Ontario

The Critical Role of Auditors in Ontario’s Capital Markets

Keynote address by Grant Vingoe
Chief Executive Officer, Ontario Securities Commission

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Check against delivery

Thank you, Jeremy, for that introduction.

I am pleased to be here and have this opportunity to talk about our work with CPAB and where we are headed next.

Today, you've heard great discussions about the evolving fraud landscape and the role of audit committees, management and auditors in managing emerging fraud risks.

Now, I want to talk about how far we've come in the 20 years since CPAB was created and why strengthening audit quality will only become more important in the future.

Specifically, the important role auditors play in capital markets, how professional skepticism and ethics are integral to that role, and where we are headed next.

Two decades ago, after high-profile scandals and audit failures in Canada and internationally, CPAB was founded to oversee the profession and improve audit quality.

In the United States, the Enron scandal had led to the collapse of Arthur Andersen, one of the big five accounting firms, and the formation of the Public Company Accounting Oversight Board.

Here in Canada, we saw our own failures, including financial mismanagement and fraud at prominent companies such as Nortel and Bre-X.

CPAB was formed with the understanding that these problems affected more than just individual companies. They had the potential to affect how people viewed the reliability of financial reporting by public companies as a whole.

While these scandals illuminated a gap in accounting oversight, they also re-enforced the importance of auditors and audit quality for the proper functioning of our capital markets.

At the OSC, as Ontario's capital markets regulator, we know that the integrity of financial reporting is important for every aspect of our mandate.

Audit quality is a cornerstone of fair, efficient and competitive capital markets, and auditors have a critical role as gatekeeper.

As gatekeepers of Ontario's capital markets, auditors play a critical role in ensuring the accuracy and reliability of financial statements so that investors can reasonably rely on this important financial information when making investment decisions.

Any actual or perceived issues related to the integrity of financial reporting can undermine investor confidence, a foundational part of market activity.

CPAB is one of two organizations, along with the provincial CPA authorities, that has a mandate to oversee public accounting firms that conduct financial statements audits of reporting issuers in Ontario.

The OSC's disclosure regime and focus on the gatekeeping function in the public interest operate alongside CPAB's focus on audit quality. This requires enthusiastic and effective collaboration between the OSC and CPAB.

CPAB and the OSC recognize the unique challenges in the Canadian marketplace.

We have a large population of smaller issuers that are often in the early growth stages of their development, and this creates a need for mid-sized and smaller audit firms to audit those issuers.

Smaller issuers can present less complexity of operations, but also greater risk of potential fraud given there is often reduced levels of internal controls.

Small companies often have fewer individuals to achieve appropriate segregation of duties, with multiple roles taken on by the same individual in the company.

These characteristics mean the approach to fraud detection and prevention by auditors and regulators needs to fit the unique needs of our market.

Canada is also characterized by the early entry into the public markets of new business types, cannabis and crypto being two notable categories.

Of course, larger issuers have their own complexities and widespread market impact and must receive focused attention as well.

I am proud of the effective partnership that the OSC and CPAB have developed over the last 20 years.

We worked together on the amendments to NI 52-108 *Auditor Oversight* that strengthened requirements for reporting issuer audits with significant operations in foreign countries.

With many companies becoming ever more international, auditor oversight often extends beyond the work of only Canadian auditors to foreign firms.

The recent changes assist CPAB in obtaining access to foreign component audit working papers and will improve audit quality for entities with global operations.

Our collaboration encompasses many other areas, including enforcement.

In 2014, EY Canada agreed to pay an $8-million fine to the OSC over its audits of Sino-Forest, which had claimed to be one of the largest commercial forestry companies in China.

Working with CPAB, we reached a settlement wherein the accounting firm agreed to change its internal policies on emerging markets.

That's one example where the audit work lacked the right level of professional skepticism—a concern we're going to come back to in a few minutes.

Despite our successful collaboration on enforcement cases, there is more to do. In 2022, the Auditor General identified information sharing between our two agencies as a concern, and we are working together with the ministry on addressing those gaps.

I applaud CPAB's efforts at enhancing transparency and expanding disclosure, including enforcement actions and results of regulatory assessments, individual firm inspection reports for every audit firm inspected by CPAB each year as well as new expectations for disclosure of inspections reports to audit committees.

Yesterday, CPAB launched a public consultation on the rule changes that are needed to achieve this enhanced level of transparency.

We also applaud CPAB's efforts to step up enforcement actions around the higher level of deficiencies identified in mid-size audit firms.

The OSC and CPAB are continuing our ongoing collaboration to strengthen audit oversight and enforce the bedrock role of audit quality in market integrity and investor confidence.

I want to turn to some recent issues that highlight the emerging challenges for regulators.

We heard from the panelists today about the risks of fraud, including greenwashing, and other recent high-profile scandals such as the downfall of Wirecard in Germany.

One common denominator among these stories is skepticism—or lack thereof.

Professional skepticism is inherently linked to audit quality, ethics, independence, and the confidence people have in the auditing profession.

It is a widely discussed concept, and the absence of skepticism has been noted by regulators in circumstances where things go wrong.

In 2020, BDO paid a $3.5-million fine for failing to bring sufficient professional skepticism to its audit of wealth management firm Crystal Wealth.

The Sino-Forest case is another that illustrates how a lack of skepticism can be a significant liability.

Reaching back even further, we can look to the Livent case from the late 1990s. After nearly two decades of litigation, the Supreme Court of Canada affirmed that Deloitte's lack of skepticism about Livent's finances meant it had contributed to the firm's eventual failure.

Professional skepticism means many things throughout the audit process.

It means properly assessing the reliability of information, including its source, and being alert to any contradictory evidence.

Auditors need to be ready to challenge the information they receive, especially on complex or subjective issues.

It means understanding the conditions where fraud can occur, including unusual circumstances, unnecessarily complex corporate structures and related party transactions.

Auditors need to ensure they understand the reasons underlying these transactions and structures and ensure the right audit procedures have been followed with a heightened level of professional skepticism.

Professional skepticism is a mindset and attitude that enhances an auditor's ability to understand, identify, and respond to risk.

In the past two decades, we've seen many examples that highlighted its importance.

Accounting standards allow for use of judgement, estimates and assumptions in management's financial reporting decisions.

The global financial crisis showed that auditors in many jurisdictions had not applied proper skepticism to the audit of management's judgements and estimates in fair value determinations, related party transactions and going concern assessments.

Lessons have been learned, and auditing standards have been enhanced to underscore the importance of professional skepticism, but it is up to the audit firms and individual auditors to ensure this important concept is embedded in all the work they do.

At the OSC, we support CPAB's work to foster a more independent and challenging mindset in auditors.

We recognize that some audit firms may need to change their culture to allow this to happen.

As auditors, the gatekeeper role means a high standard of ethics for the profession. As in other areas of business, ethics underpins every practice and policy for proper audits.

The integrity of any audit depends on the integrity of the auditors.

In 2022, PCOAB in the U.S. and CPAB and the OSC here in Canada responded to self-reported breaches of professional standards at two of the four largest accounting firms.

Given the established importance of reliable audited financial statements to the proper functioning of the capital markets, the seriousness of these ethical lapses is obvious.

At the OSC, we have been communicating and consulting with CPAB on the proper responses, and welcome CPAB's continued work to address ethics issues through its inspection and enforcement processes.

When there are breaches in those ethics, regulators need to respond.

We can take some solace in the fact that these breaches were self-reported, showing the impact that culture can have on identifying and addressing problems.

In June of this year, we identified areas that public accounting firms should consider when assessing whether their existing policies and procedures are sufficiently robust to safeguard against ethical violations in the audits of financial statements of reporting issuers.

These fall under three broad areas: Internal Ethics Policies and Procedures, the Dating of Audit Work Performed, and Internal Professional Training Programs.

On ethics, we have identified key practices that firms should consider. These include assigning ownership for ethics to a leader or leaders within the firm, targeted ethics education and guidance, and robust internal whistleblower programs.

For proper dating of audit work, firms should consider whether their current practices are sufficient. That includes dating of working papers, archiving of audit files, and what types of information can be added after the fact.

Internal training programs were a key issue in our inquiry, following the lapses identified at some of the major firms. Management should consider controls to prevent and detect cheating on training and testing programs, including sharing answers between staff. We expect to see firms have zero tolerance for such ethics failures.

By considering their practices, firms can do their part to build confidence in the profession. The gatekeeper role comes with significant responsibility for ethical conduct.

Our work in Canada is informed by international developments, in the U.S. and beyond.

The audit failures around the German payments firm Wirecard were a seminal moment for the profession.

It's important to discuss what it revealed about potential gaps in the Canadian oversight regime and how we're responding.

We are already working on improving communication between regulators here in Canada. In Germany, three different regulators failed to share the proper information to detect what was going wrong with Wirecard.

We are also looking at lessons from other jurisdictions for fraud prevention and detection. Specifically, we looked at requirements for whistleblowing procedures and internal audit, as well as the financial literacy of audit committee members.

We found that our rules may be less stringent than other jurisdictions in certain areas and we plan to review our rules in certain areas as a result.

For example, there is currently no requirement for an audit committee member of a venture issuer to be financially literate.

These accommodations were determined to be appropriate for the venture market over 20 years ago.

Given the changes in the current environment and the audit committee's role in fraud prevention and detection, we want to explore stakeholder views on whether these accommodations continue to be appropriate.

Current rules require audit committees to have procedures for complaints related to accounting, audit or internal control matters.

Given the importance of whistleblowers in detecting corporate fraud, we may consider enhancing the scope of complaint procedures to refer to fraudulent activity more broadly.

In addition, securities legislation in Canada does not require issuers to have an internal audit function or even disclose its existence.

Other jurisdictions have adopted a comply or explain approach for internal audit functions, which can be effective in fraud detection and prevention.

The CSA may explore stakeholder views on disclosure requirements about the use of internal audit for non-venture issuers.

Securities regulators, working closely with the accounting profession, need to maintain our momentum on updating and evolving our oversight and regulatory regime as we identify areas for improvement.

Audit quality will only become more important as emerging areas such as sustainability accounting raise issues such as ESG reporting and greenwashing.

The subject of auditing of crypto assets could be its own speech entirely. CPAB has already done great work on identifying the many risks in verification, custody, and other areas of concern.

Our interconnected world also brings its own complications, such as cybersecurity and risk management around data.

As always, we are taking a balanced approach to oversight, informed by our made-in-Canada approach and the unique situation in our capital markets.

As with the fundamental principles of securities regulation, the role of the auditor is technology agnostic and remains consistent as new business models and innovative products come to market.

We will continue to work with CPAB on industry oversight and encourage its continued use of its enforcement powers to raise level of professional skepticism, audit quality, and audit firm quality.

Thank you for your attention.