

Enhancing Audit Quality: Canadian Perspectives



BACKGROUNDER

This paper provides background to and an overview of the consultation process being led by the Canadian Public Accountability Board (CPAB) and the Canadian Institute of Chartered Accountants (CICA) to gain stakeholder input on key issues emerging with respect to enhancing audit quality globally, and the impact on Canada.

INTRODUCTION

Since the global financial crisis in 2008-2009, various policymakers, regulators, standard setters and others have been considering changes to the financial system to promote greater financial stability and reduce systemic risk.

Although auditors are not seen as having caused company failures during the crisis, the efforts undertaken to address weaknesses in the financial system are considering the roles of all key contributors to sound financial reporting, including auditors. Several global initiatives are now underway that will result in changes to the audit process both internationally and in North America that will affect audit quality.

Some of the major initiatives include:

- European Commission (EU) proposals on specific requirements regarding statutory audits of public-interest entities;
- United States (U.S.) Public Company Accounting Oversight Board (PCAOB) concept releases dealing with the form and content of reports on audited financial statements and with ways to enhance auditor independence, objectivity and professional skepticism;
- United Kingdom (U.K.) Financial Reporting Council proposals for effective company stewardship; and the
- International Auditing and Assurance Standards Board's (IAASB) project to enhance auditor reporting.

A summary of the underlying issues and concerns addressed by these international initiatives is provided in [Appendix A \(p. 6\)](#).

WHAT WILL GLOBAL CHANGES MEAN FOR CANADA?

Canada weathered the financial crisis well relative to many other countries and did not experience the bank and other financial system failures that are driving many of the changes to the audit process internationally. This may be attributable to a number of factors, such as Canada's:

- Sound banking, securities and financial regulatory systems;
- Well-respected corporate governance practices;
- Adoption of high quality international accounting and auditing standards;
- Strong regulatory mechanisms for auditors, including audit inspection regimes, professional qualification and continuing education requirements, and ethical standards; and
- Auditors generally performing audits of sound audit quality.

Canada has an enviable reputation on the world stage because of the stability of its financial system. Further, Canadians are involved in a number of international bodies that set policy, standards or best practices. Because of the influential voice that Canada brings to the international table, it is often said that Canada "punches above its weight."

However, Canada will not be immune to changes taking place in the U.S., Europe and the U.K. Many Canadian entities operate in an global environment so it is important for them that Canada's audit process and audit quality are consistent and comparable internationally.

Further, key elements of the Canadian financial reporting system, for example securities regulation, accounting, auditing and ethical standards, audit oversight, and corporate governance best practices, are linked internationally. Like it or not, changes to the audit enacted among our major trading partners, will likely affect audits of all Canadian entities whether listed or unlisted, profit or not-for-profit, in the public or private sectors. This will in turn affect Canadian investors and the health and smooth running of the Canadian capital markets.

The question is:

What role Canada should play as international proposals are being developed?

At an audit quality symposium conducted by CPAB in December 2011, policy makers from Canada and around the world agreed that it was important that Canada develop its own views about solutions and seek to influence final outcomes.

ENGAGING CANADA'S BUSINESS AND INVESTMENT LEADERS IN THE DISCUSSION

Recognizing that Canada will not be exempt from global changes, and the strong role Canada currently plays internationally, CPAB and the CICA initiated a research and consultation process to develop clarity on the Canadian view on the issues.

There are three primary objectives of the consultation process:

1. Provide useful input to Canadian standard setters, regulators and others as they consider any potential changes in Canada in the wake of developments taking place outside our borders;
2. Enable Canadians engaged in global discussions about enhancing audit quality to present a strong and credible Canadian voice
3. Set an appropriate context for further research, debate and guidance to support the enhancement of audit quality in Canada in the future.

Conducting such a process requires the involvement of a wide range of stakeholders. To provide effective coordination and direction to this work, an Enhancing Audit Quality Steering Group has been established representing banking, securities and audit regulators, institutional investors, audit committee chairs and the Auditing and Assurance Standards Oversight Council (AASOC). The steering group, chaired by David Brown, a leading securities lawyer and former Chair of the Ontario Securities Commission, will provide direction and oversight to the work program and output from three working groups dealing with the role of audit committees, auditor reporting and auditor independence. The steering group is responsible for ensuring a transparent process that serves the public interest.

The CICA is providing expertise and resources to support the three working groups that will address specific aspects of changes being proposed and discussed around the world. The working groups will consist of leading experts with audit committees, auditing and assurance standard setters, auditors, institutional investors, prudential and securities regulators, financial statement preparers, CPAB and the CICA.

The areas being considered by the three working groups are as follows:

The Role of the Audit Committee Working Group

- Reporting relationships among audit committees, management, auditors, audit inspectors, regulators and shareholders.
- Enhancing and promoting the application of professional skepticism by the audit committee and the auditor.

The Role of the Audit Committee Working Group will issue a discussion paper for comment by the fall of 2012 with a report reflecting the results of the consultation process developed by the winter of 2013.

The Auditor Reporting Working Group

- Enhancing the information value of the auditor's report.
- Expanded assurance by auditors on parts or all of Management's Discussion & Analysis (MD&A), quarterly financial statements, and other information.

The Auditor Reporting Working Group will issue a discussion paper for comment by late spring/summer of 2012 with a report reflecting the results of the consultation process developed by the fall of 2012.

The Auditor Independence Working Group

- Options relating to the appointment and rotation of, and services provided by, auditors that will improve independence, objectivity, professional scepticism and audit quality at firms.

The Auditor Independence Working Group will issue a discussion paper for comment by late spring/summer of 2012 with a report reflecting the results of the consultation process developed by the fall of 2012.

More information on the steering and working groups can be found [here](#).

WHERE CAN I FIND OUT MORE?

For more information about the consultation process, along with opportunities to participate and how to share your thoughts, visit the [Enhancing Audit Quality: Canadian Perspectives](#) section of the CICA website.

ABOUT CPAB:

The Canadian Public Accountability Board (CPAB) is Canada's audit regulator, dedicated to protecting the investing public's interests and to delivering value to its various stakeholders through world class audit regulation.

CPAB regulates the auditors of Canadian public companies through its national inspection program. CPAB delivers value by promoting high-quality, independent auditing. As a champion of audit quality, CPAB contributes to public confidence in the integrity of financial reporting, which supports Canada's capital markets. (www.cpab-ccrc.ca)

ABOUT CICA:

Chartered Accountants (CAs) are Canada's most valued, internationally recognized profession of leaders in senior management, advisory, financial, tax and assurance roles. Through their integrity, expertise, and internationally recognized qualification standards, Canada's more than 81,000 CAs sustain their influence and leadership position both in Canada and globally.

As trusted business advisors to Canadian organizations of all sizes, Canada's CAs foster confidence in Canadian business and contribute to the health and sustainability of Canada's capital markets and economy. The Canadian Institute of Chartered Accountants (CICA) represents Canada's CA profession both nationally and internationally. The CICA is a founding member of the International Federation of Accountants (IFAC) and the Global Accounting Alliance (GAA). (www.cica.ca)

APPENDIX A

COMMON ISSUES CONSIDERED IN INTERNATIONAL AUDIT QUALITY INITIATIVES

Most of the international proposals underway with respect to enhancing audit quality focus on one or more of the following issues:

The gaps that exist between investor expectations about (a) the audit and what an audit actually is, and (b) information investors believe they should receive and what they actually receive

Two main gaps have been identified: expectation and information gaps.

The **expectation gap** is referred to as the difference between what users expect from the auditor in a financial statement audit, and what an audit actually is. It is often attributable to a misunderstanding by users about the nature of an audit, including its scope, objectives and inherent limitations. Many users believe that the generic language used in the auditor's report does not provide a complete picture about the extent of the auditor's procedures on a particular audit.

The **information gap** refers to the fact that the information in an entity's audited financial statements and the auditor's report are only a part of the wider information set available to management and/or the auditor. A perception exists that there should be more transparency about the entity and its financial statements. In particular the key financial reporting risks and how they are being addressed, along with the audit performed, including fundamental areas of audit risk.

Users believe that the auditor's report could be enhanced to provide more information about the audit, and to provide auditor insights about the entity and the quality of its financial reporting, that would address the expectation and information gaps.

Concerns and perceptions about auditor independence, objectivity and professional skepticism

Some noted that during the financial crisis auditors gave clean audit opinions on the financial statements of some entities that shortly thereafter were identified as being in severe financial difficulty. They believe that auditors should have been raising warning flags. The issue also raises questions about the value of an audit and, in particular, auditors' independence, objectivity or professional skepticism. Further, audit inspection bodies around the globe are considering whether inspection deficiencies are attributable to a failure to exercise the required professional skepticism and objectivity. Several international bodies are considering how auditor independence, objectivity and professional skepticism can be enhanced. In this respect, a number of options are being considered such as whether:

- Joint audits should be mandated. A joint audit is an audit conducted by two or more firms that share the audit work and jointly sign the audit report;
- There should be mandatory rotation of audit firms, and if entities should be required to put the audit out to tender after a fixed period. It has been noted, for example, that some entities have retained the same auditor for many years; and
- Non-audit services provided by auditors should be prohibited.

The corporate governance reporting model

Those charged with governance of an entity (often the audit committee) have the responsibility to oversee the financial reporting process and play a role in promoting and enhancing audit quality. Effective communication between the auditor and the audit committee assists the audit committee in understanding matters related to the audit and contributes to a constructive working relationship between the auditor and the audit committee. Many auditors provide extensive information about the audit process and findings to the audit committee.

There are proposals that recommend enhancing the auditor's communications with the audit committee. It has also been suggested that it would be beneficial for the audit committee to report to the shareholders (perhaps with assurance provided by the auditors) some of this information, including matters of significance identified by the auditors, and explain how the audit committee discharged its financial reporting oversight responsibilities.

Communications between auditors and regulators

In some jurisdictions, protocols exist that require auditors to communicate reportable transactions, such as breaches of laws by a bank, to prudential regulators. The effectiveness of these communications during the financial crisis is being examined and improvements suggested. Some bodies are also considering extending such protocols more broadly to other types of entities and other regulators.

Concentration in audit providers

In some markets, such as the U.K. and many states in the European Union, the so called Big Four (Deloitte, Ernst & Young, PricewaterhouseCoopers and KPMG) have a total market share of over 90%. Entry into this top-tier section of the audit market has proven very difficult for many mid-tier audit firms. Such concentration may create a systemic risk if one of the large firms should collapse. Some bodies are considering means of addressing these risks. Joint audits, mandatory audit firm rotation and mandatory re-tendering are some of the options being contemplated.