

Quality in Financial Reporting: Four Legs are Stronger than Three—Adding the Regulator to the Table

A Discussion with Brian Hunt, Chief Executive Officer, Canadian Public Accountability Board (CPAB)

- Nationally, 82% of attendees feel they have an understanding of the steps their auditor takes to achieve quality; among those responding, 53% indicate they have a medium level of understanding, 29% indicate their level of understanding is in-depth.
- Many see this as a function of communications; 65% feel that auditor communication levels are adequate, with room to add more value.

In the wake of the financial crisis, improving audit quality—and reviewing the role of the audit committee in that process—has become a global priority. In fact, it may be more of a redefining process; as various bodies launch improvement initiatives around the world, audit committees must prepare for a potentially significant level of change in their responsibilities. The EU Commission Green Paper on Audit Policy (to which both CPAB and KPMG responded directly); a report issued by the UK House of Lords; public statements by the new head of Public Company Accounting Oversight Board (PCAOB) as well as other members of their board—all point to the growing prominence of the audit quality agenda and the need for audit committees to be involved and active in driving the discussion.

Highlighting the major issues in the current audit quality debate and giving attendees the opportunity to discuss them with a major Canadian regulator were the goals of KPMG's Spring 2011 Audit Committee Institute roundtable series, "Quality in Financial Reporting: Four Legs are Stronger than Three—Adding the Regulator to the Table."

To help lead and focus this dialogue, KPMG invited Mr. Hunt, CEO of CPAB, as the keynote speaker. Mr. Hunt was also invited to join our experienced panel, giving this roundtable a unique format by adding the regulatory perspective to that of audit committees, auditors and management. The audience then had the opportunity to ask Mr. Hunt and the panel questions and get practical, actionable answers on how audit committees can help ensure the quality and integrity of auditing and financial reporting.

"Our ultimate value proposition isn't based on exposing particular errors or deficiencies in individual files," said Mr. Hunt in his opening presentation. "It's really about identifying the root causes of problems—are they isolated or systemic? The issue is, what value can we bring as a regulator to improve audit quality going forward?"

This report highlights Mr. Hunt's highly informative presentation, as well as the robust panel and audience discussions that followed, with key audience survey results presented in the margins. Finally, we briefly take a second look at some of the top audit committee priorities KPMG outlined at the beginning of the year to see where audit committees stand now.

Brian Hunt Speaks on CPAB, Audit Quality and Changing Audit Policy

After spending much of their first seven years inspecting audit firms, CPAB's current strategic plan involves reaching out to other audit stakeholders, including audit committee members and—going forward—investors.

"Through regulation and by promoting independent quality auditing, we fulfill our mission of contributing to public confidence in the integrity of public company financial reporting in Canada. We believe audit committees have a significant governance role that has a real impact on audit quality."

CPAB has evolved into a legislated, regulatory body that conducts regular audit file reviews and examinations of Canadian audit firms that



All Regions (averaged)

In what capacity are you here today?

Audit Committee Chair	40%
Audit Committee Member	12%
Director (not on the Audit Committee)	14%
Management	16%
Other	18%

All Regions (averaged)

Which best describes the level and quality of communication you receive from your auditor:

Meets minimum requirements	11%
Adequate, but could add more value	65%
Exceeds our expectations	24%

Toronto

Do you feel you fully understand the steps your auditor takes to achieve audit quality?

Minimal level of understanding
22%

Medium, but would like further understanding
43%

In-depth understanding based on ongoing, meaningful communications about audit quality
35%

Vancouver

Do you feel you fully understand the steps your auditor takes to achieve audit quality?

Minimal level of understanding
16%

Medium, but would like further understanding
74%

In-depth understanding based on ongoing, meaningful communications about audit quality
10%

Calgary

Do you feel you fully understand the steps your auditor takes to achieve audit quality?

Minimal level of understanding
18%

Medium, but would like further understanding
41%

In-depth understanding based on ongoing, meaningful communications about audit quality
41%

audit public companies, all of whom must be and remain in good standing with CPAB. CPAB determines whether firms have the processes in place to deliver quality audits consistently, and if not, what specific areas need to be improved.

Main Themes in the CPAB 2010 Public Report

- Audit quality is generally sound in Canada, especially with complex files.
- Zero tolerance for audit deficiencies needs to be the cornerstone of the audit firm's ongoing efforts to improve audit quality. "Zero tolerance is not an expectation of zero mistakes; it is rather a mindset and a culture where audit deficiencies are not expected and that embodies a firm's determination to build in the policies, programs and methodologies required to drive changes in behaviour that meet the spirit and intent of existing audit standards."
- Enhanced engagement supervision and review is necessary.
- Heightened professional skepticism can improve audit execution.
- Improve coaching, mentoring and real-time reviews.
- Strengthen the role of the EQCR (Engagement Quality Control Review). "Canadian firms do a great job in hiring and training top talent, so what is driving audit deficiencies? It lies in execution. Senior auditors should exercise greater professional skepticism, challenging and mentoring their staff, better utilizing their EQCR and setting the appropriate 'tone at the top.'"
- Audit committees should play a significant role in improving audit quality.

The audit committee has a considerable and growing role in working with auditors to improve audit quality.

One area of concern to CPAB is the recent trend of audit committees demanding auditor fee reductions, anywhere from 10% to 40%.

"This trend may be fine now, but we are concerned that the commoditization of the audit may have quality and standards impacts down the road if excessively reduced fees eventually result in inadequate auditor reinvestment in talent acquisition and training."

In addition, a number of key audit policy issues are currently under broad debate, with several position papers available or on the way, including the EU Green Paper and publications from the International Auditing and Assurance Standards Board (IAASB) and PCAOB. Global changes in financial statement reporting models have led to recommended actions and leading practices that Canadian audit committees should be considering, including

- Adjust all known accounting errors. "Unadjusted errors are often accepted in Canadian audit culture, sometimes even when they cumulatively reach or exceed materiality. SEC and European regulators are far less tolerant of unadjusted errors, and Canada will eventually have to adopt this increased vigilance."
- Consider disclosure deficiencies more carefully and possibly get audit committee sign off.
- The auditor, audit committee, and management should discuss and define what is considered to be "aggressive" or "conservative" when it comes to estimates, valuations, and management practices, as discrepancies in understanding can result in significant profitability swings on the balance sheet and income statement.
- Understand where you are in the conservative/aggressive "fair value" spectrum, as this will be a huge, and new, concept under IFRS.

Other Areas to Discuss with Your Auditor

- What were the high-risk areas of the audit and how were they addressed?
- How did the audit team manage work done by other auditors? (Group audits)
- Are there areas of the company where controls or process could be improved, and how did this affect the audit?
- What were the more challenging issues on the conversion to IFRS?

The global debates on audit policy are discussing issues such as whether audits are currently fit for purpose and whether auditors should provide assurance on areas outside the

financial statement, such as the Management Discussion and Analysis, key performance indicators and business risk factors.

"I believe the audit reporting model will change substantially, and I encourage audit committees to be involved in the discussion. Proposed changes may be substantial, such as introducing a longer-form audit report."

Panel and Audience Discussion— Audit Quality

Challenges Past, Present and Near Future

- Transition to Canadian Auditing Standards
- Transition to IFRS
- Complexity of standards
- Understanding what new standards are being considered
- Discussions regarding audit scope and the evolving reporting model
- International independence standards

Comment Key

[BH] Brian Hunt

[A] Audience Member

[AC] Audit Committee Panelist

[M] Management Panelist

[AP] Auditor Panelist

With major challenges coming in 2011 and beyond, such as IFRS and fair value, audit committees will have to work hard to stay up-to-date and effectively fulfill their oversight role.

"These changes and challenges are truly daunting, and I think Canadian companies may get caught in the middle as we're pulled between increasingly complex US and European regulations and reporting models." [M]

"It's a major challenge now just to find people with the right acumen to serve on boards. The required attributes are greater, and it's more difficult than ever to populate boards and audit committees with people who can actually serve as experts and bring the appropriate experience." [A]

"We probably need a better methodology for assessing audit quality—that starts with

getting more information from auditors. We get information related to various control procedures, but no comprehensive report to the audit committee specifically addressing the issue of audit quality. CPAB can play a role in raising this awareness and making this type of information more accessible." [AC]

CPAB's most recent inspection report highlights the importance of improving communications between audit firms and audit committees. This seems particularly relevant given the current uncertain economic environment, the increase in regulatory requirements and the resulting complexity of financial reporting. Mr. Hunt was not surprised that a general majority of firms felt that auditor–audit committee communications could be improved.

"While better auditor–audit committee communication is important, I think the circuit should be closed with better auditor–CPAB communication as well. I often see auditors focusing excessively on minutiae related to compliance, when more interaction with CPAB might differentiate the major issues from the minor and make the whole process more efficient and mutually beneficial." [A]

"We get solid written communications from our auditor, but verbally, it's highly variable. Some firms may have a standard for verbal communication, but it would be nice if this could be raised across the board." [AC]

"My fear is that introducing a longer report could actually hurt auditor–audit committee communications and potentially create a confrontational environment. If the committee feels that *everything* they say to their auditor might turn up in the financial report, they are likely to clam up and provide the bare minimum of information, and in–committee exchanges will be less valuable and productive." [A]

"CPAB holds that the audit committee can play a significant role in improving audit quality." [BH] The audit committee can ask auditors the tough questions: what were the audit risks? How have they been dealt with? Was the accounting conservative or liberal? One of the best ways to assure audit quality is to understand what actually goes into a quality audit and make sure that it happens, but in each region, the number of attendees who

Toronto

To what extent are these matters being discussed at your boards and audit committees?

Little discussion to date

18%

Some discussion

41%

Robust discussion and awareness

41%

Vancouver

To what extent are these matters being discussed at your boards and audit committees?

Little discussion to date

13%

Some discussion

60%

Robust discussion and awareness

27%

Calgary

To what extent are these matters being discussed at your boards and audit committees?

Little discussion to date

36%

Some discussion

23%

Robust discussion and awareness

41%

All Regions (averaged)

Prior to today, what was your level of knowledge of CPAB and its role?

Minimal

41%

General awareness

43%

In-depth

16%

All Regions (averaged)

Is IFRS transition going smoothly?

It's been very challenging

13%

Going well with some bumps in the road

32%

Very smoothly

55%

All Regions (averaged)

Which IFRS issue is presenting the most concern?

Stakeholder understanding of effects on previously reported results

64%

MD&A adequately differentiating between changes due to IFRS vs. changes in the business

18%

Company's preparedness to manage ongoing changes in IFRS

18%

About the Audit Committee Roundtable Series

Held across the country periodically throughout the year, these interactive and panel-driven roundtable sessions bring together audit committee members and leaders in governance to discuss the challenges, emerging trends, and leading practices affecting the oversight of financial reporting and related risks. The Spring 2011 Audit Committee Roundtable series was held in June in Toronto, Calgary, and Vancouver.

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felt they had an in-depth knowledge of the process was less than 50%.

"We do our best to put top-quality people on our audit committee and ask the right questions of our auditor. We benchmark our auditors and request that they adhere to a timetable. It is getting more and more challenging, but we try to foster an exchange of views that accounts for concerns and viewpoints across the organization." [AC]

"Audit quality is always better when companies have sophisticated, effective internal controls and management. If these are not present, the audit is much harder to perform. And when they are present, the audit committee can focus on where the issues are and not worry about reporting minutiae. A quality audit is really a group effort." [AP]

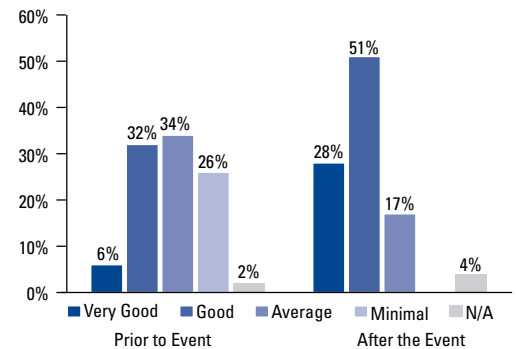
Going forward, challenges to audit quality include new auditing standards, the effects of IFRS transition and ongoing changes to IFRS; given the extent and complexity of current international and domestic business developments, there's no telling how much the pressures of change may affect the Canadian audit landscape. In this environment, boards and audit committees should be discussing these matters and deciding on specific ways to address them. While audience response shows that the majority of attendees' organizations—over 80% in Vancouver and Toronto—there was still concern that overall numbers were not higher, given the severity of the issues. While Calgary showed a high percentage who indicated robust discussions were underway, (41%), they also, curiously, had the highest percentage reporting that little discussion had occurred to date (36%).

"Our discussions go back to the transparency issue, emphasizing the need for full communication with management to ensure advanced planning and appropriate timing, especially when you get into complex and new areas." [AC]

"The comments at all the roundtables have been excellent and incisive. It's now critical that you all take these issues back to your organizations and continue the discussions there." [BH]

It was generally agreed that, while knowledge of CPAB was limited prior to the roundtable, attendees felt that they had learned a great deal, not just about the regulator's overall mission but about the practical matters they deal with.

Understanding of the topics – All Regions (averaged)



"A greater awareness of CPAB would certainly help audit committees stay abreast of any number of critical issues, but I'm not sure where that's going to come from. As an auditor, I would only bring up CPAB if the audit were under review." [A]

"A CPAB outreach program would be a great help in not only raising audit committee awareness but in helping them to formulate the kinds of questions and issues they should be raising with their auditors." [AC]

Driving the Audit Committee Agenda

At the beginning of the year, we raised a number of issues for audit committees to keep on their radars for 2011, and IFRS implementation was flagged as one of the most pressing.

"There have been a few bumps in the road. The real issue we're trying to deal with is plain-language disclosure. Standards are what they are, but I'm concerned that as audit committee members, we need to make sure readers understand what they mean." [AC]

There was general agreement among attendees that "stakeholder understanding of effects on previously reported results" was the biggest IFRS implementation issue.

"It's more a matter of management creating structure around the overall process, educating different stakeholders, including board and audit committee members, on where they should be focusing. There's just so much information—a real value-add is cutting through the complexity and creating a stakeholder-specific roadmap of the issues." [AC]

For more information about the Audit Committee Institute or the upcoming Fall 2011 Roundtable Series, please visit www.kpmg.ca/auditcommittee.