

Investor Considerations on Audit Firm Tenure

While environmental, social and governance (ESG) reporting has become synonymous with mostly environmental and social issues, governance has always been a key consideration of investors and shareholders. Investors consider many aspects of governance in their analysis of companies, including board composition, tenure and diversity, auditor appointment, executive compensation, shareholder rights and other factors. Responsible investing departments have developed processes that they use to evaluate, analyze, and consider various ESG issues. One common, key process is investor engagement with companies and boards on specific issues to better inform both the investor and the companies that they invest in. More recently, responsible investors and activists within Canada are utilizing this process to push back on shareholder proposals, director votes and auditor reappointment.

Recent Trends in Responsible Investing and Auditor Tenure

Responsible investing, or the incorporation of environmental, social and governance factors into an investor's asset portfolio, has grown significantly in the past ten years. Most of the largest financial institutions, pension funds and wealth management companies in Canada have committed to a responsible investing practice when managing their holdings, and according to the Responsible Investment Association of Canada, "Canadian [responsible investing] assets now account for 61.8% of total Canadian assets under management, up from 50.6% two years earlier"¹.

Kingsdale Advisors, a leading advisor to public companies on governance and shareholder matters, has noted that "the number of Canadian companies that have received less than 90 per cent investor support for their auditor ratification resolutions has exploded: from seven in 2021, to 23 in 2022, to 38 in 2023"², and based on their analysis of 2023/2024 proxy activity, Kingsdale expects this trend to continue³. The CCAQ also reviewed policy guidelines and voting patterns for ISS and Glass Lewis, both market leaders in North America who supply proxy advisory services. During the 2023 proxy season, ISS supported all 38 auditor ratification votes while Glass Lewis supported all but one⁴. When reviewing the 2024 *ISS Governance Insights* report, it seems that activism based on auditor tenure and reappointment is a mostly "Canadian" issue⁵, and the only significant update to the ISS' 2024 proxy benchmark policy guidelines for the Canadian market is related to "board racial or ethnic diversity" disclosure⁶, rather than guidelines covering auditor tenure.

We have observed that some asset managers and institutional investors have voted against or withheld votes for auditors and the audit committee directors who recommend them primarily due to the long

¹ Please refer to RI Market Growth within the RiA Canada website at the following link: <https://www.riacanada.ca/responsible-investment/>

² Milstead, David. "Canadian companies faced record number of activist campaigns in 2023, says Toronto consulting firm". The Globe and Mail. Published November 29, 2023.

³ "2024 AGM Trends to Watch For", Kingsdale Advisors. Link: https://cdn.b12.io/client_media/JJQEh5Z/b9460f4e-bba1-11ee-ab0f-0242ac110002-Kingsdale_Advisors_2024_AGM_Trends_to_Watch_for.pdf

⁴ "2023 Proxy Season Review – Change is Here". Kingsdale Advisors. Link: <https://www.kingsdaleadvisors.com/2023-proxy-season-review>

⁵ Belyeu, Kathey, et al. "Top Governance & Stewardship Issues in 2024: Annual Outlook". ISS Governance. Published March 4, 2024.

⁶ "ISS Governance Announces 2024 Benchmark Policy Updates". ISS STOXX. December 19, 2023. Link: <https://insights.issgovernance.com/posts/iss-governance-announces-2024-benchmark-policy-updates/>

tenure of the company's auditor, particularly those Canadian-based investors who utilize European proxy firms, where mandatory audit firm rotation is a regulatory requirement⁷. If an audit firm's tenure exceeds what these asset managers and investors believe is appropriate, they will withhold their votes. This view is based on a theory that a long tenured auditor relationship creates a familiarity threat and impairs the objectivity and independence of the external auditor, thereby lowering audit quality.

Other investors consider the regulatory and professional environment in Canada and vote in support of the recommendation by Boards and audit committees. By supporting an audit committee's recommendation, these investors base their votes on an implicit understanding that audit committees are the best-informed group to make an assessment on auditor performance, and that effective audit committees consider both independence and the quality of the audit in their overall assessment of their auditors. There is an expectation by investors that audit committees perform an annual assessment of the auditor's performance, with a periodic comprehensive review of auditor performance generally every five years. Canadian securities regulators have not required audit firms to rotate based on term limits, indicating that while audit quality is a primary consideration, tenure is not a limiting factor in overall audit quality. For those companies that are multi-jurisdictional filers, the PCAOB (Public Company Accounting Oversight Board) and the SEC (Securities and Exchange Commission) are also very active in their regulatory role of monitoring auditor independence without enforcing mandatory auditor rotation.

Glass Lewis has stated that an effective audit committee should have at least one member that meets their requirements to be designated as an "Audit Financial Expert", a designation with criteria recently revised in their 2024 Canadian Benchmark Policy Guidelines⁸. All boards should consider reviewing the composition of their audit committees to determine whether they have the expertise required to meet Glass Lewis' criteria, such as financial literacy, experience in the industry in which the company operates, and experience as an audit committee or a board member. If applicable, the audit committee should disclose these details, as well as a more comprehensive review of committee members' skills and competencies, in their Management Information Circulars.

Safeguards and Research on Auditor Tenure

Independence is an essential and necessary component of audit quality. Canadian audit independence standards are thorough and comprehensive. These rules govern both institutional (firm) and individual (practitioner) threats to independence that can jeopardize professional skepticism. The audit regulator in Canada, the Canadian Public Accountability Board (CPAB), has stated that the existing rules and safeguards in place during the financial reporting process mitigate the threat of institutional familiarity if annual and periodic comprehensive reviews are performed by the audit committee⁹.

One of the most important safeguards in place to mitigate threats to auditor independence is the mandatory rotation of the lead engagement partner, other key partners, and the engagement quality

⁷ Garcia-Blandon, Josep & Argilés, Josep & Ravenda, Diego. (2020). Audit firm tenure and audit quality: A cross-European study. *Journal of International Financial Management & Accounting*. 31. 35-64. 10.1111/jifm.12098. Link:

https://www.researchgate.net/publication/332693351_Audit_firm_tenure_and_audit_quality_A_cross-European_study

⁸ "2024 Benchmark Policy Guidelines - Canada". Glass Lewis. Link: <https://www.glasslewis.com/wp-content/uploads/2023/11/2024-Canada-Benchmark-Policy-Guidelines-Glass-Lewis.pdf>

⁹ Please refer to the publication "Enhancing Audit Quality: Canadian Perspectives – Conclusions and Recommendations" jointly authored by CPA Canada and CPAB in May 2013.

control partner. There are also regulations in place limiting or not permitting the acceptance of certain non-audit services by a company's auditor. Additionally, firms are required to maintain a system of quality management as governed by the CSQM (Canadian Standard on Quality Management) standard. Firm audit quality and internal controls are also subject to inspection by external regulatory bodies, such as CPAB, as part of their inspection mandate is to ensure compliance with independence standards in the practice of public accounting.

Another key safeguard for audit quality is the oversight and evaluation of the external auditor by 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 years of tenure of the auditor. Through the *Enhancing Audit Quality* initiative¹⁰, CPAB and CPA Canada believe that the performance of annual and periodic comprehensive reviews¹¹ by the audit committee at least every five years, along with the use of Audit Quality Indicators (AQIs), was the preferred approach to addressing institutional familiarity threats over mandatory firm rotation or a mandatory retendering process. This approach also has the support of the Institute of Corporate Directors (ICD) and the Office of the Superintendent of Financial Institutions (OSFI)¹².

The Auditor Independence Working Group¹³ that emerged from the *Enhancing Audit Quality* initiative noted that there are several unintended consequences that should be considered before implementing mandatory firm rotation. One such consequence to consider is that mandatory audit firm rotation would result in the firm losing the cumulative institutional audit knowledge gained over years of service, which may increase the risk of error. "New auditors may, for example, not have the knowledge of the company or the industry that leads to asking searching questions and to informed skepticism"¹⁴. Therefore, significant investment and time will be required by the new auditor and management to get the auditor to a comparable level of knowledge and familiarity with a company's business, controls, accounting policies and practices. Another factor to consider is that many of the audit efficiencies achieved by the incumbent auditor may also be lost resulting in increased costs associated with knowledge acquisition and staff training. The choice of a successor auditor firm could also be limited because providers of certain non-audit services to the company would 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 a limited choice.

Another aspect to consider regarding the use of tenure as the primary reason for voting against an auditor's re-appointment is that the research conducted on whether a correlation exists between tenure and quality is mixed at best. Most of the studies reviewed concluded that longer audit tenure does not

¹⁰ Please refer to the publication "*Enhancing Audit Quality: Canadian Perspectives – Conclusions and Recommendations*" jointly authored by CPA Canada and CPAB in May 2013.

¹¹ Please note that CPA Canada, CPAB and the ICD, as recommended by the Enhancing Audit Quality Initiative, have developed the "*Periodic Comprehensive Review of the External Auditor – Tool for Audit Committees*". This tool was first published in January 2014 and subsequently updated in September 2018. Other guidance and tools for audit committees are available on the CPA Canada website for CPA Canada members.

¹² 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>.

¹³ Please refer to the publication "*Enhancing Audit Quality: Canadian Perspectives – Conclusions and Recommendations*" jointly authored by CPA Canada and CPAB in May 2013. 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.

¹⁴ Please refer to the publication "*Enhancing Audit Quality: Canadian Perspectives – Conclusions and Recommendations*" jointly authored by CPA Canada and CPAB in May 2013.

reduce audit quality, or at the very least does not produce audit quality that is worse than shorter tenured audits. Some studies have concluded that longer tenure improves audit quality¹⁵.

Although there are several factors that an investor should consider when evaluating the performance of the external auditor, the most important factors remain the quality of the audit services provided, the independence of the auditor and the thoroughness of the audit committee's assessment of the external auditor. We believe that when an audit committee performs a thorough assessment of the auditor utilizing governance best practices as outlined by Canadian regulators, those actions do a better job of promoting audit quality than mandatory firm rotation and still address any independence familiarity threats.

Summary of Considerations

We believe that an effective audit committee utilizing best practices for corporate governance is in the best position to assess the audit quality and performance of the external auditor. Investors look to a company's board of directors and audit committee to showcase the independence of the auditor selection process and what safeguards are in place to avoid familiarity threats between management, the audit committee and the independent auditors. Therefore, audit committees and boards should consider improving their proxy circular disclosure of the audit quality assessment process, the best practices utilized by the audit committee, AQIs reviewed during the financial reporting process, and the factors considered when re-appointing an auditor.

For those investors who are concerned with auditor independence based on the tenure of the audit firm, we believe that requesting more transparency or engaging directly with the company and its audit committee to understand their auditor assessment and recommendation processes will provide investors with more information upon which to base their vote. Engagement with audit committees on their auditor recommendation is consistent with many responsible investor groups' published processes and will enhance the information used by investors in making voting decisions. In fact, the ISS noted in their *'In Focus Insights'* article on the 2024 Canadian Proxy Season that "this year also marked a record number of withdrawn [shareholder] proposals in the last five years, indicating a high level of engagement between Canadian companies and proponents" on all topics¹⁶.

A good understanding of the audit quality assessment process, the role of the audit committee in preserving audit quality, the Canadian regulatory environment, and best practices will lead to a more informed vote on the appointment of the external auditors. Reciprocal outreach and engagement between investor groups and the audit committee to obtain an informed understanding of the role of the

¹⁵ Please note that the CCAQ reviewed 22 studies published over a period of 11 years and across various countries and jurisdictions across the globe. We also reviewed research conducted by IFAC (International Federation of Accountants) and the AICPA (Association of International Certified Professional Accountants). An example of a study that concluded that longer auditor tenure improves audit quality include Rummell et al. (2019) in their study "Does Audit Firm Tenure Matter to Audit Committee Members? Evidence from an Accounting Dispute". Other studies that we reviewed, including a 2019 study by Kalanjati, D.S., Nasution, D., Jonnergård, K. and Sutedjo, S. (2019) reviewing "Auditor rotations and audit quality" in Indonesia, concluded that mandatory firm rotation could lead to negative audit quality outcomes.

¹⁶ Khan, Shehrbano. "In Focus: 2024 Canada Proxy Season Recap". ISS STOXX. Published August 12, 2024. Link: <https://insights.issgovernance.com/posts/in-focus-2024-canada-proxy-season-recap/>

audit committee and the quality of the assessment process carried out on recommending an auditor for reappointment will better serve investors, their clients' interests, and the company's shareholders.

This belief is echoed by the Canadian Coalition for Good Governance (CCGG), whose Chief Executive Officer, Catherine McCall, has offered the following insight:

“Investor expectations around the quality and independence of audits are heightening and institutional investors are paying increasingly close attention to how audit committees are reviewing and assessing their external auditors. CCAQ’s recommendations to audit committees with respect to how to engage with investors to satisfy these expectations are both timely and pragmatic”.

For more information, we encourage readers to review our publication addressing audit committee members on auditor tenure [here](#).

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.