

## Guidance and Tools for Audit Committees

Chartered Professional Accountants of Canada (CPA Canada) has issued new publications to help audit committees enhance their oversight of the external auditor. They were developed with input from a group of senior audit committee members along with the Institute of Corporate Directors (ICD) and the Canadian Public Accountability Board (CPAB). Here's what you need to know about the guidance and tools.

### What are the guidance and tools for audit committees?

The guidance includes an overview of activities that audit committees perform to assist them to oversee the external auditor. Two companion publications include practical tools to assist audit committees to conduct an annual assessment of the external auditor, and a periodic comprehensive review of an audit firm. The guidance reflects the [Protocol](#) issued by CPAB in March 2014 for increasing information made available to audit committees about CPAB inspection findings.

### Why were the guidance and tools for audit committees developed?

The publications are a result of the recommendations and conclusions of the [Enhancing Audit Quality \(EAQ\) initiative](#) completed by CPA Canada and CPAB in 2013. Among the recommendations, the EAQ report called for specific steps that audit committees and audit firms should take to enhance audit quality. These included performing a comprehensive review of the external audit firm at least once every five years, conducting annual assessments of the external audit firm, and providing increased transparency to audit committees on CPAB's inspections.

### Who are the materials intended for?

These materials are intended to be used by all audit committees when performing their oversight role of the external auditor. Audit committees are expected to use judgment in determining the scope, timing and processes to be followed in performing the activities that help audit committees perform their oversight role.

### What are the expected benefits from using this guidance?

Although the guidance is non-authoritative, it has been developed to improve the consistency of audit committee oversight of the external auditor. There is currently significant variation in the process audit committees go through in recommending an external auditor. The components of the annual assessment are not considered to be a change in regulation or mandate of the audit committee, but may lead to more robust activities by some audit committees. However, with respect to the comprehensive review, the guidance introduces new procedures for audit committees in their auditor oversight role to enhance quality.

Both the annual assessment and comprehensive review will produce opportunities for improvement. If an audit committee is not satisfied with the results of its reviews, it will need to discuss its concerns with the auditors. If it cannot resolve issues satisfactorily, the audit committee should raise the matters with the board of directors to determine whether to put the audit out to tender.

The guidance offers significant benefits for audit committees, including improved communications with their external auditors, augmented understanding of risk and control issues, better alignment of the audit process with principal business and financial reporting risks, improved feedback to management, and enhanced quality of the issuer's financial reporting.

A comprehensive review is a key element in the audit committee's oversight of the external auditor in addition to an annual assessment because it permits the audit committee to:

- recommend whether to hire or retain the external auditor it considers the best for the entity
- consider and recommend the timing of any change in external auditor
- hone the audit committee's skill in overseeing the external auditor and enhancing audit quality.

### **How should the guidance and tools for audit committees be used?**

The overview publication summarizes certain responsibilities of audit committees of Canadian reporting issuers and the activities that help audit committees meet those responsibilities. It also presents best practice guidance for each activity. The guidance will be of particular interest to those wishing to gain an overall understanding of the audit committee's role in overseeing the work of the external auditor.

The guidance also provides useful context for two companion publications, *Annual Assessment of the External Auditor* and *Periodic Comprehensive Review of the External Auditor*, that feature practical tools for audit committees to use in conducting annual assessments and periodic comprehensive reviews (at least once every five years) of the external auditor.

### **When should the guidance and tools for audit committees be used?**

Each year, audit committees should assess the audits performed by the external auditors. This helps audit committees fulfill their responsibility to make an informed recommendation to the board on whether or not the external auditor should be put forward in the proxy material for reappointment at the annual general meeting.

The annual assessment process is usually completed in time for the audit committee to be able to recommend to the board if the external auditor should be put forward in the proxy for reappointment at the annual general meeting. However, the tools are designed to allow audit committees the greatest flexibility possible to enable them to carry out the assessments when they best fit into the regular audit committee meeting schedule. Accordingly, different audit committees will use the annual assessment tool in different ways. For example, if there is very little time between the completion of the audit and the approval of the proxy, an audit committee may decide to substantially complete the annual assessment at an earlier meeting with final confirmation of preliminary conclusions at the meeting in which the audit is completed and the proxy approved. Therefore, the audit committee needs to determine the most appropriately timed meeting for discussion of the external auditor's annual assessment. It is best to conduct the annual assessment while the most recent audit is still fresh in audit committee members' minds. Further, it is often advantageous to discuss the annual assessment and the current year's audit strategy at the same meeting so the current year's audit strategy can incorporate suggestions for improvement from the annual assessment.

A comprehensive review should be conducted at least every five years. The audit committee should consider matters that have arisen since the last comprehensive review. Where there has been no previous comprehensive review, the audit committee will need to determine when the first comprehensive review should be performed and what period the review should cover. It may be appropriate to conduct a comprehensive review before having five years' experience of annual assessments of the external auditor. For example, an earlier comprehensive review may be advisable on the initial application of the guidance in this publication if the audit firm's tenure is already long. More frequent comprehensive reviews may be needed if problems are identified or another triggering event occurs, such as a change in the entity's corporate structure. The comprehensive review should be coordinated with the ongoing rotation of the engagement partner and other senior firm personnel.

It may not be necessary to conduct a comprehensive review within five years of the prior comprehensive review if the audit has been put out for tender during the five-year period (for example, due to a change in the corporate structure).

The comprehensive review tool includes all the questions that are contained in the annual assessment tool as well as the additional areas to be covered in a comprehensive review on the assumption that in the year of a comprehensive review the audit committee will likely combine the annual assessment and comprehensive review activities. Audit committees are expected to use and modify the tool in whatever way makes most sense to allow for effective reviews that fit within an audit committee's meeting and agenda cycles.

#### **Why does the audit committee perform a comprehensive review of the external auditor?**

Concerns have been raised about familiarity and self-interest threats between external auditors and the entities they audit at the institutional level. Such threats have become known as "institutional" familiarity threats. There is a perception that, after an extended period of time, the relationships between external auditors and their clients become too close. This familiarity may create a threat to independence that impedes the ability of the external auditor – and specifically the engagement team members – from exercising appropriate professional skepticism.

The Enhancing Audit Quality (EAQ) initiative, a joint project of CPA Canada and CPAB, examined how to enhance audit quality in light of global developments.<sup>1</sup> The initiative considered various alternatives for safeguarding against institutional familiarity threats, ranging from subjecting external auditors to term limits to calling for mandatory tendering of audits. The initiative's report *Enhancing Audit Quality: Canadian Perspectives* concludes that the alternative most likely to enhance audit quality is for audit committees to carry out a comprehensive review of the external auditor at least every five years. Such a comprehensive review is considered to be in the best interests of stakeholders, as opposed to a "one size fits all" requirement that does not account for the particular circumstances of the entity and its stakeholders. Moreover, the comprehensive review would require both audit committees and external auditors to focus significant attention on indicators of audit quality and the exercise of professional skepticism, which the alternatives do not.

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<sup>1</sup> The EAQ initiative, *Enhancing Audit Quality: Canadian Perspectives*, was a collaboration of the Chartered Professional Accountants of Canada (CPA Canada) and the Canadian Public Accountability Board (CPAB) to examine how to enhance audit quality in light of various global developments. Further information about the EAQ initiative can be found at [www.cpacanada.ca/enhancingauditquality](http://www.cpacanada.ca/enhancingauditquality).

The comprehensive review considers observations from the most recent audit as well as observations and trends from all other audits within the review period. The results of prior-years' annual assessments are an important source of information in conducting a comprehensive review. The comprehensive review is deeper and broader than an annual assessment. For example, the annual assessment focuses on the engagement team, the engagement partner, their independence and objectivity and the annual quality of audit work performed; the comprehensive review focuses on the audit firm, its independence and the application of professional skepticism. The passage of time allows the audit committee to identify issues that may not be readily apparent on an annual basis, for example:

- the impact of the tenure of the audit firm on audit quality
- trends in the audit firm's performance and expertise in a particular industry
- incidences of independence threats and the effectiveness of safeguards to mitigate those threats
- the responsiveness of the audit firm to changes in the entity's business and suggestions for improvement from regulators, the audit committee and/or management
- the consistency and rigor of the professional skepticism applied by the external auditor, for example, when challenging management's significant accounting judgments
- the quality of the engagement team and its communications.

### **What does an audit committee use the results of the annual assessment and comprehensive review for?**

When the annual assessment is complete, the audit committee will be in a position to recommend whether the board should nominate the external auditor for reappointment for a further year. Keeping a record of each annual assessment, for example, in written reports or in meeting minutes, may assist the audit committee when performing a subsequent annual assessment or comprehensive review of the external auditor. The audit committee may identify matters to be raised with the auditor for immediate follow-up or changes in the future to help auditors continually improve their performance. The audit committee may also identify actions it should take in the coming year to improve its own processes.

When the comprehensive review is complete, the audit committee will be in a position to recommend to the board whether to retain the current audit firm or put the audit out for tender. The audit committee may also recommend other actions to the board, such as the timing of the next comprehensive review, or changes to the entity's policies dealing with such things as the hiring of audit firm staff or the provision of non-audit services. Similar to an annual assessment, the audit committee may identify matters to be raised with the auditor for follow-up or future changes, and potential changes to the annual assessment, comprehensive review or other audit committee processes.

If the audit committee decides to advise the board to put the audit out for tender, the audit committee will need to consider the next steps, including the process, timing and communications required.

Once the board has reviewed and approved the results of the comprehensive review, it should determine the nature and extent to which the results are to be communicated to management, the audit firm, and any other parties it believes should be informed, such as regulators.

Public disclosure by the audit committee of the comprehensive review provides transparency to stakeholders about the review process. In preparing such a public report, the audit committee may need to seek legal advice on when, how and where in the entity's regulatory and other documents to communicate the results of the review.

### **Where can I find the guidance and tools for audit committees?**

The guidance and tools for audit committees can be found on CPA Canada website under "[Enhancing Audit Quality in Canada](#)".