Audit Committee Oversight of Foreign Operations

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The Issue

External auditor oversight can be a challenge for audit committees of reporting issuers with operations in foreign jurisdictions. Operational, financial and reputational risks stemming from foreign jurisdictions can impact the quality of the external audit and expose directors to greater liability. This publication is intended to help the audit committee acquire information critical in assessing risk. This knowledge should be tailored to the specific circumstances to enable an audit committee to establish clear expectations of management and the external auditor to ensure the financial statement audit risks stemming from operations in foreign jurisdictions are identified and addressed, and that a high-quality audit is achieved.

The Role of the External Auditor

Items to discuss with your auditor:

- Describe your understanding of the nature of the foreign components.
- What is your involvement with the foreign component auditor?
- Describe your audit strategy for the group and its foreign components.

The audit committee should share its knowledge of significant business risks with the external auditor to ensure that their understanding is consistent. This can be achieved by conducting a preliminary meeting, at the initial audit planning stage, with the external auditor to discuss the entity and its foreign components and determine whether the auditor demonstrates sufficient understanding of the specific business risks.

Understanding the component(s)

In understanding the component the auditor should exhibit the following:

- Awareness of business practices, legal structures, customs and cultural norms in the foreign jurisdiction that create specific risks.
- Assessment of compliance with foreign laws and regulations, including any peculiarities of property rights or registrations which may taint title and ownership.
- Understanding the nature of the business, the profitability drivers, the business processes and the controls of the foreign operation, and its significance to the overall consolidated group.
- Alignment of the group auditor’s risk assessment of the foreign operation with management’s. Considering whether any risks were identified by the group auditor but not considered by management and vice versa.
Understanding the component auditor
The audit committee should have a clear understanding of how the external auditor incorporated the foreign operations into its audit strategy and the extent of audit procedures to be performed. The extent of involvement of other firms should also be discussed during preliminary planning meetings, as well as why the group auditor can use their work. Areas of focus may include:

- Understanding of the regulatory environment the component auditor operates in, including the independent auditor oversight and independence requirements.
- Assessment of the component auditor’s skills and experience to perform the audit of the foreign component.
- If the group auditor intends on auditing the foreign component directly, sufficient knowledge of the accounting framework, applicable laws and regulations, and local business practices are important.
- The group auditor should have a plan to address language and cultural barriers including the component auditor having the appropriate cultural background to understand the audit risks that are present and/or access to independent resources that can help overcome language and cultural barriers.
- If tax and valuation professionals are involved in the audit of the component, they should be subject to independence requirements that are equivalent to those required of the component auditor.

The audit committee may also inquire about the external auditor’s assessment of management at the foreign operations and improvements that could be made to policies and processes from their observations during the audit.

The audit strategy for the group and its components
The audit response to identified risks could include:

- Specific audit procedures performed in response to significant audit risks and their effectiveness given any differences in laws and customs of the foreign operation.
- Evaluation of internal control testing at the foreign component and consideration if any of the findings and observations give rise to unforeseen significant risks that may impact the audit.
- A search for undisclosed related parties or intermediaries to ensure appropriate focus on higher risk areas.
- A review of significant contracts for unusual terms or conditions may identify items that warrant further investigation.
- If there was suspicion of fraud or corruption the audit approach should change and may involve a forensic audit team to provide assistance.

Example: Confirmation of Balances
Obtaining confirmations of balances from a third party is a standard audit procedure in Canada. However, such a procedure may not be reliable in a foreign jurisdiction.

For example, in Canada, bank confirmations are completed by financial institutions, following a protocol established by the Canadian Bankers Association. Such a protocol may not exist in a foreign jurisdiction, which may cause the resulting bank confirmation to be unreliable. Similarly, confirmation responses received from individuals or companies that have a close business or personal relationship with the reporting issuer may be unreliable.

If the response to a confirmation is not reliable or the auditor does not send a confirmation, the auditor would perform additional procedures to obtain assurance over the balances being tested.

Did You Know...
In certain foreign jurisdictions business practices can create challenges with respect to revenue recognition. These practices include a prevalence of verbal agreements, verbal amendments to written contracts, and billing practices that often result in delaying invoicing to defer sales taxes, even if performance obligations have been met.
The group auditor’s involvement in the supervision and review of the component

The group auditor is responsible for determining whether sufficient audit evidence was obtained from the work performed on all significant components including work performed by component auditors. The decision to visit a component is a matter of professional judgment. If the group auditor chooses not to travel to the foreign location and/or does not review the component auditor’s work, the audit committee should understand what procedures were performed by the group auditor to fulfil their professional responsibilities.

The following factors may indicate that closer supervision may be required:

- restricted access to the working papers
- size or specific risks associated with the component
- doubts about the diligence of the component auditor
- concerns over the control environment
- recent acquisition or planned disposal
- internal audit findings
- audit adjustments
- changes within component management
- new component auditor

The Role of Management

Key questions to ask management:

- What is the structure of the foreign government, legal and tax systems?
- What are the cultural and societal norms?
- How has management designed and implemented a responsive control environment at the foreign locations?
- What is group management’s involvement / oversight of management of foreign locations?

For reporting issuers operating in foreign jurisdictions, a country or region-specific risk assessment is important to help parent-company management (group management) identify and address the potential exposure to the group financial statements. Risks may originate from the political, cultural, legal and business environments and the audit committee should understand what process management followed to identify and mitigate the financial reporting risks. Areas of focus may include:

Nature of operations in foreign jurisdictions

- The structure of government
  - Assessing and responding to the likelihood of restrictions being imposed that may affect the reporting issuer’s ability to operate in the foreign jurisdiction.
  - How business is transacted in the country including the country’s ranking on the latest Corruption Perception Index\(^1\) or Bribe Payers Index\(^2\) and whether the government adheres to the Organisation for Economic Co-operation and Development (OECD) Guidelines for Multinational Enterprises\(^3\).

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\(^1\) A list of the countries of the world showing how much corruption is thought to exist among its public officials and politicians, published by Transparency International.

\(^2\) This index ranks 28 of the world’s largest economies according to the perceived likelihood of companies from these countries to pay bribes abroad. It is based on the views of business executives as captured by Transparency International’s 2011 Bribe Payer Survey.

\(^3\) The OECD Guidelines for Multinational Enterprises are recommendations addressed by governments to multinational enterprises operating in or from adhering countries. They provide non-binding principles and standards for responsible business conduct in a global context consistent with applicable laws and internationally recognized standards.
► The legal system
Understanding the nature of the legal system including:
• Whether the courts are required to follow precedent
• How the legal system protects property rights and the strength of contract law
• How effectively laws are enforced
• The complexity of legal structures and how well they are understood

► The tax system
Understanding and complying with the local tax system including:
• The frequency of legislative changes to the tax system
• Whether compliance with tax laws is subject to interpretation and judgment
• The frequency of tax disputes
• The nature of tax rules for foreign-owned companies

► The culture and social norms
• Understanding and responding to business practices, customs or cultural norms in the foreign jurisdiction and the related risks.

Obtaining region-specific expertise may be helpful in ensuring a comprehensive understanding of the reporting issuer’s circumstances. The audit committee can play a role in developing region-specific know-how through open communication with group management and identifying the need for expert assistance.

Once group management understands the environment and related risks, it must consider the effectiveness of the systems of internal control. The audit committee should understand how group management implements the policies, information systems and business processes in the foreign jurisdiction and the challenges they face.

Designing a responsive control environment

► Code of conduct, policies and procedures
• Whether the corporate code of conduct has been translated and amended to include the types of issues that may arise in the foreign jurisdiction.

• Whether policies and procedures have been translated and conformed to local laws, customs and social norms.

► Communications
• How the code of conduct, and policies and procedures were communicated to management working at the foreign operation.
• Whether regular live training sessions, awareness workshops or meetings are scheduled to ensure that the code of conduct, policies and procedures are fully understood.
• The presence of eyes and ears on the ground and whether there are any corporate officials or Canadian expatriates who speak the language.

► Whistleblower lines
• If management working at the foreign operation is being pressured to override controls and policies, ensuring there is someone to reach out to from group management.
• Whether group management has considered that employees in foreign jurisdictions may be reluctant to report wrongdoings through whistleblower lines due to fear of authority figures.
• Whether alternative conduits have been established, such as the existence of a trusted employee at the foreign location, to ensure that employees feel encouraged and protected in reporting ethical dilemmas and concerns.

► Monitoring controls
• Whether group management has ensured that incentive plans do not encourage objectionable practices.
• Awareness of employees, local partners, suppliers, agents, customers and government officials of the company’s policy around facilitation⁴ and illegal payments.
• The extent that group management electronically monitors cash disbursements and transactions such as purchase orders, donations and travel expenses for signs of unauthorized payments.
• The effectiveness of group management’s oversight of the consolidation process and the responsiveness of management at the foreign location in responding to the group’s inquiries.

⁴ Facilitation payments are small payments to low-level officials made to secure or expedite performance of ‘acts of a routine nature’. Under the CFPOA amendments, the exception for facilitation payments will eventually be removed.
The audit committee should understand significant deficiencies in internal control regardless of certification and disclosure requirements, as they may have serious implications for the reporting issuer and a direct impact on the audit. The audit committee should gain an understanding of management’s activities that mitigate the risks stemming from the control environment and the procedures that the external auditor executes to respond to the risks.

Regulatory Oversight
The Canadian Public Accountability Board (CPAB) is Canada’s audit regulator and promotes high-quality auditing of public companies through its inspections of firms that audit reporting issuers in Canada. CPAB is often not granted access to the audit work performed in foreign jurisdictions. To evaluate the group auditor’s assessment of the work of a significant component auditor, evidence of the component auditor’s work and conclusions in the component auditors working papers needs to be available for review by CPAB. The investment community should be concerned when foreign laws and regulations reduce and/or impede the auditor oversight they’ve come to expect in Canada.

Final Thoughts
It can be challenging for audit committees to effectively oversee auditors for reporting issuers with operations in foreign jurisdictions. Audit committees need to ask the right questions and establish clear expectations of management and the external auditor to ensure the financial statement audit risks arising from foreign operations are identified and mitigated, and a high-quality audit is achieved.

Did You Know...
Foreign audit firms that are component auditors involved in the audit of Canadian reporting issuers are not required to register with CPAB. This means that CPAB cannot directly review the work performed by the component auditor.

Learn more
CPAB’s thought leadership publications for audit committees are available at www.cpab-ccrc.ca.

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