



CANADIAN PUBLIC ACCOUNTABILITY BOARD  
CONSEIL CANADIEN SUR LA REDDITION DE COMPTES

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December 8, 2010

Mr. Michel Barnier  
European Commissioner for Internal Market and Services  
European Commission  
Auditing Unit-F4  
SPA 2/JII-01/112  
BE-1049 Brussels  
Belgium

Dear Commissioner Barnier,

**Re: European Commission Green paper- Audit Policy: Lessons from the Crisis**

The Canadian Public Accountability Board (“CPAB”) is pleased to comment on the European Commission’s Green Paper *Audit Policy: Lessons from the Crisis* (the “Green Paper”). We commend the European Commission for taking a lead in engaging with stakeholders on the role of the audit and how audit quality can be further enhanced.

CPAB is Canada’s independent audit regulator responsible for overseeing audit firms that audit Canadian reporting issuers. Our mandate is to promote high quality independent auditing which contributes to public confidence in the integrity of financial reporting. We accomplish our mandate by inspecting audit firms, including audit working paper files, which provides us with insights into the audit process and how audit quality can be improved.

The current state of auditing in Canada is sound; however, we do believe there are opportunities for audit quality to be further improved. Based upon the inspections of audit firms in Canada we performed over the last seven years, we believe firms have made significant progress in improving audit quality. However, we continue to find instances of a lack of professional scepticism and a lack of transparency in communicating audit results to audit committees in particular. These are discussed further below.

**Enhancing the Value of the Audit**

The financial crisis has led some stakeholders to question the value of the audit. To respond to this, auditors need to more effectively communicate the critical role played by the audit in ensuring the integrity of financial reporting, thereby sustaining capital markets. Greater transparency is needed with respect to the audit process and audit findings. Auditors also need to provide greater value to financial statement users. In recent years we have seen greater fee pressures on auditors and we are concerned the audit may be viewed as a commodity that is

differentiated primarily based on price. If this were to happen, it has the potential to negatively impact audit quality.

Greater outreach is required to ensure the concerns of financial statement users are better understood and value added improvements are made to the audit process. Auditors should be looking beyond their comfort zone to identify areas where more value could be brought to the audit. One such area could be a requirement for auditors to report significant audit issues and key risks arising from the audit to users of financial statements. This could be done either in the form of an Auditor's Discussion and Analysis, to be included in the annual report, or alternatively, audit committees could provide this information to users of financial statements with input from the auditor. Another such area could involve auditors providing assurance on areas outside the financial statements, but within their area of knowledge such as management's discussion and analysis, key performance indicators, business risk factors and quality of governance. Clearly, standards and frameworks would have to be developed to assist the auditor in performing this work. We believe, in performing the audit the auditor gains an in-depth understanding of the business and related systems and processes, which could be better utilized to bring greater value to the users of financial statements.

Auditors should enhance dialogue with bank regulators and supervisors, audit regulators and securities commissions to provide greater input into more effective monitoring and oversight of the global financial system, including areas of emerging risk. The Green Paper notes that German legislation requires the external auditor to submit a "long form report" to the supervisory board which provides greater detail on the fundamental findings of the audit on the going concern assumption, future development and risks facing the company, material disclosures, irregularities encountered, accounting methods used and any "window dressing transactions". We believe this approach has merit and should be further explored for listed companies over a market cap threshold.

## **Transparency**

Transparency is an important driver and outcome of audit quality. In the course of our inspections we have seen many instances of a lack of transparency in the information communicated to audit committees, often in higher risk, more judgemental areas of the audit. Examples include non-disclosure of ranges of estimates and financial statement disclosure that was lacking in clarity. During 2010 CPAB held roundtable discussions with audit committee members across Canada to gain further insight into the interaction between the auditor and those charged with governance. Many audit committee members commented on the need for more dialogue with auditors on higher risk areas of the audit and for less time in audit committee meetings to be spent on more compliance oriented aspects of the audit. Continuous improvement in the two-way communications with audit committees contributes to audit quality, particularly in light of increasing complexity and greater use of judgement in financial reporting. We believe it is important to further explore how communication between auditors and audit committees can be more forthright and transparent, particularly with respect to reporting of significant audit risks and related judgements. In written communications from auditors to audit committees we have seen many instances of boilerplate language and a lack of detail on the

key audit risks and how they were addressed. Auditors also need to do a better job of bringing significant financial statement note disclosure deficiencies to the attention of audit committees.

### **Professional Scepticism**

Similar to transparency, professional scepticism is an important driver of audit quality. While we have seen improvement in this area, auditors need to do more to reinforce the importance of professional scepticism. In our inspection activities we have seen examples of a lack of professional scepticism in high risk areas of the audit such as impairment and going concern assessments and testing of fair values of complex financial instruments. In these instances we believe increased professional scepticism would have led to a more substantive challenge by the auditor of management assumptions and more robust audit evidence being obtained.

Professional scepticism is related to the auditor's personal attributes such as skill, experience levels and ethical values. Some audit firms may need to improve their culture and increase emphasis on application of professional scepticism. This will take more than classroom training and needs to be embedded in firm culture and led by senior partners. A strong "tone at the top" is critical to creating the right firm culture. In building the right culture firms may need to revisit their compensation models to ensure that audit quality is appropriately measured and rewarded. Conversely, lack of audit quality should be reflected in reduced partner compensation. Audit committees and senior management also need to set the right tone and create an environment in which material judgements and estimates can be discussed in a forthright and transparent manner.

In Canada the clarified International Standards on Auditing ("ISA"s) come into effect for audits of financial statements for periods ending on or after December 14, 2010. The clarified ISAs contain many improvements and CPAB will be assessing their application in its 2011 inspections including the application of professional scepticism.

### **Auditor Communication with Financial Statement Users**

In our view, auditors need to share more information related to the audit process and the key audit risks and related findings with users of the financial statements. Much of this information is currently only provided to senior management and the audit committee. We believe it is worth exploring whether users of financial statements would also find some of this information helpful in their decision making. For example, a commentary on critical accounting policies and alternative policies available, the going concern assumption and related key assumptions and assumptions used in key accounting estimates, such as impairment assessments and valuations of financial instruments for which quoted prices are not readily available, might be of interest to financial statement users. It will be important, however, to ensure that such communication does not lead to less forthright and transparent dialogue between the auditor and those charged with governance, which could have a negative impact on audit quality.

## **Role of Other Stakeholders**

In addition to auditors, we believe other stakeholders such as preparers, those charged with governance, standard setters, regulators and investors have an important role to play in improving audit quality. For example, increasing complexity in financial reporting and increased use of fair value accounting has presented challenges for preparers and auditors. Ever increasing financial statement disclosures should also be reassessed with a focus on better and more transparent disclosure (and not necessarily more disclosure, some of which is often boilerplate). Auditing standards can also be improved by providing greater and more timely guidance in areas such as auditing fair value measurements and by improving the rigour of the quality control review performed by the concurring partner (also known as the engagement quality control reviewer or second partner).

Audit committees can promote audit quality by creating a climate of transparency and setting an appropriate “tone at the top”. We believe there is room for improvement in the quality and effectiveness of audit committees, especially in smaller and mid-size companies. Consideration should be given to developing an “Audit Committee Code” to strengthen audit quality in this area. Another theme of our audit committee member roundtable discussions related to the need for greater financial literacy amongst audit committee members, particularly for smaller and mid-size public companies. Members indicated a need for more financial literacy programs for audit committee members.

In respect of Ethics and Independence standards, the International Federation of Accountants Code of Ethics for Professional Accountants (“IFAC Code”) needs further strengthening to be robust enough to serve the public interest. To date the IFAC Code has been accepted to a far lesser degree than International Financial Reporting Standards and International Standards on Auditing. This is primarily because many countries have chosen to maintain their own ethical standards, which are considered more stringent than the IFAC Code.

Independent auditor oversight bodies such as CPAB also have an important contribution to make in improving audit quality. CPAB’s inspections of audit firms are risk based and our inspection reports focus on key recommendations that, in our view, will have the greatest impact in improving audit quality at firms we inspect.

## **Oversight of Global Audit Firms**

Audit regulators need to work together more closely to provide improved oversight of global audit firms. CPAB actively consults and collaborates with other regulators around the world to improve audit oversight and is working with the International Forum of Independent Audit Regulators (“IFIAR”) to assist other countries in building effective independent audit oversight functions. This work is critical to building effective global audit oversight.

IFIAR has constructive dialogue with the global audit firms on a number of issues, including transparency and global consistency of audit quality. Increased co-ordination amongst audit regulators when interacting with global offices of the firms will improve the effectiveness and efficiency of the oversight process. We believe IFIAR has an important leadership role to play in enhancing the oversight of global audit firms. We also believe global audit firms should lead the

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way in improving audit quality and show leadership by implementing professional standards with a high degree of rigour and by having robust risk management.

In concluding we again commend the European Commission for taking the initiative in bringing audit quality to the forefront of debate and we encourage engagement with all stakeholders, including those outside the EU, before any far reaching policy changes are made. Any significant changes in policy arising from this consultation should ensure that audit quality is not adversely affected. The economic and business landscape is continually changing and it is important that the audit process evolves to keep pace with these changes and continues to provide value. The pursuit of audit quality requires the right "tone at the top" and people who are motivated and dedicated to continuous improvement. All stakeholders have a role to play in improving audit quality.

In addition to our comments above, our responses to the questions posed in the Green Paper that fall within our purview are included in the Appendix to this letter.

We would be pleased to discuss further any of the above comments.

Very truly yours,

A handwritten signature in black ink, appearing to read "Brian Hunt". The signature is fluid and cursive, with the first name "Brian" being more prominent than the last name "Hunt".

Brian Hunt, FCA  
Chief Executive Officer

**APPENDIX:** Response to the request for specific comments:

**1. Do you believe that the general level of “audit quality” could be further enhanced (Question #3 in Green Paper)?**

We believe the general level of audit quality and value of the audit can be further enhanced. Audit firms and audit regulators should adopt an approach of continuous improvement. Our comments in the main body of this letter highlight some of the ways in which this can be done. For example, auditors need to improve the application of transparency and professional scepticism in performing audits. Auditors (including smaller and mid-size firms) need to ensure they have adequate technical resources and a robust process of internal consultation. Auditors also need to engage more with the investor community to ensure concerns of users are better understood and improvements made that add value to the audit.

Auditors should be looking beyond their comfort zone to identify areas where more value could be brought to the audit. One such area could be a requirement for auditors to report significant audit issues and key risks arising from the audit to users of financial statements. This could be done either in the form of an Auditor’s Discussion and Analysis, to be included in the annual report, or alternatively, audit committees could provide this information to users of financial statements with input from the auditor. Examples of information relating to the audit that users may find helpful include information related to critical accounting policies and alternative policies available, the going concern assumption and related key assumptions as well as assumptions used in determining key estimates such as impairments and valuations of financial instruments for which quoted prices are not readily determinable.

Another such area could involve auditors providing assurance on areas outside the financial statements, but within their area of knowledge, such as management’s discussion and analysis, key performance indicators, business risk factors and quality of governance which may provide greater value to financial statement users and the audit committee. Clearly, standards and frameworks would have to be developed to assist the auditor in performing this work. We believe, in performing the audit the auditor gains an in-depth understanding of the business and related systems and processes, which could be better utilized to bring greater value to the users of financial statements.

Auditors also need to improve dialogue with bank regulators, supervisors, securities commissions and audit regulators. See #7 below.

In addition to auditors we also believe other stakeholders such as preparers, those charged with governance, standard setters, regulators and investors have an important role to play in improving audit quality and we have outlined our suggestions in the main body of this letter and have not repeated these again here.

**2. Should “professional scepticism” be reinforced? How could this be achieved (Question #6)?**

Professional scepticism is a key driver of audit quality and is something which needs to be constantly reinforced. We believe this is an area where auditors need to do more. In our inspection activities we have seen examples of a lack of professional scepticism in high risk areas of the audit such as impairment and going concern assessments and testing of fair values of complex financial instruments. In these instances we believe increased professional scepticism would have led to a

more substantive challenge by the auditor of management assumptions and more appropriate audit evidence being obtained.

Professional scepticism is related to the auditor's personal attributes such as skill, experience levels and ethical values. Some audit firms may need to improve their culture and increase emphasis on application of professional scepticism. This will take more than classroom training and needs to be embedded in firm culture and led by senior partners. A strong "tone at the top" is critical to creating the right firm culture. In building the right culture firms may also need to revisit their compensation models to ensure audit quality is appropriately measured and rewarded.

Audit committees and senior management also need to set the right tone and create an environment in which material judgements and estimates can be discussed in a forthright and transparent manner.

**3. Is there adequate and regular dialogue between the external auditors, internal auditors and the Audit Committee? If not, how can this communication be improved (Question #9)?**

In the course of our inspections we have seen many examples of a lack of transparency in the information communicated to audit committees, often in higher risk, more judgemental areas of the audit. During 2010 CPAB held roundtable discussions with audit committee members across Canada to gain further insight into the interaction between the auditor and those charged with governance. Many audit committee members commented on the need for more dialogue with auditors on higher risk areas and for less time in audit committee meetings to be spent on more compliance oriented aspects of the audit. We believe it is important to further explore how communication between the auditors and audit committees can be more forthright and transparent, particularly with respect to reporting of significant audit risks and related judgements. Part of the solution is firm leadership and audit committees creating a climate of transparency and setting an appropriate "tone at the top" for frank and open discussion to take place. To improve communication we believe the audit committee should meet with auditors regularly throughout the year and there should be periodic, at least annual, assessments of the quality of the interaction between the auditor and audit committee. Consideration should also be given to developing an "Audit Committee Code" to strengthen audit quality in this area.

In some smaller and mid-size public company audit committee groups, members have commented on the need for greater financial literacy amongst audit committees and for more financial literacy programs to be available to them.

**4. Should there be more regular communication by the auditor to stakeholders? Also should the time gap between the year end and the date of the audit opinion be reduced (Question # 11)?**

We believe there should be more regular communication by the auditor to stakeholders. Greater transparency is required with respect to the audit process and audit findings. See also #1 and #3 above.

We do not support a reduction in the time gap between the year end and the date of the audit opinion. A reduction in the time available to the auditor to gain sufficient appropriate audit evidence to support the audit opinion could adversely affect audit quality.

**5. What other measures could be envisaged to enhance the value of audits (Question #12)?**

See #1 above.

**6. Do you support the suggestions regarding Group Auditors? Do you have any further ideas on the matter (Question #24)?**

We agree that the role of the group auditor needs to be reinforced. Group auditors should have access to reports and other documentation of all auditors reviewing sub-entities of the group.

The IAASB has made significant improvements to ISA 600 (Audits of Group Financial Statements) which comes into effect in Canada for audits of financial statements for periods ending on or after December 14, 2010. The new standard broadens the definition of component auditors and requires greater evidence of involvement of the group auditor in the risk assessment, planning and performance of the component auditor. CPAB will be monitoring implementation of this new standard in its 2011 inspections and will provide feedback to standard setters on implementation issues and any areas where we believe the standard needs to be strengthened.

**7. How could increased consultation and communication between the auditor of large listed companies and the regulator be achieved (Question #26)?**

We believe there is a need to reinforce the dialogue between regulators and auditors. Increased dialogue by auditors with bank regulators, supervisors, audit regulators and securities commissions will provide for more effective monitoring and oversight of the global financial system including areas of emerging risk. This dialogue should be a two-way process so that regulators and supervisors also alert auditors to areas of particular concern. The Green Paper notes that German legislation requires the external auditor to submit a "long form report" to the supervisory board which provides greater detail on the fundamental findings of the audit on the going concern assumption, future development and risks facing the company, material disclosures, irregularities encountered, accounting methods used and any "window dressing transactions". We believe this approach has merit and should be further explored for large-listed companies.

**8. Do you believe that the mandatory formation of an audit firm consortium with the inclusion of at least one smaller, non systemic audit firm could act as a catalyst for dynamising the audit market and allowing small and medium-sized firms to participate more substantially in the segment of larger audits (Question #28)?**

In Canada banks were previously required to have joint audits. This requirement was dropped from legislation after considerable debate and Canadian banks now have a single auditor. We are not aware of any evidence that clearly demonstrates joint audits improve audit quality. We are concerned that a move to joint audits could have a negative impact on audit quality as the division of responsibility could mean that some issues fail to get addressed as they fall between the firms. Management may engage in arbitrage between audit firms again with the potential to negatively

impact audit quality. Joint audits may also lead to increased audit cost from duplication of audit work and ineffectiveness and inefficiency may arise from each firm using a different audit methodology for portions of the audit.

Mandatory formation of audit consortia and enforced use of joint audits will not solve the issue of audit concentration, more research is required to explore other solutions to this issue. The selection process for auditors should be within the purview of investors and be driven by audit quality considerations. In our view auditor selection should not become an arbitrary process.

Accordingly, we do not support the mandatory formation of audit firm consortia or joint audits.

**9. What measures could in your view enhance the quality of the oversight of global audit players through international co-operation (Question #38)?**

Closer co-operation between audit oversight bodies internationally and increased mutual reliance between countries that have robust and independent audit oversight bodies will allow for more effective and efficient oversight of global audit firms. We share the Commission's concern with respect to supervision of the auditors of large groups which operate in multiple jurisdictions.

CPAB actively consults and collaborates with other regulators around the world to improve audit oversight and is working with IFIAR to assist other countries in building effective independent audit oversight functions. This work is critical to building effective global oversight.

CPAB is currently chairing the Global Public Policy Committee (GPPC) IFIAR Working Group that includes representatives from the six largest international accounting networks. The Working Group has established a framework for discussing matters impacting audit quality, including specific issues such as professional scepticism, beefing up engagement quality control reviews, among others. We believe IFIAR has an important leadership role to play in enhancing the oversight of global audit firms. The process to date of interacting with the GPPC firms, collectively and individually can be built upon through IFIAR. There also may be room for more coordinated inspections by major IFIAR members of audit firms and more sharing of common themes and findings, including interacting directly, or through IFIAR with the global leadership. We also believe global audit firms should lead the way in improving audit quality and show leadership by implementing professional standards with a high degree of rigour and by having robust risk management.