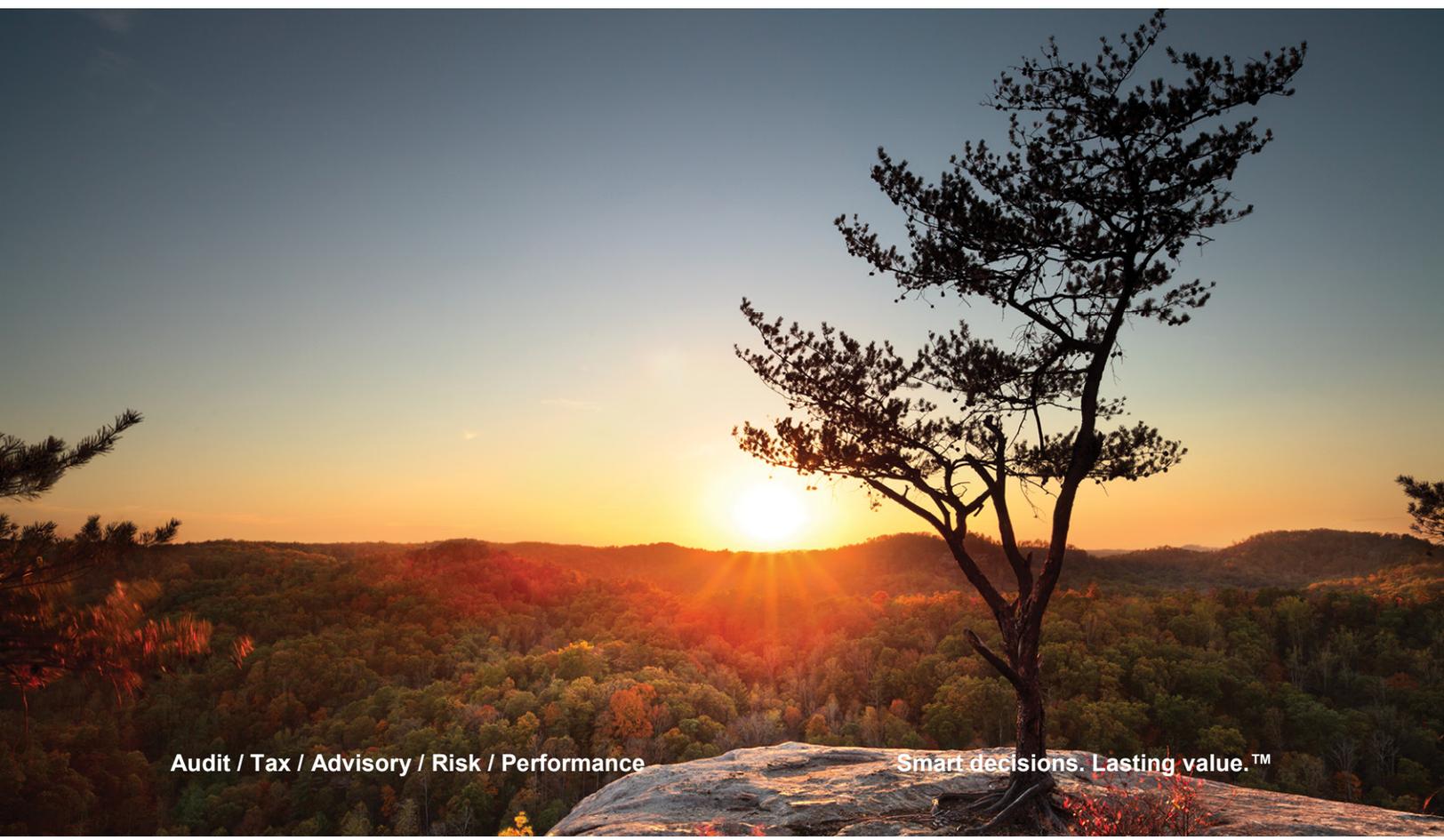




# Corporate Governance for Public Companies: The Audit Committee





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## Corporate governance

Benefits of good corporate governance include better risk management and reassured stakeholders. Corporate governance includes the structure of the board of directors, such as the number of independent directors and the audit committee. Both of the national exchanges – the New York Stock Exchange (NYSE) and the Nasdaq – require that the majority of the board members must be independent directors.<sup>1</sup> The listing requirements of those exchanges<sup>2</sup> address the role, authority, and qualifications of the board and committees of board directors beyond those discussed in this section.<sup>3</sup> Many other considerations for establishing good corporate governance exist that attempt to align the interests of the company and its stakeholders.

## The audit committee

Typically, the board of directors establishes the audit committee through a formal resolution. The audit committee's role is specified in a written charter,<sup>4</sup> which should provide the committee with sufficient flexibility to perform its duties and responsibilities as determined by the board. At a minimum, the charter should include a discussion of the audit committee's structure, membership, activities, and reporting requirements. Following are some common structural considerations.

### Audit committee size

Although the size of the audit committee should be determined by a company's specific needs and the listing requirements of the exchange, three to five members is a standard size. A minimum of three audit committee members is required by both the NYSE and the Nasdaq.<sup>5</sup> The exchanges also require that all audit committee members of listed companies are independent directors.<sup>6</sup>

### Audit committee members

The audit committee members should be selected by the board of directors. When selecting audit committee members, the board should consider an individual's capacity to serve productively as an audit committee member including his or her:

- Broad business experience
- Knowledge of the company's operations
- Familiarity with U.S. Securities and Exchange Commission (SEC) rules and regulations, generally accepted accounting principles (e.g., U.S. GAAP or International Financial Reporting Standards (IFRS)), and Public Company Accounting Oversight Board (PCAOB) standards
- Facility in obtaining information by inquiry
- Commitment and available time
- Independence

<sup>1</sup> Refer to NYSE Listed Company Manual Section 303A.01 and Nasdaq Stock Market Rules 5605(b)(1).

<sup>2</sup> The NYSE Listed Company Manual is available at <http://nysemanual.nyse.com/lcm/>, and the Nasdaq Stock Market Rules can be found at <http://nasdaq.cchwallstreet.com/NASDAQ/Main/>.

<sup>3</sup> Refer to NYSE Listed Company Manual Section 303A and Nasdaq Stock Market Rules 5605.

<sup>4</sup> Refer to NYSE Listed Company Manual Section 303A.07(b) and Nasdaq Stock Market Rules IM 5605-3.

<sup>5</sup> Refer to NYSE Listed Company Manual Section 303A.07(a) and Nasdaq Stock Market Rules 5605(c)(2).

<sup>6</sup> Refer to NYSE Listed Company Manual Section 303A.07(a) and Nasdaq Stock Market Rules 5605(c)(2).

A company is not required by the SEC to have a financial expert (as defined in Item 407(d) of [Regulation S-K](#)) sit on the committee, but it is required to disclose whether a financial expert serves on the audit committee (see same Item 407(d) of Regulation S-K). The exchanges require at least one member of the audit committee to have a certain level of financial sophistication or expertise as defined by the separate exchange rules.<sup>7</sup> Due to the long-term nature of the audit committee's activities, membership continuity also is a consideration. Reappointments and membership terms that end in different years help to achieve continuity because they prevent all experienced members from being replaced at one time.

## Audit committee meetings

The number of meetings the audit committee schedules depends on the scope of its responsibilities. Generally, quarterly meetings are held to review the Forms 10-Q and 10-K before they are issued, and additional meetings are held where other governance matters (e.g., external and internal audit planning and reporting) are covered. Many audit committees request that the CFO, director of internal audit, and independent auditors attend sessions of their committee meetings.

## Audit committee activities

As all board committees should do, the audit committee should prepare minutes for all of its meetings to document the committee's activities and recommendations. The minutes should be circulated to the company's board of directors to keep the board apprised. At least annually, the audit committee should prepare a formal report for the board of directors that summarizes the past year's activities, conclusions, and recommendations as well as the coming year's agenda.

The overall duties of an audit committee should be tailored specifically for the objectives, needs, and circumstances of the company the committee is designed to serve. The most common duties include providing the following:

- Oversight of the company's internal control
- Review of the internal audit function
- Selection and retention of independent auditors
- Review of the external audit plan
- Oversight of the company's financial reporting process, including monitoring and evaluating the adoption of new accounting standards
- Self-evaluation of the audit committee's qualifications and effectiveness

### **CROWE PRACTICE TIP:**

*A best practice for audit committees is to set aside portions of meetings for private sessions with the independent auditors and for private sessions with the internal auditors to discuss identified risks and accounting and reporting matters without the influence of management's presence.*

<sup>7</sup> Refer to NYSE Listed Company Manual Section 303A.07(a) and Nasdaq Stock Market Rules 5605(c)(2)(A).

SEC Chief Accountant Wesley R. Bricker, in a [speech](#) on March 24, 2017, highlighted the critical role of audit committees in overseeing the quality of the audit and financial reporting process, and he called on audit committees to consider a number of actions, including these:

- Understand the business operating environment.
- Evaluate the board composition, including the level of diversity.
- Evaluate the risk of audit committee work overload.
- Assess the tone at the top in the context of the control environment.
- Stay current on accounting and financial reporting developments, and evaluate implementation progress on new accounting standards and the impact on internal controls over financial reporting (ICFR).
- Evaluate non-GAAP measures and key operating metrics, including disclosure controls and procedures for accurate and consistent measures.
- Oversee the external auditor relationship.
- Consider voluntary audit committee reporting on how it oversees the external auditor and the financial reporting process, including the disclosures outlined in the 2015 SEC concept release "[Possible Revisions to Audit Committee Disclosures](#)" related to the evaluation and approval of the auditor's compensation.

### **Oversight of the company's internal control**

The audit committee's oversight of internal control generally involves reviewing the internal control evaluations performed by management, the internal auditors, and the independent auditors plus the methods they followed to make such evaluations. One of the audit committee's primary internal control concerns relates to those who oversee financial reporting. Audit committees usually plan specific discussions with senior corporate management and meet with internal and independent auditors concerning any comments the auditors might have about control improvements and any significant deficiencies or material weaknesses that have been identified.

### **Review of the internal audit function**

An effective review of internal audit activities covers planned audit work, the results of completed work, and management's implementation of the internal audit department's recommendations. The review of the internal audit plan is a significant task for audit committees and requires more oversight than the external audit plan does.

Internal audit plans should address the following activities:

- Internal audit activities, which include all areas or topics that are considered by internal audit's plan and risk assessment
- An assessment of the risks in the organization, usually those aligned to internal audit activities
- A testing plan to obtain the desired level of comfort based on the results of the risk assessment and the principal activities and initiatives in the organization
- The audit department budget
- A high-level schedule of activities for the year

The audit committee's review also focuses on the company's individual needs. For example, if a new IT system has been installed, internal audit work on the system's effectiveness, security, and other controls may assume a higher priority.

The capacity of internal auditors to fulfill their responsibilities is measured by the degree to which they are competent, which includes their proficiency and training, and whether they are independent of the activities they audit. In addition to the internal audit department's reporting relationships to top management, the interaction between the department and the audit committee can support the desired level of independence. Meetings with internal auditors and a defined reporting relationship, whereby significant internal audit findings are provided to the audit committee in written reports, can provide the internal auditors with direct access to the board of directors.

Audit committees also must monitor the status of open issues identified by internal auditors – those not resolved by management to the satisfaction of the internal auditors – paying particular attention to items that are past their planned completion date or at risk of missing the target date.

### **Selection and retention of the independent auditors**

Typically, audit committees are responsible for recommending to the board of directors, and in some cases the shareholders, an independent audit firm to audit and report on the financial statements issued by the company.

Re-engaging an independent audit firm and selecting a new firm are decidedly different activities. When re-engaging the current auditor, the audit committee can evaluate the quality of the firm's services firsthand. When hiring a new firm, the committee must obtain information about its service quality from other sources. Nevertheless, the basic considerations discussed here apply to both situations.

Among the factors pertinent to the selection of a PCAOB-registered independent audit firm are:

- The audit firm's knowledge and experience in the industry
- An evaluation of the audit firm's independence
- Consideration of rotation of both the audit partner and the engagement quality review partner assigned to the engagement (based on SEC independence rules, which require that both partners rotate every five years and that all audit periods included in a filing are subject to the rotation requirements)
- The firm's quality control procedures
- The nature of other services the firm offers
- Company management's ability to interact and communicate effectively with the firm

In addition to selecting and retaining auditors, the audit committee determines the compensation paid to the auditors for their annual audit and quarterly review services.

The committee also considers matters that affect auditor independence under PCAOB and SEC rules, such as the evaluation of nonaudit services performed by the auditor and any of the auditor's affiliates (including preapproval of those services), financial relationships (such as ownership interests and lending relationships) of the auditors with the issuer, and employment of prior audit firm staff by the issuer and its affiliates (a one-year cooling-off period applies to certain former employees of the auditing firm engaged by an audit client in a financial reporting oversight role). Independence requirements should be evaluated for both the audit and engagement periods (that is, the periods covered by the financial statements and the period for which the auditor is engaged to perform the audit) for all audit periods presented in an SEC filing.

Any nonaudit services performed by the auditor or any of the auditor's affiliates during any period that will be presented in an SEC filing should be assessed for compliance with independence rules. The risk of violating an SEC independence rule is greater because the SEC and PCAOB independence rules for public company audits are more stringent than those for private company audits. If such an independence violation is identified, the only remedy is to request a waiver from the SEC's Office of the Chief Accountant, and those waivers are very rare.

Independence matters also have to be considered for affiliates of SEC registrants and not solely for the registrant itself. Common affiliates are subsidiaries and parent companies. Refer to Article 2 of [Regulation S-X](#) for the SEC rules on the qualification of auditors.

## Resource for audit committees

In April 2017, the Center for Audit Quality (CAQ), in conjunction with the Audit Committee Collaboration, updated its "[External Auditor Assessment Tool: A Reference for US Audit Committees](#)" to help audit committees evaluate the appointment, oversight, and compensation of external auditors. It includes sample questions in three areas:

- The auditor's quality of services and sufficiency of resources
- The auditor's quality of communication and interaction
- The auditor's independence, objectivity, and professional skepticism

A sample form and rating scale are included in the tool and can be used to collect input from company personnel about the external auditor.

## Review of the external audit plan

Many audit committees hold meetings before the audit commences to discuss the audit plan with the independent auditors. The review of the annual audit plan with the independent auditors is the committee's opportunity to satisfy itself that the audit will meet the needs of the company's board of directors and shareholders. Although the audit must be based on the auditors' professional judgment, at this point the audit committee can learn the basis for the auditors' judgment and the extent of planned audit work.

Topics the audit committee typically discusses with the independent auditors include the following:

- The independent auditors' responsibilities under PCAOB standards (both auditing and independence standards)
- The general outline of the extent and timing of the auditors' proposed coverage of locations, such as departments, branches, divisions, and subsidiaries
- The general nature of the audit procedures to be performed, including coverage of various risks, transactions, and balance sheet and income statement accounts
- The extent of any planned reliance on the work of internal auditors and the anticipated effect of this reliance on the audit
- Any significant accounting and auditing issues that the auditors can foresee
- The impact on the financial statements of any new or proposed changes in accounting principles or regulatory requirements
- Significant reporting deadlines

## Oversight of the company's financial reporting process

Oversight of the financial reporting process is an important obligation of the committee and is linked directly to an SEC-required disclosure in annual proxy statements. Item 407(d)(3) of Regulation S-K requires the audit committee to state, in the registrant's annual proxy statement that discloses a shareholder meeting at which directors are to be elected, whether the committee has completed the following tasks:

- Reviewed and discussed the audited financial statements with management
- Discussed with the independent auditors the matters required to be discussed by [PCAOB Auditing Standard \(AS\) No. 16](#), "Communications With Audit Committees," which has been codified as AS 1301
- Received the independence disclosure letter from the independent auditors and discussed the auditors' independence with the independent auditors
- Recommended that the audited financial statements be included in the company's annual report on [Form 10-K](#) filed with the SEC

One key element of the financial reporting oversight role that assists the audit committee with making the aforementioned SEC-required disclosure is meeting with management and the independent auditors before the audit report has been issued. Among other matters, the audit committee discusses the results of the audit and the annual report with the independent auditors and company management. The matters discussed with the independent auditors typically include the following:

- The nature and resolution of any disagreements between the independent auditors and management (whether or not the disagreements have been resolved to their mutual satisfaction) about matters that could be significant to the financial statements or the auditors' report
- The nature of any major issues discussed by the independent auditors and management in connection with the retention of the auditors
- The nature and resolution of any significant or unusual accounting and auditing problems encountered during the audit
- The nature of any adjustments, reclassifications, or additional disclosures proposed by the auditors that are currently significant or may become significant in the future
- The adequacy of financial statement disclosures
- The nature and impact of the initial selection of and changes in significant accounting policies or their application
- The independent auditors' views concerning any auditing and accounting matters that were the subject of consultation by management with other accountants
- The nature of any unusual or significant commitments or contingent liabilities
- The process that management used to develop significant accounting estimates, and the independent auditors' basis for conclusions regarding the reasonableness of those estimates
- Any significant differences between the annual report and other reports, such as reports to regulatory agencies
- The independent auditors' responsibilities for other information in documents containing audited financial statements, any procedures performed related to the information, and the results of the procedures
- The independent auditors' observations on internal control, including any identified significant deficiencies and material weaknesses
- Any serious difficulties related to performing the audit that the independent auditors encountered in dealing with management
- A description of nonaudit services (including fee information) provided by the independent public accountants during the year under audit<sup>8</sup>

<sup>8</sup> Note that management is required to disclose fee information for both audit and nonaudit services in the annual proxy statement. Refer to Items 9(e)(1) to (e)(4) of Schedule 14A. In the registration statement, disclosure of accounting fees incurred in connection with the issuance and distribution of shares is required. Refer to Item 511 of Regulation S-K.

### **Disclosure of Critical Audit Matters (CAMs) begins in 2019**

In the second phase of the PCAOB auditing standard, AS 3101, "The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion," the auditor is required to include CAMs in the auditor's report. A CAM is a matter that is communicated or required to be communicated to the audit committee and that 1) relates to accounts or disclosures that are material to the financial statements, and 2) involves especially challenging, subjective, or complex auditor judgment. The second phase is effective for fiscal years ending on or after June 30, 2019, for large accelerated filers. For all other entities, the second phase is effective for fiscal years ending on or after Dec. 15, 2020.

Audit committees also review with the independent auditors the quarterly financial information – to confirm the following:

- GAAP has been followed and applied consistently.
- Fluctuations in financial statement balances, ratios, and statistics have been explained satisfactorily.
- Quarterly financial information has been summarized for external reporting purposes and conforms to SEC disclosure requirements.
- Significant commitments and contingent liabilities have been disclosed.
- A quarterly review has been performed by the independent auditors.

### **Self-evaluation of the audit committee's qualifications and effectiveness**

Audit committees' annual self-evaluations assess the effectiveness of the committee and include evaluations of how well the audit committee members understand the company's financial reporting process, ICFR structure, and internal audit department. The assessment also should consider how well the audit committee members communicate with the independent auditors and how well they understand the role of the auditors. In addition, the evaluation should help the committee members understand the effectiveness of the committee's structure, including its size, membership, and communication in their own meetings as well as meetings with other board members and management.





## Learn more

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