Enhancing Audit Quality: Canadian Perspectives

Conclusions and Recommendations

May 2013

CPA
CHARTERED PROFESSIONAL ACCOUNTANTS CANADA

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ENHANCING AUDIT QUALITY:
Conclusions and Recommendations

CONTENTS

Acknowledgments

This report completes the Enhancing Audit Quality initiative. The idea for this initiative arose following the audit symposium organized by the Canadian Public Accountability Board in December 2011, and work commenced in earnest in February 2012.

While this report completes the initiative, much more work is needed before the conclusions can be finalized for review and action by the pertinent competent bodies in Canada. As well, reforms introduced in other jurisdictions, such as Europe and the United States, will have to be carefully monitored to ensure that Canadian reforms are not in direct conflict with those proposed elsewhere, frustrating attempts to harmonize the solutions ultimately implemented.

We acknowledge the leadership provided by the chairs of the steering group and the three working groups. We are also grateful to the individuals in the groups who analyzed proposals, arrived at carefully reasoned conclusions and reviewed them in the light of thoughtful and helpful comments received from Canadians and others from around the world.

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President and Chief Executive Officer	Chief Executive Officer
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May 30, 2013

Foreword

The economic turmoil resulting from the 2008 global crisis continues. A number of international bodies in jurisdictions most affected by the fallout are now looking at various activities in the capital markets that may need reform to prevent such economic meltdowns in the future. The activities under review include auditing, which is the focus of this report. Virtually every body addressing issues arising from the crisis recognizes that the auditing of financial reports contributes to the efficiency of capital flows in the global market place. It is axiomatic to question what part auditing played whenever a failure occurs in any aspect of the functioning of capital markets. It also follows that the bodies addressing such questions will propose solutions aimed at correcting perceived problems. Reform is needed to ensure that the practice of auditing remains relevant and adds credibility and, therefore, value to financial reporting. We in Canada must examine the issues being raised and determine the extent to which reforms being proposed elsewhere would be appropriate for Canada or whether other reforms would better serve to enhance the quality of Canadian auditing while remaining cost effective to implement.

Rather than sit on the sidelines, the Chartered Professional Accountants of Canada[*] (CPA Canada) and the Canadian Public Accountability Board (CPAB) collaborated on an initiative to examine how to enhance audit quality to remedy perceived problems and encourage participants in the financial reporting chain to comment on the remedies suggested.

Three working groups of prominent business people carried out the Enhancing Audit Quality (EAQ) initiative, examining questions about enhancing audit quality, developing consultation papers and inviting comments on their analysis and conclusions. A steering group provided oversight for the working groups, bringing its considerable experience and knowledge to bear when probing and questioning working drafts of the discussion papers.

The three working groups each addressed a specific focus area – the auditor reporting model, auditor independence and the role of audit committees in external auditor oversight. The working groups' consultation papers were widely disseminated for comment. Thoughtful and considered comments came from a diverse group of stakeholders that included regulators, preparers, auditors and members of corporate boards and audit committees. The level of engagement was greater than expected and gratifying. The working groups reviewed the comments and re-deliberated their conclusions. The steering group then reviewed the analyses and conclusions, arriving at final positions on each area of focus. The consultation papers, comments and the analysis of the final disposition of those comments are available on the EAQ initiative web page.

This report is a synthesis of the main conclusions of the EAQ initiative; it does not compile, summarize or repeat the extensive analysis and deliberations of the working groups. Readers who would like a more thorough analysis and discussion of the issues examined are encouraged to review the consultation papers and the reports summarizing the comments received, and their disposition, posted on the web page noted above.

[*] *The CICA and CMA Canada joined together January 1, 2013 to create CPA Canada as the national organization to support unification of the Canadian accounting profession under the CPA banner.*

This report does not represent the views of regulators or standard setters, as they are required to follow due process in formulating rules or standards. Rather, the report provides the considered view of a group of experienced business people directly involved in one or more elements of the financial reporting process. In reaching their views, the working groups evaluated the extensive feedback on their discussion papers, which included varied views on the issues and varied levels of importance placed on those issues.

Appendix A sets out the composition of the steering and working groups.

We, the chairs of these groups, wish to express our gratitude to all the individuals involved – members, observers, coordinators and staff. Their dedication and hard work to complete the project within an aggressive timeline is much appreciated. We also thank the many participants who commented on the preliminary conclusions of the working groups. We found these comments thoughtful and helpful when re-deliberating our conclusions.

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Chapter 1

Introduction

1. The CPA Canada/CPAB Enhancing Audit Quality (EAQ) initiative examined numerous issues related to the audit of corporate financial reports. The issues were identified from proposals that are expected to introduce remedies through new or revised regulations and standards by policy makers, regulators and standard setters in major international jurisdictions, including the United States (US), the United Kingdom (UK) and the European Union. Several proposals would substantively reform the role and work being done by corporations, corporate governance structures – particularly audit committees – and audit firms. The EAQ initiative's working groups have not been persuaded that the proposals they examined will all achieve the expected improvements. Indeed, the EAQ groups concluded that some of the proposals might damage audit quality and increase costs not commensurate with any benefits.

2. All of the issues that the EAQ initiative's working groups examined were viewed through the lens of how they would affect audit quality. This over-arching criterion guided the groups in developing conclusions on the issues identified and introduced a central focus to their deliberations. This report focuses primarily on the contentious issues that have achieved little global consensus, and provides the reasoning supporting the conclusions the working groups reached. Many other conclusions were not disputed in the extensive working group consultations. The report summarizes those conclusions in Chapter 7.

3. The working groups focused their main deliberations on Canadian public issuer reporting. The Auditor Reporting Working Group, however, also addressed the possibility that differential audit reports may be appropriate for entities that are not public issuers. Nevertheless, conclusions reached in the other focus areas may be applicable to all entities.

4. The issues the working groups examined included the following:

   a. Will the final remedies be global in nature or jurisdiction specific? Can the Canadian authorities tolerate remedies domestically that differ from those introduced elsewhere? (See Chapter 2.)

   b. Is there an institutional familiarity threat to auditor independence caused by the long-term engagement of an audit firm? If so, what are the relative benefits of the alternatives proposed to address this issue? (See Chapter 3.)

   c. What is the current role and responsibility of audit committees in overseeing the work of the external auditors? Could or should that be enhanced? If so, what challenges, in terms of resources and expertise, will audit committees need to address? (See Chapter 4.)

   d. For assessing audit quality, should audit committees receive information about the findings and conclusions emanating from auditor inspections by independent audit oversight bodies (CPAB for Canadian reporting issuers)? (See Chapter 5.)

   e. What improvements does the auditor reporting model require to deal with acknowledged information and expectation gaps between what the reports say and what readers of the reports need? Do audit committees have a responsibility to report to investors on information received? (See Chapter 6.)

5. Chapter 7 summarizes the conclusions reached on issues that did not prove to be contentious, with respondents expressing support for the consensus view. Finally, Chapter 8 looks into possible future actions and how the conclusions reached can be finalized and made ready for action.

Chapter 2

Global Financial Reporting Environment

Background

6. Since the global economic crisis of 2008, various policymakers, regulators, standard setters and others have been considering changes to the financial system to promote greater financial stability and reduce systemic risk. The economic crisis was a stark indicator of how pervasive globalization has become. Changes – economic, regulatory or social – are now difficult to contain within any one set of borders.

7. Although auditors were 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 audit processes and structures globally, all of which will have an effect on audit quality.

8. Some of the major initiatives[1] include:

   - The European Commission's proposals on specific requirements regarding statutory audits of public-interest entities that called for mandatory audit firm rotation every six years or, in the case of joint audits, nine years; audit-only firms; requirements on tendering of audits; and further restrictions and limitations on the provision of non-audit services.
   - The US Public Company Accounting Oversight Board's 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, including consideration of mandatory audit firm rotation.
   - The UK Financial Reporting Council's proposals for effective company stewardship, which include requiring retendering of audits under a "comply-or-explain" regime for the largest UK corporations.
   - The International Auditing and Assurance Standards Board's project to enhance auditor reporting.
   - The Financial Stability Board's thematic review on risk governance, which takes stock of risk governance practices at both national authorities and firms, notes progress made since the financial crisis, identifies sound practices and offers recommendations to support further improvements.

9. These initiatives play a vital role in the international environment. In developing their proposals to address issues giving rise to the economic crisis, the regional or national bodies are playing a leadership role. They should recognize, however, that they are part of the global community and that extensive globalization is already embedded in financial reporting practices. The proposals should seek, therefore, to improve the quality of audits through international cooperation.

[1] The proposals in some of these initiatives will likely be modified in the near to medium term, making their monitoring essential as competent authorities in Canada complete their deliberations on the issues discussed in this report.

A Canadian perspective

10. The increased scrutiny of auditing structures and processes currently occurring in these other jurisdictions may have future implications for the Canadian market place, despite the fact that Canada's financial systems were relatively unaffected by the crisis that led to this scrutiny. Canada will not be immune to changes taking place in the US, Europe and the UK. As many Canadian entities operate in a global environment, it is important for them that Canada's audit structures and processes are consistent and comparable internationally.

11. Further, key elements of the Canadian financial reporting system are inter-related internationally (e.g., securities regulation, audit oversight and inspection, corporate governance best practices and accounting, auditing and ethical standards). Changes to audit structures and processes enacted by Canada's 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, the health and smooth running of the Canadian capital markets and the Canadian public interest.

12. Such a perspective is likely shared by many other jurisdictions that will be affected by the imposition of new regulations to institute desired reforms. Having identical detailed regulations in every jurisdiction may not necessarily be the most effective way for jurisdictions to meet the goals or objectives intended by those regulations. As long as clear and coordinated global objectives are established, how they are implemented could be left for jurisdictions to specify. The strengths and experience in jurisdictions can then be factored in any regulations introduced. For example, in a jurisdiction such as Canada, where the practices of audit committees are well established and regulated, it is important to recognize – rather than ignore – the role they can play to enhance audit quality.

13. As discussed in the remainder of this report, the EAQ initiative has found some international proposals wanting as they might have negative unintended consequences. It behooves those charged with the development of new requirements to take into account the global dimensions of regulations. The EAQ initiative also urges that Canadian regulators and standard setters seeking to harmonize Canadian requirements with international regulations consider permitting a degree of differentiation in the implementation of any global reforms.

Chapter 3

Audit Firm Independence and Assessment of Alternative Approaches

Background

14. The single most contentious issue addressed in this report is that of the potential threat of the lack of audit firm independence from a systemic and institutional perspective. Regulators have suggested a number of remedies ranging from subjecting audit firms to term limits to calling for mandatory retendering of audits. The arguments in support of these remedies are discussed below.

15. Those who favour introducing a term limit on audit firms reason that “by ending a firm's ability to turn each new engagement into a long-term income stream, mandatory firm rotation could fundamentally change the firm's relationship with its audit client and might, as a result, significantly enhance the auditor's ability to serve as an independent gatekeeper” (Public Company Accounting Oversight Board).[2] Further, they rebut arguments that mandatory rotation causes severe operational difficulties by pointing out that such difficulties are routinely overcome when a company chooses to appoint new auditors.

16. Regulators, such as the UK’s Financial Reporting Council, that have rejected mandatory audit firm rotation, have done so because it reduces choice and may have an adverse effect on audit quality. The Financial Reporting Council argues that “companies need to be able to secure the best auditor for their business and should not have their choice of auditor artificially constrained. This is particularly necessary when not all audit firms have expertise in a company’s business area.”[3] The Financial Reporting Council goes on to argue that companies not being able to secure their choice of auditor with the appropriate expertise would introduce an undesirable risk to audit quality and would undermine the authority of the audit committee operating in the best interests of investors.

17. Instead, the Financial Reporting Council, in its UK Corporate Governance Code, introduced a new provision that requires FTSE 350 companies to put their audits out to tender every 10 years on a “comply or explain” basis. The Financial Reporting Council considers the “comply or explain” concept an important facet of the UK’s governance regime that has been proven successful and appropriately recognizes the role of the investor in its enforcement. It argues that, without the flexibility provided by “comply or explain,” retendering for audits could take place in an inappropriate year contrary to investor’s interests. For example, when major corporate restructurings or take-over defenses are underway, audit continuity is beneficial.

18. Neither mandatory audit firm rotation nor retendering for audits are completely new proposals. For example, in the US, audit firm rotation has been considered at various times since the 1970s. There are strongly held views supporting or rejecting such proposals as well as a rich literature reporting such views. The EAQ initiative’s Auditor Independence Working Group had the benefit of reviewing the literature as it deliberated the issues for its discussion paper, *Auditor Independence*.

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[2] Public Company Accounting Oversight Board, *Concept Release on Auditor Independence and Audit Firm Rotation,* August 16, 2011.

[3] Financial Reporting Council, *Response to Competition Commission’s Statutory Audit Services Market Investigation*, March 19, 2013.

19. During its deliberations, the Auditor Independence Working Group addressed two key questions:

   a. Is there an institutional audit firm familiarity threat to auditor independence caused by the long-term engagement of an audit firm?

   b. If so, what are the relative benefits of the alternatives proposed to address this issue?

Institutional audit firm independence familiarity threat

20. Auditor independence threats can be real or perceived, and they can apply at both the individual level between management and the audit team or between audit firms and the companies they audit at the institutional level. Auditor independence threats at the individual level have been addressed through rules introduced following the corporate failures in the early 2000s. They include both prohibitions and safeguards that mitigate independence threats. The rules in Canada are essentially harmonized with those of the International Ethics Standards Board for Accountants, augmented with specific US Securities and Exchange Commission prohibitions and rules.

21. Canadian independence rules are comprehensive, and auditors have instituted significant processes and procedures to ensure that they follow the rules. These processes and procedures are detailed and necessarily complex. Auditors realize that such independence rules are a hallmark of audit quality and must be adhered to. An essential and necessary condition of audit quality is that auditors and audit firms are independent of their audit clients and have obtained sufficient appropriate audit evidence to support their independent audit opinions. In Canada, the rules are an integral part of the Rules of Professional Conduct and require, *inter alia,* prohibitions on certain non-audit services and the mandatory rotation of engagement partners and other members of the audit team. This report does not address auditor independence threats at the individual level.

22. Many of the Rules of Professional Conduct dealing with auditor independence apply to both auditors and audit firms. The primary fundamental rule states:

    "A member or <u>firm</u> who engages or participates in an engagement:
    (a) to issue a written communication under the terms of an assurance engagement; or
    (b) to issue a report on the results of applying specified auditing procedures;
    shall be and remain independent such that the member, <u>firm</u> and members of the firm shall be and remain free of any influence, interest or relationship which, in respect of the engagement, impairs the professional judgment or objectivity of the member, <u>firm</u> or a member of the firm or which, in the view of a reasonable observer, would impair the professional judgment or objectivity of the member, <u>firm</u> or a member of the firm." (Rule 204.1) (Emphasis added)

23. Other Rules of Professional Conduct require audit firms to identify any threats to their independence and, for any threats that are considered "not insignificant," to institute appropriate safeguards. If a firm cannot find appropriate safeguards, it cannot accept the engagement. If safeguards to reduce any threat to an acceptable level are available and implemented, the firm is required to document them. Comments, particularly from audit committee members, indicated that the existing rules and best practices adequately deal with any institutional familiarity threat. It is not surprising, therefore, that the majority of comments supported the rejection of mandatory audit firm rotation or mandatory retendering of audit firms.

24. In response to the first question posed in paragraph 19, the Auditor Independence Working Group accepted that there might be a perception of a threat to auditor independence caused by the long-term engagement of the same audit firm. The various proposals to deal with such threats appear to envisage a forced change of audit firms as the remedy.

25. The Auditor Independence Working Group studied the research, the proposals and the commentary on the proposals. In its view, there are few compelling arguments to support the outcomes attributed to remedies that call for a mandatory change of audit firms. Moreover, the argument that the rotation of audit firms will improve auditor skepticism when questioning management judgments and actions does not provide enough evidence to support such a conclusion. New auditors may, for example, not have the knowledge of the company or the industry that leads to asking searching questions and to informed skepticism. The exercise of auditor skepticism is a fundamental attribute of audit quality that all auditors must exercise at all times. Moreover, it must be monitored through firm quality control processes and, in the view of the Auditor Independence Working Group, by the audit committee.

26. The Auditor Independence Working Group concluded that mandatory rotation of audit firms or mandatory retendering of the audit would not contribute to the enhancement of audit quality. The decision to replace an audit firm should be an informed decision and not made merely because of a regulatory requirement to rotate audit firms whenever an arbitrary term limit is reached. Instead, a board of directors might arrive at such a decision when it determines that institutional auditor independence in reality or in perception has been compromised or that audit quality has not met the board's expectations. It is worth emphasizing that it is not corporate management that engages the auditor; the auditors – overseen by the audit committee – are appointed by, and report on the financial statements to, the shareholders.

27. The Auditor Independence Working Group did not support the Financial Reporting Council requirement for a retendering of the audit on a "comply or explain" basis. The requirement addresses the need to ensure that the replacement of the audit firm is not arbitrary and occurs on a considered basis. How the conclusion to retender or change auditors is reached is not, however, clear. Also not clear is the relationship between such a decision and audit quality.

Remedy to address an institutional familiarity threat and enhance audit quality

28. Both the Auditor Independence Working Group and the Audit Committee Working Group agreed that the proposals for mandatory audit firm rotation or mandatory retendering of an audit do not sufficiently address how they would enhance audit quality. These proposed remedies could distract the attention of audit committees and corporate management by calling for tenders and reviewing them at the expense of focusing on audit quality. The Auditor Independence Working Group put forward a third alternative: having the audit committee undertake a comprehensive review of the audit firm at least every five years, resulting in a recommendation to either retain or replace the firm. The working group's comparative analysis of the alternatives addressing the institutional familiarity threat is set out in the Addendum to this chapter.

29. The EAQ initiative concluded that the audit committee's periodic comprehensive review was the preferred alternative. The reasons for this conclusion are that this solution places an onus on the audit committee to consider any institutional familiarity threats created by the cumulative weight of increased audit firm tenure. The review would focus on issues such as the application of auditor skepticism with the aim of enhancing audit quality. The audit committee's public report on the review would improve transparency around the auditor evaluation and reappointment process. Such a periodic review would augment the current practice of an annual assessment of the external audit, which audit committees conduct to fulfill their responsibility to recommend auditors to the board.

30. The overriding benefit of a periodic comprehensive review of the audit firm accrues from the realization that the review is conducted with the best interests of shareholders in mind instead of a requirement to follow a "one size fits all" mandate that does not (or indeed cannot) take into account the particular circumstances of a corporation and its shareholders. The comprehensive review permits the audit committee to:

    a. hire or retain the audit firm it considers the best for the company, which would factor in issues such as the continuity of audit services, industry expertise and, importantly in jurisdictions such as Canada, the geographic availability of audit resources;

    b. determine the timing of any change in audit firm; and

    c. hone its skill in overseeing the audit firm and enhancing audit quality.

    The review would also enable the audit firm to focus on audit quality rather than concentrating its best efforts on winning proposals.

Conclusions

31. The Working Groups concluded that:

    a. The mandatory rotation of audit firms or mandatory retendering of the audit would not contribute to the enhancement of audit quality.

    b. Having the audit committee perform a periodic comprehensive review of the audit firm at least every five years, resulting in a recommendation to retain or replace the audit firm, is the preferred approach to address any institutional familiarity threats potentially created by audit firm tenure and to focus on audit quality.

    c. A report summarizing the results, findings and conclusions of the comprehensive review should be included in an entity's public disclosures in the year the comprehensive review is carried out.

32. The EAQ initiative's Steering Group discussed whether it was better to await final reforms elsewhere before implementing the conclusions and recommendations in this report and agreed that the conclusion supporting the audit committee's periodic comprehensive review of the audit firm offered sufficient benefits to warrant going ahead regardless of what remedy was finally introduced in other jurisdictions.

Recommendations

33. The EAQ initiative recommends that:

    a. Audit committees should perform a comprehensive review of the external auditor at least once every five years. Such comprehensive reviews would augment the audit committee's annual assessment of external auditors.

    b. Audit committees should publicly report on the scope and process of their comprehensive review and the basis for their recommendations on the retention or replacement of the audit firm.

Chapter 3 Addendum

Comparative Analysis of Proposals to Enhance Auditor Independence

	Mandatory Audit Firm Rotation	Mandatory Tendering of the Audit	Mandatory Comprehensive Review of the Auditor's Performance with a Focus on Audit Quality
Concept description	A new audit firm must be appointed, usually after a specified period. The existing audit firm is not eligible for reappointment to retain the engagement.	Potential appointment of a new audit firm, but the existing audit firm is eligible for re-appointment.	Existing audit firm will ordinarily retain the engagement, unless the audit committee has determined that the audit firm has not met audit quality expectations or that institutional familiarity threats may exist.
Independence	Depending upon the length of the rotation period, will eliminate or significantly reduce the institutional familiarity threats since a change in the audit firm must occur.	Depending upon the length of the rotation period, will eliminate or significantly reduce the institutional familiarity threat if a change is made.	Should reduce the institutional familiarity threats through either a change in the audit firm or through the assessment process itself since an assessment could drive a behavioural change in the audit firm. The process would include an assessment of institutional threats, including a consideration of the length of the service term of audit firms and their senior members.
Transparency	It is presumed there will be some type of disclosure for all three concepts, but the nature of disclosure will vary.		
	This proposal may result in a loss of transparency in why a change of auditor has taken place since the change would be mandated. As a result, any disagreements between auditors and their audit clients may become less transparent.	Provides transparency on the auditor appointment process, especially with the potential "comply-or-explain" regime; however, as with mandatory audit firm rotation, disclosure of disagreements may become less transparent.	Provides a substantial amount of transparency around the process as audit committees would communicate the basis for concluding whether or not to change the auditor.

	Mandatory Audit Firm Rotation	Mandatory Tendering of the Audit	Mandatory Comprehensive Review of the Auditor's Performance with a Focus on Audit Quality
Audit quality	The fresh perspective brought by a new audit firm could increase audit quality. Focus of the change process is on evaluating a potential new audit firm and audit fees, not the audit quality and independence of the incumbent audit firm. For the few countries that have adopted the concept, the Auditor Independence Working Group found no reliable evidence that mandatory rotation has improved audit quality. The Auditor Independence Working Group was concerned that a loss of institutional knowledge and difficulties in selecting a new and eligible audit firm with appropriate technical expertise could decrease audit quality.	Could motivate audit firms to enhance audit quality as reappointment can no longer be presumed. Potential for the auditor to be less challenging of management due to the concern of losing the engagement as the audit firm approaches the tendering period. Audit committee focus could be more on evaluating a potential new audit firm and audit fees, not on the audit quality and independence of the incumbent audit firm.	Of the various proposals to enhance audit quality, this has the greatest potential for meaningful change since it has the most comprehensive focus by having the audit committee assess audit quality, including independence, objectivity and professional skepticism.
Governance impact	Reduces audit committee's accountability and responsibility for assessing auditor performance and determining when to rotate or tender the audit.	Reduces the audit committee's consideration of the appropriate timing for tendering of the audit.	The audit committee would have accountability and responsibility for assessing the quality of the auditor and determining when a change is appropriate. Audit committee time would be focused on audit quality.
Work effort/cost	Work effort for the audit committee and audit firms would be comparable in mandatory audit firm rotation and tendering. Management will also spend more time with the new auditors to educate them on the company's operations, systems, business practices and financial reporting processes. Shareholders indirectly bear those costs.	Work effort for the audit committee and audit firms would be comparable in mandatory audit firm rotation and tendering. If a new auditor is appointed, time and costs would be comparable to mandatory audit firm rotation.	More time and effort spent by the audit committees in the review process. If mandatory comprehensive review leads to tendering, there would be costs for both the review and tendering processes. With the process being led by the audit committee, resource constraints could pose some practical challenges. Therefore, the solution would need to be scalable. Less work effort for company management when there is no change in auditor. Increased work effort required by the audit firm to demonstrate to the audit committee its independence, objectivity and professional skepticism.

Chapter 4

Enhancing the Role of Audit Committees in Overseeing External Auditors

Current role of audit committees

34. Audit Committees in Canada are generally experienced, independent and qualified because of the rigorous development and refinement in regulatory requirements since their introduction in the 1970s. The Canadian Securities Administrators issued a National Instrument in 2004 (NI 52-110) that established a wide range of audit committee responsibilities. This report focuses on the quality of audits of financial reports and does not address other audit committee responsibilities. This chapter examines the current significant role and responsibilities that audit committees play in overseeing the work of the external auditor before discussing how to enhance their role.

35. National Instrument NI 52-110, Part 2, Section 2.3 states:

    2. *An audit committee must recommend to the board of directors:*

        a. *the external auditor to be nominated for the purpose of preparing or issuing an auditor's report or performing other audit, review or attest services for the issuer; and*

        b. *the compensation of the external auditor.*

    3. *<u>An audit committee must be directly responsible for overseeing the work of the external auditor</u> engaged for the purpose of preparing or issuing an auditor's report or performing other audit, review or attest services for the issuer, including the resolution of disagreements between management and the external auditor regarding financial reporting. (Emphasis added.)*

    4. *An audit committee must pre-approve all non-audit services to be provided to the issuer or its subsidiary entities by the issuer's external auditor.*

36. NI 52-110, Part 3, specifies the composition of the audit committee, stating that an audit committee must have a minimum of three members, all of whom must be directors of the company, be independent and be financially literate. Venture issuers are exempt from certain of these requirements.

37. During its deliberations, the Audit Committee Working Group addressed the following questions:

    a. What are the current roles and responsibilities of audit committees in overseeing the work of the external auditor?

    b. How can the audit committee's role to oversee the external auditor be enhanced?

    c. What challenges in terms of resources and expertise will audit committees face, both in satisfying their current responsibilities and the recommended enhanced role?

Annual oversight responsibilities

38. The responsibility of audit committees is limited to overseeing the performance of the independent external audit; they do not conduct or participate in the audit itself. The Audit Committee Working Group reviewed the practices of leading audit committees as appropriate examples in effectively overseeing the work of external auditors and concluded that, to contribute to the enhancement of audit quality, audit committees should, every year:

    a. monitor the effectiveness of the financial reporting environment;

    b. oversee the annual work of the auditors;

    c. review the audit plan;

    d. consider the impact of business risks on the audit plan;

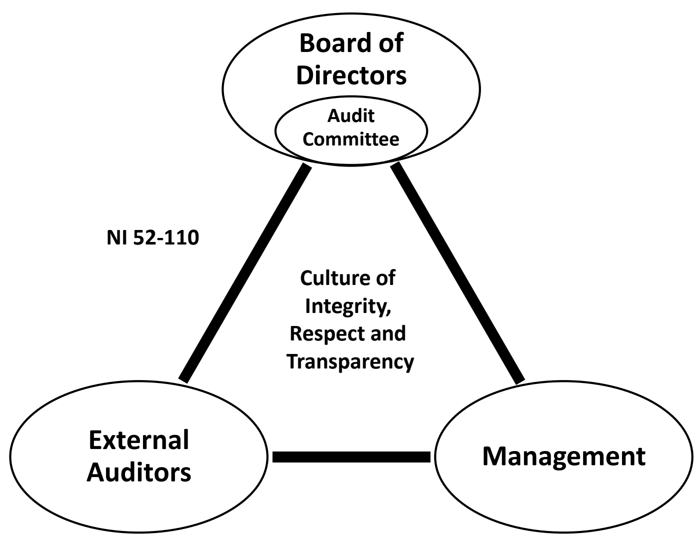
    e. assess the reasonableness of the audit fee;

    f. monitor the execution of the audit plan, with emphasis on the more complex and risky areas of the audit;

    g. review and evaluate the audit findings; and

    h. conduct an annual assessment of the auditor's performance.

39. The Working Group's Discussion Paper, *The Role of the Audit Committee in External Auditor Oversight*, provided useful practical guidance on each of the practices enumerated above. This report does not replicate that guidance. Instead, the EAQ initiative recommends that CPA Canada undertake a project to further develop the guidance on overseeing the work of external auditors, including performing annual assessments of the external auditors.



40. Strengthening the independence of the external auditors from management, while a necessary structural step, does not in itself necessarily enhance the effectiveness of an issuer's financial reporting environment. Effectiveness is maximized when the audit committee, the external auditor and management are equally committed to ensuring integrity in the issuer’s financial reporting; understand and respect each other’s roles and responsibilities; and establish constructive working relationships among all three parties.

Performing a comprehensive review

41. The Audit Committee Working Group concurred with the conclusion reached by the Auditor Independence Working Group that an audit committee’s comprehensive review of the external auditor at least once every five years, resulting in a recommendation to retain or replace the audit firm, is the preferred approach to address any institutional familiarity threats potentially created by audit firm tenure. Such a comprehensive review would augment the audit committee’s annual assessment of external auditors.

42. Audit committee responsibilities for determining the scope, timing and plan for the comprehensive review cannot be delegated to, or influenced by, either management or the external auditor. While management and the external auditor each have a supportive role to play in a comprehensive review, the overall responsibility resides solely with the audit committee. Management may assist in collecting or providing information as needed during the review. The audit firm may assist by performing a self-assessment and providing, in an open and transparent fashion, required information on firm quality control processes, procedures to deal with auditor independence issues and auditor judgment and skepticism.

43. Audit committees are well placed to extend their responsibilities for an annual assessment to include performing a periodic comprehensive review every five years. The comprehensive review would then offer certain benefits in return. In certain circumstances, the passage of time allows audit committees to identify issues not readily apparent on an annual basis. For example, audit committees would be able to evaluate the responsiveness of the audit firm to matters raised in prior periods. Indeed, the comprehensive review process should yield relevant information for the audit committee to improve its oversight responsibilities in a time frame that would allow it to probe more deeply into audit quality issues.

44. Both the annual assessment and comprehensive review will produce opportunities for improvement. If an audit committee is not satisfied with the results of its reviews, it will need to discuss its concerns with the auditors. If it cannot resolve issues satisfactorily, the audit committee should raise the matters with the board of directors to determine whether to put the audit out to tender.

45. In response to a question in paragraph 37, the Audit Committee Working Group specified issues that would feature in a periodic comprehensive review, such as:

- safeguards against institutional independence familiarity threats;
- quality and transparency of audit firm communications;
- exercise of professional skepticism;
- evaluation of the results of the annual assessments;
- quality of the engagement team; and
- resources and expertise needed.

SAFEGUARDS AGAINST INSTITUTIONAL INDEPENDENCE FAMILIARITY THREATS

46. As part of the comprehensive review, audit firms should identify for the audit committee any significant institutional threats to their independence and describe the safeguards they have put in place to mitigate these threats. The type of threats to consider include:

- the number of years the audit firm has served as external auditor for a particular client;
- the length of service of key members of the engagement team;
- the significance of the size of the client in relation to the size of the audit firm; and
- any other factors that may contribute to an institutional familiarity threat.

47. Audit committees should consider whether their audit firm has identified all familiarity threats and then critically evaluate the sufficiency of the safeguards that it has put in place. Key safeguards are the transparency of the audit firm's interactions with company management and ensuring that the audit committee is aware of any interactions that might impair auditor independence.

QUALITY AND TRANSPARENCY OF AUDIT FIRM COMMUNICATIONS

48. In reviewing the various communications from audit firms, audit committees should assess their timeliness, clarity and conciseness. They should also assess the extent to which the auditors have tailored their messages to be relevant to the specific circumstances of the entity, rather than using standardized language.

49. Audit committees should consider whether communications from their auditors are transparent and provide constructive suggestions for improvements in matters such as financial reporting issues and choices, internal controls and management's risk assessments. The external auditors have full access to the entity's records and documents, as well as to the audit team's cumulative knowledge of the business and current external economic trends affecting that business. Audit committees should assess to what extent the communications usefully reflect this information in a way that is relevant to the entity.

50. Notwithstanding the formal review process mentioned above, informal communication between audit committees and the auditors – specifically, between audit committee chairs and the lead engagement partners – on matters affecting audit quality is important and should not be delayed until the annual assessment or comprehensive review takes place. Audit committee members are encouraged to build positive professional rapport with both members of the entity's management and key members of the audit team. By fostering open communication, audit committees can expect greater transparency and more timely resolution of issues.

EXERCISE OF PROFESSIONAL SKEPTICISM

51. Professional skepticism includes being alert to such indicators as:

- contradictory audit evidence;
- information that questions the reliability of documents;
- responses to inquiries that cannot be corroborated;
- conditions that may indicate possible fraud; and
- circumstances that call for audit procedures beyond those required by auditing standards.

Professional skepticism also includes the willingness to challenge management on the assertions and representations they make in preparing the financial statements.

52. As part of the comprehensive review, auditors should be asked to identify the areas in recent audits that presented the greatest difficulty in obtaining independent corroborative audit evidence and that involved significant reliance on management representations. These areas will often involve significant accounting estimates or judgments about the application of accounting policies. For each of these areas, the auditors should briefly describe the audit approach, whether there were any initial disagreements with management, how those disagreements were resolved and, ultimately, how the auditors became comfortable in obtaining sufficient appropriate audit evidence. The audit committee should review the information provided by the audit firm and evaluate the appropriateness of the professional skepticism demonstrated by the engagement team.

53. By articulating a focus on professional skepticism, audit committees will highlight to both management and the auditors the importance of such professional skepticism in enhancing audit quality.

EVALUATION OF THE RESULTS OF THE ANNUAL ASSESSMENTS

54. The annual assessment of the effectiveness of the external auditor is a critical step in the audit committee's responsibility to oversee their work and to support its decision to recommend the reappointment of the audit firm. It often takes more than one year to evaluate the responsiveness of an audit firm to suggestions for improvement in audit quality and to assess the importance the firm places on audit quality.

55. As part of the comprehensive review, the audit committee should evaluate the annual assessments since the last comprehensive review to consider how the audit firm has responded to suggestions for improvement. The audit committee should also consider the observations CPAB sets out in its publicly available inspection reports, the significance of those observations, how those observations apply to their own audit firm and how the audit firm has responded to those observations.

QUALITY OF ENGAGEMENT TEAM

56. The nature of a client's business may have changed since the last comprehensive review, as might the types of financial reporting and audit issues that auditors need to address. Audit firms must respond to these changes by involving appropriate industry and technical expertise as necessary. It is also possible that key members of the audit team may have left due to partner rotation or for other reasons. It is important, however, that audit firms maintain an appropriate level of continuity in engagement team members year over year to reduce the amount of learning required on an engagement. Audit committees should review how their audit firms have been able to continue to provide audit teams with the appropriate level of technical and industry expertise while also achieving the objectives of a fresh set of eyes to mitigate any independence familiarity threats.

RESOURCES AND EXPERTISE NEEDED

57. The additional responsibilities placed on audit committees can be challenging, particularly for smaller, resource-constrained committees. The responsibilities are, however, self-scaling in relation to the size and complexity of an entity's operations. The oversight actions of audit committees of large multinational corporations with complex business operations will thus differ from those of small companies operating in a single market.

58. Both the Auditor Independence Working Group and Audit Committee Working Group recognized the need to develop sufficient education, guidance and tools to assist audit committees in initiating, scoping and conducting a periodic comprehensive review. The feedback on the Discussion Papers, particularly from members of audit committees, emphasized this need. The working groups acknowledge that certain audit committees, particularly those exempt from the financial literacy requirement, may find their role challenging given the resources currently available to them. In reviewing the tasks proposed for audit committees, directors may wish to reconsider the composition of their audit committees.

59. The development of an audit committee tool kit would cover such matters as:

    - how a comprehensive review is initiated;
    - what the responsibilities of the audit committee are;
    - the scope, timing and steps of a review;
    - the scalability of a review; and
    - the preparation and content of the public report from the audit committee on the review.

60. The working groups recommend that, as a preliminary step, CPA Canada undertake a project to test the implementation of the guidance and tools available and to develop effective and practical guidance and tools needed for the implementation of a comprehensive review by audit committees of the external audit firm.

Conclusions

61. The Audit Committee Working Group concluded that, to contribute to the enhancement of audit quality, audit committees should every year:

    a. monitor the effectiveness of the financial reporting environment;

    b. oversee the annual work of the auditors;

    c. review the audit plan;

    d. consider the impact of business risks on the audit plan;

    e. assess the reasonableness of the audit fee;

    f. monitor the execution of the audit plan, with emphasis on the more complex and risky areas of the audit;

    g. review and evaluate the audit findings; and

    h. conduct an annual assessment of the performance of the external auditors.

62. Both the Auditor Independence Working Group and The Audit Committee Working Group concluded that the audit committee's responsibilities for an annual assessment of the external auditors be augmented by a comprehensive review of the audit firm every five years.

Recommendations

63. The EAQ initiative recommends that CPA Canada:

    a. further develop the guidance included in the Discussion Paper, *Enhancing Audit Quality: The Role of the Audit Committee in External Auditor Oversight* on overseeing the work of the external auditor, including performing an annual assessments of the external auditor;

    b. develop guidance and tools to assist audit committees when undertaking a periodic comprehensive review of an audit firm, including guidance on the preparation and content of the audit committee's public report on the review. Such guidance and tools are a prerequisite to implementing a comprehensive review as recommended in Chapter 4 of this report;

    c. undertake a project with a group of experienced audit committees and audit firms to help audit committees implement a comprehensive review. Key outcomes of the project will be to: study the effect of a review on audit quality; gather data on the costs involved in performing a comprehensive review; and determine how to improve the guidance and tools; and

    d. develop and offer educational courses to assist audit committees perform annual assessments and periodic comprehensive reviews.

Chapter 5

Communication of Inspection Results

Background

64. The Canadian Public Accountability Board (CPAB) was established in 2003 as Canada's independent audit regulator. CPAB's mission is to contribute to public confidence in the integrity of financial reporting of reporting issuers in Canada by effective regulation and promoting high-quality, independent auditing. CPAB carries out its mission by conducting inspections of the firms it oversees. The essence of CPAB's work involves assessing methodologies, policies and quality control processes of the audit firms that participate in its oversight program. CPAB's inspection work includes reviewing parts of selected individual audit files to evaluate whether audit firm methodologies and processes drive consistent high-quality execution of audits. After each inspection, CPAB provides the firms with a private report containing findings on their quality control processes, individual file review findings and recommendations for improvement that firms must implement.

65. Audit committees currently have access to CPAB's public report. Published annually, this report includes summary information about the results of firm inspections. Findings are described at a high level, without identifying the firms or entities whose audit files gave rise to the findings. Although CPAB distinguishes between the inspection results at the Big Four and other firms, the findings are not ascribed to individual firms.

66. Although access to CPAB inspection insights would boost the ability of audit committees to oversee and evaluate their audit firms, CPAB's annual public report does not permit audit committees to learn what findings, if any, pertain to their auditors or their entities if they were selected for inspection in a particular year. At the same time, CPAB's findings on individual audit files, as communicated to the firms, may be too detailed to share with audit committees and, therefore, would need to be tailored to provide an appropriate background and context to the findings.

Transparent communications

67. The Audit Committee Working Group concluded that the evaluation of auditors and audit firms would benefit from increased transparency of CPAB findings for the following reasons:

    a. Increased transparency would lead to audit committees more effectively overseeing the work of the auditors, i.e., enhance audit committee evaluation of the quality and effectiveness of the audit.

    b. The overall goal of increased transparency would be to enhance audit quality.

    c. Increased transparency would raise awareness of issues having an impact on audit quality and the value of an audit to the capital markets.

Proposed communication of CPAB findings by audit firms

68. The Audit Committee Working Group suggests that CPAB, on an annual basis, modify its current annual report to include a more specific summary of key issues identified during their most recent inspections. This insight would allow audit committees to focus on areas of systemic quality concern that may be relevant to their own audit firms and/or entities. The report could also highlight any trends in accounting and auditing issues and, subject to client confidentiality considerations, share any industry-specific findings. With this information, audit committees would be able to concentrate their attention on what actions the external auditors have taken in specific areas of an audit file.

69. Representatives from CPAB, audit firms and audit committees should develop a protocol for increasing the inspection information made available to audit committees. The protocol would address the following matters:

    a. Audit firms should educate audit committees about the nature of CPAB inspections. The firms should ensure that audit committees understand the limited scope of CPAB's file reviews, given that inspectors look at only certain sections of an audit file.

    b. If CPAB has inspected the audit file of a particular company, its auditors would provide the audit committee, on a confidential basis, with a summary of any significant findings of the inspection and the firm's response to those findings.

    c. CPAB should review a firm's communications with audit committees to satisfy itself that post-inspection communications fairly reflected CPAB's significant findings, as well as the firm's response. If CPAB were to find the firm's communications deficient, corrective actions would have to be taken.

    d. There should be flexibility as to whether the engagement partner or another senior partner delivers the firm's inspection communications and as to whether this occurs with management present or during an *in camera* session with the audit committee.

Recommendation

70. The EAQ initiative recommends that CPAB, in conjunction with audit firm and audit committee representatives, develop a protocol for increasing the information made available to audit committees.

Chapter 6

Auditor Reporting Model

Background

71. The external audit report, which communicates the auditor's opinion on the financial statements, is highly valued for the assurance it provides. The global economic crisis of 2008 heightened attention on audit structures and communications, resulting in several global bodies proposing to revise the auditor's report to include more information and improve auditor communications.

72. The EAQ initiative's Auditor Reporting Working Group examined proposals on the auditor reporting model to determine whether they addressed the information needs of identified users. The proposals were intended to narrow the existing gaps between (a) what investors expect from an audit and what an audit actually is (the expectation gap), and (b) the information investors believe they should receive about an entity and its financial statements and what they actually receive (the information gap).

73. The independent external auditors have open access to financial and other operational information of the corporations being audited so that they can reach their opinion on the financial statements. No other external party involved with the corporation is given such access as routinely as auditors are. The conduct of an audit is a complex activity that requires highly trained and competent professionals. At the core, the audit team is expected to obtain a good understanding of the business and obtain sufficient appropriate audit evidence to support audit findings, conclusions and, ultimately, the audit opinion. Auditors are expected to exercise professional judgment and skepticism during the course of an audit. They are also required to follow generally accepted auditing standards in performing the audit. The standards set out detailed audit requirements on several issues such as quality control, risk assessments, planning an audit, documentation, fraud, communication with those charged with governance and many other requirements. The outcome of an audit is the preparation of an auditor's report that, for reporting issuers, cannot contain any modifications to the opinion and, generally, uses standardized terminology.

74. The remedies various global bodies are proposing are aimed at enhancing auditor reporting to close part or all of the information and expectations gaps. The Auditor Reporting Working Group examined proposals dealing with:

    a. the provision of additional information about the financial statements or about audit findings through auditor commentary;

    b. an assessment of whether the corporation being reported on is a going concern;

    c. clarifying the auditor's responsibility on other information in documents containing audited financial statements;

    d. the addition of clarifications and transparency about the audit process, including whether there should be a requirement to disclose the name of the engagement audit partner in the report; and

    e. expanding the scope of the audit to include information beyond the financial statements.

75. During its deliberations, the working group addressed the following questions:

a. How can the auditor reporting model be improved to deal with the acknowledged information and expectation gaps between what the reports say and what readers of the reports need?

b. Do audit committees have a responsibility to report to investors on the information they have received?

Improvements to auditor reporting

76. The Auditor Reporting Working Group examined the relationship between the auditor's report and audit quality and developed a structured framework that addresses the expectation and information gaps as well as other considerations for evaluating various auditor reporting proposals. The examination and a detailed analysis of the proposals can be referred to in its Discussion Paper, *Enhancing Audit Quality: The Auditor Reporting Model*.

77. In response to the questions in paragraph 75, the working group believes that auditor reporting does need to be improved to deal with the acknowledged gaps between what the reports say and what readers of the reports need. As discussed below, the working group did not, however, agree that all of the remedies being proposed would reduce the acknowledged gaps.

78. In Canada, auditor assurance on quarterly financial statements is optional. Moreover, auditor review reports are provided to audit committees but not published. The only reporting requirement is disclosure if the auditor has not performed a review or if the auditor's review contained a qualified conclusion. In other words, the absence of any such disclosure would imply that the auditor had reviewed and provided a review report without any qualifications on the quarterly financial statements. In Canadian capital markets, investors regularly use quarterly financial statements when assessing the financial performance of reporting issuers. This system is not transparent to investors and needs to be reassessed.

79. The Auditor Reporting Working Group concluded that other proposals that would improve the auditor reporting model include:

- the provision, under certain conditions, of auditor commentary;
- the inclusion of a clearer explanation of the auditor's responsibility for other information in documents, such as annual reports, that contain the financial statements as well as the auditor's conclusion; and
- the inclusion of a clearer description of the responsibilities of those involved in the financial reporting process.

AUDITOR COMMENTARY

80. Auditor commentary may help investors gain a better understanding about how an audit was conducted, the areas on which the auditors focused on in light of their assessment of the risks of material misstatement, as well as their procedures and conclusions in those areas. The Auditor Reporting Working Group identified the following benefits of auditor commentary:

    a. The increased focus on financial statement disclosures in the auditor's report would lead to increased discussion by auditors, management and the audit committee about such disclosures and could improve financial statement disclosures and audit quality, thereby narrowing the information gap.

    b. Investors would benefit from a better understanding of specific financial statement disclosures that the auditor has highlighted.

    c. An explanation of significant auditor judgments would help investors better understand what is involved in an audit and may increase their appreciation of the value of an audit, thereby narrowing the expectation gap. It would also serve to improve audit quality, as auditors know that their actions are more transparent.

    d. Certain discussions between the auditor and the audit committee may be reflected in the auditor's report and, therefore, become more transparent to investors. This may provide greater assurance about the enterprise's financial reporting and the quality of the audit.

81. The Auditor Reporting Working Group identified a number of challenges to auditors providing auditor commentary in the auditor's report. These include:

    - A need to provide flexibility so that auditors can use judgment in determining what matters to include in their reports.
    - A need to provide guidance on the nature, form and content of auditor commentary to promote consistency and understandability.
    - A need to avoid inclusion of subjective views in auditor commentary because such views are subject to misinterpretation and may affect the established responsibilities of auditors, management and audit committees and may have a chilling effect on the important interaction of these parties that is necessary for audit quality.

82. There seems to be increasing support for the view that the role of the external auditors is to examine financial statements and provide an independent opinion on the statements but not to comment on the statements themselves. For example, the International Auditing and Assurance Standards Board has articulated its current thinking that, having formed an opinion on the financial statements, the objective of the auditor is to communicate in the auditor's report those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements. The focus has shifted from commenting on the financial statements to highlighting key audit issues.

OTHER INFORMATION

83. Other information comprises financial and non-financial information that is not part of the audited financial statements and the auditor's report but is included, either by law, regulation or custom, in a document containing the audited financial statements and the auditor's report. The Auditor Reporting Working Group supported the inclusion of a description of the auditor's responsibility for *other information* in the auditor's report*.* In the working group's view, proposals requiring auditors to clarify their responsibilities for information other than financial statements included in annual reports need to spell out precisely the respective responsibilities of both management and the auditor for this information, including emphasizing that the auditor's responsibility is not intended to provide assurance on such *other information.*

DESCRIPTION OF AUDITOR RESPONSIBILITIES

84. A description that serves to clarify the responsibilities of the auditor, management and the audit committee is useful because such clarifications may reduce the expectation gap. The working group recognizes, however, that many financial statement readers do not read the standardized wording in auditor's reports. Accordingly, such clarifications would lead to only a limited enhancement of audit quality.

85. Although standardized wording of this nature would increase the length of the auditor's report, the working group did not support placing this additional material outside, but linked from, the auditor's report, because it would create a barrier to users reading this material. Permitting the standardized wording to be customizable, depending on the jurisdiction, may make it easier for investors to read and should be a topic for consideration.

86. The majority of the working group did not support a requirement to disclose the name of the engagement partner because it would have no effect on audit quality and because the auditor's report might be misinterpreted as being the engagement partner's product and not the firm's. The minority view was that it improved transparency and permitted readers to identify the background of those involved in the audit. The majority of respondents did not support such disclosure and the working group decided to not recommend disclosing the names of other auditors involved in the audit.

Going concern

87. The Auditor Reporting Working Group recognized that going concern is an area where the expectation gap is significant, but concluded that current proposals for the auditor to report on a corporation's going concern would increase the expectation gap even further. While acknowledging that some global bodies, particularly those in Europe, have demanded more information about a corporation's going concern status, the working group concluded that the issue is as much a financial reporting issue as it is an audit quality issue. The auditor's responsibility is to obtain sufficient appropriate audit evidence about the appropriateness of management's use of the going concern assumption in the preparation of the financial statements and to conclude whether there is a material uncertainty about the entity's ability to continue as a going concern. The auditor cannot, however, predict future events, and any commentary the auditor can make is of limited value to investors and may be open to misinterpretation. The ability of the auditor to appropriately report on going concern matters depends on clear and understandable disclosures in the financial statements. The working group recommends further work in this area, involving all parties participating in the financial reporting process.

Scope of new requirements

88. Canada's audit reporting model is applied consistently by all entities – publicly listed corporations, private enterprises, not-for-profit organizations and public sector entities. Having the same standardized auditor's report has been supported because significant differences may inhibit comparability and confuse investors about the auditing standards used in conducting the audit. The Auditor Reporting Working Group heard from several respondents who were not persuaded that the remedies being proposed were an improvement on existing auditor reporting requirements. If they were introduced, however, there was strong support for limiting the scope of such remedies to publicly listed corporations. Underlying the response was the feeling that imposing remedies for perceived problems arising from the global economic crisis would create costs in excess of any perceived benefits for entities that did not participate in capital markets. Moreover, the users of financial statements would not benefit from the additional requirements.

89. An added complication is the distinctive feature of the Canadian public issuer market, which has a large proportion of small public companies. There are approximately 2,000 public issuers with market capitalization and total assets of less than $10 million. These entities are subject to legislation pertaining to reporting issuers. Currently, there are less restrictive independence requirements in the rules of professional conduct for auditors of such entities. For example, firms auditing them are not subject to partner rotation requirements. These rules were made to reflect the fact that smaller reporting issuers often do not have qualified in-house expertise to prepare financial statements without obtaining external assistance.

90. The Auditor Reporting Working Group concluded that an element of differential audit reporting might be appropriate, particularly if proposals on audit commentary become requirements. It believes that the requirements for auditor commentary should apply only to publicly accountable enterprises, for which a clear definition should be developed. The working group recognized that any differential audit reporting would be a significant change from past practices when the dominant view was that "*one auditor's report fits all.*" Remedies supported by the working group, other than auditor commentary, could be applied to all entities as they serve to enhance auditor communications. On the question of whether the scope of the proposals should apply to small public companies, the working group concluded that all public issuers participating in the capital markets need to have the same auditor's report. Defining the scope of application between public issuers and all other entities that are not public issuers has the benefit of clarity.

Reports by audit committees about the audit

91. The Financial Reporting Council rejected adding audit commentary to auditor reporting, instead preferring requiring audit committees to provide additional information on financial reports and attendant audit findings. The Financial Reporting Council proposed:

    a. Revising standards governing the provision of reports by auditors to audit committees to ensure that auditors are required to give audit committees the information that they need to fully understand the factors that the auditors relied upon in exercising their professional judgment in the course of the audit and, in particular, in reaching their audit opinion.

b. A requirement that the audit committee reports to the board of directors, setting out:

- the issues that they considered in relation to the financial statements and how these issues were addressed, including any key judgments they made;
- the basis for its conclusion that the annual report, viewed as a whole, is fair and balanced and includes any matters relevant to that conclusion that are not addressed elsewhere; and
- an assessment of the effectiveness of the external audit and the approach taken to the appointment or reappointment of the external auditor.

92. In its deliberations, the Audit Committee Working Group rejected the notion that the audit committee has a role in reporting on the financial statements. It believes such reporting could potentially lead to generic template wording that would not contribute to increasing audit quality.

Conclusions

93. The Auditor Reporting Working Group concluded that:

    a. Proposals that would improve the auditor reporting model include:

        - the provision, under certain conditions, of auditor commentary (more recently truncated to focus on key audit matters);
        - the inclusion of a clearer explanation of the auditor's responsibility for information other than financial statements included in annual reports; and
        - the inclusion of a clearer description of the responsibilities of those involved in the financial reporting process.

    b. Proposals for the auditor to report on a corporation's going concern would increase the expectation gap and that the issue is as much a financial reporting issue as an audit quality issue.

    c. That an element of differential audit reporting might be appropriate, particularly if proposals on audit commentary become requirements, but that reporting issuers participating in the capital markets need to have the same auditor's report.

94. The Audit Committee Working Group concluded that the audit committees' responsibilities should not extend to providing additional commentary to the public about the financial statements or the audit. It believes such reporting could potentially lead to generic template wording that would not contribute to increasing audit quality.

Recommendations

95. The EAQ initiative recommends that:

    a. The Auditing and Assurance Standards Board consider the conclusions reached by the Auditor Reporting Working Group as it reviews proposals to revise the auditor reporting model.

    b. The Auditing and Assurance Standards Board evaluate whether to introduce an element of differential auditor reporting with respect to auditor commentary between public issuers and entities that are not public issuers.

    c. The Canadian Securities Administrators and the Auditing and Assurance Standards Board review the assurance requirements for quarterly financial statements to increase the transparency to investors.

Chapter 7

Other Conclusions

Background

96. In addition to the proposals on mandatory audit firm rotation and retendering of audits discussed in Chapter 2, the Auditor Independence Working Group examined proposals on non-audit services, audit-only firms and joint audits. These proposals have not yet been finalized and some appear to have been revised. The working group's conclusions, supported by the comments received, were based on the initial proposals and are summarized below.

Non-audit services

97. Initial proposals from the European Commission include a requirement for certain permissible non-audit services to be approved by audit committees. In addition, certain other services will require pre-approval by a designated authority in member states, be capped at 10% of the total statutory audit fee or be prohibited.

98. The Auditor Independence Working Group concluded that such proposals were not warranted in Canada. The existing principle-based approach in Canada adequately evaluates threats and safeguards created by the provision of non-audit services, including rule-based prohibitions for non-audit services when threats cannot be overcome. The Working Group did, however, recommend that US prohibitions on personal tax services for individuals in a financial reporting oversight role and confidential aggressive tax transactions be introduced into the Canadian independence rules. As well, the working group suggests that the provision of non-audit services on a contingency fee basis (a third area of difference in Canada/US rules) be examined to determine its effect on auditor independence.

Audit-only firms

99. The Auditor Independence Working Group rejected the proposal to restrict auditing to "audit-only" firms. The working group concluded that the proposal would reduce audit quality and would also have a negative impact on an audit firm's capacity to attract needed additional talented resources. In its view, the evidence of self-interest and self-review threats involved in the existing multi-disciplinary firm business model does not support, as its proponents would contend, the significant marketplace regulatory intrusions involved in restricting auditing to audit-only firms. Moreover, practical difficulties, such as defining the jurisdiction and determining the time frame for the evaluation of which firms are "audit-only" firms, would need to be overcome on a global basis.

Joint audits

100. The Auditor Independence Working Group rejected the possibility that joint audits might enhance audit quality based on its review of the Canadian experience with joint audits. Canada's banking regulator[4] eliminated joint audits in 2002 after concluding that joint audits produced less accountability, reduced auditor oversight and diminished the quality of financial reporting. The regulator reached that conclusion because it saw a potential division of responsibility associated with the approach; was concerned that some issues would fail to be addressed; and felt there was a potential to create incentives for management to choose the opinion of the auditor that yields the most favourable result.

[4] Office of the Superintendent of Financial Institutions, 2002 Comment Letter to European Commission's Green Paper, *Audit Policy: Lessons from the Crisis*.

Chapter 8

Future Actions

Background

101. The three primary objectives of the EAQ initiative have been met.

a. Canadian participants were engaged in discussing the global proposals. The feedback received from the extensive consultations has been thoughtful and proved valuable to the Steering Group and the three working groups as they re-deliberated their conclusions.

b. The Discussion Papers developed by the working groups, the comments received and the reports on how the comments were dealt with provide useful input to Canadian standard setters, regulators and others as they consider potential changes in Canada in the wake of developments taking place in other jurisdictions.

c. The material produced and this report sets an appropriate context for further research, debate and guidance to support the enhancement of audit quality in Canada in the future.

Summary of conclusions

102. The conclusions reached by the EAQ initiative – comprising the Steering Group, the Auditor Reporting Working Group, the Auditor Independence Working Group and the Audit Committee Working Group – consist of the following:

a. The mandatory rotation of audit firms or mandatory retendering of the audit would not contribute to the enhancement of audit quality.

b. Having audit committees perform a periodic comprehensive review of their audit firm at least every five years, resulting in a recommendation to retain or replace the audit firm, is the preferred approach to address any institutional familiarity threats potentially created by audit firm tenure.

c. A report summarizing the results, findings and conclusions of the comprehensive review should be included in an entity's public disclosures in the year in which the comprehensive review is carried out.

d. To contribute to the enhancement of audit quality, audit committees should, every year:

- monitor the effectiveness of the financial reporting environment;
- oversee the annual work of the auditors;
- review the audit plan;
- consider the impact of business risks on the audit plan;
- assess the reasonableness of the audit fee;
- monitor the execution of the audit plan, with emphasis on the more complex and risky areas of the audit;
- review and evaluate the audit findings; and
- conduct an annual assessment of the auditors' performance.

e. The audit committee's evaluation of auditors and audit firms would benefit from having increased information about CPAB findings.

f. Proposals that would improve the auditor reporting model include:

- the provision, under certain conditions, of auditor commentary (more recently truncated to focus on key audit matters);
- the inclusion of a clearer explanation of the auditor's responsibility for information other than financial statements included in annual reports; and
- the inclusion of a clearer description of the responsibilities of those involved in the financial reporting process.

g. Proposals for the auditor to report on a corporation's going concern were rejected as they would, increase the expectation gap. The issue is as much a financial reporting issue as an audit quality issue.

h. An element of differential audit reporting might be appropriate, particularly if proposals on audit commentary become requirements, but reporting issuers that participate in the capital markets need to have the same auditor's report.

i. The responsibilities of audit committees should not extend to providing additional commentary to the public about the financial statements or the audit. Such reporting could potentially lead to generic template wording that would not contribute to increasing audit quality

j. Proposals to further restrict the requirements for non-audit services beyond a possible reconciliation of differences between US and Canadian requirements were not warranted in Canada. Neither were proposals for "audit-only" firms or joint audits.

Next actions

103. The EAQ initiative recommends the following next actions:

a. That CPA Canada develop guidance and tools to assist audit committees when undertaking a periodic comprehensive review of an audit firm, including guidance on the preparation and content of the audit committee's public report on the review.

b. That CPA Canada undertake a project with a group of experienced audit committees and audit firms to help implement the periodic comprehensive review by the audit committee. Key outcomes would be to:

   - study the effect of a review of audit quality;
   - gather data on the costs of performing a comprehensive review; and
   - determine how to improve the guidance and tools previously developed. (Chapter 4)

c. That CPA Canada undertake a project to further develop the guidance on performing the annual assessments of the external auditor. (Chapter 4)

d. That CPA Canada develop and offer educational courses to assist audit committees perform comprehensive reviews. (Chapter 4)

e. That CPAB, together with audit firm and audit committee representatives, develop a protocol for increasing the information made available to audit committees. (Chapter 5)

f. That the Canadian Securities Administrators and the Auditing and Assurance Standards Board review the assurance requirements on quarterly financial statements to enhance the transparency to investors of auditor involvement in quarterly statements. (Chapter 6)

g. That the Auditing and Assurance Standards Board consider the Auditor Reporting Working Group' conclusions as it reviews proposals to revise the auditor reporting model. (Chapter 6)

h. That the Auditing and Assurance Standards Board evaluate whether to introduce, for application in Canada, an element of differential audit reporting with respect to auditor commentary between public issuers and other entities that are not public issuers. (Chapter 6)

i. That those responsible for developing rules on auditor independence consider prohibiting the following non-audit services: personal tax services for individuals in a financial reporting oversight role and confidential aggressive tax transactions. (Chapter 7)

j. That those responsible for developing rules on auditor independence examine the provision of non-audit services on a contingency fee basis to determine its effect on auditor independence. (Chapter 7)

Value of an audit

104. A significant opportunity for the future of audit is to develop a comprehensive plan to stimulate and integrate leading global thinking and practice to demonstrate and enhance the value of the audit. This would involve external validation as well as creative and innovative engagement by all participants in the financial reporting environment. A key pre-requisite would be to seek agreement on the value proposition. For example, would facilitating global capital flows, having fluid capital markets and reducing the cost of capital be measures that would demonstrate the value of an audit?

105. Issues that will need to be factored into such plans will include several that arose in the course of the EAQ initiative that, while germane to any plan to maintain and enhance the relevance and value of an audit, were not addressed as they would have broadened the scope of the EAQ initiative. These issues include:

- Gaining a better understanding of what constitutes audit quality and determining how participants in the financial reporting process, particularly audit committees, might influence and assess it.
- The role that the culture of an audit firm plays in enhancing audit quality.
- The role that the internal audit function plays in enhancing audit quality.
- Practical guidance on how to improve the exercise of professional judgment and skepticism.
- Examining issues on the use of the going concern assumption.
- Examining whether requirements for auditors of financial institutions reporting to prudential regulators could be enhanced.[5]

[5] The Basel Committee of Banking Supervision published a consultative document on March 21, 2013, which explores supervisory guidance on external audits of banks.

Appendix A: Group Membership

Steering Group

- David A. Brown, C.M., Q.C., Davies Ward Phillips & Vineberg LLP, Toronto **(Chair)**
- Phil Cowperthwaite, FCPA, FCA, Cowperthwaite Mehta, Toronto
- Janice Fukakusa, FCPA, FCA, Royal Bank of Canada, Toronto
- Nick Le Pan, Canadian Public Accountability Board, Ottawa
- Alan MacGibbon, FCPA. FCA, CMC, Global Managing Director, Deloitte Touche Tohmatsu, Toronto
- William J. McFetridge, LLB, FCPA, FCA, Bull, Housser & Tupper LLP, Vancouver
- Eileen Mercier, MBA, F.ICD, Board Chair, Ontario Teachers' Pension Plan, Toronto
- Kathleen O'Neill, FCPA, FCA, ICD.D, Independent Corporate Director, Toronto
- David Smith, FCPA, FCA, ICD.D, Independent Corporate Director, Toronto
- Jim Sylph, FCPA, FCA, ICD, International Federation of Accountants, Toronto

Observers

- Kevin Dancey, FCPA, FCA, Chartered Professional Accountants of Canada, Toronto
- Brian Hunt, FCPA, FCA, Canadian Public Accountability Board, Toronto
- Cameron McInnis, CPA, CA, CPA, Canadian Securities Administrators, Toronto

Project Coordinators

- Robert J. Muter, FCPA, FCA, PricewaterhouseCoopers, LLP, Toronto
- Ron Salole,[6] Canadian Institute of Chartered Accountants, Toronto
- Axel N. Thesberg, FCPA, FCA, KPMG LLP, Toronto

[6] Ron Salole is a Fellow of the Institute of Chartered Accountants in England and Wales.

Role of the Audit Committee Working Group

- Tom O'Neill, FCPA, FCA, BCE and Bell Canada, Toronto **(Chair)**
- Hugh Bolton, FCA, Independent Corporate Director, Calgary
- Jim Goodfellow, FCPA, FCA, Independent Corporate Director, Toronto
- Nick Kirton, FCA, Independent Corporate Director, Calgary
- Rob Scullion, FCPA, FCA, Ernst & Young LLP, Toronto
- Wally Smieliauskas, PhD, University of Toronto, Toronto
- Huw Thomas, CPA, CA, Independent Corporate Director, Toronto

Observers

- Gigi Dawe, Chartered Professional Accountants of Canada, Toronto
- Kelly Gorman, CPA, CA, Canadian Securities Administrators, Toronto
- Kam Grewal, CPA, CA, Canadian Public Accountability Board, Toronto
- Karen Stothers, CPA, CA, Office of the Superintendent of Financial Institutions, Toronto

Project Managers

- Tracy Brennan, CPA, CA, Ernst & Young LLP, Toronto
- Julia Hamilton, CPA, CA, Ernst & Young LLP, Toronto

Auditor Reporting Working Group

- Mark Davies, CIA, CPA, CA, KPMG LLP, Toronto, and Chair of the Auditing and Assurance Standards Board **(Chair)**
- Jean Bédard, PhD, FCPA, FCA, Laval University, Québec
- Anish Chopra, CPA, CA, TD Asset Management, Toronto
- L. Denis Desautels, OC, FCPA, FCA, Independent Corporate Director, Ottawa
- Marvin Martenfeld, FCPA, FCA, MNP LLP, Markham
- Tom C. Peddie, FCPA, FCA, Chief Financial Officer, Corus Entertainment Inc., Toronto
- Bruce Winter, FCPA, FCA, PricewaterhouseCoopers LLP, Toronto (Member, International Auditing and Assurance Standards Board)

Observers

- Malcolm Gilmour, CPA, CA, Canadian Public Accountability Board, Toronto
- Marion Kirsh, FCPA, FCA, Canadian Securities Administrators, Toronto

Project Manager

- Eric Turner, CPA, CA, Chartered Professional Accountants of Canada, Toronto

Auditor Independence Working Group

- Peter Mills, Q.C., B.Com., JD, ICD.D, Independent Corporate Director, Toronto **(Chair)**
- William R. Brushett, CPA, CA, Grant Thornton LLP, Toronto
- Patrick Crowley, CPA, CA, Ontario Municipal Employees Retirement System, Toronto
- Gary Hannaford, FCA, Institute of Chartered Accountants of Manitoba
- Jane E. Kinney, FCPA, FCA, Deloitte & Touche LLP, Toronto
- Andrew Kriegler, MBA, Office of the Superintendent of Financial Institutions, Toronto
- Paul R. Weiss, FCPA, FCA, Independent Corporate Director, Toronto

Observer

- Kenneth Vallillee, FCPA, FCA, Canadian Public Accountability Board, Toronto

Project Manager

- Melissa E. Langlois, BSc, CPA, CA, Deloitte & Touche LLP, Markham

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