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BEYOND COMPLIANCE

Succeeding amid change and uncertainty: Action plans for audit committees

Strengthening investor confidence

Regulators in Canada and other jurisdictions are considering new measures to reassure investors of the value of audited financial statements.

Appointing the auditors

Regulators have long feared that an auditor's objectivity diminishes when the auditor works with management over an extended audit relationship.

To reduce management's influence over the auditor, the audit committee was made responsible for the organization's relationship with the auditor. Partner rotation was implemented because regulators felt new audit leaders would refresh the relationship and introduce new perspectives. Some regulators believe mandatory firm rotation may better ensure auditor neutrality and objectivity while others suggest that mandatory periodic tendering would demonstrate that the audit committee is effectively performing its responsibilities for appointing and overseeing the auditor.

In Canada, the Chartered Professional Accountants of Canada (CPA Canada)-Canadian Public Accountability Board (CPAB) sponsored Enhancing Audit Quality initiative recommends further empowering audit committees in their responsibility for appointing, evaluating, remunerating and retaining the auditors. It believes more transparent communications with regulators and stakeholders will improve audit committee effectiveness and better enable stakeholders to understand the work done by the auditor. Audit committees, therefore, should consider providing a greater discussion of the auditor appointment process in the report to shareholders, including the selection criteria, the request for proposal process and results, the names of the decision makers, whether the proposed fees were comparable, and so on.

Evaluating the auditors

Several new initiatives are underway to provide audit committees with a more precise and disciplined auditor evaluation process. For example, a questionnaire has been developed for evaluating the auditor's performance, which covers partners' competency, the firm's performance with regard to third-party inspection programs, relationships with management, communications with the board, fair fees, and more. The questionnaire, endorsed by the Enhancing Audit Quality initiative, formalizes the performance interviews and helps audit committees document their conclusions and support their decision to re-engage the auditor or not.

In the U.S., the Public Company Accounting Oversight Board launched an initiative to define a quality audit. It looks at factors related to the audit strategy, including the audit team's expertise, industry knowledge and experience; the time partners and managers spend on the audit; the time spent identifying and addressing audit risks; consultations with others; outsourced work; firm policies; compensation policies; and so on.

Audit committees should consider integrating the principles and practices recommended by these initiatives in their auditor assessment process.

Audit committee action plan…

- Engage in a meaningful discussion of audit risks and the independent auditor response particularly in areas requiring significant judgment and estimates.
- Assess whether a "healthy tension" exists amongst management, independent auditor and the audit committee.
- Get more involved in the evaluation of the independent auditor.
- Disclose the Committee's role in achieving high quality financial reporting.
- Actively participate in regulatory developments.

Remunerating the auditor

Many regulators, including CPAB, are concerned that continuing pressures on audit fees could result in audit becoming a commodity, lead to lower quality audits, cause some audit firms to shift to providing non-audit advisory services, and force some audit firms to exit the audit market altogether.

Some audit firms want to base fees on the value of the audit, noting that audits generally contribute to an organization's lower cost of capital, better analyst reviews and a stronger marketplace reputation. Other proposals suggest that audit fees should be set by regulators.

When discussing audit fees, audit committees should consider the complexity of the organization, requirements to which the audit is submitted, the auditor's performance, and other factors, as well as expanding the audit fee discussion in the annual report beyond the minimal information required by regulation.

Reporting to shareholders

Regulators around the world are considering approaches to provide stakeholders with more information about the quality of financial reporting.

One proposal would require an AD&A (auditor's discussion and analysis) to provide the auditor's perspective on the financial reports similar to the MD&A (management's discussion and analysis), which provides management's perspective. Stakeholder feedback is being sought on the proposed content of the auditor's report, including clarifying the auditor's responsibility for fraud discovery, the going concern assertion, the length of the auditor's tenure, and the discussion of critical or key audit matters the auditor encountered during the audit.

Another proposal would require audit committees to explain how they ensured that the audit plans were appropriate, including risk identification and response; that all significant audit issues were addressed appropriately; and that sufficient evidence was obtained to support the auditor's opinion.

Yet another proposal is to provide a discussion of the results of audit firm inspections performed by the regulators, though current practices and laws prohibit CPAB inspection findings from being shared with organizations other than the audit firm under review. However, a proposed protocol for communication of inspection findings with audit committees recently released for comments by CPAB is expected to assist auditor performance assessment by the audit committee. An additional step towards greater transparency is the recent release by the Canadian Securities Administrators (CSA) of proposed amendments to National Instrument 52-108, *Auditor Oversight,* which would give the CSA greater insight into situations where CPAB has imposed significant remedial actions on an audit firm.

Audit committees may wish to consider the impact these proposals would have if they are implemented. For example, audit committees may want to discuss with the auditor the critical audit matters that would need to be discussed in the auditor's report. They may also want to review their report to shareholders to determine whether they should better explain how they satisfied themselves that the financial statements are fairly presented and free of material error.

In summary

More transparent communication with stakeholders about the audit and audit committee decisions may be the best way to close the expectation gap that exists between what stakeholders believe an auditor does and the auditor's actual work. To do so, audit committees and the auditor need to replace boilerplate statements with a more complete discussion around what was tested, who undertook the tests, the test findings, difficulties that were encountered, and the meaning of the overall conclusion.

To download the full report or connect with one of our Deloitte experts, please click here: www.deloitte.com/ca/successfulauditcommittees.

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