REPRINT

risk & compliance

AUDIT COMMITTEE DISCLOSURES

REPRINTED FROM:

RISK & COMPLIANCE MAGAZINE

APR-JUN 2019 ISSUE

www.riskandcompliancemagazine.com

Visit the website to request
a free copy of the full e-magazine

Crowe

Published by Financier Worldwide Ltd
riskandcompliance@financierworldwide.com
© 2019 Financier Worldwide Ltd. All rights reserved.

MINI-ROUNDTABLE

AUDIT COMMITTEE DISCLOSURES

PANEL EXPERTS

David Chitty
International Accounting & Audit Director
Crowe Global
T: +1 (212) 808 2027
E: david.chitty@crowe.org

David Chitty is responsible for the global leadership of accounting and auditing services at Crowe Global. He supports the development of the network's global audit methodology and audit technology, leads the global quality assurance programme, presents seminars and supports business development initiatives. He is also a member of the Institute of Chartered Accountants in England and Wales' (ICAEW) Independent Regulatory Board, is a former member of ICAEW's governing Council and ICAEW's Audit Committee.

Steve Gale
Partner
Crowe U.K. LLP
T: +44 (0)20 7842 7262
E: steve.gale@crowe.co.uk

Steve Gale is head of audit at Crowe in the UK. He has nearly 30 years' experience within the audit field and has a particular specialism in dealing with professional services firms and listed companies. He has recently been appointed to the Auditors' Advisory Group for the Brydon Review into the quality and effectiveness of audit, commissioned by the UK Department of Business, Energy and Industrial Strategy. He is a member of Crowe Global's International Audit and Accounting Committee.

Jennifer Knecht
Partner
Crowe LLP
T: +1 (317) 706 2697
E: jennifer.knecht@crowe.com

Jennifer Knecht is the Securities and Exchange Commission (SEC) practice leader for Crowe LLP. She has over 22 years of experience conducting audits and providing other financial assurance services. She also has experience with SEC reporting requirements, including initial public offerings (IPOs) and reverse merger transactions. These projects include working directly with clients and other stakeholders on registration statements, SEC comment letters and comfort letters.

Diana Huang
Incorporated Partner
Crowe MacKay LLP
T: +1 (604) 697 5274
E: diana.huang@crowemackay.ca

Diana Huang's practice is focused on public company auditing, including mining and oil and gas companies, as well as the high-tech industry, and she is able to bring a vast amount of knowledge and expertise to industry-specific issues. She routinely assists lawyers and clients with IPOs, reverse takeovers, spinout transactions, prospectus offerings and filings statements. She takes great pleasure in identifying complicated issues and in providing sound, technical solutions.

Michael Jetter
Partner
RWT Crowe GmbH
T: +49 7121 489 544
E: michael.jetter@crowe-rwt.de

Michael Jetter is an audit partner responsible for providing audit and accounting services to international, listed and non-listed, companies in Germany. His clients are drawn from sectors including manufacturing, automotive and consumer goods. In addition to his audit work, he provides International Financial Reporting Standards (IFRS) conversion services, as well as financial accounting advisory work for German subsidiaries of foreign owned business in US-generally accepted accounting principles (GAAP) and IFRS reporting matters.

R&C: Could you provide an overview of the main trends and developments affecting audit committees in recent times? How has their role evolved and have you seen a general improvement in quality and oversight?

Chitty: Audit committee disclosures provide important information for stakeholders about the audit committee's activities and exercise of its responsibilities. The audit committee has a vital role in corporate governance, including providing oversight to the financial reporting process led on a day to day basis by the chief financial officer (CFO), appointing and maintaining close contact with the external auditor, and receiving reports from and providing guidance and support to the internal auditor. The role of many committees has evolved into overseeing risk management as well as financial and 'traditional' audit affairs. Legislation and regulation, as well as codes of practice, may specify the minimum disclosures expected of an audit committee, whether in the annual report or other media issued by the company. However, in the interests of transparency and good investor and stakeholder relations, the disclosures may go beyond this minimum. The 2014 European Union (EU) Audit Directive extended the list of functions assigned to the audit committee, as follows. First, inform the administrative or supervisory body of the audited entity of the outcome of the statutory audit and explain its contribution to the integrity of the financial statements. Second, monitor the financial reporting process and submit recommendations. Third, monitor the effectiveness of the internal quality control and risk management system. Fourth, monitor the process of the audit of statutory or consolidated financial statements, mainly the findings and conclusions. Fifth, review and monitor the independence of the statutory auditor. Finally, be responsible for the procedure for the selection of the statutory auditor or audit firm. The Directive has been transposed in law in the Member States of the EU and it ought to influence disclosures by audit committees, as the committee has more responsibilities to comment upon. In practice, disclosures will be influenced by national requirements, as well as convention, in the Member State. Studies are beginning to show how committees are reporting on their extended responsibilities.

Gale: The UK Financial Reporting Council (FRC) conducted research under the auspices of the Audit and Assurance Lab, which resulted in a report, 'Audit Committee Reporting', being published at the end of 2017. Key themes that were addressed in that publication were the interaction between the audit committee and the auditors, how the audit committee reports on significant matters impacting the financial statements, and internal control matters including risk management and internal audit. With increased focus on mandatory retendering and rotation – in light of the adoption of the EU 2014 Audit Directive and Regulation, implemented in 2016 – there has been encouragement for audit committees to describe in their reports the steps they have taken when undertaking tender processes, including the key criteria they are using to assess the firms taking part in the tender, as well as how they are assessing the effectiveness of the auditor and the audit process.

Knecht: US Securities and Exchange Commission (SEC) regulations require certain minimum disclosures by audit committees. Some of the disclosures required by SEC regulations include whether the audit committee has reviewed and discussed the audited financial statements with management, discussed with the independent auditors the matters required to be discussed by Public Company Accounting Oversight Board (PCAOB) Rule 3200T, received from and discussed with the auditors disclosures regarding the auditors' independence, and whether the audit committee members are independent as defined in the applicable listing standards. While these disclosures provide some transparency to audit committee oversight, they do not cover the full range of an audit committee's activities. Audit committees play a key role in the oversight of management and the independent auditor. Effective oversight of the financial reporting process is absolutely critical to upholding the integrity of the capital markets. As more emphasis continues to be placed on disclosure effectiveness, a natural evolution is for audit committees to provide more transparency to the full range of their activities – which go well beyond the required disclosures. There have not been significant regulatory or legislative developments around required audit committee disclosures in the US for some time. However, in public statements, the SEC continues to emphasise the importance of effective audit committee disclosure. For example, in a 2017 speech, Wes Bricker, chief accountant of the SEC, encouraged audit committees to "consider whether providing additional insight into how the audit committee executes its responsibilities would make

"As more emphasis continues to be placed on disclosure effectiveness, a natural evolution is for audit committees to provide more transparency to the full range of their activities."

Jennifer Knecht,
Crowe LLP

the disclosures more effective in communicating with investors". Mr Bricker also referenced the SEC's 2015 concept release on possible revisions to audit committee disclosures as a potential tool to assist audit committees in considering disclosure enhancements. Our experience in practice is that US public companies of all sizes have continued to expand voluntary disclosures within their proxy statements on oversight responsibilities, for the benefit of their stakeholders. This push for additional transparency is understandable given the rapid pace of change seen in the economy. Going forward, calls for increased transparency into audit committee duties, including oversight of the independent auditor, are expected to grow. Audit committees can respond by providing more meaningful disclosures that increase awareness of their responsibilities and how individual committees carry them out.

Huang: In Canada, larger companies are disclosing more on the background of audit committee members. There is more focus on providing investors with information regarding the experience and expertise that members bring to the company, and also more transparency with respect to diversity – such as female representation on the board. Another trend we have noted is audit committee members of larger companies starting to formalise the process of evaluating their external auditors and providing transparency regarding the process. Overall, for smaller public companies, in our view the majority of audit committee disclosures continue to inadequately address, or completely disregard, how the committee oversees the external auditor and assesses the auditor's qualifications and work quality. We feel that there have been improvements in the number of disclosures in recent years, however this movement has not been universally or consistently adopted, especially with junior issuers. The content and adequacy of disclosures continues to evolve, but largely remains a work in progress.

"The content and adequacy of disclosures continues to evolve, but largely remains a work in progress."

Diana Huang,
Crowe MacKay LLP

Jetter: In Germany, the audit profession recently adopted the revised ISA 260 'Communication With Those Charged With Governance', requiring more intense and more frequent communication between the auditor and the audit committee compared to what we have seen previously. This should further improve oversight quality and may influence external disclosures by the committee. The main trends and developments that we are seeing are independence of the auditor and the provision of non-audit services by the auditor, as well as tendering. Tendering is spurred by the need for public interest entities (PIEs) to change their auditor as a result of EU-imposed restrictions on the maximum term an auditor can serve a PIE.

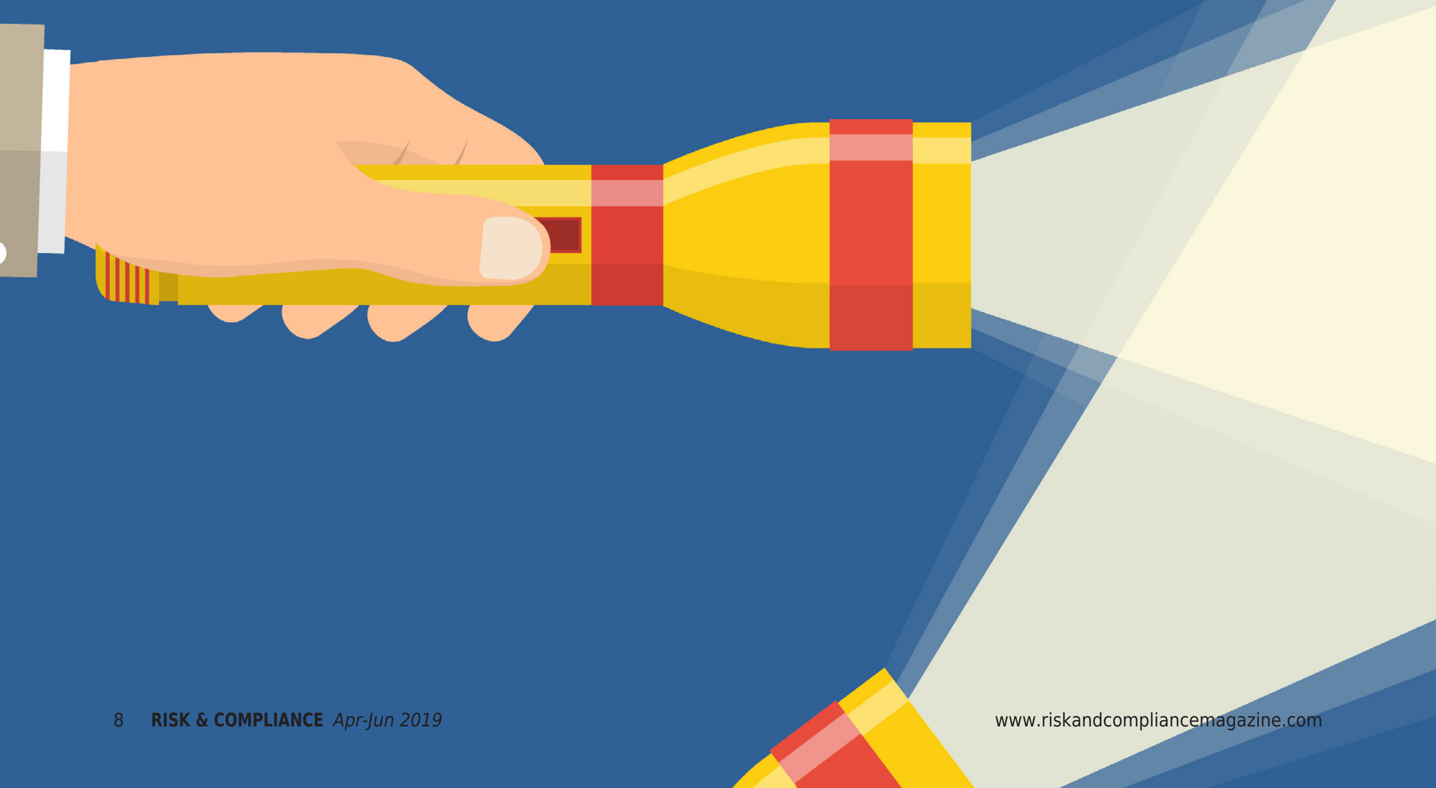
R&C: What factors are influencing and shaping the content of audit committee proxy disclosures issued by small to large public companies?

Gale: The principal factors that would appear to impact the content of audit committee reports are the sophistication of the corporate governance framework adopted by the company, as well as the nature of the external shareholders. In the UK, not all listed companies are required to prepare audit committee reports, for example those listed on AIM. Where companies do prepare a report, then those companies with less sophisticated arrangements are more likely to have reports that are less granular and detailed than those from larger companies.

Huang: Financial reporting has become more complex as a result of new standards, disclosure requirements, cyber security risks, technology risks and challenges, and additional focus by regulators, thereby adding more pressure on audit committees to have appropriate expertise and engagement, in providing oversight and challenge to management and providing additional disclosures to build confidence among investors in their roles of oversight.

Jetter: In Germany, the supervisory board is required by law to issue and publish a separate report to the shareholders on their work during the preceding year. This supervisory report includes sections on how the audit committee fulfilled its legal and statutory obligation to 'audit' the company's annual and consolidated financial statements using the auditor's work – for example whether the audit committee concurs with the results of the audit's work. This statutory obligation is also relevant for non-PIEs, which means for all entities in the legal form of a stock corporation, known as *Aktiengesellschaft* or a large limited liability company, known as a GmbH.

Knecht: The growing pressure for increased disclosures is a reflection of the increasing importance investors and stakeholders are placing on corporate governance and audit quality. An increasingly complex business environment has propelled stakeholder interest in more detailed audit committee disclosures. Investors are keenly focused on audit committee oversight as companies innovate, expand into new markets, and implement emerging technologies. One topic where stakeholders are seeing increased audit committee voluntary disclosure is cyber security. We are seeing a positive trend with respect to enhanced voluntary disclosures by audit committees. Some audit committees are now providing robust disclosures in areas such as considerations in the appointment of the audit firm, criteria used in evaluating the audit firm, and involvement in lead partner selection. In the US, the Center for Audit Quality (CAQ) has, for the last five years, published an annual 'Audit Committee Transparency Barometer' which, among other objectives, summarises trends in audit committee voluntary disclosures. The 2018 report indicates positive trends in a number of key metrics the CAQ uses to assess voluntary audit committee disclosures.



assessing whether the APMs used are most appropriate for the business as well as the adequacy of how those APMs reconcile with the measures evident from the financial statements.

Huang: For larger companies in Canada, there are general disclosures regarding the presence of audit committee charter and limited descriptions around their general responsibilities. For smaller companies we feel this is an area that is lacking and would benefit from additional disclosure. Disclosure of the topics discussed, their risk assessments and the work performed by the audit committee are lacking. Many disclose their overall responsibilities, yet fail to provide transparency around their actual processes, assessments and conclusions.

Jetter: We still see a lot of 'boilerplate' language in supervisory board reports. As the legal requirements for stock corporation laws are rather 'vague', there is a need to further clarify, customise and individualise supervisory board or audit committee reporting requirements, in order to improve communication quality with shareholders. One example is the introduction of reporting key audit matters (KAMs) in audit reports.

Knecht: One area to look at is the area of disclosure of fees paid to the auditor. SEC regulations require companies to disclose fees paid to the principal auditor in four categories: audit,

audit-related, tax, and all other for the two most recent years. Beyond the required disclosures, audit committees are not yet providing significant voluntary disclosures in the area of audit firm compensation. Audit committees may want to consider explaining their role in the fee negotiation process. For example, audit committees might consider enhanced disclosure about how the committee determines and evaluates auditor compensation, as well as significant changes in fees paid to the audit firm.

Chitty: It is interesting to consider the perspective of internal auditors about how audit committees disclose their relationship with internal audit. Internal auditors see the benefit of the audit committee being to enhance the status of the internal audit function. An effective audit committee can strengthen the position of the internal auditors by acting as an independent forum for internal auditors to raise matters affecting management. The chief audit executive (CAE) should report functionally to the audit committee, which is critical to good corporate governance. The effectiveness of the relationship between internal audit and the audit committee should have an impact on committee disclosures. Regular meetings between the audit committee and internal audit make it more likely that the audit committee remains informed and knowledgeable about relevant accounting and auditing issues. Maximum benefit from this interaction can be expected, however, if members of the audit committee have the technical expertise to understand the work of the internal audit function,

"The reciprocal relationship between the audit committee and the internal auditor is underdeveloped, which can be considered a missed opportunity for both parties."

David Chitty,
Crowe Global

together with the independence to enhance the status of the internal audit. In the absence of this, the audit committee is a rather theoretical and obligatory concept without much decisive influence. Instead of considering the internal auditor as a valuable and independent information provider, the audit committee chair may prefer to rely almost exclusively on the external auditor. Consequently, the reciprocal relationship between the audit committee and the internal auditor is underdeveloped, which can be considered a missed opportunity for both parties. Therefore, disclosure by the audit committee internally to the board and externally to stakeholders is less than effective. Due to this mismatch of interests, there will be cases where there is an under emphasis on the internal audit oversight role by the audit committee. In order to reduce this mismatch, both parties should broaden their interests in a converging way, in conjunction with clear communication about the mission and roles of internal audit. Internal auditors value audit committee support and seek to be proactive in achieving it, often by means of educating audit committee members. An effective relationship between internal audit and the audit committee ought to be disclosed and will be positive for stakeholders to be informed about.

R&C: What are the benefits of increasing transparency in audit committee disclosures?

Huang: Increased transparency provides investors with information to evaluate audit committee performance and helps with understanding the audit committee process and rationale for doing certain things, for example when appointing auditors. It also helps with increasing investor confidence.

Knecht: It is important for audit committees to engage with regulators, auditors and stakeholders. Proactively engaging in communication with others on these topics can have a meaningful impact on the development of future standards. In addition, it can provide valuable insight to audit committees about the types of disclosures that are important to stakeholders. For example, the PCAOB is currently conducting research on how auditors and audit committees interact with respect to PCAOB Rule 3526, 'Communication with Audit Committees Concerning Independence'.

Gale: For investors, there is the benefit of reassurance that the audit committee is providing an appropriate challenge to management and are focused on ensuring there is high quality corporate reporting – not only in terms of the reported results, but also that the auditors will be conducting an audit of the appropriate quality.

Chitty: Enhancing the transparency of disclosure could make the financial information more credible to investors and increase investors' confidence. This should have a very positive result in the company's development in the long term.

Jetter: Generally, increased trust in the audit committee strengthens the shareholders' interests. In the two tier-board system in Germany, the auditor explicitly serves and supports the work of the supervisory board. So, increasing transparency also means better information about the key aspects of an audit and how the supervisory board deals with these issues.

R&C: How might enhanced transparency around corporate governance help underscore audit committee improvements?

Gale: It is not a matter only of transparency but also of the quality of the corporate governance framework adopted by the company and, as part of that, the quality of the individuals involved. There is also the element that might be summed up in the phrase 'corporate culture'. If the culture that is nourished within the company is based on quality, openness, integrity and transparency, then that should permeate through all the company's financial reporting obligations, including reporting by the audit committee.

Huang: Increased transparency should lead to greater accountability and improved oversight. If audit committees were required to disclose specific processes, information considered and conclusions reached, as opposed to a general mandate, stakeholders would have the ability to monitor, measure and assess the operational effectiveness of the audit committee and the degree of their oversight.

R&C: Have there been any notable legal and regulatory developments in this area? If so, what has been the impact?

Gale: The UK adopted the EU Audit Directive and Regulation in 2016, which introduced mandatory audit tendering and rotation. As a result, there has been an increase in the frequency of audit tenders. In February 2017, the FRC also published a 'best practice' note for audit committees surrounding the process for conducting an audit tender. We might expect to see an increase in the quality of disclosures around the appointment process for auditors, including identifying the principal factors that the audit committee is using in assessing the firms participating in the tender process. The FRC publication 'Audit committee reporting', published in December 2017, provides examples of good practice in various elements of audit committee reports, which the FRC hopes will stimulate further improvements in audit committee reports.

Huang: External audit effectiveness has been subject to increased regulatory focus, by bodies such as the Canadian Public Accountability Board (CPAB) and the US PCAOB. Evaluation of external audit effectiveness is also becoming an important part of the audit committee role. The Securities Commission in Canada has also been allocated additional resources to review public disclosures – including other than financial statements – and challenging management on their disclosures. This requires deep expertise from audit committees in the areas of financial and non-financial reporting. We have noted regulators working with companies to establish and monitor key performance indicators (KPIs). This is a tool that helps to engage audit committees, establishes an approach to measure and improves performance, including audit quality. The Canadian regulator had launched an exploratory audit quality indicators (AQIs) project with certain Canadian audit committees to get feedback on the usefulness of AQIs and to support broader national and international discussions. The result of the project was that AQIs provide a better understanding among management, the audit committee and external auditors of roles and responsibilities related to audit quality, and their expectations of others. They also result in more efficient and effective interactions between the audit committee and the auditors. There are now discussions around whether audit committees should disclose AQIs in their annual filings, which some see as evidence of robust audit committee oversight of the external auditor. Canadian companies that have disclosed their AQIs publically include Magna, Royal Bank of Canada, Telus, Intact Financial and Sun Life Financial.

Chitty: There have been developments in China as the China Securities Regulatory Commission (CSRC) issued the 'Code of Corporate Governance of Listed Companies' in 2001, for the purpose of standardising the operation of listed companies and protecting the legitimate rights and interests of investors. The code was recently revised and implemented with effect from 30 September 2018. The revised guidelines require listed companies to strengthen the audit committee function and establish the basic framework for environmental, social and governance (ESG) information disclosure. In general, Chinese listed companies are used to disclose information pursuant to mandatory provisions, and the revised guidelines encourage listed companies to voluntarily disclose relevant information which may have an impact on decision making, in order to provide more comprehensive information to shareholders and other stakeholders.

"If the culture that is nourished within the company is based on quality, openness, integrity and transparency, then that should permeate through all the company's financial reporting obligations."

Steve Gale,
Crowe U.K. LLP

Jetter: Except for the introduction of the new IDW PS 470 – equivalent to the revised ISA 260 – there have been no significant developments in Germany. As the standard increases an auditor's obligation only in respect of communications between the audit committee and the auditor, the effect on shareholders and other stakeholders is probably not that significant.

R&C: What advice would you offer to companies on drafting voluntary disclosures within their proxy statements that provide stakeholders with greater insight into oversight responsibilities?

Knecht: Invest some time engaging with stakeholders to gain an understanding of the voluntary disclosures they believe are most important. Evaluate the cost-benefit of voluntary disclosures and seek ways to enhance disclosures so they will provide the most benefit.

Huang: Provide more than the basic minimum requirements. This will help with holding the committee accountable and also builds investor confidence in the various governance roles. In addition to 'what' you do, also explain 'how' you do it. In other words, explain the committee's process.

Gale: If audit committees want to make sure they are providing valuable insight to readers, an important element is to really understand what it is that readers want to know. Engaging with stakeholders and key shareholder groups will be an important part of this.

> **"I doubt that in the near term we will see a great expansion of voluntary disclosures in Germany, although stakeholder expectations on this front may change."**
>
> *Michael Jetter,*
> *RWT Crowe GmbH*

Chitty: In the Chinese market, listed companies are advised to pay attention to the quality of voluntary disclosed information (VDI), which may result in misunderstanding by the market. Care has to be taken with such voluntary disclosures in case they have price-sensitive implications. Turning to audit committee interaction with internal audit, good practice disclosures could: monitor whether the internal audit function has adequate resources; follow up on the internal audit department's scope, the results of its operations and recommendations, and on management's responses thereto; and challenge management on critical findings reported by internal audit, and report internal audit's perspective to the board.

R&C: How do you expect voluntary audit committee disclosures to evolve in the years ahead? Is there an inevitable trend toward even greater transparency and accountability?

Huang: We see trends towards additional transparency and more focus around processes and controls being described in proxy statements. We expect that regulations will continue to evolve to require more transparency.

Chitty: In the past few years in China, audit committees have continued to enhance transparency and accountability regarding VDI as required by relevant authorities in China. The revised Code will have an effect in this area. It is expected that audit committees could make improvements to the effectiveness of VDI. Turning to the EU, we can anticipate that the expansion of audit committee responsibilities resulting from the 2014 Audit Directive will result in more disclosures by the committee, because stakeholders will expect to hear about how these responsibilities are being discharged.

Jetter: I doubt that in the near term we will see a great expansion of voluntary disclosures in Germany, although stakeholder expectations on this front may change.

Knecht: In the near term, it is possible that changes to external audit standards may help facilitate enhanced disclosures by audit committees – specifically, through auditors' required disclosures of critical audit matters (CAMs) under PCAOB Auditing Standard 3101, 'The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion'. Auditor disclosure of CAMs later this year will provide audit committees with a great opportunity to communicate through enhanced disclosure their oversight activities with respect to the critical areas identified within the audit. CAMs are similar to KAMs that are required in other countries, where the reporting of KAMs has had an impact on disclosures. R&C