



**NOTES FOR REMARKS**

**BY**

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**REGULATION OF THE AUDITING PROFESSION**

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## **1. Introduction**

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, we appear to be facing a long, slow recovery—one that will be characterized by profound changes in the operation of our financial markets, including changes to financial regulation.

My remarks will focus on the evolving role of the Canadian Public Accountability Board in the context of these changes. In the course of my remarks I will also provide some background on CPAB, talk about what we have observed about audit quality over the past five years, and share our priorities for the months ahead.

## **2. About CPAB**

CPAB was established in 2003, in the wake of the Enron and other corporate scandals. During that period of time, the market system faced a serious threat—the threat of a breakdown in confidence among the very people needed to sustain it.

Canadian provincial and federal regulators recognized the gravity of the situation and realized that the problems associated with Enron and other entities were not necessarily restricted to U.S. companies. Like regulators in other countries, they saw the need to act quickly to restore public confidence in the integrity and reliability of public companies' financial statements and external audits.

And so CPAB was established, through a co-operative national effort involving federal and provincial regulators, along with Canada's Chartered Accountants. Its creation was a big step forward in giving Canadians the assurance that there would be independent, professional reviews of public company financial statements.

A bit about how we are set up: A Council of Governors oversees CPAB, conducts annual assessments of our activities and votes on bylaw amendments. The Council members are: the Superintendent of Financial

Institutions of Canada; the Chair of the Ontario Securities Commission; the Chair of the Québec Autorité des marchés financiers; the Chair of the Canadian Securities Administrators or, if the Chair is from Ontario or Quebec, the CSA selects an alternative as a governor; another governor selected by the CSA; and a member selected by the other governors who is both a professional accountant and has audit oversight regulatory experience.

As a result of recent changes to our governance structure the removal of the 3 *ex officio* positions our Board of Directors is now made up of four professional accountants and seven non-accountant directors. Our structure also includes Provincial Audit Regulators, which include Institutes of Chartered Accountants in all provinces, as well as the Certified General Accountants of BC and Alberta. We also recently created committees that formally consult with the professional accounting groups we work with on matters of common interest. I would also mention that a number of CGA firms are registered with CPAB in Alberta and BC.

We employ about 30 full-time professional staff, many of whom were previously in national accounting or auditing offices of a national firm. We also engage 10 consultants who have specialized expertise in such areas as financial instruments, valuation, taxation and IT. Most of our staff are based in Toronto but we do have people in Vancouver, Calgary and Montreal. We will be opening offices in Vancouver and Montreal in the next few months.

We also work with Provincial Audit Regulators, who carry out numerous inspections of smaller firms.

Our mission is to benefit investors, and Canadians in general, by promoting high-quality, independent auditing. This contributes to public confidence in the integrity of the financial reporting carried out by Canadian public companies.

Participation in our oversight program is mandatory for all public accounting firms that want to audit an entity that is a reporting issuer in Canada. As of last December, 203 domestic audit firms were registered with us.

CPAB inspects firms with 100 or more reporting issuer clients every year. We inspect those with between 50 and 99 such clients at least once every two years and we inspect those with fewer than 50 at least once every three years.

To put into perspective what that looks like: The six national firms each have more than 200 reporting issuer audit clients. Canada's "Big 4" accounting firms—Deloitte, Ernst & Young, KPMG and PricewaterhouseCoopers—audit approximately 97 per cent of the market capitalization of public company reporting issuers in Canada.

Eleven firms have between 51 and 200 reporting issuer clients, 54 firms have between six and 50 such clients and 132 firms have five or fewer such clients.

About 70 foreign firms are also registered with CPAB. About half of these are based in the U.S.

### **3. The Inspection Process**

When we inspect an audit firm, the first thing we do is assess its fundamentals and policies. This starts with evaluating whether management is setting an appropriate "tone at the top" by continually sending the message throughout the firm that audit quality is paramount.

We then review selected individual audit files to evaluate whether the audits were performed by independent auditors in accordance with high quality auditing standards.

In our inspections we focus on:

- Independence and ethics – which means ensuring that firm partners and managerial employees don't have investments that would violate independence standards
- Decisions relating to client acceptance and continuance
- Human resources issues, such as performance evaluation and professional development
- Documentation relating to audit engagements

- Performance on audit engagements, and
- Monitoring of quality control, which refers to the compliance work done by firms to verify that their systems of quality control are appropriately designed and operating effectively.

Following each inspection, CPAB sends the firm a private report that includes findings, recommendations and other observations. Firms are expected to implement recommendations to CPAB's satisfaction within a prescribed period of time—normally 180 days.

When a strong message is required, CPAB imposes requirements instead of recommendations. If a firm failed to do what has been recommended or required, CPAB would consider making that fact public and, in certain cases, could choose to impose restrictions or sanctions on that firm. If CPAB imposed restrictions on an audit firm, the firm would be required to notify Canadian securities regulators. If CPAB were to impose sanctions upon a firm, the firm would be required to notify Canadian securities regulators and the audit committees of its 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 it could no longer audit public companies in Canada.

CPAB does not make the results of specific firm inspections public. However, we do issue public reports annually that summarize our inspection results. Our sixth Public Report was issued last March and is available on our website.

#### **4. Observations based on five years' of inspections**

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

But we still encounter examples of audit work that falls short of professional standards.

At the national firms, CPAB has found the quality of audit work to be generally high. However, there are pockets or certain offices where quality needs to be improved. For example:

- The role of the concurring or second partner is a vital element of quality control on an audit. CPAB has found that the time spent by the concurring partner often appeared to be too little and too late in the process to have a meaningful impact. When GAAP or GAAS deficiencies that should have been evident to the concurring partner were missed, we found that the firms' quality monitoring review did not always attribute partial responsibility to the concurring partners in these situations.
- The use of specialists is also an area requiring improvement. In 2008, CPAB noted an increase in the use of in-house firm specialists, particularly those involving the use of fair values, usually in connection with business combinations, impairments and valuation of financial assets. With the global economic downturn, CPAB expects the use of specialists to increase even more. However, CPAB has noted that the engagement team did not always validate the data used by specialists. As well, where management performed valuations, CPAB found that the specialists did not always challenge their assumptions with sufficient rigour.

In our inspections of mid-size and smaller audit firms, we have found many examples of excellent audit work, usually where the firm leadership placed a strong emphasis on audit quality.

However, we find that when a mid-size firm takes on clients that are in a business different from the majority of its clients, the firm often has difficulty dealing with the accounting issues related to the company.

For example, if the majority of the firm's clients are exploration and development companies and the firm accepts a client in the business of developing and selling software, the firm may have a challenge dealing with the complexities of revenue recognition in that industry.

As I mentioned earlier, when CPAB believes disciplinary action is necessary to protect the public interest, generally due to substandard audit work or failure to implement recommendations appropriately, CPAB

imposes requirements. Most requirements arise from CPAB's concerns about the number and severity of GAAS and GAAP departures in the engagements reviewed.

In 2008, CPAB imposed requirements on nine firms, down from 11 the year before. The most common requirements were that a firm or a firm's specified partner could not accept any new reporting issuer clients. Some firms were required to have an external firm or professional standards group review audit working papers before issuing an audit report. And some specified firm partners were required to take additional training.

In most situations these requirements were lifted after CPAB performed a follow-up inspection and the audit firm had successfully implemented recommendations as requested by CPAB.

CPAB is disappointed that the number of firms that had requirements imposed in 2008 was not significantly reduced from 2007. We hope to see significant reductions in future years.

## **5. CPAB's priorities and evolving role**

The end of our fifth full year of inspection operations in 2008 marked the end of CPAB's start-up period and the beginning of our next phase of operations.

Building on a strong foundation and the experience we have gained, we are moving forward and evolving as a regulator. While we will continue to maintain an excellent inspection program, we will also increase our involvement in other key areas that affect audit quality, including input into the development of accounting and auditing standards in Canada and internationally, codes of conduct and the overall business environment.

Here are some of our key priorities in the months ahead.

## ***Legislation***

The first is our efforts to build a legislative base in each province to ensure we can carry out our mandate effectively. Ontario and Quebec have passed legislation providing immunity for CPAB's Board of Directors and staff for their actions in good faith.

The Ontario legislation also provides CPAB access to privileged working papers. This access is very important, and we are working to gain it in all provinces and territories.

This is a key priority because CPAB believes that, in order to carry out its mandate effectively, it requires statutory right of access to all material or relevant information obtained or prepared by an audit firm in connection with an audit or a reporting issuer, including information that is subject to solicitor-client privilege. It is impossible for CPAB to conduct a full and complete examination if it does not have access to all the information the auditors had access to in order to express their opinion on the financial statements.

In some cases, CPAB has been denied access to legal letters and related working papers in significant risk areas, such as environmental liabilities, asset retirement obligations, litigation and tax matters.

Disclosure of privileged information to CPAB does not constitute a waiver or negation of any solicitor-client privilege, and a clear duty of confidentiality is imposed on CPAB and all its directors, governors, employees and agents.

As I mentioned, this is a high priority for us, and we will continue to seek access to privileged documents in all jurisdictions.

## ***Partnerships***

Another priority is building partnerships, in Canada and around the world. CPAB actively consults and collaborates with other regulators on how we can work together more effectively to enhance audit quality and protect the public interest.

We participate in the International Forum of Independent Audit Regulators, which helps develop co-operative arrangements with other national auditor oversight authorities and encourages dialogue on auditor inspection techniques, results and remediation. More than 100 countries have established organizations such as CPAB and more than a third of them are members of the International Forum.

Our main international partnership is with the U.S. Public Company Accounting Oversight Board, which was established under the Sarbanes-Oxley Act in the wake of Enron and other corporate scandals.

We enjoy an excellent working relationship with our U.S. counterpart and have been performing joint inspections with it since 2004. We are also working with other regulators around the world to get to the point where we can place reliance on each other's work. We are making excellent progress with the European Union and Japan. Again, a key issue relates to confidentiality and what information we can share with other regulators.

CPAB is viewed as a world-class regulator and we will continue to work to maintain that reputation.

### ***IFRS and new Canadian Auditing Standards***

CPAB is also spending considerable time and effort on the major changes that lie ahead, including the Canadian adoption of the International Standards of Auditing for 2010 year-end and International Financial Reporting Standards in January 2011. These changes will profoundly affect auditing and financial reporting in this country.

We are providing timely training to our staff on IFRS and the new Canadian Auditing Standards and making sure these standards are incorporated into our methodology. It is important that we have the right number and mix of staff to continue to effectively carry out our mandate before, during and after the transition to IFRS.

We are enhancing our internal and external consultation processes, which will become increasingly important as Canada makes the transition to IFRS.

We are also assessing the readiness of audit firms for these changes. The new auditing standards will affect audit methodology, with audit reporting and group audits feeling the most significant impact.

Firms will need to ensure their professional staff have technical competence in IFRS. New guidance materials and tools will need to be developed to accommodate the more extensive disclosures under IFRS. There are additional policy choices required, implications for documentation and new considerations relating to auditor independence.

To assess their readiness for IFRS, CPAB is interviewing firms across the country. Our key message to them is that IFRS-readiness is a significant issue for smaller public companies, and that most of those companies have so far taken very little action to get ready for the transition.

We want firms to take steps to avoid being in a position where they are required to perform three audits for clients in the January to March period of 2012, which could occur if steps aren't taken now to ensure a smooth transition to IFRS.

We are also reaching out to small and mid-size companies to help them identify strategic opportunities in their transition to IFRS. On November 5, 2009, we co-hosted a webcast with the Canadian Accounting Standards Board to encourage companies to be proactive and to take the steps required to ensure an effective and smooth transition to IFRS.

We believe companies and their auditors can use the conversion as an opportunity to streamline accounting and reporting processes, enhance decision-making and improve internal controls. We are also strongly urging companies to identify industry-specific issues early and to focus on the IFRS elements that will have the greatest impact on their financial reporting.

## **6. Conclusion**

As we move forward, CPAB will continue to examine its processes and procedures, the scope of the entities it inspects and its mandate going forward. Several auditor oversight organizations around the world, including the U.S. Public Company Accounting Oversight Body, are expanding their mandates, and CPAB will also consider this as part of its ongoing strategic planning process.

I hope my remarks have given you a better understanding of CPAB's genesis and mandate, its work over the past five years and its priorities going forward,

Today, more than ever, high-quality audits are crucial to the integrity of financial reporting around the world. The current economic environment demands that Canada's auditors and regulators, including CPAB, continuously revisit their approach, to ensure that we are proactively and effectively addressing today's increased risks and challenges.

Thank you.