

SEC Ponders Expanding Audit Committee Disclosure

July 10, 2015

On July 1, the SEC issued a **concept release**, a forerunner to a potential rulemaking proposal, seeking public comment on whether to expand disclosure requirements about audit committees. The primary focus of the concept release is on the audit committee's responsibilities for oversight of the independent auditor. However, the SEC has invited public comment on other aspects of the audit committee's role beyond those involving the auditor, such as its oversight of financial reporting, internal controls and risk.

As the concept release notes, despite the vital role audit committees play, disclosure requirements relating to audit committees (principally contained in Item 407 of Regulation S-K) have not changed much since they were adopted in 1999. Since then, the Sarbanes-Oxley Act of 2002 and enhanced stock exchange listing standards related to audit committees have significantly strengthened the role of the audit committee, but the SEC questions whether the disclosure regime has kept pace with these changes.

The stated purpose of the concept release is to help the SEC determine whether additional disclosure about the audit committee would be useful to investors as they evaluate the audit committee's performance in connection with voting and investment decisions. If it chooses to move ahead with rulemaking, the SEC will undoubtedly draw heavily on comments it receives from the public in response to the concept release. Based on materials cited by the SEC, we expect the SEC to receive comments urging it to adopt broader disclosure requirements from institutional shareholders and their industry groups, as well as from representatives of accounting firms and director associations. As a result, companies and audit committees concerned about proliferating SEC disclosure obligations may wish to register their views at this preliminary stage, rather than wait for a rulemaking proposal. And as we have seen of late with the increased focus on the compensation committee, if new audit committee disclosure is required, companies may wonder which committee's disclosure will be scrutinized next. (After all, wouldn't investors be able to use more information on how the compensation committee operates in order to inform say-on-pay votes?)

We anticipate that any changes to the SEC's regulatory approach with respect to audit committee disclosures will take some time to develop, propose for comment and implement. In the meanwhile, companies may wish to consider the main issues raised in the concept release and weigh the merits of submitting comment letters. The comment period for the concept release ends on September 8, 2015.

Background

The concept release comes amid renewed focus on audit committees and how they exercise their oversight responsibilities, and what the SEC hypothesizes may be growing investor interest in expanded audit committee reporting. The SEC believes audit committee disclosures have been receiving significant attention from a variety of stakeholders, including U.S. and non-U.S. regulators, governance advocates and policy organizations, who have been calling on audit committees to provide greater transparency about their work, particularly as it relates to enhancing audit quality through oversight of the independent auditor.

This has borne out in heightened focus on audit committee disclosure in recent proxy seasons, and the SEC notes voluntary reporting in large-company proxy statements beyond the mandated audit committee disclosure. The SEC poses the question whether expanded voluntary disclosures might be indicative of market demand for such information, although the SEC concedes that it does not know the reason for what it sees as a trend, and further notes that these additional disclosures vary among companies.

The PCAOB has pending proposals that would require disclosure of the name of the audit engagement partner and of the length of an auditor's tenure. Other pending PCAOB proposals include new auditing standards that, if adopted, would significantly expand the scope of the audit and the auditor's responsibilities, which we previously discussed [here](#).

Request for Comments

The SEC's goal is to give investors useful information for making investment decisions, but as the nature and amount of information that investors want is not always clear to the SEC, the concept release solicits public comment on a wide variety of potential additional audit committee disclosure requirements. At the outset, the SEC questions whether changes are needed to better inform investors, and whether additional or different audit committee reporting requirements would actually be useful. Some of the proposed disclosures are complex and, if adopted as mandates, may result in audit committees and auditors changing the nature of their interactions – as many companies will recall happening when the SEC adopted more stringent independence rules in 2003. The SEC acknowledges that there may be follow-on implications to expanded disclosure requirements, and it asks about challenges audit committees may face if it expands their disclosure obligations.

The potential new disclosures are categorized into three broad areas, which focus on the audit committee's oversight of the auditor; the audit committee's process for selecting the auditor; and the audit committee's consideration of the auditor's qualifications, as outlined below.

Audit Committee's Oversight of the Auditor

Communications Between the Audit Committee and the Auditor

Current rules state that companies must disclose whether certain communications required by AU § 380 (superseded by AS 16) occurred between the audit committee and the auditor. The SEC is considering requiring additional disclosures about such communications:

- qualitative disclosures about the nature and timing of the required communications between the audit committee and the auditor, such as whether and when the required communications occurred and the audit committee's consideration of the matters discussed;
- communications with the auditor related to “the auditor's overall audit strategy, timing, significant risks identified, nature and extent of specialized skill used in the audit, planned use of other independent public accounting firms or other persons, planned use of internal audit, basis for determining that the auditor can serve as principal auditor, and results of the audit, among others, and how the audit committee considered these items in its oversight of the independent auditor”;
- *all* communications required by SEC rules and PCAOB standards;
- the nature or substance of the required communications between the audit committee and the auditor; and
- how the audit committee dealt with disagreements between company management and the auditor.

The broad scope of these potential requirements may concern companies given that they would mandate disclosure not only of the details of how often the auditor and audit committee spoke, but also precisely which topics were covered, including sensitive matters such as disagreements between management and the auditor. The SEC asks whether these potential disclosures could chill or overly formalize audit committee communications with auditors, or reveal proprietary information about the company – we think the answer to the SEC's question is clear.

Meetings Between the Audit Committee and the Auditor

While the number of audit committee meetings is already required to be disclosed, new SEC rules could require disclosure regarding specific meetings with the auditor, including the frequency of the audit committee's private sessions with the auditor and the topics discussed, as the SEC believes such information may provide additional insight into the audit committee's oversight of the auditor. Of course, detailed information about the number of contacts between the audit committee and the auditor could reveal far more, or at least raise far more questions, than how the audit committee exercises its oversight function.

Internal Quality Review and PCAOB Inspection Reports

NYSE rules require audit committees to obtain a report from the auditor describing the auditor's internal quality-control procedures and any material issues raised by the auditor's most recent quality-control review. PCAOB inspection reports are by law not public, but the PCAOB has in the past provided audit committees with guidance on the types of questions they should be asking their auditors about those reports. Required disclosures relating to these reports could include:

- whether discussion occurred about the auditor's internal quality review and most recent PCAOB inspection report; and
- the nature of any discussions with the auditor about the results of the auditor's internal quality review and most recent PCAOB inspection.

In asking whether to expand disclosures around PCAOB reports, the SEC appears aware of the risk that additional disclosure requirements could undermine the reports' confidentiality.

Auditor's Objectivity and Professional Skepticism

The SEC states conclusively that heightened oversight by the audit committee of the auditor's objectivity and professional skepticism would promote greater audit quality and requests comment with respect to the following potential disclosures:

- whether, and if so how, the audit committee assesses, promotes and reinforces the auditor's objectivity and professional skepticism; and
- the results of the evaluation of the auditor's objectivity and professional skepticism.

While the SEC's premise may be correct, it is unclear what kind of information an audit committee could provide to demonstrate that it is evaluating the auditor in this respect.

Audit Committee's Process for Selecting the Auditor

Audit Committee's Assessment of the Auditor

Noting that disclosure about the audit committee's process and criteria for assessing the auditor could provide transparency into its oversight of the auditor, the SEC requests comment on the following potential disclosures relating to the audit committee's evaluation of the performance and qualifications of the auditor:

- the steps involved in the process to assess the auditor;
- the specific elements or criteria the audit committee considered during the process (such as whether non-audit services were taken into account);
- the nature of the audit committee's involvement in evaluating and approving the auditor's compensation; and

- the use and consideration of “audit quality indicators” (published metrics and criteria to assess audit quality), to the extent used by the audit committee to assess the quality of the auditor and the audit.

Requests for Proposals for the Audit

The SEC asks whether the following disclosures concerning any RFPs relating to the audit would be useful to investors:

- the process undertaken by the audit committee;
- the number of auditors asked to make a proposal;
- information on how those auditors were selected; and
- what information the audit committee used in reaching a decision about which auditor to select for the upcoming audit.

Board Policy for Shareholder Auditor Ratification

Perhaps because one goal of the concept release is to help investors cast informed votes, the concept release focuses on the voluntary proxy ballot item of auditor ratification. Many companies already state in the proxy statement that the board or the audit committee believes that providing shareholders with a vote on the matter is a good practice, but the concept release asks questions around whether formal policies are available, which we suspect would lead to pressure to adopt such policies. Potential required disclosures in this regard include:

- the board of directors’ policy (if any) for soliciting annual shareholder ratification of the selection of the auditor;
- the factors the board considered in establishing the policy; and
- the audit committee’s consideration of the voting results in its selection process, including situations where the audit firm fails to achieve majority support.

The concept release also asks whether shareholder ratification of the auditor should continue to be considered a “routine” proxy proposal allowing for broker discretionary voting. Presumably the SEC is aware of the difficulty some companies would have achieving a quorum for the annual meeting if it changed its position on this issue.

Qualifications of the Audit Firm and Engagement Team

In obtaining more information about the audit committee’s oversight of the auditor, the concept release drills down to the individuals on the audit team – not only to their names, but also essentially to their resumes. This could lead to criticism of the audit committee if it is not immediately apparent that the professional background of the audit team aligns with the company’s business, such as experience in a particular industry, or if the audit team includes younger and therefore less experienced members – which in turn could reverberate through an audit firm’s employee hiring and promotion practices.

Engagement Team Members

New SEC rules could require disclosure regarding:

- the name of the engagement partner;
- the names of other key members of the audit engagement team (such as the engagement quality reviewer);
- the length of time they have served in their roles;

- any relevant experience (such as the number of prior audit engagements performed and whether they were in the same industry) and professional licenses; and
- if the individuals disclosed will be changing for the next audit.

The concept release asks whether identification of the engagement partner would be more appropriate in the audit report or in a separate filing with the PCAOB rather than in the audit committee report or elsewhere in the proxy. The concept release also asks whether, if the name of the engagement partner is disclosed in the audit report or in a supplemental filing with the PCAOB, it should also be reported as part of the audit committee's disclosures. The concept release further asks whether there are any liability implications (for engagement partners, audit committee members, issuers or other participants) for disclosure of participants in the audit, and whether the implications change based on where or how the disclosure is made.¹

Audit Committee Input in Selecting the Engagement Partner

The SEC asks whether the following disclosures would provide transparency and insight into the audit committee's oversight of the auditor:

- whether the audit committee participated in the selection of the engagement partner; and
- any input the audit committee had in the assignment of the engagement partner.

Auditor Tenure

Observing that the duration of the auditor's tenure may be a relevant consideration to the audit committee's determination whether to retain the auditor, and citing perceived recent public interest in the influence of auditor tenure over audit quality, the SEC seeks comment on the following proposed disclosures:

- the length of the audit relationship;
- whether, and if so how, auditor tenure was considered by the audit committee in retaining the auditor; and
- how tenure was considered in evaluating the auditor's independence and objectivity.

The concept release asks whether disclosure of auditor tenure would be more appropriate in the audit report or in a separate filing with the PCAOB rather than in the audit committee report.²

Other Audit Firms

Current rules require the auditor to communicate to the audit committee the names, locations and responsibilities of any other independent public accounting firms or other third parties that perform audit

¹ In its latest proposal, released June 30, 2015 in a supplemental request for comment, the PCAOB would require disclosure of the name of the engagement partner and information about certain other participants in the audit on a new PCAOB form rather than in the audit report, as had been previously proposed; the form would be filed on the PCAOB's website and would be available in a searchable database. The PCAOB has characterized the new proposal as a compromise approach aimed at alleviating the industry's concerns regarding the liability risks associated with disclosure of this information in the audit report. Some critics of the previous proposal expressed the concern, for example, that disclosure of this information in the audit report might lead to individuals being deemed "experts" for liability purposes under Section 11 of the Securities Act.

² As noted in the concept release, some commenters have objected to disclosure of the auditor's tenure and of the name of the engagement partner in the audit report, suggesting that these disclosures are more relevant to the audit committee's statutory oversight responsibilities relative to the auditor and to shareholder ratification of the auditor and thus are more properly made by the issuer in the audit committee report or proxy statement. If so, they would fall outside the PCAOB's jurisdiction.

procedures in the current audit period; however, the audit committee is not required to disclose any communications it may have had with the auditor about such other firms. Potential new disclosures with respect to additional audit firms could include:

- the names of the other firms and persons involved in the audit (such as tax advisors or actuaries); and
- the extent of their involvement in the audit.

Location of Audit Committee Disclosures in SEC Filings

The concept release asks whether the audit committee report and other current and potential audit committee disclosures should be included in registration statements and prospectuses in registered offerings (to the extent they are not otherwise incorporated by reference), as the SEC believes these disclosures may inform investors' investment decisions.

Other Questions

In addition to the areas for comment discussed above, the concept release seeks input on other aspects of the audit committee's role beyond those involving the auditor, such as its oversight of the accounting and financial reporting process, internal audits, risk management, complaint reporting procedures, cybersecurity and information technology risk. In essence, it shifts the focus from the auditor to an assessment of how the audit committee is performing, in which case it is unclear why the audit committee is being singled out among the board.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Alan F. Denenberg	650 752 2004	alan.denenberg@davispolk.com
Joseph A. Hall	212 450 4565	joseph.hall@davispolk.com
Michael Kaplan	212 450 4111	michael.kaplan@davispolk.com
Thomas J. Reid	212 450 4233	tom.reid@davispolk.com
Richard J. Sandler	212 450 4224	richard.sandler@davispolk.com
Richard D. Truesdell, Jr.	212 450 4674	richard.truesdell@davispolk.com
Ning Chiu	212 450 4908	ning.chiu@davispolk.com
Michele Luburich	212 450 4172	michele.luburich@davispolk.com

© 2015 Davis Polk & Wardwell LLP | 450 Lexington Avenue | New York, NY 10017

This communication, which we believe may be of interest to our clients and friends of the firm, is for general information only. It is not a full analysis of the matters presented and should not be relied upon as legal advice. This may be considered attorney advertising in some jurisdictions. Please refer to the firm's [privacy policy](#) for further details.