Enhancing Audit Quality: Canadian Perspectives— Initiative Overview

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What is Audit Quality?

1. A single, succinct and generally-accepted definition of "audit quality" appears to be elusive. Many – auditors, corporate executives, audit committee members, standard setters, regulators and others – talk about audit quality, but few agree on what it actually means. Numerous efforts to define audit quality, particularly in recent years, have met with little success. Appendix A provides possible reasons for the difficulty and summarizes the more notable recent attempts to define it.

2. Perhaps, like the concept of quality itself, audit quality defies precise definition but is recognized when seen. Moreover, it would appear to be more productive to see how audit quality can be enhanced; not by attempting to define it, but by addressing auditing shortcomings or perceptions of auditing shortcomings. In particular, it may be beneficial to begin with narrowing two significant gaps – namely, the gaps between what investors expect of audits and what audits can realistically deliver, and the information investors say they need from auditors and what an auditor's report on a set of financial statements actually provides. Further, in looking at how these gaps might be narrowed, is it still valid for auditors to retain verification and assurance as their core and only responsibilities if investors have greater expectations? Some market participants have begun to demand that auditors deliver more to meet those expectations and close the information gaps.

Global Crisis

3. During the global economic crisis that erupted in 2008, which threatened many financial institutions and the fiscal stability of several countries, numerous policymakers, regulators and others proposed significant changes to the financial system to promote greater financial stability and reduce systemic risk.

4. Although auditors were not seen as having caused corporate failures during the crisis, questions inevitably were raised about their role. People wondered how a bank could go under within a few months of receiving a "clean" audit opinion. Should the financial statements and audit report not have warned of dangers ahead? Were the financial statements credible? Why have an audit if it does not raise red flags about impending dangers?

5. For an example of the type of comments made, read the UK House of Commons Treasury Committee's Eighth Special Report of Session 2008-09, *Banking Crisis: Reforming Corporate Governance and Pay in the City: Government, UK Financial Investments Ltd and Financial Services Authority Responses to the Ninth Report from the Committee* (July 2009). Under the subheading "Auditors" on Page 14, the Report states:

"We have received very little evidence that auditors failed to fulfill their duties as currently stipulated. The fact that some banks failed soon after receiving unqualified audits does not necessarily mean that these audits were deficient. But the fact that the audit process failed to highlight developing problems in the banking sector does cause us to question exactly how useful the audit currently is. We are perturbed that the process results in 'tunnel vision', where the big picture that the shareholders want to see is lost in a sea of detail and regulatory disclosures."

6. There is a degree of investor misunderstanding regarding the responsibilities entrusted to auditors within the Canadian legal system and the limitations on what an audit can reasonably be expected to achieve. Investors judge auditors and audited information by results. If investors believe financial disclosures are unsatisfactory, they will not easily accept arcane explanations of professional responsibility as an excuse for a failure to clearly communicate relevant financial information. Neither will they accept what amounts to turf battles between various parties (including regulators) who share in the responsibility for the financial reporting.

Defining the Challenges

7. Enhancing audit quality faces two fundamental challenges:

- The first challenge is that investors place a heavy burden on auditors for the accuracy of financial information, yet auditors do not control its production. This flows from the basic concept of accountability: the party responsible for performance must account for the performance. It is not the auditor's job to tell the story. Rather, it is the auditors' role – and a vital one – to provide **independent** assurance that management's reporting of facts is accurate, its judgments in estimates and valuation are fair, and that important information is not omitted.

- The second challenge relates to auditor remuneration. In a normal exchange transaction, the person who receives a service is the one who pays for it and, therefore, can negotiate the price and terms of service. Contracts for audit services, however, follow a different pattern. As a practical matter, for a public company, it is the audit committee that is responsible for selecting and paying the auditor, often at the recommendation of management rather than the company's shareholders. In terms of investor expectations, any conflicts between the interests of shareholders and company management ought to be resolved in favour of the shareholders. Yet, if audits are to be cost-effective and successful, this must be accomplished without the auditors sacrificing the goodwill and cooperation of management.

8. There are no easy solutions to these fundamental challenges. There are no obvious changes to the assignment of responsibility for financial reporting or to the arrangements of auditor remuneration that are feasible in practice or sound in principle.

Global Initiatives

9. These challenges and questions have prompted various recent initiatives which purport to be aimed at improving audit quality:

- **June and August 2011:** In the United States (US), the Public Company Accounting Oversight Board (PCAOB) issued Concept Releases dealing with enhancing reports on audited financial statements and with ways to enhance auditor independence, objectivity and professional skepticism.
- **November 2011:** In the European Union (EU), because "the 2008 financial crisis highlighted considerable shortcomings in the European audit system," Commissioner Michel Barnier released a number of proposals "to re-establish confidence," including mandatory audit firm rotation (with a six-year rotation period), pure audit firms that would not provide non-audit services, regular and transparent mandatory tendering on audits, a very much more detailed audit report, and greater supervision of the audit sector.
- **April 2012:** In the United Kingdom (UK), the Financial Reporting Council (FRC) proposed that the largest 350 UK companies put their audit contracts out to tender at least every 10 years.

10. These proposals were criticized by some corporate executives, audit committee members, and auditors as potentially having adverse effects on audit quality. Influential regulators rebutted the criticisms by stating "the status quo is not an option," some seemingly not realizing that numerous previously promulgated standards and regulations, now making themselves felt, result in the "status quo" actually being a fast-moving target. Meanwhile, standard setters, including most recently the International Auditing and Assurance Standards Board (IAASB)[1], have been continuing their work on developing auditing standards intended to come up with a more meaningful auditor's report.

Canadian Framework for Proceeding

11. Canada weathered the financial crisis relatively well compared to many other countries, suffering none of the financial system failures that are driving many of the proposals affecting the audit process internationally. Thus, the demand for reforming the audit process, such as changes to the auditor's report or rotating audit firms, has not been widely debated in Canada.

12. Nevertheless, Canada will not be immune to what is taking place in the US, Europe and the UK. With so many Canadian entities now operating in an international environment, it is important that Canada's audit process and audit quality are consistent and comparable internationally.

13. Further, key elements of the Canadian financial reporting system, such as securities regulation, accounting, auditing and ethical standards, audit oversight and corporate governance best practices, are linked internationally. Accordingly, any reforms major Canadian trading partners propose to the regulations affecting audits may also affect how audits are conducted within Canada.

[1] In May 2011, the IAASB issued the Consultation Paper *Enhancing the Value of Auditor Reporting: Exploring Options for Change*. In June 2012, the IAASB issued the Invitation to Comment *Improving the Auditor's Report*.

14. Yet, there is a danger that initiatives appropriate for other countries would not be necessary or desirable within Canada's regulatory framework.

15. A distinctive feature of the Canadian public issuer market is the large proportion of small public companies. There are approximately 2,000 public issuers with market capitalization and total assets of under $10 million. Many of these are audited by small accounting firms; approximately half are audited by firms that are not members of the Forum of Firms, an association of international networks of accounting firms that perform transnational audits. Small public companies are listed on the TSX Venture Exchange, an electronic exchange that, as at November 2010, had 2,364 listed companies with an average capitalization of $25.7 million. (In contrast, the Toronto Stock Exchange had 1,500 listed companies, with an average capitalization of $1.3 billion.) Appendix B summarizes the Canadian public company environment.

16. At an audit quality symposium organized by the Canadian Public Accountability Board (CPAB) in December 2011, policy makers from Canada and elsewhere agreed that it was important to forge a Canadian perspective that focuses on specific elements of audit quality if Canada is to make a meaningful contribution to the global discussions on the issue.

17. This symposium prompted CPAB and the Canadian Institute of Chartered Accountants (CICA) to launch the Enhancing Audit Quality initiative. A blue-chip Steering Group was formed to exercise an overview function and coordinate this initiative and ensure that the process is transparent and serves the public interest. As well, three Working Groups were established under the auspices of the CICA to address the following priority areas:

▲ **Auditor Independence**

This Working Group is focusing on the proposals that relate to auditor appointment and rotation, and the services auditors provide, to improve independence, objectivity and professional skepticism.

▲ **Auditor Reporting**

This Working Group is focusing on the information value of the auditor's report and expanded assurance by auditors on parts of Management's Discussion & Analysis (MD&A), quarterly financial statements and other information.

▲ **Audit Committee**

This Working Group is examining the reporting relationships among audit committees, management, auditors, audit inspectors, regulators and shareholders, and how the application of professional skepticism by both audit committees and auditors might best be enhanced and promoted.

18. Other issues raised at the audit quality symposium included market concentration, audit firm succession plans and financial reporting, all of which may be addressed at a later time to permit the current initiative to focus on the specific issues considered to be directly related to enhancing audit quality.

19. Moreover, in developing initial views on the elements described above, the Working Groups will primarily consider the application of any proposals to reporting issuers. However, the scope of application may, particularly in the case of auditor reports, extend beyond or have relevance to entities other than reporting issuers. A full consideration may be needed to see whether there is a degree of “proportionality” in the proposals or if differential proposals might be required for different types of entities. Such consideration will be factored in the consultation process and included in the final position papers.

20. The members of the Steering Group and the Working Groups are listed in Appendix C.

Consultation

21. The discussion papers on auditor reporting (*Enhancing Audit Quality: Canadian Perspectives – The Auditor Reporting Model)* and auditor independence (*Enhancing Audit Quality: Canadian Perspectives – Auditor Independence*) will be released at the end of summer 2012. The consultation process with stakeholders will conclude at the end of October 2012.

22. The discussion paper on audit committees is expected to be released at the end of 2012. The consultation process with stakeholders will take place in early 2013.

23. Stakeholders will include:

    a. corporate directors;
    b. members of corporate audit committees;
    c. preparers of financial reports;
    d. institutional investors;
    e. financial institutions regulators;
    f. securities regulators; and
    g. government officials.

24. On completion of the consultation process, a report on the proposals reflecting the findings of the consultation will be prepared and issued in spring 2013.

Appendix A

What is Audit Quality?

A1. There is not a generally-accepted definition of "audit quality." But why is it so difficult to define? There are a number of reasons, including:

- Although two auditors follow the same audit process, the judgments they make during their audits may be quite different depending on such things as: the nature of the entities' businesses, their underlying accounting practices and controls, and many others. Despite these differences, both resulting audits may be of the same high quality.
- Continually changing accounting standards add another dimension to the difficulty. For example, to better reflect accounting transactions in financial statements, today's accounting standards often require management to make more complex judgments. The audit has had to evolve over time in response. So while audits may be of higher quality now than they were previously, it does not mean that the assurance they provide is higher than before. Rather, it may just mean that they better respond to the new accounting environment.

A2. The IAASB recognized the complexities involved in making decisions about improving audit quality and is undertaking a project to develop an international audit quality framework. As a first step, the IAASB published *Audit Quality: An IAASB Perspective* in 2011. This publication notes that audit quality is subject to many direct and indirect influences. While there are direct influences that affect the quality of an individual audit, such as the calibre of the audit team, this perspective alone is not sufficient to address the question of whether audit quality is achieved in the broader context. Perceptions of audit quality vary among stakeholders depending on their level of direct involvement in audits and the lens through which they assess audit quality. For example, management might focus on such things as the efficiency of the audit process, as well as the timeliness and usefulness of communications from the audit team. Regulators might focus on evidence of compliance with auditing standards and the rigour auditors have demonstrated in dealing with complex accounting issues. Both management and regulators may believe that an audit is of high quality, but for different reasons.

A3. If it is difficult to define audit quality, is it possible to develop indicators of it? Apparently in this belief, Article 40 of the EU's Eighth Directive, issued in 2006 for implementation by 2008, required that auditors of public entities publish on their websites an annual "transparency report" that includes 10 items of information:

- Legal structure and ownership;
- Association with any network, and its structure and arrangements;
- Governance structure;
- Internal quality control system and leadership statement on its effectiveness;
- Date of last quality assurance review;
- List of public entities audited during the last fiscal year;
- Independence practices and confirmation of independence compliance review;

- Policy on continuing professional education;
- Financial information, such as total audit fees as a percentage of total revenues; and fees charged for other assurance, tax, and non-audit services; and
- Partners' compensation policies.

A4. The fact that none of these indicators provides any direct evidence about the quality of the audit personnel, or of the judgments they make, is a strong signal that they are of limited use.

A5. Another possibility is to identify "drivers" of audit quality. In 2008, the FRC, after extensive consultation[2], identified five drivers:

- The culture within an audit firm
- The skills and qualities of audit partners and staff
- The effectiveness of the audit process
- The reliability and usefulness of audit reporting
- Factors outside the control of auditors.

A6. For each of these drivers, the FRC developed up to eight indicators of audit quality. These were more specific and required more judgment than the items to be disclosed under the EU's Eighth Directive. For example, they included:

- Partners and staff exhibit professional skepticism in their work and are robust in dealing with issues identified during the audit.
- High-quality technical support is available when the audit team requires it or encounters a situation it is not familiar with.

A7. Yet, despite the time and efforts involved, none of these efforts and attempts at finding solutions for enhancing audit quality seems to have satisfied the desire for understanding just what audit quality is and how to make improvements to it.

[2] This consultation included the issuance of the 67-page Discussion Paper *Promoting Audit Quality* in November 2006, and a subsequent 30-page paper with the same title, which took into account the comments on the earlier paper, released October 2007.

Appendix B

The Canadian Environment

B1. The following features of the Canadian environment that affect public issuers differ from corresponding features in many or all other jurisdictions. Where the proposals of a particular jurisdiction are of interest, the jurisdiction's specific requirements will need to be compared with the relevant Canadian requirements.

B2. These features are summarized and only give general indications of the requirements. For a full understanding, the detailed provisions of the statutes or regulations should be referred to.

B3. **Office of the Superintendent of Financial Institutions (OSFI):** OSFI was established in 1987 to contribute to public confidence in the Canadian financial system. It supervises and regulates more than 450 banks and insurers, none of which have failed since it was established. It has offices in Ottawa, Montreal, Toronto and Vancouver.

B4. **Provincial Securities Commissions:** There is no national securities commission (such as the Securities and Exchange Commission (SEC) in the US); rather, each province and territory has its own securities regulator (e.g., the Ontario Securities Commission) and its own securities legislation (e.g., the Ontario Securities Act). Some of the provincial securities commissions issue "Policy Statements," "Notices" or "Staff Accounting Communiques."

B5. **Canadian Securities Administrators (CSA):** The CSA is a voluntary umbrella organization of the provincial and territorial securities regulators referred to above. It aims to achieve consensus on policy decisions affecting Canada's capital market and its participants. It has had a permanent secretariat in Montreal since 2004.

B6. The CSA issues nine types of documents, including (a) National Instrument/Multilateral Instrument; (b) National Policy/Multilateral Policy; and (c) CSA Notice. (A National Instrument or Policy is adopted by all CSA jurisdictions; a Multilateral Instrument or Policy has not been adopted by one or more jurisdictions.)

B7. **Audit by Firms Registered with CPAB:** All public issuers in Canada have to be audited by firms registered with CPAB and subject to its inspection and discipline. CPAB, which was established in 2002, is a member of the International Forum of Independent Audit Regulators (IFIAR), and there is an IFIAR member in most developed countries.

B8. **Canadian Companies Listed on US Exchanges:** Approximately 250 companies are listed on US exchanges in addition to Canadian exchanges. While these include the large Canadian banks and companies such as Barrick, CPR, Encana, and Potash, the majority are smaller mining companies seeking access to the US capital markets. The auditors of these companies, in addition to being subject to CPAB inspection, may also be inspected by the US PCAOB. In addition, some Canadian companies, particularly mining companies, choose to list only on a US exchange; again, their auditors are subject to inspection by the PCAOB.

B9. **Audit Committee Requirements:** National Instrument 52-110, which went into effect in most jurisdictions in 2004, sets out requirements for audit committees that may exceed those of other jurisdictions in certain areas. Such areas include the committee's responsibilities, composition, financial literacy and reporting obligations. (A companion policy 52-110CP provides information on the interpretation and application of NI 52-110.) The responsibilities must include the following:

- Recommending to the Board of Directors the external audit firm and its compensation.
- Overseeing the work of the external auditor.
- Pre-approving all non-audit services to be provided by the external auditor.
- Reviewing the financial statements, MD&A and "profit or loss press releases" prior to public release.
- Being satisfied about the adequacy of procedures for reviewing financial information to be disclosed.
- Establishing procedures for the receipt and treatment of complaints about financial matters, and the confidential, anonymous receipt of employees' concerns.
- Approving hiring policies regarding former personnel of the external auditor.

Appendix C

Group Membership

Steering Group

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

Observers

- Kevin Dancey, FCA, President and Chief Executive Officer, CICA, Toronto
- Brian Hunt, FCA, Chief Executive Officer, Canadian Public Accountability Board, Toronto
- Cameron McInnis, CA, CPA, Canadian Securities Administrators, Toronto

Project Coordinators

- Robert J. Muter, FCA, PricewaterhouseCoopers, LLP, Toronto
- Ron Salole, CICA, Toronto
- Axel N. Thesberg, FCA, KPMG, LLP, Toronto

Role of the Audit Committee Working Group

- Tom O'Neil, FCA, BCE and Bell Canada, Toronto **(Chair)**
- Jim Goodfellow, FCA, Corporate Director, Toronto
- Rob Scullion, FCA, Ernst & Young LLP, Toronto
- Kim Shannon, CFA, MBA, Sionna Investment Managers Inc., Toronto
- Wally Smieliauskas, PhD, University of Toronto, Toronto
- Huw Thomas, CA, Corporate Director, Toronto
- Victor Young, CA, International Verifact Inc., Toronto

Observers

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

Project Manager

- Tracy Brennan, CA, Ernst & Young LLP, Toronto

Auditor Reporting Working Group

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

Observers

- Malcolm Gilmour, CA, CPAB, Toronto
- Marion Kirsh, FCA, Canadian Securities Administrators, Toronto

Project Manager

- Eric Turner, CA, CICA, Toronto

Auditor Independence Working Group

- Peter Mills, Q.C., B.Com., JD, ICD.D, Corporate Director, Toronto **(Chair)**
- William R. Brushett, CA, Grant Thornton, LLP, Toronto
- Patrick Crowley, CA, OMERS, Toronto
- Jane E. Kinney, FCA, Deloitte & Touche, LLP, Toronto
- Andrew Kriegler, MBA, CIBC, Toronto
- Paul R. Weiss, FCA, Corporate Director, Toronto

Observer

- Kenneth Vallillee, FCA, CPAB, Toronto

Project Manager

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