



## GETTING THE MOST FROM THE RELATIONSHIP WITH YOUR EXTERNAL AUDITOR

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The evolution of corporate audit committees in Canada over the past 15 years has been remarkable. Not so long ago, meetings between audit committees and external auditors seemed like waltzes choreographed by management, which sought to get the financial statements through the committee and approved by the board with minimum controversy. Auditors were circumspect about raising difficult issues with audit committees for fear of alienating the management team that paid their fees. Audit committees that did not ask the right questions would learn little, and some committees gave the impression that they were not particularly interested in being confronted by difficult issues in any case.

Much has changed for the better. Securities commissions in Canada have issued Multilateral Instrument 52-110 setting out the responsibilities and composition of audit committees. Auditors' professional obligations to communicate with audit committees have been greatly expanded. An array of publications is available to guide audit committees on how job to do their job well<sup>1</sup>. And audit committee members have become acutely aware that they are at personal risk should they be negligent in carrying out their responsibilities.

The Canadian Public Accountability Board (CPAB) was created in 2003 as part of the package of investor confidence initiatives that included 52-110. CPAB provides independent public oversight of auditors of entities that are reporting issuers to Canadian securities commissions. Our principal activity is inspections of the audit firms subject to our oversight in order to understand and evaluate their systems of quality control and to make recommendations for improvement where appropriate. Those inspections include the review of a sample of public company audit engagements, which in turn includes assessing the timeliness and quality of auditors' communications to the audit committee. This article sets out some considerations for audit committee members, based on our experience to date.

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<sup>1</sup> Particularly recommended is *Integrity in the Spotlight: Opportunities for Audit Committees* by Maureen Sabia and Jim Goodfellow. Originally published by the CICA in 2002, a revised version is expected in 2005.

## **Does your auditor think you are high risk?**

Increasingly, auditors are rating the risk of each client in their portfolio as part of their decision whether to accept or continue with each particular audit engagement. Among other things, such ratings normally consider the integrity and competence of management, the effectiveness of corporate governance, and the effectiveness of internal controls over financial reporting. In most firms, the outcome is the stratification of clients into three or more qualitative categories of risk. However, at least one large firm has a relatively sophisticated scoring algorithm that produces a “risk score” for each client. As an audit committee member, you should find out where your company is on the risk spectrum of your audit firm’s client portfolio. Are you towards the high end? If so, do you understand why and can anything be done about the underlying drivers?

## **What should your auditor be telling you?**

Generally accepted auditing standards require the auditor to communicate a great deal of information to the audit committee, but in practice we find that some auditors are not doing this as well as they should. A comprehensive list of everything that the auditor must communicate is beyond the scope of this article, but here are some questions that you should ask:

- What are the complex or judgmental matters that the auditor believes create particular risk of material error in the financial statements? As a rule of thumb, there are normally between three and ten such matters in every audit. Make sure you understand what they are and how the auditor’s work plan is designed to reduce the risk of undetected material error to an acceptable level. You should gain an understanding of these issues early in the year and monitor them quarterly. Do not wait until the eleventh hour when the year-end financial statements are being finalized.
- What errors did the auditor find in the financial statements drafted by management? You should know what they are and why they arose, even if they were corrected as audit adjustments. They are symptomatic of weaknesses in internal control. We have been surprised to find a number of situations where audit committees were not informed of the errors.
- For items in the financial statements that are subject to estimation within a reasonable range, does management exhibit consistent bias in picking the aggressive or conservative end of the range?
- Have the auditors become aware of any unusual arrangements where management or people closely related to management have received significant benefits that would not normally be considered to be part of an executive compensation package? This is a particularly good question to ask if the company has a rather domineering CEO. In our work, we have noted a small number of cases where

auditors became aware of unusual arrangements, but apparently did not inform the audit committee. Auditors are supposed to report to the audit committee any evidence of fraud or suspected fraud that result or may result in a material misstatement of the financial statements. However, they may not be sure whether the activity constitutes fraud or they may consider it not to be material. You should be prepared to ask some probing questions.

- Have the auditors become aware of any evidence of illegal acts that results or may result in a material misstatement of the financial statements. For example, we have noted cases where auditors have become aware of “facilitating payments” being made by entities in foreign jurisdictions, but have not reported those to the audit committee.

### **How does your audit firm manage quality?**

The same auditing standards apply to every audit, but, in reality, audits do vary in quality. Is a less than robust audit hiding behind a well-polished veneer? How can an audit committee assess whether its audit firm is working to a high level of quality?

Recently-introduced professional standards now require audit firms to implement comprehensive systems of quality control at a firm level and at the level of each engagement. Each firm subject to CPAB oversight is required to provide us with a Quality Control Report setting out, in its own words, how it satisfies the standards. We do not audit those documents, but we publish them on our website. If we inspect a firm, we look to see whether the documents are a fair reflection of reality. Audit committees should familiarize themselves with these documents and be prepared to query the auditing firm on any aspect of its system of quality control that seems questionable or incomplete.

We are finding that while some firms have good systems of quality, others have much to do. Where there are gaps, we make recommendations that firms must implement to our satisfaction within 180 days; otherwise, we will make public the fact that they have not done so. During less than a year of inspections, CPAB has made several hundred recommendations. Audit committees should ask their auditors (1) whether they have been inspected by CPAB, (2) whether they intend to implement CPAB’s recommendations within the prescribed period and (3) if not, why not.

### **What about internal controls?**

In the United States, the requirements of section 404 of the Sarbanes-Oxley Act (Sarbox) have, at the time of writing, resulted in more than 600 companies reporting that their systems of control over financial reporting have significant deficiencies. The number will increase. Many of the companies are small by U.S. standards, but some are household names.

Most auditors would agree that small companies tend to have less effective controls than large companies. In Canada, our public companies are on average much smaller than those in the United States. Therefore, based on the U.S. experience, it is prudent to assume that many Canadian public companies, particularly smaller ones, do not have particularly effective systems of internal control over financial reporting. In many cases, in-house accounting personnel cannot keep up with the growing volume and complexity of accounting standards.

As an audit committee member, you should ensure that your audit firm informs you about any weaknesses it has observed in internal controls over financial reporting. Unless you are already subject to Sarbox 404 reporting, the auditor will probably not be able to give you a comprehensive report on controls effectiveness. However, if the audit firm tells you that it cannot comment at all because it has not relied on internal controls, that is not good enough. Auditing standards require that auditors gain an understanding of internal control in order to plan their audit, even if they do not intend to place reliance on those controls. Therefore, the auditors should be able to give you some informed perspective about the state of controls.

### **A thought about audit committee meetings**

Much has been written elsewhere about audit committee meetings, but here is one thought on which I would like to end this article. From time to time, the committee should meet without anyone else present. Not everyone on an audit committee has equivalent financial expertise; and an *in camera* meeting gives members a chance to raise issues or ask questions about which they may be unsure, but may be reluctant to raise with management or the auditor present. The committee can discuss the issue and decide whether it should be raised with management or the auditor.