# ENHANCING AUDIT QUALITY: THE ROLE OF THE AUDIT COMMITTEE IN EXTERNAL AUDITOR OVERSIGHT

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Foreword

This discussion paper is the result of a collaborative initiative by the Canadian Institute of Chartered Accountants (CICA) and the Canadian Public Accountability Board (CPAB), following the CPAB audit symposium of December 2011. The initiative focuses on three interrelated key areas in enhancing audit quality – the role of audit committees, the independence of auditors and auditor reporting. An accompanying paper sets out the project’s genesis, describes how the project is organized, outlines proposals made by a number of global bodies, and highlights certain features of the Canadian environment. Readers are encouraged to refer to the Initiative Overview paper for a comprehensive understanding of this joint CICA/CPAB project.

The Audit Committee Working Group (ACWG or the Group) prepared this discussion paper to consider ways in which audit committees can contribute to audit quality. It is the external auditor’s responsibility to perform a quality audit in accordance with Generally Accepted Auditing Standards (GAAS). CPAB, as Canada’s audit regulator, oversees the auditors of Canadian reporting issuers and contributes to public confidence in the integrity of financial reporting. In the view of the ACWG, the role of the audit committee in fostering audit quality is to focus on the independence and professional skepticism of the external auditor and to contribute to audit effectiveness in its oversight capacity as discussed throughout this paper. The ACWG acknowledges that the role of the audit committee includes a wider range of tasks than contemplated here; this paper should not be interpreted as an all-encompassing document for audit committees.

The objectives of this paper are to:

▲ identify which activities of the audit committee contribute to enhancing audit quality;
▲ provide guidance and suggestions on how to perform those activities;
▲ address comments raised by the Independence Working Group (IWG) and the Auditor Reporting Working Group (ARWG) as they relate to audit committees;
▲ inform and engage stakeholders in the global debate on enhancing audit quality; and
▲ present a balanced view of the ACWG’s deliberations.

The ACWG has developed general suggestions and included elements, but not necessarily mechanics, of desired activities in this discussion paper. It is acknowledged that each audit committee will tailor its actions to the specifics of the entity it helps to oversee, its management and its auditors. The establishment of audit committees is not a new concept in Canada for reporting issuers and financial institutions.1 The depth and breadth of audit committee experience offers the Canadian financial reporting environment a significant knowledge base for implementing the recommendations in this report in a straightforward and competent manner.

The guidance in this discussion paper addresses best practices for audit committees in fulfilling their duties under the current regulatory requirements and proposes augmented activities to further contribute to enhanced audit quality. There is presently significant variation in the process audit committees go through in recommending an external auditor. The components of the annual assessment, as discussed

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1 Federal legislation including the Bank Act, Insurance Companies Act, Trust and Loan Companies Act, and Cooperative Credit Associations Act require the establishment of an audit committee.
in Chapter 2, are not considered to be a change in regulation or mandate of the audit committee, but may lead to more robust activities by some audit committees. However, with respect to the proposed comprehensive review in Chapter 3, the recommendations of the ACWG do introduce new procedures and propose an increased mandate for audit committees in its auditor oversight role to enhance quality.

The ACWG recognizes there is a large number of small public entities in Canada, including some of the TSX Venture Exchange issuers, but believes that the recommendations in this paper can be appropriately applied to all reporting issuers. The recommendations may also be applicable to non-public entities, particularly larger private companies or not-for-profit organizations; audit committees of such entities may find the guidance useful.

In developing its recommendations, the Group noted that all audit committees of reporting issuers in Canada are currently governed by National Instrument 52-110 Audit Committees (NI 52-110), which specifies the composition, responsibilities and authority of audit committees. The responsibilities set out in NI 52-110, Part 2, “Audit Committee Responsibilities” (Part 2) are without exemption under the existing regulation. Thus, our suggestions that support the audit committee fulfilling the duties under Part 2 are recommended for adoption by all audit committees².

The ACWG acknowledges that proposed regulation not yet finalized may have an impact on certain audit committees. Specifically, the Canadian Securities Administrators (CSA) has proposed new National Instrument 51-103 Ongoing Governance and Disclosure Requirements for Venture Issuers (NI 51-103). Proposed NI 51-103 includes provisions that, if adopted, would change the audit committee requirements for TSX Venture Exchange issuers from those currently set out in NI 52-110. In the event that new regulation is adopted, the ACWG would revisit its recommendations set out in this paper³.

After an introduction in Chapter 1, the paper discusses and provides guidance on the role that audit committees play when overseeing the work of the external auditor in Chapter 2, Chapter 3 introduces and discusses the role of audit committees when conducting a comprehensive review of the audit firm their entity currently employs. The paper then proceeds to discuss the communication of CPAB audit inspection results in Chapter 4, Chapter 5 discusses the issue of having audit committees issue public commentary, followed by the conclusions of the ACWG in Chapter 6.

The ACWG is interested in hearing from stakeholders on whether they endorse or reject the views and recommendations contained in this discussion paper. Comments are requested by March 15, 2013 and should be sent to eaq.ac@cica.ca. Comments will be available on the CICA website shortly after the comment deadline.

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² Section V of OSFI’s guideline, “Corporate Governance of Federally-Regulated Financial Institutions," articulates the requirements and expectations of audit committees of federally-regulated financial institutions and closely reflects the requirements of NI 52-110.

³ The Chairs of the Enhancing Audit Quality Steering Group, Auditor Independence and Role of the Audit Committee Working Groups have provided comments to the CSA recommending that there be a single statement of audit committee responsibilities for all reporting issuers in Canada. Specifically, the letter to the CSA notes that, among other changes, NI 51-103 proposes to delete the requirement for the audit committee to pre-approve non-audit services and the requirement for the audit committee to recommend the compensation of the external auditor. The authors are opposed to these proposed changes, as in their view NI 51-103 could reduce the responsibilities of the audit committee and weaken their effectiveness for Venture issuers. A copy of the letter can be found on the CICA website.
Working Group Members

▲ Tom O’Neill, FCA (Chair) – Chair of the Board, BCE Inc.; Director and Audit Committee Chair of Nexen Inc. and The Bank of Nova Scotia; Director of Adecco SA and Loblaw Companies Limited; former Chairman, CEO and Partner of PricewaterhouseCoopers LLP

▲ Hugh Bolton, FCA – Chair of the Board, EPCOR Utilities Inc.; Director and Audit Committee Chair of Teck Resources Limited and WestJet Airlines Limited; Director and Audit Committee Member of Canadian National Railway Company and Toronto-Dominion Bank; Director of Capital Power Corporation; former Chairman, CEO and Managing Partner of Coopers & Lybrand AG

▲ Jim Goodfellow, FCA – Director and Audit Committee Chair, Discovery Air Inc.; Director and Audit Committee Member of Department of Foreign Affairs and International Trade and Canadian Tire Corporation Limited; former Vice-Chairman and Partner of Deloitte & Touche LLP

▲ Nick Kirton, FCA, ICD.D – Director and Audit Committee Chair of Gran Tierra Energy Inc., Essential Energy Services Ltd and the Canadian Investor Protection Fund; Governor and Audit Committee Vice Chair of the University of Calgary; former Partner of KPMG LLP

▲ Robert Scullion, FCA – Chair of Council, Institute of Chartered Accountants of Ontario; Director, Mackenzie Health Foundation; Leader of Public Policy and Regulatory Affairs of Ernst & Young LLP

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## Acronyms Used in this Discussion Paper

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<td>ACWG</td>
<td>The Role of the Audit Committee Working Group</td>
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<td>ARWG</td>
<td>Auditor Reporting Working Group</td>
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<td>ASIC</td>
<td>Australian Securities and Investments Commission</td>
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<td>CAS</td>
<td>Canadian Auditing Standard</td>
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<td>CEO</td>
<td>Chief Executive Officer</td>
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<td>Engagement Quality Control Reviewer</td>
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<td>UK Financial Reporting Council</td>
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<td>GAAS</td>
<td>Generally Accepted Auditing Standards</td>
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<td>IWG</td>
<td>Independence Working Group</td>
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<td>MD&amp;A</td>
<td>Management Discussion and Analysis</td>
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<td>NI</td>
<td>National Instrument</td>
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<td>PCAOB</td>
<td>Public Company Accounting Oversight Board</td>
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<td>SEC</td>
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Chapter 1. Introduction

1. The ACWG intends this paper to provide clarity to audit committees in discharging their responsibilities and offer guidance on the activities that help enhance audit quality. The aim in creating this working group was to generate guidance to help audit committees continually enhance the quality and effectiveness of the external audit and of the issuer’s financial reporting governance. Both will contribute to the continual improvement of the quality and reliability of financial reporting, which will benefit issuers’ shareholders and other investors.

2. This paper is written for audit committees and boards of directors of Canadian reporting issuers. It does not address the additional requirements that may be imposed on issuers that are also registrants with the Securities and Exchange Commission (SEC) in the United States (US) or by other foreign regulatory bodies.

3. Specifically, this report examines the role of audit committees in overseeing the work of external auditors as established in NI 52-110, and proposes conducting a comprehensive review to evaluate auditor performance as one element in improving the contribution of the audit committee to audit quality. The ACWG believes that its overall suggestions offer significant benefits for audit committees, including improved communications with their external auditors, augmented understanding of risk and control issues, better alignment of the audit process with principal business and financial reporting risks, improved feedback to management, and enhanced quality of the issuer’s financial reporting.

4. The ACWG notes that audit committees in Canada are viewed as integral to the audit process. The authoritative role of the audit committee should be used in a collaborative manner with management and the external auditor in ensuring the auditor executes a quality audit. The Group believes that leveraging the existing strengths in the Canadian audit committee structure provides significant opportunity to improve the quality of the audit process.

5. While audit quality and audit execution are the responsibility of the external auditor, the ACWG outlines in this report how, through a combination of understanding the external audit plan and increased access to the inspections results by regulators of audit firms, Canadian audit committees may more effectively oversee the work of their external auditors, thereby contributing to enhanced audit quality.
Chapter 2. Overseeing the Work of the External Auditor

6. The responsibilities of the audit committees of all Canadian reporting issuers are set out in NI 52-110, Part 2, section 2.3:

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. An audit committee must be directly responsible for overseeing the work of the external auditor 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.

7. NI 52-110 does not provide explicit guidance on what “overseeing the work of the external auditor” means nor suggest what audit committees are expected to do in discharging this responsibility. This paper provides guidance to help audit committees fulfill this responsibility and deal with other aspects of working with their external auditors in the context of augmenting audit quality.

8. While NI 52-110 does not provide specific guidance on execution, the ACWG reviewed the practices of leading audit committees as appropriate examples in effectively overseeing the work of external auditors. In the view of the Group, audit committees should perform the following activities:

- ▲ Monitor the effectiveness of the financial reporting environment.
- ▲ Oversee the annual work of the auditor.
- ▲ Review the audit plan and assess the reasonableness of the audit fee.
- ▲ Monitor the execution of the audit plan.
- ▲ Review and evaluate the auditor’s findings.
- ▲ Conduct an annual assessment.

9. The composition of the audit committee is specified in NI 52-110, Part 3, which states 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. The ACWG acknowledges that certain audit committees, particularly those exempt from the financial literacy requirement, may find the guidance in this report challenging with current resources. In reviewing the proposed additional tasks for audit committees, directors may wish to reconsider the composition of their audit committee.
10. Audit committees should ensure that they are familiar with any supplemental regulatory requirements for certain industries, such as financial institutions, which are not discussed in this paper.

11. The ACWG notes that audit committees are not in any way tasked with the execution of the audit. Their responsibility is limited to oversight of the audit function. The Group noted that the implementation of the recommendations in this report will, similar to the extent of the audit itself, be 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.

12. Effective oversight of the work of the external auditor should help safeguard the auditor’s independence while contributing to the quality and effectiveness of the audit overall. This oversight will facilitate integration of the knowledge and concerns of the audit committee into the audit process. Each of these elements is discussed in detail below.

**Monitor the effectiveness of the financial reporting environment**

13. NI 52-110 was issued in 2004 to strengthen the independence of audit committee members for TSX issuers and the independence of the external auditors of all reporting issuers by clarifying that the external auditors are directly accountable to the audit committee. Strengthening the external auditors’ independence 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 auditors and management are equally committed to ensuring there is integrity in the issuer’s financial reporting; have understanding and respect for each other’s roles and responsibilities; and establish constructive working relationships among all three parties.

14. The following diagram illustrates the relationships between the parties involved in the financial reporting environment:

![Figure One: Key Relationships in Financial Reporting Governance](image_url)
15. Candid communication among the parties involved in an issuer’s financial reporting is a fundamental element of quality financial reporting. This communication requires constant monitoring, evaluation, assessment and a commitment to take corrective action if required.

16. The diagram illustrates that the audit committee will be in direct communication with both management and the external auditors. As well, the audit committee oversees the nature of the interactions between management and the auditors. The ACWG notes that the relationship between management and its auditors, as referenced throughout this report, is for purposes of effective communication throughout the execution of the audit and not in the context of a relationship to sell services.

17. Under the framework noted above, the ACWG considers that it is important that there be a mutually respectful working relationship between the auditors and the audit committee and, in particular, between the lead audit partner and the chair of the audit committee.

18. The audit committee must set the proper tone at the top by establishing the expectation of open, candid and direct communications among management, the external auditors and the audit committee. In its 2011 public report, CPAB emphasised that effective two-way communication between the audit committee and the auditors helps improve the quality of the audit by:

- ensuring that the audit committee, which is responsible for the oversight of financial reporting, is fully informed about significant matters related to the audit and the financial statements;
- making the auditors aware of the audit committee's insights and information about transactions and events; and
- ensuring the auditors learn of any audit committee concerns about accounting or auditing matters.

19. Professional auditing standards require auditors to formally report to the audit committee on their independence and a number of other items, as noted later in this report. While such formal reporting is mandated, regular informal communications with the chair of the audit committee between meetings, discussions at audit committee meetings and candid discussion of issues during in camera sessions at audit committee meetings are likewise important. The audit committee must clearly state its expectation that the auditors conduct their audit with an appropriate degree of professional skepticism, recognizing that it is a key contributor to audit quality. The audit committee should monitor the tone of communications and intervene appropriately if the auditors do not appear to be exercising such skepticism or if management is reacting inappropriately in response.

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4 Canadian Public Accountability Board, 2011 Public Report, Meeting the Challenge “A Call to Action” (Toronto: Canadian Public Accountability Board Oversight Program, April 2012), p.10.
20. Integrity and candour on the part of both management and external auditors are essential for the effective operation of the financial reporting process. Professional skepticism and mutual respect between them are key to ensuring a free flow of information so that, for example, there are no impediments to the auditors’ access to information relevant to the execution of the audit. There are potential benefits to management from maintaining a professional relationship with its auditor, such as increased directness in the communication of any audit findings and increased receptiveness towards auditor commentary that could lead to improvements in the effectiveness of internal controls and the quality of management’s financial reporting. Management should respect that external auditors approach audits with professional skepticism, which includes maintaining a questioning mind and being alert for information that is contrary to management’s representations.

21. The following are potential warning signs that may indicate that the culture of integrity in the issuer’s financial reporting governance structure is weak or deteriorating:

- Communications are formal, carefully scripted and lacking in substance.
- The auditors do not appear to be exercising healthy professional skepticism in conducting the audit.
- The auditors’ suspicions are heightened and they are more aggressively challenging management’s estimates and valuations.
- Management is unduly defensive about issues raised by the auditors or auditor requests for further information and documentation to support management’s estimates and judgments.
- The audit team encounters unanticipated management restrictions.
- Management’s unwillingness to document and support various accounting estimates and judgments or to provide their assessment of the company’s ability to continue as a going concern when the auditor asks for this assessment.
- Management does not view the auditors as a source of useful input on continuous improvement to the quality of the issuer’s financial reporting.
- Management seeks to overly control the relationship with the external auditors, and makes the auditors rely on particular members of management for information.
- Differences of opinion on accounting matters rapidly increase the tension between the auditors and management, with both parties adopting defensive, hard-line positions.
- Changes in management do not significantly change the dynamics of the relationship: suspicions and tensions remain or continue to escalate.

22. While the remainder of this paper focuses on audit committee oversight of the work of the external auditors, it should be noted that audit committees need to exercise similar oversight over the work of the chief financial officer (CFO), the internal audit function, the finance function and other members of management involved in the financial reporting process. Audit committees should ensure that they can rely on the integrity of the CFO and that the chief executive officer (CEO) and CFO are creating a culture of integrity in the financial reporting function and throughout the organization consistent with the spirit and intent of the Corporate Governance Guidelines established in NP 58-201.
23. An audit committee should take action whenever it senses that communications between management and the auditors are starting to deteriorate, or that there are increased risks to the organization’s culture of integrity in the financial reporting function. Where the audit committee becomes aware of such risks, it should report this to the board of directors, along with recommendations for improvements. Should the audit committee not act on such red flags, it risks not detecting or uncovering lapses in integrity or competence, which in turn increases the risk of material omissions or misstatements in the issuer’s financial reporting.

24. The ACWG considered whether there was any need to provide new Canadian commentary or guidance on the relationship between auditors and audit committees. After reviewing the professional literature on GAAS and the regulatory environment, including Corporation Acts, Securities Commissions, etc., the Group concluded that there is ample direction on how each party should execute its respective responsibilities. Such pronouncements share a commonality in mandating principles of independence in fact and substance and the necessity for each party to maintain professional skepticism with respect to management and its representations in external reporting.

25. The absence of a respectful professional relationship between any combination of the audit committee, management and the external auditors would be detrimental to the independent audit process. The audit committee can make a positive contribution to the audit environment through fostering and monitoring the appropriate tone in communications among all parties.

Oversee the annual work of the external auditor

26. Professional standards require that the external auditors develop an overall strategy and a detailed audit plan governing the nature and timing of the audit procedures and resources required. The audit committee should focus its oversight on the overall audit strategy, the rationale supporting critical audit planning decisions and choices, the timing of major audit activities, a demonstration of the external auditors’ knowledge of the business in their analysis of the entity’s specific business risks, key audit deliverables and the resources needed to execute the audit plan.

27. The external auditors should review their proposed audit strategy with the audit committee early in the financial reporting year. This may occur at a special audit committee meeting or as part of a regular quarterly meeting when the auditors are engaged to perform quarterly review procedures. The audit committee should establish a communication protocol with the auditors to ensure it is satisfied with the transparency and frequency of opportunities to oversee the auditors’ work.

Review the audit plan and assess the reasonableness of the audit fee

28. To execute a quality audit, auditors must first obtain a sufficient understanding of an entity’s business risks. During the review of the audit plan, the audit committee should share its knowledge of significant business risks with the auditors to ensure that their analysis and demonstration of knowledge of the business is congruent with and adequately dealt with in the audit plan.
29. Audit committees may expect to see the following addressed in the proposed audit plan:

- Identification and timeline for communication of key deliverables, such as quarterly review results, progress reports on key audit areas, subsidiary audited financial statements, annual financial statement audit opinion, etc.
- Materiality thresholds to be used in planning the audit and evaluating audit findings.
- Assessment of significant financial reporting risks and how the audit plan addresses these risks.
- Extent of reliance on and testing of internal controls over financial reporting.
- Extent of reliance to be placed on internal audit and how such reliance will be supported.
- Nature and timing of audit procedures (e.g., substantive procedures performed at year end vs. control testing performed throughout the year).
- Selection of locations to be audited, assets to be verified, etc.
- Involvement of other firms in the audit.
- Firm resources scheduled for executing the audit plan, including partner leadership and involvement, specialized resources such as tax and valuations, industry experience and expected levels of technical consultations.

30. Audit committees should be prepared to consider the elements relevant to their entity in relation to the entity’s risks and, in turn, advise the auditors of any other business or financial risks that are of concern but have not been addressed in the audit plan. It is important for audit committee members to understand the customization of the audit strategy by the external auditors in response to the major risks facing the entity and the adequacy of resources planned to be used to address those risks.

31. NI 52-110 specifies that one audit committee task is to recommend the compensation of the external auditors to the board of directors. This includes ensuring that the fee is fair and reasonable for all parties.

32. When assessing the reasonableness of the audit fees, audit committees may consider the following:

- Discussion with the engagement partner regarding the reasonableness of the fee in relation to the size, complexity and risk of the engagement compared to other similar engagements.
- Impact of changes in the issuer’s risk profile, investment, or lack thereof, in control systems, IT, internal audit, etc.
- Discussion on how the engagement partner ensures both effectiveness and efficiency (such as auditors’ use and leverage of IT, internal audit, etc.) in conducting the audit.
- Impact of any changes in scope, any inefficiency such as delays in management’s delivery of audit support, multiple versions of key documents, etc.
33. Audit committees should review the proposed audit fee in conjunction with the audit plan and assess whether the fee will adequately support the execution of the audit plan in full. In formulating their views on the appropriateness of the audit fee and plan, it may be helpful for audit committees to hold discussions with management on the key risks facing the entity and changes in the business that may affect the audit fee and plan. Nevertheless, audit committees remain responsible for recommending the audit fee for board approval; this decision cannot be delegated to management.

34. Audit committees are also responsible for approving any non-audit services that the auditors might provide. In doing so, they should:

- establish a process for appropriate approval of non-audit services and related fees;
- consider whether the nature of the non-audit work, by its scope, significance, or working relationship between the auditor and management will create a threat to independence;
- assess whether the auditors should perform the non-audit service, considering, for example, whether certain industry expertise would make the external audit firm more qualified than other firms to perform the task; and
- ensure that there are no prohibitions from a regulatory or independence perspective.

Monitor the execution of the audit plan

35. Many mid to large reporting issuers engage their external auditors to perform a review of their quarterly financial statements and then to report to the audit committee on these reviews, giving the external auditors a scheduled opportunity to provide the audit committee with a progress report on the annual audit. To make such reporting more effective, the audit plan could be organized with deliverables and timing of key audit activities allocated to specific time periods, thus facilitating progress reports to the audit committee.

36. Smaller reporting issuers generally tend not to engage external auditors to perform such quarterly reviews. For them, the external auditors’ plan is often based on performing audit procedures on or after the year-end date and, consequently, there would be no audit work performed throughout the year. The audit partner and the audit committee chair should maintain regular communications so that the auditors can respond to any significant transactions or changes in the business as they occur.

37. When an entity has engaged its external auditors to perform quarterly reviews, the audit committee’s ability to effectively monitor the execution of the audit plan depends on both the quality of the progress reports the external auditors give the audit committee before the quarterly meetings and the committee being well prepared for those meetings.

38. If an audit committee is to effectively monitor the execution of the audit plan, it is beneficial for its chair to have a briefing session with the external auditors before the audit committee meets to ensure that the chair fully understands the issues and implications of any matters the auditors plan to raise, and how these matters should be addressed during the meeting.
39. In reporting to the audit committee, auditors should communicate any significant difficulties they have encountered in executing their audit plan, which could include:

   ▲ significant management delays in performing required accounting tasks, lack of access to certain company personnel, or management unwillingness to provide the information the auditors need;
   ▲ areas where the audit timetable was behind schedule or where planned targets and deliverables were not met, and the reasons for such slippage;
   ▲ unexpected extensive auditor effort required to obtain sufficient appropriate audit evidence;
   ▲ changes in business conditions or circumstances, or changes in systems or accounting personnel not anticipated in the audit plan;
   ▲ unanticipated management restrictions encountered by the audit team;
   ▲ management's unwillingness to document and support various accounting estimates and judgments or their assessment of the company's ability to continue as a going concern when requested by the auditor; and
   ▲ the identification of unexpected audit results, such as internal control deficiencies, and their impact on the audit.

40. An important component of monitoring the execution of the audit plan is assessing the communication of audit findings to management and the audit committee. This includes assessing the timeliness of both formal and informal communications and how issues the auditors have raised are addressed. Management and the auditors must ensure that all significant issues are communicated promptly to the audit committee and in a manner that is complete, fair and balanced. Where accounting issues are raised, the communication must fully articulate the accounting options available, the impacts of those options and the reasons for adopting the selected option. When issues arise, management is responsible for making any necessary corrections and the audit committee is responsible for overseeing that management has done so.

41. To assist in effective communication of problems and any sensitive issues that may have arisen, the audit committee should meet in camera after having held separate discussions with each of:

   ▲ the external auditors;
   ▲ key management personnel; and
   ▲ internal auditors.

   This discussion should ensure that everyone is on the same page with respect to the implications of the auditors’ findings and how they are to be resolved.

42. Finally, the reports from the audit committee to the board of directors on the execution of the audit plan, and any issues raised in the performance of the audit, should be timely and sufficiently comprehensive to enable the board to understand the progression of the audit and the strategy to address any issues identified.
Review and evaluate the auditor’s findings

43. Professional auditing standards require auditors to communicate specific matters to the audit committee, either annually, or when a specific event occurs. Required communications include, inter alia:

- significant audit adjustments, including significant disclosure differences that merit the attention of those charged with governance, even when considered by management to be immaterial;
- the auditor’s judgments about the quality of the issuer’s implementation of accounting principles;
- methods of accounting for significant unusual transactions and for controversial or emerging areas;
- sensitive accounting estimates;
- material alternative accounting treatments discussed with management;
- when the auditors become aware of consultations management has held with other accountants;
- serious difficulties in dealing with management;
- significant deficiencies and material weaknesses in internal control over financial reporting; and
- matters related to subsidiaries of the issuer.

44. The primary focus of the audit committee’s review of the required auditor communications is to ensure it has enough information for recommending the approval of the financial statements to the board. It should also review these communications for indications that the auditors have exercised professional skepticism and performed a quality audit.

45. Prompt communication and in-depth discussion with both management and the auditors are required if any audit findings arise that could require the auditors to modify their report, add a matter of emphasis paragraph to their report, cause management to disclose a material deficiency in internal control in the Management Discussion and Analysis (MD&A), or lead the auditors to question the issuer’s ability to continue to operate as a going concern.
Conduct an annual assessment

46. Each year, audit committees should assess the effectiveness of the external auditors in fulfilling their responsibility to make an informed recommendation to the board on whether or not the external audit firm should be put forward in the proxy material for reappointment at the annual general meeting. This annual evaluation should, at a minimum, encompass an assessment of the qualifications and performance of the auditors; the quality and candour of the auditors’ communications with the audit committee and management; and the auditors’ independence, objectivity and application of professional skepticism exhibited in conducting their work. The assessment should be reviewed with the external auditors to help them continually improve their effectiveness and performance. The audit committee should obtain management input as one information source when conducting the annual assessment.

47. The following is a suggested list of factors audit committees should consider in their annual assessment to support their auditor reappointment recommendation:

- Performance of the audit team in meeting its commitments and deadlines as outlined in the audit plan.
- How management was challenged during the conduct of the audit, particularly with regards to assessment of fraud risk, management’s estimates and assumptions and the choice of accounting policies, thereby demonstrating that the external auditors exercised professional skepticism.
- Maintenance of the auditors’ independence, including mitigation of any independence threats, such as considering the significance of non-audit services performed by the auditor in aggregate.
- How unanticipated issues that arose during the audit were addressed.
- The quality of insights and observations provided by the auditors on the issuer’s financial reporting, internal controls operating performance, etc.
- The timeliness and quality of communications on significant accounting issues and the effectiveness of related resolution on any accounting differences.
- Extent of consultation and use of specialists on complex technical matters.
- Effectiveness of the auditors’ formal and informal communications with management and the audit committee.
- Consideration of financial reporting and disclosure comments received from regulators.
- CPAB inspection findings, as discussed in Chapter 4.
48. The audit committee may consider the extent of involvement of the engagement quality control reviewer (EQCR). As required by Canadian Auditing Standard 220 *Quality control for an audit of financial statements* (CAS 220), an engagement quality control review is mandatory for listed entities and other engagements identified by the audit firm. Per CAS 220.20, “The engagement quality control reviewer shall perform an objective evaluation of the significant judgments made by the engagement team, and the conclusions reached in formulating the auditor’s report.” Often, the EQCR will have no direct interaction with the entity’s management or with the audit committee. However, the audit committee could find it helpful to ask the engagement partner about any matters in which the EQCR was involved during the audit and any concerns the EQCR raised in assessing significant judgments made by the audit team.

49. In October 2012, a consortium of corporate governance organizations in the US published the paper, “Audit Committee Annual Evaluation of the External Auditor.” The document includes questions audit committees should consider when evaluating the audit team, its lead partner and engagement quality control partner, along with a sample rating system audit committees could consider useful. Refer to Appendix B for the complete publication. The ACWG recommends the development of a Canadian document, similar to the US document, to assist audit committees in their execution of the annual assessment.

**Conclusion**

50. The ACWG identified activities that, to contribute to the enhancement of audit quality, audit committees should perform 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 risk areas of the audit.
- Review and evaluate the audit findings.
- Conduct an annual assessment of the auditors’ performance.

*Do you agree that audit committees should perform these activities each year?*

*Are there any other activities that audit committees should perform each year to contribute to the enhancement of audit quality?*

*Do you agree it would be helpful to develop a document for Canadian audit committees similar to the US publication in Appendix B to assist in the execution of annual assessments of the external auditors?*
Chapter 3. Conducting a Comprehensive Review of Audit Firm

51. Independence and professional conduct rules for external auditors address familiarity threats at the individual level between management and the external audit team through partner rotation rules; however, the financial environment is now identifying concerns about familiarity and self-interest threats between audit firms and the companies they audit at the institutional level. Such threats have become known as “institutional” familiarity threats. There is a perception that audit firms could develop an overly close relationship with clients over time, which may create a threat to independence that impedes the ability of the firm and, more specifically, members of the engagement team, from exercising an appropriate level of professional skepticism.

52. In its discussion paper, *Enhancing Audit Quality: Canadian Perspectives – Auditor Independence*, the IWG recommended that the best option for safeguarding external auditors against institutional familiarity threats is by having audit committees undertake a comprehensive review of its external auditors. This review would assess the ongoing effectiveness of the professional relationship between the audit firm and the issuer, focusing on the external audit team’s independence and any impairment of objectivity or effectiveness in conducting the audit. A periodic comprehensive review is considered to be a more practical and cost-effective alternative to either mandatory audit firm rotation or mandatory tendering, which are currently being considered in other jurisdictions. Moreover, the comprehensive review would require both audit committees and external auditors to focus significant attention on indicators of audit quality and the exercise of professional skepticism, which the alternatives reviewed by the IWG do not.

53. The comprehensive review is recommended in addition to the audit committee’s annual assessment of the external audit undertaken as part of its NI 52-110 responsibilities discussed in *Chapter 2*. The comprehensive review would be of greater depth and breadth than an annual assessment. For example, where the annual assessment would focus on the audit team, the engagement partner, their independence and objectivity and the annual quality of audit work performed, the comprehensive review would focus more on the audit firm, its independence and the application of professional skepticism.

54. The IWG suggested that the audit committee perform a comprehensive review every five years. The ACWG supports this recommendation and suggests the comprehensive review and partner rotation not occur in the same year. A comprehensive review conducted at least once every five years can focus on areas that the annual assessment cannot do, such as focusing on the audit firm and any institutional familiarity threats potentially created by increased audit tenure. It is a solution that better addresses the issues that the proposals of mandatory audit firm rotation or mandatory tendering of audits are intended to resolve by including an evaluation of audit quality.

55. The comprehensive review would provide the audit committee with information not otherwise included in its assessment activities. In certain circumstances, the passage of time allows the committee to identify issues not readily apparent on an annual basis. The comprehensive review should consider the following:
Significant factors related to changes and trends in the audit firm's performance and qualifications not evident from a year over year assessment would become clearer. For example, in assessing an audit firm's expertise in a particular industry, departures of industry specialists or changes in the firm's client base in the industry may not be material year over year but, over a five-year period, a significant change may become evident.

Similarly, some aspects of an issuer’s business or its operating environment may change only marginally from year to year but, when considered over five years, it may become obvious that the auditors' expertise is not keeping up. For example, the issuer may do a small but increasing amount of business in a particular industry segment where the audit firm has no other clients; over a five-year period, this business may have increased to the point that another audit firm with expertise in that segment would better meet the issuer's needs.

The annual assessments of an audit firm may have been generally satisfactory but, when the audit committee reviews the findings over five years, it may find that the responsiveness to suggestions for improvement from regulators, the audit committee and/or management, has fallen short of expectations.

When there has been some turnover in the membership of the audit committee, the committee may find it more difficult to assess or discern year-to-year changes in its auditor’s performance, which may be more evident over a five-year period. This might be particularly true in subjective areas, such as the degree of skepticism exercised by auditors when challenging key estimates made by management.

Irrespective of the continuity in composition of the audit committee, it may be easier to identify changes in facts and circumstances over a five-year period that have created independence threats. Similarly, it may be easier to identify a lack of adequately challenging management’s assumptions or deterioration in the application of professional skepticism when reviewing an extended period.

There may be assessment challenges when an issuer’s finance department personnel experiences significant turnover. The audit committee’s questions to the finance personnel on changes in the auditor’s performance may elicit more relevant information in these circumstances over a period of five years than over a shorter period.

In addition to these points, most, if not all, of the factors the audit committee should consider during its annual assessment could benefit from a more detailed consideration during the comprehensive review.

The audit committee is responsible for determining the scope of the comprehensive review. The audit committee chair would begin to determine that scope by discussing the nature and extent of the comprehensive review with a senior partner of the audit firm that is neither involved in the issuer’s audit engagement, nor in providing other professional services to the issuer. That partner would, therefore, bring a fresh and independent eye to the project. Once they have agreed on the details, the audit committee chair would present the proposed comprehensive review plan to the audit committee for approval. At a minimum, the scope would include the items discussed below. Once the scope is established, the next step is to request and obtain the audit firm’s self-assessment that includes the activities and processes the firm uses to safeguard against institutional independence threats and to enhance audit quality.
58. The ACWG recognizes that the execution of the comprehensive review represents an additional responsibility for the audit committee and that committees, particularly smaller, resource-constrained committees, may have challenges in implementing such a review. However, if the review process is designed to yield relevant information for the audit committee’s consideration, the comprehensive review can be a beneficial, insightful process that will better enable audit committees to have a meaningful role in the exercise of its oversight responsibilities.

59. The scope of the comprehensive review should generally include reviewing and evaluating the following factors and how the audit firm has applied them to the audit:

- Safeguards against institutional independence familiarity threats.
- Quality of communications from the audit firm.
- Manner in which the audit firm ensures that its auditors have exercised professional skepticism.
- Results of the annual assessments (including communications received about CPAB inspections) since the previous comprehensive review and how the firm has responded to these assessments.
- Quality of the engagement team the firm has provided since the last comprehensive review, including technical and industry expertise.
- Quality and relevance of thought leadership shared by the auditor on any new accounting pronouncements or regulatory requirements.
- Transparency of communications from the auditor, particularly with respect to resolving any controversial accounting or audit issues.
- How the firm handled any partner rotations during the period.

60. The comprehensive review should also include any additional entity-specific issues that may have arisen since the last comprehensive review, such as restatements, significant financial reporting criticisms made by securities regulators or the press, and how the firm responded to these issues.

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**Safeguards against institutional independence familiarity threats**

61. 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:

- number of years the audit firm has served as external auditor for a particular client;
- 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.
62. Audit committees should consider whether their audit firm has identified all familiarity threats and then critically evaluate the sufficiency of the safeguards that have been put in place. A key safeguard is the transparency of audit firm and company management interactions and ensuring that the audit committee is aware of all those interactions.

Quality of communications from audit firm

63. In reviewing the various communications from the auditors, 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.

64. Audit committees should consider whether communications from their auditors 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 contemplate the extent to which the communications reflect this information in a useful manner that is relevant to the entity.

Exercising professional skepticism

65. According to Paragraph 15 of the discussion paper on Enhancing Audit Quality: Canadian Perspectives – Auditor Independence, released in September 2012:

“Professional skepticism includes being alert to, for example:

▲ audit evidence that contradicts other audit evidence obtained;
▲ information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence;
▲ conditions that may indicate possible fraud; and/or
▲ circumstances that suggest the need for audit procedures in addition to those required by the basic audit standards.

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

66. Auditors should identify the areas in recent audits that presented the greatest difficulty in obtaining independent corroborative audit evidence and which 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 and 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.
67. By articulating its focus on professional skepticism, the audit committee will highlight to both management and the auditors the importance of such professional skepticism in enhancing audit quality.

Response to annual assessments (including communications about CPAB inspections) since the last comprehensive review

68. The annual assessment of the auditors’ effectiveness is a critical step in the audit committee’s responsibility to oversee the work of the external auditors 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.

69. As part of the comprehensive review, the audit committee should step back and revisit 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 from CPAB in its 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

70. 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 the auditors need to address. It is essential that the audit firm responds to these changes by involving appropriate industry and technical expertise as necessary. It is also possible that key members of the audit team have left due to partner rotation or for other reasons. It is important, however, that the audit firm maintain an appropriate level of continuity in its engagement team members year over year to reduce the amount of learning required on the engagement. The audit committee should review how the audit firm has been able to continue to provide an audit team 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.

Results of the annual assessment or comprehensive review

71. It is anticipated that 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 things satisfactorily, the audit committee should raise the matters with the board of directors to determine whether the audit should be put out to tender.

72. Notwithstanding the formal review process recommended above, the ACWG noted that often informal communication between audit committees and the auditors – specifically, between the audit committee chair and the lead engagement partner – on matters affecting audit quality is important and should not be delayed until the annual assessment or comprehensive review takes place. The ACWG encourages audit committee members 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.
Conclusion

73. The ACWG concurs with the consensus reached by the IWG that audit committees should conduct a mandatory comprehensive review of the external audit firm at least once every five years. Such comprehensive reviews will be considerably more rigorous than the annual assessments of the auditor’s work, and:

- Audit committees should use the comprehensive reviews to make recommendations on retaining the present audit firm or engaging another firm.
- Audit committees should disclose the process they have undertaken and the basis for their recommendations.

74. The comprehensive review would have a broader scope than merely addressing the institutional familiarity threat; it also offers audit committees the significant benefits of augmenting their annual assessments and focusing on how their audit firm ensures that its audits are of high quality, including ensuring that the auditors have exercised appropriate skepticism, as well as permitting audit committees to better evaluate the continuous improvement culture of the audit firm.

75. Specifically, the ACWG suggests that audit committees summarize the results, findings and conclusion of the review in support of their recommendation for the nomination of an external auditor. This summary should be included in the public disclosure documents of the entity in the year in which the comprehensive review is carried out.

76. The ACWG recognizes education, guidance and tools to be important implementation considerations and recommends that such resources be developed.

77. Audit committees are encouraged to adopt the comprehensive review process. The ACWG acknowledges that it may be beneficial for the CSA to modify securities regulation to ensure timely and consistent implementation of comprehensive reviews.

Do you agree with the recommendation that comprehensive reviews of external audit firms, on which retention recommendations will be based, be conducted at least every five years?

Do you believe the comprehensive review should be made a requirement under securities legislation?

Do you agree that it would be helpful to develop a document to assist Canadian audit committees in executing the comprehensive reviews of external auditors? If so, please share any suggestions on what guidance audit committees would find helpful.

What needs do you identify for resources, education, guidance and tools? What other implementation concerns do you have?
Chapter 4. Communication of Inspection Results

78. Regulatory inspection of firms that audit public companies is a key feature of the Canadian financial reporting system. Depending on the nature of the entities a firm audits, it may be subject to inspection by CPAB, the US Public Company Accounting Oversight Board and the provincial institutes/ordre. The ACWG considered the audit regulation environment in multiple jurisdictions before focusing its discussion on the CPAB inspection process.

79. 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 quality, independent auditing. CPAB carries out its mission by conducting inspections of the firms over which it has oversight responsibility.

80. 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. Following each inspection, CPAB provides the firms with a private report containing findings on their quality control processes, individual file review findings, recommendations for improvement and other observations.

81. All firms must implement the recommendations to CPAB’s satisfaction within a prescribed period of time, which is typically 180 days. When CPAB believes a stronger message is needed, it imposes requirements. Should a firm fail to implement the recommendations or requirements, CPAB will impose sanctions on that firm.

82. Audit committees presently 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.

83. The ACWG considered current practices in other jurisdictions of oversight bodies tasked with monitoring financial reporting and auditor regulation. Refer to Appendix A for commentary on current practices in other countries. The ACWG noted that there is a trend toward asking for more transparent communications on inspection results between regulators and audit committees in certain key jurisdictions having financial reporting environments similar to Canada. Regulators cite as their motivation for enhancing communications the mutual interest in improving audit quality and protecting investors through strengthening the reliability of audited financial statements. Specifically, the Group discussed the challenges in maintaining a Canadian policy that deviates significantly from the practice in the US, given the significant overlap in the capital markets.

84. The view of the ACWG is that the ability of audit committees to oversee and evaluate their auditors is hampered by their current lack of access to CPAB inspection insights. CPAB’s annual public report does not permit audit committees to learn what findings, if any, pertain to their auditor or their entity, 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.
85. The ACWG acknowledges that the inspection activities conducted by the various provincial institutes/ordre provide another source of insight on the quality of audit work performed. Accordingly, provincial institute/ordre inspection findings should also be looked at to see if they would provide meaningful information to audit committees. The ACWG suggests that the provincial institutes/ordre consider ways to communicate relevant findings to audit committees subsequent to the development of the protocol established with CPAB.

**Increase transparency of CPAB findings with audit committees**

86. The ACWG considered what CPAB inspection information audit committees would find useful for enhancing their ability to effectively oversee the work of the auditors and how this information should be shared on a confidential basis. The Group noted that the objective should be to assist audit committees in conducting their annual assessment of the auditors, as well as conducting a meaningful comprehensive review on a periodic basis.

87. Criteria for evaluating the impact of increased transparency of CPAB reporting include the following:

- Increased transparency should 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.
- The overall goal of increased transparency should be to enhance audit quality.
- Increased transparency should not decrease firm responsiveness to CPAB findings and recommendations or significantly increase the time required to complete an inspection and for firms to implement CPAB’s recommendations.
- Increased transparency should raise awareness of issues having an impact on audit quality and the value of an audit to the capital markets.

88. The Group considered recommending the release of CPAB findings on individual entities and the full CPAB report as issued to each of the audit firms. It was noted that CPAB currently writes its reports for a specific audience: firm leadership and the engagement partners. ACWG believes that the findings, as written in this context and given the level of detail they contain, would not benefit audit committees or the investing public. The ACWG believes that confidential reporting of CPAB inspection findings to audit committees, derived and adapted from the detailed CPAB findings issued to the audit firms, is a more effective alternative to promoting a continuous improvement approach to audit quality.
Proposed communication of CPAB findings by the audit firms with audit committees

89. The ACWG suggests that CPAB, on an annual basis, modify its current public 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 firm and/or entity. The report could also highlight any trends in accounting and auditing issues, and, subject to client confidentiality considerations, share any industry-specific findings. Providing this information should focus the attention of the audit committee on what actions the external auditors have taken in specific areas of the audit file.

90. The ACWG believes that CPAB and the audit firms it regulates should develop a protocol for increasing the information made available to audit committees. Specifically, the Group suggests that audit firms be permitted to share significant inspection results from individual audit files with the audit committee of those clients following CPAB’s review.

91. The Group considered the roles of engagement partners, audit firms, audit committees and CPAB in facilitating communication of inspection results. The ACWG proposes the following for consideration in developing an appropriate communication protocol:

1. Audit firms should educate the 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.

2. In the event that CPAB has inspected the audit file of a particular company, its auditors should 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.

3. CPAB should review a firm’s communications with audit committees as part of its subsequent inspection process 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 that the firm’s communications were insufficient, corrective actions would be taken.

4. 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.

92. The ACWG considers it essential that authoritative guidance be issued to mandate uniform communication from all firms to all audit committees. The most effective mechanism for implementing the communication protocol appears to be its inclusion in the rules of the CPAB Participation Agreement. As the ACWG considers the sharing of CPAB inspection findings to be an important, time-sensitive initiative, it is recommended that CPAB and the firms work jointly to develop the protocol, with input from affected stakeholders, for insertion in the Participation Agreement at the earliest opportunity.
93. The establishment of a communication protocol for CPAB inspection findings will make it possible to customize relevant communications to the oversight role of audit committees and at a level of detail appropriate to their mandate. As well, the increased transparency of CPAB inspection results will assist audit committees in better fulfilling their oversight responsibilities and in monitoring quality improvements in the audit files and processes.
Conclusion

94. To facilitate the performance of the annual assessment and the mandatory comprehensive review, the ACWG recommends that CPAB and the audit firms it regulates develop a protocol for increasing the information made available to audit committees.

Do you agree that components of the CPAB inspection findings should be communicated to audit committees to facilitate their comprehensive reviews?

What elements of the inspection results do you believe should be communicated?

Do you believe inclusion of such a protocol in the Participation Agreement is appropriate?
Chapter 5. Public Commentary by the Audit Committee

95. The ARWG noted in its discussion paper, *Enhancing Audit Quality: Canadian Perspectives – The Auditor Reporting Model*, that users have been asking for additional information in the independent auditor’s report to increase their ability to identify areas of greater significance in complex reports, to provide additional discussion of risk assessment and audit execution and to share auditor insights. The ARWG noted, in its discussion of auditor commentary, that certain proposals, “would make the audit committee (and not the auditor) responsible for providing additional information to shareholders as they may be a more effective solution than auditor commentary.” Refer to the full report for the comprehensive context of this comment.

96. There are other organizations currently addressing the topic of expanding auditor reports to contain increased public commentary by the auditor and/or the audit committee, including the Financial Reporting Council (FRC) in the United Kingdom. On the suggestion of having the audit committee provide additional commentary to the public on the above noted topics, the ACWG concluded that this could potentially lead to generic template wording that would not contribute to increasing audit quality. The Group noted that audit committees vary in size and degree of sophistication, both across Canada and in other jurisdictions, thus, globally, there would appear to be greater opportunity to enhance audit quality through augmented auditor commentary than through audit committee commentary.

97. The ACWG did acknowledge, however, that public audit committee commentary would be appropriate for informing shareholders that the audit committee conducted a comprehensive review of the independent auditors in arriving at its recommendation to the board on either the retention or replacement of the incumbent audit firm. Consistent with the IWG, the ACWG suggests that the audit committee disclose when it has performed a comprehensive review, the process it undertook and the rationale underlying its recommendation to the board. The ACWG recommends this disclosure could be incorporated into existing corporate governance communications.

Conclusion

98. The ACWG recommends that audit committees publicly report on their comprehensive reviews, describing the process undertaken and the conclusions reached, and that this disclosure be mandated by the Canadian Securities Administrators and other regulators.

*Do you agree that audit committees should report on comprehensive reviews?*

*Do you agree the disclosure requirement should be mandated through securities legislation?*

*Do you believe there should be additional audit committee commentary beyond the report on the comprehensive review?*
Chapter 6. Conclusion

99. In summary, the ACWG believes that audit committees have a significant opportunity to contribute to enhancing audit quality in Canada. The nature of the financial reporting system and regulatory environment, combined with the expertise of audit committee members, provides an appropriate forum for effective oversight of the audit process. Use of the review tools proposed in this paper will increase the effectiveness of the audit committee’s involvement in assessing the execution of an entity’s audit. The ACWG believes that the adoption of the recommended comprehensive review process will empower audit committees to contribute to enhancing audit quality.
Appendix A: Financial Regulators – Global Perspective

The current reporting model used by CPAB, or a variant thereof, is the most widely used globally, including in Australia, Brazil, France, Germany, Japan and South Africa.

Examples of alternative inspection reporting models include the United Kingdom and United States:

The Audit Inspection Unit of the Financial Reporting Council in the **United Kingdom** issues public inspection reports for each of the major audit firms. These inspection reports summarize significant firm level quality control deficiencies, as well as individual audit engagement findings, without disclosing the names of issuers. More detailed confidential inspection reports are also issued to the individual firms. In addition to public and confidential reporting at a firm level, FRC prepares individual audit file findings reports for all audit files inspected. These reports are sent to the firms with the expectation that the engagement partners will share the reports with the chairs of their respective audit committees.

In the **United States**, the Public Company Accounting Oversight Board’s (PCAOB) individual firm inspection reports include a section that is made public and a section that is kept non-public. The public section describes file review findings by issuer, without disclosing the names of the issuers. The non-public section might include criticism of, or potential defects in, a firm’s quality control systems and other information concerning the firm’s audit practice. The PCAOB will make these findings public if the quality control deficiencies are not addressed to their satisfaction within 12 months after the date of the inspection report.

The PCAOB issued Release No. 2012-003 in August 2012 to educate audit committees on the PCAOB inspection process. This release was in response to feedback received from audit committees whose auditors declined to discuss PCAOB inspection results or “downplay(ed) the results of any adverse findings that may be included in the report.” In addition to clarifying the context and nature of the inspections conducted by the PCAOB, the release suggests questions for audit committees to ask the auditors concerning the PCAOB inspection and its results. The overall message to audit committees is to discuss inspection findings, both at the engagement level and at the firm level, with their auditor.

Similar to the Canadian model, in **Australia**, the Australian Securities and Investments Commission (ASIC) inspection findings are kept confidential, being communicated only to the firms involved. ASIC periodically publishes a report containing key inspection observations and findings, but does so without identifying the firms or audited entities involved. However, the Corporations Legislation Amendment (Audit Enhancement) Bill 2012, passed in June 2012, gives ASIC the authority to publish audit deficiency reports in the event an audit firm does not remedy its findings satisfactorily within six months. The Bill also gives ASIC the ability to communicate directly with senior management of the audited entity, the board of directors and the audit committee when information on audit or accounting issues identified through the inspection process will assist the entity in managing its affairs.
Appendix B: Audit Committee Annual Evaluation of the External Auditor
Audit Committee Annual Evaluation of the External Auditor

INTRODUCTION

Audit committees of public companies and registered investment companies have direct responsibility to oversee the integrity of a company’s financial statements and to hire, compensate and oversee the external auditor. Public focus on how audit committees discharge their responsibilities, including their oversight of the external auditor, has increased significantly.

Each year, audit committees should evaluate the external auditor in fulfilling their duty to make an informed recommendation to the Board whether to retain the auditor. The evaluation should encompass an assessment of the qualifications and performance of the auditor; the quality and candor of the auditor’s communications with the audit committee and the company; and the auditor’s independence, objectivity and professional skepticism.

To this end, this assessment questionnaire can be used by audit committees to inform their evaluation of the auditor (i.e., the audit firm, as well as the lead audit engagement partner, audit team, and engagement quality reviewer). The sample questions highlight some of the more important areas for consideration and are not intended to cover all areas that might be relevant to a particular audit committee’s evaluation of its auditor or suggest a “one size fits all” approach. Moreover, this assessment tool is not meant to provide a summary of legal or regulatory requirements for audit committees or auditors. Sources of additional information on hiring and evaluating the auditor and an overview of portions of the relevant standards on required auditor communications with the audit committee are included at the end of this assessment.

ASSESSMENT PROCESS

The annual auditor assessment should draw upon the audit committee’s experience with the auditor during the current engagement (presentations; reports; dialogue during formal, ad hoc and executive sessions), informed by prior year evaluations. It is appropriate to obtain observations on the auditor from others within the company, including management and internal audit, accompanied by discussions with key managers. A suggested survey for obtaining observations from others within the company follows the assessment questionnaire. In assessing information obtained from management, the audit committee should be sensitive to the need for the auditor to be objective and skeptical while still maintaining an effective and open relationship. Accordingly, audit committees should be alert to both a strong preference for and a strong opposition to the auditor by management and follow up as appropriate.

It makes good sense for audit committee members to continuously evaluate the auditor’s performance throughout the audit process, for example, noting the auditor’s skepticism in evaluating unusual transactions or responsiveness to issues. These contemporaneous assessments provide important input into the annual assessment. Audit committees may wish to consider those contemporaneous observations during a more formal assessment process, perhaps by using a questionnaire or guide that considers all relevant factors year-over-year. To ensure that all views are considered, audit committees may wish to finalize their assessment during group discussions (as opposed to collecting audit committee member comments separately) during formal committee meetings or conference calls.

Finally, audit committees should consider advising shareholders that they perform an annual evaluation of the auditor and explain their process and scope of the assessment.
QUALITY OF SERVICES AND SUFFICIENCY OF RESOURCES PROVIDED BY THE AUDITOR

The audit committee’s evaluation of the auditor begins with an examination of the quality of the services provided by the engagement team during the audit and throughout the financial reporting year. Because audit quality largely depends on the individuals who conduct the audit, the audit committee should assess whether the primary members of the audit engagement team demonstrated the skills and experience necessary to address the company’s areas of greatest financial reporting risk and had access to appropriate specialists and/or national office resources during the audit. The engagement team should have provided a sound risk assessment at the outset of the audit, including an assessment of fraud risk. During the engagement, the auditor should have demonstrated a good understanding of the company’s business, industry, and the impact of the economic environment on the company. Moreover, the auditor should have identified and responded to any auditing and accounting issues that arose from changes in the company or its industry, or changes in applicable accounting and auditing requirements. Another consideration for the audit committee is the quality of the engagement teams that perform portions of the audit in various domestic locations, or abroad by the firm’s global network or other audit firms.

SAMPLE QUESTIONS

| Q1 | Did the lead engagement partner and audit team have the necessary knowledge and skills (company-specific, industry, accounting, auditing) to meet the company’s audit requirements? Were the right resources dedicated to the audit? Did the auditor seek feedback on the quality of the services provided? How did the auditor respond to feedback? Was the lead engagement partner accessible to the audit committee and company management? Did he/she devote sufficient attention and leadership to the audit? |
| Q2 | Did the lead engagement partner discuss the audit plan and how it addressed company/industry-specific areas of accounting and audit risk (including fraud risk) with the audit committee? Did the lead engagement partner identify the appropriate risks in planning the audit? Did the lead engagement partner discuss any risks of fraud in the financial statement that were factored into the audit plan? |
| Q3 | If portions of the audit were performed by other teams in various domestic locations, or abroad by the firm’s global network or other audit firms, did the lead engagement partner provide information about the technical skills, experience and professional objectivity of those auditors? Did the lead engagement partner explain how he/she exercises quality control over those auditors? |
| Q4 | During the audit, did the auditor meet the agreed upon performance criteria, such as the engagement letter and audit scope? Did the auditor adjust the audit plan to respond to changing risks and circumstances? Did the audit committee understand the changes and agree that they were appropriate? |
| Q5 | Did the lead engagement partner advise the audit committee of the results of consultations with the firm’s national professional practice office or other technical resources on accounting or auditing matters? Were such consultations executed in a timely and transparent manner? |
QUALITY OF SERVICES AND SUFFICIENCY OF RESOURCES PROVIDED BY THE AUDITOR  

A broader but important consideration is whether the audit firm has the relevant industry expertise, as well as the geographical reach necessary to continue to serve the company, and whether the engagement team effectively utilizes those resources. Other firm-wide questions include the results of the audit firm’s most recent inspection report by the Public Company Accounting Oversight Board (PCAOB), including whether the company’s audit had been inspected and, if so, whether the PCAOB made comments on the quality or results of the audit. The audit committee also may want to know how the firm plans to respond to PCAOB comments contained in the inspection report, more generally, and to any internal findings regarding its quality control program.

SAMPLE QUESTIONS

| Q6 | If the company’s audit was subject to inspection by the PCAOB or other regulators, did the auditor advise the audit committee of the selection of the audit, findings, and the impact, if any, on the audit results in a timely manner? Did the auditor communicate the results of the firm’s inspection more generally, such as findings regarding companies in similar industries with similar accounting/audit issues that may be pertinent to the company? Did the auditor explain how the firm planned to respond to the inspection findings and to internal findings regarding its quality control program? |
| Q7 | Was the cost of the audit reasonable and sufficient for the size, complexity and risks of the company? Were the reasons for any changes to cost (e.g., change in scope of work) communicated to the audit committee? Did the audit committee agree with the reasons? |
| Q8 | Does the audit firm have the necessary industry experience, specialized expertise in the company’s critical accounting policies, and geographical reach required to continue to serve the company? |
| Q9 | Did the audit engagement team have sufficient access to specialized expertise during the audit? Were additional resources dedicated to the audit as necessary to complete work in a timely manner? |
COMMUNICATION AND INTERACTION WITH THE AUDITOR

Frequent and open communication between the audit committee and the auditor is essential for the audit committee to obtain the information it needs to fulfill its responsibilities to oversee the company’s financial reporting processes. The quality of communications also provides opportunities to assess the auditor’s performance. While the auditor should communicate with the audit committee as significant issues arise, the auditor ordinarily should meet with the audit committee on a frequent enough basis to ensure the audit committee has a complete understanding of the stages of the audit cycle (e.g., planning, completion of final procedures, and, if applicable, completion of interim procedures). Such communications should focus on the key accounting or auditing issues that, in the auditor’s judgment, give rise to a greater risk of material misstatement of the financial statements, as well as any questions or concerns of the audit committee.

PCAOB standards, SEC rules, and exchange listing requirements identify a number of matters the auditor must discuss with the audit committee. Audit committees should be familiar with those requirements and consider not only whether the auditor made all of the required communications, but, importantly, the level of openness and quality of these communications, whether held with management present or in executive session.

SAMPLE QUESTIONS

| Q10 | Did the audit engagement partner maintain a professional and open dialogue with the audit committee and audit committee chair? Were discussions frank and complete? Was the audit engagement partner able to explain accounting and auditing issues in an understandable manner? |
| Q11 | Did the auditor adequately discuss the quality of the company’s financial reporting, including the reasonableness of accounting estimates and judgments? Did the auditor discuss how the company’s accounting policies compare with industry trends and leading practices? |
| Q12 | In executive sessions, did the auditor discuss sensitive issues candidly and professionally (e.g., his/her views on, including any concerns about, management’s reporting processes; internal control over financial reporting (e.g., internal whistle blower policy); the quality of the company’s financial management team)? Did the audit engagement partner promptly alert the audit committee if he/she did not receive sufficient cooperation? |
| Q13 | Did the auditor ensure that the audit committee was informed of current developments in accounting principles and auditing standards relevant to the company’s financial statements and the potential impact on the audit? |
AUDITOR INDEPENDENCE, OBJECTIVITY AND PROFESSIONAL SKEPTICISM

The auditor must be independent of the issuer and — in the case of mutual funds, independent of the investment company complex. Audit committees should be familiar with the statutory and regulatory independence requirements for auditors, including requirements that the auditor advise the audit committee of any services or relationships that reasonably can be thought to bear on the firm’s independence.

The technical competence of the auditor alone is not sufficient to ensure a high-quality audit. The auditor also must exercise a high level of objectivity and professional skepticism. The audit committee’s interactions with the auditor during the audit provide a number of opportunities to evaluate whether the auditor demonstrated integrity, objectivity and professional skepticism. For example, the use of estimates and judgments in the financial statements and related disclosures (e.g., fair value, impairment) continues to be an important component of financial reporting. The auditor must be able to evaluate the methods and assumptions used and challenge, where necessary, management’s assumptions and application of accounting policies, including the completeness and transparency of the related disclosures.

An important part of evaluating the auditor’s objectivity and professional skepticism is for the audit committee to gauge the frankness and informative nature of responses to open-ended questions put to the lead audit engagement partner (and members of the audit engagement team as appropriate). Examples of appropriate topics include: the financial reporting challenges posed by the company’s business model; the quality of the financial management team; the robustness of the internal control environment; changes in accounting methods or key assumptions underlying critical estimates; and the range of accounting issues discussed with management during the audit (including alternative accounting treatments and the treatment preferred by the auditor). The auditor also should be able to clearly articulate the processes followed and summarize the evidence used to evaluate the significant estimates and judgments, and to form an opinion whether the financial statements, taken as a whole, were fairly presented in accordance with Generally Accepted Accounting Principles.

SAMPLE QUESTIONS

| Q14 | Did the audit firm report to the audit committee all matters that might reasonably be thought to bear on the firm’s independence, including exceptions to its compliance with independence requirements? Did the audit firm discuss safeguards in place to detect independence issues? |
| Q15 | Were there any significant differences in views between management and the auditor? If so, did the auditor present a clear point of view on accounting issues where management’s initial perspective differed? Was the process of reconciling views achieved in a timely and professional manner? |
| Q16 | If the auditor is placing reliance on management and internal audit testing, did the audit committee agree with the extent of such reliance? Were there any significant differences in views between the internal auditors and the auditor? If so, were they resolved in a professional manner? |
| Q17 | In obtaining pre-approval from the audit committee for all non-audit services, did the lead engagement partner discuss safeguards in place to protect the independence, objectivity and professional skepticism of the auditor? |
EXAMPLE FORM

OBTAINING INPUT ON THE EXTERNAL AUDITOR FROM COMPANY PERSONNEL

Because you have substantial contact with the external auditors throughout the year, the Audit Committee is interested in your views on the quality of service provided, and the independence, objectivity, and professional skepticism demonstrated throughout the engagement by the external audit team and firm.

Please rate the auditor’s performance on each of the following attributes using a five-point scale, where 5 = Very High/Completely Satisfied and 1 = Very Low/Completely Dissatisfied.

<table>
<thead>
<tr>
<th>QUALITY OF SERVICES PROVIDED BY THE EXTERNAL AUDITOR</th>
<th>RATING</th>
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<tbody>
<tr>
<td>1. Meets commitments e.g., by meeting agreed upon performance delivery dates, being available and accessible to management and the audit committee.</td>
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<tr>
<td>2. Is responsive and communicative e.g., by soliciting input relative to business risks or issues that might impact the audit plan, identifying and resolving issues in a timely fashion, and adapting to changing risks quickly.</td>
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<tr>
<td>3. Proactively identifies opportunities and risks e.g., by anticipating and providing insights and approaches for potential business issues, bringing appropriate expertise to bear, and by identifying meaningful alternatives and discussing their impacts.</td>
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<tr>
<td>4. Delivers value for money e.g., by charging fees that fairly reflect the cost of the services provided, and being thoughtful about ways to achieve a cost-effective quality audit.</td>
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<tr>
<th>SUFFICIENCY OF AUDIT FIRM RESOURCES</th>
<th>RATING</th>
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<tr>
<td>5. Is technically competent and able to translate knowledge into practice e.g., by delivering quality services within the scope of the engagement, using technical knowledge and independent judgment to provide realistic analysis of issues, and providing appropriate levels of competence across the team.</td>
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<tr>
<td>6. Understands our business and our industry e.g., by demonstrating an understanding of our specific business risks, processes, systems and operations, by sharing relevant industry experience, and by providing access to firm experts on industry and technical matters.</td>
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<tr>
<td>7. Assigned sufficient resources to complete work in a timely manner e.g., by providing access to specialized expertise during the audit and assigning additional resources to the audit as necessary to complete work in a timely manner.</td>
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## COMMUNICATION AND INTERACTION

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<th>Rating</th>
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<td>8</td>
<td>Communicates effectively e.g., by maintaining appropriate levels of contact/dialogue throughout the year, effectively communicating verbally and in writing, being constructive and respectful in all interactions, and providing timely and informative communications about accounting and other relevant developments.</td>
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<th>Rating</th>
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<td>9</td>
<td>Communicates about matters affecting the firm or its reputation e.g., by advising us on significant matters pertaining to the firm while respecting the confidentiality of other clients’ information, and complying with professional standards and legal requirements, including informing us when the company’s audit is subject to inspection by the PCAOB or other regulatory review and sharing the results of the review that are pertinent to the company’s accounting or auditing issues.</td>
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## INDEPENDENCE, OBJECTIVITY AND PROFESSIONAL SKEPTICISM

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<th>Rating</th>
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<tr>
<td>10</td>
<td>Demonstrates integrity and objectivity e.g., by maintaining a respectful but questioning approach throughout the audit, proactively raising important issues to appropriate levels of the organization until resolution is reached, and articulating a point of view on issues.</td>
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<th>Rating</th>
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<td>11</td>
<td>Demonstrates independence e.g., by proactively discussing independence matters and reporting exceptions to its compliance with independence requirements.</td>
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<th>Rating</th>
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<tr>
<td>12</td>
<td>Is forthright in dealing with difficult situations e.g., by proactively identifying, communicating and resolving technical issues, raising important issues to appropriate levels in the organization, and by handling sensitive issues constructively.</td>
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## RECOMMENDATIONS

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<tr>
<td>13</td>
<td>Are there actions the external auditor should take to improve its delivery of a quality audit?</td>
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</table>

Please sign, date and return the form to ________________________________ by ___________.

Questions may be directed to ________________________________. Thank you.

Signed ________________________________________________ Title________________________

Date ___________________
RELEVANT REQUIREMENTS AND STANDARDS

PROHIBITED NON-AUDIT SERVICES

There are nine statutory categories of non-audit services that may not be provided to companies by the external auditors (Section 10A (g) to the Securities Exchange Act of 1934). For investment companies, these non-audit services may not be provided to any company in the investment company complex (as defined in 210.2-01(f)(14)):

- Bookkeeping or other services related to the accounting records or financial statements of the audit client;
- Financial information systems design and implementation;
- Appraisal or valuation services, fairness opinions, or contribution-in-kind reports;
- Actuarial services;
- Internal audit outsourcing services;
- Management functions or human resources;
- Broker or dealer, investment adviser, or investment banking services;
- Legal services and expert services unrelated to the audit; and
- Any other service that the PCAOB determines, by regulation, is impermissible.

Audit committees must pre-approve the provision of all other non-audit services by the auditor.

OVERVIEW OF AUDITOR COMMUNICATIONS WITH AUDIT COMMITTEES

SEC Rule 2-07 requires the auditor to communicate the following to the audit committee prior to the filing of the company’s Form 10-K. For investment companies that file Form N-CSR, these communications must take place annually, except that if the annual communication takes place more than 90 days prior to the filing, the auditor must provide an update describing any changes to the previously reported information.

- Critical accounting policies and practices used by the issuer;
- Alternative accounting treatments within U.S. GAAP for accounting policies and practices related to material items that have been discussed with management during the current audit period, including the ramifications of the use of such alternative disclosures and treatments and the treatment preferred by the independent auditor;
- Material written communications between the independent auditor and management of the issuer; and
- If the audit client is an investment company, all non-audit services provided to any entity in an investment company complex that were not pre-approved by the investment company’s audit committee pursuant to 210.2-01(c)(7).

PCAOB Auditing Standard No. 16 (AS 16), Communications with Audit Committees, replaces AU 380 for audits of issuers for fiscal years ending on or after December 15, 2012. The standard requires the following communication with the audit committee:

- The independent auditor’s responsibilities in relation to the audit under the standards of the PCAOB; as part of establishing an understanding with the audit committee on the terms of the engagement; preferably through a written communication (i.e., engagement letter). Also requires communication of major issues discussed with management prior to the initial selection or retention as auditors;
- Whether the audit committee is aware of any matters relevant to the audit, particularly any violations of laws or regulations. Also requires the auditor to communicate the overall audit strategy, timing of the audit and significant risks; including the participation of others in the audit (i.e., specialists, firms beside the principal auditor, etc.); and

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1 Auditors of emerging growth companies and broker dealers are subject to AU 380 until the SEC determines to extend AS 16 to the former and adopts amendments to SEC Rule 17a-5 for the latter.
The following with respect to the entity’s accounting policies and practices, estimates and significant unusual transactions; and the auditor’s evaluation of the quality of a company’s financial reporting:

- Significant accounting policies and practices – Management’s initial selection of, or changes in the current period; the effect on financial statements or disclosures for policies that are considered controversial, there is a lack of guidance, or diversity in practice; and the auditor’s qualitative assessment of such policies and practices. Specifically, the quality, not just the acceptability, of the company’s accounting principles as applied in its financial reporting and disclosures, including situations in which the auditor identified bias in management’s judgments and the auditor’s evaluation of the differences between (i) estimates best supported by the audit evidence and (ii) estimates included in the financial statements which are individually reasonable, that indicate a possible bias on the part of company management;

- Critical accounting policies and practices – The reasons such policies and practices are considered critical; how current and anticipated events could affect this determination; and the auditor’s assessment of related management disclosures;

- Critical accounting estimates – A description of the process used to develop such estimates; management’s significant assumptions in the estimates that have a high degree of subjectivity; any significant changes in management’s process to develop an estimate; and the auditor’s conclusion as to the reasonableness of such estimates;

- Significant unusual transactions – Significant transactions outside the normal course of business, or that are unusual due to timing, size or nature; and the auditor’s understanding for the business rationale of such transactions;

- Financial statement presentation – The evaluation of whether the financial statements and related disclosures are presented fairly in accordance with the applicable financial reporting framework;

- New accounting pronouncements – Any concern identified by the auditor related to management’s application of pronouncements that have been issued but are not yet effective in relation to future periods; and

- Alternative accounting treatments – All alternative treatments permissible under the applicable financial reporting framework for policies and practices related to material items that have been discussed with management, including the ramifications of the use of such alternative disclosures and treatments and the treatment preferred by the auditor.

Other communications from the auditor include:

- Other information – The auditor’s responsibility with respect to and results of audit procedures performed on other information accompanying the audited financial statements;

- Difficult or contentious matters for which the auditor consulted;

- Management consultation with other accountants;

- Going concern – Whether the auditor believes there is: i) substantial doubt including related events or conditions; ii) substantial doubt has been alleviated due to management’s plan; iii) substantial doubt remains despite management’s plans; and iv) related effect on the financial statements;

- Corrected and uncorrected misstatements and omitted disclosures – Requires the auditor to provide the audit committee with a written schedule of uncorrected misstatements that was provided to management. Also requires communication for the basis of whether: i) uncorrected misstatements were immaterial, including qualitative assessment; ii) uncorrected misstatements or underlying matters could potentially cause future-period financial statements to be materially misstated; and iii) corrected misstatements other than those deemed trivial, that might not have been detected other than through the audit procedures;

- Disagreements with management, whether or not satisfactorily resolved that individually or in the aggregate could be significant to the entity’s financial statements or the audit report; and

- Significant difficulties encountered with management in performing the audit.

**PCAOB standards** require the independent auditor to communicate all material weaknesses and significant deficiencies identified during the audit to the audit committee. If the independent auditor concludes that the audit committee’s oversight of the company’s external financial reporting and internal control over financial reporting is ineffective, the auditor is required to inform the board of directors.

**PCAOB rules** also require at least an annual written statement delineating all relationships between the independent auditor and the company, including individuals in financial reporting oversight roles at the company that reasonably can be thought to bear on independence.
New York Stock Exchange Rule 303A.07(b), from its Listed Company Manual, requires audit committees to have a written charter that sets forth the committee's purpose, including, at a minimum, certain provisions of SEC rule 10A-3(b) (2), (3), (4), and (5), as well as other specific duties and responsibilities, to assist board oversight of the integrity of the company's financial statements, and the independent auditor's qualifications, independence and performance. Pertinent to auditor oversight, the rule includes the following audit committee requirements:

- Obtain and review at least annually a report by the independent auditor which describes the firm's internal quality-control procedures; any material issues raised by the most recent internal quality-control review, or peer review, of the firm, or by any inquiry or investigation by governmental or professional authorities, within the preceding five years, respecting one or more independent audits carried out by the firm, and any steps taken to deal with any such issues; and (to assess the auditor's independence) all relationships between the independent auditor and the listed company;

- Meet to review and discuss the listed company's annual audited financial statements and quarterly financial statements with management and the independent auditor, including reviewing the listed company's i) specific disclosures under “Management's Discussion and Analysis of Financial Condition and Results of Operations”; and ii) policies with respect to risk assessment and risk management, the company's earnings press releases, as well as financial information and earnings guidance provided to analysts and rating agencies;

- Meet separately, periodically, with management, with internal auditors (or other personnel responsible for the internal audit function) and with independent auditors;

- Review with the independent auditor any audit problems or difficulties and management's response;

- Set clear hiring policies for employees or former employees of the independent auditors; and

- Report regularly to the board of directors.

Commentary to the rule pertinent to the assessment of the independent auditor further provides that after reviewing the auditor's quality control report and the auditor's work throughout the year, the audit committee will be in a position to evaluate the auditor's qualifications, performance and independence (including a review and evaluation of the lead partner) taking into account the opinions of management and the company's internal auditors. The commentary further provides that, in addition to assuring the regular rotation of the lead audit partner as required by law, the audit committee should consider whether, in order to assure continuing auditor independence, there should be regular rotation of the audit firm itself. Finally, audit committees are instructed to present their conclusions to the full board of directors.
RECENT SOURCES AND SUGGESTED READINGS


Public Company Accounting Oversight Board. *Information for Audit Committees about the PCAOB’s Inspection Process*. August 2012.


The Institute of Chartered Accountants in Australia, the Financial Reporting Council, and The Institute of Chartered Accountants of Scotland. *Walk the line: Discussions and insights with leading audit committee members*. February 2012.


Ernst & Young LLP. *Audit Committee Member Toolkit*. June 2009.
The Discussion Paper has been prepared by the Role of the Audit Committee Working Group (ACWG) of the Enhancing Audit Quality (EAQ) initiative under the oversight of the EAQ Steering Group. It has not been approved by any Board or Committee of the Canadian Institute of Chartered Accountants (CICA) or Canadian Public Accountability Board (CPAB) and neither CICA, CPAB, nor the group members accept any responsibility or liability that might occur directly or indirectly as a consequence of the use, application or reliance on this material.

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