



THE AUDIT COMMITTEE OF THE FUTURE

The U.S. approach to audit committee composition and expertise has been successful, but it can be improved. An expert panel identified a range of possible enhancements for the audit committee of the future, with a particular focus on financial expertise among committee members.

Given the ever-evolving risk landscape for public companies, effective audit committees are increasingly important in the financial reporting supply chain. In April 2016, the Center for Audit Quality (CAQ) and the John L. Weinberg Center for Corporate Governance at the University of Delaware convened an expert panel to explore the composition of the audit committee of the future.¹ The discussion covered what skills audit committees will need, especially in light of emerging challenges such as cybersecurity, as well the possibility of the U.S. Securities and Exchange Commission (SEC) or the stock exchanges reexamining the definition of an “audit committee financial expert” (ACFE). The panelists also considered whether investors are getting enough information about the experience of audit committee members.

For the most part, the panel agreed that the current approach to audit committee composition—as determined largely by the SEC’s implementation of the Sarbanes-Oxley Act of 2002 (SOX)—is working well. By the same token, however, consensus was strong that the topic of audit committee expertise deserves continual attention. Panelists also offered a range of ideas that could enhance how future audit committees operate.

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THE EVOLUTION OF AUDIT COMMITTEE EXPERTISE

“We have more CFOs, audit partners, controllers—people who have actually experienced how to control risk and how to reflect it in good financial reporting.”

The discussion began with the observation that explicit requirements around audit committees are a relatively recent feature of U.S. corporate governance, with exchanges first adopting audit committee requirements in the 1970s. Yet even with these requirements, it was observed, the audit committee remained a fairly obscure board assignment for several decades. Quipped one panelist, the audit committee was long deemed the place for directors “that they can’t figure out what else to do with.”

The audit committee’s prominence rose dramatically, however, with the turn-of-the-century market downturn brought about in part by accounting scandals at Enron, WorldCom, and elsewhere. A reaction to those developments, SOX contained several provisions aimed at audit committees, including calling for SEC registrants to disclose whether or not they had a “financial expert” on the audit committee.

In 2003, the SEC adopted a rule implementing SOX’s provision on ACFE disclosure. The rule defined the ACFE as a person with the following attributes:

- ▶ An understanding of Generally Accepted Accounting Principles and financial statements;
- ▶ The ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves;
- ▶ Experience preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the registrant’s financial statements, or experience actively supervising one or more persons engaged in such activities;
- ▶ An understanding of internal controls and procedures for financial reporting; and
- ▶ An understanding of audit committee functions.

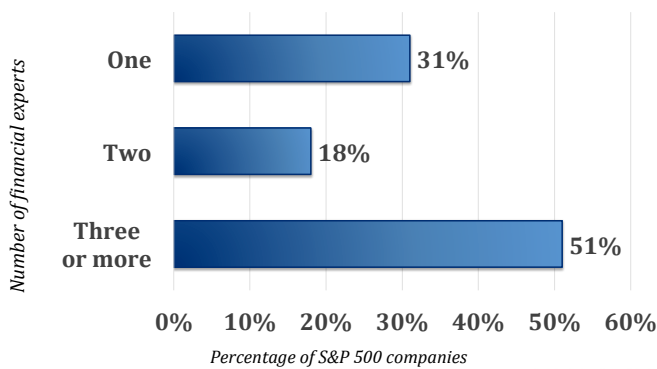
The 2003 rule also stipulated that the ACFE must have acquired such attributes through any one or more of the following:

1. Education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor or experience in one or more positions that involve the performance of similar functions;
2. Experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions;
3. Experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements; or
4. Other relevant experience.²



Driving the rule, according to one panelist, was the need to have “somebody who has been there...who understands how executives cut deals that need strong control systems.” Today, regulators continue to take an expansive and risk-aware view of financial literacy on audit committees. As observed by SEC Chair Mary Jo White in December 2015: “Just meeting the technical requirements of financial literacy may not be enough to fully understand the financial reporting requirements or to challenge senior management on major, complex decisions.”³

Number of Financial Experts on S&P 500 Audit Committees, 2015



Source: CAQ/Audit Analytics analysis of 2015 proxy statements

AN EFFECTIVE APPROACH—THAT CAN BE STRENGTHENED

Agreement on the panel was strong that the SEC rule strikes a good balance on audit committee expertise. “It has worked,” said one panelist, adding that “we have more CFOs, audit partners, controllers—people who have actually experienced how to control risk and how to reflect it in good financial reporting.” Added another: “I don’t think we should change the existing rules.”

As evidence of this success, panelists pointed to data on financial expertise on audit committees of leading U.S. companies. According to research from the CAQ and Audit Analytics, 51 percent of S&P 500 companies reported having three or more financial experts in 2015. What’s more, it was observed, many companies likely have more ACFEs than their disclosures indicate.

In keeping with these favorable views and statistics regarding the current state of audit committee composition, participants predicted that federal regulators would not likely revisit ACFE requirements in the foreseeable future. Still, panelists stressed that a low likelihood of regulatory action did not mean the ACFE requirement shouldn’t continue to receive attention. “You worry that a requirement that came in 20 years ago gets a little stale if we don’t talk about it,” said one. “I would like to see it strengthened,” added another.

FIVE WAYS TO ENHANCE THE AUDIT COMMITTEE OF THE FUTURE

Throughout the dialogue, five recurring themes emerged regarding what panelists thought would lead to stronger audit committees.

- ▶ **Tightening the ACFE definition (carefully):** Several on the panel warned against imposing excessive requirements regarding board expertise. “If we try to prescribe what the board should be composed of, we lose that flexibility component,” said one. Another agreed, noting that adding “single-issue directors” to the board, even on urgent matters like cybersecurity, was generally inadvisable. “We are wary of tokenism,” said the panelist. While several voices stressed the point that the traditional CPA background was standard for achieving an ACFE designation, it was also suggested that each company is unique and may have an ACFE with other relevant experience to instill appropriate rigor in the audit process.



Still, a few discussants offered ways that the ACFE definition might be tightened. One participant suggested that the supervisory element of the SEC’s ACFE definition (e.g., a CEO with a marketing background who has a CFO reporting to her/him) should be eliminated. Another called for higher standards when it comes to knowledge of Generally Accepted Accounting Principles and Generally Accepted Auditing Standards. “The real test of an effective audit committee member is not just being able to ask good questions—it’s being able to properly assess the responses received from external auditors and others,” he said.

- ▶ **Enhancing voluntary audit committee disclosure:** Across the board, panelists believed that voluntary disclosure is a critical first step to improving communication around audit committee composition and expertise, particularly given that some audit committees may not be adequately disclosing the expertise they already have. “Transparency is the name of the game in many different elements of corporate governance,” said one. “Disclosing more about the attributes [audit committee members] bring would be a good thing.” Another agreed, saying that the audit committee should “go on the record” as to why each individual is on the committee—their perspective and skill set.” Disclosing what experience qualifies a committee member to be an ACFE, added a panelist, would be extremely instructive.
- ▶ **Fostering robust communication and engagement:** In addition to enhancing communication with investors and other parties via disclosure, panelists agreed that audit committees need to focus strongly on developing healthy channels of internal communication. “That’s an important skill set for the chairman of the audit committee,” said one, “how to make sure you’re having those periodic meetings outside the boardroom with the auditor, with the internal auditor, with the CFO, with the controller.”

Of course, the onus on fostering communication does not fall on the audit committee chair alone. “It’s important to have all parties around the table fully engaged,” said one participant. Others emphasized the need for external auditors to engage in dialogue, particularly if a sense emerges that the audit committee is not asking the right questions. “You need an audit firm to speak up,” said a panelist.

- ▶ **Prioritizing continuing education:** Several discussants stressed the importance of continuing education for audit committee members, especially given the growing complexity of accounting standards and financial reporting rules. The ACFE “cannot rest on her or his laurels,” said one. “It’s imperative that knowledge be kept current through CPE [Continuing Professional Education] courses and otherwise.”
- ▶ **Addressing the “kitchen sink” challenge:** While tasked with a critical responsibility—oversight of the company’s financial reporting process—many audit committees have seen workloads expand into areas that may be loosely related.⁴ “There are so many responsibilities that get dumped into the ‘kitchen sink’ of the audit committee,” observed a panelist. Working to avoid blurring of the committee’s focus can help when thinking through composition. In the words of one participant, “we should not lose track of the fact that the core function of the audit committee is financial reporting.”

GOOD FOR BUSINESS, SHAREHOLDERS

The session closed with a reminder that taking some or all of the steps above transcends simply building a better audit committee of the future—it can strengthen the financial reporting processes that underpin capital markets as a whole. “Good process is good for business,” said a participant. “Anything you can do to enhance the process is going to benefit shareholders.”

“AUDIT COMMITTEE OF THE FUTURE” PANELISTS

- ▶ **Dennis Bereforsd**, Executive-in Residence, J.M. Tull School of Accounting, Terry College of Business, University of Georgia; former Chairman of the Financial Accounting Standards Board
- ▶ **Charles Elson (moderator)**, Director, John L. Weinberg Center for Corporate Governance, Alfred Lerner College of Business & Economics, University of Delaware; Edgar S. Woolard Chair in Corporate Governance; and Professor of Finance
- ▶ **Cindy Fornelli**, Executive Director, Center for Audit Quality
- ▶ **The Honorable Randy J. Holland**, Justice, Delaware Supreme Court
- ▶ **Angela Brock-Kyle**, Audit Committee Member, Infinity Property and Casualty Corp.
- ▶ **Philip Livingston**, Audit Committee Chair, Vision Energy; former CEO of Financial Executives International
- ▶ **Paula Loop**, Leader, PwC’s Governance Insights Center
- ▶ **Zach Oleksiuk**, Americas Head, BlackRock Investment Stewardship
- ▶ **John White**, Partner, Cravath, Swaine & Moore



All photos courtesy of the University of Delaware.

FOR MORE INFORMATION

Together with its partners in the Audit Committee Collaboration, the CAQ produces numerous resources for audit committees, including evaluation tools, policy perspectives, and best practices on audit committee disclosure. With partner Audit Analytics, the CAQ publishes the *Audit Committee Transparency Barometer*, an annual publication presenting data and trends regarding audit committee disclosures among S&P Composite 1500 companies. These resources and more can be found at the Audit Committee Collaboration website, www.auditcommitteecollaboration.org.

For more on the audit committee of the future, please see the companion video for this *CAQ Insights*. Featuring audit committee members at Freddie Mac, Microsoft, PPG Industries, SanDisk, and Wal-Mart Stores, the video is available at the CAQ's YouTube channel, www.youtube.com/user/theCAQorg.

Also, a May 2016 interview on "Inside America's Boardrooms" (available at www.bit.ly/acfexpert) examines issues such as having multiple financial experts on the audit committee, recruiting qualified board members, and finding the right mix of skill sets.

ABOUT THE CENTER FOR AUDIT QUALITY

The CAQ is an autonomous public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets. The CAQ fosters high quality performance by public company auditors, convenes and collaborates with other stakeholders to advance the discussion of critical issues requiring action and intervention, and advocates policies and standards that promote public company auditors' objectivity, effectiveness and responsiveness to dynamic market conditions.

NOTES

¹ The "Audit Committee of the Future" event was held at the Gore Recital Hall at the University of Delaware's Newark, DE campus. To encourage candor and a robust exchange of views, the discussion proceeded under the "Chatham House Rule," under which event attendees may convey what was said at an event but may not attribute comments (explicitly or implicitly) to individual participants.

² See, "Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002," available at <https://www.sec.gov/rules/final/33-8177.htm>.

³ See, "Keynote Address at the 2015 AICPA National Conference," available at <https://www.sec.gov/news/speech/keynote-2015-aicpa-white.html>

⁴ See, for example, Michael Rapoport and Joann S. Lublin, "Meet the Corporate Board's 'Kitchen Junk Drawer,'" *Wall Street Journal*, February 15, 2015. Available at <http://www.wsj.com/articles/meet-the-corporate-boards-kitchen-junk-drawer-1422933078>.



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