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Audit committee disclosure in proxy statements—2017 trends

Over the past several years, investors and other governance groups have sought expanded disclosures on how audit committees execute their duties. The desired disclosures include details on how audit committees select (or, in many cases, re-appoint) the independent auditor; how committees assess and mitigate risks, including cyber-risk; and how they evaluate auditor independence, including the impact of tenure. The SEC also weighed in on the discussion when it issued a request for public comment on these topics in a July 2015 concept release titled *Possible Revisions to Audit Committee Disclosures*.

The SEC has not yet changed audit committee disclosure requirements in response to these efforts, and there is no indication that rule changes are likely any time soon. However, over the past several years, companies have generally increased voluntary disclosures about the role and activities of audit committees. Deloitte's analysis of the 2017 proxies of S&P 100 companies[1] indicates that 50% of the disclosure topics included in the analysis increased as compared to 2016. Thirty-seven percent showed reduced disclosures concerning those topics. Because the composition of the S&P 100 changes annually, the companies analyzed in 2017 differed from those covered by the 2016 analysis. Added detail provided in the footnote.

Deloitte's 2016 analysis revealed that disclosures in three areas increased by 10 percent or more over 2015: the number of financial experts on the audit committee, the audit committee's role in reviewing earnings or annual report press releases with management and the independent auditor, and the audit committee's role in approving audit engagement fees. In contrast, the 2017 analysis indicates that disclosures did not increase by more than 10 percent in any area. For the remainder of the areas reviewed, changes in disclosure increased or decreased by no more than four percent. However, the analysis revealed that, across all areas, the number of increases in disclosure outpaced decreases by twelve percentage points.

[1] The 2017 analysis included all sections of the most recent annual proxy statements filed as of June 15, 2017, for the companies included in the S&P 100 index as of April 15, 2017. Because the composition of the S&P 100 changes annually, the companies analyzed in 2017 differed from those covered by the 2016 analysis; five of the companies in the 2017 analysis were not included 2016 analysis.

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These statistics may be affected by a number of factors, including that as more companies have increased their audit committee disclosures over time, the year-over-year increases have diminished. It is also possible that companies have reduced the amount of "routine but not required" audit committee disclosures in favor of more substantive disclosures. However, it is not possible to determine whether these or other factors have influenced the modest increases, whether either or both of these factors explains the decreases reflected in the 2017 data, or whether other factors were at play.

Deloitte's analysis indicates that S&P 100 companies uniformly comply with disclosure requirements related to the audit committee, which are summarized in the appendix. Therefore, the focus of this article will be on disclosures that either expanded on or went beyond those required elements, especially in the areas of oversight of the independent auditor, oversight of the financial reporting process, and other oversight responsibilities.

Audit committee composition

The majority of audit committee disclosure requirements, principally found in *Item 407 of SEC Regulation S-K*, were adopted in 1999. Enhancements to audit committee disclosures were included in the Sarbanes-Oxley Act of 2002.

Among other things, companies are required to disclose whether their audit committee has at least one financial expert. (Audit committees are not required to have a financial expert, but if they do not, they must explain why.) Given the complex issues many audit committees oversee today, many are choosing to have more than one financial expert on the committee. In 2017, 86 percent of the S&P 100 disclosed that their audit committees have more than one financial expert, a two percent decrease from 2016.

The New York Stock Exchange Listed Company Manual requires each member of the audit committee to be financially literate[2]; 66 percent of the companies in the 2017 analysis disclosed this, up three percent from 2016.

Most common audit committee disclosures	
Roles and responsibilities of the audit committee	100%
Responsibility for risk oversight generally	99%
Topics of discussion for the audit committee	96%
Discussion of the audit committee's oversight of the company's financial reporting process	91%
Discussion of the audit committee's role is overseeing the internal audit function	89%

Oversight of the independent auditor

The Sarbanes-Oxley Act of 2002 recognized the importance of independent audit committees to the audit process by mandating that the audit committee be directly responsible for the appointment, compensation, and oversight of the independent auditor. As a result, many audit committee-related proxy statement disclosures focus on these key responsibilities. Consistent with Deloitte's 2016 analysis, all the companies in the 2017 analysis disclosed information about their audit committees' oversight of the independent auditor. However, not all companies disclosed the same types of information.

Appointment and evaluation of the independent auditor

Sixty-one percent of the companies explicitly disclosed that the audit committee evaluates the independent auditor. This represents a two percent increase over 2016 and a return to the 2015 level. Factors considered in those evaluations included the independent auditor's qualifications, performance, independence, and tenure.

The analysis indicated very little change, in the number of companies that disclosed the reasons for retaining the incumbent independent auditor. While some merely stated that retention was in the best interest of the company, a number included additional insight into the factors considered in making this determination. The reasons cited most often were quality and performance, including the results of PCAOB and peer reviews, tenure of the relationship, and the audit team's knowledge of and experience with the industry and the company's operations. Some companies also cited the appropriateness of fees, both on an absolute basis and as compared to peer firms, and others commented on the potential impact of changing independent auditors.

[2] NYSE Listed Company Manual Section 303A.07(a).

Audit tenure

Seventy-one percent of the companies in the analysis disclosed the tenure of their audit firm in their most recent proxy statement. In June 2017, the PCAOB adopted a new auditing standard that, if approved by the SEC, will substantially expand the auditor's report. Under that standards, beginning for fiscal years ending on or after December 15, 2017, the PCAOB will require the independent auditor to disclose its tenure as auditor in its audit report. In its release adopting this requirement, the PCAOB acknowledged that many companies already voluntarily disclose auditor tenure and explained that the disclosure is intended to add to the mix of publicly available information and does not necessarily suggest a specific correlation with audit quality or independence.

A number of companies in the analysis specifically addressed the company's consideration of auditor tenure, highlighting the benefits of a long relationship. The most commonly cited benefits were:

- Higher audit quality due to the independent auditor's deep understanding of the company's business, accounting policies and practices, and internal control over financial reporting
- Efficient fee structures due to the independent auditor's familiarity with the company and industry expertise
- Avoidance of the significant costs and disruptions, including management time and distractions, that would be associated with bringing on a new independent auditor

A number of these companies also discussed the robust safeguards for auditor independence, including:

- A strong regulatory framework for auditor independence, including limitations on non-audit services and mandatory audit partner rotation requirements
- Audit committee oversight of the independent auditor that includes regular communication and evaluation, both on the quality of the audit and on auditor independence
- The independent auditor's own internal independence process and compliance reviews

Compensation of the independent auditor

Only 20 percent of audit committees disclosed that they are responsible for negotiating fees, a three percent decrease from 2016. Most companies—63 percent—provided general disclosures around the audit committee's role in reviewing and approving the audit engagement fees, a slight (two percent) decrease as compared to 2016. In addition to disclosing the audit committee's responsibility for reviewing and approving the independent auditor's fees, some companies also disclosed that the audit committee established preapproval policies related to all audit and non-audit services provided by the independent auditor.

Discussions around the auditor's responsibilities

Sixty-five percent of the companies in the analysis provided disclosures regarding the responsibilities of the independent auditor, a four percent decrease as compared to 2016. Responsibilities mentioned frequently included:

- Performing an audit of, and expressing an opinion on, the company's financial statements and its internal control over financial reporting

- Discussing with the audit committee any matters deemed appropriate.

Additionally, 65 percent disclosed that the audit committee has separate meetings with the independent auditor, and 60 percent disclosed that they discussed the overall scope of and plans for the audit with the auditor, decreases of two and three percent, respectively, versus 2016.

While only six percent of companies disclosed that they discussed issues encountered during the audit with the independent auditor (the same percentage as in 2016), this number may change when the new PCAOB standard on the auditor's reporting model becomes effective.

New auditor's reporting model

If the new PCAOB auditing standard is approved by the SEC, it will substantially expand the auditor's report. The PCAOB has stated that the standard is intended to increase the informational value, usefulness, and relevance of the auditor's report. The new report purports to retain the current pass/fail approach, while adding a significant new section discussing "critical audit matters" (CAMs)—matters that were communicated or are required to be communicated to the audit committee that relate to accounts or disclosures material to the financial statements and involve especially challenging, subjective, or complex aspects of the audit. In addition, the new standard will require certain changes to the standard portion of the auditor's report, as well as disclosure of the current independent auditor's tenure.

The new standard takes effect for audit reports on fiscal years ending on or after December 15, 2017 (as to changes to the standard report and tenure disclosures). The provisions of the new standard relating to CAM disclosure takes effect for audit reports on fiscal years beginning on or after June 30, 2019 (for accelerated large filers) and fiscal years ending on or after December 15, 2020 (for other filers).

Heads Up—PCAOB adopts changes to the auditor's report provides additional information on the new standard.

Oversight of the financial reporting process

Deloitte's 2017 analysis found that 91 percent of the S&P 100 companies discussed the audit committee's role in overseeing the financial reporting process, compared to 88 percent in 2016. While some companies simply noted that one of the audit committee's responsibilities was to oversee the financial reporting process, many others provided additional details. Continuing the trend observed in the 2016 analysis, more companies noted that their audit committees review the earnings/annual report press releases with management and the independent auditor prior to their release. Disclosure in this area increased to 32 percent from 30 percent (which in turn was up significantly from the 20 percent reported in 2015), and it may increase further given the SEC's recent focus on non-GAAP measures. Twenty-five percent, up from 21 percent—said their audit committees discuss the financial statements in advance of earnings announcements.

Disclosures related to the audit committee's review of significant accounting policies were up slightly, to 57 percent in 2017 versus 56 percent in 2016. Additionally, 34 percent of the companies in the analysis disclosed information about their audit committees' review of management judgments and/or accounting estimates, versus 32 percent in 2016.

Non-GAAP measures

Beginning in 2016, the SEC increased its focus on disclosure of non-GAAP measures due to concerns about their increased use and prominence. As a result, companies and audit committees should consider reexamining their use of non-GAAP measures and related controls and procedures for disclosure of such measures. Consider reviewing Deloitte's roadmap to non-GAAP financial measures, which combines the SEC's guidance with Deloitte's interpretations and examples, and includes questions for companies to consider when disclosing these measures. Also refer to Deloitte's *Heads Up* for questions audit committee members can consider related to non-GAAP measures.

Other oversight responsibilities

In addition to their responsibility for overseeing the independent auditor and financial reporting process, many audit committees discussed other oversight responsibilities. In 2017, the analysis continued to focus on disclosures about the audit committee's oversight of areas such as risk, internal audit, and cybersecurity.

Role of the audit committee in overseeing risk

The role of the board and its committees in overseeing risk continues to be a hot topic. Ninety-nine percent of the S&P 100 companies disclosed the role of the audit committee in overseeing risk. The level of responsibility assigned to the audit committee, however, differed from company to company. Companies disclosed that the audit committee was responsible for overseeing risks associated with traditional areas such as financial reporting, internal controls, and compliance, and some noted that the audit committee's role in risk oversight extended beyond these areas. Thirty percent of the S&P 100 companies (versus 27 percent in 2016) disclosed the audit committee's role in overseeing cybersecurity risk.

Role of the audit committee in overseeing internal audit

For 2017, 89 percent of companies discussed the audit committee's role in overseeing the internal audit function, an increase over 85 percent in 2016. Disclosures often noted the audit committee's role in the following areas:

- assisting the board of directors in fulfilling its oversight responsibility with respect to the qualifications and performance of the internal audit function and internal auditors;
- meeting with internal audit to review and discuss the internal audit scope and plan and the results of internal audit activities; and
- overseeing the appointment, removal, performance, and compensation of the chief audit executive.

Other topics discussed by the audit committee

All the S&P 100 companies disclosed at least some topics of discussion between the audit committee and management, the independent auditor, internal audit, or others. Most companies limited this disclosure to the five items required by Item 407 of the SEC's Regulation S-K[3]. Those companies that identified additional topics of discussion generally limited their disclosures to the topics covered and did not include details from the discussion. The topics listed most commonly were:

- the audited financial statements, results, and/or performance, including the quality and acceptability of the accounting principles and clarity of the disclosures in the financial statements;
- the evaluation of the company's internal controls and overall quality of the company's financial reporting; and
- the policies and procedures with respect to the company's risk assessment and risk management.

Least common audit committee disclosures	
Discussion of issues encountered during the audit	6%
Audit committee sets the compensation for the independent auditor	10%
Audit committee is responsible for audit fee negotiations	20%
Audit committee discussions about the financial statements before earnings announcements	25%
Additional disclosure about significant accounting policies	26%

Conclusion

Based on Deloitte's analysis, transparency into the audit committee's oversight activities and performance can provide investors with a better understanding of both the audit committee's performance and the audit process. While it is not necessary, or possible, to disclose everything an audit committee does each year in fulfilling its duties, providing additional insight into the structure and key activities of the audit committee can help increase investor confidence in both the audit committee and the company as a whole.

Based on the analysis of the S&P 100's audit committee-related proxy disclosures, calls for transparency seem to be leading companies to continue expanding disclosures beyond what is required, as half of the disclosures reviewed increased from 2016 to 2017. And even though just over a third of the disclosures reviewed decreased in number, investors can be encouraged by the positive 12 percentage point difference for the companies that enhanced their disclosures compared to those who decreased the disclosures. Based upon Deloitte's day-to-day interactions with audit committees, many of them are doing much more to fulfill their responsibilities than they disclose.

Voluntary expansion of audit committee disclosures in a number of areas can enhance investor confidence in the committee's oversight role and reduce the need for additional disclosure regulation. These areas include (1) the direct reporting relationship between the committee and the auditor; (2) the committee's assessment of audit quality and auditor independence; (3) the extent of communications between the committee and the auditor, beyond what is required by regulation and listing requirements; (4) the committee's process and rationale for appointing the auditor; and (5) the Committee's activities and actions during the year.

[3] See a list of these required disclosures in the appendix.

Appendix

Required disclosures related to the audit committee

SEC rules and regulations require that certain information about the audit committee be disclosed. Most companies include all the required disclosures in their annual proxy statement. Item 407 of Regulation S-K requires:

- Disclosure of whether the company has an audit committee, and if it does, the names of the members, the number of times the committee met in the past year, certain information about member attendance at these meetings, and a brief description of the functions performed.
- Disclosure of whether the audit committee is governed by a charter and, if so, whether a current copy of the charter is available on the registrant's website or included as an appendix to a proxy or information statement provided to security holders at least once every three fiscal years (or sooner if the charter has been materially amended).
- If the board of directors appoints a director to the audit committee who is not independent, as defined in the applicable listing standards[4], discloswee of the nature of the relationship that makes the individual not independent and the reasons for the board of director's determination.
- Disclosure of whether the audit committee has at least one financial expert, and the name (and in some cases attributes) of the expert(s).
- An audit committee report that states whether the audit committee has:
  1. Reviewed and discussed the audited financial statements with management
  2. Discussed the required communication matters under applicable auditing standards with the independent auditor
  3. Received the required written independence communications from the independent auditor as required by the rules of the PCAOB and discussed the independent auditor's independence with the independent auditor
  4. Recommended to the board of directors that the audited financial statements be included in the company's annual report on Form 10-K.
- The name of each member of the audit committee must appear below these required disclosures.

The SEC's regulations pertaining to the preparation of a company's annual proxy statement (Schedule 14A, Item 9) also require that the company disclose the audit committee's policies and procedures regarding the preapproval of fees paid to the independent auditor.

In addition to the disclosures required by the SEC, New York Stock Exchange Listed Company Manual Item 303A.07 requires that public companies disclose whether any audit committee member serves on the audit committee of more than three public companies, and if so, why the board determined this was appropriate.

[4] Director independence disclosures are also required under NYSE Listed Company Manual Section 303A.02(a) and NASDAQ Listing Rule 5605(b)(1).

Summary results of analysis

Disclosure in the proxy statement	Percent of S&P 100 companies that included related disclosures in their proxy			
	2017	% Change from 2016 to 2017[5]	2016	2015
Disclosure related to the composition of the audit committee				
1. Audit committee has more than one financial expert	86%	(2%)	88%	76%
2. Financial literacy of audit committee members	66%	3%	63%	59%
Disclosure related to the role of the audit committee				
3. Roles and responsibilities of the audit committee	100%	0%	100%	100%
4. Information about the charter beyond its existence	73%	2%	71%	77%
5. Topics of discussion for the audit committee	96%	(4%)	100%	100%
Disclosure related to the oversight of the financial reporting process				
6. Audit committee review of significant accounting policies	57%	1%	56%	47%
7. Additional disclosure about significant accounting policies	26%	(1%)	27%	28%
8. Discussion of management judgments and/or accounting estimates	34%	2%	32%	28%
9. Audit committee review of the earnings/annual report press release with management and the independent auditor	32%	2%	30%	20%
10. Audit committee discussions about the financial statements before earnings announcements	25%	4%	21%	18%
Disclosure related to the oversight of the independent auditor				
11. Audit committee evaluates the independent auditor	61%	2%	59%	61%
12. Why the audit committee decided to reappoint the independent auditor	41%	(1%)	42%	35%
13. Audit committee or its chair is involved in the selection of the auditor's new lead engagement partner	73%	0%	73%	71%
14. Tenure of the independent auditor	71%	4%	67%	64%
15. Retention of the incumbent independent auditor is in the best interest of the company and its investors	77%	(2%)	79%	73%
16. Audit committee consideration of changing or regularly rotating the independent auditor	75%	0%	75%	74%
17. Steps to be taken if the majority of shareholders do not ratify the independent auditor	77%	(1%)	78%	80%
18. Audit committee compensates the independent auditor	78%	(2%)	80%	77%
19. Audit committee approves the audit engagement fees	63%	(2%)	65%	40%
20. Audit committee is responsible for audit fee negotiations	20%	(1%)	21%	23%
21. Audit committee sets the compensation for the independent auditor	10%	4%	6%	7%
22. Responsibilities of the independent auditor	65%	(4%)	69%	68%
23. Audit committee discussion with the independent auditor regarding the scope of and plans for the audit	60%	(3%)	63%	62%
24. Discussion of issues encountered during the audit	6%	0%	6%	7%
25. Separate meetings between the audit committee and the independent auditor	65%	(2%)	67%	68%
Disclosure related to the responsibilities of the audit committee				
26. Audit committee is responsible for the oversight of risk	99%	3%	96%	N/A
27. Discussion of the audit committee's oversight of the company's financial reporting process	91%	3%	88%	N/A
28. Discussion of the audit committee's role in the oversight of cybersecurity	30%	3%	27%	N/A
29. Discussion of the audit committee's role in overseeing the internal audit function	89%	2%	85%	N/A
30. Discussion of the actions the audit committee has taken during the prior year	45%	2%	43%	N/A

[5] The changes from 2016 to 2017 are color coded to highlight:
Red—decrease in disclosure reported from 2016 to 2017
Yellow—no changes in the disclosures reported in 2016 and 2017
Green—increase in disclosure reported from 2016 to 2017

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