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*Serving Investors, Public Company Auditors & the Markets*

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Office of the Secretary  
Securities and Exchange Commission  
100 F Street, N.E.  
Washington, DC 20549-1090

## **Re: Request for Comment on Subpart 400 of Regulation S-K Disclosure Requirements Relating to Management, Certain Security Holders and Corporate Governance Matters; File No. S7-18-16**

Dear Office of the Secretary:

The Center for Audit Quality (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. Based in Washington, DC, the CAQ is affiliated with the American Institute of CPAs.

The CAQ commends the Securities and Exchange Commission (SEC or Commission) for its ongoing efforts to evaluate and improve its disclosure and registration requirements, in an effort to leverage technology, modernize and simplify requirements, and to improve the systems of disclosure through which investors receive the necessary information to make informed investment and voting decisions.

We appreciate the opportunity to share our views on the *Request for Comment on Subpart 400 of Regulation S-K Disclosure Requirements Relating to Management, Certain Security Holders and Corporate Governance Matters* (Request for Comment). We respectfully submit the observations of the CAQ with regards to codes of ethics and corporate governance matters, but note that they are not necessarily the views of any specific member firm, individual, or CAQ Governing Board member.

In this letter, we offer for the Commission's consideration our views regarding the issues raised in the Request for Comment, organized into the following sections:

- I. Item 406 of Regulation S-K: Code of Ethics
- II. Item 407 of Regulation S-K: Corporate Governance
  - a. Item 407(d): Audit Committee
    - i. Positive Trends in Voluntary Audit Committee Disclosure
    - ii. Audit Committee Financial Experts
  - b. Item 407(g): Smaller Reporting Companies

## I. Item 406 of Regulation S-K: Code of Ethics

Item 406 of Regulation S-K requires disclosures about whether the registrant has adopted a code of ethics and, if it has not adopted a code of ethics, an explanation of why it has not done so. Through its work as a member of the Anti-Fraud Collaboration, the CAQ published the *Fraud-Resistant Organization*<sup>1</sup>, which observes that an absence – or lack of enforcement – of codes of ethics in companies can lead to an increased risk of a culture being conducive to fraud. The report states: “If an organization has no affirmative code of ethics, or if it exists but is not visibly promoted, or if the culture does not encourage the reporting of ‘bad news,’ then it will be even easier for employees to keep silent and rationalize their fraudulent behavior.”<sup>2</sup>

Additional research from KPMG<sup>3</sup> found that more than half of the 3,500 employees of U.S. companies who participated in the *Integrity Survey 2013* had observed misconduct in their organizations in the previous year, and 60 percent of those cited the driver of misconduct to be the belief that the company’s code of conduct was not taken seriously. In other words, and as the *Fraud-Resistant Organization* report suggests, if employees are familiar with their organization’s code of ethics and the organization stresses its importance, fraud is less likely to take root or flourish.

From an investor standpoint, the Council of Institutional Investors (CII) states in its corporate governance policies that every company should have an ethics code that applies to all employees and directors.<sup>4</sup> Notably, codes of conduct or ethics are also relatively inexpensive mechanisms for helping deter fraud, an important consideration for small companies. As noted in the Association of Certified Fraud Examiners *2016 Report to the Nations on Occupational Fraud and Abuse*<sup>5</sup>, “While it is understandable that small businesses do not have the resources necessary to invest in some of the more expensive internal controls noted, several controls—such as a code of conduct, management review procedures, and fraud training for staff members—can be implemented with minimal investment.”

The CAQ believes the SEC should retain this regulation, in its current state, going forward. Codes of ethics are an important part of a strong, highly ethical “tone at the top,” and an effective fraud risk management tool. We therefore support the Commission’s requirement for registrants to disclose whether they have adopted a code of ethics. More particularly, we believe that if a registrant has not adopted a code of ethics, it is important for investors and other stakeholders to understand the reasons why they have not done so.

## II. Item 407 of Regulation S-K: Corporate Governance

Effective corporate governance has been an area of focus for the CAQ and for many of its stakeholders, including investors, boards of directors, and others. For instance, the recent “Commonsense Corporate Governance Principles” put forth by leaders of Berkshire Hathaway, BlackRock, General Motors, JPMorgan Chase, The Vanguard Group, and Verizon, among others, posits: “Because well-managed and well-governed

<sup>1</sup> See the Anti-Fraud Collaboration’s *The Fraud-Resistance Organization* (November 2014), available at <http://www.thecaq.org/fraud-resistant-organization>. In addition to the Center for Audit Quality, members include Financial Executives International, the National Association of Corporate Directors, and The Institute of Internal Auditors. For information, please see <http://www.antifraudcollaboration.org>

<sup>2</sup> See page 11 of *The Fraud-Resistance Organization* (November 2014), available at <http://www.thecaq.org/fraud-resistant-organization>.

<sup>3</sup> KPMG LLP’s *Integrity Survey 2013* is available at <http://www.kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Documents/Integrity-Survey-2013-O-201307.pdf>.

<sup>4</sup> See item 1.3 in the Council of Institutional Investor’s *Corporate Governance Principles* (April 2015), available at [http://www.cii.org/files/committees/policies/2015/04\\_01\\_15\\_corp\\_gov\\_policies.pdf](http://www.cii.org/files/committees/policies/2015/04_01_15_corp_gov_policies.pdf)

<sup>5</sup> See page 30 of the Association of Certified Fraud Examiners *2016 Report to the Nations on Occupational Fraud and Abuse*, available at <http://www.acfe.com/rtn2016.aspx>.

businesses are the engine of our economy, good corporate governance must be more than just a catch phrase or fad.”<sup>6</sup> We agree that well-governed companies are essential to shareholder and public trust in the capital markets.

Specifically, the CAQ views quality financial reporting and transparent disclosure as critical to good corporate governance. This premise was underscored by California Public Employees’ Retirement System Investment Director, Sustainability, Anne Simpson, at a September 21, 2016 House Financial Services Committee Capital Markets Subcommittee hearing entitled *Corporate Governance: Fostering a System that Promotes Capital Formation and Maximizes Shareholder Value*. Simpson testified that, “Corporate financial reporting plays a key role in capital markets by providing transparent and relevant information about the economic performance and condition of businesses. Because we believe in transparency related to operating, financial, and governance information, we strongly support a review of the effectiveness of SEC disclosures, but such review should have a strong focus on the needs of investors and other users.”<sup>7</sup>

#### **a. Item 407(d): Audit Committee**

The CAQ believes that the needs of investors and other users should be a primary focus of the Commission’s disclosure effectiveness considerations. Consequently, given the importance of audit committees in the protection of investor interests and the proper functioning of capital markets, we believe it is vital for investors and other stakeholders to understand and have confidence in the audit committee’s processes and communications. Public disclosures, including those outlined in Section 407(d) of Regulation S-K, are the primary channel through which audit committees communicate with investors and other stakeholders about their critical responsibilities and how they execute those responsibilities.<sup>8</sup>

##### **i. Positive Trends in Voluntary Audit Committee Disclosure**

In recent years, investors have increasingly been communicating directly with audit committees about the types of disclosures they find useful. For instance, in each proxy season since 2012, the pension fund of the United Brotherhood of Carpenters and Joiners of America has written letters to a number of companies seeking additional audit committee disclosures related to the audit committee’s responsibilities with regard to the external auditor. In its *Proxy Voting Guidelines for U.S. Securities*, BlackRock highlighted its expectations around audit committee reports, noting “[w]e look 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 committee.”<sup>9</sup>

As discussed in the CAQ’s September 2015 response to the SEC’s Concept Release on *Possible Revisions to Audit Committee Disclosures*,<sup>10</sup> we believe that audit committees and the market are in the best position to continue to determine which disclosures are most meaningful to companies investors and other relevant market

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<sup>6</sup> See “Commonsense Corporate Governance Principles,” (July 21, 2016), available at <http://www.governanceprinciples.org/>.

<sup>7</sup> See Testimony of Anne Simpson (September 21, 2016), available at <http://financialservices.house.gov/uploadedfiles/hhrg-114-ba16-wstate-asimpson-20160921.pdf>.

<sup>8</sup> See The Conference Board Governance Center Task Force on Corporate/Investor Engagement’s *Guidelines for Engagement* (March 11, 2014), available at <https://www.conference-board.org/publications/publicationdetail.cfm?publicationid=2708>.

<sup>9</sup> See page 7 of BlackRock’s *Proxy Voting Guidelines for U.S. Securities* (February 2015), available at <http://www.blackrock.com/corporate/en-us/literature/fact-sheet/blk-responsible-investment-guidelines-us.pdf>.

<sup>10</sup> See CAQ letter in response to File No. S7-13-15 (August 12, 2015), available at <https://www.sec.gov/comments/s7-13-15/s71315-12.pdf>.

participants. The continuing positive trend of enhanced audit committee disclosures—which the data discussed below indicates is already occurring— informs our belief that a voluntary, market-driven approach is most effective at increasing transparency around information investors find useful.

Further, we believe prescriptive requirements could stifle innovation and eliminate the differentiation that the market is currently providing. A mandatory set of prescriptive disclosures would not allow for the flexibility needed to reflect the myriad of unique company challenges and particular circumstances audit committees encounter. Finally, it is our belief that the audit committee, taking into consideration input from investors and other stakeholders, is best positioned to determine which disclosures to include since it can take a holistic view of the financial reporting process and consider relevant factors, including what information could be material based on communication with, or requests from, those investors and other stakeholders.

With its partners in the Audit Committee Collaboration, the CAQ published “*Enhancing the Audit Committee Report: A Call to Action (A Call to Action)*.”<sup>11</sup> The report called for strengthened disclosures and encouraged public company audit committees to *voluntarily* improve their disclosures. The report also highlighted the positive trend of voluntary, enhanced disclosures and provided examples from large public companies’ proxy statements demonstrating innovative and effective audit committee disclosure practices.<sup>12</sup>

Data shows that the trend noted in *A Call to Action* has continued with growth over the last several years in the number of audit committees that are voluntarily providing disclosures that are tailored, innovative, and responsive to investor and other stakeholder needs. In fact, a recent EY Center for Board Matters report—*Audit Committee Reporting to Shareholders in 2016*—analyzes the 2016 proxy statements of Fortune 100 companies and concludes, “voluntary audit-related disclosures continue to trend upward in a number of areas.”<sup>13</sup> Among other notable positive trends over the past several years, the report notes that:

- In 2016, 82% of reviewed companies specified that the audit committee is responsible for the appointment, compensation, and oversight of the auditor, compared with 42% in 2012.
- 73% of reviewed companies disclosed that the audit committee was involved in the selection of the audit firm’s lead engagement partner; in 2012, only 1% of the companies did so.
- Of the reviewed companies, 63% disclosed auditor tenure, compared with 24% in 2012.

Fortune 100 companies are not the only ones in which there are evident voluntary increases in enhanced disclosures. In 2014, the CAQ and Audit Analytics<sup>14</sup> began taking a deeper dive into audit committee reporting and applying a “barometer”<sup>15</sup> to measure the robustness of disclosures among Standard & Poor’s (S&P) 500 Large Cap companies, S&P Mid Cap 400, and S&P Small Cap 600.

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<sup>11</sup> The Center for Audit Quality, the National Association of Corporate Directors, NYSE Governance Services, Tapestry Networks, Mutual Fund Directors Forum, AACM Inc., and the Directors’ Council comprise the Audit Committee Collaboration. See its report *Enhancing the Audit Committee Report, A Call to Action* (November 20, 2013), available at <http://www.thecaq.org/enhancing-audit-committee-report-call-action>.

<sup>12</sup> See pages 8-16 of the *Call to Action*, with excerpts from the 2013 proxy statements of Coca-Cola, Prudential Financial, General Electric Company, Citigroup Inc., Pfizer Inc., Comcast Corporation, McDonald’s Corporation, et. al.

<sup>13</sup> See EY’s Center for Board Matters *Audit Committee Reporting to Shareholders in 2016* (September 2016), available at [http://www.ey.com/Publication/vwLUAssets/ey-audit-committee-reporting-to-shareholders-in-2016/\\$FILE/ey-audit-committee-reporting-to-shareholders-in-2016.pdf](http://www.ey.com/Publication/vwLUAssets/ey-audit-committee-reporting-to-shareholders-in-2016/$FILE/ey-audit-committee-reporting-to-shareholders-in-2016.pdf).

<sup>14</sup> Audit Analytics is an independent research provider that enables accounting, legal and investment communities to analyze auditor market intelligence, public company disclosure trends and risk indicators.

<sup>15</sup> The “barometer” of audit committee transparency is focused on measuring the content of proxy statement disclosures in certain key areas, including auditor oversight and audit committee scope of duties. See *Audit Committee Transparency Barometer* reports, available at <http://www.thecaq.org/audit-committee-transparency-barometer>.

The CAQ and Audit Analytics recently analyzed information on disclosure practices by companies in these indices from the 2016 proxy season, and have highlighted a sample of the information that will be published in the 2016 Barometer, set for publication in November 2016 (Table 1). From 2014 to 2016, the data shows double-digit growth in the percentage of S&P 500 companies disclosing information in several key areas of external auditor oversight, including external auditor appointment, tenure of audit firm engagement, audit firm compensation, engagement partner selection, engagement partner rotation, and evaluation criteria of the external audit firm. Disclosure around criteria considered when evaluating the audit firm has more than quadrupled in S&P 500 proxy statements, compared to 2014.

**Table 1: Select 2016 S&P 1500 Proxy Statements: Disclosures re. Auditor Oversight**

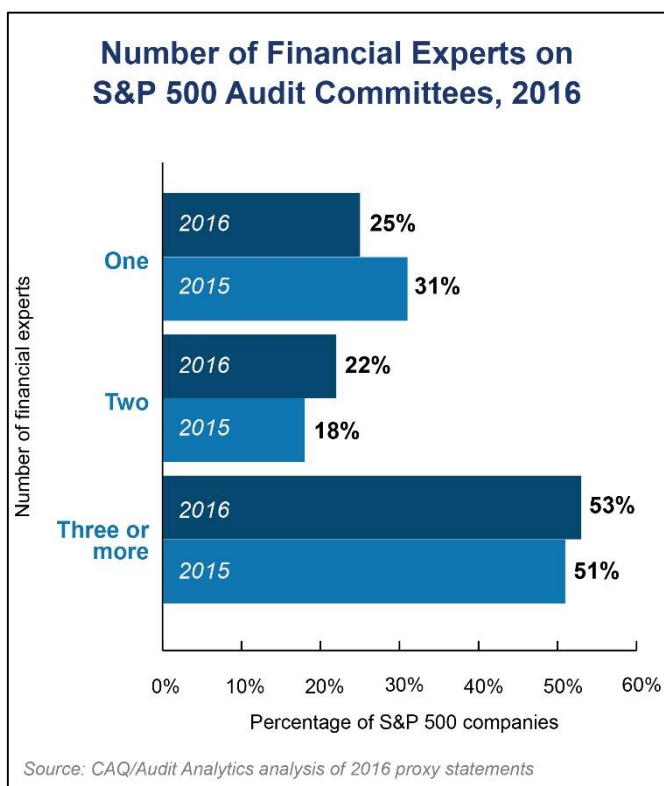
<b>Auditor Oversight Proxy Statement Disclosures Among S&amp;P Companies</b>					
CATEGORY	DISCLOSURE QUESTION	YEAR	S&P 500	S&P MIDCAP	S&P SMALLCAP
Audit Firm Selection	Is there a discussion of audit committee considerations in appointing the external auditor?	2016	31%	22%	17%
		2015	25%	16%	11%
		2014	13%	10%	8%
	Do they disclose the length of time the auditor has been engaged?	2016	59%	45%	48%
		2015	54%	44%	46%
		2014	47%	42%	50%
Audit Firm Evaluation/Supervision	Is there a discussion of criteria considered when evaluating the audit firm?	2016	34%	26%	25%
		2015	24%	25%	22%
		2014	8%	7%	15%
Audit Partner Selection	Is it explicitly stated that the audit committee is involved in selection of audit engagement partner?	2016	43%	10%	6%
		2015	31%	5%	3%
		2014	13%	1%	1%

The data suggests, and the CAQ believes, that audit committees are responding to increased interest by investors, regulators, and other stakeholders in their roles and responsibilities by providing the marketplace with more meaningful information about the audit committee's role in external auditor oversight. Therefore, the CAQ supports continued voluntary disclosure that reflects the needs and interests of market participants.

ii. Item 407(d)(5): Audit Committee Financial Expert

While the U.S. approach to audit committee composition and expertise has been successful, the topic of audit committee expertise deserves continual attention, and the CAQ commends the SEC for seeking comment on this issue. In April 2016, the 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, including a look at the definition of "audit committee financial expert" (ACFE). As noted in our summary of the event,<sup>16</sup> for the most part, panelists agreed that the current SEC rule on ACFEs strikes a good balance on audit committee expertise. As evidence of this success, panelists pointed to data on financial expertise on audit committees of leading U.S. companies. According to 2016 research from the CAQ and Audit Analytics, 53% of S&P 500 companies reported having three or more financial experts in 2016 (Table 2).

<sup>16</sup> See *CAQ Insights – The Audit Committee of the Future* (June 6, 2016), available at [http://www.thecaq.org/sites/default/files/caq\\_insights\\_audit\\_committee\\_future\\_0.pdf](http://www.thecaq.org/sites/default/files/caq_insights_audit_committee_future_0.pdf).

**Table 2: S&P 500 Disclosures re. Audit Committee Financial Experts**

It was observed, however, that many companies likely have more ACFEs than their disclosures indicate, since the Instruction to Item 407(d)(5)(i) states: “If the registrant’s board of directors has determined that the registrant has more than one audit committee financial expert serving on its audit committee, the registrant may, *but is not required to*, disclose the names of those additional persons” (emphasis added).

The data suggests that, compared to the previous year (2015), more companies in 2016 disclosed if they had more than one (i.e., two or more) ACFEs. Specifically, in 2016 75% of companies in the S&P 500 disclosed that they had either two or more ACFEs, up from 2015 when 69% of companies reported two or more ACFEs on their audit committee.

Finally, in June 2016, the CAQ released a video<sup>17</sup> on the topic of the ACFE that features interviews of leading audit committee chairs regarding their views on the importance of audit committee financial

experts. There was unanimous agreement surrounding the importance of the ACFE, along with acknowledgement that a diversity of skill-sets is also very important to the proper functioning of the audit committee. We encourage companies to continue to add transparency around how many audit committee financial experts they have as well as their qualifications, and we recommend the SEC continue the dialogue around this important topic.

#### **b. Item 407(g): Smaller Reporting Companies**

As outlined in the CAQ’s August 30, 2016 joint letter with CII in response to the Commission’s proposal, Amendments to Smaller Reporting Company Definition,<sup>18</sup> the CAQ strongly supports maintaining the current accelerated filer public float threshold. As stated in that comment letter, the CAQ also opposes any amendments that would erode Section 404(b) or increase the accelerated filer public float threshold. The CAQ and CII believe that any amendment that erodes Section 404(b) would substantially impact the quality of financial reporting by public companies to the detriment of investors and our capital markets more generally.

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<sup>17</sup> See *CAQ Insights – Audit Committee Financial Expert* (June 6, 2016), available at <http://www.thecaq.org/caq-insights-audit-committee-financial-expert>.

<sup>18</sup> See CAQ and CII joint letter in response to Release No.33-10107, Amendments to Smaller Reporting Company Definition (August 30, 2016), available at <http://www.thecaq.org/sec-amendments-smaller-reporting-company-definition>.

We thank the SEC for providing the Center for Audit Quality with the opportunity to express its views on the Request for Comment. As described above, the CAQ is supportive of efforts to improve corporate governance, particularly through the encouragement of strong codes of ethics as well as through effective corporate governance and transparent disclosure that is responsive to investor and market needs.

As the data cited in this letter suggests, positive, market-driven trends in enhanced audit committee disclosures are increasingly affording improved transparency regarding audit committee roles and responsibilities. We believe it would be prudent for the SEC to encourage and continue to let audit committees voluntarily enhance and tailor their disclosures based on their particular circumstances. Like audit committee reporting, we believe market-driven solutions are also most likely to be effective in promoting effective corporate governance, and, as evidenced by the aforementioned *Commonsense Corporate Governance Principles*, companies are taking note.

Sincerely,



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Executive Director  
Center for Audit Quality

cc:

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