



*Implication of
International
Developments in Auditing
for Canada*

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- Opportunity to consider how to enhance the role of audit to meet the changing needs of the capital markets, audit quality and confidence in audit
 - Auditors must be willing to change and have responsibilities and reporting evolve
 - Global proposals are for consideration and we are at the beginning of a process which will take some time

Broad Principles

- Maintain or improve audit quality
- Have a net benefit to users
- Maintain or enhance effectiveness of the interactions of auditors, audit committees and management
- Give greater transparency to the audit process
- Supported by empirical evidence

Views on Priorities for Canada

- Establish a coordinated Canadian process to respond to the public interest and investors for more comprehensive reporting from auditors
- Profession to continue to put audit quality as priority including skepticism and objectivity and concerns about potential auditor conflicts

More Comprehensive Reporting by Auditors

- Changing audit report to be more descriptive of the auditor's role and responsibility
- Focus on providing more insight into the audit itself
 - The meaning of reasonable assurance
 - The concept of materiality
 - The auditor's responsibility for information that is not subject to audit but is included in the annual report
 - Auditor's responsibility related to fraud

Principles around Extending Audit Assurance to Other Information

- Net benefits to users
- Maintaining timeliness of financial reporting
- Clear criteria around what is reported
 - MD&A
 - Non-GAAP measures
 - Press releases

Auditor Discussion and Analysis

- Request for auditors to report publicly on the quality of the management's assumptions and estimates, accounting policies and disclosures
- Concerns:
 - Risk of subjectivity and inconsistency
 - Practicality and timeliness
 - Impacting candour of communication and negative effect on audit quality
 - Inconsistent with current corporate reporting model – management reports information / auditors provide assurance

Possible Alternatives to Auditor Discussion and Analysis

- Audit committee communication to investors on significant management estimates and judgments and key issues discussed with auditors
- Mandatory use of emphasis of a matter language particularly regarding management estimates
- Accounting profession initiative to increase education on auditor role and responsibility

Other Observations on Reporting

- Expanding communication with regulator by auditor and company management
- Encourage collaboration between IAASB and PCAOB addressing the auditor's report – many Canadian SEC registrants
- Review the corporate reporting model disclosures to meet investor and systemic risk needs
 - Systemic risks for company beyond the financial statements
 - Risks in company's business model
 - Enhanced disclosure about going concern

Audit Profession Focus on Audit Quality Skepticism, Objectivity and Independence

- CPAB, PCAOB and EU Green Paper observations
- Possible solutions suggested:
 - More involvement of senior practitioners in high risk areas – suggest cause is audit performance (*CPAB*)
 - Mandatory audit firm rotation – suggest cause is familiarity risk (*EU Green Paper, PCAOB*)
 - Joint audits (*EU Green Paper*)
 - Further restrictions on non-audit services – suggests cause is self-interest risk (*EU Green Paper*)
- Audit evidence, behavioural or audit skills/performance/standards issue?

Negatives Associated with Mandatory Auditor Rotation

- Loss of auditor cumulative knowledge
- Undermines audit committee's role
- Cost to companies
- Arbitrary timing may be problematic for company
- Impact on audit firm human capital
- Absence of evidence linking change in audit firm to enhanced audit quality
- Creates resource issue if it leads to high frequency of first year audits
- Does not address concerns about “marketing features” of some audit proposals – these could be addressed in audit firm culture guidance in IAASB framework on audit quality

Objectivity, Independence and Skepticism Are Fundamental to Audit Quality But So Are Other Factors

- Skepticism – “an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to fraud or error and a critical assessment of evidence”
- Opportunity to improve execution of standard on auditing accounting estimates
- Increased importance of auditing management judgments and estimates
 - More principles-based IFRS
 - Increased prevalence of fair values in GAAP
 - More challenging than auditing historical cost
 - Issues arising out of credit crisis – impairment of assets/write-down to fair value, liquidity and going concern

Rigorous Performance in Applying Standard on Auditing Management Estimates Drives Skepticism

- Steps in the standard on auditing estimates
 - Understand company's business model and risks
 - Identify important management estimates as key risks in planning the audit
 - Build sufficient time in the audit budget to address these key risks
 - Develop tailored audit programs to address these key risks
 - Assess controls/models/use of external experts over development of estimates
 - Emphasize the need to obtain and examine external evidence to corroborate management estimates
 - Assess contradictory evidence
 - Reminder that management representation is not sufficient

Rigorous Performance in Applying Standard on Auditing Management Estimates Drives Skepticism (continued)

- Documentation in a critical matter of evidence and reason for accepting management estimate
- Sign-off by engagement reader and quality reviewer on this conclusion and reasons for it
- Look for and assess evidence of possible management bias – prior estimates, bonuses, earnings expectations
- Discuss the key estimates with the audit committee
- Review adequacy of related disclosure in financial reporting
- Consider an emphasis of a matter reference to key estimate in auditor's report

Benefits

- Consistent execution of audit of estimates standard way of evidencing professional skepticism
- Put more transparency on reporting of management estimates
- Consider adequacy of the standard itself in post-implementation review
- Not a substitute for steps which provide for greater clarity and public acceptance around auditor independence

Focus on Audit Committee Role in Governing the Audit Firm – Public Company Relationship

- Audit committees have a direct relationship to shareholders
- Audit committee role in audit performance, independence/objectivity and appointment
- Share understanding of what qualitative and quantitative measures should be used to evaluate performance of auditors
- Greater communication by audit committees with shareholders
- Overcomes most of the negative consequences of mandatory audit firm rotation

Challenge of Globalization of Audit Standards for Canada

- Continue to monitor and engage in developments – Canada is already active
- Large number of small cap public companies in Canada
- Challenge of maintaining Canadian R&D when standards are global – domestic research or contribute to global?
- Mechanism to coordinate Canadian standards, regulatory and legislation response to global developments