



## **FULL DISCLOSURE**

*Enhancing the Quality and Transparency of  
Financial Statements During Challenging Economic Times*

NOTES FOR REMARKS BY

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**CHECK AGAINST DELIVERY**

## **1. Introduction**

Good afternoon and thank you for being here today.

As everyone in this room knows, we are in the midst of global economic uncertainty. While there are indications that the worldwide recession is easing, the recovery remains fragile. We are also facing profound changes in the operation of our financial markets, including changes to financial regulation.

In this context, high-quality audits are more important than ever. They are a key part of the process that ensures the integrity of financial reporting, which, in turn, is crucial to public confidence in our financial system.

The Canadian Public Accountability Board – CPAB – is the regulator that oversees the auditors of Canadian public companies. As part of this oversight, CPAB inspects these audit firms.

We also release an annual public report of our findings.

Today we are releasing the public report that summarizes the results of our 2009 inspections. These findings are the focus of my remarks today.

I will also talk about a number of challenges that have the potential to negatively affect audit quality in the months ahead. In our view, audit firms, audit committees, boards of directors, CEOs and CFOs should take these challenges very seriously.

As well, we strongly believe they all have an important role to play in addressing these challenges, in order to maintain and enhance audit quality.

## **2. CPAB's 2009 Inspection Approach**

The global economic downturn that began in 2008 continued to be felt in 2009. It affected the financial statements of many companies. Auditors, management, boards of directors and audit committees faced a number of challenges, including determining the fair value of illiquid investments, assessing going concern considerations and providing enhanced financial statement disclosures.

The situation also influenced CPAB's approach to its 2009 inspections, in that we focused on areas most affected by the economic downturn and on audit work related to those areas.

Our inspection process starts with a thorough risk analysis designed to identify high risk audit engagements. To do this, we used several external databases.

Once the engagement files were chosen, we conducted a detailed analysis of the financial statements and related public information to decide which specific audit

risks within the financial statements would be the subject of our focused review. As you might expect, these are the areas that give rise to more complex estimates and judgments. The areas selected were then reviewed, from planning all the way through to completion and reporting to the audit committee.

CPAB also arranged meetings with the senior leadership of Canada's six largest National audit firms—Deloitte & Touche, Ernst & Young, KPMG and PricewaterhouseCoopers—in late 2008 and early 2009.

The purpose of these meetings was to assess the firms' readiness to audit during the economic downturn and to convey our expectations for 2009 audits.

I'm pleased to say that we were satisfied that each firm made considerable effort to be ready to deal with the accounting and auditing issues arising from the economic downturn. They introduced additional quality control processes, issued a great deal of internal guidance and training and provided additional support to high-risk engagements.

### **3. Overview**

This year, we have made a number of changes to our public report. For the first time, we provided feedback to the audit firms that identified possible changes to audit processes. We believe that these changes, if addressed, would have the greatest impact on improving audit quality.

While a number of these issues must be addressed by audit firms, we want to emphasize that all involved parties—including management and audit committees—have an important role to play to maintain audit quality.

For example, in our 2009 inspections, we noted a lack of transparency in the information some companies provided in their financial statements.

Although the primary responsibility for financial reporting rests with preparers of financial statements, CPAB believes that an important public interest role served by auditors is to impress upon their clients their accountability for the quality and transparency of financial statements.

Where there is a lack of transparency in reporting, the auditor should seek remediation by management or inform the audit committee.

I'd like to emphasize that audit committees play an increasingly important role in oversight and corporate governance.

Lack of transparent communication between an audit firm and audit committee may affect decisions by the audit committee that could significantly impact the company's financial statements.

Improving the two-way communication between auditors and audit committees contributes to audit quality, particularly during the current volatile economic environment and in light of the increasing complexity of financial reporting.

Audit committees need to make sure they have all the facts and that their companies' financial disclosures are sufficiently robust.

### ***Pressure on Audit Firms***

On the subject of audit committees, I'd like to talk about one additional area that concerns CPAB.

Tough market conditions have forced many businesses to look for ways to reduce costs. CPAB is aware of several instances in which audit committees are placing undue pressure on firms to significantly reduce their audit fees.

Given the important role of audit committees in oversight, corporate governance and in helping to ensure the integrity of financial reporting, we are concerned that their focus on reducing audit fees could negatively impact audit quality in both the short and long term.

We appreciate that there will always be negotiations between audit firms and audit committees regarding what constitutes appropriate and fair audit fees. However, given that one of an audit committee's key priorities should be obtaining high quality auditing services, CPAB believes audit committees should not focus solely on fees or place unreasonable pressure on audit firms to arbitrarily reduce them.

CPAB is not alone in these concerns. The issue has also been raised in the United States and Europe and has been the subject of discussion among international audit regulators.

We are concerned that these undue pressures on audit firms may create an environment that could cause the firms to lose their focus on audit quality.

The potential risks to audit quality include inappropriate reductions to the nature and extent of audit procedures in order to achieve cost savings, or placing additional demands on audit engagement teams.

Any material reductions in investments by firms in training, recruitment or audit systems are likely to negatively affect audit quality.

Over the longer term, these pressures could affect the recruitment and retention of auditors, potentially leading to a serious shortage of qualified professionals to undertake this crucial function.

We would therefore urge audit committees to look beyond short-term pressures and consider the longer-term ramifications of their decisions and actions on audit quality.

#### **4. National Firms**

I'd now like to talk in greater detail about the results of our 2009 inspections of the National public accounting firms.

These firms audit about 3,800 public companies or other reporting issuers in Canada, representing more than 92 per cent of the total market, measured by market capitalization.

As I mentioned, we focused on the audit work performed on financial statement items that would be most affected by the economic downturn. In all, we selected and reviewed 118 audit engagement files.

In our inspections, we saw many examples of excellent audit work. However, as I mentioned, we did identify some key audit areas that, if addressed, would do the most to enhance audit quality.

#### ***Enhancing the Role of the Engagement Quality Control Review***

A recommendation that we made to nearly all firms, of all sizes, was to enhance the role of the engagement quality control reviewers, also known as the second-partner review.

The purpose of this review is to provide an objective evaluation—before the audit report is issued—of the significant judgments the audit team made and the conclusions it reached. Done properly, this review can identify significant deficiencies and be an effective safeguard against errors or insufficient audit work. In short, it is a critical element of quality control and a major contributor to audit quality.

However, our inspections found that, in many firms, the second-partner review was simply too little, too late.

We found instances where the reviewers appeared to spend very little time on their reviews. Some didn't sign off until after the firm had issued the audit report. Some did not challenge the engagement teams on significant accounting and auditing issues. And some did not review the working papers related to the higher risk areas of the engagement.

For certain files, we believe that the second-partner review might have caught the deficiencies we identified in our inspections, if they had applied more rigour and been more involved, especially in high-risk areas of the audit.

And we are concerned that the second partner reviewers were not always held sufficiently accountable for the deficiencies we identified. Almost all firms have processes in place that hold engagement partners responsible for deficiencies when their performance is evaluated. However, the second-partner reviewer is not always held to a similar standard.

In our feedback to firms, we made a number of suggestions on how they can enhance the role of the engagement quality control reviewer.

These include increasing the reviewers' accountability and considering disciplinary action when significant audit deficiencies can be linked to an inadequate second-partner review.

In addition, the firms need to have policies in place to ensure that the second-partner reviewer is actively engaged throughout the audit. Firms must evaluate and adjust assignments to ensure that reviewers' workloads are reasonable given their quality control responsibility.

In summary, we believe the engagement quality control review is a key component in a firm's quality control process.

### ***Improving the Evaluation of Unadjusted Audit Differences***

The second major issue we identified was the assessment and disposition of unadjusted audit differences.

Certain audit engagement teams appeared to have a high tolerance for unadjusted audit differences, both in the number recorded and the large dollar amounts they represented.

In the audit of one company, the total value of unadjusted errors was 199 per cent higher than the amount that had been established as materiality for audit purposes.

In two cases, more than 40 unadjusted errors were recorded. Most of them were known errors, not matters of judgment.

This concerns us, because failure to correct known errors reduces a company's flexibility to deal with errors that may be undetected.

It can also affect the future interim and year-end financial statements, when the errors flow through to the next reporting period.

CPAB believes that financial statement preparers should correct all known errors. While auditors should drive changes in behaviour in this area, we also believe that audit committees have an important role to play in ensuring these errors are corrected. Again, audit committees need to play a more active role in this area.

### ***Enhancing Transparency***

A third area of concern was a lack of transparency in the information that firms communicated to audit committees.

In one firm, there was a client file in which the firm informed the audit committee that certain valuation estimates were “aggressive” while others were “conservative”.

However, the firm did not disclose to the audit committee the actual dollar impact that these estimates could have on the company’s financial statements.

Depending on how they were incorporated, this impact could have resulted in a significant swing in the company’s income.

CPAB believes the audit firm should have disclosed the dollar amounts involved in these estimates as well as the possible impact on the financial statements, so the audit committee could assess whether it was acceptable to live with these unadjusted differences.

The fourth and final major issue we noted was a lack of transparency in the information some reporting issuers provided in their financial statements.

In one instance, inadequate disclosures were made on the nature of a significant legal claim. This meant that users of the financial statements could not properly assess the risks related to the legal claim.

We also found instances in which related-party transactions were not disclosed, including those with senior management that likely would be of interest to shareholders.

Regarding issues of transparency, it is our strongly held view that the auditors, management and audit committees all have an important role to play in this area.

We believe audit firms should conduct a robust review of the financial statements and accompanying notes at an earlier stage in the audit process.

Where this review reveals significant accounting and disclosure errors, omissions or lack of transparency in reporting, the auditor should seek to have these issues addressed by management; otherwise they should be reported to the audit committee.

Our report suggests that audit firms implement quality improvement programs for their communications with audit committees.

Over the next few months, CPAB plans to conduct a series of round-table discussions of our findings with members of audit committees.

## **5. Regional and Local Firms**

I'd now like to talk about the results of our 2009 inspections of Regional and Local firms.

Once again, our approach was risk-based. We inspected 28 Regional and Local firms in 2009, including 15 first-time and 19 follow-up inspections. We reviewed 84 audit engagement files.

Most of the major issues we identified in our inspections of the National Firms—including the ones I've just talked about—were also identified in our inspections of Regional and Local firms.

In addition, we identified two other major issues.

### ***Audit Planning for Non-Routine Transactions***

The first was audit planning for non-routine transactions.

While Regional and Local firms appear to be comfortable dealing with recurring or routine transactions, they often struggle with transactions that are outside their comfort zone.

Examples of these transactions include stock-based compensation, audit work on asset retirement obligations and the recognition and measurement of future income tax assets.

We recommended that these firms enhance their audit planning for non-routine transactions, to increase the level of audit assurance.

### ***Client Documentation of Complex Transactions***

The second major issue was inadequate client documentation of the basis of accounting for complex transactions.

This resulted in the audit firms having to perform a significant portion of the analysis and research to determine the appropriate accounting.

We believe that the auditor's role is to audit the work done by the reporting issuer, not to carry out the supporting work.

We therefore recommended that firms enhance their audit planning to ensure their clients complete the analysis and research required to support the accounting for complex transactions in advance of the audit.

## **6. Disciplinary Action**

Following our inspections, we sent each audit firm a private report that included our findings, recommendations and feedback. Firms are expected to implement recommendations to our satisfaction within 180 days.

In our 2009 inspections, we did find some significant departures from generally accepted auditing standards and generally accepted accounting principles—GAAS and GAAP. Additional details can be found in our report, which is posted on our website.

We also placed requirements on two firms, a decrease from previous years. As well, six firms that had requirements placed on them as a result of our 2008 inspections have had the requirements lifted.

## **7. The Challenges Ahead**

As a result of our inspections, we believe the state of auditing in Canada is sound.

Looking ahead, however, we are concerned about a number of challenges that have the potential to negatively affect audit quality. I have already addressed our concerns regarding audit committees putting undue pressure on firms to significantly reduce audit fees. I'd like to touch on two additional challenges before concluding my remarks.

### ***Global Economic Downturn***

The first is the difficult economic environment, which will continue to create issues for auditors, management, boards of directors and audit committees in their 2009 financial statements. These will be similar to, and, in some cases, even more significant than the challenges that existed in late 2008.

As we did in early 2009, CPAB met with the leadership of the National firms to assess their preparations to audit in this environment. While good work has been done to date, we believe firms must continue to be vigilant. Their processes and guidance must continue to evolve to address ongoing and changing risks.

For our part, CPAB's 2010 inspections will continue to focus on areas most affected by the economic environment.

### ***International Financial Reporting Standards***

The second challenge is the impending introduction of new standards.

International Financial Reporting Standards—IFRS—take effect in Canada for fiscal years beginning on or after January 1, 2011. This is the biggest change to financial reporting in Canada in recent history.

While conversion to IFRS poses some risks to Canadian companies, we believe it creates opportunities for them to identify and select options that most faithfully represent their financial results and position.

We are working with audit firms and companies to encourage them to be proactive and to view the transition to IFRS as a strategic opportunity.

Last November, for example, we hosted, along with the Accounting Standards Board, a webcast that focused on what small and mid-sized companies should be doing to ensure an effective and smooth transition to IFRS. We also outlined our expectation that audit firms will have technical competence in the new standards.

First-time adoption of IFRS creates a heightened audit risk and the audit approach must respond to those risks. We are urging firms to develop resources to assist with IFRS conversion issues.

### ***New Canadian Auditing Standards***

IFRS is not the only standard that will be changing. Canada is also adopting International Standards on Auditing as Canadian Auditing Standards.

This change will take effect before IFRS, in that the new standards apply to audits of financial statements for periods ending on or after December 14, 2010.

These new standards increase the emphasis on risk assessment and will help ensure that auditors respond to risks in the audit. While there is significant overlap between the current and new standards, certain new ones will require auditors to perform new procedures.

Planning for the transition to these standards should be underway now, and we are urging firms to undertake training on a timely basis.

To assist with this, CPAB and the Auditing and Assurance Standards Board are co-hosting a webcast on May 6.

The webcast will identify some of the key considerations that auditors need to address in their transition to the new Canadian Auditing Standards, including how they can use it to improve the effectiveness of the audit process. Further details are available on our website.

## **8. Conclusion**

CPAB has completed six years of inspections. Based on our inspections, it appears that more audits now meet a high standard of quality than they did six years ago. Overall, most audit firms have good processes in place to ensure quality control.

But, as I have outlined today, we still encounter examples of audit work that falls short of professional standards. We are also concerned about the challenges ahead that may negatively affect audit quality.

We urge audit firms, audit committees, boards of directors and management to be mindful of these challenges and to work with us to ensure Canada continues to benefit from high quality audits that enhance the quality and transparency of financial statements.

High-quality financial statements that faithfully represent a company's financial position are crucial to the integrity of financial reporting around the world. The current economic environment demands that Canada's companies, auditors and regulators, including CPAB, continuously revisit their approach. This is the only way to ensure that we are proactively and effectively addressing today's increased risks and challenges, and ultimately protecting audit quality.

Thank you.