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June 7, 2019

Sir Donald Brydon
Brydon Review
Orchard 1, 1st floor
Department for Business, Energy & Industrial Strategy
1 Victoria Street
London
SW1H 0ET

Subject: Independent Review of the Quality and Effectiveness of Audit

Dear Sir Donald,

Chartered Professional Accountants of Canada (CPA Canada) appreciates the opportunity to provide its comments in response to the Call for Views regarding your above-noted review. CPA Canada represents more than 217,000 members and conducts research into current and emerging business issues and supports the setting of accounting, auditing and assurance standards for businesses, not-for-profit organizations and government. CPA Canada also issues guidance and thought leadership on a variety of technical matters, publishes professional literature and develops education and the Canadian CPA certification program.

CPA Canada is very supportive of the Independent Review into the Quality and Effectiveness of Audit (the Review) and recognize that the profession as well as all actors in the audit eco-system, must continually find opportunities for improvement, particularly in response to the rapid change and disruption we are all facing. At the same time, we do wish to highlight that the mandate for the Review is focused on examining the quality and effectiveness of audit from a UK perspective while auditing is a global profession and accordingly, it is essential to recognize any proposed recommendations may have global implications.

The future of audit is a key area of focus for the Canadian CPA accounting profession. In formulating our response to the questions raised in the Review, we have drawn on our knowledge of audit and assurance practices in Canada and outreach undertaken with various stakeholders including auditors, audit committee members, investors, regulators, standard-setters, academia and other senior business leaders. In order to provide context for our responses, we identify below recent research activities undertaken by CPA Canada which we feel are relevant to the Review. Our responses to select questions raised in the Call for Views are based on our learnings from these various initiatives and are set out in the appendix to this letter.

The Expectation Gap

CPA Canada has long studied the "expectation gap" between what auditors can and reasonably should be expected to deliver, and what investors, regulators and other users have come to expect of them. CPA Canada's *Report of the Commission to Study the Public's Expectation of Audits* (Macdonald Commission Report) released in 1988 contains an extensive analysis of the expectation gap and many of the issues raised are still relevant today. Earlier this year, CPA Canada convened a panel of experts to discuss various issues related to the question "*Can auditors close the great expectation gap for good?*" (Expectation Gap Panel). The discussion covered matters such as the nature and extent of the expectation gap, its causes and what can be done to address them. There are many different components of the expectation gap and each need to be analyzed separately to determine the appropriate solution. More information on the research findings are included in the appendix in response to questions 4 through 6.

The Impact of Disruptive Technology

In addition to analyzing the needs and expectations of the public and user community, we are also looking at the impact of disruptive technology on the audit. For example, CPA Canada recently issued a white paper exploring blockchain technology and its potential impact on the audit and assurance profession (e.g. the skill sets and knowledge CPAs will need to obtain to meet the anticipated demands of the business world as blockchain technology is more widely adopted). *An Inside Look at How Auditors Are Using Data Analytics,* a study published in April 2019, examined how and why auditors in Canada are using audit data analytics (ADAs) and explored the effectiveness of ADAs and the challenges and barriers to further use (further information provided in response to question 45).

Foresight Initiative

To help our profession prepare for the future, in the fall of 2018 CPA Canada launched an extensive stakeholder consultation project called Foresight: Reimagining the Future of the Profession. Phase 1 entailed an ambitious, multi-stakeholder consultation process that challenged the status quo and considered what implications arising from a rapidly changing environment could mean for the accounting profession, including auditors. We obtained input using a combination of in-person roundtables and a digital conversation to discuss how the drivers of change – technology, geopolitical instability, changing societal perspectives, environmental and economic issues – will impact the accounting profession. Participants included CPAs across all sectors of the economy as well as standard-setters, investors, regulators, academics, and experts in technology and sustainability.

Through the consultation process, Foresight participants have come to realize that many of the profession's current systems have been designed to meet the needs of the industrial age – and with all of the global changes in the business environment, the time for transformation is now if accountants want to thrive in this new dynamic world. The result of Phase I of this initiative was the creation of *The Way Forward*, a blueprint to engage key stakeholders in some of the critical areas of research needed to move these initial findings into action. As it relates to the future of audit and assurance some of the key learnings from Foresight are as follows:

- Investing decisions are being made based on non-financial information that has not been subject to any form of independent assurance.

- We are moving from hindsight to foresight where real time information is used to drive decision making.
- In a data driven environment traditional financial statements and GAAP measures are becoming less relevant as indicators of historical, present or future value.

As part of Phase 2 of Foresight CPA Canada is are now considering how these trends will impact issues such as the future relevance of the audit of financial statements, what types of non-financial information users will require to support investment decisions and new areas of attestation and assurance which will enhance the reliability, consistency and comparability of this information.

The Evolution of Audit and Assurance

Future of Audit Symposiums
CPA Canada and the Institute of Chartered Accountants of Scotland's (ICAS) joint Future of Audit symposiums brought together senior representatives from business, the profession, regulators, standard-setters and academia to discuss and debate the future of the audit profession in the digital age and how technology might be used to enhance the audit. The 2017 symposium highlighted five key calls to action necessary to evolve and advance the value and relevance of audit and assurance: innovation, collaboration, education, adaptability and experimentation. The 2018 symposium reinforced the five critical calls to action and outlined recommendations for the assurance profession to stay relevant and enhance the value they provide. Recommendations focused on the impact of technology on what is audited, how the audit is executed, and the need to ensure that audit and assurance is fit for purpose for tomorrow's world. These symposiums provided insight into the demands to broaden the scope of audit and the benefits and challenges in applying technology in an audit. More information on these findings are included in the appendix in responses to questions 21, 22 and 45.

*Non-GAAP Performance Measure*s
Over the past few years, the Canadian Auditing and Assurance Standards Board (AASB) and CPA Canada have performed outreach activities with investors to discuss enhancing the relevance of audit and the value of providing assurance over key performance indicators (KPIs). A recurring message was that audited financial statements remain as the foundation for an investor's analysis. However, investors have also told us that financial statements are only a small percentage of the information they use to make decisions and indicated that more and more, they are relying on non-GAAP financial measures and operational KPIs as part of their determination of corporate performance. In addition, investors have told us they have concerns over the consistency, comparability and transparency of KPIs reported outside of the financial statements due to a lack of a recognized framework for reporting these types of measures. A key consideration in improving corporate reporting is improving what is required to be reported by management including how it is to be reported (e.g. in a consistent manner that allows comparability across similar companies).

The profession needs to evolve in order to address these challenges, seize opportunities and lead change in this era of ongoing disruption. In our view, the evolution of audit and assurance requires all parties in the corporate reporting ecosystem to be involved. One party cannot make these changes; they need a collaborative effort. Due to increased investor and societal interest in understanding an organization's accountability for all the resources it utilizes (such as human, social and natural capital), the nature and extent of corporate reporting assured by the audit profession needs to be re-assessed – by the accounting profession, regulators, auditors, the corporates themselves and investors. A holistic review of audit by the corporate reporting ecosystem should provide recommendations that will improve consistency and comparability between organizations and jurisdictions.

In conclusion, we look forward to continued participation in the work of the Review and would be happy to expand upon our comments in this response. At CPA Canada we see this review as an opportunity to initiate a global conversation about the future of audit such that the work of audit professionals continues to meet the needs of users and support our wider public interest mandate.

We therefore appreciate the opportunity to provide input from a Canadian perspective, and trust that you will find our comments useful as you pursue this important project.

Yours very truly,

Joy Thomas
President and CEO, CPA Canada

APPENDIX: Responses to Select Questions

CHAPTER 1 - DEFINITIONS OF AUDIT AND ITS USERS

Q1: For whose benefit should audit be conducted? How is it of value to users?
Q2: Should the audit be designed to enhance the degree of confidence of intended users in the entity or just in the financial statements?

The audit is conducted for the intended users of the audited information. The intended users are defined in the Glossary of Terms within the *CPA Canada Handbook – Assurance* as "the individual(s) or organization(s), or group(s) thereof that the practitioner expects will use the assurance report. In some cases, there may be intended users other than those to whom the assurance report is addressed." IFAC's International Framework for Assurance Engagements notes that in cases where there is a large number of people who have access to an assurance report, intended users may be limited to major stakeholders with significant and common interests. Intended users may be identified in different ways, for example, by agreement between the practitioner and the responsible party or engaging party, by law[1].

Companies are required to produce financial statements to reduce the information gap between the shareholders and management to a reasonable level. The external financial statement audit's primary purpose is to add credibility management's financial statements. Outreach with investors conducted by the CFA Society of Toronto, the Canadian Public Accountability Board (CPAB), the Canadian Accounting Standards Board (AcSB) and the Canadian Auditing and Assurance Standards Board (AASB) in 2017 found that the financial statements continue to have a foundational value even though investors feel that a greater breadth of the information being disclosed by companies outside the financial statements is more relevant to their decision making[2].

The audit of the financial statements alone should be designed to enhance the degree of confidence of intended users in the financial statements. The discussion regarding wider assurance addresses assurance over additional information that may enhance the degree of confidence of intended users in the entity (see Q7, Q21 and 22). In today's rapidly changing digital reporting environment with an increasing volume of information reported outside of the financial statements, investors increasingly rely on unaudited non-GAAP and other customized measures for which there are no rules governing their construction and disclosure. As such, the auditor's involvement with information reported outside of the financial statements should be a key priority for this Review. We see opportunities to build confidence in non-GAAP measures and other information that influences investors decision making.

In Canada, we have an assurance standard (Canadian Standard on Assurance Engagements 3001, *Direct Engagements)* that does not exist either in the UK or internationally. It is used to enable practitioners to provide assurance directly over information outside of the financial statements. While this standard is primarily used for auditors in the public sector, it could be used to report on information where management does not make an assertion. Such engagements are of value to users because they allow auditors to provide an independent opinion on matters such as effectiveness or efficiency of a process

[1] http://www.ifac.org/system/files/downloads/b003-2010-iaasb-handbook-framework.pdf
[2] http://www.cpab-ccrc.ca/Documents/Topics/Audit%20Quality%20Symposium/2017%20AQS%20Key%20Messages%20EN.pdf

that cannot be addressed when management does not make a public statement on or assertion about the matter.

Two matters the Review may wish to consider:

- The Review seems to primarily focus on audits of PIEs. This may be appropriate. On the other hand, it may be useful to also consider that the quality and effectiveness of audits are highly relevant to stakeholders in other types of entities. The Review will need to be cognizant of the consequences of any recommendations from this Review and the impact on audits of entities other than PIEs. For example, the IAASB is already exploring how to address the ongoing challenges related to the complexity and difficulties in applying the International Standards on Auditing (ISAs) faced by those auditing smaller entities. Smaller entities make a critical contribution to the economy and in Canada, although we do not have a statutory audit requirement for non-PIEs, many obtain audits in response to financing or other contractual requirements. Therefore, it is essential to ensure any new recommendations are scalable to take into consideration the impact on non-PIEs.
- The Review also seems to focus primarily on investors as users, but there are many other users of financial statement who many need financial information for their purpose; the Review should not design an audit environment in isolation of these different users (e.g. creditors and lenders, government ministries and agencies, regulators) and their different needs.

CHAPTER 2 – THE 'EXPECTATION GAP'

Q4. Do respondents consider there is an expectation gap?
Q5. If so, how would respondents characterise that gap?
Q6. Is there also a significant 'delivery' or 'quality' gap between auditors' existing responsibilities in law and auditing standards, and how those responsibilities are currently met?

There is clearly an expectation gap. This has been the subject of many initiatives and discussions in Canada and elsewhere.

The auditor's role is defined by the auditing and assurance standards. However, it is common for the general public to misunderstand the scope of an auditor's work. The difference between the understanding that the public has about the auditor's responsibilities and the actual defined responsibilities of the auditor is the expectation gap. There are many different aspects of the expectation gap.

The following Canadian initiatives have discussed the expectation gap:

<u>Future of Audit symposiums</u>
At the 2017 Future of Audit symposium we heard that investors are increasingly turning to non-traditional metrics in investment decision making and there is a belief by key stakeholders that all information disclosed by entities is equally reliable. This expectation gap brings two issues to light:

1. There is a misconception from users that information of the financial statements is subject to some form of assurance

2. Even when it is understood what is audited, there is a lack of understanding of what an audit entails.

They symposium highlighted the need for investors to engage more actively and effectively with companies to discuss the information needed to support decision making.

At the 2018 Future of Audit symposium participants indicated that while investors value the audit, studies continue to show they do not understand the audit. It was noted that auditors today are being asked to "do more" and in response how the work of auditors has to evolve to meet the evolving needs of investors and the capital markets. Based on these discussions it is likely that going forward audits will be expected to move beyond historical data to include internal controls or a more-in-depth review of future-oriented information.

<u>Expectation Gap Panel</u>
The Canadian panel discussion on the expectation gap noted that the expectation gap is a large and thorny issue for the audit profession and the change needed to address the issue is not a simple solution. Even the definition is up for debate. For example, the gap between the auditing profession's definition of audit and what users understand to be the level of assurance provided can vary depending on the sophistication of the various users.

Overall views expressed regarding the characterization of the gap included the following:

- The public's perspective of an audit may not match up with what an audit is designed to deliver. When something goes awry, then there is a lot of questioning by government and by the wider public: Where were the auditors? What were they doing? Why did we have this outcome? Did the auditors not audit everything in the company's annual reporting package that contains the auditor's report?
- Analysts want auditors to audit more than the financial statements (see Q21 for the additional information that could be subject to some form of independent assurance)).
- There is a communications gap. Auditors' reports are clear on what auditors do and do not do. However, auditors' reports are not being read (see Q51 for more information about why auditors' reports are not being read).

The panel noted developments that have helped reduce the expectation gap, including:

- CPAB publishing reports around audit quality providing transparency around the issues, what firms are doing about them and the improvements that have been made over time
- The expanded auditor's report that explains the audit process and what auditors do
- New independence rules put in place over the past number of years, and non-audit services policies that are in place

Panelists also discussed the need to broaden the scope of audit noting that, for example, there is a broader role for auditors within the context of Enterprise Risk Management of an organization.

<u>Macdonald Commission Report</u>
Paragraphs 1.20 and 1.21 of the Macdonald Commission Report describe the expectation gap as being the difference between what the public expects from the audit and the public's perception of auditor

performance. The report usefully identifies various components and subcomponents that help to characterize distinct aspects of the expectation gap, as set out below.[3] [4]

1. The *Standards Gap.* This is the difference between what the public expects from the audit and what the current standards require. The standards gap has two subcomponents:
   1.1 The *unreasonable expectation gap* (i.e., some user expectations are unreasonable).
   1.2 The *reasonable expectation gap* (i.e., users are sometimes correct in expecting standards to require more).

2. The *Performance Gap*. This is the difference between what the auditing standards currently require and the public's perception of auditor performance. The performance gap has two subcomponents:
   2.1 The *actual performance shortfall gap.* This is the gap between what standards currently require and auditors' actual performance. This subcomponent may be represented, for example, by audit deficiencies identified by audit regulators.
   2.2 The *performance shortfall perceived but not real gap*. This is the gap between auditors' actual performance and the public's perception of auditor performance.

These distinct components and subcomponents are important in deciding what actions to take to try to close the expectation gap. For example, the report suggests that subcomponents 1.1 and 2.2 might be addressed by better communications between the auditing profession and the public (i.e., users of audited financial statements). Subcomponents 1.2 and 2.1 would require "professional improvements" (i.e., changes in standards and auditor performance). The different aspects of the expectation gap need to be identified and analyzed in order to come up with targeted and effective solutions.

An Inside Look at How Auditors in Canada are Using Data Analytics (Inside Look)
An audited entity's management, audit committee and board of directors are important users of audit services. From the perspective of these users, there may be two gaps. They might be described as an *audit efficiency gap* and *an advisory services gap*.

- An *audit efficiency gap* may exist when the time and cost of the audit are higher than what management and the audit committee expect.
- An *advisory services gap* may exist when the nature and extent of advice to management that the auditor is able to provide as a by-product of the audit (without violating independence rules) are different from the quantity and quality of advice management expects to receive.

Both of these gaps have perhaps become more evident as a result of increased use of data analytics by some auditors, and expectations regarding the effects of such use. For example, the Inside Look refers to various circumstances encountered by engagement teams starting to use data analytics. One

[3] Models with similar components have been used in academic studies of the expectation gap. For example: Porter, Brenda, Ciaran Ó hÓgartaigh, and Rachel Baskerville, Revisited: Evidence from New Zealand and the United Kingdom Part 1: The Gap in New Zealand and the United Kingdom in 2008, *International Journal of Auditing,*16: 101–129 (2012).

[4] Components of the expectation gap may be defined or described in various ways. For example, the ACCA refers to three components: the knowledge gap, the performance gap and the evolution gap. (see ACCA - Closing the Expectation Gap)

engagement team encountered an audit committee that had an unrealistic view that, through use of information technology, the audit could eventually be performed automatically at the push of a button. In the view of this committee, this would significantly reduce the cost of the audit.[5] However, in contrast to this assumption the report notes that in fact some auditors believe, at least in the short term, that their costs will increase as a result of implementing data analytics into the audit process. For example, the introduction of data analytics will often entail using experts and more senior personnel. Further, obtaining relevant and reliable data in an appropriate format may be costly.[6] Finally, firms will need to make significant investments in both technology and training. To sustain ongoing investments and make future spends, these costs will have to be recovered.[7]

Regarding a possible advisory services gap, the Inside Look states that auditor use of data analytics may provide management with useful insights as a by-product of the audit since use of data analytics may involve looking at entire data populations. Also, these data analytics may provide the audit committee with useful insights from the audit thereby helping to meet stakeholder expectations.[8]

Thoughts on the Future of External Auditing (June 2015)

The possible existence of these expectation gaps are identified by James Goodfellow drawn, in part, from his role as co-moderator of three Audit Quality Symposiums held by Canada's audit regulator, CPAB.

Goodfellow does not use the terms "audit efficiency gap" and "advisory services gap". He refers to what he calls the audit commodity trap. He states that when in the commodity trap, audit committees view a good audit as one that is GAAS compliant and delivered at the cheapest price. While external auditing improves the efficiency of markets and reduces the cost of capital, it seems that many audit committees perceive the real value of the audit as the ability to exercise a reliance-on-an-expert defence in the event of a shareholder lawsuit. And, since all firms can provide this defence, it makes sense for them to purchase this defence at the cheapest price. He goes on to state that there are two ways for auditors to escape from the commodity trap (without fundamentally transforming the annual audit). They can:

1. Differentiate by developing new ways of performing GAAS compliant audits that are faster, better and more efficient than their competitors.
2. Deliver superior service and professional advice that differentiates them from their competitors.[9]

Therefore, Goodfellow notes that there is a possibility that audit efficiency and advisory services connected to the audit will increasingly be important components of actual and perceived audit quality. There will no doubt be gaps between what is expected from auditors and what is delivered.

[5] See page 28.
[6] See for example, pages 22 and 23.
[7] See page 43.
[8] See page v of the Executive Summary.
[9] See page 5 pf Goodfellow's paper.

CHAPTER 3 – AUDIT AND WIDER ASSURANCE

Q7: What should be the role of audit within wider assurance?

Regarding the role of audit within wider assurance, paragraph 39 of Chapter 3 refers to, for example, the provision of assurance on non-financial reporting. We have addressed this question more broadly in our response to questions 21 and 22.

Q11. Do current eligibility requirements for external auditors focus too much on independence at the potential expense of market innovation and the quality of the audit product?

Paragraph 38 of the Call for Views refers to the potential development of alternative models for audits. As we move forward there will be an opportunity to consider new partnerships and particularly the need for specialization as it relates to complex areas of audit such as technology, use of analytics, and valuations. For example, the audit of the future could involve a small front-line staff working with specialists from other areas of the organizations or external consultants. This may require us to rethink our expectations of independence, the nature of partnerships and revised business models for audit firms.

<u>Foresight Initiative</u>

The report from Phase 1 of CPA Canada Foresight initiative refers to the need to consider new models of value creation and further challenges readers to think about how these new drivers of value can be measured and reported so that it is consistent and comparable. The report also identifies concerns related to trust and contemplates the role of an audit professional to provide some type of assurance that the reported information can be relied upon by investors. For example, the report notes that successful economies and societies rely on trust, but mistrust of institutions and professions is at extraordinary levels. This is a problem for accountants, and, accountants must work to remedy it. Accountants' primary work product is trust, and they must ensure that integrity and ethical behavior continue to be fundamental to the profession. It is vital to keep ethics at the forefront recognizing the difficulty of translating codes and standards through to actual behavior[10]. To build trust in the information age, accountants will need to shift their roles from that of mitigating and avoiding risk to being more strategic in creating new models that assess value in a fair, comprehensive and accurate way. In creating the conditions that make for a successful society, the profession will be able to retain what sets it apart – ethical standards and its status as stewards of the public interest.[11]

The Phase 1 report also discusses matters pertinent to the reference in the Review to alternative models and the technology business leading the audit. For example, the report notes that technological change is amassing global information flows at breakneck speeds, causing a huge surge in data. No clear models exist to help manage this wave of data, nor how it will be commoditized, standardized or verified in the future. If data is power, then the profession's livelihood depends on its ability to determine the role it will play in identifying, measuring and creating value from this proliferation of data.[12] Foresight will continue to explore how auditors can provide assurance to enhance trust in data, systems and the information that is ultimately produced by new technologies, such as AI.

[10] See page 26 of the report.
[11] See page 18 of the report. Note that references in the report to "accountants" includes auditors.
[12] See page 15 of the report.

In applying this to the audit profession one example of how we might need to change is to reconsider the nature of audit independence. There will be a need to strike an appropriate balance between maintaining auditor independence and the opportunity for auditors to leverage the new insights derived from the use of emerging technologies such as audit data analytics and share these learnings with management and the Audit Committee.

CHAPTER 4 – THE SCOPE AND PURPOSE OF AUDIT

Before debating the scope and purpose of audit, it is important to consider the subject matter that is being audited. If the information reported by an entity does not meet the needs of investors, changing the scope and purpose of audit will not address investors concerns. A key consideration in improving corporate reporting is improving what is required to be reported by management including how it is to be reported (e.g. in a consistent manner that allows comparability across similar companies). Some of CPA Canada's initiatives to enhance reporting practices are provided below in response to Q 21 and 22.

For example, CPA Canada completed a study[13] focusing on investor needs related to climate-related financial disclosures; investors offered a number of suggestions that, if adopted, would be levers of change in improving the quality of climate-related financial disclosures in capital markets (see page 14 of the report). In this case, if companies do not adopt these recommendations then the information investors are looking for is not even available to be audited.

Our response to Q 21 and 22 discusses further barriers we will need to overcome to expand the scope of audit.

Risk and Internal Controls

Q12: Should directors make a more explicit statement in respect of risk management and internal controls? If so, should such a statement be subject to audit?

Q13: Should auditors' responsibilities regarding assessing the effectiveness of an entity's system of internal control be extended or clarified?

Q14: Auditors are currently required to report to audit committees their views on the effectiveness of relevant internal controls for listed and other relevant entities. Should auditors be required to report publicly these views?

In the United States, Section 404 of the Sarbanes-Oxley Act requires a public company's annual report to include the company's own assessment of internal control over financial reporting, and an auditor's report on that assessment. Canadian securities regulators decided to require officers in public companies (e.g. the Chief Executive Officer and Chief Financial Officer) to annually provide a Certification of Annual Filings, including certifications regarding internal control over financial reporting (ICFR). However, the decision was made to not require an audit of management's assessment of ICFR.

The officers are required to certify, for example, that they have:

- Designed ICFR, or caused it to be designed under their supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with the issuer's GAAP.

[13] https://www.cpacanada.ca/en/business-and-accounting-resources/financial-and-non-financial-reporting/mdanda-and-other-financial-reporting/publications/investor-interviews-on-climate-disclosure

- Evaluated, or caused to be evaluated under their supervision, the effectiveness of the issuer's ICFR at the financial year end, and the issuer has disclosed in its annual MD&A:
    - Their conclusions about the effectiveness of ICFR at the financial year end based on that evaluation; and
    - When applicable, for each material weakness relating to operations existing at the financial year end:
        - A description of the material weakness;
        - The impact of the material weakness on the issuer's financial reporting and its ICFR; and the issuer's current plans, if any, or any actions already undertaken, for remediating the material weakness.
- Disclosed, based on their recent evaluation of ICFR, to the issuer's auditors, and to the board of directors or the audit committee of the board of directors, any fraud that involves management or other employees who have a significant role in the issuer's ICFR.

Canadian securities regulators decided that the cost of an audit of ICFR would outweigh the benefits obtained. This decision was made based on extensive input from stakeholders. For example, the consulting firm Charles River Associates Canada Limited prepared a report for the Ontario Securities Commission entitled *The Cost and Benefits of Management Reporting and Auditor Attestation on Internal Controls over Financial Reporting*. Interviews were held with 28 Canadian securities issuers of various types and sizes.[14] The introduction and summary findings of the paper (pages 1 through 17) provide a useful overview of key issues related to measuring the relevant costs and benefits, and the limitations of, such measurements. Two overall findings regarding the costs and benefits of audit of ICFR were as follows:

- Elimination of the auditor attestation requirement could reduce costs significantly, as the attestation costs are estimated to be between 40% and 70% of total costs. Cost savings to reach the same quality level of internal controls achieved with auditor attestation may be closer to 40% to 50%, and further savings may reflect less comprehensive or in-depth evaluation, improvement and ongoing testing of internal controls.
- Auditor attestation is likely to be important for setting consistent standards for reporting on the functioning of internal controls over financial reporting and for inducing issuers to improve internal controls. Retaining the management report without auditor attestation, or a set of specific requirements issued by regulators, could result in greater variation in the depth to which issuers evaluate internal controls in making management reports. Thus, while the costs may be lower, so too would be the benefits.[15]

It is important to note that while Canadian securities regulators do not require an audit of management's assessment of ICFR, many Toronto Stock Exchange and TSX Venture Exchange companies seek secondary listings on the US exchanges. In doing so, these companies must register their securities under the US Exchange Act and are therefore subject to the requirements of Sarbanes Oxley, including Section 404 requirements related to ICFR.

[14] See page 5 of the report

[15] See pg. 13 of the report.

Going Concern

Q15: **Is the current regulatory framework relating to going concern fit for purpose (including company law and accounting standards)?**

Q16: **Should there be greater transparency regarding identified "events or conditions that may cast significant doubt on the entity's ability to continue as a going concern"?**

Q17: **Should directors make a statement about the sustainability of the entity's business model beyond that already provided in the viability statement?**

Q18: **Should such a statement be subject to assurance?**

Q19: **Who might be capable of giving such assurance?**

Q20. **Is there a case for a more forward-looking audit? What would be the main benefits and risks?**

In Canada, corporate directors are not required to make viability statements. Nevertheless, questions 17 through 20 raise important matters to be considered regarding the respective responsibilities of management, the audit committee (or board of directors) and the auditor. The following Canadian initiatives have discussed these issues:

<u>Expectation Gap Panel</u>

- The expectation gap is wide because the general public thinks auditors provide some kind of insurance policy against a corporate failure. Many people in the UK now think auditors are no longer relevant because recent events have demonstrated that an audit does not provide that kind of guarantee.
- The answer to the going concern problem may be to give auditors some form of broader role within the context of the Enterprise Risk Management of organizations. This could promote dialogue among management, the audit committee and the auditor. The result could be a mutual understanding of the risks that an entity is facing. Everyone would be on the same page. Each party, including the auditor, would not be standing alone.
- Audit failures tend to create more regulation. However, new draconian rules do not necessarily drive higher audit quality and value. Regulations can result in a tick-the-box mentality within the firms, which can, in and of itself, reduce audit quality.

<u>Macdonald Commission Report</u>

Regarding question 16, over 30 years ago, the Macdonald Commission Report noted that the public expects better warning of the risks of financial failure, and that often the public equates business failure with audit failure.

At the time of the report, public accountants were of the view that better disclosure of risks and uncertainties in the financial statements should make it more evident to the public that a business can fail for many reasons, some of which are unpredictable. Others who were surveyed were of the view that there should be more discussion of these matters in the auditor's report. [16]

Although GAAP and GAAS have evolved significantly over the years, it appears that, in the minds of some users, the changes made are still not adequate. Perhaps yet more time is needed. For example, the changes to ISA/CAS 570 came into effect only recently. ISA 570 is effective for financial statements

[16] See paragraph 2.18 to 2.23(pages 15-16) of the Macdonald Commission report

for periods ending on or after December 15, 2016. CAS 570, adopted from the ISA, is effective for financial statements for periods ending on or after December 15, 2018. Also, use of technology now available, including predictive analytics, may result in more inroads being made to address the going concern issue.

Adoption of ISA 570 in Canada

In Canada, the AASB adopted ISA 570, *Going Concern*, as CAS 570, without amendment (other than delaying the effective date). In adopting ISA 570, we noted matters set out in the IAASB's *Basis for Conclusions, Reporting on Audited Financial (IAASB Auditor Reporting BFC)* regarding going concern issued in January 2015.[17] For example, the Basis for Conclusions notes that users of the financial statements and auditor's report thereon may not have a consistent understanding of certain concepts, in particular "material uncertainty". Consistent definitions of concepts between accounting standards and auditing standards are needed to avoid potential misinterpretations by users. Such misinterpretations could widen the expectation gap. Therefore, coordination is needed in setting accounting and auditing standards related to going concern.[18]

Unaudited information

Q21: Would audit or assurance over financial and non-financial information outside the annual financial statements (for example KPIs or non-financial metrics, payment practices or half-yearly reports) enhance its reliability and therefore be of benefit to users?

Q22. If so, what information might usefully be subject to audit or another form of assurance and why?

Expectation Gap Panel

Relevant points discussed by panelists include:

- During a roundtable that CPA Canada held with investors, it became clear that some of the investors were not aware of what the auditor's involvement was with information such as that included in Management's Discussion (MD&A), including Key Performance Indicators (KPIs). Some observed, "Well, it's probably been audited because there's an audit report in the package".
- It is this other information that analysts, in particular, would like to see audited. Further, investors are not only interested in assurance around the numbers, but also around the narrative that management puts forward. On the other hand, management of the audited entity is unlikely to support having its MD&A and KPIs audited. Management uses these measures to run the business and discloses them to better explain the results obtained. They may view an audit of this information as a restriction on their ability to tell their story.
- Much of this other information comes from operational systems and processes that are not used to generate the financial statements. There are significant barriers to expanding the auditor's role to encompass other information. First, management is likely to resist such expansion, as noted above. Second, costs might exceed actual or perceived benefits. Third, there is no equivalent of accounting standards to provide criteria against which the auditor can evaluate this other information. Fourth, these criteria, and auditing standards specifically covering the audit of other information, would be needed to enable a high-quality audit of other information.

[17] See paragraphs 79 through 115.

[18] See paragraph 80.

These standards also would be needed to provide auditors with a safe harbour against potential legal liability that this expanded service could attract.

- Despite these barriers, there is a need to extend the usefulness of an audit. The auditing profession has to be bold enough to say that it is in the information verification business, which extends beyond auditing financial statements.

Future of Audit Symposiums, 2017 and 2018

In today's fast-paced, complex and rapidly changing world, companies face increasing pressure to provide a continuous flow of high-quality corporate reporting on a wide spectrum of issues. This includes disclosure of KPIs. Companies are using a broader range of non-traditional metrics, such as customer base, new customers/subscribers, customer retention rate, and Environmental, Social and Governance (ESG) measures to explain their performance. Therefore, investors are increasingly exposed to different sources of unaudited information, which they are using to make their investment decisions.

They are rightly concerned about the lack of transparency, comparability within industries and consistency in the reporting of these measures. Perhaps more importantly, they are not clear on what is assured or even what assurance means or should mean in this new era.

On the other hand, there is a lack of demand from investors and audit committees for assurance on KPIs (including non-GAAP measures). Two expectation gap issues exist:

- A misconception from users that information outside of the financial statements is already subject to some form of assurance.
- Even when users understand what is audited, there is a lack of understanding of what an audit entails.

In 2018, symposium participants provided their views in response to questions posed to them. These responses may be useful indicators of the demand for, and perceived value of, auditors providing assurance on subject matter information beyond financial statements. For example:

- Participants indicated the extent to which they currently encounter demands for other assurance services:
    - Occasionally – 60%
    - Not sure – 17%
    - Regularly – 11%
    - Frequently – 6%
    - Other – 6%
- Various subject matters for which additional assurance services would likely be highly valued were identified. These subject matters, and the percentages of participants who identified them, were as follows:[19]
    - Going concern/financial viability – 64%
    - KPIs and non-GAAP measures – 48%
    - Culture – 28%
    - Front-half of the annual report – 12%
    - Not sure – 4%

[19] A participant could identify more than one value-added assurance service.

  - No value in added assurance – 0%

A key issue identified was the lack of a framework for reporting on KPIs.

Canadian Initiatives to Enhance Reporting Practices

Because there is no recognized framework, both the Canadian Accounting Standards Board (AcSB) and CPA Canada have issued guidance to enhance reporting practices as it relates to KPIs and other performance measures:

- The AcSB released a *Framework for Reporting Performance Measures* in December 2018. The Framework was created to help entities – from public to private companies, to not-for-profits and pension plans – improve the quality of financial and non-financial performance measures they choose to report outside of the financial statements. The Framework sets out what the AcSB thinks is best practice guidance for:
  - Selecting, developing and reporting performance measures; and
  - implementing and maintaining controls and governance practices
- CPA Canada has developed and issued:
  - *Management Considerations for Effective KPI Disclosure*. This sets out six principles to assist management in appropriately selecting and effectively disclosing KPIs.
  - *Key Performance Indicators - A Tool for Audit Committees*. This provides a description of each of the four KPI categories often presented in MD&A and earnings press releases and six characteristics to help audit committee members review the appropriateness of management-selected KPIs.
  - *Webinar - KPIs - Getting Them Right*. This includes a discussion of investor uses and disclosure expectations relating to key performance indicators (KPIs). It suggests what audit committees, with the help of management, can do to ensure reported KPIs are appropriately selected, presented and are meeting stakeholder needs.

Other Canadian Reference Sources

In May 2017, CPAB held its 4th 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. 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. In response to various polling questions put to the audience:

- Seventy-eight per cent 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.
- Forty-four per cent thought that audit committees could benefit from expanded auditor assurance and support on the MD&A.
- Seventy-seven per cent 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.

Addressing the investor expectation gap and enhancing the value and relevance of the external audit is a "burning platform" requiring immediate action.

The Director, Audit and Assurance Standards who leads the staff work in support of the Canadian AASB, has noted that commentators across Canada and the globe have been talking about KPIs and how to strengthen their transparency, consistency and comparability. However, there are no global solutions yet. The main reason is that enhancing the reliability of KPIs does not lie on the doorstep of any one stakeholder. A collaborative effort is needed involving investors, industry organizations, professional bodies, standard setters and other policymakers. (*See Enhancing Audit Relevance for Investors*)

The Canadian AASB held an outreach session in October 2017. Participants included, for example, investors, audit committee members, financial statement preparers and auditors. They provided forthright views on whether there is a role for the auditor with respect to information investors use beyond the financial statements. It was noted that audited financial statements only account for about 20 per cent of the information investors use to make their decisions. Investors focus on key performance indicators. However, often this information is not consistent, comparable, reliable or well-disclosed. Further, investors are not clear on the nature and extent of management, audit committee, auditor and regulatory involvement with that information – a critical expectation gap. In responses by participants to polling questions:

- More than 90% per cent agreed that the investor expectation gap is an issue that should be given high priority.
- More than 70% indicated that reliability of information and the ability to compare it with competitors are the most important attributes that need to be addressed.
- Forty per cent indicated that the Canadian AASB should focus on assurance standards around processes to develop and approve other information, with a further 45% indicating that the AASB needs to perform further study first. (See AASB Outreach 2017)

Other Reference Sources

Other accounting bodies have explored issues regarding public accountants providing assurance on KPIs. For example:

- The Institute of Chartered Accountants of England and Wales (ICAEW) published a document entitled *Assurance Over Key Performance Indicators*. It notes that reporting on KPIs can be complicated. For example, the assurance provider would need to consider what other KPIs could have been included and judge whether the combination of reported KPIs will distort a reader's impression of the business. Also, KPIs are, or should be, linked to explanatory narrative reporting. While not specifically mentioned in this ICAEW publication, MD&A may contain many KPIs with interrelated narrative discussions. It may be difficult to clearly distinguish those KPIs for which assurance is being provided from other KPIs. It may also be difficult to determine where best to locate the auditor's report on KPIs.
- The Institute of Chartered Accountants of Scotland (ICAS) published a document entitled *Towards Transparency: Assurance on KPIs – A practical guide for audit committee and boards*. The guidance includes a series of characteristics and criteria that committees and boards can refer to during the KPI selection process and provides an assurance matrix to enable them to evidence and communicate the extent of challenge and scrutiny over KPIs.

CHAPTER 5 – AUDIT PRODUCT AND QUALITY

Audit quality is enhanced through the interaction of three parties: the auditor, the audit committee and management (the "three-legged stool"). The commitment and participation of each leg of the stool is needed to enhance audit quality. CPA Canada conducted a study to assess management's understanding of the importance of its role as a contributor to the quality of the audit[20].

Q28: To what extent, if any, has producer-led audit (including standards-setting) inhibited innovation and development for the benefit of users?

In February 2018, both CPA Canada and the Canadian AASB responded to the Monitoring Group Consultation paper entitled *Strengthening the Governance and Oversight of the International Audit-Related Standard Setting Boards in the Public Interest.* Examples of comments from CPA Canada and the AASB related to producer-led standard setting include the following:

- The accounting profession is aligned with the identification of the public interest as the overarching principle. This is at the ethical core of what defines a profession. The basis of our value to society depends on the recognition and protection of the public interest.
- The current international standard-setting processes for audit and assurance and ethics operate well and appropriately recognize and consider the public interest. A variety of existing checks and balances operate within the system (from nominating to due process approvals) to ensure oversight and prioritization of the public interest.
- The Monitoring Group has for many years expressed a concern that too much funding for the standard-setting process comes from the accounting profession and that there is, therefore, a risk of perceived influence over that process. IFAC has echoed this concern. At the same time, a viable financial source other than the accounting profession has not been identified. Going forward, we believe that new and additional sources of financing should be sought to diversify funding. Enhanced appropriate checks and balances can be put in place. Any new suggested funding mechanism or source must be evaluated in the context of how it addresses the risk of perceived influence over the standard-setting process.
- Enhancements can be made to improve the overall standard-setting process for the benefit of the public interest. This can be done without the need to abandon all processes and resources that exist because of years of investment, development and concerted effort.
- Auditing Standards Board members require appropriate and relevant technical expertise, a mix of experience, and an ability to represent the public interest.
- More standards-setting staff will be needed for future efforts to help develop timely and relevant standards in an increasingly complex environment. The challenge in finding suitable candidates and the funding for extra positions should not be underestimated.
- It is critical for standards-setting staff to be able to address technology issues resulting from rapidly advancing innovations affecting the accounting profession, including auditors.

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[20] https://www.cpacanada.ca/en/business-and-accounting-resources/audit-and-assurance/enhancing-audit-quality/publications/how-management-contributes-to-audit-quality

CHAPTER 9 – AUDITOR LIABILITY

Q40. Is the audit profession's willingness to embrace change constrained by their exposure to litigation?

Q41. If there were a quantifiable limit on auditor liability, how might this lead to improvements in audit quality and/or effectiveness?

Expectation Gap Panel

As indicated in our responses to questions 21 and 22, some expectation gap panel members were of the view that exposure to litigation may have an adverse effect on the willingness of auditors to expand the scope of the audit to include other information. However, it was noted by some panelists that having suitable criteria against which to evaluate such information, and auditing standards directed at how audits of such information should be performed, could help provide auditors with a safe harbour against litigation, provided, for example, that the auditor has complied with relevant standards.

CHAPTER 10 - OTHER ISSUES

Technology

Q45. How far is new technology actually used in audits today? Does the use of technology enable a higher level of assurance to be given?

Q46. In what way does new technology enable assurance to be given on a broader range of issues than is covered by the traditional audit?

An Inside Look at How Auditors in Canada are Using Data Analytics (Inside Look)

In 2017, CPA Canada held a series of interviews with engagement teams from nine participating public accounting firms ranging in size from very small to very large to discuss the use of data analytics on specific audit files. These engagement teams were just starting to use audit data analytics (ADAs). Based on the results of this initiative, the use of ADAs is not yet widespread. However, firms and practitioners are obtaining the skills needed to perform ADAs and building advanced ADAs that can execute enhanced risk assessments and carry out substantive procedures. The real challenge remains in extracting the data - both the right data for the ADA and in the right format for the tool being used. This is further complicated when an entity has more than one enterprise resource planning (ERP) system or a customized ERP system. Time and effort are required by both the auditor and members of the entity's management to progress the use of ADAs.

All participants concurred that their primary objective for using ADAs is to improve the quality of audit evidence obtained to support the auditor's opinion. Improved audit efficiency, while desirable, is not their main objective.

Participants identified a number of significant challenges to using ADAs. Some participants had success (or at least partial success) in meeting these challenges. Examples of these challenges were:

- Establishing ADAs as a replacement for traditional audit procedures.
- Establishing that ADAs are at least as efficient and effective as traditional audit procedures.
- Obtaining the support of entity management and the audit committee regarding the use of ADAs.

Virtually all participants expressed a strong commitment to continue improving how they use ADAs and to expand such use. This commitment includes, for example, using ADAs in performing substantive procedures intended to be a primary source of audit evidence and as tests of controls. Participants expressed optimism that significant progress will be made. However, they also acknowledged that there is still much to learn about how to make more widespread use of ADAs. In addition, some noted a need for changes in auditing standards to address the use of ADAs specifically and for a transparent conversation with audit regulators about their views of such use.

Future of Audit Symposiums, 2017 and 2018

More than two-thirds (68%) of the 2017 symposium participants stated that they are already using data analytics to some degree to assist with risk assessment, in performing substantive analytical procedures and/or tests of details. Eighty-two percent of participants expect to be using data analytics in all areas of the audit in the future.

Symposium participants identified the largest benefit from ADAs as a higher quality audit over audit efficiency and increased value to management and the audit committee. More specifically, ADAs are able to:

- Identify unusual or unexpected characteristics of transactions.
- Provide greater insight into risk at the entity.
- Test a greater portion of an entity's transactions.
- That said, symposium participants also cited several barriers to using ADAs, including, for example:
    - Getting full sets of data from clients.
    - Determining the integrity of the data obtained.
    - Organizing and cleansing of the data.

When the 2018 symposium participants were asked what they saw as the greatest barrier to technology being universally applied to all audits in the future, the responses were as follows:

- Seventy-one percent - lack of appropriate expertise/knowledge.
- Forty-six percent - the perceived cost of investment is not commensurate with the benefit.
- Thirty-nine percent - challenges around how to obtain sufficient appropriate audit evidence.

Symposium participants were also asked to share their thoughts on the top priority for the auditing profession in responding to advances in technology at audit clients. The responses were as follows:

- Forty-three percent – rethink the audit risk model.
- Twenty-six percent – enhance auditor training and development.
- Fifteen percent – support academic research into new audit techniques.
- Thirteen percent – encourage update of auditing standards.
- Four percent – other.

Other Canadian Reference Sources

In early 2019, an article entitled *Could High-Tech Tools Make the Expectation Gap Wider?* was issued in CPA Canada's Pivot magazine. In that article, the Chair of Canadian Auditing and Assurance Standards Board expressed his view that much of the talk around technology has been about tools meant to make audits more efficient. These include analytics that allow auditors to look at every transaction a company makes instead of just a sample. Also, AI is used to search for anomalies in financial statements and even ferrets out fraud. It's not just auditors talking about these possibilities. Software vendors are touting technological tools that can review 100 per cent of the information at hand. This suggests that some people think fraud should never, ever go undetected in the future. That sets unrealistic expectations of the profession. Until everyone fully understands what these tools can and cannot do, there is a risk that expectations will further outstrip reality.

Shareholders

Q51. What use do shareholders currently make of audit reports? Are they read by shareholders generally? What role does AI play in reading and analysing such reports?

The Canadian AASB has adopted the revised ISAs on auditors' reports. The initial work on the IAASB's audit reporting project included commissioning academic research. This included a 2009 paper by Mock, Turner, Gray and Coram entitled The Unqualified Auditor's Report: A Study of User Perspectives, Effects on User Decisions and Decision Processes. A key finding was that even though auditors' reports are often not read, they are still valued. That finding, as set out in paragraph 2.1.7 of the paper quoted below:

> Based on the focus groups, financial statement users do not appear to actually read the entire auditor's report and, in fact, non-professional investors indicated they do not even look at the report. CFOs, bankers, and analyst groups indicate they look at the auditor's report only to see if there is an unqualified opinion and which audit firm signed the report. If the report is unqualified and signed by a Big 4 firm, then they do not consider it again. If it is not signed by a Big 4 firm, they may try to determine the qualifications or reputation of the audit firm. At least one participant in each focus group, including the auditor group, commented that a simple "OK" could replace the existing unqualified auditor's report. An auditor taking this comment a step further said that in addition to "OK", the name of the auditing firm and the standards under which the audit was conducted also should be included. Participants in all focus groups except the non-professional investors frequently stressed the point that the audit and auditor's report essentially are a compliance issue in that an audit is required. For public companies, it is required by the SEC, and for private companies, it typically is required by the bank, venture capitalist, or other organization providing financing to the company. The auditor's report indicates the organization either passed or failed the audit. Several participants echoed the binary aspect of the auditor's report using terms, such as pass/fail and "check the box," which means to see if an unqualified opinion is there and if yes, move on to analyzing the financial statements.
>
> It is important to note that these comments regarding the current auditor's report should not be interpreted that users do not value the audit or the auditor's report. Quite the contrary was true. All participants in the user groups, including the non-professional investors who indicated they never look at the auditor's report, value both the audit and the auditor's report. Participants were unable to place a quantitative value on either, but said audited financial statements clearly are more valuable than unaudited financial statements.

Other Reference Sources

- Outreach conducted by the CFA Society of Toronto, CPAB, the Canadian AcSB and the Canadian AASB in 2017 found that the financial statements retain a foundational value (see page 3) although the GAAP financials today represent somewhere in the 15 – 20 per cent range of what users actually use to make a decision[21].

[21] http://www.cpab-ccrc.ca/Documents/Topics/Audit%20Quality%20Symposium/2017%20AQS%20Key%20Messages%20EN.pdf

- The CFA Institute published a paper, "How Information is Consumed in the New Age" in July of 2018 discussing how regulatory filings are consumed.

- The June 2017 issue of CPA Journal contains an article by Ting Sun and Prof. Miklos Vasarhelyi entitled *Deep Learning and the Future of Auditing - How an Evolving Technology Could Transform Analysis and Improve Judgment* (see CPA Journal article). It notes, for example, that deep learning algorithms might be used to draft auditor's reports. Further, text data can be classified based on features of interest. Based on this article and many others on the increasing use of natural processing language (NPL), it seems likely that users of financial statements and auditor's reports may use text analysis to search for key words or phrases (such as "reservation of opinion" or "material uncertainty") that would be used to identify matters that are more likely to be of particular interest to those users.