

September 28, 2012

EXECUTIVE DIRECTOR

Cynthia M. Fornelli

GOVERNING BOARD

Chairman

Robert E. Moritz, Chairman and Senior Partner
PricewaterhouseCoopers LLP

Vice Chair

Charles M. Allen, CEO
Crowe Horwath LLP

Vice Chair

Harvey J. Goldschmid, Dwight Professor of Law
Columbia University

Joe Adams, Managing Partner and CEO
McGladrey & Pullen, LLP

Stephen Chipman, CEO and Executive Partner
Grant Thornton LLP

Joe Echevarria, CEO
Deloitte LLP

Michele J. Hooper, President and CEO
The Directors' Council

Stephen R. Howe, Jr., Managing Partner
Ernst & Young LLP

Barry C. Melancon, President and CEO
AICPA

Lynn S. Paine, Professor of Business
Administration and Senior Associate Dean,
Director of Faculty Development
Harvard Business School

John B. Veihmeyer, U.S. Chairman and CEO
KPMG LLP

Jack Weisbaum, CEO
BDO USA, LLP

Fédération des Experts-comptables Européens - Federation of European Accountants

Avenue d'Auderghem, 22-28/8

B-1040 Brussels

Via secretariat@fee.be

Dear Sir or Madam:

The Center for Audit Quality (CAQ) is an autonomous 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 Certified Public Accountants (AICPA).

The CAQ appreciates the opportunity to respond to the Federation of European Accountants' (FEE) Discussion Paper on the Functioning of Audit Committees. This letter represents the observations of the CAQ, but not necessarily the views of any specific firm, individual, or CAQ Governing Board member. Our comments provide a U.S.-based perspective reflecting current legal requirements informed by insights on audit committee practices across U.S. publicly-traded companies.

Guiding Principles

Our perspective is shaped by the following guiding principles that we have found useful in assessing new or revised requirements in the United States relating to the functioning of audit committees; we believe they may be equally relevant in this context as well. Requirements should:

- Improve or at least maintain audit quality
- Support and enhance the role of the audit committee in meeting its important responsibility to protect the interests of shareholders in relation to a company's financial reporting and internal controls;
- Not impose a "one size fits all" approach to the multiplicity of company and board situations;
- Meet its objectives in a manner such that the costs do not exceed the benefits; and
- Take into consideration the implications for other major markets, given that consistency across jurisdictions is an important goal.

We understand the difficulties of aligning audit committee practices across Europe, where different jurisdictional requirements are layered on to European Union requirements, as we have a somewhat similar interplay between federal and state laws (common law) in the United States. Having said that, audit committees of U.S. publicly traded companies are subject to specific duties under the U.S. federal securities laws (most recently through the Sarbanes-Oxley Act of 2002) and stock exchange listing requirements. Among other things, audit committee members must be independent of management, as described below; and are directed to oversee the company's financial reporting process, hire and oversee the external auditor, monitor a whistleblower hotline and other complaints regarding the company's financial reporting, and report on certain of their activities in the company's annual proxy statement. How an audit committee implements these statutory requirements is largely guided by corporate governance provisions in exchange listing standards,¹ and best practices developed by the corporate director and public accounting communities.

Improving the Functioning of Audit Committees

The CAQ believes that the complexities of financial reporting require all boards of public interest entities to appoint a standing committee dedicated to overseeing the financial reporting process, including the control environment and the external audit. Accordingly, we strongly support FEE's view that strong audit committees are essential to the quality of financial information provided by companies. We also agree that audit committee effectiveness could be improved by clarifying the competencies required of individual audit committee members and the committee as a whole, as well as by more substantive delineation of the scope of their responsibilities in overseeing financial reporting processes at a company. We are particularly supportive of providing additional guidance around reporting practices by company management and internal and external auditors to audit committees, as well as by audit committees to their boards of directors and shareholders. We believe that such guidance should be consistent across global markets to the extent practicable and stand ready to support such efforts.

Composition, Independence and Competence of Audit Committee Members

The CAQ supports FEE's recommendations aimed at strengthening the composition, independence and competence of audit committee members. In the United States, all members of the audit committee of a public company must be "independent" of the company, its directors and controlling shareholders, a requirement that greatly adds to their ability to oversee the financial reporting processes of a company and the external auditor in an objective manner and free from undue pressure from management.² We therefore support efforts to encourage audit committees to be composed solely of independent board members to the extent practical, although we recognize that this may not be practical for all public interest entities.

With respect to competence, each U.S. publicly-traded company is required to disclose on an annual basis whether it has at least one "audit committee financial expert"³ serving on its audit committee, and if so, the

¹ See sections 303A.06-303A.07 of the NYSE Listed Company Manual and NASDAQ Listing Rules sections-- 5605-4 through - 6 on audit committees. SEC rule 10A-3 under the Securities Exchange Act, Standards Related to Listed Company Audit Committees, directed registered securities exchanges to adopt listing requirements that implement the Sarbanes-Oxley Act of 2002 requirements for audit committees.

² Independent board members should not receive compensation or funds from the company other than that related to their service as a board and committee member, although they are allowed to hold stock in the company.

³ SEC regulations define an audit committee financial expert as a person who has the following attributes: an understanding of generally accepted accounting principles and financial statements; the ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves; experience preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the registrant's financial statements, or experience actively supervising one or more persons engaged in such activities; an understanding of internal controls and procedures for financial reporting; and an understanding of audit committee functions. See 17 CFR §228.401 (Item 401).

name of the expert and whether the expert is independent as described above. A company that does not have such an expert must disclose this fact and explain why it has no such expert.⁴

The CAQ supports FEE's position that it is important for the committee as a whole to have a range of financial expertise, in addition to having business and other experience pertinent to the company. The CAQ recently recommended that U.S. audit committees have a member with *direct* financial accounting or auditing experience.⁵ The CAQ also recommended that *all* audit committee members should receive specific training on the financial statement audit and an overview of auditor independence, quality control and other applicable rules. In addition to emphasizing the need for having significant experience in matters within the remit of the audit committees, it is important to call for qualities such as professional judgment, objectivity, and high integrity as key competencies for audit committee members. One source of material on how "competence" could be defined is the non-exclusive list of competencies that must be present to be an audit committee financial expert contained in SEC regulations, which calls for experience in accounting, financial reporting and internal controls or other relevant experience.⁶ The financial expertise required by the SEC's regulations, including the examples for how such expertise may be gained, provide additional detail that could be used in guidance relative to the composition of audit committees.

Responsibilities of the Audit Committee

To enable audit committees to fulfill the duties delegated to it by the board of directors on behalf of shareholders, they should have a charter that clearly defines the audit committee's responsibilities, and grants the committee the authority to obtain outside advice and counsel as appropriate.

In connection with its responsibility for overseeing financial reporting, we support recommendations that audit committees have clear responsibility to help ensure that the company has an appropriately robust and effective system of internal controls over financial reporting, and processes around risk management more generally. In overseeing the external auditor, we believe the audit committee should evaluate the external auditor's performance throughout the engagement, culminating in a formal annual assessment of the auditor after completion of the audit, in connection with recommending whether the board engage the auditor in the coming year. The assessment should include the quality of the audit services and sufficiency of resources provided during the engagement; the quality of communications and interactions between the auditor and management and the audit committee, respectively; and the auditor's independence, objectivity and professional skepticism. Audit committees also should provide transparency about this assessment to shareholders, subject to confidentiality constraints discussed further below.

We also agree that it is appropriate for the internal audit function – like the external auditor – to have a direct reporting line to the audit committee on financial risk management issues in order to support the independence and objectivity of the internal audit function.

Reporting to and from the Audit Committee

Currently, communications between the audit committee and the external auditor are governed by auditing standards and supplemented by best practices developed by the audit committee and auditor communities. We support development of best practices for audit committees around their communications with management and with auditors on critical accounting policies, judgments and other matters that are relevant their oversight responsibilities. We note that the PCAOB recently adopted Auditing Standard No. 16, which updates

⁴ Section 407 of the Sarbanes-Oxley Act of 2002.

⁵ See Written Statement of Cindy Fornelli, Executive Director, CAQ, for PCAOB Open Meeting on Auditor Independence and Audit Firm Rotation (March 22, 2011).

<http://www.thecaq.org/resources/pdfs/CindyFornelliPCAOBMeetingStatement03222012.pdf>.

⁶ SEC amendments to Item 401 of Regulations S-K and S-B (January 23, 2003).

required auditor communications with audit committees.⁷ The standard, which is pending SEC approval, generally is aligned with FEE's recommendations.

The CAQ agrees that similar enhancements to communications between audit committees and management and internal audit could be made through additional guidance for those groups. Audit committees depend on management and the internal audit function to provide information that is timely, concise and comprehensive – and of a level of quality that leads to a free and open discussion of all relevant topics. We recognize the challenge of sharing sufficient information without causing information overload, which management, external and internal auditors, and audit committees must continuously balance in assuring that each is able to perform their duties fully and efficiently. The subject matters contained in FEE's recommendations would help to identify the critical information that should be discussed with the audit committee by management, internal auditors and external auditors.

Finally, we support greater transparency by audit committees, although we also are sensitive to the need for audit committees and boards of directors to maintain the confidentiality of certain information proprietary to the company. Thus, we support further exploration of what more audit committees might share with shareholders about their activities in overseeing the financial reporting process, about the statutory audit, or regarding its audit assessment and appointment process. This additional transparency would help to promote accountability across audit committees, inform other audit committees about emerging best practices, and improve stakeholder confidence in the important role of the audit committee more generally. Another area that could benefit from discussion and guidance is the appropriate role of audit committees and other committees of the board with respect to responding to communications and inquiries made directly to them from investors and other stakeholders.

Conclusion

Strong audit committees are essential to the quality of financial information provided by companies. The CAQ supports FEE's recommendations to strengthen the functioning of audit committees by clarifying the competencies required of individual audit committee members and the committee as a whole, as well as by more substantive articulation of the scope of their responsibilities in overseeing the financial reporting process. We are particularly supportive of providing additional guidance around reporting practices by audit committees to their boards of directors and to shareholders.

We appreciate the opportunity to comment on FEE's Discussion Paper on the Functioning of Audit Committees. Because of the important role audit committees play in supporting the integrity of financial reporting, the CAQ encourages consistency in the development of guidance for audit committees across global markets and stands ready to help support such efforts with the audit committee community in the United States.

Sincerely,



Cynthia M. Fornelli
Executive Director
Center for Audit Quality

⁷ http://pcaobus.org/Rules/Rulemaking/Docket030/Release_2012-004.pdf