EY Center for Board Matters

What Canadian audit committees need to know at the end of 2019

Building a better working world

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Introduction

In this 2019 edition of our annual review of issues affecting audit committees during the year-end audit cycle, we summarize key developments for audit committees to consider. The audit committee role grows more demanding and complex amid fast-paced change, and this report will assist audit committees as they proactively address recent and upcoming developments in risk management, financial reporting, tax, environmental and social governance and regulatory developments.

1 Risk management

Risk Management

With disruption occurring at an increasing pace across a number of dimensions (e.g., new technologies, changing consumer preferences, new competitors), organizations are embracing new technologies to transform their business models, drive growth and improve efficiency.

They are leveraging big data to drive competitive insights and entering into strategic transactions, such as mergers, acquisitions, divestitures, alliances and joint ventures, to enhance their competitive advantage. Management is also re-evaluating existing operating models to identify ways to become more agile and efficient to deliver results while responding quickly to new business challenges. All of these developments create both opportunities and challenges for risk management.

Audit committees, or those committees tasked with risk management oversight (given that this varies by company and industry), must help organizations balance shifting priorities and resources to guide the organization in addressing the key risks it faces today and anticipating emerging risks. In this continually changing environment, boards and committees tasked with risk management oversight should continue to encourage their organizations to optimize risk management practices while also enhancing their own oversight of risk.

While the insights in this document apply to any committee responsible for risk management oversight, we will refer to the audit committee for the remainder of this section.

> “The siloed and reactive view of risk management prevalent today is no longer enough to guarantee the integrity and consistency necessary to build trust. Organizations need to adopt a proactive, future-facing and fully integrated approach to risk.
>
> **Amy Brachio**
> EY Global Advisory Risk & Performance Improvement Leader

Further discussion

A move toward optimizing enterprise risk management (ERM)

CEOs, directors and institutional investors believe unfavourable economic conditions, people issues (such as talent shortages due to technology change and failure to upskill) and national and corporate cybersecurity are the biggest risks that will most affect businesses in the next 12 months.

Other risks, such as those related to innovation, culture, geopolitics, the abundance (possibly overabundance) of data, privacy, environmental and social factors, and resilience (particularly in critical infrastructure) continue to weigh on and challenge organizations and their risk functions.

Leading organizations are conducting enterprise-wide risk assessments that capture all categories of risk – strategic, operational (including technology), reputational, financial and compliance – on a continuous basis to help focus and recalibrate on the key risks. Audit committees should verify that these dynamic assessments take a holistic view of risk and have a direct link to the organization's overall strategy and ERM program. ERM programs should include both quantitative and qualitative considerations and incorporate forward-looking perspectives, such as risks associated with corporate objectives, growth strategies, new products, and environmental/social and regulatory changes.

With many businesses moving faster than ever, executing ERM at the speed of the business is a challenge across the three lines of defence:

Management and audit committees expect risk functions to be more agile and run at the speed of the business and technological innovation. Risk leaders across the lines of defence are examining how technological innovation can deliver risk-related services faster and more efficiently.

Digitally enabled risk optimization tools can enable management to anticipate changes in the market and developments in the consumer context. Accordingly, audit committees are expecting the internal audit function to provide leading-class assurance by going beyond financial and compliance internal controls assurance to assessing the areas that matter most to the company and board, including strategy, operations, outside market forces and emerging risks.

While boards generally say that ERM at their organization is effective in managing established risks, only 40% of boards are satisfied with the management of new and emerging risks.

This highlights the need for organizations to enhance their ERM practices, particularly in the management of atypical and emerging risks. Better and faster integrated risk intelligence that provides timely insights on opportunities, risk exposures and external considerations can drive more risk-confident decisions at organizations and allow them to respond more quickly to market pivot points. However, more organizations are examining what they need to put in place to generate this competitive leverage.

This paradigm change is causing audit committees and boards to reflect on the organization's skill sets and talent needs for the future. This applies across finance, risk and compliance professionals as well as boards and audit committees themselves. It is important to consider skills across multiple risk topics (e.g., compliance and operational risk) and types of risks (e.g., cyber and resilience). Making use of new technologies also requires strong knowledge of legal frameworks for external data hosting, audit procedures across different platforms, and internal and external data protection risks.

Leading organizations are also using machine learning, artificial intelligence and other technologies to enhance their risk management efforts and provide predictive, forward-looking risk insights to management and boards. This is helping chief audit executives, chief risk officers and others to not only provide greater and deeper insight, but also to drive efficiencies.

Internal audit functions are monitoring financial (e.g., control failures) and compliance risks through risk dashboards that provide continuous control monitoring and real-time assurance, enabling them to see areas of potential concern before they become an issue by recognizing correlations and patterns in data. For example, companies can make use of automated techniques for more ongoing monitoring of emerging risks, deploying tolerance thresholds for key risk indicators and using machine learning algorithms to survey data across multiple years of history.

Enhancing oversight of cybersecurity

With technology disruption viewed as one of the top two strategic opportunities and a significant risk area, this also opens the door to exponential increased cyber risk. Boards and audit committees should remain vigilant and enhance their oversight of this dynamic risk by:

- Setting the tone that cybersecurity is a critical business issue, since the time and effort the board spends on cybersecurity signify whether it is a priority for the company.
- Confirming that the company's new technology and business arrangements are designed with security, risk and compliance in mind from the beginning by embracing a trust-by-design philosophy.
- Understanding the company's value at risk in dollar terms.
- Remaining familiar with the company's processes to identify, assess and manage third-party and supply chain risks.
- Making sure the cybersecurity risk management program is independently and appropriately assessed by a third party which should report back to the board.
- Having comprehensive knowledge of the company's ability to respond and recover, which should include simulations and arranging protocols with third-party professionals before a crisis hits.
- Having a thorough understanding of the cybersecurity incident and breach escalation process and protocols within the organization, including when the board should be notified.
- Staying attuned to evolving board and committee cybersecurity oversight practices and disclosures, including asking management for a review of the company's cybersecurity disclosures over the last two to three years with peer benchmarking.

The EY Global Information Security Survey

Now in its 21st year, the EY Global Information Security Survey (GISS) in 2018-19 covered more than 1,400 respondents worldwide. For Canadian organizations that participated in the survey, findings included:

- Only 16% of boards have a comprehensive understanding of information security to fully evaluate the cyber risks the organization faces and the measures it takes.
- 70% of respondents have increased their cybersecurity budgets in the last 12 months, while 91% said they will inject more resources into cybersecurity in the next year.
- With regard to the effectiveness of the organizations' information security reporting, 21% of respondents do not receive reports, 21% of reports do not meet expectations, 51% of reports meet some expectations; and only 7% of reports meet all expectations set by the board.

EY SURVEY RESULTS

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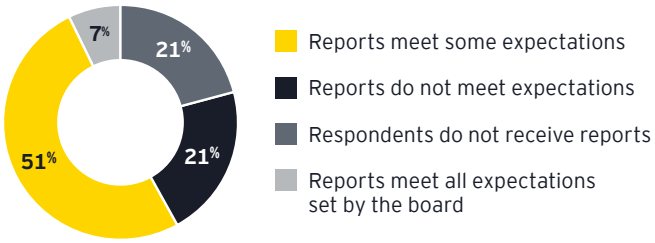
91% said they will inject more resources into cybersecurity in the next year.

Effectiveness of the organizations' information security reporting:



Oversight of privacy

New and emerging privacy laws, as well as the increasingly acute attention many stakeholders are paying to privacy, are creating uncertainty and risk for organizations. While privacy has historically been treated as a legal, compliance or security risk, it is now evolving as a key component of reputational risk, foundational to consumer trust, and a critical tool for differentiation in the marketplace. As companies explore new ways to gather and use data, these risks are becoming fundamental to board discussions about strategy and risk.

New legal requirements in Canada and other jurisdictions — such as the European Union's General Data Protection Regulation, the new California Consumer Privacy Act, and the potential for additional state and federal privacy laws in the US — are creating steep compliance challenges. Audit committees will need to oversee compliance and readiness efforts related to a multitude of newly effective laws, some of which may conflict with each other.

For Canadian organizations, it is important to consider the amendment made to the *Personal Information Protection and Electronic Documents Act* (PIPEDA) that became effective in November 2018. Any organization subject to PIPEDA is required to report any breach to the Office of the Privacy Commissioner of Canada should the incident create a "real risk of significant harm."

In this environment, audit committees must understand the organization's privacy posture, develop related competence (including how data privacy issues and new privacy laws and regulations are being addressed at the organization) and enhance monitoring efforts through data governance reporting metrics. Audit committees should also verify that management has the appropriate governance structures over data, including making the appropriate updates to systems, processes and policies. Adopting a control-based framework that spans an organization's three lines of defence will provide a disciplined and comprehensive approach to addressing privacy risk and compliance.

Board and audit committee oversight of compliance

Increased regulation and enforcement and the adoption of new technology are changing the nature of compliance risks at organizations. As business has become more global and developing countries more prosperous, a movement has grown against the culture of corruption. Companies should remain proactive with managing anti-corruption risk and compliance with regulatory requirements, such as Canada's *Corruption of Foreign Public Officials Act* and the US *Foreign Corrupt Practices Act*.

Audit committees play a key role in setting the tone at the top regarding issues of integrity and verifying that organizations have effective compliance programs that promote ethical behaviour above and beyond compliance with laws. While some organizations have a dedicated compliance function, others are taking a cross-functional approach to enhancing compliance efforts that includes internal audit, human resources, legal and finance.

At leading organizations, the ownership of compliance and ethics is being distributed throughout the organization to the business leaders and embedded in all lines of the business. Given the importance of compliance, some audit committees are using a variety of metrics to validate the effectiveness of their compliance program (e.g., internal hotline metrics and compliance training results) and performing external benchmarking on the effectiveness of their compliance program through formal third-party assessments on a periodic basis.

There is also an increase in the use of digital compliance tools. For example, artificial intelligence can provide communications and risk alerts tailored to individuals in real time, which can be more effective than classroom or web-based training. These can optimize monitoring and reporting, and even the use of resources. In addition, audit committees should closely monitor and keep their finger on the pulse of how culture can affect internal controls and compliance. This includes consideration of analytics of cultural trends, benchmarking to other entities or standards, lessons-learned analyses, reviews of behavioural trends, and surveys of risk attitudes and risk awareness.

Risk management

Questions for the audit committee to consider

1. Has the audit committee reviewed the effectiveness of management's risk management programs in relation to identifying both risks and opportunities?
2. How effective is the organization in adjusting its risk appetite in response to changes in the risk landscape?
3. How is the organization deploying new tools and technologies to identify patterns and correlations in company data to identify potential warning areas?
4. Does the organization have the necessary skill sets, talent and culture to effectively manage the organization's significant risks? If not, what are the gaps, and how will management address them?
5. Has the audit committee considered the company's total risk exposure for a cyberattack, including the financial, legal and reputational impacts? Have escalation and response plans been developed and simulations conducted?

Additional reference

- EY 21st Global Information Security Survey 2018-19 (Canada Highlights)
- How to inspire confidence in the Transformative Age
- How boards are governing disruptive technology
- Four ways to 'unlock' the chief audit executive and create trust
- Five fast questions for CROs contemplating the year ahead
- How a real-time read of all risks can open new opportunities
- How to manage the evolving risks of emerging technology
- What boards are doing today to better oversee cyber risk
- What companies are sharing about cybersecurity risk and oversight
- SEC Statement and Guidance on Public Company Cybersecurity Disclosures
- Why you need a strategic approach to political risk

2 Financial reporting

Revenue recognition

In adopting the new revenue standard (IFRS 15), Canadian companies have focused on areas of judgment such as identifying performance obligations, estimating variable consideration, recognizing revenue over time or at a point in time, analyzing principal versus agent considerations and disaggregating revenue for disclosure purposes. Issuers have been asked to further explain and sometimes provide their analysis for judgments and estimates made in the application of the standard. In the US, the volume of SEC comments related to revenue recognition (ASC 606) nearly doubled the year ended 30 June 2019 and represented about one third of all comments. Overall, this was not unexpected because revenue is frequently an area of comment, and the implementation of a new standard is typically an SEC staff focus area.

During the year, the IFRS Interpretations Committee (IFRIC) issued a number of final agenda decisions (AD) and tentative agenda decisions (TAD) on IFRS 15 related to issues that have been raised globally since adoption of the standard, including:

- The assessment of the goods and services promised in a contract and the identification of performance obligations, where an upfront fee is received (January 2019, AD)
- The capitalisation of borrowing costs related to a constructed good where revenue is recognised over time (March 2019, AD)
- Accounting for costs incurred to fulfil a contract as an entity satisfies a performance obligation in the contract over time (June 2019, AD)

Leases

In our experience, there is complexity associated with complying with the volume of disclosures required in adopting the new leases standard (IFRS 16). Deficiencies identified in reviews of interim financial statements have included inadequate disclosure related to judgments (e.g. lease term), estimates (e.g. incremental borrowing rate) and transition impact (e.g. not quantifying material adjustments by line item). Some entities did not provide the new accounting policy under IFRS 16, omitted the reconciliation of operating lease commitments to lease liabilities or did not disclose the effect on comparatives of adopting IFRS 16. Issuers should ensure IFRS 16 related disclosures are complete in their annual financial statements.

Entities that have adopted the new leases standard need to make sure that they have policies, processes and controls in place to account for new or modified leases and those that must be reassessed or remeasured under IFRS 16.

During the implementation many companies used manual workarounds when implementing the new leases standard. A critical step in accounting for new, modified or reassessed lease contracts is to determine the appropriate lease term and inputs used to estimate the incremental borrowing rate. Lessors that have adopted the new leases standard will need to monitor the collectability of lease payments (and any amounts necessary to satisfy a residual value guarantee) both at and after the lease commencement date.

The IFRIC has issued a number of final agenda decisions and tentative agenda decisions on IFRS 16 related to issues that have been raised globally since adoption of the standard, including:

- Recognition of liabilities (including lease liabilities) in relation to a joint operator's interest in a joint operation (March 2019, AD)
- Accounting for a customer's right to access a supplier's software hosted on the cloud (March 2019, AD)
- Accounting for contracts for subsurface rights (June 2019, AD)
- The definition of a lessee's incremental borrowing rate (September 2019, AD)
- The determination of the lease term of cancellable and renewable leases and useful life of any non-removable leasehold improvements relating to such a lease (November 2019, AD)

Financial instruments

The new financial instruments standard (IFRS 9) affects entities in all industries, not just those in financial services, and introduces significant changes to the accounting and disclosures for credit losses on a wide variety of financial instruments, including loans, reinsurance and trade receivables. Some of the areas we have seen Canadian companies focusing on include the assessment of how forward-looking information has been incorporated into the determination of expected credit losses, how companies define default and how companies determine that a significant change in credit risk has occurred.

Entities should consider whether they need to create or enhance their processes and controls over key judgments to comply with the new credit loss model.

Similar to IFRS 15 and IFRS 16, during the year, the IFRIC issued a number of final agenda decisions and tentative agenda decisions on IFRS 9 related to a number of issues that have been raised globally since adoption of the standard.

Non-GAAP financial measures

Securities regulators continue to focus on deficiencies in disclosure of non-GAAP financial measures. In particular, prominence of non-GAAP financial measures (ensuring they are less prominent than related GAAP financial measures), inconsistent presentation in different fiscal periods, excluding normal recurring cash operating expenses from performance measures and adjustments that reflect individually tailored GAAP recognition and measurement principles. We expect there to be more focus by regulators on non-GAAP financial measures for the 2019 reporting cycle given the adoption of the new leasing standard.

Audit committees can play an important role in understanding how management uses non-GAAP financial measures and how they supplement the GAAP financial statements. Audit committees that display strong interest in non-GAAP financial measures can have a positive effect on the quality of disclosures.

In 2018 the CSA published for comment Proposed National Instrument 52-112, Non-GAAP and Other Financial Measures Disclosure, intended to improve issuers consistency and transparency of disclosures. The CSA received 42 comment letters on this proposal, and we understand that based on this feedback the proposal will be modified and re-exposed for comment in the near future.

Business acquisitions

A reporting issuer that is not an investment fund is required to file a business acquisition report (BAR) after completing a significant acquisition. In September 2019, the CSA issued proposals aimed at reducing the regulatory burden associated with the requirement to file BARs.

The Proposed Amendments:

- Alter the determination of significance for reporting issuers that are not venture issuers such that an acquisition of a business or related businesses is a significant acquisition only if at least two of the existing significance tests are triggered; and
- Increase the significance test threshold for reporting issuers that are not venture issuers from 20% to 30%.

The comment period for the proposed amendments closed on December 4, 2019 and the CSA are deliberating 14 comment letters received.

Corporate Governance Disclosures

In November 2019, the CSA published Staff Notice 51-359 *Corporate Governance Related Disclosure Expectations for Reporting Issuers in the Cannabis Industry* observing instances of inadequate transparency relating to the cross-ownership of financial interests by reporting issuers in the cannabis industry or directors/executive officers of such issuers, involved in mergers, acquisitions or other significant corporate transactions. Instances were observed where board members were identified as being independent, without giving adequate consideration to potential conflicts of interest or other factors that may compromise their independence.

While this Notice is directed towards cannabis reporting issuers, its content is equally relevant to other issuers, including those operating in emerging growth industries.

Financial reporting

Questions for the audit committee to consider

1. Has the audit committee played a role in understanding how management may be using non-GAAP financial measures to supplement GAAP financial statements and the appropriateness of disclosure controls? Why does management believe the non-GAAP measures provide meaningful and useful information to investors?
2. What internal controls has management designed around both its implementation process for new accounting standards and ongoing processes for accounting under the new standards?
3. Has the company's management sufficiently challenged the adequacy of its disclosures required under new accounting standards, particularly in areas that require significant judgment or estimates?
4. How is technology changing the company's finance function, and what sort of assurance is the audit committee getting that financial information integrity is preserved during and after any transition?

Additional reference

- CSA Staff Notice 52-306 (Revised) Non-GAAP Financial Measures
- OSC Corporate Finance Branch 2019 Annual Report (Staff Notice 51-730)
- CSA Staff Notice 51-359 (Corporate Governance Related Disclosure Expectations for Reporting Issuers in the Cannabis Industry)
- SEC Comments and Trends: An analysis of current reporting issues

3 Tax

Tax

Global digital tax initiatives, continued tax reform and changes to tax laws around the world, and ongoing trade volatility all continue to contribute to an unpredictable tax landscape for businesses.

Boards and audit committees are tasked with overseeing businesses' responses to these and other considerations and making sure their organizations are able to respond rapidly to disruption in the tax space. Adapting and excelling in this environment requires a greater focus on risk and compliance oversight, as well as greater involvement in monitoring policy developments and modeling different potential scenarios. Companies that can make use of new tools to access and process information will have a competitive edge in this transformative period.

Canada Signs Multilateral Tax Agreement

On August 29, 2019, Canada deposited its instrument of ratification for the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (MLI). The MLI became effective on December 1, 2019 and will apply to some of Canada's tax treaties with effect on January 1, 2020.

The MLI is one of the initiatives of the Organization for Economic Co-operation and Development (OECD) to counter perceived base erosion and profit shifting (BEPS). The MLI has been signed by a number of jurisdictions and seeks to amend bilateral tax treaties through an expedited process. The MLI measures are designed to help enhance Canada's ability to challenge perceived treaty abuse and improve dispute resolution procedures.

The MLI includes certain measures such as a principal purpose test to potentially deny treaty benefits where it is reasonable to conclude that the principal purpose of the arrangement or transactions was to obtain treaty benefits. The MLI also introduces certain holding period tests that may be relevant for obtaining treaty benefits.

Boards and audit committees should understand the structures that are in place, and whether the MLI will have an impact on existing or future contemplated structures. Boards and audit committees should continue to monitor international tax developments considering BEPS.

Tax Cuts and Jobs Act

Nearly two years after its enactment, the Tax Cuts and Jobs Act (TCJA) continues to be a major focus of tax planning and a source of uncertainty for business taxpayers. Changes to the international tax system have required businesses to revisit their structures, supply chains and overall tax planning.

Regulatory guidance related to the US TCJA is still being drafted, with several important final packages related to international tax provisions expected. This expected guidance may provide opportunities as taxpayers plan for the future. Forms and systems necessary to file tax returns are also still being finalized, increasing compliance burdens and the potential for errors. In addition, each state is working through the expected impact of the TCJA. As a result, state taxation is more complex than ever before. While some states quickly adopt federal tax changes, others adopt much more slowly, and still others may enact state-specific legislation to account for the impact the TCJA had on income taxes in their jurisdiction.

The eventual finalization of regulations related to the TCJA and state tax updates could lead to changes in financial statement tax reserves and uncertain tax position disclosures on future tax returns and amended returns. These developments could result in tax controversies related to post-TCJA tax return years, making it important for companies to thoroughly document their tax return positions while the law remains in transition and for boards to understand what management is doing to address this need.

Boards and audit committees should understand any tax planning changes their companies have made in the wake of the TCJA and whether any additional taxing authority examination risks have been identified. In addition, boards and audit committees should continue to monitor the issuance of regulatory guidance. This guidance could impact common structures put in place and require ongoing restructuring of financing and other types of arrangements currently in place.

Trade policy

The trade environment remains volatile and challenging from a business planning perspective and will likely continue to have repercussions for the global economy.

From a legislative standpoint the US House of Representatives approved the US-Mexico-Canada Agreement (USMCA), the revised North America Free Trade Agreement (NAFTA). The deal now heads to the Republican controlled Senate. Mexico has already ratified the deal and the Canadian government has said that it will ratify once the US does.

Given the huge potential implications of global trade shifts for supply chains and prices, boards will need to stay on top of this fluid situation. Boards need to understand management's approach to addressing this and other potential geopolitical and regulatory developments, including impacts on strategy and risk management. Companies and boards should consider the broader risk and operational impacts of tariffs and changes in trade policy, such as the implications of an undiversified supply chain, potential changes to the organization's cost structure and operational inefficiencies. Scenario analysis and stress testing critical assumptions can help boards better understand management's process for mitigating the risks associated with an uncertain trade environment.

Taxation of the digital economy

The European Union and individual European countries have been examining digital services taxes (DSTs) and other new forms of taxation. With these efforts as a backdrop, the OECD has undertaken a project to address digital tax challenges in a globally coordinated way. The OECD effort has implications for all multinationals, not just digital businesses.

The OECD project would change longstanding nexus and profit allocation rules and include new global minimum tax rules. The timeline is aggressive, with a goal of a conceptual agreement by the end of 2019 and full consensus on details of the new rules by the end of 2020. This timeline is largely driven by a desire to avert countries' unilateral DSTs and instead develop globally coordinated rules. This only puts more pressure on transfer pricing arrangements globally.

These efforts reflect another source of uncertainty as the initiative could modify longstanding global international tax standards and practices. Boards and audit committees should make efforts to understand their company's tax strategy and digital aspirations to determine the implications of these potential new rules.

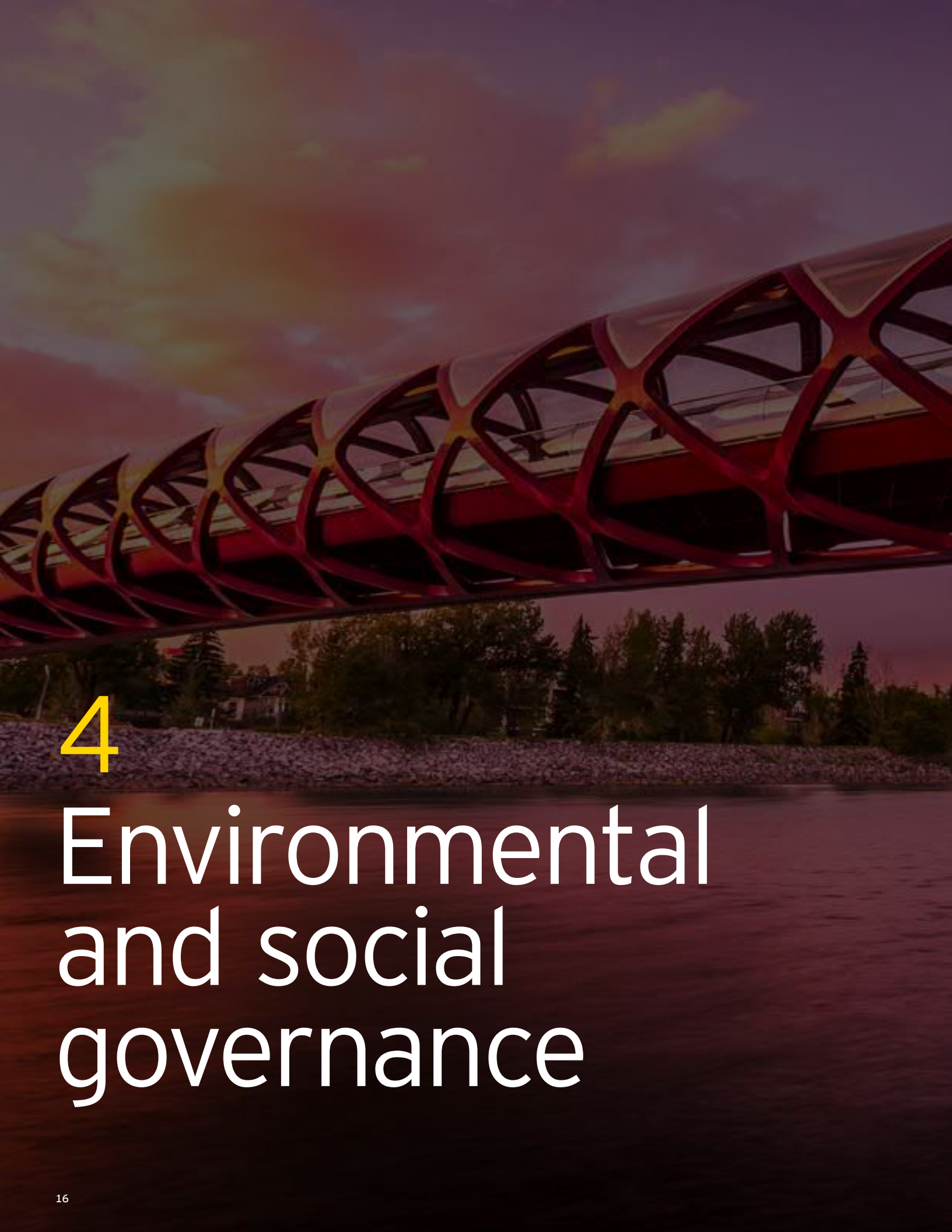
Tax

Questions for the audit committee to consider

1. What additional investment and/or tax planning has the organization undertaken in response to legislative changes?
2. What changes to internal controls have been designed and what key actions has management taken to address the tax legislation?
3. What additional compliance procedures have been performed because of new legislation, and have any additional audit risks been identified? If so, how have they been addressed?
4. Has the company engaged in modelling and scenario planning to weigh the potential impacts of tariffs and other trade policy developments?
5. Has the company considered proactive engagement with the OECD or individual countries on digital tax issues?

Additional reference

- 2019 Canadian Tax Alerts
- US tax reform web page
- Five Things to Know on the One-Year Anniversary of the Tax Cuts and Jobs Act



4 Environmental and social governance

ESG reporting continues to evolve – focus on climate change

Investor requirements

Analysis of corporate reporting on environmental, social and governance (ESG) factors has now become broadly accepted as a fundamental element of how debt and equity investors evaluate investment risk. This has evolved despite a lack of a single generally accepted reporting framework to measure specific or overall corporate ESG performance. Where ESG factors originally mattered most to participants in "ethical" investing, they are now considered relevant by many investors in their estimation of overall risk to future returns.

Numerous rating agencies now assign ESG ratings to corporate issuers and even to investment funds based on published corporate data, media coverage and their own proprietary methodologies to develop an overall ESG score. Many asset managers rely on these third-party ratings and their own internal measures to allocate investment funds. As a result, companies need to understand what industry-specific ESG matters are most important to investors and ensure that they are providing clear, transparent data consistent with the most widely accepted disclosure frameworks available.

Regulatory requirements

In general terms, North American securities regulators have been hesitant to pass regulations mandating or codifying the contents of ESG disclosures since material ESG risks are theoretically covered by existing overall risk disclosure requirements.

However, political pressures are mounting, largely due to climate change fears, but also due to societal concerns around social issues and the role of corporations. The effect of political and social pressures is seen most clearly in the rise of requirements to provide disclosures around climate change.

The Canadian Securities Administrators recently published *CSA Staff Notice 51-358: Reporting of Climate Change-related Risks*, which elaborates on their previously published environmental risk disclosure guidance. The CSA notice provides guidance on identifying and disclosing climate change-specific risks over the short, medium and long term. The CSA encourages boards and management to assess their expertise at identifying such risks and develop a process to fully analyze them.

The CSA notice provides many helpful questions for boards to ask:

- Is the board provided with appropriate orientation and information to help members understand sector-specific climate change-related issues?
- Has the board been provided sufficient information, including management's materiality assessments in respect of the issuer's climate change-related risks, to appropriately oversee and consider management's assessment of these risks?
- Is the board comfortable with the methodology used by management to capture the nature of climate change-related risks and assess the materiality of such risks?
- Is the board aware of how investors are factoring climate change-related risks into their investment and voting decisions?
- Is oversight and management of climate change-related risks and opportunities integrated into the issuer's strategic plan, and if so to what extent?
- Has the board considered the effectiveness of the disclosure controls and procedures in place in relation to climate change-related risks?

The CSA notice provides a lengthier list of questions for management which are not reproduced here.

The onus is now on companies to have done their homework on how climate change could affect them and to provide clear company-specific information to investors through the Management Discussion and Analysis or the Annual Information Form.

> Companies need to understand what industry-specific ESG matters are most important to investors.

What is climate change risk?

Many people struggle with how to think about climate change risk. Climate change risk is typically evaluated and disclosed in terms of "transition" risks and "physical" risks.

Transition risks are changes in the company's business environment caused by society taking steps to mitigate climate change. These include carbon taxation and other regulatory changes such as banning single-use plastics, consumer behavioural changes such as shifting away from fossil fuel usage, as well as technological changes and litigation risks. These risks are usually industry and even company specific.

Physical risks are the direct impacts on a business due to changing temperatures resulting in changes in weather and water levels, for example. For many companies, the transition risks are the most impactful.

To illustrate risk, expectations are that companies will provide qualitative and quantitative scenario analysis of how different outcomes could affect the company. For example, what changes in regulation and consumer behaviour are expected to take place if the objective is to limit global warming to 2 degrees Celsius over this century? Conversely, how might a 6 degree increase physically affect the enterprise?

Due to concerns around the destabilizing effect on the financial system arising from climate change, the Financial Stability Board has issued disclosure recommendations to global financial institutions along these very lines. These are included in its *Final Report: Recommendations of the Task Force on Climate-related Financial Disclosures*. The expected adoption of these standards and the likely need for the financial institutions to demonstrate to regulators that they apply this risk analysis methodology to manage climate risk in their loan portfolio will only increase the pressure on corporate issuers to complete this analysis and provide adequate disclosures.

In summary, companies and their boards must take control of their business strategy and disclosure narrative related to ESG factors, especially to climate change. They should ask the right questions to ensure they are undertaking a process to fully understand the effects of potential climate change and society's response, and how their business strategy would adapt in these scenarios. Investors are already asking these questions and will be doing so at an increasing rate.

Environmental and social governance

Questions for the audit committee to consider

1. Does the company understand what industry-specific environmental, social and governance (ESG) matters are most important to investors and ensure that they are providing clear, transparent data, consistent with the most widely accepted disclosure frameworks available?
2. Has the board undertaken a process to fully understand the effects of potential climate change and society's response, and how the business strategy would adapt in these scenarios?
3. Is the board provided with appropriate orientation and information to help members understand sector-specific climate change-related issues?
4. Is the board comfortable with the methodology used by management to capture the nature of climate change-related risks and assess the materiality of such risks?

Additional reference

- CSA Staff Notice 51-358: Reporting of Climate Change-related Risks
- Final Report: Recommendations of the Task Force on Climate-related Financial Disclosures
- Embankment Project for Inclusive Capitalism Report

5 Regulatory developments

OSC Reducing Regulatory Burden initiative

In November 2019, the Ontario Securities Commission (OSC) issued its report, *Reducing Regulatory Burden in Ontario's Capital Markets*, which outlines 107 decisions and recommendations to reduce regulatory burden. Some of these initiatives have been completed or published for comment and are achievable over a relatively short time frame of about a year, while other changes will require legislative amendments, harmonization with other regulators, or long-term investments that will be addressed over a longer time frame. The report is wide ranging and could potentially impact all market participants operating in Ontario's capital markets.

Some of the recommendations in the report include:

- Process for confidential staff reviews of prospectuses prior to announcing offerings.
- Publishing guidance about issues staff may raise during prospectus reviews.
- Harmonizing requirements for financial statements in a long-form prospectus for an issuer's primary business.
- Reducing instances when financial statements are required to be filed for significant acquisitions in business acquisition reports. See also Business acquisitions section on page 12.
- Streamlining prospectus disclosure requirements, including considering having two years of financial statements in IPO prospectuses.
- Streamlining AIF and MD&A disclosure.

The recommendations in the report set targets of between six months and two years for implementation.

Key audit matters implementation

New requirements on disclosure of key audit matters (KAMs) in audit reports will become effective for audits of TSX-listed entities, other than those required to comply with NI 81-106, for financial statement periods ending on or after December 15, 2020. The requirements have been extended to other listed entities, including entities listed on exchanges other than the TSX (i.e. NEO, CSE and TSX-V), but excluding listed entities required to comply with NI 81-106, for financial statement periods ending on or after December 15, 2022. KAMs are defined as those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. KAMs are selected from matters communicated with those charged with governance.

Management and audit committees should work with their auditors to understand the requirements related to KAMs and many are performing a dry run prior to the year of adoption so that appropriate process changes can me made. This will also help reporting issuers prepare for questions that may be received from investors, regulators and others.

The PCAOB standard includes a similar reporting concept to communication of KAMs — critical audit matter reporting (CAMs) — that became effective for fiscal years ending on or after June 30, 2019 for large accelerated filers. While a limited number of audit reports with CAMs have been filed to date, the average number of CAMs is two, and the most frequently identified CAMs are related to goodwill and intangible assets, revenue and income taxes.

CPAB Big Four firm inspection findings

The Canadian Public Accountability Board (CPAB) inspected 66 out of 72 planned audit engagement files across the Big Four audit firms in 2019 at the time of issuing its fall inspections results. It identified significant inspection findings in 12 of those files. CPAB noted that engagement file inspection findings across Canada's four largest public accounting firms indicate some improvement overall compared to 2018, but that firms must do more to fully embed audit quality consistently.

More than half the significant findings were related to the audit of estimates; the other half were related to basic audit procedures that were either not performed (e.g., inventory counts not attended) or not performed appropriately (e.g., procedures to test revenue not sufficiently precise).

CPAB observed that auditors had challenges in auditing fair value estimates of assets acquired, liabilities assumed and non-cash consideration transferred in business combinations. In the audits of cannabis companies, CPAB notes that estimating fair value of biological assets is complicated by market uncertainty and volatility related to volume and price of expected sales, and auditors are not always appropriately assessing the potential impact.

As in prior years, the audit of revenue recognized based on the percentage of work completed continues to be a concern for CPAB, since auditors do not always obtain sufficient and appropriate evidence to support the estimate of progress achieved.

Over the past few years, CPAB has evolved its audit oversight methodology (supplementary to engagement file inspections) to assess the effectiveness of the four largest firms' Quality Management Systems (QMS). In the fall inspection results, CPAB noted the level of commitment the firms demonstrated to improve their QMS and to link them to CPAB's five audit quality assessment criteria: accountability, risk management, talent management, resource management and oversight. Firms are seeing the benefits of implementing QMS on audit quality outcomes.

Audit quality indicators

In 2019, CPAB engaged with audit firms and audit committees to explore the most frequently used audit quality indicators (AQIs) and their impact on driving quality improvements. CPAB noted that AQIs can improve the depth of discussion among the audit committee, management and the auditor by providing a range of effective measures to match the unique needs of each audit committee. In its November 2019 publication *Audit Quality Indicators: How to put them to work*, CPAB shares common AQIs and leading practices for sharing AQIs with audit committees.

Examples of common and non-traditional AQIs include:

- Hours by phase of audit
- Audit effort (number of hours) by risk area
- Timeliness of management deliverables
- Hours by specialists
- Reliance on internal controls
- Use of new and emerging technology in the audit

PCAOB developments

The *PCAOB 2018-2022 Strategic Plan* places an emphasis on improved engagement with a broad array of investors, audit committees, preparers and other stakeholders to enhance the quality of audit services. The PCAOB plans to enhance the timeliness, usefulness and clarity of PCAOB inspection reports and cultivate effective and dynamic dialogue with stakeholders. A new deputy director of the PCAOB's Office of External Affairs has been appointed as a direct point of contact for, and liaison to, investors, audit committees and preparers.

In addition to increased stakeholder engagement, the *PCAOB 2018-2022 Strategic Plan* includes innovation as a strategic priority. This is particularly the case regarding the approach to inspections and standard setting, and the PCAOB Division of Registration and Inspections staff is currently reviewing how it plans, conducts and reports on its inspections. This includes consideration of procedures to review engagement and systems of quality control, their approach to selecting engagements and areas of focus, and how results of inspections are communicated. In December 2019 the PCAOB issued a Concept Release on a potential approach to revising the PCAOB's Quality control standards. The PCAOB also plans to make its oversight more forward looking to consider evolving risks, environmental factors and stakeholder needs.

UK regulatory developments

On December 18, 2019, Sir Donald Brydon published his final report, the Bryden Report, which is an independent review into the quality and effectiveness of the audit of public interest entities. The report makes a number of recommendations, including the establishment of a new corporate auditing profession with a unifying purpose and set of principles. It also makes recommendations in relation to:

Companies, which include the following, among others:

- Directors to publish a Risk Report prior to the audit committee meeting at which the scope of the next audit is determined and endorsed, leaving sufficient time for shareholders to comment, to help determine the scope of the following year's audit.
- Audit committees to present a three-year rolling Audit and Assurance Policy to be submitted to an advisory vote by the shareholders.
- Directors to publish a Resilience Statement that will incorporate short-, medium- and long-term considerations.
- Directors to report on internal controls effectiveness, and to explain the actions they have taken to prevent material fraud.

Auditors, which include the following, among others:

- A redefinition of the purpose of the audit, providing greater clarity about who the audit is for and reinforcing its role as a public interest function.
- Auditors to exercise suspicion as well as scepticism.
- The extension of audit scope beyond examining financial statements, to reflect the wider interests of everyone who depends on the company's ongoing viability.
- Clarification that auditors should endeavour to find material fraud, and a requirement that they undertake education in forensic accounting and fraud awareness.

These are recommendations only at this stage, and together with the Competition & Markets Authority review recommendations from its study issued in April 2019 and the Kingman review issued in December 2018, will now be considered by the Secretary of State for the Government Department for Business, Energy and Industrial Strategy, who will decide what legislation, if any, to bring to Parliament.

EY has consistently expressed its strong view that the multi-disciplinary model provides the structure, breadth and depth of technical skills and industry expertise necessary to meet our public interest obligations to deliver high-quality audits. We believe reforms should enhance, or at least not create risks to, audit quality. To be effective and sustainable, reforms need to focus on improving the audit ecosystem as a whole.

Regulatory developments

Questions for the audit committee to consider

1. What discussions has the audit committee had with its independent auditor regarding audit quality matters, especially the Canadian Public Accountability Board's Big Four audit firms' public inspection report?
2. Has the audit committee had discussions with the auditor to understand how KAMs will be determined by the auditor and related processes that will be followed to meet disclosure requirements?
3. To what extent has the audit committee engaged in dialogue with the auditor on AQIs to help evaluate audit quality and enhance the audit oversight by the audit committee?
4. What process does the audit committee have in place for regular regulatory updates, and is the committee sufficiently engaged in dialogue providing views and input as needed on regulatory consultations?

Additional reference

- Reducing Regulatory Burden in Ontario's Capital Markets- 2019 Report
- CPAB 2019 Fall Inspections Results
- Audit Quality Indicators: How to put them to work
- PCAOB 2018-2022 Strategic Plan
- Report of the Independent Review into the Quality and Effectiveness of Audit (Brydon Report)

Questions for audit committees to consider

Risk management

1. Has the audit committee reviewed the effectiveness of management's risk management programs in relation to identifying both risks and opportunities?
2. How effective is the organization in adjusting its risk appetite in response to changes in the risk landscape?
3. How is the organization deploying new tools and technologies to identify patterns and correlations in company data to identify potential warning areas?
4. Does the organization have the necessary skill sets, talent and culture to effectively manage the organization's significant risks? If not, what are the gaps, and how will management address them?
5. Has the audit committee considered the company's total risk exposure for a cyberattack, including the financial, legal and reputational impacts? Have escalation and response plans been developed and simulations conducted?

Financial reporting

1. Has the audit committee played a role in understanding how management may be using non-GAAP financial measures to supplement GAAP financial statements and the appropriateness of disclosure controls? Why does management believe the non-GAAP measures provide meaningful and useful information to investors?
2. What internal controls has management designed around both its implementation process for new accounting standards and ongoing processes for accounting under the new standards?
3. Has the company's management sufficiently challenged the adequacy of its disclosures required under new accounting standards, particularly in areas that require significant judgment or estimates?
4. How is technology changing the company's finance function, and what sort of assurance is the audit committee getting that financial information integrity is preserved during and after any transition?

Tax

1. What additional investment and/or tax planning has the organization undertaken in response to legislative changes?
2. What changes to internal controls have been designed and what key actions has management taken to address the tax legislation?
3. What additional compliance procedures have been performed because of new legislation, and have any additional audit risks been identified? If so, how have they been addressed?
4. Has the company engaged in modelling and scenario planning to weigh the potential impacts of tariffs and other trade policy developments?
5. Has the company considered proactive engagement with the OECD or individual countries on digital tax issues?

Environmental and social governance

1. Does the company understand what industry-specific environmental, social and governance (ESG) matters are most important to investors and ensure that they are providing clear, transparent data, consistent with the most widely accepted disclosure frameworks available?
2. Has the board undertaken a process to fully understand the effects of potential climate change and society's response, and how the business strategy would adapt in these scenarios?
3. Is the board provided with appropriate orientation and information to help members understand sector-specific climate change-related issues?
4. Is the board comfortable with the methodology used by management to capture the nature of climate change-related risks and assess the materiality of such risks?

Regulatory developments

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3. To what extent has the audit committee engaged in dialogue with the auditor on AQIs to help evaluate audit quality and enhance the audit oversight by the audit committee?
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