

Chapman *Insights*

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Should Audit Committees Voluntarily Step Up Their Game? Practical Considerations to Guide 2016 Audit Committee Disclosure Discussion

With the 2016 proxy season quickly approaching, reporting companies will begin contemplating the various disclosures they will make, both in response to regulatory requirements as well as voluntarily, in their proxy statements. Increasingly, audit committees in particular are being asked to voluntarily provide enhanced disclosure relating to how they perform their oversight duties and responsibilities. Certain institutional investors, regulatory authorities and corporate governance advocacy/industry groups, for example, have urged audit committees to make more meaningful disclosures. It is argued that greater transparency of an audit committee's oversight duties and responsibilities and relationship with external auditors may provide, among other benefits, more reliable financial reporting processes and a more independent audit environment, thus achieving increased investor confidence and greater alignment with shareholder interests.

This corporate governance update (1) highlights certain current issues and recent regulatory developments with respect to audit committees and corresponding disclosures, (2) summarizes the current audit committee disclosure policies and positions of several large asset managers and pension funds, and of certain other corporate governance advocates, to provide insight into the expectations of these entities with respect to such disclosures and (3) presents practical considerations for audit committees and boards to help facilitate discussion on audit committee disclosures.

The Audit Committee, Corporate Governance and Corresponding Disclosures

Duties and Responsibilities. As generally dictated by the Securities and Exchange Commission ("SEC"), national exchanges and best corporate governance practices, duties and responsibilities of the audit committee typically include assisting the board in fulfilling its responsibility for oversight of the (1) integrity of the company's financial statements, (2) qualifications, independence and performance of the company's independent auditors,

(3) performance of the company's internal audit function, (4) company's compliance with applicable legal and regulatory requirements and (5) quality and integrity of the accounting, auditing and reporting practices of the company.¹

Transparency, Disclosures and Regulatory Developments. Shareholders and other stakeholders are increasingly focusing on the activities and transparency of audit committees, particularly as those activities relate to enhanced audit quality through oversight of the independent external auditor. Greater transparency of audit committee duties and responsibilities may benefit stakeholders by providing those parties with a better understanding of how the committee oversees the external audit firm, performs its other duties and responsibilities and contributes to the overall corporate governance of the company. A survey of certain institutional investors revealed that such investors consider audit committee disclosures concerning selection and tenure of audit firms to be "very important" when voting on auditor ratification and audit committee members.²

Although SEC rules require the audit committee to make certain disclosures in the company's annual proxy statement, these disclosures, which have increasingly become boilerplate, are frequently being seen by stakeholders, including shareholders, as inadequate in that they do not provide appropriate insight into "how" the committee is fulfilling its duties and responsibilities.³ Highlighting the importance of audit committee disclosure responsibilities, the SEC's Chief Accountant recently encouraged audit committees to "set the tone for the organization – one that expects effective disclosure and robust judgments on preparing it. Empower management and embrace efforts to focus on disclosure effectiveness."⁴

In response to the call for enhanced audit committee disclosures, in July 2015 the SEC published a concept release seeking public comment on current audit

committee disclosure requirements, focusing on the committee's oversight of independent auditors and enhancing the information provided to investors about the audit committee's responsibilities and activities.⁵ In its release, the SEC acknowledged that some market participants have expressed concern that current SEC disclosure rules may not result in disclosures about audit committees and their activities that are sufficient to help investors understand and evaluate audit committee performance, which in turn may affect those investors' investment or proxy voting decisions (as the majority of these disclosure requirements that exist in their current form were adopted in 1999; since then, there have been significant changes in the role and responsibilities of audit committees arising out of, among other things, the Sarbanes-Oxley Act of 2002, enhanced listing requirements for audit committees, enhanced requirements for auditor communications with the audit committee arising out of the rules of the PCAOB and changes in best practices).⁶

In addition, in June 2015 the PCAOB issued a supplemental request for comment on proposed rules to require disclosures about the audit partner and certain other audit participants, including the name of the engagement partner on the current-year audit and the names, country locations of headquarters and extent of participation of other public accounting firms participating in the audit (above a 5% threshold based on total audit hours). Although it appears that the PCAOB envisions that such disclosures would appear in the auditor's report, some commenters have suggested that the audit committee report in the company's proxy statement might be a more appropriate place for such disclosures.⁷

Current Policies and Positions of Certain Institutional Investors and Other Corporate Governance Advocates as They Relate to Audit Committee Disclosure

There is no one-size-fits-all approach to corporate governance and audit committee duties and responsibilities and related disclosure. The unique characteristics of the company, the industry in which it operates and the adoption of corporate governance and disclosure policies the company and its board feel are essential to generate long-term shareholder value often influence, in part, audit committee disclosures. To provide insight into certain expectations relating to audit committee disclosures, a summary of the disclosure policies and positions of several large institutional investors and other corporate governance advocates is provided below.

Institutional Investors – Asset Managers:

- BlackRock, Inc. ("BlackRock"):
 - looks to the audit committee report for insight into the scope of the audit committee's responsibilities, including an overview of audit committee processes, issues on the audit committee's agenda and key decisions taken by the audit committee⁸
- State Street Global Advisors ("SSgA"):
 - supports the approval of auditors and auditor compensation, provided that the company has properly disclosed audit and non-audit fees relative to market practice and the audit fees are not deemed excessive (i.e., if the non-audit fees for the prior year constituted 50% or more of the total fees paid to the auditor)
 - supports the disclosure of auditor and consulting relationships when the same or related entities are conducting both activities⁹
- Allianz Global Investors ("Allianz"):
 - states that the main role and responsibilities of the audit committee and the process by which the audit committee reviews and monitors the independence of the external auditors should be disclosed and explained¹⁰

*Institutional Investors – Pension Funds:*¹¹

- California Public Employees' Retirement System ("CalPERS"):
 - believes that the audit committee should disclose (1) the content of audit committee discussions with external auditors, (2) an assessment of the independence and objectivity of the external auditor to assure the auditors and their staff have no financial, business, employment or family and other personal relationships with the company, (3) an assessment of the appropriateness of total fees charged by the auditors, (4) an assessment of non-audit services and fees charged, including limitations or restrictions tied to the provision of non-audit services, (5) an explanation of why non-audit services were provided by the auditor rather than by another party and how the auditor's independence has been safeguarded, (6) the rationale for recommending the

appointment, reappointment or removal of the external auditor, including information on tendering frequency, tenure and any contractual obligations that acted to restrict the choice of external auditors and (7) the auditor rotation period¹²

- California State Teachers' Retirement System ("CalSTRS"):
 - maintains that the audit committee should be governed by a formal, written charter stating its responsibilities and that there should be disclosure in the company's proxy statement stating that the audit committee has complied with the charter responsibilities¹³
- Florida State Board of Administration ("Florida SBA"):
 - asserts that audit committees should disclose, among other items, all factors considered when selecting or reappointing an audit firm, information related to negotiating auditor fees, the tenure of the current external audit firm and a description of how the audit committee oversees and evaluates the work of the external auditor¹⁴

Other Corporate Governance Advocates:

- Glass, Lewis & Co., LLC ("Glass Lewis") (in its capacity as a proxy advisory firm):
 - takes a "dim view" of audit committee reports that are boilerplate and that provide little or no information or transparency to investors
 - considers, in forming its judgment with respect to the audit committee, the transparency of the audit committee report, particularly when a problem such as a material weakness, a restatement or a late filing occurs¹⁵
- CII (advocating on behalf of shareholders):
 - believes that the audit committee report should disclose how the committee carries out its responsibilities, including (1) an explanation of how the committee carries out its auditor compensation responsibilities in consideration of audit quality objectives and (2) a fact-specific explanation for not changing the company's auditor if the committee chooses to renew the engagement of an auditor with more than 10 consecutive years of service or if the auditor is retained despite knowledge of substantive
- deficiencies identified during the committee's audit review
 - notes that the proxy statement should include a copy of the audit committee charter and a statement by the audit committee that it has complied with the duties outlined in the charter
 - suggests that audit committee charters should mandate that if the board's selection of external auditor fails to achieve the support of a majority of the "for" and "against" votes cast, the audit committee should (1) take the shareholders' views into consideration and reconsider its choice of auditor and (2) solicit the views of major shareholders to determine why broad levels of shareholder support were not achieved¹⁶
- The Business Roundtable ("BRT") (advocating on behalf of management):
 - states that mandating additional disclosure requirements related to the audit committee's oversight (including aiding in selecting, overseeing and communicating with the independent auditor) would not prove productive or provide investors material information
 - argues that over the past several years many public companies and their audit committees have voluntarily expanded their audit committee-related disclosures to provide investors additional insight into the multifaceted work of the audit committee, and that this evolving trend should be given time to develop, particularly as voluntary disclosures are more likely to result in material, tailored information being provided to investors and other stakeholders, as compared to disclosures that result from one-size-fits-all mandated requirements¹⁷
- Society of Corporate Secretaries & Governance Professionals ("SCSGP") (advocating on behalf of corporate governance professionals):
 - advocates, among other related positions, that (1) current SEC and exchange listing disclosure requirements sufficiently convey that audit committees are having appropriate and relevant communications with the independent auditor, (2) mandatory disclosure of the substance of communications between an audit committee and the independent auditor could have detrimental consequences, (3) mandatory

disclosure of whether and how an audit committee assesses, promotes and reinforces the independent auditor’s objectivity and professional skepticism is likely to be vague and unhelpful to investors, (4) any mandatory disclosure requirements relating to auditor selection or retention should be principles-based to accommodate company-specific facts and circumstances and should focus on a description of the material factors considered rather than a discussion of the analysis of those factors, (5) mandatory disclosure of the audit engagement partner and other members of the audit engagement team is not likely to be useful to investors and may in fact be misleading and impose additional burdens and costs on companies and (6) mandatory disclosure of auditor tenure could misleadingly imply SEC acceptance of an otherwise unproven correlation between auditor tenure and audit quality¹⁸

ensure that all regulatory disclosure requirements are satisfied. In light of the evolving regulatory landscape, committees should monitor any new disclosure requirements in addition to the development of disclosure best practices, including, to the extent applicable, those relating to oversight of risk and external auditors, and how the committee executes its responsibilities.

- **Voluntarily Increase Audit Committee Disclosure.** Companies are increasingly voluntarily enhancing disclosure relating to the audit committee’s duties and responsibilities, particularly with respect to the committee’s oversight of the company’s external auditor and how the committee executes its responsibilities. Although impending SEC and PCAOB regulatory actions may require enhanced audit report and/or audit committee-related disclosures, companies should consider whether such voluntary disclosures might now benefit their shareholders and other stakeholders. Recent findings from the review of 2015 proxy statements of Fortune 100 companies revealed that more than half of those companies voluntarily disclosed, among other items, that the audit committee considers non-audit fees/services when assessing auditor independence and believes that its selection of external auditor is in the best interests of the company and its shareholders, and the length of the external auditor tenure.¹⁹

Considerations for Audit Committees and Boards

To facilitate discussion among audit committee and other board members on ways that the audit committee may voluntarily increase disclosures and thereby potentially contribute to more effective corporate governance, directors may consider the following:

- **Ensure Required Disclosures Are Adequate.** Audit committees should conduct an annual review of their proxy statement report and other disclosures to

Voluntarily enhancing audit committee proxy statement disclosures may:

Pros	Cons
<ul style="list-style-type: none"> ▪ improve transparency and lead to increased investor and other stakeholder confidence in the company and the committee ▪ improve audit quality by increasing the accountability of the committee (as supported by recent academic research)²⁰ ▪ provide the committee with greater leverage over management and thus, more conservative financial reporting and improved audit quality ▪ provide investors with the ability to more effectively benchmark one committee’s practices against another’s²¹ ▪ align the committee with emerging best corporate governance practices (voluntary disclosures, however, should only be made to the extent that the committee determines that the benefits exceed the costs/risks of such additional disclosures) 	<ul style="list-style-type: none"> ▪ be resource intensive (e.g., determining exactly what and how to disclose) ▪ decrease audit quality by focusing the committee on reporting rather than actual oversight duties ▪ hinder candid discussions by management with the committee ▪ establish an undesired disclosure precedent (e.g., once information is voluntarily disclosed, a committee may feel compelled to continue to disclose it or risk raising potential red flags with, and enhanced scrutiny by, stakeholders and proxy advisory firms) ▪ inspire meritless litigation attributable to the additional disclosure ▪ draw unnecessary or unwanted attention to the committee, the board and the company and create public relations concerns

- **Benchmark Peer Disclosures.** Companies should determine and continue to monitor whether their audit committee disclosures are aligned with peer companies and the industry in which they operate (as an outlier may become the target of activist shareholder campaigns or be identified by institutional investors as an entity with potentially problematic financial reporting practices). Audit committees should review applicable 2015 peer proxy disclosures to assist with benchmarking disclosure practices and determine what, if any, enhanced audit committee disclosures they should make in their 2016 proxy statement. Emerging best practices suggest that benchmarking may assist an audit committee with evaluating how effectively its own disclosures (1) clarify the scope of the audit committee's duties, (2) clearly define the audit committee's composition and (3) provide relevant information about (a) factors considered when selecting or reappointing an audit firm, (b) selection of the lead audit engagement partner, (c) factors considered when determining auditor compensation, (d) how the committee oversees the external auditor and (e) the evaluation of the external auditor.²²
- **Review Audit Committee Charter.** Although many may consider the proxy statement audit committee report as the primary disclosure medium for the committee, the audit committee charter is another medium for such disclosure. Accordingly, the audit committee, as part of the periodic evaluation of its charter, should assess it with the view of how the committee might be able to enhance the charter to provide greater transparency to stakeholders of its oversight duties and responsibilities and how they are executed. Further, ongoing regulatory actions continue to increase the duties and responsibilities of the audit committee, including those relating to the internal audit, the external auditor and disclosure obligations. It is essential, therefore, that audit committee charters accurately delineate such duties and responsibilities. Audit committees often use their

charters as a checklist to make sure that they are fulfilling certain fiduciary duties. Robust formal charter review and amendment processes will ensure that the audit committee charter remains relevant to the company's and board's needs, reflects regulatory requirements and incorporates governance best practices. Full board approval should be required to make any charter amendment.

How Chapman Can Help

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1 See, for example, SEC Regulation S-K, Item 407(d) (Audit Committee) and the listing requirements set forth in New York Stock Exchange Listed Company Manual Section 303A.06 (Audit Committee) and Section 303A.07 (Audit Committee Additional Requirements), and Nasdaq Stock Market Listing Rule 5605(c) (Audit Committee Requirements) (which regulatory requirements set forth rules regarding, among other things, audit committee (i) composition, (ii) duties, responsibilities and authority and (iii) charter requirements).

2 A majority of the surveyed investors identify disclosures of (i) the relevant factors the audit committee considers when selecting or reappointing an audit firm and (ii) the tenure of the current audit firm, as "very important" factors in making informed voting decisions on auditor ratification and the reelection of audit committee members. *2014-2015 Policy Survey Summary of Results*, Institutional Shareholder Services Inc. ("ISS") (September 2014).

- 3 For example, Regulation S-K, Item 407(d)(3) generally requires that the audit committee provide proxy disclosure of whether it has (i) reviewed and discussed the audited financial statements with management, (ii) discussed with the independent auditors the matters required to be discussed by Public Company Accounting Oversight Board ("PCAOB") rules regarding certain communications by the independent auditors with the audit committee, (iii) received the written disclosures from the independent auditors required by the PCAOB concerning the auditors' independence and (iv) based on the review and discussions referred to in (i) through (iii), recommended to the board of directors that the audited financial statements be included in the company's Form 10-K.
- 4 *Remarks Before the UCI Audit Committee Summit*, James Schnurr, SEC Chief Accountant (October 23, 2015).
- 5 *Possible Revisions to Audit Committee Disclosures*, SEC Release No. 33-9862 File No. S7-13-15 (July 1, 2015). Potential changes to audit committee disclosures, as outlined in the release, focus on the:
- (i) audit committee's oversight of the external auditor – including (a) additional information regarding the communications between the committee and the auditor, (b) the frequency with which the committee met with the auditor, (c) review of and discussion about the auditor's internal quality review and most recent PCAOB inspection report and (d) whether and how the committee assesses, promotes and reinforces the auditor's objectivity and professional skepticism;
 - (ii) audit committee's process for appointing or retaining the external auditor – including (a) how the committee assessed the auditor, such as the auditor's independence, objectivity and audit quality, and the committee's rationale for selecting or retaining the auditor, (b) if the committee sought requests for proposals for the independent audit, the process the committee undertook to seek such proposals and the factors it considered in selecting the auditor, and (c) the board's policy, if any, for an annual shareholder vote on the selection of the auditor and the committee's consideration of the voting results in its evaluation and selection of the audit firm; and
 - (iii) qualifications of the audit firm and certain members of the engagement team selected by the audit committee – including (a) disclosures of certain individuals on the engagement team, (b) committee input in selecting the engagement partner, (c) the number of years the auditor has audited the company and (d) other firms involved in the audit.
- The public comment period for this release ended on September 8, 2015. As of the date of this publication, the SEC had not taken any subsequent related action.
- 6 *Id.* See Regulation S-K, Item 407(d)(3) (regarding certain audit committee disclosures currently required by the SEC), *supra* note 3. See also *Audit Committee Disclosure*, SEC Release No. 34-42266 File No. S7-22-99 (December 22, 1999) (amending Item 7 of Schedule 14A to require audit committee proxy disclosure, among other items, of (i) whether the company's board of directors has adopted a written charter for the committee, (ii) whether the committee members are independent (as independence for audit committee members is defined in the listing standards applicable to the company), (iii) the identification of each committee member, (iv) the number of committee meetings held during the last fiscal year and (v) a brief description of the functions performed by the committee).
- 7 *Supplemental Request for Comment: Rules to Require Disclosure of Certain Audit Participants on a New PCAOB Form*, PCAOB Release No. 2015-004 (June 30, 2015). The public comment period on this supplemental request ended on August 31, 2015. As of the date of this publication, the PCAOB has not taken any subsequent related action.
- 8 *Proxy Voting Guidelines for U.S. Securities*, BlackRock (February 2015).
- 9 *Proxy Voting and Engagement Guidelines – United States*, SSgA (March 2015).
- 10 *Corporate Governance Guidelines and Proxy Voting Policy*, Allianz (2015).
- 11 Our research revealed that many large public pension funds, similar to other institutional investors, do not publicly disclose a formal position on audit committee disclosures. The United Brotherhood of Carpenters and Joiners of America ("UBC"), however, has taken a public stance and urges companies to improve auditor independence disclosures in their proxy statements by disclosing the following: (i) the year in which the audit firm was first retained, (ii) that the audit committee is responsible for the audit fee negotiations associated with the audit firm, (iii) that the audit committee periodically considers whether there should be a regular rotation of the independent external audit firm, (iv) that the audit committee and its chairperson are directly involved in the selection of the audit firm's new lead engagement partner at the time of mandated rotation and (v) that the members of the board and its audit committee believe that the continued retention of the audit firm to serve as the company's independent external auditor is in the best interests of the company and its investors. The UBC believes these disclosures are important "for shareholders to have when they are determining if any conflicts of interest exist" and if companies continue to resist providing this information, shareholders should begin to vote "against" auditor ratification or the audit committee chair. The UBC has also been active in the shareholder proposal process as it has been reported that during the 2014 and 2015 proxy seasons, UBC submitted proposals asking 95 and 91 Fortune 500 companies, respectively, to include the aforementioned disclosures in their proxy statements. *Carpenter Funds' 2014 Proxy Season Report*, UBC (2015). See also *Carpenters' Fund Continues to Make Progress on Auditor Disclosure*, Council of Institutional Investors ("CII"), Rosemary Lally (July 16, 2015).
- 12 *Global Governance Principles*, CalPERS (March 16, 2015).
- 13 *Corporate Governance Principles*, CalSTRS (April 3, 2015).

- 14 *2015 Corporate Governance & Proxy Voting Guidelines*, Florida SBA (2015).
- 15 *Proxy Paper Guidelines 2016 Proxy Season: An Overview of the Glass Lewis Approach to Proxy Advice (United States)*, Glass Lewis (November 2015). Notably, our research revealed that ISS, another proxy advisory firm, does not publicly disclose a formal position specifically addressing audit committee disclosures.
- 16 *Corporate Governance Policies*, CII (April 1, 2015).
- 17 Letter to the SEC in response to the SEC's Concept Release on Possible Revisions to Audit Committee Disclosures, BRT (September 8, 2015).
- 18 Letter to the SEC in response to the SEC's Concept Release on Possible Revisions to Audit Committee Disclosures, SCSGP (September 8, 2015).
- 19 *Audit Committee Reporting to Shareholders in 2015*, EY (2015).
- 20 See *Impact of Auditor and Audit Committee Report Changes on Audit Quality and Costs: Evidence from the United Kingdom*, Lauren C. Reid, Joseph V. Carcello, Chan Li and Terry L. Neal, (August 17, 2015) (finding, among other things, that new auditor and audit committee reporting requirements in the U.K. are associated with a "significant improvement in audit quality without detecting a significant incremental cost").
- 21 Such benchmarking may provide assurances about the company's use of one auditor over another and the quality of the financial audit processes and thus, the overall quality of the company's financial statements.
- 22 *Enhancing the Audit Committee Report – A Call to Action*, Audit Committee Collaboration (November 2013).

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