ending on or after 15 December 2020.
- 5 Center for Audit Quality Main Street Survey, 25 October 2017, CAQ website, <https://www.thecaq.org/2017-main-street-investor-survey>, accessed August 2018.
- 6 Audit Analytics 2017 Financial Restatements – A 17-year comparison, May 2018, available through Audit Analytics.

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