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# INVESTIGATING THE REGULATION OF FINANCIAL REPORTING AND AUDIT QUALITY IN CANADA

The notion of financial reporting and audit quality has been at the heart of public discussions and of significant interest to both academics (Knechel et al. 2013; Knechel 2016) and practitioners (Deloitte 2017; KPMG 2017) alike. Following several highly publicized corporate scandals, the collapse of Arthur Andersen in 2002, and the apparent need to restore both auditors' professional legitimacy and investors' confidence in the governance and financial reporting systems, Canada has experienced a significant regulatory transformation with the creation of a series of rules aiming at improving the quality of audited financial information provided to investors by reporting issuers.

Illustrating the common perception that quality is a "three-legged stool" (CPA Canada and CFERF 2017, 1) supported by auditors, management, and audit committees, the new Canadian rules have specifically targeted the work of these contributors. For the purpose of my thesis, I focus on two rules that directly affect auditors and corporate directors sitting on audit committees: National Instrument 52-108, which created the Canadian Public Accountability Board (CPAB) responsible for independently overseeing and inspecting auditors of Canadian reporting issuers; and National Instrument 52-110, which sets specific requirements for audit committees regarding their responsibilities around audits and financial reporting matters, as well as their structure in terms of minimum size, level of independence and requisite expertise (Bédard and Compernolle 2014).

These new regulatory requirements are considered as one of the most important changes in the field in decades (DeFond, 2010; Malsch and Gendron 2011). Consequently, one can expect these rules to have substantially modified the work and perceptions of individuals who must comply with them: auditors and audit committee members. My thesis thus aims to investigate the evolution of the Canadian regulatory environment and answer the following series of questions: 1) How have Canadian audit firms responded to the implementation of CPAB inspections? What has changed in the audit process as a result? How does the work of audit regulators impact the auditing profession? 2) How do directors experience their corporate governance role considering the additional requirements for audit committee members? How do directors cope with these additional responsibilities; and what are the challenges encountered to fulfill them?

To answer these questions, I collected data via semi-structured interviews with audit partners, audit managers and directors of Canadian reporting issuers sitting on audit committees, and via public documents pertaining to the issues being investigated. Upon interviewees' agreement, I recorded and transcribed interviews, and then used the Atlas.ti software to analyze the transcripts. I conducted over 60 interviews, resulting in more than 70 hours of audio recordings, and close to a thousand pages of transcripts. My analysis reveals several patterns and schemes currently happening in the financial reporting environment. In particular, my data show that for all parties involved, regulatory changes have resulted in a convoluted financial reporting environment which at times jeopardizes more than it strengthens the quality of financial documents and audits.

For audit committee members, complexity mainly arises from the paradox they are facing: while they are expected to possess the necessary financial literacy and expertise to oversee and scrutinize various processes – financial reporting, auditing, internal controls and risks, amongst others –, the dissimilarity between these processes, the constant evolution of accounting and auditing standards, the intricacy of the technical concepts included in these norms and the additional regulatory requirements that weigh down Canadian public companies have made that task incredibly more difficult, if not impossible. Despite audit committee members all meeting regulators' financial literacy requirements on paper, this complexity has highlighted the limits of audit committee members' perceptions of their knowledge, as most participants question their expertise as well as the practicality of the work they must accomplish.

As a result, audit committee members do not approach their role on the audit committee similarly. I identify different overseeing styles among participants – inspectors, laissez-faire, messengers – which I define as approaches and methods used by AC members to achieve their objectives and fulfill their responsibilities on the AC. These overseeing styles vary in terms of the time invested by audit committee members to prepare for meetings, the type of documents and information they focus on during their preparation, the nature of the questions they prepare as well as their level of reliance on consultants and external experts to help them with audit committee duties. Overall, because of the overseeing styles adopted by their committee members, some audit committee appear better equipped than others to effectively fulfill their purpose as laid out by regulators.

For audit partners, complexity arises from the influence of CPAB in the audit field. The work of CPAB has indeed created significant changes in the way partners are nominated, assessed, and recognized within the firms by prioritizing regulatory compliance and documentation over client service and commercial metrics like profitability or efficiency. By scrutinizing auditors' compliance to standards and professional requirements, CPAB inspections have accentuated pre-existing conditions of complexity and further strained on auditors' attempts to find a balance between their professional obligations and the commercial imperatives of their relationships with clients. CPAB has also given rise to a technician logic of professionalism, driven by inspectors promoting a theoretical ideal of best practices and technical minutiae, competing with a clinical logic of professionalism, driven by partners and managers promoting a more practical and applied form of expert knowledge. However, patterns of resistance have also emerged among audit partners who feel their professional autonomy and expertise are being threatened by regulators, which may hinder regulators' efforts and objectives through the creation of administrative processes aiming at anticipating CPAB's questions and negotiating CPAB's interpretations.

All in all, NI 52-108 and 110 appear to have had positive impacts on the financial reporting system through their influence on auditors' and audit committee members' behaviors, schemes of thoughts and practices. However, and as several participants expressed, perfect is the enemy of good, and it seems that regulation is at risk of creating unachievable objectives or overly complex processes not anchored enough in the intricate environment of auditors and directors of Canadian public companies, which may discourage some of these key stakeholders from fully engaging with it.