CANADIAN PUBLIC ACCOUNTABILITY BOARD
CONSEIL CANADIEN SUR LA REDDITION DE COMPTES

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Inquiry Manager Statutory Audit Investigation
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Re: Notice of possible remedies – Statutory audit services market investigation

The Canadian Public Accountability Board (CPAB) is pleased to comment on the notice of possible remedies of the Competition Commission's statutory audit services market investigation. We commend the Competition Commission (the "Commission") for undertaking an investigation of the audit market in the UK and for exploring ways to improve auditor independence, objectivity and professional scepticism.

CPAB is Canada's independent audit regulator and is responsible for overseeing firms that audit Canadian reporting issuers. Our mandate is to promote high quality independent auditing that contributes to public confidence in the integrity of reporting issuers' financial reporting. We accomplish our mandate by inspecting audit firms and audit working paper files which provides us with insights into how audit quality might be improved. In responding to the notice of possible remedies we have focused on the implications to audit quality and provided an independent audit regulator perspective on how to improve audit quality.

Audit Quality

Auditing is becoming more complex and global in its nature and increasingly many stakeholders are questioning the value and relevance of the audit. Audit quality issues raised in the Commission reports are global issues. The effective operation of our capital markets depends upon public confidence in the integrity of financial reporting, which has its basis in high-quality financial audits. Auditors need to consistently bring to bear their independence, objectivity and an appropriate level of skepticism; characteristics shareholders expect in high-quality audits.

CPAB supports the need for change and improvement in the audit process. The status quo is not an option. Change needs to be responsive to the needs of shareholders, and should be implemented in a thoughtful, proportionate way such that audit quality is enhanced and in no way diminished. The work of the Commission is being closely followed in many jurisdictions and will influence actions taken by policy makers and regulators around the world.

A strong financial reporting environment requires auditors, audit committees and management to perform effectively in their roles with a culture of integrity, respect and transparency. Below we consider these roles and provide our perspectives on remedies to enhance audit effectiveness.

Enhancing the Role of the Auditor

Based on our inspections we believe audit methodologies at the firms are generally sound, and the majority of audits are well done. However, consistent execution of high-quality audits is a challenge for firms. CPAB believes this is the primary cause of the majority of audit deficiencies identified. A lack of professional scepticism, coupled with inadequate supervision and review, contributes to many of our more significant inspection findings. CPAB's inspection findings are comparable to those of other audit regulators around the world, including the Financial Reporting Council (FRC) Audit Quality Review Team (AQRT).

Firms need to build greater quality into the execution of the audit and commit to continuous improvement at all levels of their organizations in a manner which is sustainable. This will mean, in some cases, a shift in audit firm culture and organizational structure to enhance accountability and incentivise behaviours that drive continuous improvement in audit quality. Firms should increase the rigour and effectiveness of the role of the quality control partner including making greater use of a more in depth preissuance review of the audit work in high risk areas which focuses on whether the audit opinion is correct before issuance of the audit report. Since audit firms are both a business and a profession they need to ensure they strike the appropriate balance that serves the public interest.

Mandatory Tendering/Mandatory Rotation

We agree with the Commission's findings that firms need to improve audit quality and support increased competition in the audit market based on quality. However, we are concerned that implementing a mandatory rotation and/or mandatory tendering regime may have unintended consequences leading to diminishing audit quality and undermining the role of the audit committee. We expect that audit firms will devote more resources to business development, proposal activities and managing the tendering process which will likely mean there are fewer resources available to support audit quality.

While certain jurisdictions around the world have adopted a mandatory rotation and/or mandatory tendering regime, we are not aware of compelling evidence that this policy has led to improved audit quality and our understanding is that it may have led to a substantial reduction in audit fees in some jurisdictions. Moving to mandatory rotation/tendering may lead to increased price competition and our concern would be that the audit becomes a commodity to be differentiated on price and not quality. A race to the bottom on fees would not be in the shareholders' interest.

In our view, mandatory tendering would result in change in auditors among the Big 4 firms with minimal impact on the competitive landscape. This is especially true for the largest public companies whose geographical reach exceeds all but the Big 4 firms. While changing auditors can bring renewed objectivity to the auditor/client relationship it also creates greater risk as the auditor becomes familiar with the new client. A combination of reduced audit fees and the increased risk of taking on new audits of complex global enterprises will negatively impact audit quality and is not in the public interest.

Mandatory tendering and rotation may also limit choice in specialized industries thereby negatively impacting audit quality. In circumstances where a non-auditor firm is providing substantial consulting services to a company it might not be willing to forego this work to become the auditor, thereby actually reducing the potential choices to only one or two others. Such a limited choice among alternatives may actually lead to reduced audit quality in the longer term. We are also concerned whether mandatory tendering will create incentives for performing a quality audit or the converse. In an environment of mandatory tendering there may be less incentives for auditors to take a tough stand on material issues when that could impair their chances of success in the upcoming tendering process.

We agree, however, that there is a risk that, after an extended period of time, audit firms could develop a close relationship with their clients that could potentially affect the firms' independence and, ultimately, their ability to exercise appropriate skepticism.

In 2012, CPAB in collaboration with the Canadian Institute of Chartered Accountants launched the Enhancing Audit Quality Initiative (EAQ) and formed working groups to explore ways in which audit quality can be enhanced in three key areas:

(i) Auditor Independence
(ii) The Role of the Audit Committee
(iii) Auditor Reporting

The key recommendation of both the EAQ Independence and Audit Committee working groups to address the threat of institutional independence and enhance auditor professional scepticism is for the Audit Committee to enhance its oversight of the work of the external auditor and perform a Mandatory Comprehensive Review. We encourage the Commission to strengthen the audit committee's oversight of the work of the external auditor and enhance the evaluation of the auditor through a Mandatory Comprehensive Review as an alternative to Mandatory firm rotation and tendering.

Mandatory Comprehensive Review and the Role of the Audit Committee

To safeguard the auditor against institutional familiarity threats at the audit firm level the audit committee should perform a comprehensive review of the issuer's relationship with the auditor on a periodic basis. This review would include, among other items, evaluation of audit quality including the auditor's level of professional skepticism, the quality of the engagement team, and the length of tenure of the firm and key engagement team members, and consideration of audit regulator inspection findings. This review would require the audit committee to carefully consider the quality and value of their current auditor and would be combined with reporting to shareholders of the results and conclusion of this review. A mandatory comprehensive review may lead to tendering or a change in auditor as a consequence of this review. The mandatory comprehensive review would require both the audit committee and auditor to focus significant attention on indicators of audit quality and the exercise of professional scepticism and challenge to management, which mandatory rotation and tendering do not. This will drive behavioural and cultural change in the interaction between audit firms, audit committees and management.

Consistent with this mandatory review, we support other measures to strengthen the audit committee's annual assessment of the auditor, including the development of guidance and tools for audit committees to strengthen the accountability of the external auditor to the audit committee. These measures include greater oversight and dialogue on higher risk areas of the audit. Audit committees should intervene if auditors do not appear to be exercising appropriate professional scepticism or if management is reacting inappropriately in response. There needs to be a "healthy tension" in the interactions between these parties. Management needs to respect that auditors are acting on behalf of the shareholders and need to approach their audit with a questioning mind and be alert for management bias and information that is contrary to management's representations.

Additional information can be found in the EAQ Auditor Independence and Audit Committee discussion papers issued by the working groups at:

http://www.cica.ca/enhancing-audit-quality-canadian-perspective/item68293.pdf

http://www.cica.ca/enhancing-audit-quality-canadian-perspective/item71922.pdf

Shareholder-Auditor Engagement

CPAB supports the Commission's recommendations to enhance shareholder-auditor engagement and extend the auditor's reporting requirements. We agree that auditors need to provide greater value to audit committees and financial statement users. Greater innovation is required with respect to audit outputs by enhanced auditor reporting to shareholders, audit committees and management. We are concerned that the audit is being increasingly viewed as a commodity differentiated primarily based on price. If this trend continues, or is exacerbated by imposing mandatory tendering, it has the potential to negatively impact audit quality. We believe that 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.

Auditor Reporting

CPAB agrees with the Commission's recommendation to extend auditor reporting. We support the work being performed by the International Auditing and Assurance Standards Board (IAASB) to improve auditor reporting. We believe that the concept of an Auditor Commentary is an appropriate response to the call for auditors to provide more information to users through the auditor's report. The increased transparency into the audit process will improve audit quality and ultimately lead to improved disclosures in publicly available financial information. It will also help contribute to the users' appreciation of the relevance of the audit. To be effective the Auditor Commentary should be targeted at the key risk areas of most importance to the users' understanding of the audit.

Corporate Reporting Framework

While our comments in this letter are focused on improvements to the audit process, we believe there is a need for a more holistic review of the corporate reporting framework in an increasingly global, 24/7 interconnected world demanding more real time information. In our view, the debate on the value and relevance of the audit should be part of a more comprehensive initiative to reform the corporate reporting framework which will require the active involvement of all stakeholders, including policy makers, investors, regulators, standard setters, corporate directors, company management and auditors.

In conclusion, CPAB supports the need for change and improvement in the audit process. Change needs to be responsive to the needs of stakeholders, and should be implemented in a thoughtful, proportionate way such that audit quality is enhanced and in no way diminished.

In addition to our comments above, we have responded to certain of the questions posed in the remedies notice. These responses are included in Appendix 1 to this letter.

We appreciate the opportunity to respond to the remedies notice, and would be pleased to discuss any of the above comments with you at your request.

Yours very truly,

Brian Hunt, FCPA, FCA
Chief Executive Officer

CPAB
CCRC

Appendix 1: Response to questions in the remedies notice

Remedy 1: Mandatory tendering

26. **Views are invited on the specification, effectiveness and proportionality of this remedy and, in particular, on the following:**

(a) **What an appropriate time frame for requiring mandatory tendering might be, given the bounds suggested above?**

(b) **Whether and for what reason the measure may be subject to 'comply or explain' implementation?**

(c) **How a valid 'tender' and its constituents should be defined, including whether and how best to provide access to relevant information on an 'open book' basis?**

(d) **What costs and benefits would arise as a result of this remedy?**

(e) **What should be the requirements for phasing in this remedy? For example, those companies with the longest period since last tender may be required to tender first within a specified period.**

(f) **Whether there are any other relevant considerations to be taken into account in evaluating and implementing this remedy?**

We have expressed our reservations and concerns with imposing mandatory tendering and mandatory rotation in our covering letter, so it is not appropriate for us to comment on how such a policy should be implemented.

We are aware that the Financial Reporting Council recently made changes to the Corporate Governance Code in the UK to require audit tendering for FTSE 350 companies. Although compliance with this code is on a comply or explain basis we believe it is reasonable and appropriate to monitor the impact of these changes over a period of time before making tendering or audit firm rotation mandatory.

Remedy 2: Mandatory rotation of audit firm

34. **Views are invited on the specification, effectiveness and proportionality of this remedy and, in particular, on the following:** *(a)* **What an appropriate time frame for requiring mandatory rotation might be, given the bounds suggested above and how this might relate to mandatory tendering periods if this were also to be pursued?**

(b) **Should any such measure be subject to a waiver from the regulator (FRC) if a company's choice of auditor was substantially constrained and how would such a waiver operate?**

(c) **How a valid 'tender' and its constituents should be defined as a prelude to rotation, including whether and how best to provide access to relevant information on an 'open book' basis?**

(d) **What costs and benefits would arise as a result of this remedy?**

(e) **What should be the requirements for phasing in this remedy? For example; those companies with the longest period since last rotation may be required to rotate first within a specified period.**

(f) **Whether there are any other relevant considerations to be taken into account in evaluating and implementing this remedy?**

We have evaluated mandatory tendering and mandatory rotation together in our covering letter.

Remedy 3: Expanded remit and/or frequency of AQRT reporting

41. **Views are invited on the specification, effectiveness and proportionality of this remedy and, in particular, on the following:**

(a) **How the AQRT's remit should be designed in terms of enhanced scope and frequency. For example;** (i) **How frequently should FTSE 350 company audits be reviewed (and whether this should differ between FTSE 100 and FTSE 250 companies)?**

(ii) **Should the AQRT be required to published FTSE 350 results separately from other Public Interest Entity results?**

(iii) **Should the AQRT be required to change the scope of its review and if so, how? For example; should the AQRT be required to revisit key audit judgements based on the information then available?**

(iv) **How could AQRT reporting be expanded to allow better comparison of Big 4 and non-Big-4 firms?**

(b) **How should any expanded remit of the AQRT be funded?**

(c) **What costs and benefits would arise as a result of this remedy?**

(d) **Whether there are any other relevant considerations to be taken into account in evaluating and implementing this remedy?**

We are supportive of increased transparency of inspection findings with the objective to improve audit quality. However, there needs to be appropriate balance between transparency and the publication of inspection findings and trust and confidence in auditing in the capital markets. Such reporting should be balanced to ensure that the information provided to the public and audit committees enhances audit quality while also allowing audit regulators flexibility to make private impactful recommendations to regulated firms that have the greatest potential to improve audit quality. Transparency should be enhanced in a way that preserves the effectiveness of the regulatory approach and does not create unintended consequences for audit quality or for reporting issuers.

In response to (a)(iii), our audit inspections are designed to evaluate an auditor's compliance with the applicable auditing standards. In considering significant estimates and areas of professional judgement we evaluate the audit work performed and the quality of the audit evidence based on the information that was available at the audit report date. We do not believe audit regulators should use the benefit of hindsight to revisit key audit judgments using information available after the date of the audit report.

Remedy 4: Prohibition of contractual clauses in template documents limiting choice to the Big 4 firms

45. **Views are invited on the specification, effectiveness and proportionality of this remedy and, in particular, on the following:** *(a)* **The range of documents to which this prohibition should be imposed and how the prohibition could be best implemented. For example: are there documents in addition to Loan Management Association lending agreements that this prohibition should cover?**

(b) **What costs and benefits would arise as a result of this remedy?**

(c) **Whether there are any other relevant considerations to be taken into account in evaluating and implementing this remedy?**

We are supportive of the removal of contractual clauses limiting choice to the Big 4 firms.

Remedy 5: Strengthen accountability of the External Auditor to the AC

52. **Views are invited on the specification, effectiveness and proportionality of this remedy and, in particular, on the following:**

(a) **How this remedy could be practically specified and implemented? For example, what change to ACC availability and remuneration would be necessary for ACCs to take on an enhanced role effectively? How should this measure be specified to avoid circumvention?**

(b) **Whether this remedy could be implemented as an extension to the current guidance on the role of the AC? How this could be implemented without affecting the current collective legal obligations of the directors of a company?**

(c) **What costs and benefits would arise as a result of this remedy?**

(d) **Whether there are any other relevant considerations to be taken into account in evaluating and implementing this remedy?**

CPAB agrees with the findings of the Commission that the Audit Committee is an important and, by and large, powerful force in directing audit firms towards satisfying the interests of shareholders. We believe that enhancing the effectiveness of the audit committee's oversight of the external auditor is an important component of the solution to many of the issues raised by the Commission reports and we support measures to increase the accountability of the auditor to the audit committee. This will reduce the influence of executive management over the audit process.

Audit committees can improve audit quality by creating a climate of transparency and setting an appropriate "tone at the top". Based on our inspections, we believe there is room for improvement in the quality and effectiveness of audit committees. Consideration should be given to developing a set of guidelines for audit committees, or an "audit committee code" to strengthen audit quality and global consistency in this area. The current focus on audit quality also raises a question as to whether audit committees should have at least one member with experience in auditing public companies.

We believe the strengthening of the audit committee's role should be supported through the development of guidance and tools and greater resources to assist audit committee members in performing the duties required to fulfill their obligations to oversee auditors and contribute to enhanced audit effectiveness.

In our roundtable discussions with audit committees in Canada, many audit committee members have 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. 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.

The implementation of a mandatory comprehensive auditor review discussed in our covering letter would also strengthen the accountability of the auditor to the audit committee.

We encourage the Commission to review the report published by Canada's EAQ Audit Committee working group at http://www.cica.ca/enhancing-audit-quality-canadian-perspective/item71922.pdf which discusses the role of the audit committee in external auditor oversight.

Remedy 6: Enhanced shareholder-auditor engagement

57. **Views are invited on the specification, effectiveness and proportionality of this remedy and, in particular, on the following:**

(a) **What are considered to be the most effective means of enhancing shareholder engagement on audit and financial reporting issues?**

(b) **Suggestions as to how such means could be achieved.**

(c) **What costs and benefits would arise as a result of this remedy?**

(d) **Whether there are any other relevant considerations to be taken into account in evaluating and implementing this remedy?**

We are supportive of dialogue with shareholders to determine the most effective means of enhancing shareholder engagement on audit and financial reporting issues. We believe the strengthening of the role of the audit committee is an important step in supporting shareholder interests. However, there are also additional areas that shareholders can provide additional input such as increased involvement in the auditor appointment process and increased interaction with auditors at the annual general meeting. Given the size and differing levels of engagement of the shareholder group as a whole, there will be limitations on how effective this can be.

Remedy 7: Extended reporting requirements—in either the AC's or auditor's report

64. **Views are invited on the specification, effectiveness and proportionality of this remedy and, in particular, on the following:** *(a)* **How the CC may best support the FRC in establishing enhanced reporting and whether there are other avenues, including direct measures by the CC, that should also be pursued?**

(b) **What should be the scope and form of enhanced reporting proposals? For example:** (i) **whether further disclosure should be made via the AC's report or the auditor's report;**

(ii) **what the content of the additional disclosure should be. For example, should this be some form of commentary as to how the company's interpretation of the accounting standards compares with the norm; or commentary on the main topics of debate between auditor and management; or something else; and**

(iii) **what guidance as to the form of the disclosure should be required.**

(c) **What costs and benefits would arise as a result of this remedy?**

(d) **Whether there are any other relevant considerations to be taken into account in evaluating and implementing this remedy?**

We recognize the need for change and improvement with respect to auditor reporting. Auditors need to provide greater value by sharing more information, related to the audit, directly with financial statement users. Change needs to be responsive to the needs of users, and should be implemented in a thoughtful, responsible way such that audit quality is enhanced and in no way diminished.

Users clearly value the pass/fail nature of the current audit report, but the lack of transparency with respect to the nature and extent of professional judgment exercised by the auditor, particularly in auditing high risk areas, is a significant contributor to the current information gap between auditors and users. As our financial systems become more global and grow in complexity users are recognizing the importance of informed decision making. While users may still place high value on the auditor's opinion as to the fairness of the presentation of the financial statements, they would have a better appreciation for that opinion if they were aware of the significant matters the auditor considered and how the auditor was satisfied that the matters had been appropriately addressed.

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. 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 the financial statements.

In our inspection of audit files, we see examples of where the audit approach taken in high risk areas does not clearly demonstrate a link with the identified risk with the result that it is not readily apparent that the risk was mitigated. We believe that if an auditor had to disclose the significant risks identified and the approach taken to address those risks it would reduce those inconsistencies and improve audit quality.

We believe that the concept of an Auditor Commentary outlined in the IAASB's "Invitation to Comment – Improving the Auditor's Report" is an appropriate response to the call for auditors to provide more information to users through the auditor's report. The increased transparency into the audit process will improve audit quality and ultimately lead to improved disclosures in publicly available financial information. It will also help contribute to the users' appreciation of the relevance of the audit. To be effective the Auditor Commentary should be targeted at the key risk areas of most importance to the users' understanding of the audit.