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Audit Committee Institute – Canada

Game-changing developments in Europe and the United States

Implications for Canadian Audit Committees

Fall 2011 Audit Committee
Roundtable Series



Today's discussion

- **Proposed changes from EC Green Paper on Audit Policy**
- **Public Company Accounting Oversight Board (PCAOB) concept releases**
- **What does this mean to audit quality and the role of the Audit Committee?**

In what capacity are you here today:

1. Audit Committee Chair
2. Audit Committee Member
3. Director (not on the Audit Committee)
4. Management
5. Other

Introduction



Background 1/2

- **Financial crisis of 2007/2008 and beyond**
- **Focus on role of various stakeholders:**
 - Wall Street, Ratings Agencies, ... Auditors, Audit Committees
- **Unqualified auditors' opinion followed, in certain cases, by failure of large institutions**
- **Should auditors have done something differently?**
- **Should auditors have predicted some of the collapses?**
- **Should Audit Committees have done something differently?**

Background 2/2

- **Various groups in the EU and the US have been assessing what steps need to be taken**
- **EU: European Commission led by Internal Markets Commissioner Michel Barnier; UK House of Lords**
- **US: Public Company Accounting Oversight Board (PCAOB concept releases)**
- **Other activities from regulatory bodies (CPAB, OSFI, IFIAR, etc.)**

European Commission Green Paper on Audit Policy: Lessons from the Crisis



EC draft proposals – status

- **European Parliament’s report to the Commission, voted on 13 September, more measured than the Commission’s proposals**
- **Commissioner Barnier consulted within the EU**
- **Proposals tabled on Nov 30, 2011**
- **The Commission seems determined to try to bring about significant changes to market structure**
- **Large firm market concentration and auditor independence are the headline areas of focus**

Update on proposals – background

We have reached an important milestone in the EC's Audit Reform proposals, which are a key part of Commissioner Barnier's review of European regulatory infrastructure...

- **Oct 2010**
 - Issuance of Green Paper
- **Dec 2010**
 - Closing of consultation
- **Sept 2011**
 - Adoption of the European Parliament of Committee report
- **Oct 2011**
 - Leak of EC proposals (in circulation for Inter Services Consultation)
- **Nov 2011**
 - Publication of final proposals

Proposals are in two separate instruments:

- *Directive* – binding on Member States as to objectives to be achieved, but provides discretion on how to do so. Require enactment by Member States before becoming effective
- *Regulation* – directly applicable and binding throughout the EU. Equivalent to national law in each Member State

The more radical proposals are included in the Regulation

...and the legislative process will take 18 to 24 months (or longer) with an effective date two years after entry in the Official Journal

Update on proposals – the key proposals

Audit-only firms	<ul style="list-style-type: none"> • Intended to change Big 4 within EU • > 1/3 annual audit revenue from large PIEs • Part of network with audit revenues > € 1.5 bn within the EU
Limits on non-audit services	<ul style="list-style-type: none"> • Essentially a ban on all non-audit services as permitted items are mostly extensions of audit • Some concessions, with Audit Committee and Competent Authority approval
Mandatory joint audits	<ul style="list-style-type: none"> • Mandatory requirement dropped • Voluntary joint audits enable extended rotation
Mandatory joint firm rotation for all PIEs	<ul style="list-style-type: none"> • Maximum tenure = 6 years (extendable to 8) • If joint audit, max = 9 years (extendable to 12) • Minimum 2-year appointment; 4-year cooling off
Require audit firms to disclose financial information	<ul style="list-style-type: none"> • Audited financial statements of EU member firms • Combined audited financial statement of network
Mandated changes to audit reports/ auditor communications	<ul style="list-style-type: none"> • Demonstrates lack of understanding of what an audit is

EC's key draft proposals

Prohibition of non-audit services (Art. 10)

- Prohibition of services other than related financial audit services (i.e. review of interims, accounting reviews, assurance on corporate governance statements, CSR etc.)
- Cap on such related financial audit services: 10% of audit fees (Art. 9)
- List of explicitly prohibited services (Art. 9), i.e.
 - Tax consultancy and advisory services
 - Due-diligence services
 - Internal audit services
- Where firm has $> 1/3$ audit revenues from large PIEs and belongs to a network with combined audit revenues > 1.5 bn € - it shall not provide services other than statutory audit services or related audit services within the Union

EC's key draft proposals

Audit Report (Art. 22)

- List of 23 minimum reporting items, including:
 - “(h) how much of the balance sheet has been directly verified and how much has been based on system and compliance testing”
 - “the audit report shall not be longer than four pages or 10,000 characters (without spaces)...”

Additional Internal Report (Art. 23)

- Addressed to the Audit Committee
- List of 14 minimum reporting items, including “(f) indicate and explain judgments about material uncertainty that may cast doubt about the entity’s ability to continue as a going concern”

Duty to report to supervisors of PIEs (Art. 24)

- Any material breach of laws
- The impairment of the continuous functioning of the PIE
- A refusal to certify financial statements or the expression of reservations.

PCAOB



Overview

PCAOB has issued two concept releases

1. Auditor's reporting model – June 21, 2011, comment period ended
2. Auditor Independence and audit firm rotation, August 16, 2011, comments due by December 14, 2011

Auditor's Reporting Model



Background

- **Based on concerns of investors and other users of financial statements**
- **Auditors have significant information regarding financial statements and the audit that is currently not reported**
- **This information could be useful to investors and other users of financial statements**
- **Potentially lead to more efficient markets and improved allocations of capital**

Stated purpose

Discuss alternatives for changing auditor's reporting model that:

- Increase its transparency
- Increase relevance to financial statement users
- Does not compromise audit quality

Alternatives being considered

- **An auditor's discussion and analysis**
- **Required and expanded use of emphasis paragraphs**
- **Auditor assurance on other information outside the financial statements**
- **Clarification of language in the standard auditor's report**
- **Alternatives are not intended to be mutually exclusive**

Intentions of the alternatives

- **Retain the pass/fail opinion of current model**
- **Not intended to alter the auditor's responsibility to obtain sufficient and appropriate audit evidence**
- **Not intended to qualify or piecemeal auditor's opinion or shift the requirement to assess the risk of material misstatement from the auditor to investors or other users**

Other considerations

Could result in increased scope of audit procedures

- Likely would require new auditing standards
- Increased cost

Auditor's discussion and analysis

- **Provides auditor with ability to discuss views**
- **Type of information included**
- **Not intended to provide separate assurance on individual balances, disclosures, transactions or any other matters discussed**

Required and expanded use of emphasis paragraphs

- **Currently not required but may be included at auditor's discretion**
- **Auditor could be required to comment on key audit procedures performed related to the identified matters**

Auditor assurance on other information

- **Could improve the quality, completeness, and reliability of such information and provide investors and other users of financial statements with a higher level of confidence in that information**
- **Auditor currently not required to provide assurance on earnings releases, non-GAAP information, or MD&A**
- **Companies have the ability to retain the auditor to provide some level of assurance under PCAOB standards**
- **Implementing this alternative might require the SEC to develop new management reporting requirements and the PCAOB to develop additional professional standards**

Clarification of language in the standard auditor's report

Possible language and concepts that could be clarified include:

- Reasonable assurance
- Auditor's responsibility for fraud
- Auditor's responsibility for financial statement disclosures
- Management's responsibility for the preparation of financial statements
- Auditor's responsibility for information outside of the financial statements, and auditor independence

Considerations

- **Could result in increased scope of audit procedures**
- **Would require new auditing standards**
- **Increased cost**
- **Affect on audit quality**
- **Affect on audit committee oversight**
- **Compromised confidentiality and competitive positioning**
- **Could affect ability to meet current filing deadlines**
- **Auditor communicating financial statement information directly to users**

Other steps

October 11, 2011: PCAOB proposed amendments to improve transparency through disclosure of engagement partner and certain other participants in audits

- Comments due January 9, 2012

Auditor Independence and Audit Firm Rotation



Background

The PCAOB recently issued a concept release on auditor independence and mandatory audit firm rotation

- The concept release requests input on ways auditor independence, objectivity, and professional skepticism could be enhanced
- Primarily focuses on the issue of mandatory audit firm rotation

The idea of mandatory audit firm rotation is not new

- Congress considered this during debates on the Sarbanes-Oxley Act
- The Government Accountability Office (GAO) studied the matter in 2003 and concluded it may not be the most efficient way to enhance auditor independence and audit quality
- In light of the PCAOB's experiences since its inception and the various proposals being considered outside the United States for auditor regulation, the PCAOB believes it is time to reconsider this matter

Historical perspectives on mandatory audit firm rotation - opponents

The concept release cites views of historical opponents of mandatory audit firm rotation; audit quality could suffer:

- Changing audit firms may increase the risk of an audit failure due to a steep learning curve
- Would add significant cost and disruption to issuers
- Independence could suffer as firms knowing that the audit relationship is coming to an end, would use the time to focus on marketing future non-audit services to the audit client
- A limited choice of alternative audit firms could exist, particularly for large multinationals, due to factors such as:
 - Geographic reach
 - Industry expertise
 - Sufficient capacity
 - Performance of non-audit services that may impair independence of alternative audit firms

Historical perspectives on mandatory audit firm rotation - proponents

The concept release cites the following views of historical proponents of mandatory audit firm rotation:

- Setting a limit on the continuous stream of audit fees from one client would free the auditor, to a significant degree, from the effects of management pressure
- Opportunity for a fresh look at the company's financial reporting
- The auditor would know its work would be scrutinized in the future by a competitor, which may increase the incentive to enhance audit quality
- Mandatory audit firm rotation could fundamentally change an audit firm's relationship with its audit client, which might significantly enhance the auditor's ability to serve as an independent gatekeeper

Other alternatives to enhance auditor independence

The PCAOB also requested comments about other measures that could enhance auditor independence, objectivity, and professional skepticism. Examples the PCAOB cited for consideration include:

- Enhancements to audit committee oversight to improve auditor independence
- Enhanced or improved PCAOB inspection process focused on professional skepticism
- Mandatory joint audits
- A requirement for audit committees to solicit bids on the audit after a certain number of years (i.e. mandatory tendering, with option to stay with incumbent auditor)

Mandatory audit firm rotation – other considerations 1/2

In light of the possibility that the PCAOB could decide to move forward with a mandatory audit firm rotation requirement, the concept release requests comment on implementation issues, including the following:

- What is the appropriate transition period prior to implementing mandatory audit firm rotation?
- Should limitations exist on an issuer to remove an auditor before the end of a fixed term?
- What is the appropriate term limitation and should it vary for different types of issuers?

Mandatory audit firm rotation – other considerations 2/2

Should a mandatory audit firm rotation requirement be limited to just a subset of issuers?

What measures should be taken to address the risks of mandatory audit firm rotation? Potential examples cited include:

- Enhancements to audit firm's quality control systems
- Additional audit supervision and oversight in the first few years of a new engagement
- Increased communication between predecessor and successor auditors
- Application of certain other audit procedures

Summary and next steps

Fundamental questions PCAOB is seeking input on:

- Whether mandatory audit firm rotation would enhance auditor independence, objectivity and professional skepticism
- Advantages and disadvantages of mandatory audit firm rotation
- Impact on audit quality and costs

Comments on the concept release are due December 14, 2011

The PCAOB announced plans for a public roundtable in March 2012



And Now ...

What Do You Think?



Prior to our discussion this morning, what level of awareness did you have surrounding the proposed changes and questions coming from the EC and PCAOB?

1. No awareness
2. Some awareness
3. High level of awareness

How relevant do you feel these developments are to your audit committee oversight duties?

1. Not relevant
2. Somewhat relevant
3. Highly relevant
4. Unsure

Panel Discussion



Panel discussion

- **What are your overall views on these developments?**
- **If the primary objective is improving audit quality, are these proposals going in the right direction?**
- **Proposals /considerations are emanating from Europe and the US, what does it mean for Canada?**

Currently, the decision to tender your audit remains fully with the audit committee. How do you feel about proposed changes to your role?

1. Should remain fully with the AC
2. Remain with the AC with guidelines from the regulator
3. Auditor rotation should be mandated by regulation
4. Unsure

Panel discussion

Now let's drill down into some of the specifics.

**Can we get your reaction to the market concentration/
mandatory firm rotation proposals?**

- Are joint audits to extend tenure a step in the right direction?
- Are “audit only” firms part of the solution?
- What are your thoughts on mandatory audit firm rotation?

Panel discussion

Auditor's reporting model:

- Do you feel the auditor's standard report is due for a revamp, and if so, what should be the areas of focus?
- Is there value in an Auditor's Discussion & Analysis ("AD&A")?
- Do you support auditors reporting on information outside of the financial statements?

What Does this Mean for the Role of the Audit Committee and Audit Quality?



The issues

- **Is there sufficient competition in the audit market?**
- **Do long term audit relationships threaten independence and impair audit quality?**
- **Do we need change?**
 - In the relationship between auditor and audit committee
 - In the role of the auditor
 - In the role of the audit committee

Audit quality and the role of the audit committee

- **The evolving role of the audit committee**
- **The current relationships among auditor, audit committee and management**
- **Proposed changes to these relationships**
- **Assessing audit quality**
- **What are the implications of the global developments in the role of the Canadian audit committee?**

Do you understand the factors contributing to high audit quality?

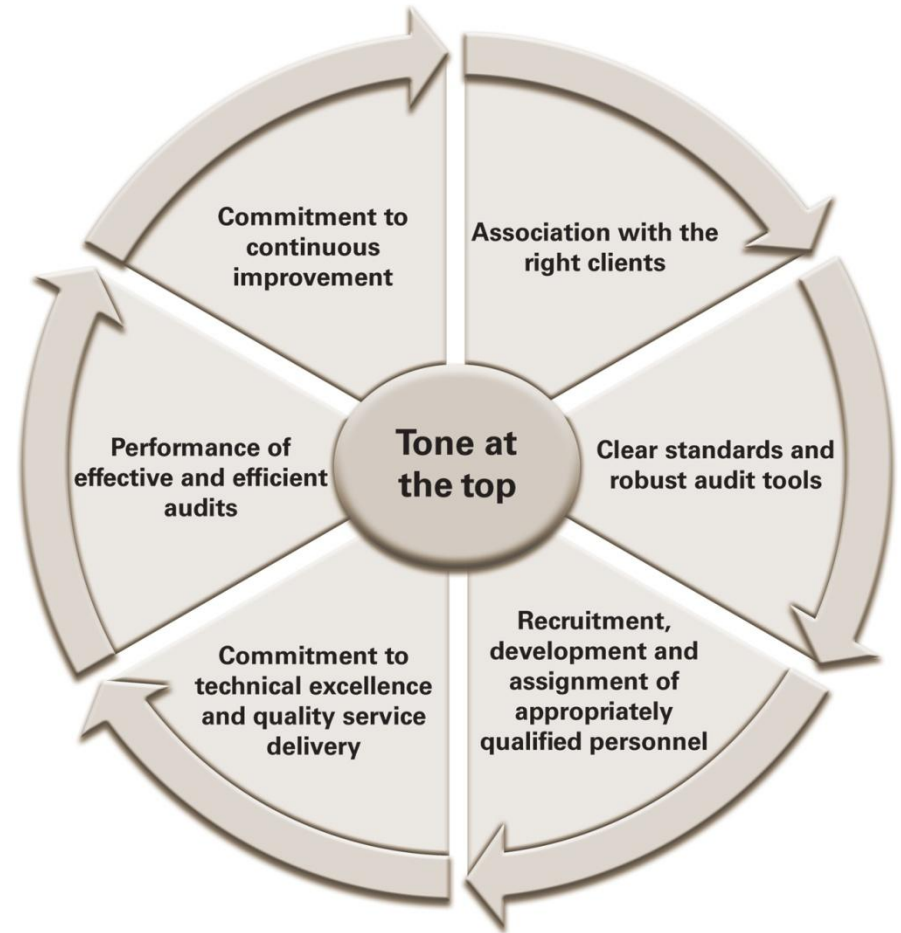
1. High understanding
2. Medium understanding
3. Low understanding

As an Audit Committee, do you discuss and assess audit quality with management and your auditors?

1. Frequently discuss
2. Occasionally discuss
3. Seldom discuss

What is audit quality?

- **Process vs. final audit opinion**
- **Process, technical excellence, commitment**
- **Open, transparent discussions between auditor, audit committee, management**
- **Relationships are key**



How do you assess audit quality?

- **What questions should you ask your auditor?**
- **What questions should you ask management?**
- **What role does the regulator play?**

Last spring, we asked about your depth of understanding of the steps your auditor takes to achieve quality. Let's ask you again:

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

1. Minimal level of understanding
2. Medium, but would like further understanding
3. In-depth understanding based on ongoing, meaningful communications about audit quality

Audit quality – results comparison

Now let's look at your responses from 6 months ago:

Minimal level of understanding	22%
Medium, but would like further understanding	43%
In-depth understanding based on ongoing, meaningful communications about audit quality	35%

Closing Notes

*Please Join Us For
Another Cup of Coffee*



Thank you for your participation today

We hope to see you at
the Spring 2012 Audit
Committee Roundtable

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