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Audit Quality – Utilizing the Three-Legged Stool

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Introduction

The strength of Canada's capital markets is dependent on confidence in the reliability of information available to investors and other key decision-makers. High-quality independent audits are essential to ensuring trust in the reliability of the financial system and financial information subject to an independent audit ("financial information"). The foundation of a high-quality audit can be achieved through a governance model, often referred to as the "three-legged" stool, involving active engagement from the independent auditor, the audit committee and management.

The purpose of this paper is to outline the responsibility placed on each "leg" of the three-legged stool for ensuring a high-quality audit outcome. This paper will be of interest to members of a company's management and finance team, audit committee members and independent auditors.

The Three-Legged Stool Model of Audit Quality

Management
Management is responsible for establishing their own internal processes for accounting controls, the safeguarding of assets, the accuracy of transactions recorded, and the preparation of financial information free from material misstatement whether due to error or fraud.

Audit committee
"Audit committees are responsible for creating an environment that accommodates an open discussion in a culture of integrity, respect and transparency between management and the auditors."
Source: The Canadian Public Accountability Board (CPAB) — Role of the Audit Committee

The audit committee has legal and fiduciary responsibilities to its stakeholders and investors.

Independent auditor
An independent accounting professional whose role is "to provide independent assurance that management's reporting of facts is accurate, its judgments in estimates and valuation are fair, and that important information is not omitted."
Source: Enhancing Audit Quality: Canadian Perspectives

"Auditors play a vital role in establishing trust in the financial system by providing independent assurance of financial information."
Source: Canadian Securities Administrators — Canadian roundtable on audit quality addresses current state and trends

Similarly, the Global Public Policy Committee (GPPC)[1] refers to this principle as a "holistic approach to the corporate reporting ecosystem"[2]. All participants perform essential roles to help achieve high-quality reporting and auditing so that the capital markets can operate effectively with the highest level of integrity.

An important factor in a holistic approach to corporate reporting is that the roles and responsibilities of each participant in the 3-legged stool model are clearly defined to decrease the expectation gaps that could occur between each participant by preventing overreliance on one party, such as the auditor.

1. The Global Public Policy Committee, or the GPPC, was established by the global CEOs of BDO, Deloitte, EY, Grant Thornton, KPMG and PwC, and is "focused on public policy issues of global scope. Its primary objectives are to constructively engage on priority public policy issues to advance the public interest and enhance public confidence in the multidisciplinary accounting profession." To learn more, please visit the following link: https://www.globalpublicpolicycommittee.org/about/#about
2. *"The Corporate Reporting Ecosystem: What is it and Why it Matters".* Global Public Policy Committee. Published September 15, 2024. https://www.globalpublicpolicycommittee.org/publication/the-corporate-reporting-ecosystem-what-it-is-and-why-it-matters/

Audit quality requires the audit committee, the independent auditor and management to create an environment that allows for open communication, transparency and respect, with the goal of providing shareholders with high-quality financial information. Audit quality itself is not a fixed measure and is influenced by rapidly evolving auditing standards, and a dynamic risk and business environment. Interdependency across the various participants in the financial reporting ecosystem is particularly important as auditing and accounting standards increase in number, complexity and scope to address professional standards, to incorporate advances in technology, and to consider other emerging trends such as the proliferation of GenAI and other artificial intelligence tools. All "legs" of the three-legged stool model must be current on new accounting and auditing standards relevant to their role, or risk falling offside with market and regulator expectations.

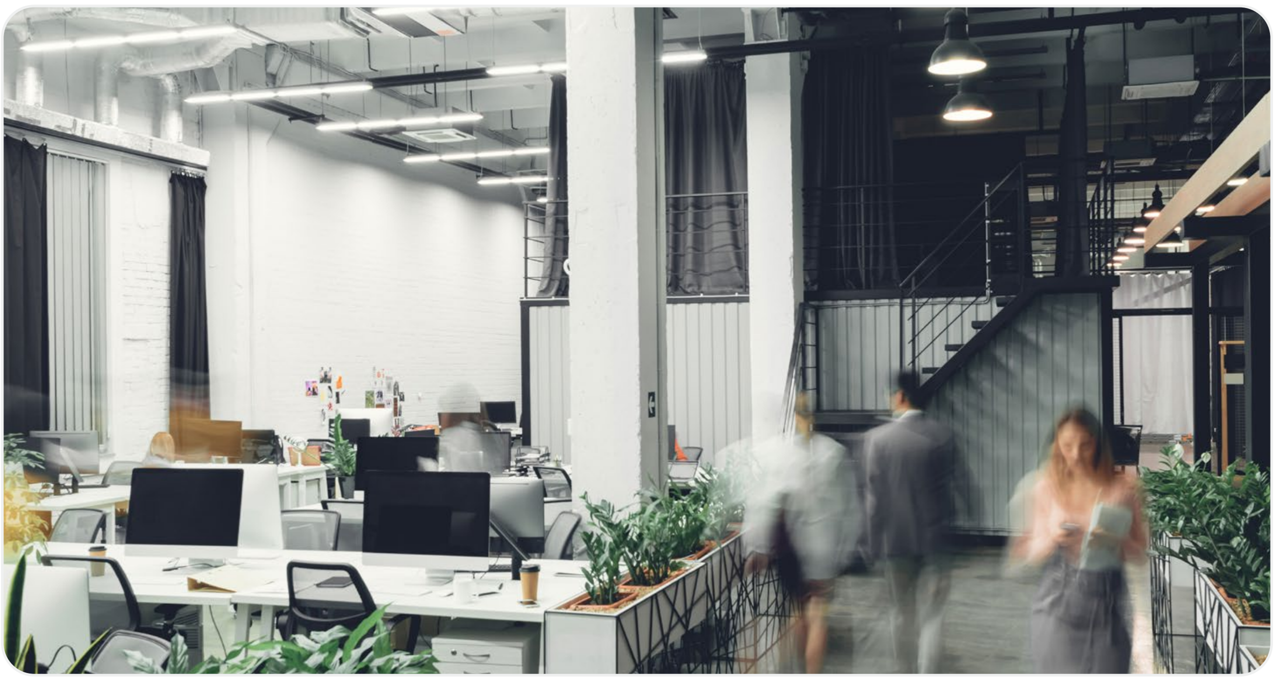
Audit quality assessment and inspection programs in place by regulators, including the provincial CPA regulatory bodies, the Canadian Public Accountability Board (CPAB) and the PCAOB (Public Company Accounting Oversight Board for SEC issuers) can also contribute to the level of investor confidence in public company financial reporting and the audit profession. While there could be many measures of audit quality available, restatements as a result of these audit quality assessment programs are considered by some to be the most direct and valuable metric of audit quality, and the quality of the financial information reported[3].

The following reviews each of the participants in the three-legged stool model and their role in audit quality.

3. Ho, Christina. "*Building Trust and Inspiring Hope in the Accounting and Auditing Profession*". Public Company Accounting Oversight Board. Speech delivered on September 24, 2024. Link: https://pcaobus.org/news-events/speeches/speech-detail/building-trust-and-inspiring-hope-in-the-accounting-and-auditing-profession

Management

High-quality financial information prepared by a company's management team is critical to achieving a quality audit. The financial statements are ultimately management's responsibility, and according to *Canadian Auditing Standards ("CAS")*, management is responsible for the preparation of financial statements in accordance with an applicable financial reporting framework, as well as for establishing a robust system of internal controls that is necessary in the preparation of financial statements that are free from material misstatement, due to either fraud or error[4]. Complete and accurate financial information is a crucial first step to a high-quality audit, and management can implement certain best practices, as noted by CPA Canada, to ensure a satisfactory outcome for all stakeholders, such as enabling an adequate audit trail, planning with the auditor and improving communication[5].



Expertise

The presence of Canadian CPAs and other experienced professional accountants in management positions with a strong financial reporting foundation is one of the keys to producing high-quality financial information. "Without strong talent within an issuer, quality of the management reports, internal controls as well as internal audit could suffer"[6]. This is why the provincial and territorial regulators of the CPA designation have stringent requirements for CPAs practicing in public accounting in Canada, and ongoing continuing professional development requirements to ensure that CPAs are maintaining their knowledge and skill levels.

Management should also consider hiring or bringing in individuals with additional skill sets where necessary, including external accounting, valuations, information technology, risk, tax or other specialists.

4. Please refer to CAS 200 "*Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Canadian Auditing Standards*".
5. "*How Management Contributes to Audit Quality*"; Chartered Professional Accountants of Canada (CPA Canada) and the Canadian Financial Executives Research Foundation (CFERF). As published in 2017.
6. Refer to a speech titled "*The Legacy of Audit Committees*" delivered by Christina Ho, Board Member of the PCAOB on May 8, 2024. Link: https://pcaobus.org/news-events/speeches/speech-detail/the-legacy-of-audit-committees

Audit Planning and Processes

Management should establish internal processes for managing and supporting the independent audit. These internal processes could include defined roles and responsibilities, informed audit responses and a methodology to track progress towards the completion of the audit. For example, regular meetings with the independent auditor to support continuous improvement and address key issues, along with a schedule to ensure that audit findings and recommendations are addressed in a timely manner, remain internal best practices that we recommend.

Management should also ensure that they proactively update the auditors on changes to the business and control environment, including any internal control deficiencies, as early as possible. Management should continue to have regular dialogue with its auditors throughout the acceptance and continuance, planning, interim and year end phases of an audit. Significant changes in the organization that occurred during the year should be reviewed with the auditors on an ongoing basis so that the auditor is able to appropriately respond.

Audit firms are increasingly investing in big data and artificial intelligence analysis, which can provide insights into financial information and the system of internal controls, and as such management should take this opportunity to digitize their records.

Internal Controls Over Financial Reporting

Management for many public companies that operate in the U.S. capital markets must disclose the results of its annual assessment of internal controls over financial reporting (ICFR), including many Canadian multi-jurisdictional filers who have listed on a U.S. stock exchange[7]. Similarly, each annual period, a TSX-listed company's management team in Canada must certify their disclosure controls and procedures (DC&P) and its internal controls over financial reporting under National Instrument (NI) 52-109, *Certification of Disclosure in Issuers' Annual and Interim Filings*.

Management's effective design, implementation and operation of internal controls is essential to producing high-quality information, as effective internal controls over financial reporting generally lead to higher quality audits. For all Canadian companies, a robust system that considers both the design and implementation of internal controls and whether those controls are operating as intended is necessary to ensure that an auditor can rely on internal controls for their audit procedures.

7. Per SOX 404(c), "companies that are neither large accelerated filers nor accelerated filers are exempt from the auditor attestation requirement for ICFR". As of March 12, 2020, the Securities and Exchange Commission (SEC) voted to "approve amendments to the "accelerated filer" and "large accelerated filer" definitions to provide a narrow carve-out for companies that qualify as "smaller reporting companies" (SRCs) and reported less than $100 million in annual revenues in the most recent fiscal year for which audited financial statements were available. Most significantly, under the amendments, companies qualifying for the carve-out will no longer be subject to the SOX 404(b) requirement to have an auditor attestation report on internal control over financial reporting (ICFR), a requirement that applies to accelerated and large accelerated filers". The purpose of these amendments was to provide additional relief to smaller issuers by reducing some of the regulatory and cost burden for these issuers without compromising investor protections. Source: Cooley Alert "*SEC Amends 'Accelerated Filer' Definition to Exempt Low-Revenue Smaller Reporting Companies From SOX 404(b)*". Cooley LLP and Cooley (UK) LLP. Published April 23, 2020. Link: https://www.cooley.com/news/insight/2020/2020-04-23-sec-amends-accelerated-filer-definition-exempt-low-revenue-smaller-reporting-companies

Building a Positive Working Relationship with the Internal and Independent Auditor

A positive working relationship between a company's management and finance team and the internal and independent auditors can reap significant benefits in the independent audit process. Being transparent and candid and establishing effective two-way communication will benefit both management and the internal and independent auditors, increasing the efficiency and quality of the audits performed. Based on research and survey feedback provided to CPA Canada, "as management's involvement [in the audit] increases, so does the quality (as judged by management) of the audit"[8].

The nature and extent of independent and internal auditor findings may indicate that there are opportunities to improve management's financial reporting environment. Indicators that there are matters requiring management's attention include:

- Number, nature and extent of internal control deficiencies identified;
- Number of audit adjustments and accounting errors identified;
- Length of financial close period at month-end, quarter-end or year-end; and
- The number, nature, and extent of disagreements on accounting positions between management and the auditors without a timely resolution.

Building a Positive Working Relationship with the Audit Committee

Management teams should work with the members of their audit committee to ensure that they have a full understanding of financial performance, key transactions during the period and the effectiveness of the company's system of internal controls over financial reporting. In turn, the audit committee should support management in establishing strong internal controls, ensuring that appropriate resources are allocated to the finance team to support the financial reporting and control process, and to set a transparent and ethical "tone at the top" of the organization.

8. "*How Management Contributes to Audit Quality*"; Chartered Professional Accountants of Canada (CPA Canada) and the Canadian Financial Executives Research Foundation (CFERF). As published in 2017.

The Audit Committee

The Audit Committee's Role in Audit Quality

The audit committee and the board of directors are responsible for oversight of the company's financial statements and other corporate reporting. Audit committee members are "instrumental in setting a tone at the top for the quality of an issuer's reporting to investors and other users of the company's reports"[9]. In fact, "since its origin, the audit committee was designed to play a vital role in corporate governance by, in the words of former SEC Commissioner Loomis, 'serving as a check on management control' by 'providing a separate channel of information to the board of directors' through its independent oversight"[10].

James L. Goodfellow, the coauthor of *Integrity in the Spotlight: Audit Committees in a High Risk World* further notes that the goal of an audit committee should be to build and sustain "a high energy healthy culture" that does not "undermine an organization's stated values, impede change, [nor] support behaviors that damage financial performance, reputation, and brand. ...[As audit committee members], [you] have a fundamental choice: [you] can either work with management to shape its culture or [you] can let the culture evolve on its own and shape the organization"[11].

As part of promoting a culture of audit quality, many audit committees use Audit Quality Indicators (AQIs) and annual and periodic comprehensive review tools to monitor audit quality[12], which have the support of CPAB, CPA Canada, and the Institute of Corporate Directors. The performance of periodic comprehensive reviews by the audit committee includes consideration of CPAB's annual inspection report and individual firm inspection reports. For audit committees of SEC registrants in the United States, the PCAOB issues firm specific inspection reports.

The audit committee should hold management responsible for providing the auditors with sufficient and appropriate audit documentation and evidence. The audit committee should also ensure that the auditor is appropriately compensated, considering auditor independence, performance and effort, whether the audit is adequately resourced with experienced professionals, and any potential impacts on audit quality if only the lowest fee proposals are considered.

An audit committee member can also review other sources to provide relevant information on overall audit quality. Some larger firms have a regulatory requirement[13] to issue an annual transparency report, outlining their audit quality management process, internal firm inspection process, investments in technology and training, and how the firm is addressing emerging issues.

9. Refer to a speech titled "*Furthering Our Special Relationship*" delivered by Kara M. Stein, Board Member of the PCAOB on September 8, 2023. Link: https://pcaobus.org/news-events/speeches/speech-detail/furthering-our-special-relationship
10. Refer to a speech titled "*The Legacy of Audit Committees*" delivered by Christina Ho, Board Member of the PCAOB on May 8, 2024. Link: https://pcaobus.org/news-events/speeches/speech-detail/the-legacy-of-audit-committees
11. "*On the board's agenda – Would you recognize the warning signs of a toxic culture?*", Deloitte Global Center for Corporate Governance. Published May 2017. Link: https://www.deloitte.com/content/dam/assets-shared/legacy/docs/services/risk-advisory/2022/on-the-boards-agenda-may.pdf
12. Please refer to the published guidance and annual assessment tools developed by CPA Canada, including the following publications:
    1. "*Oversight of the external auditor: Guidance for audit committees*", as originally published in January 2014 and updated in September 2018.
    2. "*Annual assessment of the external auditor: Tool for audit committees*", as originally published in January 2014 and updated in September 2018.
13. Please note that transparency reporting is driven by the European Union, and is often mandated elsewhere, including by the Financial Reporting Council in the United Kingdom, and the Australian Securities and Investments Commission in Australia. If an audit member firm services a client who meets the definition of a public interest entity by European Union standards, or another jurisdiction that mandates this reporting, you will see that member firm publish an "Audit Quality Transparency" report.

Building An Effective Audit Committee

An effective audit committee should not only look outward towards the performance of the independent auditor and management when reviewing the accuracy and quality of financial information, but inward to ensure that governance best practices are being observed and that the members of the audit committee have the appropriate qualifications and experience. The audit committee should be composed of individuals who are independent in accordance with appropriate securities regulations, who are financially literate, who are adequately experienced in the industry in which the company operates, and who are knowledgeable in emerging trends such as cyber security, artificial intelligence and sustainability reporting.

Currently, venture issuers in Canada are not required to have an independent or financially literate audit committee. Venture issuers are also not required by NI 52-109, *Certification of Disclosure in Issuers' Annual and Interim Filings* to certify their ICFR. Notwithstanding current regulatory requirements, those charged with governance at a venture issuer, as well as other issuers, should consider whether their Board of Directors and audit committee members have the appropriate skillset to fulfil their mandate. Venture issuers might also consider recruiting independent members to their Board and audit committee to benefit from a diverse skillset and independent review.

The audit committee should also ensure that it meets regularly with management, the broader Board of Directors, and the internal and independent auditors at appropriate intervals to successfully discharge their oversight responsibilities over the Company's financial reporting. The audit committee should have a "well-defined… scope of responsibilities",[14] a mandate that is understood by all parties, and should ensure that all meetings have an agenda and pre-read materials circulated ahead of time. Lastly, the audit committee should ensure that the Management Information Circular issued annually, where applicable, is transparent and appropriately discloses how the audit committee has discharged its duties to its shareholders, allowing shareholders to properly assess the performance and effectiveness of the committee[15].

14. Tugman, Laurie; Leka, Laura. "*5 Key Factors to Enhance Audit Committee Effectiveness*". IFAC. Published September 20, 2019. Link: https://www.ifac.org/knowledge-gateway/supporting-international-standards/discussion/5-key-factors-enhance-audit-committee-effectiveness
15. Ibid.

The Independent Auditor

"Consistent execution of high-quality audits is crucial to maintaining confidence in financial reporting and protecting the investing public and the integrity and stability of the Canadian capital markets".[16]

Independence is foundational

Auditor independence from management is necessary to uphold the integrity of and confidence in the financial reporting system. Regulators have developed independence rules and audit firms have developed independence compliance systems to ensure that auditors maintain their independence throughout the audit engagement. These rules include requiring mandatory partner rotation on a reporting issuer or listed entity and limiting non-audit work performed by the independent auditors that may impair independence.

Investments in audit quality

Many Canadian audit firms continue to make significant investments in audit quality initiatives through strengthening their systems of quality management, prioritizing the learning and development of partners and staff, enhancing their audit methodologies and developing and using various technologies to further improve both audit quality and effectiveness.

The Canadian Standard on Quality Management (CSQM) 1 is now effective for all Canadian audit firms. This standard requires a firm to utilize a risk-assessment process[17] that is tailored to the firm's nature and circumstances, as well as the engagements it performs (e.g., establishing quality objectives; identifying and assessing risks to achieving those objectives; designing and implementing policies and procedures; and monitoring the operating effectiveness of the processes)[18].

As a result of firm-wide quality management efforts, audit firms may have internal inspection file review programs, additional consultations while audits are in progress, robust client acceptance processes including systems that address the acceptance of certain non-audit services that may impair independence, monitoring activities to ensure appropriate staff and partner workloads, and the mandatory rotation of engagement partners, engagement quality control partners, and other audit staff members on audit engagements. Due to these internal quality processes and the external inspections conducted by audit regulators, a public company audit partner will typically be subject to either an internal or external inspection at least once every two to three years, with a firm undergoing an inspection for their systems of quality management at least once every three years by the provincial regulators.

Audit firms must also make significant investments in technical and ethics training each year for both staff and partners. Most firms have implemented a consultation or training network that will proactively review working papers and audit files to coach and train staff on audit or accounting issues as they arise. These individuals generally support engagement teams on both publicly traded and privately held audit clients, consulting with practitioners on challenging issues prior to the issuance of the financial statements. Firms actively encourage their engagement teams to ask for support when they come across a challenging area of the audit.

16. "*Canadian roundtable on audit quality addresses current state and trends*". Canadian Securities Administrators (CSA), the Canadian Public Accountability Board (CPAB), and the Office of the Superintendent of Financial Institutions (OSFI). Published October 29, 2024. Link: https://www.securities-administrators.ca/news/canadian-roundtable-on-audit-quality-addresses-current-state-and-trends/
17. CPA Canada noted that "CSQM 1 moves away from a focus on quality control and introduces a new approach to managing quality. The concept of quality control was considered to be reactive in nature, with many reviewing files after they were performed to ensure the requirements of quality control were met. Quality management, on the other hand, is intended to be risk-based and proactive in nature, introducing a continuous process that is ingrained in the firm's culture and strategy" Source: McGuire, Rosemary. "Raising the bar on audit". CPA Canada. As published December 9, 2024.
18. CPA Canada: "*Getting ready for the new quality management standard CSQM1*". Published August 26, 2022.

Measuring audit quality

Measuring the impact of these investments in audit quality is challenging, but audit firms recognize the necessity of continuing to invest. While external inspection results can be an indicator of audit quality, these review programs generally have a selection bias towards high risk or complex areas or engagements, and accordingly, their results cannot be used to extrapolate across all audit engagements. There are several other factors that are considered when assessing overall audit quality, including the number of restatements, the results of firm internal inspections, other regulatory reviews, and the operating effectiveness of a firm's quality management system[19].

The external inspection process also highlights the importance of building a positive working relationship with audit regulators. The communication of expectations on what constitutes "sufficient appropriate audit evidence" for emerging issues, such as the use of artificial intelligence, will help to ensure that audit firms are at the forefront of innovation in audit quality.

Continuous improvement

Quality management systems, inclusive of the results from internal and external inspections, provide audit firms with continuous feedback on areas requiring additional focus to meet their objective of consistently delivering high-quality audits. Audit firms consider information provided within the auditing standards, as well as feedback from regulators, to continuously evolve their policies and procedures to address changing risks within the regulatory environment. A mindset of continuous improvement is critical to meeting the high expectations of stakeholders, resulting in higher confidence in our capital markets.

Technology

Firms also consider the use of technology and its role in the execution of a quality audit. Canadian audit firms are increasingly investing in artificial intelligence, data analytics and other technologies, which are transforming the way audits are conducted. The automation, digitization, and innovation of audit documentation and data-enabled workflows can allow firms and practitioners to focus on higher risk areas of the audit, while improving effectiveness in lower risk areas and developing systems of pattern recognition to improve overall quality.

19. CPAB has noted in its 2025 Annual Report that they "*have observed a correlation between the firms that invest in a robust system of quality management and a lower level of significant [inspection] findings.*"

Summary

Efforts to strengthen audit quality continue to evolve as business transactions, the financial reporting environment, and audit and accounting standards become increasingly complex. All participants in the financial reporting ecosystem must work together to invest in quality, to provide communication on what constitutes quality financial information, and to improve interactions between the various parties involved in producing quality financial information.

Management, the audit committee, and the independent auditor must all do their part to ensure that the foundation of the three-legged stool model for audit quality remains strong.

About the Canadian Centre for Audit Quality

The Canadian Centre for Audit Quality (CCAQ) is an independent not-for-profit 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.