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CPAB quality inspections of external auditors: What can audit committees expect to learn about them?

The responsibilities of audit committees of public companies and other reporting issuers are set out in section 2.3 of Multilateral Instrument 52-110 issued by the Canadian Securities Administrators. These responsibilities include oversight of the work of the external auditor. This note has been prepared by CPAB to assist audit committees in their understanding of what they may expect to learn about any CPAB inspection of their audit firm that may have taken place.

Public reports

CPAB is committed to contributing to public confidence in the integrity of financial reporting by companies that are reporting issuers in Canada. It does this in part by conducting a rigorous program of quality inspections of public accounting firms that issue audit reports on reporting issuers' financial statements. The quality inspections have two principal outputs: periodic public reports that discuss recurring findings arising from inspection results across a group of firms (available on CPAB's website), and private reports of findings and recommendations to the individual firms inspected. Audit Committees should find the contents of the public reports useful to the oversight of their external auditor.

Private reports

CPAB's private reports to audit firms contain two categories of recommendations: those that address potential weaknesses in the firm's system of quality control over audits, and those requiring action with respect to one or more individual audits included in the sample of the firm's completed audits selected by CPAB for review. CPAB inspection reports are not finalized until the firm has had an opportunity to comment on each issue.

Normally CPAB expects the firm to commit in writing to take appropriate action. CPAB follows up after a 180-day implementation period has expired to see whether the promised action has been taken by the firm. If the firm implements the specific recommendations made by CPAB within the prescribed time period, the recommendations and the resulting action remain confidential between CPAB and the firm. A failure of a firm to implement one or more recommendations to CPAB's satisfaction may result in CPAB making public on its website the relevant portion or portions of the inspection report, after providing notice to the firm of its intention to do so.

CPAB believes that the opportunity to correct weaknesses identified in a private confidential report, coupled with the possibility of public disclosure for any failure to do so, provides the strongest incentives for audit firms to make prompt improvements in overall audit quality. In egregious circumstances, however, CPAB will take whatever steps are necessary steps to protect the public interest.

Inspections

There are approximately 300 participating audit firms subject to CPAB's oversight. CPAB inspects the largest firms annually and certain other firms biennially or triennially. For small Canadian accounting firms that do not audit any SEC registrant clients, CPAB relies principally on the results of the inspections undertaken by the provincial professional accounting bodies with jurisdiction over the firms' practice offices.

CPAB inspects only a small sample of each firm's completed audit engagements. The selection of individual engagements is weighted towards the clients in the firm's portfolio that are large (measured by market capitalization), complex and/or appear to have a higher than normal likelihood of significant financial reporting issues. For each engagement selected, CPAB considers the way that the firm planned, supervised and completed the audit as well as the specific audit work done by the firm with respect to 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 judgement.

CPAB has no objection to an audit firm disclosing to a client's audit committee when it was last subject to a quality inspection by CPAB and whether the audit engagement of the particular client was selected by CPAB for review as part of the quality inspection process.

Under CPAB's rules, if the audit firm implements, within the prescribed time period, CPAB's recommendations relating to the audit firm's system of internal control, the audit committee will not learn about the particulars of those recommendations. The audit firm is permitted to inform the audit committee whether it has implemented or intends to implement, all of the recommendations made by CPAB. The audit committee can take comfort from the fact that CPAB follows up to ensure that the firm carries out its commitments. Audit committees should ask their external auditor about the status of recommendations made by CPAB.

At the level of an individual engagement, audit committees would be interested in any CPAB findings and recommendations pertaining to auditor independence, an accounting error in the issuer's financial statements or a deficiency in the way the audit was conducted.

Independence issues

Independence issues normally fall into one of two categories: an inappropriate investment in the client's securities by a partner or staff member of the audit firm, contrary to professional standards, or non-audit services provided to the client by the audit firm that would be perceived as a threat to auditor independence. Auditors are required to notify the audit committee in writing about such circumstances when the auditor is aware of them. If CPAB becomes aware of matters that have not been reported, it asks the audit firm to notify the audit committee in writing about the circumstances and follows up to ensure that such notification has taken place. In addition, audit committees should expect their auditor to provide them, at least annually, with a confirmation of the auditor's independence. Generally accepted auditing standards require the auditor to provide such a confirmation.

Accounting errors

If an accounting error discovered in a CPAB review of an engagement appears to be material to reported income or cash flow, CPAB asks the auditor to request its client's management to discuss the matter with the appropriate securities commission. We expect that the audit committee would be advised by management and the auditor of this request. We also expect that the auditor would be present at any discussion with the commission. We follow up with the auditor and, if necessary, with the commission to ascertain whether appropriate discussion with the commission has taken place. The issuer and the commission may agree that previously issued financial statements should be restated, that some alternative course of action is appropriate, or that no action is necessary. If the accounting error involves a misclassification on a balance sheet or income statement or a need for amendments to the notes to the financial statements, but not a material error to reported income or cash flow, CPAB secures the auditor's agreement that the matter will be raised with the client for consideration when the client next prepares interim or annual financial statements.

Audit deficiencies

Audit deficiencies mean that CPAB does not think the quality or quantity of the audit evidence is sufficient to support the opinion that the auditor has expressed. Sometimes this is a matter of documenting audit work that was done but not documented; on other occasions, additional audit work is required to remediate the deficiency. Usually, the conclusion from any extra work is that the client's financial statements and the audit firm's opinion thereon do not require adjustment; if so, the audit firm is not required to inform the audit committee that extra audit work has been done on a completed audit. However, if the extra work reveals an accounting error, the process for accounting errors described in the previous paragraph would apply.

Restrictions and sanctions

In very unusual circumstances, CPAB may impose a restriction or sanction on a participating audit firm. Under CSA National Instrument 52-108, the firm must notify the audit committee of each reporting issuer audit client when:

- It is subject to a CPAB restriction intended to address defects in its quality control system and is informed by CPAB that it failed to address such defects to the satisfaction of CPAB within the agreed time period; or
- It is subject to a sanction imposed by CPAB.

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