FINANCIAL INSTITUTIONS

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Financial Institutions Industry Forum Highlights

The Canadian Public Accountability Board (CPAB) held its second annual Financial Institutions Industry Forum on December 13, 2017 for audit committee chairs of large Canadian banks and insurance companies.

Co-hosted by **Alan MacGibbon**, audit committee chair of TD Bank Financial Group, the Forum featured a roundtable discussion about matters that are topical for audit committees of Canadian banks and insurance companies. The Forum included a discussion led by CPAB about emerging developments in audit quality and audit partner perspectives about the industry from **Bill Cunningham**, insurance partner, Deloitte LLP, and **Bill Schlich**, banking partner, EY LLP.

This document highlights items of note on the following matters:

1. Technology, disruption and cybersecurity risks.
2. Expanded auditor's report.
3. Implementation of new accounting standards.
4. Strategies for maximizing the efficiency and effectiveness of the audit committee.
5. Use by audit committees of audit quality indicators and comprehensive review frameworks.

Technology, disruption, and cybersecurity risks

The financial services industry is being disrupted by new technologies, non-traditional competitors, regulatory changes and growing expectations from customers. Audit practitioners described for participants items to consider as they oversee the technology programs of their entities.

Technology risk, which encompasses risks related to innovation, transformation, implementation and cybersecurity, was described as the biggest risk faced by financial institutions today. Financial institutions need sound strategies for dealing with these risks. Risk appetites should be well defined and approved by the board. Further, as financial institutions expand their technology platforms through partnerships with third parties, audit committees need to broaden their outlook about governance to include oversight over the extended enterprise.

Participants also discussed the need for sound crisis-response plans. Organizations need to be ready to respond to unforeseen events as the landscape for financial institutions continues to increase in complexity. Opportunities to leverage insights from external auditors in this area given their visibility into practices across their clients were discussed.

New auditor's report

Several of the largest financial institutions in Canada that are also listed on US stock exchanges will be subject to the new auditor reporting requirements issued by the Public Company Accounting Oversight Board (PCAOB) with the most significant changes coming in 2019 or 2020 depending on the size of the issuer. The new standard will require auditors to report on critical audit matters (CAMs) as well as on how long they have been the auditors of the entity.

In Canada, the Auditing and Assurance Standards Board (AASB) currently provides for voluntary reporting of key audit matters (KAMs).

This reporting may become mandatory as early as 2020 for TSX listed companies in an effort to remain consistent with the requirements in the US.

Participants expressed concerns about having two auditor's reports for dual filers because of differences in the auditor reporting standards where a combined auditor's report was acceptable to the US Securities and Exchange Commission (SEC) in the past. Also discussed was whether the reporting would require auditors to report on KAMs that contain information deemed proprietary or sensitive by management in addition to the possibility of the reporting becoming boilerplate and ultimately less useful to readers.

CPAB advised participants to start the dialogue with their auditors and to consider:

- What matters could be reported as KAMs by the auditor?
- How will management and audit committees engage with the auditor as KAMs are identified and the auditor's descriptions of the KAMs are developed?
- How do the auditor's descriptions of KAMs compare to management's disclosures on those same matters?

New accounting standards

A suite of new accounting standards is set to impact financial reporting for financial institutions over the next few years. IFRS 9, *Financial Instruments*, IFRS 15, *Revenue from Contracts with Customers*, IFRS 16, *Leases* and IFRS 17, *Insurance Contracts* are expected to present more significant implementation challenges for banks and insurance companies than the 2011 transition to IFRS standards.

For instance, the most significant change under IFRS 9 requires financial institutions to measure impairment on loans based on an expectation of how likely customers are to repay those loans; called the expected loss model. This is a significant departure from the existing requirement to recognize loan losses on an incurred loss basis. Modelling for expected losses will involve more estimation uncertainty requiring information inputs from the front, middle and back offices of the financial institution. The need for increased coordination among functional areas of financial institutions in turn increases execution risk.

Audit practitioners described key questions for audit committees as they oversee implementation programs at their entities:

- Does management have a clear strategy for implementation with milestone accountability and reporting?
- Are there sufficient policies and governance over model design, build and validation, ongoing model review, the integrity of data used and model adjustments or qualitative overlays?
- What are the views of the auditors on how far along the entity's implementation is and whether the entity's models and assumptions are in line with peers?

Efficiency and effectiveness of the audit committee

The mandate of audit committees of financial institutions continues to expand. Participants discussed steps they have taken to address audit committee efficiency and effectiveness, focusing on the following:

- Allocation of oversight responsibilities to audit committees.
- Quality of formal meetings of audit committees.
- Use of informal meetings.

Differences were noted among participants in terms of which board committees had primary oversight responsibility over the following programs: (i) conduct review, (ii) technology and cybersecurity risks and (iii) anti-money laundering and anti-terrorist financing programs. Generally, participants noted significant overlap between the responsibilities of the risk and audit committees and some participants had practices of joint committee sessions or members on both committees. Participants also described efforts by their audit committees to prompt more effective communications, both written and verbal, from the parties that report into them. They described the large volume of pre-reading material and efforts to streamline that information to better direct the attention of audit committee members.

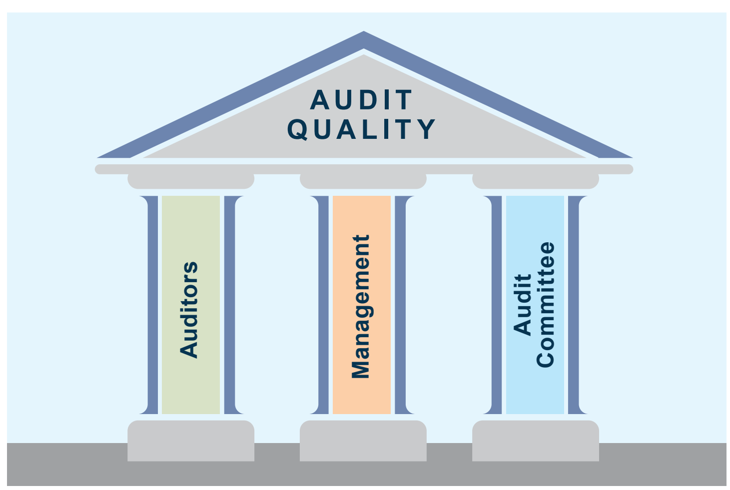
Audit committee efficiency and effectiveness is aided considerably by the engagement of audit committee chairs with management and auditors outside of formal meetings. Participants described pre- and post-meetings as good practice for directing management and internal/external auditors on matters to focus on during audit committee meetings and for communicating what should be improved at future meetings. Participants also commonly use consent agendas to deal more efficiently with routine items that do not require additional consideration during meetings.

Audit quality indicators (AQIs) and comprehensive reviews

Audit committees have shown an interest in tools and activities that can enhance their oversight of financial reporting and the audit. Two activities discussed by CPAB were the use of AQIs and conducting a periodic comprehensive review of the auditor.

AQIs

Many of the participants are currently using AQIs to enhance the quality and depth of discussions with management and their auditors. Some said the process of discussing AQIs with auditors was itself useful because it helps audit committee members that are not financial experts better understand the requirements of an audit. Others said the value of using AQIs would be realized over several periods because “what gets measured gets addressed”.



CPAB's observations suggest that AQIs have significant potential to enhance the quality of corporate governance over the audit and financial reporting. We encourage audit committees, management and audit firms to continue to explore how AQIs can be integrated into their audit processes. For additional information about AQIs, please visit our website.

Comprehensive reviews

A number of audit committees have found comprehensive reviews are an effective activity to evaluate their auditor. Most of the participants have carried out comprehensive reviews over the past few years and plan to perform them every three to five years. CPAB is undertaking a new project in 2018 to identify challenges and best practices associated with performing comprehensive reviews. More information about this project can be found at our website.

Thank You

CPAB thanks everyone for their participation. We encourage ongoing dialogue and look forward to continuing the audit quality discussion at future Industry Forum Series events across Canada.

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