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## **SECOND PUBLIC REPORT**

# **ON QUALITY INSPECTIONS OF PUBLIC ACCOUNTING FIRMS**

**SUBJECT TO THE**

**CANADIAN PUBLIC ACCOUNTABILITY BOARD  
OVERSIGHT PROGRAM**

**AUGUST 2005**

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## Executive Summary

The Canadian Public Accountability Board's (CPAB) second public report is based on inspections of 23 public accounting firms in Canada, ranging in size from national partnerships with numerous offices in various provinces to sole practitioners with a single office. These firms audit more than 5,500 public companies and other reporting issuers in Canada, representing about 80 per cent of the total market in terms of number of clients and well over 90 per cent if measured by market capitalization.

CPAB's second public report concludes that there is room for significant improvement in the quality of audit work being done on the financial statements of reporting issuers in Canada. However, while the inspection process indicates that improvements are required in a number of areas, CPAB is encouraged by the co-operation it has received from audit firms and their understanding that the public interest requires them to place greater emphasis on audit quality. Each firm has accepted CPAB's recommendations and has provided written commitments that problems identified will be remedied.

Inspections of the four largest accounting firms were the subject of CPAB's first report in October 2004. This second report provides an update on the status of the recommendations made to these four firms last year. Based on the follow-up conducted to date, it appears these firms have put in place policies and procedures to implement last year's recommendations.

For the majority of firms inspected since October 2004, the necessary improvements can be described as further enhancements to basically sound audit processes. However, a minority of firms have an urgent need to implement substantial improvement if they are to continue to audit public companies. Audit quality problems identified in the weakest firms included:

- Inadequate implementation of the revisions to independence rules introduced in early 2004.
- Lack of effective internal quality controls.
- Accepting or retaining clients who pose an unacceptable risk.
- Lack of staff evaluation with respect to audit quality issues.
- Inadequate training to ensure familiarity with current accounting and auditing requirements.

Many of the weaknesses identified are due to inadequate resources being devoted to ensure audit quality. Quality control standards for the Canadian accounting profession are relatively recent, and it is taking some time for some firms to develop and support the systems needed to achieve the quality levels now required.

As a result of this second round of CPAB inspections, recommendations for change have been issued to all firms. As well, requirements have been placed on four firms. These requirements – which include making substantive improvements before being allowed to accept new audit clients and specifying which partners may or may not carry out engagement quality control reviews – will remain in place until these firms fully implement all of the recommendations arising from CPAB's inspection.

Each firm inspected has received a private report from CPAB that includes specific recommendations. The firms have 180 days or less to implement the recommendations.

In less than two years, CPAB has instigated a number of changes to improve the quality of audits in this country. It has inspected the public accounting firms that account for the bulk of the audits of public companies in Canada and made recommendations for the improvements that were needed for high quality audits. These are now being implemented. This should enhance the credibility of financial statements and confidence in Canada's capital markets.

## Introduction

1. CPAB was created by the provincial securities commissions, the Office of the Superintendent of Financial Institutions (OSFI) and the Canadian Institute of Chartered Accountants (CICA) to promote high quality external audits of entities that are reporting issuers in Canada. In carrying out that role, CPAB conducts quality inspections of the firms subject to its oversight, either directly or in cooperation with provincial or foreign regulatory authorities.
2. In Canada, there are approximately 7,000 reporting issuers, as defined in provincial securities legislation. A public accounting firm wishing to serve as an auditor of an entity that is a reporting issuer in Canada is required by the Canadian Securities Administrators' National Instrument 52-108 to become a participant in the CPAB oversight program. As of April 30, 2005 a total of 263 Canadian accounting firms and 22 foreign accounting firms had completed the registration process, signed Participation Agreements with CPAB and had become participating audit firms. Some details about these firms, including their own descriptions of their quality control policies and procedures, may be found on the CPAB Web site at [www.cpab-ccrc.ca](http://www.cpab-ccrc.ca). Over three years (2005-2007), CPAB plans to inspect annually all participating audit firms that have 50 or more reporting issuer audit clients. In 2004 there were 12 such firms and all have been inspected. Over this three-year period, CPAB will also inspect, at least once, another 34 Canadian participating audit firms that have fewer than 50 reporting issuer audit clients but that audit the financial statements of one or more entities that are registrants with the Securities and Exchange Commission (SEC) in the United States. In 2004, CPAB inspected eight of these firms. For the remaining Canadian participating audit firms that audit fewer than 50 reporting issuer clients and no SEC registrants, CPAB oversight will consist primarily of reviews of the results of the quality inspections of these firms carried out by the relevant provincial accounting bodies, i.e., Institutes of Chartered Accountants or Associations of Certified General Accountants. Based on the results of those reviews, CPAB will decide whether there are any indications of serious quality weaknesses that require a quality inspection by CPAB. While this third group of firms constitutes a significant number of participating audit firms, they actually audit fewer than 11 per cent of all reporting issuers, the vast majority of which are entities with very small market capitalization. In the last year, CPAB inspected three firms in this category.
3. The remaining group comprises foreign participating audit firms that have registered with CPAB. CPAB's inspection approach to any particular foreign firm depends on whether that firm is subject to a rigorous independent quality inspection process in its home jurisdiction and whether CPAB has access to the inspection results. Most of the foreign firms are based in the United States and are subject to the oversight of the Public Company Accounting Oversight Board (PCAOB), with which CPAB has a co-operative working relationship. CPAB and the PCAOB will, from time to time, conduct combined inspections of firms that have registered with both organizations. In 2004 and early 2005, CPAB and the PCAOB conducted three such inspections. In some cases, CPAB may rely on the PCAOB's inspection activity relating to a U.S. firm and decide that additional field inspection activity by CPAB is unnecessary. By contrast, CPAB will conduct full inspections of participating audit firms in jurisdictions where independent oversight of auditors is limited or non-existent. There are currently five firms that fall into this category.

## Scope of CPAB Quality Inspections

4. CPAB quality inspections are designed and carried out to:
  - Acquire an understanding of the design of each firm's system of quality control, organized around the following principal elements:
    - Tone at the top/leadership;
    - Independence and ethics;
    - Client and engagement acceptance and continuance;
    - Human resources policies and procedures;
    - Performance on audit engagements; and
    - Quality monitoring.
  - Test the effectiveness of the implementation of each firm's system of quality control.
  - Test each firm's compliance with relevant accounting, auditing and auditor independence standards and with the firm's own policies.
5. As part of each inspection, interviews are carried out with the senior executives in each firm who have management responsibilities relating to audit quality. These interviews allow CPAB to understand the design of the firm's systems of quality control. In the largest firms, more than 30 individuals are usually interviewed. In the smaller firms, interviews are conducted with everyone who carries out the relevant management functions.
6. The inspections also involve an examination of a variety of evidence to better understand the design of a firm's systems of quality control and the effectiveness of their implementation. This evidence includes:
  - Policy and procedures manuals;
  - Quality-related communications from a firm's leadership to its partners and staff;
  - Independence confirmations;
  - Client acceptance and continuance documentation;
  - Personnel files;
  - Training curricula and attendance records;
  - Staff satisfaction survey results;
  - The results of the firm's own quality monitoring program; and
  - The working papers for a sample of completed audit engagements.
7. In larger firms, CPAB has conducted focus groups to solicit the input of a variety of partners and staff with respect to quality-related issues. By voting on electronic keypads,

participants indicate the extent to which they agree or disagree with various assertions related to audit quality. The voting distribution is then presented to the participants, who are asked to help CPAB understand the results. Through this process, information that might not otherwise come to light is gathered about issues germane to a firm's audit quality procedures and implementation.

8. Following each inspection, CPAB provides each participating audit firm with a private report that includes findings, recommendations and other observations. Recommendations are impositions that firms are expected to implement to CPAB's satisfaction within a prescribed period of time – normally 180 days. When a stronger message is needed, CPAB imposes requirements instead of recommendations. If a firm failed to do what has been recommended or required, CPAB would make that fact public and, in certain cases, could choose to impose restrictions or sanctions on that firm. Were CPAB to impose restrictions or sanctions upon an audit firm, in these circumstances, there would be notification to Canadian securities regulators and the audit committees of the firm's reporting issuer audit clients. In the most extreme case, CPAB could declare that an audit firm is not a participant in good standing, meaning that firm could no longer audit public companies in Canada.
9. While CPAB has the power to impose requirements, restrictions or sanctions to achieve the changes it considers necessary, its intent is to work with the participating firms in a positive and constructive manner to bring about audit quality improvements where they are appropriate.

## **Overview of Findings to Date**

10. In October 2004, CPAB reported on its initial quality inspections of the four largest public accounting firms in Canada, which were conducted between April 2004 and September 2004. As a result of those inspections, more than 100 recommendations were made and the firms had 180 days to comply with them.
11. CPAB has begun its second annual inspection of each of these four firms. Based on the work done so far, it appears that these firms have put in place policies and procedures to implement the recommendations. Changes include:
  - Review of work done by auditors of foreign subsidiaries.
  - Increasing the time invested on audit monitoring activities.
  - Changing and expanding training activities.
  - Strengthening client acceptance and continuance policies and procedures.
  - Expanding monitoring procedures to ensure compliance with independence rules.
  - Improving the quality of policies relating to the documentation of audit work and monitoring of compliance with those policies.

A more definitive statement of how effectively these changes have been implemented will be available, after CPAB completes its second round of inspections, in a public report planned for release in late autumn, 2005.

12. Between September 2004 and April 2005, CPAB conducted quality inspections of another 19 participating audit firms ranging in size from national partnerships with numerous offices in various provinces to sole practitioners with a single office. The 23 firms inspected to the end of April 2005 audit more than 5,500 public companies and other reporting issuers in Canada, representing about 80 per cent of the total market in terms of numbers of clients and well over 90 per cent if measured by market capitalization.
13. The inspections carried out to date indicate that there is room for significant improvement in the quality of audit work being done on the financial statements of reporting issuers in Canada. The more serious and common issues are described in the remainder of this report. CPAB's private reports to the firms inspected contain a large number of recommendations for actions they must take to address these issues or to improve their systems of quality to minimize future issues. CPAB expects the firms to implement these recommendations and will follow up with them to ensure they have done so to CPAB's satisfaction within the prescribed time period, which is normally 180 days but, in some circumstances, is shorter.
14. As a result of its inspections, CPAB has placed requirements on four firms. These include:
  - Requiring three firms to not accept any new reporting issuer audit clients until all of CPAB's recommendations have been dealt with in a satisfactory manner.
  - Requiring a fourth firm to permit only certain partners to carry out engagement quality control reviews and specifically prohibiting certain other partners from performing such reviews.
15. The larger firms and a number of medium-sized firms emphasize audit quality as one of their top priorities. These firms have quality-related policies and procedures that are designed to minimize the risk of non-compliance with professional standards. These policies, in the main, operate effectively. As well, a number of smaller firms were also ranked as having an appropriate level of emphasis on quality in their tone at the top and as having developed appropriate support systems. For all these firms, there is room for further improvement, but in general, CPAB's recommendations build upon an already solid quality foundation.
16. However, a minority of firms have an urgent need to implement substantial improvement. In the weakest firms:
  - There has been inadequate implementation of the comprehensive revisions to the independence rules that became effective at the beginning of 2004. There are few if any internal controls to prevent or detect independence violations.

- Partners operate substantially autonomously on their individual client portfolios with little internal firm oversight of the quality of that work. Many of the engagement-related issues found by CPAB inspectors could have been detected if the firm had an effective quality control review process.
- There is an apparent willingness to accept or retain almost any entity as an audit client. CPAB has noted instances where firms retained clients despite clear evidence from the audit work that the integrity of management was in significant doubt.
- Human resources systems are rudimentary. There is little evidence of effective counselling and evaluation of staff members with respect to audit quality issues, and some firms lack personnel files.
- Training is ad hoc, with no prescribed curriculum for partners and staff and no assigned accountability to ensure that the firm's intellectual capital is maintained or enhanced. Some practitioners in these firms were not sufficiently familiar with current accounting and auditing requirements.
- Audit methodologies do not address certain requirements of Generally Accepted Auditing Standards (GAAS).

17. CPAB's conclusion is that these weaknesses stem mainly from:

- Insufficient emphasis on audit quality. This is typically due to inadequate resources being devoted to systems that ensure quality audits will be carried out by the firm.
- The fact that formal quality control standards for audits are relatively new. CPAB has required participating audit firms to comply with the General Standards for Firms—Quality Control, issued by the Auditing and Assurance Standards Board, as of January 1, 2005.

As a result of these new quality control requirements, considerable investment will be required by audit firms to develop and support the infrastructure needed to achieve the quality levels expected. Although the largest firms now have sophisticated control systems in place, it is more challenging for smaller firms to invest in the policies and procedures required to ensure compliance with the standards of performance that auditors of reporting issuers must meet. The more successful of the smaller firms inspected have accomplished this by focussing on market segments, reinforced by leadership from the partner group that demonstrates an ongoing commitment to quality.

## **Recommendations Arising from the Inspections**

### ***Tone at the top/Leadership***

18. Generally, the larger firms have articulated strategic priorities that include an emphasis on audit quality. This was reinforced by the focus group findings in 2004, which showed that participants consistently ranked audit quality higher than other priorities as a determinant of their compensation and advancement in the firm. The leaders of larger firms, in their internal communications to partners and staff, are increasingly emphasizing the need to make an uncompromising effort to do the highest quality work on every engagement.

19. Even in the larger firms, however, CPAB found that the ultimate responsibility for quality in the firm and day-to-day operational responsibility for effective operation of the various facets of the quality systems were sometimes not as well articulated as they should be in individual job descriptions. CPAB has therefore made recommendations to most of the firms inspected to establish more clearly delineated responsibilities and accountability for quality.
20. In some firms, including some that audit more than 50 reporting issuers, the leadership's commitment to quality has not been demonstrated to partners and staff as well as one would expect. CPAB has recommended, when appropriate, more effective communications or changes to the management structure to enhance the tone at the top.

### ***Independence and Ethics***

21. Major changes in the accounting profession's independence standards came into effect on January 1, 2004. The response to those new standards has varied. Larger firms have typically implemented new policies, procedures and training designed to ensure compliance with the new standards. On the other hand, some smaller firms did not appear to have reacted to the new standards at all. CPAB has recommended to every firm inspected some further enhancements or clarification to the firm's policies and procedures, such as the requirement to document on every audit any threats to independence and the safeguards employed to reduce such threats to an acceptable level.
22. The new auditor independence rules severely reduce the non-audit services an auditor can provide to a client. In firms of all sizes, the independence lists often include only public companies, omitting the non-public operating subsidiaries or other affiliates to which non-audit service restrictions apply. CPAB has recommended, especially to the larger firms with global clients, that independence lists be expanded to include not only the audit client but also its operating subsidiaries and other affiliates. Larger firms are also required to set up internal control systems whereby an affiliate in another country is prevented from supplying restricted non-audit services to an audit client or its subsidiaries or affiliates.
23. CPAB's October 2004 report emphasized the challenges the new independence standards presented to the four largest firms. CPAB's second round of inspections is examining the progress these firms have made in dealing with these issues.
24. In smaller firms with only a few reporting issuer clients, the provision of non-audit services to clients constitutes the main threat to auditor independence. Under the independence standards, certain services may not be provided to a reporting issuer audit client. Others may be provided, but only with the application of appropriate safeguards. Generally, CPAB found a high level of awareness of these requirements and encountered few cases in which, in CPAB's judgment, non-audit services provided by an audit firm may have impaired the audit firm's independence. For some firms, however, CPAB has recommended that more effective controls be implemented to ensure that a proposed non-audit service to a reporting issuer audit client does not constitute a threat to independence,

or, if it does, to consider whether appropriate safeguards can be put in place to mitigate that threat.

25. Audit firms normally prepare an annual engagement letter for their clients that sets out the roles and responsibilities of the various parties involved with the audit. It is customary for management of the client entity to sign such letters as an acknowledgement of their agreement with the contents. Auditors' concerns about the extent of their liability have in recent years caused some firms to begin to include in such letters certain provisions designed to limit their liability in certain circumstances. Such provisions may include a cap on the maximum liability of the auditor to the client entity and/or indemnification by the client of settlements by the auditor to third parties. Not all firms use these provisions, but some of those who do appear to be using them for all audit clients, including those that are SEC registrants. Such firms were apparently unaware that the SEC regards auditor liability limitation as an impairment of auditor independence. The audit firms in this situation have agreed to discontinue this practice immediately and to consult counsel to ascertain how they can withdraw or amend what was an incorrect letter at the time of the last audit.

### ***Client and Engagement Acceptance and Continuance***

26. Most firms have standard processes to approve new or continuing audit engagements. In larger firms, clients are rated according to the risk posed by the likelihood that they would prepare financial statements containing material error. A rating of higher risk does not necessarily mean that client management has the incentive, inclination or opportunity to misstate the financial statements deliberately, although in some cases it may. More often, the error is the result of other client characteristics, such as limited accounting capability, weak internal controls or an ineffective audit committee. One would expect an audit firm's senior management to give more attention to ensuring that higher-risk clients are acceptable to the firm and to the way that engagement teams manage the risks of audit engagements for such clients.
27. However, there is varying sophistication in the way that the firms collect and manage the information used to assess client and engagement risk. In some firms, there are just three qualitative categories of risk into which the clients are grouped, which does not provide sufficient differentiation. As well, details of the risk analysis are decentralized at the practice office level. By contrast, other firms have sophisticated, centralized systems for quantifying risk and assessing other factors relevant to the approval of new audit clients and recurring audit engagements. Those responsible for accepting or rejecting clients or engagements are able to use the system to assess the risk score and the engagement team's analysis of the risk and the action being proposed to manage the risk. In a number of instances, CPAB has made recommendations it believes would improve the way firms monitor and manage higher-risk engagements.
28. In its inspections, CPAB saw evidence that most of the larger firms are becoming increasingly selective about their client base and are discontinuing the provision of audit services to certain clients that they deem to pose unacceptable risk. Some of the smaller firms are also quite selective about the clients they will serve. Several of these firms view

potential clients that were previously audited by larger firms with an appropriate amount of scepticism, inquiring extensively into the reason why the other firm had dropped the client. However, in its inspections of other firms, CPAB did note cases in which clients were retained despite clear evidence from audit work that the integrity of management was in significant doubt. CPAB has recommended improved client acceptance and continuance processes to these firms.

29. CPAB encourages participating audit firms to be selective about the clients they accept and retain. An independent audit is an important part of the securities regulatory process. By requiring clients to have satisfactory levels of ability and willingness to comply with securities regulation and other laws, auditors can make an important contribution to investor protection.
30. CPAB has observed that while some of the smaller firms are careful to take on as clients only entities for which they have the required competencies to do an effective audit, certain other participating audit firms are doing audit engagements for which they may have insufficient expertise. For example, CPAB has noted cases in which firms doing audits of SEC registrants did not have ready access to, or were not using, expertise in U.S. accounting principles and auditing standards. This is inappropriate. Another example concerns audits of companies with significant operations in China that have access to Canadian equity markets by means of reverse takeovers of inactive companies that were already reporting issuers in Canada. These audits should be regarded as higher risk and should be undertaken only by audit firms with professionals who possess both the relevant linguistic skills and a sound understanding of Chinese business practices. Most Canadian audit firms do not have the capability to perform these audits. In these cases, CPAB has recommended that the firms acquire the necessary expertise or discontinue the audits in question.

### ***Human Resources Policies and Procedures***

31. The larger firms have extensive policies and procedures related to their human resources (HR), and their HR systems appear, in general, to be operating as designed. However, there is a shortcoming relating to performance evaluations that is common to all of these firms. These evaluations are an important technique for letting audit staff members know how to improve the quality of their work in future. The focus group session participants indicated that performance evaluations are not as timely as they should be. While it is recognized that those responsible for preparing evaluations are busy professionals with many competing demands on their time, firms must build more discipline into the timeliness of their evaluations and/or simplify the process so that the evaluations do not require a greater time investment than is realistic.
32. A number of the smaller firms have also implemented effective HR systems. However, other firms operate without any real HR system at all. Performance expectations have either not been articulated or give insufficient emphasis to audit quality, periodic personnel evaluations are not conducted or are not documented and, in some cases, personnel files do not exist. CPAB has recommended that these firms implement proper staff evaluation systems.

33. CPAB believes that participating audit firms should have expectations relating to the continuing education partners and staff require in order to stay current with rapidly changing professional standards. In addition, firms should have mechanisms to monitor whether partners and staff are attending the courses prescribed for them. However, training in some firms is ad hoc, with no prescribed curriculum for partners and staff and no assigned accountability to ensure that the firm's intellectual capital is maintained or enhanced. CPAB has recommended that these firms rectify these deficiencies.
34. CPAB has noted a definite correlation between the quality of the audit work and the emphasis given to HR systems and training. In firms that have neglected their intellectual capital, CPAB normally finds deficient audits and practitioners who are insufficiently familiar with current accounting and auditing requirements.

### *Performance on Audit Engagements*

35. For each engagement selected, CPAB considers the way that the firm planned, supervised and completed the audit. CPAB also considers the specific audit work done by the firm on certain aspects of the client's financial statements that appear to be particularly significant or complex or that may require the application of considerable professional judgment. CPAB does not review every aspect of every audit engagement selected for consideration, because to do so would be prohibitively costly. The absence of significant findings in the review of a particular engagement cannot, therefore, be an endorsement that the client's financial statements were necessarily fairly presented or that all aspects of the audit were fully compliant with professional standards.
36. In its first year of inspections, CPAB reviewed working papers for approximately 150 audits of the financial statements of reporting issuers, a number that will increase in future years. Overall, 15 financial statements appeared to contain material departures from Generally Accepted Accounting Principles (GAAP), although in some cases there was simply not enough evidence in the audit working papers to draw a definite conclusion. Nearly all of these cases involved very small entities. Where the errors affected reported net income, CPAB has, in its recommendations, insisted that the audit firm and its client discuss a possible restatement with the relevant securities commission. Where the errors related to a lack of transparency in the notes to the financial statements, CPAB has usually called for enhanced note disclosure for the future.
37. In a number of cases, CPAB questioned whether there was impairment of the financial statement carrying values of assets such as goodwill, other intangible assets, future income taxes recoverable and certain deferred costs. GAAP requires financial statement preparers to undertake assessments of whether the carrying value of assets is recoverable. Based on its inspections, CPAB believes that some reporting issuers are not making the assessments with the required rigour and that some auditors are not insisting that they do so. It is inappropriate for auditors to do impairment assessments on behalf of issuers because, if they did so, their audit independence would be impaired. Instead, they must insist the client management carries out its obligations and decline to express an opinion on the financial statements until management has done so.

38. The accounting for and disclosure of transactions with related parties is another area where there is room for improvement, particularly in the case of smaller Canadian public companies, which, in many cases, are controlled or managed by related parties. Shareholders other than the related parties should expect full and transparent disclosure of transactions with related parties, but, in some cases, the disclosure falls short.
39. Some firms lack financial statement disclosure checklists that would enable them to compare their clients' financial statements to the increasingly complex requirements of GAAP. CPAB has recommended that firms lacking such checklists should acquire them.
40. CPAB concluded that 20 audits for which it reviewed working papers were not conducted in accordance with GAAS because the audit report was not supported by sufficient appropriate audit evidence. In many other cases, although CPAB was able to accept the file in its totality, the quality of the working paper files was unsatisfactory. These files often contained sections that did not adequately support the asset, liability or income statement account to which they were intended to relate. For these engagements, CPAB recommended that appropriate remedial action be taken, such as obtaining further evidence to support the firm's audit report. CPAB also made a number of other recommendations to the firms with respect to engagement performance improvement in general, or by reference to specific engagements. These recommendations included:
- Assessing the risk of material error at the level of financial statement line items and their underlying assertions and developing audit programs clearly responsive to those risks.
  - Preparing better documentation of the nature, scope and conclusions resulting from consultation on judgmental or contentious matters, and the agreement of any parties who were consulted (see also paragraph 46 below).
  - Improving the analysis of errors in the financial statements detected during the course of the audit.
  - Improving compliance with the auditing standards for using specialists in audit engagements, such as actuaries and petroleum and mining engineers.
  - Improving compliance with the auditing standards for using the work of a client's internal auditors.
  - Improving compliance with the auditing standards for reliance on another auditor (see also paragraph 47 below).
  - Improving the accuracy, completeness and transparency of reports to audit committees. There is also room to improve the documentation of discussion at meetings with audit committees. Too often, these committee minutes are cursory and there is no other evidence in the audit working papers of the discussion. CPAB noted a small number of cases in which auditors were aware that management may have committed potentially illegal acts, but there was no evidence that the auditors had informed the audit committee or discussed the situation with the committee.

- Improving the timeliness and consistency with which partners and staff members date and sign off to denote responsibility for the work that they have done.
  - Making better use of independent confirmations from third parties as audit evidence, particularly with respect to material financial asset and liability balances. CPAB found cases in which auditors had not sought third-party confirmations of material bank balances, of large trade accounts receivable balances and of large loans receivable or payable.
  - Comparing financial statements filed by the client with the System for Electronic Document Analysis and Retrieval (SEDAR) or the Electronic Data-Gathering, Analysis and Retrieval system (EDGAR), or posted to its Web site, with the financial statements that were audited. CPAB found a few cases in which the statements were different and noted that the auditors were unaware of the differences because they had not done the required comparison.
41. One important quality control that is part of the audit of a public company, prior to the signing of the opinion, is an independent engagement quality control review by a partner other than the partner responsible for the engagement. These reviews are required by the professional standards related to quality control and are an integral part of the internal policies and procedures of the larger firms and some smaller firms. Nearly all of the engagement deficiencies revealed by CPAB's inspections should have been detected by a proper independent review by the audit firm prior to completing the engagement. The fact that the deficiencies existed, had not been identified and were not corrected demonstrates that there is substantial room for improvement in this area. CPAB has recommended to most firms that they either enhance the quality of their engagement quality control reviews or implement new procedures.

### ***Monitoring of Quality Control***

42. Monitoring of quality control refers to the compliance work done by the firms themselves to verify that their systems of quality control are appropriately designed and operating effectively. For example, firms should periodically inspect a sample of their own completed audit engagements to test whether they were carried out in accordance with professional standards and their own policies and procedures.
43. The effectiveness of the monitoring activity varies from firm to firm. Most of the larger firms recognize the importance of effective quality monitoring. CPAB has seen evidence of improved transparency in the reporting of results to senior management of the firm and to audit partners and staff, better action plans with clear accountability and timely follow-up and, increasingly, consequences for those responsible for work judged to be unsatisfactory. In other firms, quality monitoring takes place, but the time invested in reviewing individual files seems insufficient to carry out a review of sufficient scope (typically the time invested to review a particular engagement is much less than CPAB spends), results are not well communicated to partners and staff, and action plans with timelines and accountability are not well developed. CPAB noted this problem in firms of all sizes. In still other firms, there is no quality monitoring at all. CPAB has made

recommendations that oblige firms without effective quality monitoring programs to implement them.

## **Enhancement of Canadian Generally Accepted Auditing Standards**

44. The Auditing and Assurance Standards Board (AASB) is responsible for setting GAAS in Canada. The AASB has been following an ambitious agenda to enhance GAAS. Various new or improved standards have been recently approved in final form, have been exposed for public comment or are under development. Among the subjects that have been addressed recently are audit risk, audit planning, engagement letters, management representation letters and reliance on service organizations. CPAB participates in the public oversight of the AASB through membership on the Auditing and Assurance Standards Oversight Council (AASOC). In addition, CPAB provides AASB with comments on each exposure draft that it publishes.
45. CPAB strongly supports the work that AASB is doing to develop new standards and wishes to emphasize two areas where it is important that current Canadian standards be enhanced as soon as possible.
46. A significant number of CPAB's recommendations for improved engagement performance are due to incomplete documentation of work that was done, or was said by the engagement teams to have been done. The current Canadian auditing standard pertaining to audit documentation is not, in CPAB's view, sufficiently prescriptive or comprehensive. In the United States in 2004, the PCAOB issued a new audit documentation standard that CPAB considers to be much superior to the current Canadian standard. CPAB has written to the Chair of the AASB, emphasizing the need for Canadian auditing standards to include, as soon as possible, a robust world-class audit documentation standard. In June 2005, the AASB approved an exposure draft of a new Canadian audit documentation standard..
47. The other area requiring particular attention is the work that should be done by an audit firm relying on work done by another audit firm on part of the financial statements. For example, one firm (the primary auditor) may be appointed to audit an entity's consolidated financial statements, but a different firm (a secondary auditor) may be responsible for the audit of an important overseas operation that is part of the consolidation. The two firms may or may not be part of the same global network of accounting firms. Some Canadian primary auditors are signing opinions on consolidated financial statements while relying on one or more secondary auditors to do substantially all of the audit work on the underlying assets and revenues, and rarely is the reliance disclosed to shareholders. Where the primary and secondary auditors are part of the same global network of accounting firms, use the same audit methodology and are subject to substantially the same quality control policies and procedures, this reliance may not present a serious problem for the primary auditor. However, where the firms are not so closely linked, it may be difficult for the primary auditor to gain enough assurance to sign the opinion on the consolidated financial statements. Most large accounting firms will not accept an audit of consolidated financial statements unless they and their affiliated network firms audit the majority of consolidated assets and revenues. The AASB should

consider improving Canadian GAAS with standards and guidance on the required extent of involvement by the primary auditor in the work of the secondary auditor, particularly when that work comprises a significant or predominant component of the consolidated entity. The standards should include requiring the primary auditor to not accept or continue the engagement when the required level of involvement is not possible or practical. We are aware that the International Auditing and Assurance Standards Board (IAASB) has issued a re-exposure draft of a new International Standard on Auditing (ISA) on the audit of group financial statements. The AASB has requested comments from Canadian stakeholders on the IAASB's proposals, to which CPAB has responded. It is our understanding that the ISA would be used by the AASB as a primary reference source in developing a revised Canadian standard. We urge the AASB to ensure that updated Canadian standards on group audits are made available to Canadian stakeholders as soon as possible.

## **Conclusion**

48. CPAB's quality inspections to date demonstrate that there is room for significant improvement in the quality of the audit work being done on the financial statements of reporting issuers in Canada. In some firms, the necessary improvements could be characterized as further enhancement to an already fundamentally sound process. Other firms have an urgent need to implement substantial improvement in order to continue to audit reporting issuers. The early results from the second inspection of the four largest firms indicate that CPAB's work is having the desired effect on audit quality and independence. CPAB continues to be encouraged by the understanding in audit firms that the public interest requires them to place greater emphasis on audit quality and "getting it right" every time, with no tolerance for substandard performance. Every firm inspected so far has committed in writing to implement all of CPAB's recommendations. CPAB expects the firms to follow through on their commitments and there will be consequences for those that fail to do so. CPAB will revisit the firms inspected to date over the remainder of 2005 to test whether they have fully implemented the recommendations to CPAB's satisfaction.

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