Thoughts on the Future of External Auditing
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External auditing plays a critical role in the effective functioning of our capital markets. While audit regulators and the profession continue to enhance the reliability of statutory auditing, there is a risk that external auditing may be losing its relevance and value. Mitigating this risk should also be a priority. This will require innovation and leadership from the audit profession, audit firms, audit regulators and the combined efforts of several other stakeholders, most notably audit committees, investors, securities regulators, and academics.

This paper provides some thoughts on the future of external auditing, which are drawn from my experience as an auditor, corporate director, audit committee member and chair, and from the presentations, discussions and participant feedback obtained at the last three Canadian Public Accountability Board (CPAB) Auditing Quality Symposiums where I had the privilege to act as a co-moderator.

The Canadian Audit Environment

These observations have been shaped by these key features of the Canadian audit environment:

- The requirement for an independent audit of a public company's annual financial statements is set out in the *Companies Acts and Securities Acts* of Canada's federal and provincial governments. These audits are to be performed in accordance with International Auditing Standards.

- The auditor's report only covers the company's annual financial statements. It does not include the company's Annual Report, Management Discussion and Analysis (MD&A), earnings news releases or other regulatory filings.

- Limited reviews of a listed company's quarterly financial reports by the external auditor are not mandated in Canada, as they are in the United States, and they are not designed to obtain reasonable assurance that the interim financial information is free of material misstatement. These limited reviews are not integrated into the audit process or into Generally Accepted Auditing Standards (GAAS), and they are not covered in the CPAB inspections.

- The auditor does not report on management's assessment of internal controls over financial reporting which is disclosed in the MD&A of larger listed companies (unlike in the US where auditors are required to provide such reports under SOX 404).

In short, the fundamental focus and scope of the external audit in Canada, as it is currently mandated, is limited to the annual financial statements – something that has not changed since external audits were introduced following the stock market crash of 1929! I suspect, however, that this situation is similar to that of many other countries. For example, in a December 3, 2014 speech to the US Chamber of Commerce's Conference on The Future Of Financial Reporting, Jim Doty, Chairman of the Public Company Accounting Oversight Board (PCAOB) observed:

"Yet the audit itself, including the audit report that communicates the reliability of financial information, hasn't been updated in any meaningful way since FDR was president."

Is External Auditing Keeping Pace?

Since the time of FDR, there have been tremendous advances in the development of the capital markets and in the sophistication of the information and communication technologies on which the operations of those markets depend. When audits were first required, the annual financial statements were the primary communication and accountability report – however, they no longer play this role. Today, share prices and capital markets are driven by quarterly and six-month reporting that are matched against the street's expectations. These quarterly reports are complemented by a variety of other disclosure releases containing other financial and non-financial metrics, which are growing in importance and used by investors to assess a company's past and future performance, cash flows and financial condition. In today's disclosure universe, the annual financial statements are a single component, and one that may be fading into the background of investment decision making.

Today's markets operate in a 24/7 timeframe, where funds flow at the speed of light. Information used in investment decision making can be obtained on mobile devices and is communicated and exchanged electronically through emails, blogs and social networks. Transactions can be executed on smart phones from any location with an Internet connection. High Frequency Traders and Day Traders use sophisticated computerized algorithms to move in and out of positions in milliseconds. Computer based market manipulations, system resilience, privacy and cyber security have become major regulatory and business issues.

While FDR would be amazed by the speed and sophistication of today's capital markets, and the way investment decisions are made, I think he would be puzzled as to why external audits have not kept pace with these developments.

All of these developments raise three fundamental questions to be addressed by audit regulators, securities regulators, auditors, audit committees and investors:

1. Is the annual external audit keeping pace or losing relevance in today's global, technology-driven, real-time capital markets?

2. Are we auditing the right things?

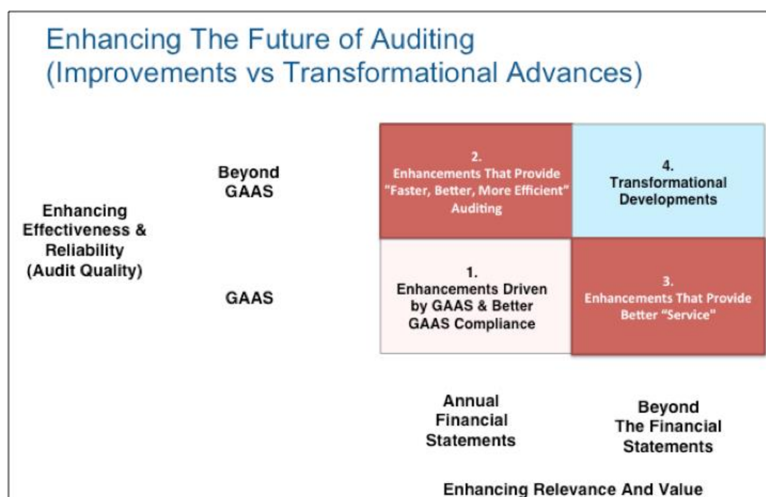
3. What should be done to enhance the external audit's relevance and value?

The Reliability vs Relevance Dimensions of External Auditing

Auditing standard setters, regulators and auditors are working hard to improve the quality and reliability of external audits. There is, however, another dimension that must also be addressed, namely the relevance and value of external audits. The relevance and value of the external audit is directly linked to the information being audited. The quality of auditing is one dimension, and the relevance of the information being audited is another. Auditing will have a sustainable and rewarding future if we advance both its quality and its relevance.

The following chart illustrates the interaction of these two dimensions. The vertical axis represents the changes and improvements that enhance the reliability and cost effectiveness of external auditing; and is divided between those changes introduced through GAAS and those

innovations in auditing methods and techniques introduced by auditors (enhancements that provide faster, better, more efficient auditing). The horizontal axis represents the changes that enhance the relevance and value of audits, and are divided between enhancements to the audit of the annual financial statements and innovations in the delivery of auditing services (enhancements that provide better service).



The chart also distinguishes between continual improvements and transformational advances.

Improvements are incremental. They enhance the way external audits are performed, and how auditing services are provided, but they do not fundamentally change the value of external audits. As stated earlier, the value of the external audit is determined primarily by the relevance and utility of what is being audited – the annual financial statements.

Transformational developments, on the other hand, are those game changing events that transform the audit market, change what is being audited and, in so doing, significantly advance the relevance and economic value of the audit for shareholders, audit committees and the capital markets. Transformational advances are driven by questions like: how can external auditing add greater value to audit committees (who purchase audit services) and investors (who use financial information to make investment decisions)? And, are external auditors auditing the right things?

Quadrant 1: The Commodity Trap

Audits of financial statements are driven by GAAS and the auditor's performance is monitored by audit regulators. New auditing standards, and other ongoing improvements in this area, focus on correcting auditing deficiencies and enhancing the reliability and effectiveness of audits – important objectives, but they also drive conformity. At the last CPAB Audit Quality Symposium an experienced audit committee chair and former leader of one of the Big Four firms said that in his experience: "All firms look the same. They all do good work. But it is hard to tell them apart."

There are many reasons for this perceived high level of conformity. The volume of professional standards continues to expand and audit regulators, together with the audit firm's internal quality

control systems, conduct inspections to ensure that individual auditors perform and deliver audits in accordance with these standards, and there are penalties for non-compliance. The threat of legal liability also drives conformity, since compliance with auditing standards provides a good defense in litigation.

Auditors complain that all this focus on compliance and conformity is driving a checklist approach to auditing, an excessive focus on documentation, and in so doing creating a risk that the forest is missed for the trees. They argue that the very best auditors rely on their business knowledge, instinct and professional savvy which leads them to the places they should be looking and checking. Professional savvy and instinct is not easily codified into a checklist, but checklists are an effective and efficient way to demonstrate compliance. This raises a concern as to whether these efforts to enhance compliance and conformity could be restricting auditors to think outside the box and develop innovative and creative approaches to auditing.

It is worth noting, however, that the UK participants at the last CPAB Audit Quality Symposium held in 2014 believe the new auditor's reporting standard might help alleviate this compliance and conformity problem. They stated that the new auditor's report provides investors with insights into how the auditors exercise their judgment, and the way auditors approached critical audit areas. These new disclosures show promise in stimulating innovation in critical audit areas and helping readers differentiate between auditors. And if it does, this would be an encouraging development.

Normally, one would expect market forces to drive improvements and innovations in the quality of the service being provided. Currently, however, it is difficult for audit committees (the purchaser of audit services) to differentiate among audit firms (the suppliers of audit services) on the basis of audit quality. There is little line of sight or transparency to the audit committee with respect to the quality of audit work. Audit committees, therefore, assume that all the audit firms comply with auditing standards and perform good work. They rely on the audit regulators' inspections to ensure audit quality. They focus their attention on other visible factors, such as the people they see, the fees they pay, and quality of the service and communication they receive. Without better information on audit quality, subjective factors like the board room presence and communication/presentation skills of the senior partners leading the engagement, and audit fees may drive the audit committee's assessment of the quality of work performed by the audit firm.

If audit regulators want audit committees to evaluate and select audit firms on the basis of audit quality, we need to ensure audit committees are provided with relevant and meaningful information on audit quality. The unfortunate economic reality is that when customers cannot differentiate among suppliers on the basis of the quality of a product or service, price will likely drive purchasing decisions. This is the Commodity Trap.

A recent research report **Who's Really in Charge? Audit Committee versus CFO Power and Audit Fees,** published in the November/December 2014 Issue of the Accounting Review by Elaine G. Mauldin and Matthew J. Beck, analyzed the audit fees of US companies between 2006-09 and found:" in many companies it is still primarily the CFO who calls the shots when it comes to hiring an auditor and setting the audit fee."

This study suggests that many audit committees are abdicating their responsibilities for selecting, evaluating and compensating the auditor and are instead delegating these tasks to the executive who is responsible for preparing the information to be audited. If the study's

findings are representative of current practice, then the problems posed by the Commodity Trap are even greater.

In the Commodity Trap audit committees view a good audit as one that is GAAS compliant and delivered at the cheapest price. While external auditing improves the efficiency of our markets and reduces the cost of capital, it seems that many audit committees perceive the real value of the audit as the ability to exercise a reliance-on-an- expert defense in the event of a shareholder lawsuit. And since all firms can provide this defense, it makes sense for them to purchase this defense at the cheapest price. This mindset needs to change.

In addition, an audit firm, or audit department in a multi service firm faces many challenges in the Commodity Trap. Today auditors from all firms tell me that they are under constant fee and cost containment pressure. There are internal and external inspections for GAAS compliance, penalties for non-compliance, severe litigation risks, professional satisfaction for work well done is difficult to attain, doing the minimum and doing it quickly is the norm, utilization is closely monitored, and attracting top talent to work in this environment is becoming a challenge.

Escaping from or breaking out of the Commodity Trap seems to be the obvious solution. But how to do this is not as obvious.

Quadrant 2: Faster, Better, Cheaper Auditing Methods

There are two ways for auditors to escape from the Commodity Trap (without fundamentally transforming the annual audit, which is quadrant 4):

1. They can differentiate by developing new ways of performing GAAS compliant audits that are faster, better and more efficient than their competitors (quadrant 2), or

2. They can deliver superior service and professional advice that differentiates them from their competitors (quadrant 3).

Naturally, an audit firm can attempt to execute a combination of these strategies at the same time, but the literature on strategy suggests that it is difficult to be both a low cost producer and a value added differentiator. It is also risky to go all in and commit to one of these two broad strategies, with the result that firms may in fact choose to stay in the Commodity Trap.

The first of these two differentiation strategies focuses on developing auditing methods and techniques that enable the firm to achieve a competitive advantage by delivering faster, better and more efficient (i.e., cheaper) audits than its competitors. Examples of innovations in auditing methods have included the development of computer auditing methods, control testing techniques, statistical auditing techniques and risk-based audit approaches. The current research into the use of Big Data and data analytics techniques may further improve audit effectiveness, reduce costs and enhance auditor insights. Pattern recognition analysis and software that automates the execution of audit procedures to enable continuous auditing also have the potential to further improve external auditing.

If auditing is to keep pace with the globalization of business, the rapid evolution of information technologies and the increasing sophistication of our capital markets, there must be ongoing innovation and investment in new auditing methodologies, tools and techniques. However, if audit committees cannot, or chose not to, differentiate between firms on the basis of audit

quality, it will be difficult for audit firms to sustain innovative auditing R&D efforts – other than those directed at reducing audit costs.

Simply put: what incentive is there for auditors to invest in developing innovative auditing methods and techniques to produce a higher quality audit, if the purchaser pays little attention to audit quality? There are rewards for auditing innovations that produce faster and cheaper audits, but what are the incentives or rewards for innovations that produce higher quality audits – particularly if they come with a higher price tag?

Audit committees have the ability to stimulate and reward audit innovations that focus on delivering better audits, not just cheaper audits. But will they use it? What are their incentives to do so?

Ensuring that there are appropriate incentives to sustain ongoing innovation and investment in auditing methods and techniques, that enhance audit quality and not just improve efficiency, is critical for the future of external auditing; and something audit regulators should be focused on.

Quadrant 3: Differentiating on Better Service

The second way for auditors to survive or escape the Commodity Trap is to deliver a GAAS compliant audit and differentiate themselves by providing a higher level of service, business insights and professional advice than that provided by their competitors.

For their part, audit committees and management often encourage such service differentiation when they ask auditors questions like: "We know you can deliver a GAAS compliant audit, but what else can you do for us?" Auditors, quite naturally, are quick to respond. In many cases, this response leads to services that add value to the audit committee and management, but there can be unintended consequences.

This quadrant has been the focus of intense scrutiny and debate with respect to the nature and extent of the non-audit services that audit firms provide to their audit clients; and whether a focus on service excellence and long-term service relationships impairs the auditor's independence and ability to exercise professional skepticism.

If Mauldin and Beck are correct and many audit committees are delegating their responsibility for managing the auditor relationship to management, auditors will naturally put a higher priority on meeting the expectations of management compared to those of the audit committee – which of course is a rational but problematic response.

Direct, candid, and effective communications between the auditors and the audit committee is a service component that is very important to audit committees. At the CPAB symposiums, many audit committee members expressed frustration with the quality of communications provided by their auditors, which they described as too formal, highly edited (by both management and the firms), technical and boilerplate. They said that, in addition to reporting on compliance with accounting standards, they also wanted to hear from their auditors on matters such as the health and condition of their businesses, quality of the finance executives, conservativeness vs. aggressiveness of accounting estimates, quality of earnings, major risks beyond financial reporting risks, culture and control issues, and what the auditors are anticipating as potential problems. In short, these directors want straight talk on the tough issues, not slick presentations or formal letters filled with caveats. Improving communications between the

auditor and the audit committee (which should be a two-way exercise) can enhance the relevance and value of the external audit, even if the focus of the audit is not changed.

In a competitive market audit committees will focus on what is highly visible to them – namely, the partners who lead the engagement, the service/communication they provide and the fees. If we want audit committees to focus on audit quality, we need to make sure that audit quality is more visible, transparent and valued. External auditing must be relevant and responsive not just to shareholders, but to the needs, concerns and evolving responsibilities of audit committees who purchase the audit service on behalf of the shareholders.

Quadrant 4: Transformational Developments

The first three quadrants focus on the dynamics involved in performing individual audits. Quadrant 4 shifts the focus from micro issues to macro issues. In this quadrant, the focus is on how auditing can better protect investors and support the functioning of the capital markets. Quadrants 2 and 3 outline differentiation strategies to escape the Commodity Trap presented in Quadrant 1. In Quadrant 4 we focus on enhancing the value of external auditing, not just to the purchaser of audit services, but to investors, the capital markets and the broader public interest.

The global capital markets are a complex set of systems and sub systems that allocate capital and transfer risk both within and between countries. The efficiency of our capital markets depends on reliable information. If critical information is concealed, inaccurate or misstated, the price discovery process suffers, risk is incorrectly priced and the markets don't operate efficiently. The consequences can be severe.

The financial crisis of 2007-08 exposed serious weaknesses in disclosure related to structured financial products that were used to raise capital and transfer risk through complex agreements and structures – and while the majority of these products received AAA credit ratings, very few were subjected to independent audits. This raises some interesting questions: would the financial crisis have been averted, or its outcome been different, if the structured financial products that were a root cause of the crisis been subjected to independent audits? And, why were the independent auditors left sitting on the sidelines while these new products escalated exponentially and then imploded? And what has changed in the reporting and auditing of structured finance since the financial crisis? I can picture FDR scratching his head.

Much to my own surprise, I can think of just four significant transformational developments that have occurred over the past 40 years, which reshaped auditing and what was being audited:

1. SOX 404 and the requirement for the auditors to report on internal control.
2. The introduction of limited reviews for interim financial reports.
3. The introduction of audit regulators, and the impact of the new auditor independence requirements, following the Sarbanes-Oxley legislation in the United States.
4. The introduction and evolution of audit committees.

SOX 404

Of these developments, the most significant one, in my opinion, was the much debated and highly controversial introduction of SOX 404 which expanded the scope of the external audit to include an auditor's report on internal control. This development pushed the audit's scope beyond the information contained in the annual financial statements to internal controls over financial reporting.

Review of Interim Financial Statements

The auditor's review of interim financial statements was another transformational development (because it involved auditors with quarterly reporting), but this expansion of auditor involvement has had a limited impact because these reviews have not been integrated into the external audit in the same way as SOX 404 reporting. Nevertheless, external auditors are now involved with the quarterly reporting process, but in my view this needs to be integrated into the external audit.

Introduction of Audit Regulators and New Independence Standards

The introduction of independent audit regulation has transformed the oversight of audit firms and changed their approach to audit quality.

The new independence standards that followed Sarbanes-Oxley clearly transformed the market for non-audit services provided by audit firms. From the audit committee's perspective, however, it is not clear that restricting the non-audit services that can be provided by auditors has enhanced the relevance and value of the external audit. It is true that auditors may now be more focused on performing the external audit, but it is the same annual audit, focused on the same annual financial statements, with the same deliverables being provided by auditors operating in the Commodity Trap.

Audit Committees

The introduction and evolution of audit committees has had a transformational impact, however, in Canada their performance and effectiveness is uneven; larger companies tend to have more effective audit committees than small cap companies. While there is a level of conformity among auditors, the same cannot be said for audit committees. I suspect this situation is similar to other countries.

In Canada, a company's external auditors are legally appointed by and responsible to the shareholders. In practice, however, shareholders are too dispersed to either exercise any meaningful oversight of the external auditors or to make meaningful decisions on the selection of audit firms, audit scope or the auditor's performance and compensation. For this reason, securities regulators have assigned the responsibility for managing the relationship with the external auditor to the audit committee to ensure that the external audit is conducted independently of management. The result is that the audit committee is now the customer for the external audit while the shareholder is the beneficiary. This solution is only effective, however, when the audit committee is composed of competent people who are, and most importantly act, independently of management.

Audit committees that lack independence in substance from management are like dry rot in a wooden ship. They don't support or protect the auditor's independence; nor do they put in place the conditions for effective auditing and for auditors to exercise professional skepticism. They are, therefore, a risk to the existing audit process, the governance of our public companies and are unlikely to advance the relevance and value of the external audit. In short, weak audit committees sustain and reinforce the Commodity Trap discussed earlier. A very senior and experienced audit partner described this challenge as follows: "In 33 years of auditing, and 30 public companies served for between four and 10 years, with four-five audit committee meetings a year, I have only been asked once if I thought we were doing enough work."

Audit committee agendas are very full, and they have minimal time to allocate to the annual audit except at the year-end meeting. The audit committee's agendas and meeting schedules are driven by the quarterly reporting cycle – not the annual audit. While the quarterly reviews

performed by the auditor provide some degree of comfort and value, it is limited by the auditor's caveats and disclaimers. The MD&A and earnings news releases are outside the scope of the audit (except for a consistency review) as are risk management programs beyond financial reporting risks. What keeps an audit committee awake at night is the prospect of a material financial reporting error being detected at the year-end, which causes a restatement of an interim filing, in which case there is probably no reliance on an expert defense available to the audit committee. And cyber security risks are causing a lot of sleepless nights too.

As the audit committee's work and responsibilities expand in response to changing business conditions (e.g., many audit committees now have oversight responsibilities for internal audit and risk management and are now struggling with cyber security risks), the relevance of the annual audit continues to diminish. External auditing must also be responsive and relevant to the changing role and needs of audit committees.

I raise these audit committee issues because, based on my experience on both sides of the boardroom table, audit committees can play a pivotal role in shaping the future of auditing. An effective audit committee can have a substantial and positive impact on the quality of external auditing and the benefits to be derived from it. Audit regulators and audit firms should actively engage audit committees on audit regulation issues, listen to their needs and concerns, ensure audit committees are being provided with meaningful information on audit quality, help them monitor and assess audit quality. The audit profession and audit firms should work with audit committees to transform the external audit so that it is more relevant and valuable to them as the customers for external auditing.

Conclusion

Each of the four quadrants has their own dynamics, incentives, risks and rewards. They are all connected and together they will shape the future of auditing. I hope this quadrant analysis will help audit regulators and leaders of our profession take a holistic view of the interrelated dynamics of external auditing. Regulators should step back from their inspections and consider how each of these quadrants should help shape the future of auditing. For example, do we have the right incentives and competitive conditions to stimulate ongoing innovation and investment in auditing methods in quadrant 2, service excellence in quadrant 3, so that auditors compete on the basis of audit quality, and not just price, in quadrant 1? This will create the foundation necessary to address the transformational challenges in quadrant 4.

Which leads to these types of questions – are external auditors auditing the right things, at the right time with the right methods and tools?

Answering these questions and repositioning external auditing so that it better protects investors, contributes to the efficiency of the capital markets and supports the audit committee will be a difficult and challenging task, but it needs to be done, and this process needs to start now. Bringing about such transformations requires innovation, bold leadership and the support of the various parties in the financial reporting process, including political support. It requires a compelling and convincing vision of the role and value that external auditing can bring to investors, the capital markets and the boards of directors/audit committees who are responsible for the governance of our public companies.

Audit committees have a critical role to play in shaping the future of auditing. But many audit committees need to raise their level of performance too. Outreach programs, like the CPAB Audit Quality Symposiums that bring together leading directors, professional leaders, audit firm

leaders and regulators help encourage a constructive dialogue, stimulate innovative ideas and build commitment to change. Working together, auditors, audit committees, audit regulators and management can help auditing escape from the Commodity Trap, and tackle the transformational challenges that are needed to make external auditing relevant and valuable in the 21st century.