CCAQ THE CANADIAN CENTRE FOR AUDIT QUALITY

Comments on audit quality and firm tenure

As boards and management teams plan for their upcoming annual general shareholder meetings, they should consider a trend in Canada that has emerged during the proxy voting seasons over the past few years. Votes in support of audit committee directors and the external auditors have been declining. Why? Because some investors and proxy voters have determined that a time limit for an audit relationship is necessary. This is based on a presumption that long tenured auditor relationships create a familiarity threat and impair the objectivity and independence of the external auditor, impacting audit quality. If an audit firm's tenure exceeds the arbitrary time limit that investors believe is appropriate, they will withhold votes for auditors and the audit committee members who recommended them.

It is difficult for us to establish exactly who votes for and against motions and resolutions at shareholder meetings, which may provide additional insights into why this voting trend is happening. Direct engagement between audit committees and investors will provide directors with company specific insights on voting and provide an opportunity to share information. Using audit firm tenure as the primary consideration for voting for or against an audit appointment is drawing closer to mandatory firm rotation policies, which have been adopted in many European countries and the U.K.

Mandatory Firm Rotation in North America

While Europe and the U.K. have adopted mandatory audit firm rotation, Canada and the United States have followed a different path based on the regulatory and professional environment in North America.

Following the Enron collapse and the introduction of the Sarbanes-Oxley Act in 2002, the United States General Accounting Office (GAO) conducted a study on the potential effects of mandatory firm rotation on public accounting firms and audit quality in 2003[1]. The conclusion of this study was that the GAO did not believe that mandatory firm rotation (MFR) was an efficient nor effective way to improve audit quality or ensure auditor independence. The loss of institutional knowledge and the increased costs associated with changing audit firms were assessed as significant. The perceived benefits associated with MFR were found to be too difficult to quantify.

The 2008 global financial crisis created additional pressure from investors concerned about audit quality and auditor independence, which led to greater scrutiny from global regulators. In certain countries, audit firm rotation has been studied and left up to the markets; however, mandatory

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[1] Please refer to the United States General Accounting Office: Report to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services, *Public Accounting Firms - Required Study on the Potential Effects of Mandatory Audit Firm Rotation*. As published November 2003. Link: https://www.gao.gov/assets/gao-04-216.pdf

engagement partner rotation (e.g. the U.S. and Canada) is required to address the independence and familiarity threat. The Public Company Accounting Oversight Board (PCAOB) in 2011[2] and the Canadian Public Accountability Board (CPAB) in 2013[3] considered MFR for stricter regulatory governance, however concluded that it would not contribute to the enhancement of audit quality. The American Institute of Certified Public Accountants (AICPA) has previously remarked that research suggests that the first three years of an audit relationship is when fraud and error are more likely to occur[4]. Similarly, a study out of Indonesia[5] noted that the cumulative number of audit partner rotations is positively associated with audit quality. Conversely, it found that the cumulative number of audit firm rotations is negatively associated with audit quality.

Other countries have adopted mandatory audit firm rotation of between eight and 20 years (e.g., China, the U.K., the European Union, and Australia). Some countries that have adopted mandatory firm rotation are re-considering that approach after studies have demonstrated a lack of clear evidence regarding audit firm rotation enhancing audit quality. Consider Singapore, which ceased MFR in 2017 as the research conducted did not provide conclusive evidence linking MFR with an improvement in audit quality[6]. The International Federation of Accountants (IFAC)[7] has indicated that "evidence does not clearly support the notion that mandatory audit firm rotation will enhance audit quality. Academic research is at best mixed, and practical examples are too often confounded by other elements." In February 2023, the International Ethics Standards Board for Accountants (IESBA) released an update to their independence rules. Although this update provides guidance on partner rotation on audit files, they did not recommend MFR, nor is MFR in the IESBA's work plan.

Enhancing Audit Quality: Canadian Perspectives

CPA Canada and CPAB, Canada's public company audit regulator, formed a task force in 2013 to address audit quality issues, and that included the creation of an Auditor Independence Working Group. The Auditor Independence Working Group's mandate was to review the relative benefits of the various alternatives proposed to address the perception of an institutional familiarity threat to independence in an audit relationship.

[2] The concept release on *Audit Independence and Audit Firm Rotation* was issued by the PCAOB on August 16, 2011. Please refer to the news release at the following link: https://pcaobus.org/news-events/news-releases/news-release-detail/pcaob-issues-concept-release-on-auditor-independence-and-audit-firm-rotation_348

[3] Please refer to the publication "*Enhancing Audit Quality: Canadian Perspectives – Conclusions and Recommendations*" jointly authored by CPA Canada and CPAB in May 2013.

[4] Please refer to the AICPA response to the "*Request for Public Comment: Concept Release on Auditor Independence and Audit Firm Rotation*" issued December 14, 2011 at the following link: https://pcaobus.org/Rulemaking/Docket037/413_AICPA.pdf

[5] Kalanjati, D.S., Nasution, D., Jonnergård, K. and Sutedjo, S. (2019), "Auditor rotations and audit quality: A perspective from cumulative number of audit partner and audit firm rotations", Asian Review of Accounting, Vol. 27 No. 4, pp. 639-660. https://doi.org/10.1108/ARA-10-2018-0182

[6] Please review the regulatory notice by the government of Singapore on the appointment of auditors for a bank entity at the following link: https://www.mas.gov.sg/-/media/mas-media-library/regulation/notices/bd/notice-fhc-n615/fhc-n615.pdf?sc_lang=en

[7] International Federation of Accountants (IFAC) Response to IRBA Consultation Paper dated January 18, 2017. Link: https://www.ifac.org/_flysystem/azure-private/publications/exposure-drafts/IFAC-Response-to-IRBA-Consultation-Paper-MAFR-October-2016-FINAL.pdf

The working group put forth the following observations on audit quality[8]:

- The current partner rotation rules and expected personnel changes at both the reporting issuers and audit teams already mitigate familiarity threats.
- Audit firm rotation results in losing the cumulative audit knowledge gained over years of service, resulting in a higher risk of undetected financial statement misstatements.
- Audit quality may suffer during the early years of a new appointment as the audit firm is still gaining sufficient knowledge of the Company.
- New auditors may not have sufficient knowledge of the Company or industry to be able to ask the appropriate probing questions or have the appropriate level of informed professional skepticism.
- Audit firm rotation will increase the amount of time that management will spend during a transition on educating the new auditors on the company's operations, systems, business practices and financial reporting processes. Shareholders will indirectly bear those costs.
- Competitive pressure on fees during the tendering process could have long-term negative impacts on audit quality.

In addition, the choice of a successor auditor firm could be limited because the providers of certain non-audit services to the company will be ineligible to be appointed as the new auditor. Companies in specialized industries (e.g. financial institutions) or with a global footprint could be particularly affected by such limited choice.

Extensive safeguards already exist in Canada to maintain auditor independence and objectivity, including:

- mandatory audit partner rotation – there is a seven-year (five-year for SEC registrants) rotational period for the lead audit partner with a five-year cooling off period, and seven years for other partners with a two-year cooling off period;
- a quality review partner is required on each reporting issuer audit engagement, and is also subject to a rotation and a cooling off period;
- external inspections by CPAB and the provincial institutes, and in the case of SEC registrant companies, the PCAOB;
- audit committee pre-approval of non-audit services and monitoring of the audit to non-audit fee ratio for any affects on auditor objectivity;
- audit firm internal quality control procedures, including internal file inspections; and
- the audit committee oversight of auditor independence, as required by NI 52-110, *Audit Committees*.

[8] Please refer to the publication "*Enhancing Audit Quality: Canadian Perspectives – Conclusions and Recommendations*" jointly authored by CPA Canada and CPAB in May 2013.

In addition, Canadian regulatory and accounting member bodies have recommended the use of Audit Quality Indicators (AQIs) and periodic comprehensive reviews to monitor audit quality[9]. CPAB has produced thought leadership on AQIs[10] and periodic comprehensive reviews in collaboration with CPA Canada and the Institute of Corporate Directors. The use of AQIs can be a powerful tool for audit committees to continually evaluate whether the auditor is performing high quality audits by, among other things, devoting attention to key risks in the audit, engaging specialists as part of the audit team to address complex areas, and so forth[11]. The performance of a comprehensive review by the audit committee of the external auditor at least every five years was recommended by the *Enhancing Audit Quality* initiative, and is meant to provide the audit committee with a tool to perform a deeper, more nuanced analysis of the external auditor's performance[12]. This guidance is also supported by the Office of the Superintendent of Financial Institutions (OSFI)[13].

International and Canadian regulators have also introduced new audit firm quality management standards, known as ISQM and CSQM, which will require firms to adopt a risk-based approach when designing, implementing, and operating a firm-wide quality management system for audit and other assurance engagements.

As noted by the US Center for Audit Quality in their 2023 Audit Committee Transparency Barometer publication[14], the important factor that stakeholders should consider is how the audit committee analyzes the relationship between audit firm tenure, audit quality and auditor independence.

The role of the audit committee

By not introducing mandatory firm rotation in North America, the securities regulators, audit regulators and professional bodies in Canada and the United States have acknowledged that the audit committee and Board of directors are in the best position to make an informed decision of whether a change in auditor would enhance audit quality and be in the best interests of the company and its shareholders.

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[9] Please refer to the published guidance and annual assessment tool by CPA Canada at the following links:
Guidance for Audit Committees - https://www.cpacanada.ca/business-and-accounting-resources/audit-and-assurance/enhancing-audit-quality/publications/external-auditor-oversight-audit-committee-guidance
Auditor Annual Assessment Tool - https://www.cpacanada.ca/en/business-and-accounting-resources/audit-and-assurance/enhancing-audit-quality/publications/annual-assessment-of-external-auditor-tool

[10] Please refer to CPAB's resources on Audit Quality Indicators (AQIs) at the following link: https://cpab-ccrc.ca/insights/aqi

[11] "Audit committee guide to audit quality indicators" published in 2018. Link: https://www.cpacanada.ca/business-and-accounting-resources/audit-and-assurance/enhancing-audit-quality/publications/guide-to-audit-quality-indicators

[12] Please refer to the tool developed for periodic comprehensive reviews of the external auditor at this link: https://www.cpacanada.ca/en/business-and-accounting-resources/audit-and-assurance/enhancing-audit-quality/publications/comprehensive-review-of-external-auditor-tool

[13] Please refer to the following guidance on external audit quality initiatives from the OSFI website. Link: https://www.osfi-bsif.gc.ca/en/guidance/guidance-library/external-audit-quality-initiatives-deposit-taking-institutions.

[14] Please refer to the 2023 Audit Committee Transparency Barometer report as published in November 2023. Link: https://www.thecaq.org/2023-Barometer

This conclusion is based on two fundamental principles:

- Overall audit quality should be the basis of the appointment of an external auditor, not just audit tenure; and
- The group that is best informed to evaluate overall audit quality is the audit committee.

The audit committee's evaluation of the external auditor is complex and cannot be reduced to a single data point, such as the tenure of the auditor. While audit tenure may be a consideration in the overall evaluation of the auditor, it should not be used as a proxy for overall audit quality. Audit committees consider several factors in their evaluation when recommending an incumbent auditor for appointment, including the auditor's performance, experience, specific company knowledge and industry expertise, audit methodologies used, technologies applied in the audit process, the quality of communication and observations, and the potential disruption and costs that an auditor change can have on the company.

When an audit committee has experienced a decline in shareholder support during past proxy seasons, they should consider pre-emptively:

- Reaching out to key investors before the proxy season begins based on how those investors voted the previous year;
- Engaging with large investors by providing them with further information on the role of the audit committee and how they perform their assessment of the external auditors; and
- Disclosing additional information on their role and their assessment of the external auditors in the proxy document.

Summary

We believe that the diligent monitoring and periodic evaluation of an audit firm by independent directors of the company's audit committee supports an informed decision on auditor selection, rather than relying exclusively on a term limit. Voting against audit committees and audit firms primarily based on the tenure of the audit firm may result in unintended consequences. Maintaining overall audit quality can be challenging when there is a change in auditors. As a result, audit firm rotations imposed upon companies may lead to a decline in overall audit quality in the capital markets and introduce unnecessary risk for investors, eroding trust.

Audit committees may consider engaging directly with investors and other stakeholders, if possible, to demonstrate the quality of the process that they employ when assessing the performance of their auditors. The audit committee should also consider disclosing their auditor assessment process in the proxy circular on audit committee activities, similar to best practice disclosure as noted by the US

Center for Audit Quality in their 2023 Audit Committee Transparency Barometer publication[15]. These activities can help to ensure that investors are fully informed about the detailed work the audit committee conducts in recommending an auditor.

Imposing tenure limits on an engagement audit partner, quality review partner and key specialists engaged on audit engagements is an effective tool in safeguarding against institutional familiarity between reporting issuers and their auditors, while allowing auditors to operate with detailed knowledge and a deep understanding of a reporting issuer's business and associated risks to enhance audit quality.

We are not aware of any North American regulators who support auditor tenure limits, and tenure has not been demonstrated to be the primary metric for audit quality. Those investors who use audit tenure as the primary reason for voting against the appointment of auditors should consider the complexity of the issue and the quality assessments conducted by the audit committee and engage with audit committees and Boards on the rationale for their recommendations. We encourage audit committees to engage with investors on this issue directly and through enhanced proxy circular disclosures.

The Canadian Centre for Audit Quality (CCAQ) is an independent not-for-profit Canadian corporation dedicated to supporting Canadian audit firms and public accountants in fulfilling their public interest role, and investors and other stakeholders with public policy and public interest issues. The CCAQ's founding members are the seven largest Canadian independent registered CPA accounting firms.

[15] Please refer to Examples 1 and 2 in Appendix II and Appendix III in the 2023 Audit Committee Transparency Barometer report as published in November 2023. Link: https://www.thecaq.org/2023-Barometer