



# Auditor Independence in Canada since 2004



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### Introduction

Good corporate governance requires effective internal controls, a function facilitated by a firm's external auditors. It is thus crucial that advice from auditors be unencumbered by conflicts of interest, either real or perceived. In 2004, the Clarkson Centre for Board Effectiveness began a longitudinal piece of research into auditor independence spanning six fiscal years. This study comprises 199 companies taken from the S&P/TSX Composite in 2010. By obtaining annual audit and consultancy (non-audit) costs from Annual Information Forms and other relevant public filings, our research reveals a clear fall in consultancy fees since the enactment of the Sarbanes-Oxley Act 2002 (SOX). Consultancy fees include non-audit services such as tax compliance, advice and planning. The decline in consultancy fees is mirrored by a rise in audit fees, which suggests an increase in auditor independence.

### Sarbanes-Oxley Act 2002

In search for greater profit, auditors have evolved from traditional 'gatekeepers' of companies to sales/business advisors.<sup>1</sup> Instead of monitoring errors and alerting their clients of potential problems, auditors made more money by advising clients on circumventing regulations rather than tackling the existing problems. Giving evidence before the Securities Exchange Commission on 26 July 2000, Professor John Coffee Jr. said that the concept of independent auditors as gatekeepers has to be reexamined. In a June 2000 release, the SEC said that "the federal securities laws ... make independent auditors 'gatekeepers' to the public securities markets."<sup>2</sup> According to Professor Coffee Jr., the incentive for an auditor to acquiesce has grown because the economic gains from being a 'multi-faceted vendor of business advisory services' is attractive.<sup>3</sup> Further, the potential sanctions for acquiescence have decreased. This incentive asymmetry compromised auditors' objectivity and independence. Enacted on 30 July 2002, SOX attempted to improve public confidence and trust in companies and their gatekeepers such as lawyers, auditors and regulators.

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<sup>1</sup> The notion of auditors as 'gatekeepers' was first advocated by Gilson and Kraakman (1984) R.J. Gilson and R.H. Kraakman, The mechanisms of market efficiency, *Virginia Law Review* **70** (1984), pp. 549–621 and Kraakman (1986) R.H. Kraakman, Gatekeepers: The anatomy of a third-party enforcement strategy, *Journal of Law Economics and Organization* **2** (1986), pp. 53–104.

<sup>2</sup> 2000 SEC Lexis 1389, 11.

<sup>3</sup> Testimony of Professor John C. Coffee, Jr. Adolf A. Berle Professor of Law, Before the Securities and Exchange Commission on July 26, 2000, Gatekeepers and the Concept of Auditor Independence. Online:

<http://www.sec.gov/rules/proposed/s71300/testimony/coffee1.htm>.

SOX applies to all publicly traded companies in the United States. Title II of SOX deals with auditor independence. The fundamental guiding principles of auditor independence are that an auditor cannot function in the role of management, audit his/her own work or be the client's advocate. Auditors already providing audit services to their clients cannot engage in bookkeeping, financial information systems design and implementation, appraisal or valuation services, fairness opinions, actuarial services, internal audit outsourcing services, management and human resources functions, broker or investment banking services, legal services and expert services unrelated to the audit.

SOX states that auditors can provide tax services such as tax compliance, planning and advice for audit clients, subject to requisite pre-approval. No approval is required if the tax fees constitute less than 5% of the annual revenue paid by the client to its auditor. There also needs to be prompt notification of this to the audit committee and investors. However, merely calling a service as a 'tax service' will not protect that activity if in essence the activity is prohibited under section 201 of SOX.

Section 404 of SOX requires all publicly-traded companies to set up internal controls and procedures for financial reporting. Companies also need to document, test and maintain those controls and procedures to ensure their effectiveness. Section 404 aims to reduce corporate fraud by increasing the stringency of procedures and requirements for financial reporting.

SOX is of interest and relevance to Canadian companies because as at August 2011, there are 74 Canadian companies listed on the New York Stock Exchange and 45 companies listed on the NASDAQ<sup>4</sup> in addition to their listing on the Toronto Stock Exchange. According to the Canadian Parliament, section 404 of SOX is 'laying the groundwork for sounder financial reporting and better investment decisions'<sup>5</sup>. In addition, Meuwissen et al. (2003)<sup>6</sup> show that auditor independence regulation is associated with higher quality accounting information. Meaningful auditor independence is understood by these parties as helpful in restoring investor confidence in companies.

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<sup>4</sup> [www.nyse.com](http://www.nyse.com) and [www.nasdaq.com](http://www.nasdaq.com).

<sup>5</sup> Gray, T. (2005) Canadian response to the US. Sarbanes-Oxley Act of 2002: New directions for corporate governance. 4 October 2005. [Online] <http://www.parl.gc.ca/Content/LOP/researchpublications/prb0537-e.htm>.

<sup>6</sup> Meuwissen, R., Moers, F., Peek, E., & Vanstraelen, A. (2003). The Influence of Auditor Independence Regulation on Earnings Quality: An Empirical Analysis of Firms Cross-Listed in the US. *Working Paper*.

## Canada's response to SOX

The seismic effect of Enron, WorldCom, Tyco, etc. was felt less in Canada than in the United States. In addition, since Canadian companies are smaller than US companies in terms of market capitalization, directly enforcing SOX in Canada would produce disproportionate costs and burden. Nevertheless, investors in Canada needed reassurance from the Canadian regulators that measures were being taken to avoid the governance failures felt south of the border. The Canadian Securities Administrators (CSA) and Ontario Securities Commission (OSC) have thus passed a number of rules to reflect the main principles of SOX, while incorporating local features at the same time. CSA regulations are principles-based, an approach closer to the UK corporate governance strategy than the US, where the latter adopts a prescriptive, rules-based approach to financial regulation.

In Canada, the auditor independence rules form part of the professional conduct rules of each provincial Institute of Chartered Accountants. Below is a summary of the position on auditor independence:

- In 2002, the Canadian Public Accountability Board (CPAB) was established to oversee accounting firms that audit Canadian public companies. The CPAB promotes high quality, independent auditing (CPAB Rule 101).
- The CPAB has an inspection programme which oversees auditors' independence in Canadian public companies.
- Prior audit committee approval for any services provided by auditors.
- The de-minimis exception to non-audit services applies.
- The following non-audit services are prohibited when an auditor already provides audit services to a client: bookkeeping, valuations, internal audit outsourcing, information systems design or implementation, human resource functions, corporate finance activities, legal services, and actuarial services.

The above rules are mainly derived from National Instrument 52-110. They endorse the fundamental tenet of SOX in that auditors must be independent of their clients.

## Results

Among firms listed on the S&P/TSX Composite Index as at Oct 15, 2010 (n=199), we observed a dramatic change in the balance between audit and non-audit costs following the implementation of auditor independence regulation in Canada (see Table 1 below). In addition, among those firms who remained on the Index throughout every year of our sample (n=88) audit and audit-related costs have increased 59% in absolute dollars since 2004. Given the mandatory nature of the regulation, these results are not surprising, however the changes were more dramatic than we expected. The following table reveals the results we gathered between 2004-2010:

	Audit fees (% of annual total company expenditure)	Consultancy fees (% of total expenditure)
2004	<b>69.01</b>	<b>30.99</b>
2005	<b>79.08</b>	<b>20.92</b>
2006	<b>83.57</b>	<b>16.43</b>
2007	<b>89.38</b>	<b>10.62</b>
2008	<b>85.23</b>	<b>14.77</b>
2009	<b>85.93</b>	<b>14.07</b>
2010	<b>87.13</b>	<b>12.87</b>

Table 1: Average figures for 199 firms listed on the S&P/TSX Composite Index as of 2010

### Summary:

With the increase in expenditure on audit costs, investors should expect better disclosure from companies, and investor confidence should follow. Whilst the picture seems to be relatively

rosy in Canada even after the financial crisis of 2007, auditing practices have been called into question in the US. Ernst and Young provided Lehman Brothers with an unqualified audit opinion on its annual accounts in January 2008. They also approved its quarterly accounts in July 2008. However by early August, Lehman Brothers experienced severe financial problems due to the subprime mortgage crisis. They filed for bankruptcy in September 2008. Bear Stearns had a similar fate. These incidents may have been isolated but still highlight that improvements can definitely be made to auditing practices in the US. Canada will be watching closely on this issue.

O2, a UK mobile phone company has a slogan with the phrase 'We are better, connected'. The slogan has two messages: first, that O2 are better connected than their competitors. With the help of the comma, the second message emphasizes 'us'. We are all better if we are connected by a shared purpose. Would the slogan 'We are better, audited' apply to auditor independence in Canada? It appears that Canadian auditors are better audited than their US counterparts. Society as a whole would certainly benefit from good auditing practices and auditor independence. Better disclosure, independence and objectivity would increase investor confidence. Investors will feel confident in relying on their auditors and directors. Perhaps a more appropriate slogan would be 'We are better, audited *independently*'.

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