SEC Concept Release on Audit Committee Disclosures: Summary & Considerations for Stakeholder Comment

OVERVIEW

THE PROPOSAL

On July 1, 2015, the Securities and Exchange Commission (SEC) published a concept release[1] seeking public comment on possible revisions to audit committee reporting requirements, with specific focus on the audit committee's oversight of the independent auditor. Under the Sarbanes-Oxley Act, the audit committee, independent of management, was made directly responsible for the appointment, compensation, and oversight of the independent external auditor.

WHY STAKEHOLDERS SHOULD COMMENT

According to the SEC, concept releases are preliminary steps used to "solicit the public's views…so that [the SEC] can better evaluate the need for future rulemaking." The SEC's next steps will be largely affected by the comments it receives on its concept release. Stakeholders interested in financial reporting, and the performance of audit committees and auditors are encouraged to comment. It is particularly critical that the SEC receives input from investors and the audit committee community, given their unique understanding of the usefulness and practicality of the ideas presented.

SUBMITTING A COMMENT

Content: It is not necessary for commenters to respond to any and/or all questions. Comment letters can be provided at a thematic level and/or focus only on the question(s) or topic(s) on which you have a point of view. The information below provides additional information on key areas and questions on which you may consider commenting.

Deadline: Comments are due on or before September 8; however, historically the SEC has accepted comments after the deadline, especially for concept releases.

How to submit comments:

- Use the SEC's Internet comment form: *http://www.sec.gov/rules/concept.shtml*
- Send an email to *rule-comments@sec.gov* with subject line "File Number S7-13-15"
- Follow the instructions on the Federal eRulemaking Portal: *http://www.regulations.gov*
- Mail paper comments to Secretary, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549-1090
- All submissions should refer to File Number S7-13-15

[1] *The release is available at http://www.sec.gov/rules/concept/2015/33-9862.pdf and contains 74 numbered questions with additional questions embedded in the majority of those, resulting in over 200 questions. See Appendix A for a complete list of the questions.*

Concept Release Summary

This release focuses primarily on the role of the audit committee with respect to overseeing the external auditor and seeks feedback on potential disclosures relating to the:

- **audit committee's oversight of the auditor**, including communications and meetings between the auditor and audit committee (on, for example, critical accounting policies and estimates), its review of PCAOB inspections, its assessment of the auditor's objectivity and skepticism, and the role of the audit committee in audit scope;

- **audit committee's process for appointing or retaining the auditor,** including how the audit committee assessed the auditor's performance, the request for proposal and selection process, shareholder ratification of the auditor, and the audit committee's role in compensation determinations;
- **qualifications of the audit firm and certain members of the engagement team** selected by the audit committee, including selection of the engagement partner as well as auditor tenure;
- **location of audit committee disclosures in SEC filings**, whether they should be included in the audit committee report, elsewhere in the proxy statement, annual report, or within the company website; and
- **applicability to smaller reporting companies and emerging growth companies**.

> **Comment Letter Consideration**: *Strong audit committees promote audit quality and foster an audit environment aligned with investor interests protected from undue management influence. How would additional disclosures help or hinder that objective?*

Why is the SEC Focusing on Audit Committee Disclosures?

SEC Chair White made disclosure part of her official platform early in her tenure (see her remarks from the October 15, 2013 Leadership Conference of the National Association of Corporate Directors, "The Path Forward on Disclosure"). The SEC's focus on audit committee disclosures can be appreciated in light of the essential role independent audit committees play in broadly overseeing the financial reporting process, including the work of the internal and external auditors. The annual audit committee report included in the proxy statement is the principal source of public audit committee-related information (other than the audit committee charter) and public disclosures are the primary channel through which audit committees educate investors and other stakeholders about their critical responsibilities and demonstrate effectiveness in executing those responsibilities.

> **Comment Letter Consideration**: *Do current audit committee disclosures provide sufficient information for investors to vote on the ratification of the auditor?*

The SEC's concept release states that the majority of audit committee disclosure rules date back to 1999. Since then there have been significant changes in the role and responsibilities of audit committees due to a number of factors including the Sarbanes-Oxley Act of 2002, and enhanced exchange listing requirements. Although the release's introduction notes the Commission's "long history of promoting effective and independent audit committees," it has been over a decade since it has officially considered what these changes have meant to the investing public. As such, the release posits that *"[s]ome have expressed a view that the Commission's disclosure rules for audit committees may not result in disclosures that are sufficient to help investors understand and evaluate audit committee performance, which may in turn inform those investors' investment or voting decisions."*

Scope of the Concept Release

The SEC's release acknowledges the multifaceted role the audit committee plays in overseeing the integrity of a company's accounting and financial reporting processes, and both internal and external audits. However, the release is primarily focused on one facet of responsibility: the audit committee's oversight of the external audit. To this point, the Commission is seeking feedback on the content and scope of audit committee disclosures.

> **Comment Letter Consideration***: Is the SEC's release focused on the types of disclosures most important for investors?*

For example, Question 6 asks, *"Should the audit committee provide disclosure of its work in other areas, for example, its oversight of the financial reporting process or the internal audit function?"* while Question 74 asks, *"Should the audit committee disclose its role, if any, in risk governance? Should the audit committee report on other areas of oversight? For example, audit committees may be charged with overseeing treatment of complaints, cyber risks, information technology risks, or other areas. Would this disclosure distract from the report's focus on oversight of the audit function? ...."*

Prescriptive vs. Principles-based Disclosure

Exploring a balance between prescriptive and principles-based disclosures as well as quantitative and qualitative disclosures that investors should have is an important part of this effort. Many questions ask about disclosing highly detailed information[2]. Avoiding unintended consequences is an important consideration. Very specific new disclosure requirements for all audit committees could potentially result in an undue focus on information that is not relevant to audit quality, a check-the-box mentality, and/or disclosure overload that buries meaningful information or otherwise results in boilerplate disclosure after a few iterations. The release acknowledges these possibilities, noting that some audit committee members view additional reporting *"as possibly contributing to a state of 'disclosure overload,'"* while others suggest the need for *"principles-based reporting to allow for flexibility and to avoid a 'one size fits all' approach."*

> **Comment Letter Consideration***: Because a core function of the audit committee is to stand in the shoes of investors, what is the best way to provide investors with critical information regarding its work, without chilling communication with the external auditor?*

The SEC solicits feedback regarding potential disclosures which, by their nature, get into the specific content and precise information that flows between the auditor and audit committee, as well as on the potential unintended consequences of such disclosures.

Voluntary vs. Mandatory Disclosure

Distinguishing which information is important for investors and others and therefore should be disclosed requires balancing of interests and priorities, and recognition that in many cases, one-size does not fit all. Given companies' unique differences, an overly prescriptive approach to required audit committee disclosures may not provide the flexibility needed to deliver the right information to investors and could discourage innovation in audit committee reporting. On the other hand, there may be certain disclosures or areas of disclosure that warrant common action by audit committees.

[2] *See Question 12 related to communications regarding how the auditor planned and performed the audit and other information required by PCAOB Auditing Standard 16, detailing standards related to required communications between the auditor and audit committee*

Comment Letter Consideration*: Would an SEC rulemaking deter innovation or voluntary audit committee disclosure?*

The release references several recent studies that note a growing trend among audit committees to voluntarily enhance their disclosures. Audit committees are likely choosing to enhance those disclosures they believe are most relevant to -- or in response to requests from -- investors. It is important when considering the right balance between mandatory and voluntary disclosures, to consider what effect mandated disclosures would have on this trend of enhanced voluntary disclosure, as well as what value investors derive from the current variance in disclosures.

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Historically, investor engagement around audit policies and issues has been fairly limited. However, it is important that SEC hear from investors, who are at the heart of the SEC's mission, regardless of their views on the release.

Audit committee members are also strongly encouraged to submit comments to the SEC as they continue to consider communication and engagement around the disclosure of the committee's key responsibilities and issues.