



CANADIAN PUBLIC ACCOUNTABILITY BOARD
CONSEIL CANADIEN SUR LA REDDITION DE COMPTES

Earning Investor Confidence

May 2017

Audit Quality Symposium

A large graphic consisting of two overlapping, thick, curved lines in blue and light green, forming a circular shape around a central orange circle.A decorative graphic in the bottom left corner of the blue bar, consisting of several overlapping, curved lines in shades of blue and white, resembling a stylized globe or a network.

KEY MESSAGES

Audit Quality Symposium: Earning Investor Confidence

May 16 & 17, 2017



Introduction

In May 2017, the Canadian Public Accountability Board (CPAB) held its fourth Audit Quality Symposium: Earning Investor Confidence. The Symposium was attended by corporate directors, regulators and standard setters, leaders from public accounting firms and other professional organizations, investors, and academics.

In the months leading up to the Symposium, CPAB reached out to the Canadian investor community to better understand what information they use to make decisions and how they value the audit today. We learned that although the financial statements, and the related audit, continue to have a *foundational value*, investors feel that a greater breadth of the information being disclosed by companies outside the financial statements is more relevant to their decision making.

Symposium participants were asked whether there is an opportunity for the audit profession and those charged with governance to engage increasingly with information disclosed outside the financial statements to enhance its reliability.

The Symposium featured a keynote address by Steve Harris, board member of the US Public Company Accounting Oversight Board (PCAOB), and three panels where we heard from regulators, investors, corporate directors, and audit leaders from Canada and around the world (refer to **Appendix A** for the Symposium program).

Three key messages emerged from our discussions with investors and key stakeholders and dialogue during and following the Symposium:

- 1. Investors use a wide variety of financial and non-financial information to assess a company's performance, financial condition and future prospects; very little of which comes from the annual audited financial statements. The belief by key stakeholders that all information disclosed by reporting issuers is equally reliable represents an expectations gap that creates a risk to the capital markets.**
- 2. Auditors and audit committees have an opportunity to engage increasingly with information outside the financial statements to enhance its reliability and reduce the expectations gap.**
- 3. Transformational change is required to ensure there is continued confidence in the information that drives the capital markets and the audit remains relevant. A fundamental transformation will only be successful if all parties in the financial reporting and disclosure system are engaged, support this transformation and reassess their respective roles and responsibilities.**

**KEY
MESSAGE
1**

Investors use a wide variety of financial and non-financial information to assess a company's performance, financial condition and future prospects; very little of which comes from the annual audited financial statements. The belief by key stakeholders that all information disclosed by reporting issuers is equally reliable represents an expectations gap that creates a risk to the capital markets.

The CFA Society Toronto, CPAB, the Accounting Standards Board (AcSB), and the Auditing and Assurance Standards Board (AASB), collaborated to engage representatives of the investor community in a series of roundtable and one-on-one discussions in the first half of 2017 to understand their perspectives. This included buy-side analysts, representing organizations that manage approximately \$3 trillion in assets, and prominent sell-side analysts and credit analysts.

The following insights emerged from these discussions and lay the groundwork for much of the discussion at the Symposium:

1. **Audited financial information represents a declining proportion of the information used by stakeholders.**
2. **Investors have limited knowledge of the nature and scope of the audit.**
3. **Investors have concerns with the consistency, comparability, and transparency of key performance indicators.**

Audited financial information represents a declining proportion of the information used by stakeholders

Although the financial statements retain a *foundational value*, investors today have access to a significantly greater breadth of information outside the financial statements which they regard as more relevant to their decision making.

Symposium speakers in their own words...

“ The GAAP financials today represent somewhere in the 15-20 per cent range of what users actually use to make a decision. ”

Investor panelist

Investors are particularly interested in information that provides insights into whether historical earnings are likely to recur and information about the value-enhancing opportunities being pursued by companies that create additional sources of earnings. This information tends to be forward-looking in nature and is generally reported outside the audited financial statements.

This desire for information by investors has led to an increase in company reporting of key performance indicators (KPIs) outside the financial statements. The primary sources for this type of information are the Management’s Discussion and Analysis (MD&A), press releases, and investor calls/presentations (Exhibit 1).

Investors have limited knowledge of the nature and scope of the audit

Investors generally have a limited understanding of the scope, process, and accountabilities of the audit. There continues to be confusion regarding what information disclosed by reporting issuers is included within the scope of the external audit and the degree of oversight applied to that information by audit committees.

This limited understanding leads investors to have an expectation that all information presented alongside audited financial statements (e.g. MD&A) is reliable because it is believed to be subject to attestation by the auditors. This has been referred to as the expectations gap.

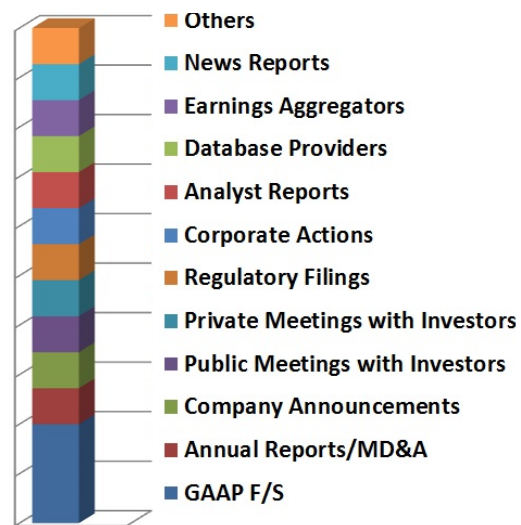
“ Investors are less concerned about what happened and more concerned about what that information tells us about the future direction, about the trend, and trying to understand why it happened. ”

Investor panelist

Exhibit 1



Sources of Information



Source: CFA Society Toronto


“ ...audited, unaudited, capital markets make no distinction. ”





Investor panelist

Investors have concerns with the consistency, comparability, and transparency of key performance indicators

Richard Talbot, board member of the CFA Society Toronto, described at the Symposium the types of KPIs disclosed by companies and the regulatory framework that applies to each type (Exhibit 2). KPIs reported in the financial statements (e.g. EPS) are within the scope of the audit while KPIs included in the MD&A attract limited or no external review. While there is a staff notice by the Canadian Securities Administrators that addresses the presentation of non-GAAP financial KPIs, there is little guidance available to preparers for other financial or operating KPIs.

Investor panelists noted a lack of comparability in KPIs reported outside the financial statements among companies within the same industry and inconsistent reporting by companies over different periods. Further, investors noted there is a lack of transparency around why companies choose to disclose some KPIs over others and whether these measures are linked to a company's longer-term strategies.

Exhibit 2 

Information	Examples	Standard/ Policy Set by	Verification
GAAP Financial KPI	EPS	GAAP (NI 52-109)	External Audit 
Non-GAAP Financial KPI	Pro-Forma EPS, Adj. EBITDA, Free Cash Flow	Securities Regulators (Staff Notice 52-306)	Audit Committee; Auditor Review - "not inconsistent" with GAAP F/S 
Other Financial KPI	ARPU, SSS, Sales/sqft	Management	As above 
Operating KPI	Churn, Barrels, Subscribers, Customer Sat	Management	As above 

Source: CFA Society Toronto

The risk to the capital markets

If audited information represents a small proportion of the information used by investors, then the majority of the information that drives capital allocation decisions may not be as reliable as stakeholders believe it is. This represents a risk to the effective and efficient functioning of the capital markets.

This information is not independently verified by an external auditor and generally lacks the established structure which would address concerns raised by investors over comparability, consistency, and transparency of this information.

Further, because KPIs reported outside the financial statements do not generally fall under a company's system of internal control over financial reporting, these measures may lack the rigor and oversight associated with GAAP measures, further reducing their reliability.

“ Why has there been no call to action (by investors)? I think the answer to that unfortunately, as we saw from our dialogue, is that ignorance is bliss. They just don't know that there is this gap.”

Investor panelist

**KEY
MESSAGE
2**

Auditors and audit committees have an opportunity to engage increasingly with information outside the financial statements to enhance its reliability and reduce the expectations gap.

Symposium panelists representing the audit profession and corporate directors provided their perspectives on the following questions:

- 1. Is there an opportunity for the audit profession to engage with important information that is found outside the financial statements that is relevant to stakeholders of the capital markets?**
- 2. What is the role of the audit committee in relation to information that falls outside the financial statements?**

Opportunities for the audit profession

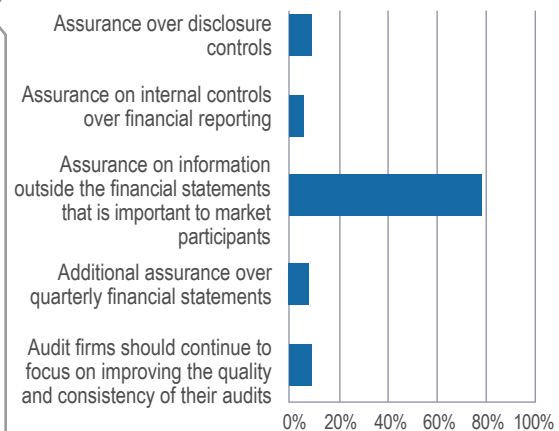
During the Symposium, we polled the audience on a number of topics. In response to the question: “What action do you think would be most effective at enhancing the relevance of the audit in the future?”, 78 per cent of participants thought that the relevance of audit could be enhanced by having auditors provide assurance on information important to investors that is found outside the financial statements (Exhibit 3).

Audit leader panelists acknowledged that the audit profession must manage the challenge to its perceived relevance because the profession will struggle to attract and retain the best and brightest if the industry is perceived to be on the decline.

Symposium speakers in their own words...

Exhibit 3

What action do you think would be most effective at enhancing the relevance of the audit in the future?



“ I don’t know how we can inspire confidence if our work is limited to only a fraction of what is relevant and almost all of it is historical in nature. ”

Audit Leader panelist

However, panelists believed that the lack of significant engagement by auditors with information outside the financial statements is not due to a lack of innovation or specialized skills. What appears to be lacking, according to panelists, is demand. Panelists noted that reporting issuers have not sought an expansion in the scope of the external audit, the role of the auditor, or additional assurance on KPI reporting.

Opportunities for audit committees

Audit committee panelists agreed that audit committees have a responsibility to oversee the quality of all reporting that is important to stakeholders but acknowledged there is an opportunity to improve the oversight of information disclosed outside the financial statements.

Audit committee panelists agreed that KPIs reported outside the financial statements often lack the mature processes and internal controls associated with KPIs reported in the financial statements. Further, panelists thought that audit committees should be more engaged with investors to understand which KPIs are perceived as most relevant and whether those correspond with those viewed as important by the board of directors and used to compensate management.

Panelists also explored whether there is an opportunity for the audit profession to assist the audit committee across a greater range of the audit committee mandate beyond the audit of the financial statements. In response to a polling question, 44 per cent of the Symposium audience thought that audit committees could benefit from expanded auditor assurance and support on the MD&A, 28 per cent favored expanded auditor engagement on matters dealing with risk management including cybersecurity, and 14 per cent saw an opportunity for auditor assurance on internal controls over financial reporting (Exhibit 4).

“ The other missing piece here appears to be the market demand or the reward for additional assurance on and the reliability of this information. ”

Audit Leader panelist

“ If we applied SOX level controls expectations to some of the KPIs, that would be a huge monumental change to how companies think about those [KPIs] and collect that information. ”

Audit Committee panelist

“ ...one of the things that amazes me is how few directors actually listen in to the analyst call, or listen to the recording, or read the analyst reports... I think it’s really important for directors to get a third party view of the company. ”

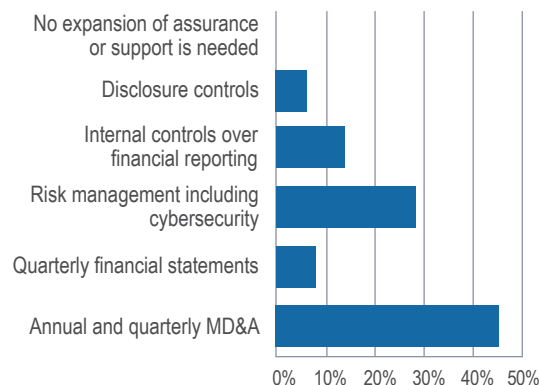
Audit Committee panelist

“ I think that if there is a KPI that isn’t fundamentally linked to the strategy and value proposition of the company, we should be saying what is it doing there? ”

Audit Committee panelist

Exhibit 4

Which of the following areas provides the greatest opportunity for auditors to enhance the assurance and support to audit committees?



Relevance of corporate reporting

While the capital markets have undergone significant changes over the past few decades, several panelists thought that corporate reporting requirements in Canada haven't changed enough to keep pace with the needs of investors and other stakeholders.

Stakeholders around the world are demanding more transparency from companies. Panelists agreed that KPIs reported outside the financial statements could be enhanced through better disclosures by companies around their strategies, business models and risks and how they intend to grow in a sustainable way.

“ If corporate reports are themselves not useful, than the [audit] profession faces an uphill battle in improving its own relevance. ”

Regulator panelist

KEY MESSAGE # 3

Transformational change is required to ensure there is continued confidence in the information that drives the capital markets and the audit remains relevant. A fundamental transformation will only be successful if all parties in the financial reporting and disclosure system are engaged, support this transformation and reassess their respective roles and responsibilities.

A significant proportion of the information that drives capital allocation decisions attracts limited involvement from the external auditors, and lacks standardized definitions and sufficiently mature internal control processes to ensure that it is reliable.

The expanding disclosure universe creates risks for investors, corporations, boards of directors and the efficient allocation of capital if these disclosures are inaccurate, inconsistent, incomplete, or misleading.

Participants in the capital markets appear to believe that auditors are more engaged in verifying disclosures reported outside the financial statements than they actually are. As a result, there is a significant and widening expectations gap between what investors, boards of directors and audit committees need and expect from auditors and what auditors actually provide.

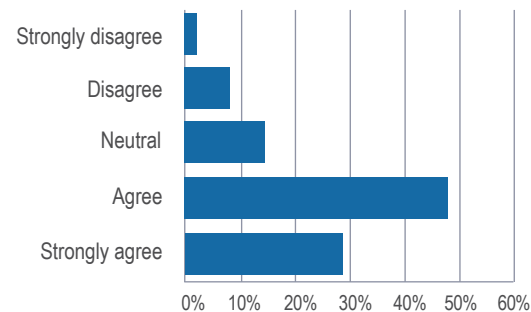
However, Symposium participants agreed that the solution cannot be limited to educating investors and waiting for activism to surface. The scope and approach to independent auditing has to fundamentally change. Closing this growing expectations gap requires a new, bold and transformational approach that will preserve its foundational independent assessment role, enhance the cost effectiveness of independent auditing, and better align independent auditing with the needs of investors, boards of directors, audit committees, and the evolving capital markets.

Seventy-seven per cent of Symposium participants either agreed or strongly agreed that the audit profession should be engaged to provide assurance over a greater proportion of the information that drives the capital markets (Exhibit 5). Participants also thought that other solutions deserved attention including enhanced oversight by corporate directors and standardization of KPIs reported outside the financial statements by industry groups.



Exhibit 5

Addressing the investor expectations gap and enhancing the value and relevance of the external audit is a “burning platform” requiring immediate action.



Jim Goodfellow, Corporate Director and co-chair of the Symposium, emphasized the need for a broader collaboration by all the relevant stakeholders, which he referred to as “the players in the system”, to collectively bring about the fundamental changes needed to address these risks (Exhibit 6).

What’s next?

CPAB supports the establishment of a multi-stakeholder group to determine next steps and priority areas of attention to address this risk to capital markets. Areas this group could consider include:

1. **Improve KPIs reported outside the financial statements to enhance intra-period consistency and inter-company comparability.**
2. **Expansion of the role of the auditor over other information.**
3. **Auditor reporting (targeted to the expectations gap).**
4. **Audit committee reporting (to assist in explaining the audit committee’s role in providing confidence to capital markets).**
5. **Rethinking of corporate reporting including simplification where possible and enhancement of disclosures of information important to investors including management remuneration KPIs, company performance KPIs and debt covenant KPIs.**
6. **Enhancements to communications among financial information users, preparers and standard setters.**

Appendix A – Symposium program

May 16, 2017 (dinner event)

Keynote address by **Steven B. Harris**, Board Member of the Public Company Accounting Oversight Board (PCAOB)

May 17, 2017

Panel 1:

Investor perspectives and update on international regulations that enhance investor confidence

Moderator: Jim Goodfellow, Corporate Director and former Vice Chair of Deloitte Canada

Panelists:

Stephen Haddrill, Chief Executive Officer, Financial Reporting Council (FRC)
Steven B. Harris, Board Member, Public Company Accounting Oversight Board (PCAOB)
Irene Nattel, Managing Director, Global Equity Research, RBC Capital Markets
Kiyotaka Sasaki, Secretary General, Securities and Exchange Surveillance Commission (SESC), Japan
Richard Talbot, Board Member, CFA Society Toronto

Panel 2:

The role of the audit committee in earning investor confidence

Moderator: Sheila Fraser, Corporate Director and former Auditor General of Canada

Panelists:

William D. Anderson, Audit Committee Chair, Sun Life Financial
Rahul Bhardwaj, President and Chief Executive Officer, The Institute of Corporate Directors (ICD)
David F. Denison, Audit Committee Chair, Royal Bank of Canada
Eileen A. Mercier, Audit Committee Chair, Intact Financial

Panel 3:

The role of the auditor in earning investor confidence

Moderator: Jim Goodfellow, Corporate Director and former Vice Chair of Deloitte Canada

Panelists:

Richard Olfert, Managing Partner, Regulatory, Quality & Risk, Deloitte Canada
Richard Sexton, Global Assurance Leader, PwC International
Bill Thomas, Chairman Elect, KPMG International
Jeff Wong, Global Chief Innovation Officer, EY International

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