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CONSEIL CANADIEN SUR LA REDDITION DE COMPTES

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FIFTH PUBLIC REPORT

Inspections of the Quality of Audits Conducted by Public Accounting Firms

SUBJECT TO THE

CANADIAN PUBLIC ACCOUNTABILITY BOARD OVERSIGHT PROGRAM

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Executive Summary

1. **Background and Scope**

The Canadian Public Accountability Board (CPAB) was created to promote high quality external audits of financial statements of reporting issuers in Canada. In carrying out that mandate, CPAB conducts inspections of public accounting firms performing those audits. This Fifth Public Report gives the results of CPAB's inspections between October 1, 2006 and December 31, 2007. The firms inspected were:

- Canada's six national public accounting firms;
- Eleven firms that operate on a regional or local scale and have at least 50 reporting issuer audit clients;
- Thirty firms that have fewer than 50 reporting issuer audit clients; and
- Four firms based outside Canada that audit Canadian reporting issuer clients.

This Report covers a period of 15 months because CPAB has changed the timing of its annual cycle of planning, operations and reporting. That cycle will now be on a calendar year basis and CPAB will report on this basis in future years. This change maximizes comparability among the results of inspections as most revisions in audit-related standards are introduced at the start of a calendar year.

2. **Audit Quality Improvements**

Over the past four years, CPAB has inspected the public accounting firms conducting the bulk of public company audits in Canada and has recommended improvements to ensure more consistently high quality audits. CPAB sends each firm reviewed a private report that includes specific recommendations, each of which requires a response. The firms have implemented or are in the course of implementing substantially all of the recommendations made by CPAB.

3. **Areas of Concern**

CPAB notes that it is not reporting significant overall improvements in audit quality in respect of the firms that it reviewed in the last quarter of 2006 and calendar 2007. Although the majority of the audit files that CPAB reviews are

done well, it has particular concerns in a substantial number of firms regarding:

- overall quality of consultations and documentation thereof;
- the extent and quality of engagement quality control reviews (EQCRs), in which a partner other than the partner responsible for the engagement performs a review of key areas in the file and;
- quality monitoring, in which partners independent of the engagement conduct a post issuance review of engagement files to ascertain compliance with professional and firm standards.

Although these concerns apply to both large and small firms, in the larger firms it is usually the case that the controls in a firm's system have not been applied as designed whereas in the smaller firms, many of which do only audits of relatively small reporting issuers, there is often an absence of the control systems themselves. The issues identified have been raised by CPAB in earlier public reports. These areas require ongoing improvement in order to enhance overall performance on audit engagements overall and to address the reasons for the deficiencies in the files that CPAB has reviewed.

4. **Scope**

The scope of CPAB's reviews of some individual audit engagements continues to be restricted by lack of access to documents because of legal privilege. While CPAB understands concerns about legal privilege, any restrictions on its reviews are contrary to its objectives. The passage of the Canadian Public Accountability Board Act (Ontario) 2006 and An Act to amend the Chartered Accountants Act in Quebec will significantly improve CPAB's situation. CPAB continues to seek statutory authority in all jurisdictions to have access to privileged information without negating that privilege.

5. **The Six National Firms**

The six national firms audit reporting issuers in Canada, representing about 95 per cent of the market if measured by the market capitalization, revenues or assets of the reporting issuers.

Each firm has made progress since CPAB commenced its quality inspections and

substantially all of the recommendations made to the firms following those inspections have been implemented. The firms have strong leadership with a commitment to quality (tone at the top) and generally effective controls over human resources and client acceptance and continuance. All six firms have strong programs to deal with the requirements of independence standards.

The primary area that requires further improvement is engagement performance and most of the firms have more work to do to improve audit quality and achieve consistent adherence to professional standards and to their firm's standards. CPAB remains concerned that in too many of the files reviewed, there continues to be a need for the firms to significantly improve their documentation of consultations and of the support for key audit judgments made to support the audit opinion.

Of the 130 audit engagements CPAB selected for review in the six firms (primarily higher-risk files), 11 engagements had serious deficiencies in the application of Generally Accepted Auditing Standards (GAAS) concerning the sufficiency of the work done, documentation of the work, and/or evidence of review. In 5 engagements, deficiencies in the application of Generally Accepted Accounting Principles (GAAP) resulted in remedial action being required or having to be taken to have financial statements reissued, restated or corrected in the subsequent year.

CPAB concludes that EQCR and quality monitoring are the areas most in need of improvement.

At the end of its 2007 reviews, CPAB placed one requirement on one of these firms.

6. Regional and Local Firms that have more than 50 Reporting Issuer Clients

In the period under review, CPAB inspected 11 firms that have more than 50 reporting issuer clients for either the third or fourth time and carried out follow up inspections on 6 of these firms. CPAB is encouraged by the firms' co-operation but disappointed with poor results on engagement performance. *As a result of these reviews, CPAB placed requirements on four firms.*

Some of the firms have shown that they are striving to continuously improve audit quality. Those firms have strong quality leadership, which sets a tone at the top that shows a commitment to audit quality. CPAB was generally pleased with the progress of some firms in the area of client and engagement acceptance and continuance, but made recommendations to refine the process. The majority of firms also have generally adequate controls over the human resources area.

Several firms still have work to do to comply with independence requirements.

Of the 81 audit engagements from firms in this group that CPAB selected for review (primarily higher-risk engagements), 12 had serious deficiencies in the sufficiency of the work done, documentation of the work and/or evidence of review. In 14 engagements, deficiencies in the application of GAAP resulted in remedial action being required or having to be taken to have financial statements reissued, restated or corrected in the subsequent year.

CPAB had strong concerns about the effectiveness of the EQCR and quality monitoring processes in some of the firms.

7. Firms Reviewed with less than 50 Reporting Issuer Clients

During this period, CPAB reviewed 30 firms in this group; 18 were full reviews (7 of these for the first time) and 12 were follow-up reviews.

Several of the smaller firms have shown that they are working to continuously improve audit quality. Those firms set a tone at the top that shows a commitment to audit quality, but there is still work to be done in delivering the message that audit quality should be paramount. CPAB was pleased with the progress of some firms in the area of client and engagement acceptance and continuance, but noted a lack of rigour in some firms.

CPAB found several of the firms to be deficient in the area of human resources policies. Several firms still have work to do to comply with independence requirements.

Of the 81 audit engagements CPAB selected for review (primarily the higher-risk engagements), 16 had serious deficiencies in the sufficiency of the work done,

documentation of the work and/or evidence of review. In 13 engagements, deficiencies in the application of GAAP resulted in remedial action being required or having to be taken to have financial statements reissued, restated or corrected in the subsequent year.

CPAB has significant concerns about the ability and desire of some of these smaller firms to develop and apply the required quality control review and quality monitoring processes. *As a consequence of these reviews, CPAB placed requirements on 10 firms.*

8. **Foreign Based Firms**

During 2007 CPAB reviewed the files of 4 firms based outside of Canada that audit Canadian reporting issuers. Each of these firms is a foreign affiliate of a national six firm. Two of the affiliates were based in the US and CPAB carried out these reviews together with the Public Company Accounting Oversight Board. Generally the affiliate firms have the same systems and methodologies as the Canadian firm in the same network, and CPAB was pleased to note the consistency of these standards in the files it reviewed.

9. **Disciplinary actions taken**

As a result of its 2007 reviews CPAB placed 20 requirements on 15 firms (see Table 1), one of which was a national firm and four of which were regional/local with more than 50 reporting issuer clients. The firms were required to do one or all of the following measures:

- Not to take on additional reporting issuer clients until complied with CPAB's recommendations,
- To have their files reviewed by another firm or the firm's professional standards function before they issued any audit reports on reporting issuer clients,
- To increase their resources or reduce their commitments so that resources and commitments were more fully in balance.
- To prevent specified partners or staff from working on the EQCR function for

reporting issuers.

- Not to issue audit reports on existing clients until the firm has demonstrated its independence from those clients (one firm).

10. **Conclusion**

While high quality audit work was typically evident throughout its inspections, CPAB has concerns that it identified so many instances where engagement teams did not fully comply with an aspect of GAAS or with the firm's own internal procedures. There continues to be room for improvement in performance at all levels, particularly in consultation, documentation, engagement quality control review and quality monitoring. CPAB expects that each firm will impress upon its partners and staff the need to improve compliance in the future

Table 1
Number and Type of Requirements Placed on Firms

	2005	2006	2007
Number of Firms receiving requirements	5	7	11
Firm is required not to accept any new reporting issuer clients	5	7	7
Specified partners/staff are required to take additional training	2	-	2
Specified partners/staff not to work on Quality Control Reviews	1	-	1
All audit reports on reporting issuers to be reviewed by an external firm before issue	1	2	3
Firm to increase senior resources or reduce commitments	-	-	1
Independence matter to be addressed	-	-	2
Total Requirements Placed	9	9	16

N.B. Four of the requirements placed in 2007 arose from inspections carried out at the end of 2006 and are included in the 2006 column above. These requirements were each placed on a different firm.

Scope

1. CPAB has changed the timing of its annual cycle of reviews and this report covers work done by CPAB in the last quarter of 2006 and calendar 2007. This change permits CPAB to report primarily on work performed in the prior calendar year and maximizes comparability across inspections as audit related standards are usually introduced at the start of a new calendar year.
2. There are 268 firms registered with CPAB, 215 Canadian and 53 that are based outside Canada. (See Table 2) During the last quarter of 2006 and calendar 2007, CPAB carried out:
 - Fourth year inspections at each of the six national firms
 - Third or fourth year inspections of eleven other firms that have 50 or more reporting issuer clients
 - Inspections of eighteen firms with fewer than 50 reporting issuer clients
 - Follow-up inspections of six firms that had 50 or more reporting issuer clients and twelve firms with fewer than 50 reporting issuer clients
 - Inspections of files at four affiliates of three of the six national firms, situated outside Canada

Table 2
Number of Firms Registered with CPAB 2004-2007

End of Year	Canadian	Foreign	Total
2004	241	12	253
2005	260	28	288
2006	243	40	283
2007	215	53	268

Notes:

1. The reduction in Canadian registrants is a combination of firms merging and others, usually small firms, ceasing to perform the audits of reporting issuers.
2. Approximately fifty percent of foreign based firms are based in the USA.
3. 36 of the 268 firms registered at December 31, 2007 did not have any reporting issuer clients at that date.

Further comments on scope are set out in Appendix B.

Engagement Reviews (All Firms)

3. The engagements reviewed were selected to satisfy a number of criteria, including size, complexity, level of risk and a balance between Securities and Exchange Commission (SEC) and non-SEC engagements. For each engagement selected, CPAB considers the way the firm planned, supervised, conducted and completed the audit. It also considers the specific audit work done by the firm with respect to certain aspects of the client's financial statements that appear to CPAB to be particularly significant, complex or that may require the application of considerable professional judgment.

CPAB does not review every aspect of audit engagements selected for consideration, because to do so would be prohibitively expensive. The absence of significant findings in CPAB's review of a particular engagement is therefore not an endorsement that the client's financial statements were necessarily fairly presented in accordance with accounting standards or that all aspects of the audit were fully compliant with auditing standards.

4. One of CPAB's major concerns continues to be the lack of documentation of audit procedures performed. Under the PCAOB Auditing Standard No. 3 and the proposed Documentation standard of the Canadian Institute of Chartered Accountants (CICA) (CICA Handbook section 5145), if work is not documented then there is no evidence that it was done. If there is no such evidence, the file is deficient. CPAB will continue to require the firms to more fully document the procedures performed.
5. CPAB was once again disappointed by the number of GAAP and GAAS deficiencies in the files that it reviewed. Appendices C, D and E (in the electronic version only) list the more significant issues that CPAB identified in individual files.

6. CPAB has noted that many of the smaller firms have not implemented standards dealing with the engagement quality control review (EQCR) and quality monitoring. Given the pervasiveness of the findings in these areas, CPAB has significant concerns about the ability of many of these smaller firms to develop the processes and resources required in these areas.
7. CPAB notes that in earlier years it has indicated concern about lack of documentation of consultations, non-compliance with standards for using specialists, inadequate time being spent on EQCR and weaknesses in quality monitoring. These continue to be identified as areas of concern.

Other

8. While CPAB has the power to impose requirements, restrictions or sanctions (see Appendix A for an explanation of these terms) 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 appropriate audit quality improvements. As a consequence of its 2007 inspections, and notwithstanding the recommendations that have been made to the firms, CPAB imposed one requirement on one of the six national firms, imposed requirements on 4 of the other firms with 50 or more reporting issuer clients and imposed requirements on 10 of the firms with less than 50 reporting issuer clients. No restrictions or sanctions were imposed on any firms.
9. Over the four years since it was established, CPAB has reviewed a total of 60 firms, several between two and four times. During that period, it has placed requirements on twenty one firms, two of them twice. One of these firms was subsequently deregistered and one withdrew from auditing reporting issuers. Of the requirements placed, CPAB has lifted the requirements on ten firms because the firms had complied with the recommendations made and eleven are still in place. (See Table 3)

Table 3

SUMMARY OF STATUS OF REQUIREMENTS

	Number of Firms (a)	Number of Requirements (b)	Lifted (c)	Firm Resigned or Terminated (d)	Firms with Requirements Still in Force (e) [(a)–(c)– (d)]
2005	5	8	3	2	-
2006	7	9	6	-	1
2007	11	16	1	-	10

10. In order to avoid duplication and to control overall cost CPAB believes there must be effective co-operation with independent audit regulators based in other countries in the conduct of audit inspections.
11. CPAB led the inspection work in 11 joint inspections conducted in Canada with representatives of the PCAOB. In the reviews of these joint issuers, the PCAOB inspected a number of audit files for clients registered with the SEC only.
12. The International Forum of Independent Audit Regulators (IFIAR), which is a group of oversight bodies representing 22 countries, is developing protocols to increase the effective and efficient conduct of audit inspections internationally. During 2007, CPAB inspected 9 files at four firms based outside of Canada which audited Canadian reporting issuers CPAB worked with other regulators in two of the countries (the third does not have a CPAB equivalent).
13. The Auditing and Assurance Standards Board (AASB) is responsible for setting Generally Accepted Auditing Standards (GAAS) in Canada and it has been following an ambitious agenda to enhance GAAS. In doing so, the AASB elected to move to international auditing standards and has been working with the International Auditing and Assurance Standards Board (IAASB) to develop and update auditing standards which are expected to be introduced for audits

commencing after December 31, 2009. Twenty exposure drafts were issued in 2007, CPAB commented on most of these to both the IAASB and the CICA. CPAB's main concern was that the specificity of many of the existing Canadian standards will be lost and it will take a great deal of discipline on the part of the firms to ensure this does not lead to a reduction in the quality of audit work being done.

14. CPAB strongly supports the work the AASB is doing to develop new and improved auditing standards and believes the implementation of these new or improved standards could lead to an improvement in the level of audit quality in key areas.
15. CPAB participates in the public oversight of the AASB through membership on the Auditing and Assurance Standards Oversight Council (AASOC).
16. CPAB follows up all complaints received on its hotline. Anyone can use the hotline to anonymously express concerns relating to the audits of reporting issuers or concerns regarding a financial reporting or accounting matter. Anyone who has concerns regarding CPAB's inspections or inspectors can also use the hotline.

Recommendations Arising from the Inspections

The Six National Firms

Introduction

17. Each firm has made improvements since CPAB commenced its inspections but CPAB still found that some of the files that it reviewed did not demonstrate the required quality in such areas as engagement quality control review (EQCR) and documentation.

In too many files, CPAB had significant concerns about the lack of documents for key areas such as consultations and support for audit judgments. There remains the question as to why the firms' own EQCR processes did not identify these matters prior to the release of the audit opinion.

Tone at the Top/Leadership

18. All of the firms have a number of strategic priorities that, as CPAB would expect, include an emphasis on audit quality. The firms' reputations depend, more than anything else, on being able to achieve and sustain a consistently high level of quality in their audit work.
19. In their internal communications to partners and staff, all firm leaders emphasize the need to make an uncompromising effort to perform the highest quality work on every audit engagement. Furthermore, CPAB is satisfied that each firm's leadership is prepared to take strong action to deal with serious quality shortcomings.

Performance on Audit Engagements

General

20. The majority of the 130 audits reviewed in 2007 had generally been performed at an acceptable standard. However, there were a number that, in CPAB's opinion, contained deficiencies.
21. CPAB concluded that in 11 of the 130 engagements, the audit was deficient in the sufficiency of the work done, documentation of the work, and/or evidence of

- review. In 5 cases, CPAB considered the financial statements to require either reissuance, restatement or correction in the subsequent year. There continues to be a need for the firms to significantly improve documentation of the reasons for key audit judgments made in support of the audit opinion.
22. As in previous years in many situations, CPAB was unable to access working papers deemed to be privileged, although the PCAOB obtained access to these same papers when the reporting issuer was an SEC registrant. In a further situation CPAB was unable to access working papers held in another country when it became clear the documentation maintained by the firm in Canada did not provide a sufficient summary of the work performed by the secondary auditor.
 23. For each file that had audit deficiencies, CPAB required the firm to either carry out further audit work or to add documentation to the file. In all cases the firms have agreed to do so.
 24. For some of these files, the firms also intend to conduct a quality review of other selected reporting issuer audit engagements for which the relevant engagement partners are responsible, in order to determine whether quality deficiencies also exist in these engagements. CPAB will review the findings from these reviews and the actions taken as a result.

Systemic Issues

25. CPAB made a number of recommendations on findings that were systemic to some of the firms with respect to engagement performance improvement in general, or by reference to specific engagements. The systemic issues covered by CPAB's recommendations included the following:
 - **Consultation** - All six firms have cultures that encourage consultation with technical accounting or auditing experts, wherever appropriate, on matters that require judgment or are contentious. However, CPAB once again noted failures to properly document the nature and/or scope of alternatives considered or conclusions reached from some consultations. CPAB noted a number of failures to secure the written agreement of the party consulted to the conclusion reached, even though auditing standards require this.
 - **Documentation** - Although firm and professional standards require all work that is significant to the opinion to be documented (see CICA Handbook

section 5145), we required the firms to make documentation improvements in almost 25% of the files that we reviewed.

- **Review Process** - CPAB concluded that the time recorded by the engagement partner on certain files was low given the complexity of the engagement. In some of these cases the firm suggested that the time had been spent but not recorded. CPAB considers this to be an inappropriate and an unacceptable practice. CPAB has asked the firms to better monitor the partner time being charged to audit files.
- **Audit Committee Discussions** - As CPAB has noted before, there is a need to improve the documentation of discussion at meetings with audit committees. While the audit working papers often comprehensively document the information the engagement team presented to the committee, they do not always document what questions were asked, how these were answered, or particulars of any other audit-related discussions that took place.
- **Secondary Auditors** - In four of the firms CPAB reviewed files dealing with reporting issuers that had significant foreign operations which were audited by foreign affiliates. In several of these situations, CPAB concluded that the documentation in the working papers of the Canadian firms was insufficient to support the audit opinion. CPAB was disappointed that in certain situations it was not possible to determine planning, issue identification and issue resolution from the evidence in the files.
- **Reporting of Corrected and Unadjusted Errors** - While the quality of reporting to audit committees by all six firms is generally satisfactory, one area continues to require improvement. This is the reporting of corrected errors, and known and most likely unadjusted errors, in the financial statements. Understanding the nature and extent of corrected and unadjusted errors in the financial statements helps the audit committee understand the effectiveness of the issuer's controls over financial reporting.
- **Sampling** - In one firm CPAB had concerns in several of the files reviewed relating to the method used to calculate sample size, select sample items and document the selected sample.

Engagement Quality Control Review (EQCR)

26. A very important aspect of quality control for a public company audit is an independent engagement quality control review performed prior to the signing of the opinion. A partner other than the partner responsible for the engagement performs this review. These reviews are required by the professional standards related to quality control and are an integral part of the internal policies and procedures of all six firms.
- In a number of files reviewed, CPAB considered that the time spent or recorded by the EQCR partner was insufficient for him/her to have carried out an adequate review. CPAB strongly suggests that each firm should develop a minimum standard for such time.
 - Although part of such a review is required to be carried out at the end of planning of the engagement, this did not always occur. In CPAB's view, evidence indicating that the review was performed just prior to the release of the financial statements demonstrates that the review was not timely.

CPAB believes that many of the engagement deficiencies revealed by its inspections should have been detected by a proper independent review by a second partner prior to the issuance of the audit report.

Monitoring of Quality Control

27. Monitoring of quality control refers to the compliance work done by the firms to verify that their systems of quality control are appropriately designed and operating effectively. For example, all six firms inspect a sample of their own completed audit engagements to test whether they were done in accordance with professional standards and their own policies and procedures.
28. The effectiveness of the monitoring activity varies among firms. In most of the firms, quality monitoring is done with evident rigour, results are reported transparently to senior management, action plans with clear accountability and timely follow up are established, and those responsible for work judged to be unsatisfactory experience consequences. For these firms, CPAB had no recommendations for further improvement. In the other firms, although the programs are effectively designed, their implementation lacks rigour. CPAB continues to make substantive recommendations to these firms.

Independence and Ethics

29. Four of the firms operate electronic investment monitoring systems into which individual partners and certain staff must enter their personal investment portfolios and transactions. The systems compare individuals' investments against the firm's master list of audit client securities that are prohibited investments for some or all of the firm's partners and staff. Any exception that is revealed by this comparison is typically reported to independence specialists in the firm, who work with the affected individual to ensure that the situation is investigated and resolved in a timely and appropriate manner, if necessary by disposal of the securities in question.
30. Pursuant to SEC requirements, four of the firms must undertake internal audits of the investment holdings of partners and managerial employees to ensure that the portfolios entered by individuals into their independence monitoring systems are accurate and complete, and do not include prohibited client securities. As part of these audits, individuals provide the firm with brokerage statements and other documentation related to their personal investments.
31. The audits to date have identified a number of exceptions, which usually involved the failure of individuals to input some of their investments into the investment monitoring system. However, some firms also found a few cases where the non-reported investments were securities on the firm's prohibited investment list. There is no evidence in any firm of improper motivation in holding or failing to report holdings of client securities and, although numerous, each individual exception was clearly of an insignificant nature. Nonetheless, any situation that compromises even the appearance of independence has the potential to undermine the credibility of the audit process.
32. In one of the firms, audit coverage of all the partners is incomplete. CPAB has raised this and the firm has agreed that full coverage will be achieved by the end of 2008. Not all firms have yet begun the coverage of their managers and other senior staff. CPAB has requested that they do so by the time of its next review.
33. All six of the firms obtain annual independence confirmations from their partners and staff and have adequate procedures to follow up and resolve any exceptions identified in the confirmation process.
34. All six firms are acting with resolve to deal with any exceptions discovered, including the introduction of monitoring and disciplining programs. CPAB will

continue to monitor the results of the compliance audit programs, the appropriateness of actions taken against individuals incurring infractions, and steps taken by the firms to reduce the frequency of infractions in future.

Client and Engagement Acceptance and Continuance

35. Senior management in all firms is giving increasing attention to managing the risks associated with accepting and retaining clients and particular engagements for those clients. All of the firms have effective policies to approve new or continuing audit engagements. Clients are rated on risk according to the firms' assessments of the clients and senior management's integrity and reputation; the nature of the entities' operations; their business practices; the clients' attitudes toward such matters as the internal control environment and aggressive interpretation of accounting standards; and how likely they are to prepare financial statements containing material error.

36. CPAB noted that, in some situations, the detailed consideration of the factors affecting a decision to continue an existing client audit relationship normally occurs after the firm has been appointed as auditor at the client's Annual General Meeting (AGM), but before detailed audit planning commences. In some cases, the continuance procedures may not be documented until well after the completion of the planning phase. CPAB has recommended that the firms make and document the continuance decision as soon as possible following the completion of the prior year's audit, so that any decision to discontinue the relationship can be communicated to the client before the firm is nominated for reappointment at the AGM.

Human Resources Policies and Procedures

37. All six firms have extensive policies and procedures related to their human resources (HR), and their HR systems appear, in general, to be operating effectively. In particular, the firms have made progress with respect to the timeliness and effectiveness of their performance evaluation systems.
38. The firms have policies requiring them to carry out assessments of personnel during the year usually after each significant engagement. Two of the firms failed to carry out these interim assessments of personnel on a regular basis during the year. CPAB believes that regular assessments are an important part of building and maintaining staff morale. CPAB encourages these firms to bring their performance in this area up to what their policies require.
39. We also have concerns that certain of the firms did not monitor the amount of professional development (PD) undertaken by partners and staff. Ensuring that all partners and staff undertake the PD mandated by professional institutes/associations is an important part of maintaining performance standards.

Recommendations Arising from the Inspections of Regional and Local Firms With More Than 50 Reporting Issuer Clients

Introduction

40. CPAB reviewed 11 of these firms and carried out follow up reviews on 6 of the firms. CPAB placed requirements on 4 of the firms.

Tone at the Top/Leadership

41. The leadership of most of the regional and local firms with more than 50 reporting issuer clients has demonstrated a commitment to audit quality and communicated the message consistently to partners and staff.
42. The leadership of some of these firms has not emphasized the message that audit quality is the major objective in the performance of audits. This was apparent because those firms had one or more of the following situations:
 - Outdated quality control manuals;
 - Insufficient partner resources;
 - Nominal time charged by partners on their audits and minimal documentation of partner involvement;
 - Numerous GAAP and GAAS deficiencies;
 - No firm oversight of the assignment of partners and EQC partners to audit engagements to ensure the appropriate level of expertise and experience; and
 - Advertising that included the provision of prohibited services to reporting issuers.

Performance on Audit Engagements

General

43. Most of the audits reviewed had generally been performed to an acceptable standard. However, CPAB believes that in too many cases the files contained deficiencies that were sufficiently significant to require further action on the part

of the firm (see **Systemic Issues** below and **Appendix D – Individual Files**).

44. CPAB followed the same process to select files for review in these firms as it did for the six national firms. CPAB reviewed working papers for 81 audit engagements.
45. The significant GAAS and GAAP deficiencies encountered in the review of files led CPAB to impose requirements on 4 firms. These requirements included not accepting new reporting issuer clients and having audit files reviewed by a separate firm prior to signing the audit report.
46. CPAB found that in the 81 engagements reviewed, 14 of the GAAP issues identified were serious enough to constitute significant GAAP deficiencies causing the financial statements to require restatement and reissuance or correction in the subsequent year.
47. CPAB also identified 12 files that contained significant GAAS deficiencies. For each file with GAAS deficiencies, CPAB required the firm to either carry out further audit work or add documentation to the file.
48. Where CPAB made recommendations specific to individual files, it also required the EQC reviewer assigned to the engagement to be responsible for following up to ensure that appropriate changes are made to the file and to next year's audit plan.

Systemic Issues

49. In 2007, CPAB again made many recommendations of a systemic nature to some of the firms with respect to engagement performance in general or by reference to specific engagements. These recommendations covered a variety of systemic issues. Each of the recommendations noted below related to at least twenty-five per cent of the firms and, in some cases, to more than two thirds of the firms reviewed:
 - **Documentation** - The overall poor quality of documentation continues to be a major area of concern. CPAB frequently had to require engagement teams to improve the level of documentation.
 - **Review Process** - Problems with the review process were apparent as CPAB inspected files where there was inadequate time devoted by the engagement

partner and/or EQCR reviewer to the audit file, or the work was done late in the audit or after the date of the audit report. Documentation of the engagement and EQC reviews was also inadequate.

- **Fraud Risk** - Some firms did not have appropriate fraud risk programs, their fraud risk procedures were inadequate and the new audit risk standard was not adequately addressed.
- **Calculation of Materiality** - CPAB recommended that some firms improve their guidance to audit teams on calculating materiality as there was evidence that it was not always being calculated properly.
- **Secondary Auditors** - Several firms did not have appropriate policies and procedures regarding the use of secondary auditors, including those circumstances where the firm, as primary auditors, relied heavily on the work done by the secondary auditors.
- **Audit Committee Discussions** - CPAB again noted that firm processes for reporting to audit committees did not always meet professional standards in that there was no or incomplete communication and, in some cases, no documentation of meetings with audit committees.
- **Sampling** - CPAB saw evidence of the use of inappropriate sampling techniques, including the extent of testing, as well as a lack of documentation in that area.
- **Stock-Based Compensation** - There was frequently no audit program, insufficient procedures and/or poor documentation regarding stock-based compensation. This included assumptions regarding fair value, volatility, expected term, issues surrounding non-employees, repricing and forfeiture of options, grant dates, and a lack of board approval.
- **Disclosure** - There were many deficiencies with financial statement and note disclosure. Comprehensive financial statement review checklists are necessary in order to address disclosure issues.
- **Dating and/or sign off** - There were problems in several files regarding the dating and/or sign off of working papers resulting in questions being raised about the date of substantial completion of the audit and the proper release date.

Quality Control

50. An effective process of engagement quality control review is essential if a firm is to adhere to high standards of audit quality. CPAB has expressed concern in the past about the effectiveness of the EQCR process in many of these firms, including the amount of time spent by engagement quality control reviewers on their review of files. A firm's own internal processes should identify deficiencies in the audit process and misstatements in the financial statements prior to release. If appropriate policies regarding the scope, timing and documentation of the EQCR are not in place or are not operating effectively, the risk of financial statements containing misstatements being released increases with the potential for a restatement. Firms must develop policies regarding the responsibilities of engagement quality control reviewers and impress upon all engagement staff the importance of this role .
51. In several firms CPAB found evidence that there was either no EQCR or a very low number of hours were devoted to the file by the engagement quality control reviewer. CPAB also encountered cases where the EQCR was not performed until much too late in the audit engagement to be of real value, nor was such review always documented and signed off.
52. CPAB is disappointed to have once again discovered many instances where the firms' own system of EQCR did not appear to be operating effectively. CPAB regards these deficiencies as a priority item for firms to address as quality control within the firm itself is one of the main ways in which they can achieve high quality audits.

Monitoring of Quality Control

53. All firms, regardless of size, are required by professional standards to monitor audit quality by verifying that their systems of quality control are appropriately designed, implemented and operating effectively. Firms fulfil their obligation to monitor audit quality by periodically reviewing a sample of their audit engagements to assess whether they were carried out in accordance with professional standards and the firm's own standards.
54. The firms with more than 50 reporting issuer clients varied significantly in the

extent and quality of the quality monitoring process. Some of these firms had not conducted or completed their internal monitoring program at the time of CPAB's inspection.

55. Deficiencies in the design of quality monitoring policies and procedures and implementation of the program in some of the firms inspected led to several recommendations by CPAB requiring firms to improve their performance in this area including:

- Increase the rigour of quality monitoring by devoting more time to the program, particularly on individual file reviews.
- Develop specific action plans to follow-up significant issues identified during the reviews.
- Prepare an annual report on the results of the quality monitoring program.
- Communicate the results of the monitoring reviews to partners and staff on a timely basis.
- Expand the quality monitoring program to include, not only quality controls related to engagement performance, but also an evaluation of all areas of the firm's system of quality control such as compliance with independence policies and procedures and professional development.
- Revise the quality monitoring program to assess the quality of audit programs.
- Expand the quality monitoring program to review not only annual audit files but also quarterly review and prospectus files.
- Emphasize the review of the financial statements and note disclosures for compliance with GAAP during the internal monitoring process.
- Appoint a quality monitor for engagement file reviews who is independent (i.e. was not involved in performing the engagement and did not act as the EQCR).
- Incorporate the results of quality monitoring reviews of individual engagements into performance evaluations.

Independence and Ethics

56. All public accounting firms are required to comply with the auditor independence rules. CPAB is encouraged by the progress that most of the firms with more than 50 reporting issuer clients have been making with respect to this quality element.
57. CPAB did identify some areas relating to independence that required improvement and brought them to the attention of the firms in the form of recommendations.
58. One firm was required to update its independence policies and procedures to include all aspects of the independence requirements as set out in the Rules of Professional Conduct and the SEC independence rules.
59. CPAB recommended that a few firms amend their policies to require confirmation of independence from others upon whose work the firm will be relying. This would include the confirmation of compliance with Canadian independence rules by secondary or downstream auditors and international affiliates in network firms.
60. The auditor independence rules require the rotation of engagement partners and the EQCR partner every five years when the reporting issuer has total assets or market capitalization in excess of \$10 million. At least three of these firms had not established a comprehensive rotation plan. Rather than considering rotation on an engagement by engagement basis, CPAB instructed the firms to develop and maintain accurate rotation plans and to actively monitor the transition of their clients to reporting issuer status.
61. Two firms incorrectly included a limitation of liability in engagement letters for Canadian reporting issuers that are also SEC registrants. CPAB recommended that the firms advise the audit committees and consult legal counsel.
62. CPAB required another firm to set an annual deadline for obtaining annual independence confirmations from partners, staff and contractors; and modify the confirmation to also address the SEC independence rules.

Client and Engagement Acceptance and Continuance

63. As indicated in the Fourth Public Report, firms have generally started to put more emphasis on the client and engagement acceptance and continuance process.
64. CPAB continues to be concerned, however, that in a few of these firms, the client

- acceptance process lacks rigor. In one instance, despite having a client acceptance process that requires due diligence and the approval of a client acceptance committee, the firm was accepting clients even though there was no evidence of review of a business plan, of minimal financial worth or of experience in the business they were proposing to take public.
65. Other deficiencies contributing to CPAB's concern over the general lack of rigor in some of these firms included failing to consult personnel prior to accepting engagements to determine if there were any independence concerns and a lack of communication with predecessor auditors prior to accepting engagements.
 66. Once again CPAB saw evidence that the formal client acceptance process was not always being completed on a timely basis (in one case not until 7 months after the change of auditor notice was filed). CPAB advised that the process should be completed on a more timely basis.
 67. CPAB continues to be concerned that a few firms are not assessing during their continuance process whether they have the language capability to perform an audit when the books and accounting records and other evidence are in a foreign language, the extent of foreign operations, and the firm's ability to access the accounting records of foreign operations. Such firms should either not accept the engagement or hire personnel with the requisite language skills, including senior personnel who will be reviewing the work of more junior staff.

Human Resources Policies and Procedures

68. Several of the regional and local firms have appropriate human resources policies and procedures, but CPAB had concerns in a few firms.
69. CPAB had concerns about insufficient partner resources at two firms. In one firm, for example, two of the firm's assurance partners have responsibility for the audits of a significant number of Canadian reporting issuers and/or US issuers that report to the SEC functioning as either the engagement partner or the EQC reviewer on each engagement. This level of workload has the potential to affect the quality of work on the reporting issuer clients. In order to maintain high audit quality, CPAB recommended that the firm either increase its partner resources, contract externally for an individual to perform the EQCR function or reduce the

- number of audit clients.
70. An adequate system of performance appraisals must be in place in order for individuals to receive meaningful feedback on their performance on engagements and mentoring, including advice on areas where they need to improve their performance and receive additional training. CPAB found that the performance appraisal process at some of the firms needed to be improved. The firms should define criteria for advancement and compensation in which audit quality is the most important consideration. These criteria should form part of the annual review process and be linked to expected skill sets. The results of the firm's quality monitoring process should also be incorporated into the performance appraisal process.
 71. CPAB made a few recommendations regarding professional development but generally found that firms have responded to the need to provide their professionals with the training required to keep up-to-date on the increasing number and complexity of professional standards. CPAB did ask one firm to develop a process to identify the skills and competencies needed by personnel assigned to reporting issuer engagements and to identify the professional development programs that could address those needs. Another firm was directed to appoint an individual to formally monitor the training requirements of audit personnel and whether personnel are taking the training required to fulfill their professional responsibilities.

Recommendations Arising from the Inspections of Firms With Fewer Than 50 Reporting Issuer Clients

Introduction

72. CPAB reviewed 18 of these firms and conducted follow up reviews on 12 other firms. CPAB placed requirements on 10 of the firms.

Tone at the Top/Leadership

73. The leadership of some of the firms with fewer than 50 reporting issuer clients has demonstrated a commitment to audit quality and communicated the message consistently to partners and staff.
74. In many of the firms reviewed there was a lack of emphasis on the importance of audit quality This was evidenced by:
- No or inadequate communication of the message from the leadership of the firm of the importance of delivering quality audit services.
 - Outdated or inadequate quality control manuals.
 - Nominal time charged by partners on their audits and minimal documentation of partner involvement.
 - Numerous GAAP and GAAS deficiencies.
 - No documentation of management and quality control committees meetings where firm strategies and priorities are discussed.
 - No training on quality control policies.
 - Inadequate documentation of firm policies and maintenance of training materials.
 - Insufficient quality controls such as no quality monitoring system, no internal quality monitoring to date or a delay in the implementation of a system of quality control.
 - No partnership agreement and therefore no formal mechanism for disciplining or terminating partners who violate firm standards.
 - No clear strategy or plan for partner rotation.
 - Failure to appoint a managing partner, conflict of interest leader and professional development leader.
 - No tracking of attendance at professional development courses.

Performance on Audit Engagements

General

75. A number of the audits reviewed had generally been performed to an acceptable standard. However, CPAB believes that many contained deficiencies that were sufficiently significant to require further action on the part of the firm (see **Systemic Issues** below and **Appendix E – Individual Files** below).
76. CPAB followed the same process to select files for review in the firms with fewer than 50 reporting issuer clients as it did for the six national firms. CPAB reviewed working papers for 81 audit engagements.
77. The significant GAAS and GAAP deficiencies encountered in the review of files led CPAB to impose requirements on 10 firms. These requirements included not accepting new reporting issuer clients, taking additional professional development courses and having all reporting issuer files subject to an external pre-issuance EQCR.
78. CPAB found that in the 81 engagements reviewed, 13 of the GAAP issues identified were serious enough to constitute significant GAAP deficiencies causing the financial statements to require reissuance and restatement or correction in the subsequent year.
79. CPAB also identified 16 files that contained significant GAAS deficiencies. For each file with GAAS deficiencies, CPAB required the firm to either carry out further audit work or add documentation to the file.
80. Where CPAB made recommendations specific to individual files, it also required the EQC reviewer assigned to the engagement to be responsible for following up to ensure that appropriate changes are made to the file and to next year's audit plan.

Systemic Issues

81. CPAB made many recommendations again this year with respect to engagement performance in general and on specific engagements. Some recommendations, although related to different files, are the same as those identified in its reports. Some recommendations are the same or similar to those made to regional and

local firms with more than 50 reporting issuer clients. The recommendations covered a variety of systemic issues. Each of the recommendations related to at least a quarter of the firms and, in some cases, to as many as three-quarters of the firms reviewed. The systemic issues included the following:

- **Documentation** - The overall poor quality of documentation continues to be a major area of concern. CPAB frequently had to require engagement teams to improve the level of documentation.
- **Review Process** - CPAB inspected files where there was inadequate time devoted by the engagement partner and/or the EQCR partner to the audit file, or time was incurred late in the audit or after the date of the audit report. Documentation of the engagement and EQCR partner reviews was also inadequate.
- **Fraud Risk** - Some firms did not have appropriate fraud risk programs, procedures carried out to assess the risk of fraud were inadequate and they had not adequately addressed the new audit risk model.
- **Calculation of Materiality** - CPAB recommended that some firms improve their guidance to audit teams on the calculation of materiality as there was evidence that it was not always being calculated properly.
- **Secondary Auditors** - several firms did not have appropriate policies and procedures regarding the use of secondary auditors, including those circumstances where the firm, as primary auditors, relied heavily on the work done by the secondary auditors.
- **Audit Committee Discussions** - CPAB again noted that firm processes for reporting to audit committees did not always meet professional standards in that there was no or incomplete communication and, in some cases, no documentation of meetings with audit committees.
- **EQCR partner selection** - Several of the firms had problems with the EQCR partner selection process including selecting individuals who did not have the experience required to fulfill that role and the use of individuals, such as the manager on the audit engagement who would not be independent. On a number of occasions responsibility for the EQCR of public company audits was not at the partner level.
- **Association with Public Documents** - Several firms did not comply with the

requirements of professional standards with respect to the auditor's association with public documents such as the Management Discussion and Analysis..

- **Analytical Review Procedures** - Several files did not include evidence of the design and evaluation of analytical review procedures as required by professional standards. This included a lack of procedures at the planning phase of the audit, or any documentation of the procedures.
- **Specialists** - Some firms had not developed appropriate policies and audit procedures regarding the use of specialists, such as valuers.

Quality Control

82. Overall, CPAB found that the firms with fewer than 50 reporting issuer clients performed their EQCR processes poorly. The majority of these firms had significant problems in this area, including all of those identified in firms with more than 50 reporting issuer clients.
83. In addition, CPAB also saw evidence that inappropriate individuals were being selected to serve as engagement quality control reviewers and that they received inadequate coaching and training.
84. CPAB expects firms to significantly improve the effective operation of their systems of quality control on a timely basis.

Monitoring of Quality Control

85. Firms of all sizes are required by professional standards to monitor audit quality by verifying that their systems of quality control are appropriately designed, implemented and operating effectively.
86. CPAB found many of the firms with fewer than 50 reporting issuer clients had problems in the area of quality monitoring. Some of these firms had the same deficiencies in the area of quality monitoring as the firms with more than 50 reporting issuer clients, as well as some additional problems. Seven of these firms did not have a quality monitoring program in place at the time of the inspection or, if one was in place, had not conducted any monitoring activity and, in at least one case, had not formally appointed a monitor.

87. Some of the recommendations CPAB made to these firms included:
- Immediately develop and implement a quality monitoring system.
 - Increase the rigour of quality monitoring by devoting significantly more time to the program, including the review of individual files.
 - Develop specific action plans to deal with issues identified during the monitoring reviews.
 - Expand the quality monitoring process to ensure compliance with all aspects of the professional standards related to quality control such as new developments in standards.
 - Appoint a qualified quality monitoring leader with sufficient and appropriate experience.
 - Hire an independent qualified external individual or firm to carry out quality monitoring activities (in smaller firms where there are small numbers of partners, all of the partners may have been involved as the engagement partner or EQCR on the engagement).
 - Develop additional selection criteria to ensure a sufficient number of audit files are selected each year for review and that there is adequate coverage of partners.
 - Select individual engagements for review based on such factors as risk, complexity, size and nature of operations, rather than by random selection.
 - Hold a training course to specifically address the findings of the quality monitoring process.
 - Include the monitoring of reporting issuers in the international firm's monitoring of the local firm.

Independence and Ethics

88. Despite the fact that all public accounting firms are required to comply with the auditor independence rules, these firms do not appear to be making as much progress in this area as the larger firms.
89. CPAB identified several issues previously included in its Fourth Public Report as well as some other problems. These findings resulted in a variety of

- recommendations.
90. It is essential that a firm maintain a complete, accurate and accessible listing of restricted investments to prevent and detect independence breaches. Many firms had not maintained a complete, accurate and up-to-date listing and failed to reflect changes to reporting issuer clients on a timely basis.
 91. CPAB made several recommendations to require firms to reflect accurate information in their partner rotation plans. In one firm the engagement partners had served in that role for more than five years in violation of the independence rules. Several firms were also directed to develop an annual process to assess whether clients are reporting issuers and modify the partner rotation plans accordingly.
 92. There is still a need in some cases for firms to provide formal training on independence standards to partners and staff and to increase training on the SEC independence requirements.
 93. CPAB instructed several firms to establish policies and processes to ensure downstream auditors and specialists comply with Canadian independence rules.
 94. A number of firms did not obtain annual confirmations of compliance with independence standards from all personnel who are required to be independent. This included confirmations upon hiring and from those on a leave of absence.
 95. In some cases there was a lack of timely follow-up by the firm and resolution of all potential breaches of independence.

Client and Engagement Acceptance and Continuance

96. CPAB noted a wide variety of issues pertaining to client and engagement acceptance and continuance in many of the firms with fewer than 50 reporting issuer clients. Most of the problem areas revolve around the lack of rigor in the process including many of the same deficiencies that were apparent in CPAB's review of the firms with more than 50 reporting issuer clients.
97. CPAB's recommendations to the firms with fewer than 50 reporting issuer clients included:
 - Ensure that engagement teams use the acceptance and continuance forms as required by firm policy and perform risk tolerance assessments.

- Perform and document an assessment of management and board integrity and reputation.
- Provide additional training on the need to consider and document whether the engagement team has the requisite skills to conduct the engagement.
- Emphasize that all EQC reviewers should formally review and approve acceptance and continuance decisions and document the review process.
- Require the acceptance and continuance process to include an assessment of whether the firm/engagement team has the necessary linguistic skills. If a secondary auditor or external contractor is used who has the requisite language skills, ensure professional standards regarding reliance on other auditors or the use of specialists are complied with.
- Develop policies for communicating with predecessor auditors to ascertain whether there are circumstances the firm should take into account in deciding whether to accept the engagement.
- Improve documentation of the entire client and engagement acceptance and continuance process.
- Complete and document the client continuance assessment process at the completion of an engagement, before the firm is reappointed as auditor at the client's annual general meeting.

Human Resources Policies and Procedures

98. CPAB recognizes that where firms with fewer than 50 reporting issuer clients have a small number of audit partners, the development and implementation of a formalized system for human resources and professional development may not be a top priority for the firm. Nevertheless, regardless of the number of audit partners in these firms, there must be a focus on human resources and professional development in the interests of promoting audit quality.
99. Examples of areas where CPAB found several firms to be deficient and provided recommendations included:
 - Define the criteria for advancement and compensation, with audit quality being of paramount importance.

- Establish formal criteria for admission to partnership.
- Ensure the performance appraisal process includes the setting, review and monitoring of goals and objectives.
- Incorporate the results of the firm's quality monitoring into the performance appraisal process.
- Conduct performance evaluations at the end of each significant engagement, as well as annual reviews.
- Modify the performance appraisal process to assess competence in both accounting and auditing.
- Establish career development plans for partners and professional staff.
- Document all aspects of the performance evaluation process.
- Review the professional development needs of partners and professional staff on a regular basis and develop and document a strategy for each.
- Monitor and track attendance at professional development courses.
- Maintain accurate and complete personnel records.
- Verify the references and professional credentials of staff hired.

Conclusion

100. CPAB wishes to emphasize that it received the unconditional co-operation of all firms during the course of its inspection activity. Except for information protected by legal privilege, and some difficulties accessing working papers from a secondary auditor, CPAB received the information requested and all firms were forthcoming in responding to questions.
101. CPAB's 2007 quality inspections of the firms showed that substantially all of its previous recommendations have been implemented effectively. However, as each year it reviews different files, partners and in some cases firms it is not surprising that it continues to identify issues.
102. The six national firms have sound tone at the top and strong quality leadership. Controls in the areas of client and engagement acceptance and continuance, human resources policies and procedures and quality monitoring are generally well designed and operate effectively. Quality monitoring is operating as designed in most of these firms. Policies and procedures relating to independence and ethics are also well designed in all six firms, but compliance audits have revealed a number of exceptions with respect to firm policies and procedures related to both the entering of personal investments into the firms' investment monitoring systems and holdings of prohibited client investments.
103. Many of the regional and local firms have adequate systems, but in too many of them CPAB sees a need for a greater partner commitment to improve the emphasis on audit quality.
104. While high quality audit work was often evident throughout its inspections, CPAB continues to identify many instances where engagement teams did not fully comply with an aspect of GAAS or with the firms' own policies and procedures. CPAB expects that each firm will impress upon its partners and staff the need to improve compliance in the future.
105. There continues to be room for improvement in the performance of audit engagements at all levels, in particular in consultation, documentation, engagement quality control review and quality monitoring. Despite implementing substantially all of CPAB's recommendations in previous years, too many firms continue to perform inadequately in these important areas.
106. In its 2008 inspections, CPAB will be focussing its attention on adherence to

standards for engagement quality control reviews and quality monitoring and will be considering placing stronger requirements, restrictions or sanctions on firms that do not meet these standards.

Appendix A

Background

1. CPAB was created by the provincial securities commissions, the Office of the Superintendent of Financial Institutions (OSFI) and the CICA to promote high quality external audits of entities that are reporting issuers in Canada. In carrying out that role, CPAB conducts inspections of the firms subject to its oversight, either directly or in co-operation with provincial or foreign regulatory authorities.
2. Canada has 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 December 31, 2007, 215 Canadian accounting firms and 53 foreign accounting firms have completed the registration process, signed Participation Agreements with CPAB, become and continue to be participating audit firms. Since CPAB commenced operations in 2003, over 80 accounting firms that initially registered, have subsequently withdrawn their registration (approximately 10% of these were for merger reasons).
3. The six national public accounting firms in Canada are BDO Dunwoody LLP, Deloitte & Touche LLP, Ernst & Young LLP, Grant Thornton Canada (practicing as Grant Thornton LLP and Raymond Chabot Grant Thornton LLP), KPMG LLP and PricewaterhouseCoopers LLP. These firms audit more than 4,500 entities that are public companies or other reporting issuers in Canada, representing about 70 per cent of the total market by number of clients and, CPAB estimates, more than 95 per cent if measured by market capitalization.
4. Each year, CPAB also reviews all other firms that audit 100 or more reporting issuers. CPAB also reviews, at least every two years, firms with between 50 and 99 reporting issuer audit clients. Over three years, all firms registered with the PCAOB are inspected. During the past four years CPAB has inspected each of the six National Six firms four times; CPAB has inspected each of the firms that audit more than 50 reporting issuers at least twice in this period and the majority three times. CPAB has also reviewed a further 43 firms. For the remaining Canadian participating audit firms, CPAB primarily relies on its reviews of the quality inspections carried out by the relevant provincial accounting bodies, i.e.,

Institutes of Chartered Accountants or Associations of Certified General Accountants, although it may and has elected to review some of those firms directly.

Following each inspection, CPAB sends the firm a private report that includes findings, recommendations and other observations. Firms are expected to implement the recommendations 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 had 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 upon an audit firm, the firm would be required to notify the Canadian securities regulators. If CPAB were to impose sanctions upon an audit firm, the firm would be required to notify the 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 firm could no longer audit public companies in Canada.

Appendix B

Scope of CPAB Inspections of Quality (All Firms)

1. CPAB's inspections are planned and carried out to:
 - Confirm CPAB's understanding of the design of each firm's system of quality control, organized under the following principal elements:
 - Tone at the top/leadership
 - Independence and ethics
 - Client and engagement acceptance and continuance
 - Human resources policies and procedures
 - Engagement performance
 - 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
 - Confirm that, where required, the firms had implemented their responses to the recommendations made in CPAB's previous quality inspection reports
2. 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 update its understanding of the design of the firms' systems of quality control. CPAB also interviewed the leaders of each of the engagements it reviewed.
3. CPAB also examines a variety of evidence to better understand the design of a firm's system of quality control and the effectiveness of its implementation.
4. The scope of CPAB's review of individual audit engagements was restricted by certain firms' removal from their audit files of documents that were said by them or their clients to be subject to legal privilege.

Appendix C

Selected Significant Issues Identified in Individual Files of the Six National Firms

Significant issues identified in individual file reviews included the following:

- In a situation where more than one third of sales occurred in the last two months of the year the sales were not evaluated with other transactions with a major customer nor was adequate cut off testing performed on the sale.
- In one file the engagement team was unable to trace its physical inventory counts to the final inventory listing. Additionally, the team was unable to verify tag control in the final inventory listing. As these items were not included in the final audit memo, they did not come to the attention of the EQC partner.
- The income tax reconciliation note in a financial statement appeared to be unusual, with no supporting explanation in the firms audit working papers.
- In one engagement CPAB considered that a potential for a significant GAAP departure was identified, but at the time of writing this report, not quantified. The client booked revenue for a shipment made just before year end where title had not passed to the buyer.
- In one engagement CPAB considered that the financial statements were not presented in accordance with the applicable GAAP. The income tax reconciliation note had a material error that was caused by stating an amount as a credit instead of a debit.

Appendix D

Selected Significant Issues Identified in Individual Files of Firms with More than 50 Reporting Issuer Clients

Significant issues identified in individual file reviews included the following:

- Inappropriate reflection on the income statement of a significant income tax reduction related to a capital transaction that, when combined with other misstatements, almost reached the materiality level set for the engagement.
- Failure to examine original invoices related to transactions involving resource properties accounting for nearly all of the non-cash assets, one-half of total assets and three-quarters of expenditures. In addition, the engagement team did not perform an appropriate review of wire transfers.
- Incorrect grant date used in determining the fair value of stock options resulting in a material restatement of the financial statements to record additional stock based compensation. In addition, there was no evidence of consultation with the EQC partner with respect to the option grant date and the approval of the board of directors was not obtained before the options were deemed to have been granted.
- Inadequate review of the travel and entertainment expenses of senior officials of an exploration and development company despite a significant increase from the previous year.
- Incorrect recording of shares issued to acquire another company at nominal value. This resulted in a restatement of the financial statements.
- Inadequate audit work on the revenues and cost of sales representing 90% of the revenues and cost of sales arising from the purchase and resale of services.
- Incomplete audit work on the fair values attributed to stock-based compensation and shares issued in settlement of debt.
- Incomplete documentation on the volatility parameters for the accounting of stock-based options and warrants granted during the year.
- Inadequate documentation regarding the audit work performed on a major acquisition including the key areas of assessing the fair value of monetary net assets, a legal claim, and the mineral property and capital assets acquired.
- Lack of documentation of consultations with tax experts to support the audit of significant receivables for sales tax and investment tax credits.
- Incorrect application of the depletion formula resulting in the material understatement of depletion expense.

- Incorrect presentation as a current asset of a material compensating balance to be held for the term of a long-term debt.
- Failure to develop an audit program that addressed the issues relevant to software revenue recognition in accordance with professional standards.
- Inadequate audit programs for stock based compensation in all seven engagements reviewed at one firm.

Appendix E

Selected Significant Issues Identified in Individual Files of Firms with Fewer than 50 Reporting Issuer Clients

Significant issues identified in individual file reviews included the following:

- Insufficient audit evidence regarding a material asset on the balance sheet, and the failure to quantify the amount of a GAAP misstatement.
- Failure to obtain bank confirmations related to non-Canadian banking relationships.
- Failure to perform audit procedures on the indefinite life intangible assets impairment or no evidence in the file that an impairment analysis was performed.
- Inappropriate reduction of the stock based compensation expense upon the surrender of vested options held by a principal shareholder in order that the company could issue new options to other employees resulting in a material misstatement in the stock based compensation expense.
- No consideration in the engagement team's fraud analysis of a management bonus entitlement if a specific earnings level was achieved and no procedures were performed to address the risk.
- Lack of an audit plan for the audit of finance receivables or retained interest in securitized finance receivables representing more than 50% and 30% of the total assets on the balance sheet respectively.
- Lack of evidence of verification of loan loss or prepayment provisions.
- Failure to quantify or follow-up a possible overstatement of provisions against retained interests in financed receivables securitized.
- No analysis of why an entity established to handle the securitization of receivables was not a variable interest entity.
- Failure to obtain a letter from the predecessor auditor and no evidence of a review of the predecessor auditor's working papers.
- No evidence of verification of income tax balances and provisions or assessment.
- Inadequate audit work and documentation to support reliance on a secondary auditor in a foreign country where the subsidiary represented almost all of the consolidated assets, revenue and expenses. No one on the engagement team

understood the language used by the secondary auditors to document their procedures. No evidence that the engagement team had verified the qualifications, reliability and independence of the secondary auditor or considered differences between Canadian GAAS and the foreign country's auditing standards.

- No EQCR was performed on the reporting issuer engagements and the files contained unsigned copies of important agreements in the two files reviewed at one firm.
- An audit approach that primarily provided audit assurance regarding sales transactions around year-end but minimal assurance on sales that occurred during the remainder of the year.