

2014

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# AUDIT COMMITTEE TRANSPARENCY BAROMETER

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CENTER  
FOR AUDIT  
QUALITY

*Serving Investors, Public Company Auditors & the Markets*

AUDIT ANALYTICS®



## **About the Center for Audit Quality**

The Center for Audit Quality (CAQ) is an autonomous, nonpartisan public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets. The CAQ fosters high quality performance by public company auditors, convenes and collaborates with other stakeholders to advance the discussion of critical issues requiring action and intervention, and advocates policies and standards that promote public company auditors' objectivity, effectiveness, and responsiveness to dynamic market conditions. Based in Washington, D.C., the CAQ is affiliated with the American Institute of CPAs. For more information, visit [www.theqaq.org](http://www.theqaq.org).

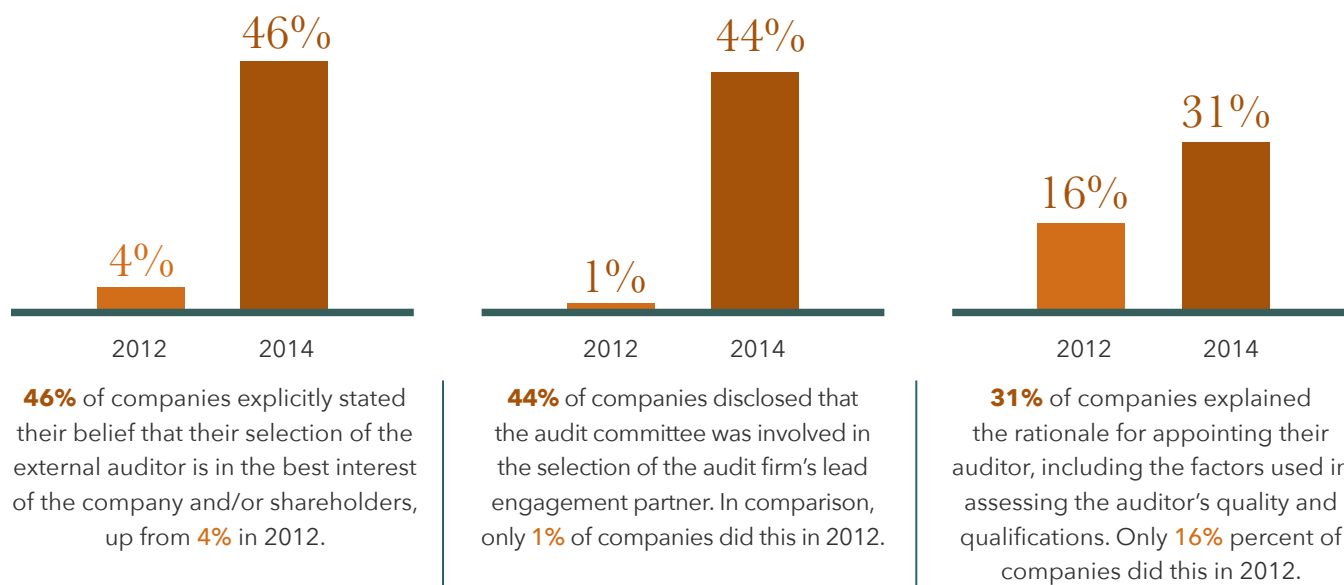
## **About Audit Analytics**

Audit Analytics is an independent research provider that enables the accounting, legal and investment communities to analyze auditor market intelligence, public company disclosure trends and risk indicators. For more information please e-mail [info@auditanalytics.com](mailto:info@auditanalytics.com) or call 508-476-7007.

Audit committees play a critical role in financial reporting oversight, and investors have expressed interest in increased transparency into the audit committee’s activities. The annual audit committee report included in the proxy statement is the principal source of public audit committee-related information, other than its committee charter. Public disclosures are the primary channel through which audit committees can inform and educate investors and other stakeholders about their critical responsibilities, and demonstrate their effectiveness in executing those responsibilities.<sup>1</sup>

A year ago, the Center for Audit Quality (CAQ), as part of the Audit Committee Collaboration, encouraged, through *Enhancing the Audit Committee Report: A Call to Action*, public company audit committees “to voluntarily and proactively improve their public disclosures to more effectively convey to investors and others the critical aspects of the important work that they currently perform.”<sup>2</sup> EY’s Center for Board Matters recently published its 2014 proxy season update, which evaluated data-driven trends in audit committee reporting in the proxy statement over a three-year period. The EY report noted “an increased number of Fortune 100 companies are going

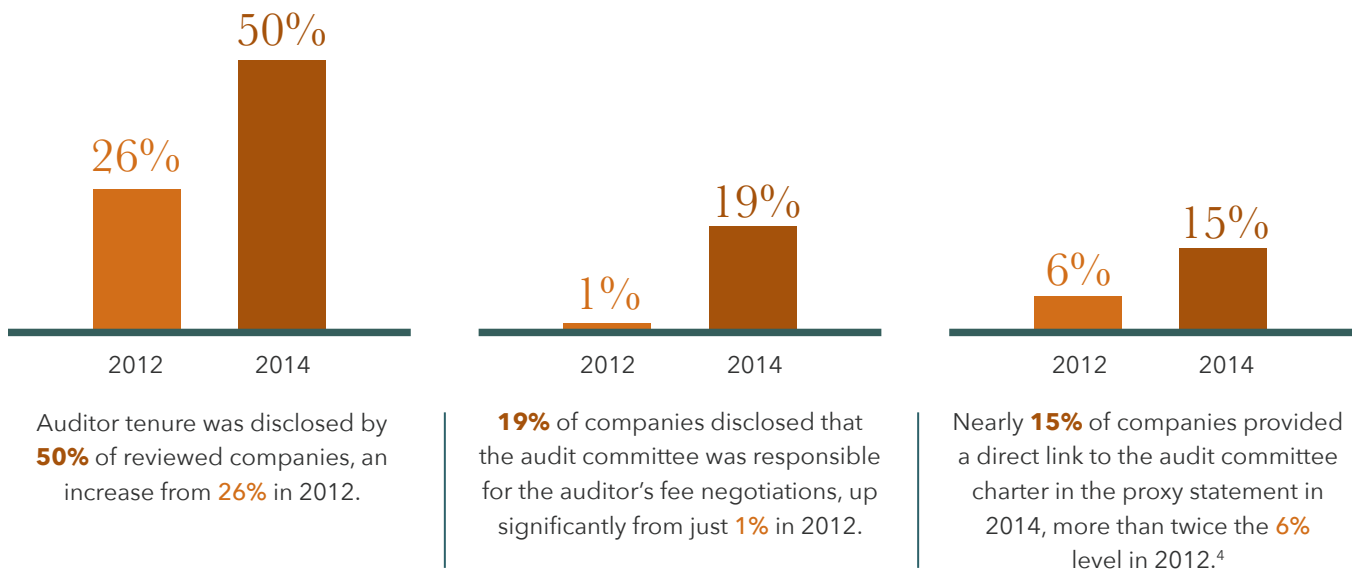
beyond the minimum disclosures required. These disclosures are also more robust – providing valuable perspectives on the activities of audit committees, including their oversight of external auditors.”<sup>3</sup> In response to significant attention on audit committee disclosures from a variety of stakeholders, including regulators, investors, and policy organizations, such as the CAQ, EY’s 2014 proxy season update appears to indicate that companies and their audit committees are answering the call, as many have revised their disclosures in several key ways, particularly in the area of auditor oversight as compared to 2012 proxy disclosures:



<sup>1</sup> The Conference Board, in its report on Investor Engagement, [[http://tcbblogs.org/public\\_html/wp-content/uploads/Corporate-Investor%20Guidelines.pdf](http://tcbblogs.org/public_html/wp-content/uploads/Corporate-Investor%20Guidelines.pdf)] describes a layered approach to investor engagement, displayed as a pyramid, which at its base includes public disclosures and broad dissemination of company information to the market.

<sup>2</sup> Several nationally recognized U.S. governance organizations came together to collaborate on projects intended to leverage their efforts to expand audit committee member access to useful tools and materials across the spectrum of public companies to strengthen audit committee performance and transparency. Known as the Audit Committee Collaboration, one of these projects was “Enhancing the Audit Committee Report: A Call to Action,” published in November, 2013. [<http://www.thecaq.org/docs/audit-committees/enhancing-the-audit-committee-report-a-call-to-action.pdf?sfvrsn=2>]

<sup>3</sup> EY “Let’s talk: governance, Audit committee reporting to shareholders, 2014 proxy season update,” [[http://www.ey.com/Publication/vwLUAssets/ey-lets-talk-governance-august-2014/\\$FILE/ey-lets-talk-governance-august-2014.pdf](http://www.ey.com/Publication/vwLUAssets/ey-lets-talk-governance-august-2014/$FILE/ey-lets-talk-governance-august-2014.pdf)]



## A Deeper Dive

In an effort to gauge how other public company audit committees approach the communication of their oversight activities, the CAQ, together with Audit Analytics, has undertaken a deeper analysis of 2014 audit committee disclosures, applying a “barometer” for the first time to measure the robustness of these disclosures among Standard & Poor’s (S&P) 500 large-cap (S&P 500) companies, S&P MidCap 400 (S&P MidCap) companies, and S&P SmallCap 600 (S&P SmallCap) companies. A barometer is defined as both a measuring instrument and something that reflects changes in circumstances and opinions. The barometer of audit committee transparency is focused on measuring the content of proxy statement disclosures in certain key areas, including auditor oversight and audit committee scope of duties. We expect that this information will serve as a baseline reference point measurement for reporting by companies in these indices in future proxy seasons.

## Overview of Findings

In our proxy review, we found that across the small-cap to large-cap spectrum, many companies are disclosing more than what is required, and many of the required disclosures are either consolidated in the audit committee

report or found within dedicated, labeled sections of the proxy, minimizing the “treasure hunt” for these disclosures.

We recognize that some disclosures about audit committee-related activities appear outside the audit committee report, i.e. elsewhere in the proxy statement, in the audit committee charter, in the annual report, or on a company’s website. A complete understanding of the audit committee’s activities may require reviewing information that is in disparate locations and often within very lengthy documents. In our proxy review, we found the average length of the proxy for S&P 500 companies is 85 pages, while S&P MidCap company proxies average 72 pages, and S&P SmallCap company proxies average 61 pages. Consolidating information, where possible, cross-referencing information to a specified section of the proxy, and/or providing a direct link to the audit committee charter facilitates access to this information by investors and others.

## Methodology

Together with Audit Analytics, we reviewed the most current proxies (filed through the end of June 2014) of 1,500 S&P Composite companies, including companies in the S&P

<sup>4</sup>EY “Let’s talk: governance, Audit committee reporting to shareholders, 2014 proxy season update,” [http://www.ey.com/Publication/vwLUAssets/ey-lets-talk-governance-august-2014/\$FILE/ey-lets-talk-governance-august-2014.pdf]

500, S&P MidCap, and S&P SmallCap indices. More than a third of the companies in our sample disclosed the same information in multiple locations, i.e. the audit committee report, other sections of the proxy, and/or the audit committee charter. We categorized the locations of the disclosures as follows, for purposes of discussing our findings:

- Audit Committee Report - Disclosed in the audit committee report, but in certain instances, the disclosure could also be duplicated in other sections of the proxy or charter.
- Proxy or Proxy including Audit Committee Report - Disclosed somewhere in the proxy, which includes both the audit committee report and other sections of the proxy, but in certain instances, the disclosure could also be duplicated in the charter.

## Auditor Oversight by the Audit Committee

Under Section 301 of the Sarbanes-Oxley Act of 2002 (“SOX”), each audit committee of a

listed company is “directly responsible for the appointment, compensation, and oversight” of the outside auditor and auditors are to report directly to the audit committee. SOX further stipulated that the audit committee is to be afforded the funding that it determines appropriate for compensating the auditor and any advisers it may employ.<sup>5</sup> The oversight of the auditor is an extremely important function of the audit committee, and many investors and other stakeholders have expressed their desire to have increased visibility into how this function is performed. Some companies included incremental information in their proxies with respect to this oversight function, including how the audit firm is selected by the audit committee, how the audit firm is evaluated by the audit committee, and auditor compensation and its connection to audit quality.

Providing context around the selection and appointment of an audit firm can help build investor confidence by underscoring the thoroughness of the process that led to the audit committee’s decision. Discussing factors

### *Auditor Oversight / Evaluation*

*“The Audit Committee evaluates the performance of the Independent Auditors, including the senior audit engagement team members, each year and determines whether to re-engage the current Independent Auditors or consider other audit firms. In doing so, the Audit Committee considers the quality and efficiency of the services provided by the Independent Auditors, along with the Independent Auditor’s capabilities, technical expertise, and knowledge of our operations and industry. In addition, the Audit Committee reviews with the senior members of our financial management team and Director, Internal Audit, the overall audit scope and plans, the results of internal and external audit examinations, evaluations by management and the Independent Auditors of our internal control over financial reporting and the quality of our financial reporting, and the ability of the Independent Auditors to remain independent. Based on these evaluations, the Audit Committee decided to engage [Independent Auditor] as our Independent Auditors for fiscal year 2015.”*

Source: The J.M. Smucker Company (S&P 500), 2014 Audit Committee Report

<sup>5</sup>SOX Section 301, “Public company audit committees” [<https://www.sec.gov/about/laws/soa2002.pdf>]

such as the firm’s qualifications and expertise, as well as its geographic reach help provide that context. Further, including relevant information about the annual evaluation of the external auditor helps further support that the audit committee is performing its auditor oversight function effectively.

- A discussion of the audit committee’s considerations in appointing the auditor in terms of qualifications, geographic reach, and firm expertise was found in **13%** of S&P 500, **10%** of S&P MidCap, and **8%** of S&P SmallCap company proxies. (See Example A.)
- A discussion of criteria considered when evaluating the audit firm was found in **8%** of S&P 500, **7%** of S&P MidCap, and **15%** of S&P SmallCap company proxies.

- The length of time an auditor has been engaged was disclosed in **47%** of S&P 500, **42%** of S&P MidCap, and **50%** of S&P SmallCap company proxies.

Disclosure of key factors the audit committee considered in determining appropriate compensation of the external auditor could help investors understand the direct and primary role the audit committee played, and the important balance the audit committee struck in ensuring that the auditor is paid a reasonable amount that is consistent with the delivery of a quality audit. Linking this type of contextual information to compensation policies or decisions could be useful to those seeking to better understand how the audit committee determined the appropriateness of audit firm compensation.

#### *Example A - Auditor Appointment*

*“The Audit Committee considered and has recommended to the full Board that [Independent Auditor] be reappointed as the Company’s independent registered public accounting firm for 2014. That recommendation calls for the reappointment to be subject to ratification by the Company’s shareholders at the 2014 annual meeting. In determining whether to make the recommendation to reappoint [Independent Auditor], the Audit Committee took into consideration a number of factors including, but not limited to:*

- The quality of the Audit Committee’s ongoing discussions with [Independent Auditor];
- [Independent Auditor]’s independence;
- Management’s perceptions of [Independent Auditor]’s industry expertise and past performance;
- External data relating to audit quality and performance, including recent PCAOB reports on [Independent Auditor] and its peer firms; and
- The appropriateness of fees charged.

*[Independent Auditor] has been the Company’s independent auditor since May 17, 2002.”*

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Source: Vectren Corporation (S&P MidCap), 2014 Audit Committee Report

- Discussion of audit fees and their connection to audit quality was found in **13%** of S&P 500, **4%** of S&P MidCap and **1%** of S&P SmallCap company proxies. (See Example B.)
- Discussion of how the audit committee considers auditor compensation was found in **1%** of S&P 500 and **1%** of S&P MidCap company proxies, but was not found in S&P SmallCap company proxies.

Another important provision of SOX designed to support auditor independence is the mandatory rotation of the lead audit partner after five years.<sup>6</sup> More effective disclosure about the audit committee’s involvement in the selection of a new lead audit engagement partner may provide more confidence in this process.

- An explicit statement that the audit committee is involved in the selection of the audit engagement partner was found in **13%** of S&P 500 and **1%** in both S&P MidCap and S&P SmallCap company proxies. (See Example C.)

Some auditor oversight disclosures are required disclosures in the proxy and/or the charter. The audit committee charter is required to state the audit committee’s responsibility for the appointment, compensation and oversight of the independent auditor.<sup>7</sup> Further, SEC rules require public companies to disclose in the proxy the total fees paid to the external auditor within four categories: audit, audit-related, tax, and other fees.<sup>8</sup> A discussion of pre-approval of non-audit services is also a required SEC disclosure<sup>9</sup>; however a discussion in the proxy of how non-audit services may impact independence is not.

While not required, **83%** of S&P 500 companies, **69%** of S&P MidCap companies, and **58%** of S&P SmallCap companies discussed how non-audit services may impact independence in their audit committee reports and/or other sections of the proxy. (See Example D.)

A table summarizing the results of these and other findings related to auditor oversight disclosures can be found on page six.

### *Example B - Auditor Oversight and Connection to Audit Quality*

*The Audit and Finance Committee considers whether the independent registered public accounting firm is best positioned and qualified to provide the most effective and efficient service, based on factors such as the independent registered public accounting firm’s familiarity with the Company’s business, personnel, culture, accounting systems or risk profile and whether provision of the service by the independent registered public accounting firm would enhance the Company’s ability to manage or control risk or improve audit quality.*

Source: AOL Inc. (S&P MidCap), 2014 Proxy

<sup>6</sup>SOX Section 203, “Audit partner rotation” [https://www.sec.gov/about/laws/soa2002.pdf]

<sup>7</sup>SOX Section 301, “Public company audit committees” [https://www.sec.gov/about/laws/soa2002.pdf]

<sup>8</sup>SEC. 2000. Final Rule 33-7919, “Revision of the Commission’s Auditor Independence Requirements.” [http://www.sec.gov/rules/final/33-7919.htm]

<sup>9</sup>SOX Section 202, “Preapproval requirements” [https://www.sec.gov/about/laws/soa2002.pdf]

# AUDITOR OVERSIGHT DISCLOSURES AMONG S&P COMPANIES

CATEGORY	DISCLOSURE QUESTION	S&P 500	S&P MIDCAP	S&P SMALLCAP
		PROXY (INCLUDING AUDIT COMMITTEE REPORT)		
Audit firm selection	Is there a discussion of audit committee considerations in appointing the auditor in terms of: qualifications, geographic reach, firm expertise?	13%	10%	8%
	Do they disclose the length of time the auditor has been engaged?	47%	42%	50%
Auditor compensation	Is there a discussion of audit fees and its connection to audit quality?	13%	4%	1%
	Is there a discussion of how the audit committee considers auditor compensation?	1%	1%	0%
	Is there a discussion of how non-audit services may impact independence?	83%	69%	58%
Auditor evaluation/supervision	Is there a discussion of criteria considered when evaluating the audit firm?	8%	7%	15%
	Is there a disclosure of significant areas addressed with the auditor?	3%	2%	1%
Selection of audit partner	Is it stated that the engagement partner rotates every five years?	16%	3%	4%
	Is it explicitly stated that the audit committee is involved in selection of the audit engagement partner?	13%	1%	1%

*Note: Audit committee report percentages are not presented as most of the amounts are not meaningful, i.e. less than 5%. Proxy percentages reflect disclosures in the entire proxy, including the audit committee report. One category did have meaningful results in the audit committee report - a discussion of how non-audit services may impact independence (included in 46% of S&P 500, 44% of S&P MidCap, and 37% of S&P SmallCap audit committee reports).*



### *Example C - Selection of Audit Engagement Partner*

*"Pursuant to the five-year rotation requirement mandated by the Sarbanes-Oxley Act of 2002, [Independent Auditor]'s lead engagement partner rotated in 2014. The process for selecting the new lead audit partner involved an assessment of many factors, including the candidates' independence, objectivity, broad-based business judgment, multinational and industry experience, commitment to serving the Company, ability to leverage the resources of the firm and commitment to continuous improvement and robust dialogue with the Audit Committee. The selection process also involved discussions with management regarding each of the candidates and a meeting between the Audit Committee chair and the final candidate for the role."*

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*Source: Colgate-Palmolive Company (S&P 500), 2014 Audit Committee Report*

### *Example D - Non-Audit Services and Auditor Independence*

*"...The Audit Committee has pre-approval policies and procedures related to the provision of audit and non-audit services by the independent registered public accounting firm. Under these procedures, the Audit Committee pre-approves both the type of services to be provided by the independent registered public accounting firm and the estimated fees related to these services. During the pre-approval process, the Audit Committee considers the impact of the types of services and the related fees on the independence of the independent registered public accounting firm. The services and fees must be deemed compatible with the maintenance of the independence of the independent registered public accounting firm, including compliance with the SEC's rules and regulations.*

*The Audit Committee will, as necessary, consider and, if appropriate, pre-approve the provision of additional audit and non-audit services by the independent registered public accounting firm that were not encompassed by the Audit Committee's annual pre-approval and that are not prohibited by law. The Audit Committee has delegated to the Chair of the Audit Committee the authority to pre-approve, on a case-by-case basis, these additional audit and non-audit services, provided that the Chair shall promptly report any decisions to pre-approve such services to the Audit Committee."*

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*Source: Allele, Inc. (S&P SmallCap), 2014 Audit Committee Report*

## Audit Committee Scope of Duties

All audit committees of companies listed on the NYSE and NASDAQ must include their specific duties in their charters. Included within those duties should be a discussion of the audit committee's responsibility for risk oversight. The audit committee is not required to be the sole body responsible for risk assessment and management, but must discuss guidelines and policies to govern the process by which risk assessment and management is undertaken.<sup>10</sup>

NYSE listing rules require that public company audit committee charters be located on the company's website, and that listed companies also provide a link to the charter somewhere in their proxy.<sup>11</sup> Some companies provided a direct link to the charter in the proxy (5% of S&P 500 companies and 5% of S&P MidCap companies), while the majority linked to the company's overall website or a dedicated section of that website. Given the importance of increasing the public's understanding of the

role of the audit committee, the audit committee could ensure that its charter is easy to locate through a link and, where relevant, more disclosure in the audit committee report and/or other dedicated section of the proxy around key provisions of the charter.

Most companies in the S&P (93% of S&P 500, 94% of S&P MidCap, and 98% of S&P SmallCap) took the additional step of including some elements of their charter in the audit committee report or other section of the proxy.

Forty-four percent of S&P 500, 31% S&P MidCap and 43% of S&P SmallCap companies had at a minimum a brief, outlined explanation of the audit committee's duties in their audit committee reports. (See Example E)

Some companies also included other elements of their charter and information on the audit committee's shared risk oversight in their audit committee reports.

### *Example E - Audit Committee Explanation of Duties*

*"...The Audit and Finance Committee is responsible for assisting the Board of Directors in monitoring:*

- the integrity of the Corporation's financial statements;*
- the Corporation's compliance with legal and regulatory requirements;*
- the Corporation's independent auditor's qualifications and independence; and*
- the performance of the Corporation's independent auditor and the Corporation's internal audit function."*

*Source: DineEquity, Inc. (S&P SmallCap), 2014 Audit Committee Report*

<sup>10</sup> Refer to NYSE Rule 303A.07(b)(iii) [[http://nysemanual.nyse.com/LCMTools/PlatformViewer.asp?selectednode=chp\\_1\\_4\\_3\\_8&manual=%2Ffcm-sections%2Fsections%2Ffcm-sections%2F](http://nysemanual.nyse.com/LCMTools/PlatformViewer.asp?selectednode=chp_1_4_3_8&manual=%2Ffcm-sections%2Fsections%2Ffcm-sections%2F)] and NASDAQ Listing Rule IM-5605-3 [[http://nasdaq.cchwallstreet.com/NASDAQTools/PlatformViewer.asp?selectednode=chp\\_1\\_1\\_4\\_3\\_8\\_3&manual=%2Ffnasdaq%2Fmain%2Ffnasdaq-equityrules%2F](http://nasdaq.cchwallstreet.com/NASDAQTools/PlatformViewer.asp?selectednode=chp_1_1_4_3_8_3&manual=%2Ffnasdaq%2Fmain%2Ffnasdaq-equityrules%2F)]

<sup>11</sup> Refer to NYSE Rule 303A.07 (b) [[http://nysemanual.nyse.com/LCMTools/PlatformViewer.asp?selectednode=chp\\_1\\_4\\_3\\_8&manual=%2Ffcm-sections%2Ffcm-sections%2F](http://nysemanual.nyse.com/LCMTools/PlatformViewer.asp?selectednode=chp_1_4_3_8&manual=%2Ffcm-sections%2Ffcm-sections%2F)]

## **Conclusion**

The analysis performed for the Audit Committee Transparency Barometer provides baseline readings across the small-cap to large-cap spectrum of companies in the S&P Composite 1500, as they prepare for the upcoming proxy season. We, both at the CAQ and Audit Analytics, look forward to future readings of the barometer to gauge further enhancement in audit committee disclosures. We expect continued regulatory focus on improving these proxy disclosures will further support these efforts and encourage companies to look at these disclosures with a fresh perspective.



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