Insights from our conversations with audit committees

Introduction

The Canadian Public Accountability Board (CPAB) is Canada's independent, public company audit regulator. Charged with overseeing audits performed by registered public accounting firms, CPAB contributes to public confidence in the integrity of financial reporting and is committed to protecting Canada's investing public. CPAB promotes audit quality through proactive regulation, dialogue with domestic and international stakeholders, and practicable insights to inform capital market participants.

CPAB's audit committee outreach

Audit committees play a vital role in monitoring the effectiveness of a company's internal controls and in providing oversight of financial reporting and the external audit. They may also assist the board with risk oversight, compliance with laws and regulations, and oversight of the internal audit process.

We reach out to audit committees through one-on-one discussions, audit committee forums, audit quality symposiums, and presentations at conferences and other events. This publication offers insights gathered through these activities.

Key topics that were covered in 2023 included fraud; professional skepticism; auditor independence; the control environment; the impact of technology, including the role of service organizations and generative artificial intelligence; and environmental, social and governance (ESG) reporting.

CPAB's engagement with audit committees in 2023

- Held eight audit committee forums (135 participants attended).
- Engaged with directors of more than 277 reporting issuers.
- Engaged with reporting issuers representing a market capitalization of $1.9 trillion.

Fraud

In discussions regarding the role of the auditor in mitigating fraud risks, audit committees shared some examples of important considerations:

- The auditor's understanding of management's compensation arrangements including how this may lead to incentives to manipulate financial results.

- The auditor's attendance at corporate earnings calls to understand the views of analysts, where the expectations could motivate management.

- The audit committee's role in encouraging a comprehensive and open-ended discussion with the auditor regarding how fraud could occur at their entity.

Audit committees engaged with us on how they evaluate their organization's anti-fraud controls and processes, including their whistleblower program, which are required for public companies in Canada. An ineffective program may be indicative of weaknesses in the entity's control environment.

Practical perspectives shared on whistleblower programs include:

- There is value in audit committees understanding the nature of the information that is reported through whistleblower programs, including asking for more details when concerns are raised relating to human resources, supplier relationships and financial reporting.

- A lack of tips from the whistleblower program is seen by some audit committee chairs as a weakness in the system, or as a lack of awareness of the program, not as an indication that no issues exist.

Importance of professional skepticism

On the topic of professional skepticism, audit committee members have noted the high level of skepticism that needs to be applied by all parties, including the external auditor, to evaluate judgmental areas.

As it relates to their review of the financial statements, audit committees noted a number of areas to consider including:

- Whether management has sufficient capabilities, and should an external expert be engaged.

- Whether the various scenarios that are being used to support financial information are reasonable, and should the committee challenge assumptions that appear more aggressive.

- The quality of management's budgeting and forecasting, changes in future cashflow and projected financial capacity, and assessing whether growth rates that were projected in the past were achieved.

Where significant judgment needs to be applied, audit committees have raised awareness of the potential need for financial statement disclosure, with going concern close calls noted as one such area.

In their oversight of the auditor:

- Audit committees have stressed the importance of communication with the external auditor and management. This might include a discussion on the timing of the issuance of the financial statements to ensure that the external auditor has sufficient information to opine on the financial statements, and whether disclosures are appropriate.

- Some audit committees have found it useful to have direct discussions with the external auditor's specialists, saying that this practice provides the opportunity to assess their expertise and gain a better understanding of the reasonableness of management's forecasting range and point estimate.

Auditor independence

Audit committees continue to raise concerns over the external auditor's independence. Examples shared of threats to auditor independence include familiarity with, or the provision of, non-audit services.

In order to maintain auditor independence, audit committee members have commented on the importance of audit firm selection being led by the board, not management.

Practical examples shared include:

- The audit committee taking the lead in assessing audit partner candidates when audit partner rotation is required. This includes interviewing a short list of partners and assessing their experience and ability to speak candidly with the audit committee on challenging issues.

- How the audit committee could enhance their understanding of the auditing process by carefully assessing the audit plan and proposed audit engagement team rather than delegating these responsibilities to management.

Considerations for audit firm rotation and evaluation

Even though Canada has no requirements to rotate audit firms, some institutional investors have begun withholding their vote for the reappointment of auditors with long tenure. In such cases, the resulting lower voting percentage has increased the attention of audit committees on this topic.

Many audit committees we have met with continue to believe that the number of years of tenure is not, alone, a reason to rotate audit firms.

Practical considerations on this topic shared by audit committees include:

- Audit committees have found audit quality indicators – quantitative measures about the external audit – useful to support their evaluation of the auditor.

- Several audit committees have increased the depth of their discussion of the evaluation of the auditor in their management information circular. This includes details of the actions taken by the audit committee to evaluate the auditor using a comprehensive review, audit quality indicators or other techniques to evaluate their auditor.

- Where the reporting issuer had conducted a tender and reappointed the incumbent auditor, audit committee chairs noted the importance of disclosing this in their public documents to ensure better transparency of the audit committee’s evaluation.

- Several audit committee chairs indicated they had met with some of their institutional investors to provide more information about the audit committee’s auditor evaluation and reappointment process.

Where audit committees have elected to tender, some have found that the announcement of their intentions for a future year can be helpful in improving auditor choice by enabling firms to clear potential conflicts in order to bid for the engagement. Upon appointing a new auditor, audit committees of larger reporting issuers have commented on how they have leveraged internal audit functions to oversee the complex process of managing the transition.

Control environment

The digitization of business processes and financial transactions is resulting in a more complex control environment. It is becoming more difficult for an auditor to complete their audit without reliance on internal controls.

Examples of how audit committees are addressing this development include:

- Audit committees are asking auditors to identify where internal controls were not relied upon, and are discussing internal control deficiencies.

- Where internal control deficiencies continue to exist, audit committees are asking for quality indicators that measure how long it will take management to remediate the control deficiencies.

Technology

Service organizations

Reporting issuers are using third-party IT organizations to optimize their business operations. Examples include cloud services, third-party e-commerce platforms, and managed IT services. Audit committees have noted their oversight in this area, including:

- Obtaining an inventory from management of the number and scope of these third-party relationships, how they are being managed and controlled, and the safeguards over how the reporting issuer's data is being stored and used.

- Inquiring about management's processes to review the quality of the internal controls at these service organizations including obtaining the service organizations' control reports, and whether these reports have been assessed by both management and the external auditor.

- Inquiring about the cyber due diligence conducted when engaging and monitoring third-party providers, and access to the information needed to evaluate the impact of a cyberbreach when data is being exchanged with third parties.

Generative artificial intelligence (AI)

At this point, audit committee chairs indicate they have not seen widespread use of artificial intelligence tools within the finance function of reporting issuers. Some audit committee chairs are finding this to be a good time to ensure appropriate policies are in place to govern its use.

Generative AI is likely to transform financial reporting and the external audit processes, but it will be important for the external auditor to understand how and when the reporting issuer is using these tools.

Environmental, social and governance matters

ESG is a trending topic for audit committees as standards and disclosure requirements continue to evolve and corporate practices mature. A number of audit committees commented on the following:

- That their boards are delegating to them responsibilities for how ESG matters are measured and reported on.
- Designing and testing appropriate disclosure processes and controls.
- Investor interest in how their companies account for material climate-related risks and decarbonization commitments in their audited financial statements.
- Social matters as an important area for consideration. Examples raised include the oversight of businesses with global supply chains. The desire for their vendors to comply with changing regulatory requirements as well as diversity, equity and inclusion.
- Some chairs have raised the positive impact that diverse committees have had in reaching fair and balanced decisions, and in mitigating the risks of unconscious bias, for example in dealing with whistleblowing complaints.

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