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## **FOURTH PUBLIC REPORT**

# **ON 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

The Canadian Public Accountability Board's (CPAB's) fourth public report covers:

- CPAB's 2006 quality inspections of Canada's six national public accounting firms: BDO Dunwoody LLP, Deloitte & Touche LLP, Ernst & Young LLP, Grant Thornton Canada (practising as Grant Thornton LLP and Raymond Chabot Grant Thornton LLP), KPMG LLP and PricewaterhouseCoopers LLP
- The 21 firms operating on a regional or local scale that were reviewed by CPAB between October 1, 2005 and September 30, 2006

## 1. Audit Quality Improvements

Over the past three 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. Most of these recommendations have been implemented and should enhance the credibility of financial statements of public companies and confidence in Canada's capital markets. This credibility should be further enhanced by the new audit standards that have been issued regarding quality control, terms of audit engagements, management representations and the authority of auditing standards.

CPAB continues to have concerns, however, regarding the extent and quality of second partner review and quality monitoring. These areas require ongoing improvement in order to improve performance on audit engagements overall and to address the number of deficiencies in the files CPAB reviewed.

## 2. International Developments

During the past year, CPAB became a founding member of the International Forum of Independent Audit Regulators (IFIAR), which consists of similar oversight bodies representing 18 countries throughout the world, as well as the U.S. Public Company Accounting Oversight Board (PCAOB) as an observer. The IFIAR has been developing international protocols to enable its members to work together effectively.

CPAB has conducted several joint inspections of firms with the PCAOB and appreciates the cooperation that it has received.

### **3. External Complaints**

CPAB maintains a hotline that can be used by anyone to lodge an anonymous complaint relating to work done by firms on the audits of reporting issuers or to express concerns regarding financial reporting and accounting matters. The hotline can also be used by anyone who has concerns regarding CPAB's inspections or inspectors. CPAB follows up on all such complaints. CPAB received one complaint on the hotline, which it has followed up with the firm concerned. After investigating, CPAB concluded that there was no need to pursue the matter further. CPAB also received one other expression of concern, which it is reviewing with the firm concerned.

### **4. Scope**

The scope of CPAB's reviews of some individual audit engagements was 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 Bill 151 in Ontario and Bill 7 in Quebec will significantly improve CPAB's situation. CPAB continues to seek statutory authority in other jurisdictions to have access to privileged information without negating that privilege.

### **5. The Six National Firms**

The six national firms audit more than 4,500 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 90 per cent if measured by the market capitalization.

Each firm has made progress since CPAB's quality inspections in prior years and substantially all of the recommendations made to the firms following those inspections have been implemented. However, CPAB remains concerned that in too many of the files reviewed, there continues to be a need for the firms to significantly improve documentation of the reasons for key audit judgments made to support the

audit opinion.

The firms have strong quality leadership and tone at the top and generally effective controls over human resources, client acceptance and continuance. All six firms are working to address any independence exceptions discovered as a result of the monitoring and disciplinary programs the firms have introduced. On the other hand, all of the firms have more work to do to improve audit quality and achieve consistent adherence to firm and professional standards.

The primary area that requires improvement is performance on audit engagements. While high quality audit work was evident throughout the inspections, there is a need for continued improvement. Of the 121 audit engagements CPAB selected for review in the six firms (primarily high-risk files), 9 engagements had serious deficiencies in the sufficiency of the work done, documentation of the work, and/or evidence of review. In five other cases, deficiencies in the application of GAAP resulted in remedial action being required or having been taken to have financial statements reissued, restated or corrected in the subsequent year.

Quality control (where a second partner other than the partner responsible for the engagement reviews the audit file) and quality monitoring are also areas requiring improvement.

Apart from the issue of legal privilege, CPAB is encouraged by the ongoing co-operation it receives from all six national firms. Given the improvements required in a number of areas, CPAB is also encouraged by the firms' understanding that the public interest requires them to place greater emphasis on audit quality.

## **6. Other Firms Reviewed**

CPAB inspected 21 other firms for either the first or second time. These are small and mid-sized firms operating on a regional or local basis. CPAB is encouraged by the firms' co-operation and by the progress that firms being inspected for the second year demonstrated in several areas.

Several 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. CPAB is concerned that these firms have either no independence policies and procedures or have ones that are insufficient or not being followed.

Engagement performance was also inconsistent across the firms. Of the 120 audit engagements CPAB selected for review (primarily high-risk engagements), 13 had significant Generally Accepted Accounting Principles (GAAP) deficiencies that required restatement and 30 had significant Generally Accepted Auditing Standards (GAAS) deficiencies.

CPAB had similar concerns about the effectiveness of the quality control review and quality monitoring processes in some regional and local firms as it did for the national firms.

As a result of its reviews, CPAB placed requirements on three firms that required them not to take on additional reporting issuer clients until they complied with CPAB's recommendations. In addition, CPAB deregistered one firm that failed to comply with CPAB requirements.

## Introduction

1. CPAB was created by the provincial securities commissions, the Office of the Superintendent of Financial Institutions (OSFI) and the Canadian Institute of Chartered Accountants (CICA) to promote high quality external audits of entities that are reporting issuers in Canada. In carrying out that role, CPAB conducts 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 September 30, 2006, a total of 246 Canadian accounting firms and 40 foreign accounting firms had completed the registration process, signed Participation Agreements with CPAB and become participating audit firms. Since CPAB commenced operations in 2003, 47 additional accounting firms initially registered, but subsequently withdrew their registration.
3. The six national public accounting firms in Canada are BDO Dunwoody LLP, Deloitte & Touche LLP, Ernst & Young LLP, Grant Thornton Canada (practising 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 90 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 other firms that are registered with the PCAOB are inspected. For the remaining Canadian participating audit firms, CPAB will primarily rely 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 elect to review some of those firms directly.
5. 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. Were CPAB to impose restrictions upon an audit firm, there would be notification to Canadian securities regulators. If CPAB were to impose sanctions upon an audit firm, there would be notification to Canadian securities regulators and the audit committees of the firm's reporting issuer audit clients. In the most extreme case, CPAB could declare that an audit firm is not a participant in good standing, meaning that firm could no longer audit public companies in Canada.

This report covers the more significant issues arising from the following inspections:

- Third-year inspections at the four largest national firms
- Second-year inspections at the other two national firms
- Second-year inspections of five firms that had 50 or more reporting issuer audit clients
- First inspections of 16 firms, of which five had 50 or more reporting issuer audit clients

## **Scope of CPAB Inspections of Quality (All Firms)**

6. The 2006 inspections were 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 2005 quality inspection reports
7. 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.
8. 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. In the larger firms, this evidence includes:
- Policy and procedures manuals
  - Quality-related communications from a firm's leadership to its partners and staff
  - Independence confirmations
  - Client acceptance and continuance documentation
  - Personnel files
  - Training curricula and attendance records
  - Staff satisfaction survey results
  - Client satisfaction surveys
  - Marketing materials
  - The results of the firm's own quality monitoring program
  - The working papers for a sample of completed audit engagements
9. While CPAB has the power to impose requirements, restrictions or sanctions to achieve the changes it considers necessary, its intent is to work with the participating firms in a positive and constructive manner to bring about

- appropriate audit quality improvements. As a consequence of its 2006 inspections, and notwithstanding the recommendations that have been made to the firms, CPAB imposed no requirements on the six national firms but did impose requirements on three of the smaller firms. No restrictions or sanctions were imposed on any firms. One firm inspected in 2005 failed to comply with CPAB's requirements and its registration was cancelled in September 2006.
10. 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. While CPAB understands the reasons for the removal of documents that are genuinely subject to legal privilege, any restriction on the scope of its review is unsatisfactory to CPAB and contrary to its purpose. The passage of Bill 151 in Ontario and Bill 7 in Quebec will significantly improve CPAB's situation. CPAB continues to seek statutory authority in other jurisdictions to have access to privileged information without the privilege attaching to that information being negated.
  11. In one engagement selected for review, CPAB was denied access to the working papers for the audit of a significant subsidiary that was performed by a member firm of the international group. The member firm was not registered with CPAB. CPAB was therefore unable to make a full assessment of the quality of the audit work done at the overseas location because the documentation in the files of the Canadian firm was inadequate for this purpose.

## **File Reviews (All Firms)**

12. The engagements 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 normally considers the way the firm planned, supervised 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 or that all aspects of the audit were fully compliant with professional standards.
13. 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 CICA Documentation standard, if work is not documented then there is no evidence that it was done. If there is no such evidence, then the file is deficient. CPAB will continue to require the firms to more fully document the procedures performed.
  14. Certain firms noted that they considered their files to be in accordance with GAAS, even though they might not meet the standards set out in the firms' own manuals. If a firm's internal policies establish a higher standard than GAAS, then CPAB will apply that higher standard in assessing the adequacy of the file. Should there be a significant disparity, or a series of disparities, between the audit work performed on an engagement and the firm's higher standards, CPAB assesses the file as having a significant deficiency.

## **Other**

15. CPAB believes there must be effective co-operation with independent audit regulators based in other countries in the conduct of audit inspections in order to avoid duplication and to control overall cost. During the past year, CPAB became a founding member of the IFIAR. This group of oversight bodies, representing 18 countries and with the PCAOB as an observer, is developing protocols to increase the effective and efficient conduct of audit inspections internationally.

CPAB led the inspection work in nine joint inspections conducted with representatives of the PCAOB. The PCAOB reviewed a number of joint issuers and a number of clients registered with the SEC only. The PCAOB has not yet released its reports on these inspections.

16. CPAB follows up all complaints received on its hotline. Anyone can use the hotline to anonymously express concerns relating to work done by firms on the audits of reporting issuers or concerns regarding a financial reporting or

accounting matter. The hotline can also be used by anyone who has concerns regarding CPAB's inspections or inspectors. CPAB received one complaint on the hotline and, after following up with the firm concerned, concluded there was no need to pursue the matter further. CPAB also received one other expression of concern, which it is reviewing with the firm concerned.

# Recommendations Arising from the Inspections

## The Six National Firms

### *Tone at the Top/Leadership*

17. 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.
18. 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.

### *Independence and Ethics*

19. 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 a 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.
20. Pursuant to SEC requirements, the four largest 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.
21. 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, each firm 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.

22. 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.
23. 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***

24. Senior management in all of the 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 how likely they are to prepare financial statements containing material error.
25. CPAB noted that, for some firms, 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***

26. All of the 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. CPAB made only minor recommendations in this area. CPAB also notes that two of the firms were recently included in a list of Canada's top 100 employers.
27. In some firms, mandatory training courses are not identified. This is compounded by a lack of follow up to ensure that senior personnel take the required training.

### ***Performance on Audit Engagements***

#### **General**

28. The majority of the audits reviewed had generally been performed at an acceptable standard. However, there were a number that, in CPAB's opinion, contained deficiencies.
29. CPAB reviewed the audit working papers for 121 engagements conducted by the firms.
30. CPAB concluded that in 9 of the 121 engagements, the audit was seriously deficient in the sufficiency of the work done, documentation of the work, and/or evidence of review. In five other 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.
31. 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.
32. 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 these findings and the actions taken as a result.

### **Systemic Issues**

33. CPAB made a number of recommendations of a systemic nature 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:

- All of the firms have cultures that encourage consultation with technical accounting or auditing experts, wherever appropriate, on matters that require judgment or are contentious. However, CPAB again noted failures to properly document the nature, scope or conclusions reached from some consultations when they occurred. CPAB noted even more frequent failures to secure the written agreement of the party consulted, even though auditing standards require this.
- This was the second year in which the auditing standard that deals with the auditor's responsibility to consider fraud was applied. The standard has a number of prescriptive requirements that, at times, are being carried out in a cursory manner or, in a few cases, not at all. The procedures were, at times, carried out by relatively junior members of the engagement team when they should have been conducted at a more senior level.
- In some situations, the engagement team had to contact former employees to obtain information to complete the audit file. The need for the auditor to document matters providing evidence to support the audit report has been required for many years and the lack of such information is unacceptable.
- As CPAB noted last year, there is a need to improve the documentation of discussion at meetings with audit committees. Often, the audit working papers comprehensively document the information the engagement team presented to the committee, but not what questions were asked, how these were answered, or particulars of any other audit-related discussions that took place.
- While the quality of reporting to audit committees by all six firms is generally satisfactory, one area requires 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.

- In some cases, audit teams, having appropriately identified the required procedures to be followed, failed to carry them out. They then compounded the problem by neglecting to explain why they did not follow the originally designed program or why the substituted procedures were deemed to be a satisfactory replacement.
- Engagement teams must compare the financial statements that were audited with the financial statements filed by the client with SEDAR, with the Electronic Data-Gathering, Analysis and Retrieval system (EDGAR) or posted to its website. Some teams failed to make such comparisons, notwithstanding that auditing standards require this.

### **Individual Files**

34. Individual file reviews identified the following issues:

- Inadequate audit work was performed on venture investment portfolios of two LSIFs. Under Canadian GAAP, investments by an LSIF must be carried at fair value. However, many of the investments in some LSIFs are in a portfolio of start-up companies that have little revenue, no history of profitability and no identifiable cash flows. In such cases, there was inadequate audit support for the values ascribed to such investments on the balance sheet.
- A reporting issuer operates in multiple business segments but has not presented segmented information. The same issuer converted during the year from a corporation to an income trust and prepared financial statements only from the date of the conversion, with no comparative financial statements for the periods prior to the conversion, contrary to the requirements of GAAP and the securities commissions.
- Another reporting issuer included in the current year's income statement, without any disclosure, material income tax benefits that were directly associated with prior years and are non-recurring.
- Inadequate audit work was conducted on a reporting issuer's liabilities, where significant amounts of liabilities were forfeited and brought into income. The

engagement team did not, for example, confirm the existence and forfeiture of the liabilities.

- No independent confirmation was obtained corroborating the existence and ownership of investment assets held by an investment management firm. These assets represented more than 50 per cent of the total consolidated assets.
- A lack of documentation in the file to evidence how the engagement team gained comfort on the audit work performed by a network firm with respect to an overseas operation that accounted for over 50 per cent of the revenue of the consolidated entity.

### **Quality Control**

35. 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 second partner was insufficient for him/her to have carried out an adequate review.
  - Although part of such a review is required to be carried out at the end of planning the engagement, this did not always occur. In CPAB's view, evidence showing that the review was performed just prior to the release of the financial statements also demonstrates that the review was not timely.
  - Many of the engagement deficiencies revealed by CPAB's inspections should have been detected by a proper independent review by a second partner prior to the issuance of the audit report.

### **Conclusion**

36. While high quality audit work was evident throughout its inspections, CPAB is disappointed that its inspection work identified so 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 share this sense of disappointment and will work diligently to impress upon its partners and staff the need to improve compliance in the future.

### *Monitoring of Quality Control*

37. 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 of the 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.
38. The effectiveness of the monitoring activity varies from firm to firm. 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 has made substantive recommendations to these firms.

## Recommendations Arising from the Inspections Regional and Local Firms

### *Tone at the Top/Leadership*

39. The leadership of some of the regional and local firms has demonstrated a commitment to audit quality and communicated the message consistently to partners and staff. While some firms did not establish or implement quality policies and procedures for the audits of public companies by the designated implementation date of January 1, 2005, as mandated by CPAB, CPAB is encouraged by the progress the firms have demonstrated. In some cases, CPAB has recommended that policies, procedures and communications be enhanced to further reinforce the importance of audit quality and improve the effective operation of quality systems.
40. The leadership of some other firms has not emphasized the message that audit quality is the major objective in the performance of audits. This was apparent in those firms by:
- Audit guidance that did not appropriately reflect professional standards
  - Nominal time charged by partners on their audits and minimal documentation of partner involvement
  - Numerous GAAP and GAAS deficiencies
  - Compensation models that do not reward the performance of high quality audit work

As in the last round of inspections, CPAB found that a lack of focus on audit quality is often accompanied by a lack of clarity surrounding the responsibilities for quality control. CPAB recommended to such firms that the ultimate authority and responsibility for audit quality and the related decision-making processes should be formally assigned and those charged with this task should be held accountable.

### *Independence and Ethics*

41. Despite the fact that all public accounting firms have been required to comply with the auditor independence rules for nearly two years now, some regional and local firms are still having difficulties implementing the requirements. Most of the firms have recognized the need to allocate adequate resources to independence. Where this was not the case, CPAB recommended that the firm appoint a designated partner to oversee the area of independence and ethics.
42. Several firms had either not established formal policies and procedures to address independence and ethics, or the policies and processes in place were incomplete or lacked clarity. This includes failing to institute requirements to: establish a reporting process for independence breaches; document independence issues and resolutions; report independence violations to audit committees; and obtain the approval of the firm's independence leader and the audit committee prior to providing non-assurance services to audit clients. CPAB has recommended that these firms establish and implement all of the requirements pertaining to independence and ethics, update the firm's guidance and, in some cases, provide additional training to partners and staff.
43. One of the cornerstones of a sound system to prevent and detect independence breaches is the maintenance of a complete and accurate listing of prohibited investments. Without such a list, partners and staff may inadvertently invest in the prohibited investments or fail to divest themselves of such investments. The majority of firms maintain a list of reporting issuer clients. However, CPAB noted that many firms did not include all subsidiaries, affiliates and related joint ventures of their public company audit clients.
44. The auditor independence rules require the rotation of engagement partners and engagement quality control reviewers every five years when the reporting issuer has total assets or market capitalization in excess of \$10 million. Several firms, including five of the mid-size firms, had not established a comprehensive rotation plan. In addition, the rotation plans of several firms were inaccurate, incomplete or out of date. CPAB instructed the firms to develop and maintain accurate rotation plans.
45. Several mid-size firms and a few small firms had not developed a policy or process to confirm the independence of others upon whose work the firm will be

- relying. This includes secondary or downstream auditors, international affiliates in network firms, external specialists, consultants and contractors. CPAB required firms to develop policies and procedures to confirm the independence of secondary auditors, network firms, specialists and consultants. Because they must comply with all aspects of Canadian independence rules, firms should clearly set out the independence standards that they expect others to meet.
46. CPAB also made recommendations to remedy problems observed regarding the independence confirmation process itself. These deficiencies included: lack of guidance; untimely confirmation processes; failure to obtain confirmations; lack of action on confirmations that identified issues; weak processes for following up outstanding confirmations; failure to tailor confirmations for partners to reflect the more onerous restrictions placed on partners; and failure to consider the Rules of Professional Conduct affecting ethical conduct and competence.

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

47. Firms have an increased focus on making appropriate decisions regarding client and engagement acceptance and continuance based on acceptable levels of risk. While the majority of firms have formal policies and processes in place to approve new or continuing clients and engagements, CPAB required some firms to revise their policies and checklists to reflect more appropriate processes. Firms that did not have formal policies and procedures surrounding acceptance and continuance and proposals were required to immediately establish them.
48. Some firms neglected to carry out continuance reviews for all reporting issuer audit clients. Firms must increase the frequency of continuance reviews and ensure that partners review the firm's client list annually to re-evaluate the acceptability of each client and engagement.
49. CPAB counselled several firms to continue their efforts to complete and document their client continuance assessment process at the completion of an engagement, before the firm is reappointed as auditor at the client's AGM. If the firm has concerns about retaining a client, moving the timeline forward allows the firm to follow a systematic process and make a decision prior to the auditor's name being placed before the shareholders.
50. Documentation supporting the decision-making process continues to be an area

where the majority of firms should focus their efforts, including the timely approval of acceptance and continuance decisions. Where engagement partners were making continuance decisions on their own, without formal review and approval of other partners, CPAB advised the firm that this unacceptable practice should cease.

51. CPAB continues to be concerned that some firms are accepting audit clients for which they do not have the linguistic ability required to perform an audit of books, accounting records and supporting evidence maintained in foreign languages. A number of these clients have significant foreign operations, thereby increasing the firms' risk that they will opine on financial statements that contain a material error. CPAB has observed situations where the firm engaged translators to interpret contracts or verify translations, but they were not professional accountants. CPAB has asked these firms to demonstrate how they satisfy the professional obligation of assigning appropriate personnel to an assurance engagement. Where appropriate, firms should hire more senior engagement personnel with the requisite language skills.

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

52. Many of the mid-size firms and some of the smaller firms have well formulated human resources policies and procedures. However, this area has not always been well developed in firms with only a few audit partners.
53. That being said, even regional and local firms with established human resource systems have room for improvement. For example, CPAB found that some firms did not have any guidance on recruiting or mentoring, any standards regarding the content and quality of personnel files, or a requirement to check professional credentials and references of staff hired.
54. One of the most effective ways to improve audit quality is to give meaningful and timely feedback to partners and audit staff. Performance evaluations continue to be an area where CPAB would like the majority of regional and local firms to improve and build more rigour into the process. In particular, CPAB would have expected audit quality to play a larger role in the partner and staff performance assessment process and in decisions regarding compensation and promotion. This criterion was often absent.

55. There should be a requirement for staff to be reviewed both on an annual basis and at the conclusion of significant engagements. Firms must also address the timeliness of the process and consequences for failing to comply. CPAB encountered firms that had not developed criteria for the advancement of individuals to the partnership. Some of the mid-size firms failed to perform evaluations for all partners, and documentation relating to performance, compensation, and promotion discussions and decisions was frequently inadequate.
56. CPAB made some recommendations regarding professional development but, on the whole, found that firms recognize the crucial role ongoing training programs play in achieving quality audit work in an environment of increasingly complex accounting and auditing standards. The few firms with no formal professional development plans were directed to develop a strategy and track the professional development needs of its partners and staff. CPAB also asked some firms to maintain professional development records, monitor attendance and establish consequences for failing to attend mandatory training courses.

### *Performance on Audit Engagements*

#### **General**

57. The majority of the audits reviewed had generally been performed to an acceptable standard. However, there were a number that CPAB believes contained deficiencies that were significant enough to require further action on the part of the firm (see **Systemic Issues** and **Individual Files** below).
58. CPAB followed the same process to select files for review in the regional and local firms as it did for the six national firms (see paragraph 12). CPAB reviewed working papers for 120 audit engagements.
59. The significant GAAS and GAAP deficiencies encountered in the review of files led CPAB to impose requirements on three firms.

In one case, CPAB has required the firm to not accept any new reporting issuer clients until it has satisfactorily implemented all of CPAB's recommendations. CPAB also required this firm to have a pre-issuance engagement quality control review conducted by a partner in another firm of chartered accountants approved by CPAB.

- CPAB required two other firms to not accept any new reporting issuer audit clients until they have satisfactorily implemented all of the recommendations in CPAB's report and those pertaining to specific engagement files. They must also demonstrate that they are performing public company audits based on the considerations described in paragraph 12.
60. CPAB found that in 120 engagements reviewed, 13 of the GAAP issues identified were serious enough to constitute significant GAAP deficiencies. CPAB also identified 30 files that contained significant GAAS deficiencies.
  61. For each file with GAAP or GAAS deficiencies, CPAB required the firm to either carry out further audit work or add documentation to the file and, in certain cases, to restate the financial statements.
  62. Where CPAB made recommendations specific to individual files, it also made the engagement quality control reviewer assigned to the engagement responsible for following up to ensure that appropriate changes are made to the file and to next year's audit plan.

### **Systemic Issues**

63. CPAB made many recommendations again this year with respect to engagement performance in general and on specific engagements. Some recommendations are the same as those identified in its previous report. These recommendations covered a variety of systemic issues. Each of the recommendations related to, in some cases, at least one-third of the firms and, in many cases, to one-half of the firms reviewed:
  - CPAB noted weak approaches to audit planning. In some cases, planning meetings were not held and the audit plan was poorly documented. Some firms lacked appropriate guidance regarding materiality, which was not always calculated properly.
  - Some firms continue to lack any or appropriate policies and procedures regarding the use of other auditors, including those circumstances where the firm, as primary auditors, relied heavily on the work done by the secondary auditors. CPAB noted many GAAS deficiencies in this regard.
  - Some firms still have not developed policies and procedures regarding the use of specialists, such as valuers.

- The poor overall quality of documentation continues to be a major area of concern. CPAB frequently had to ask firms to enhance their documentation policies, including the documentation of issues and conclusions reached on consultations with technical experts, and to direct engagement teams to improve the level of documentation in particular files.
- Some firms had inadequate policies and procedures to address supervision and review.
- In several firms, audit programs, templates and checklists had to be developed or updated because they did not appropriately address all aspects of professional standards. Three mid-size firms did not have a standard audit methodology and were advised of the need to develop one.
- CPAB again noted that firm processes for reporting to audit committees did not always meet professional standards. For example, audit committees do not always receive planning material or have an opportunity to discuss the plan prior to the commencement of the audit. As in the previous year, discussions with audit committees and meetings with management were often not documented by several of the firms.
- In some files, engagement letters and management representation letters did not comply with requirements.
- The subsequent events review process needs to be reconsidered in some firms. CPAB saw evidence that it was not performed properly or updated to the date of the auditor's report. Some legal response letters contained issues that were not followed up and others obtained considerably before the end of fieldwork were not updated to the date of the auditor's report.
- Some engagement teams did not document reviews of the financial statements and other filings by the client as required. Discrepancies were noted in several files when CPAB compared the information in the Management, Discussion & Analysis, Annual Information Forms and other public documents.

## **Individual Files**

64. CPAB was disappointed by the number of GAAP and GAAS deficiencies in the files that it reviewed. In addition to the significant issues summarized below, CPAB identified other significant issues as matters that were not, in its opinion, as important, but that still require additional audit work, documentation or reconsideration the following year.
65. Significant issues identified in individual file reviews included the following:
- Inadequate audit work and documentation to support reliance on a secondary auditor in a foreign country when almost all of the consolidated revenue was generated by a foreign subsidiary. In the same file, insufficient work was done to support the valuation of a material customer list and the basis used for amortization. There was inadequate documentation and disclosure of going concern considerations.
  - Inadequate documentation of work done with respect to the capitalization of deferred exploration costs, inadequate procedures for the reliance on the secondary auditor of three foreign affiliates and inadequate confirmations obtained from the foreign affiliates of the client.
  - Inadequate client continuance procedures and inadequate audit plans surrounding the assignment of firm personnel, including the requisite IT capabilities, in an Internet gaming business audit.
  - Failure to accrue a material amount of withholding taxes on accrued interest receivable from three foreign affiliates that the client accounts for using the equity method of accounting.
  - Failure to include all stock options in determining stock-based compensation expense.
  - Recording of the sale of a building and resulting gain in Q1 rather than Q2 when the transaction closed and title transferred.
  - Failure to record a liability arising from a commitment the client had made to ship a commodity at no charge to former suppliers as part of a settlement although the client knew it was going to incur a loss from the commitment.

## **Quality Control**

66. Last year, CPAB expressed concern about the effectiveness of the quality control review process, including the amount of time spent by engagement quality control reviewers on their review of files. The scope and timing of the engagement quality control review was once again an issue in some firms. The firms' internal processes should have identified, prior to the release of the financial statements, most if not all of the deficiencies CPAB observed this year. If the only time spent on a file by the engagement quality control reviewer is immediately prior to the release of the financial statements, the likelihood of identifying problems with the audit approach and technical issues declines and does not meet professional standards. If a firm does not require the engagement quality control reviewer to sign off on his or her review, financial statements can be released without going through the appropriate review process. CPAB required these firms to strengthen their compliance with professional standards on quality control review.
67. CPAB encountered a few firms where reporting issuer files were being reviewed entirely by a manager. CPAB advised the firms that a partner must review all reporting issuer files or oversee the manager's detailed review. This is because the partner has the ultimate responsibility for ensuring that reporting issuer audit files meet GAAS and GAAP or the firm's standards in those cases where the firm's standards exceed professional standards. These firms were also required to establish criteria for engagement quality control reviewers.
68. CPAB also saw evidence that some engagement quality control reviewers did not have the experience necessary to review reporting issuer audits. In these cases, CPAB required the engagement quality control reviewers to receive appropriate coaching.
69. In some cases, CPAB required firms to reconsider how differences of opinion between the engagement quality control reviewer and the engagement partner are to be resolved.

## **Conclusion**

70. Although firms reviewed for the second time generally showed improvements, there are far too many common areas of deficiencies in the files. CPAB is disappointed that its inspection work identified so 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 share this sense of disappointment and will work diligently to impress upon its partners and staff the need to improve compliance in the future.

### *Monitoring of Quality Control*

71. Professional standards require firms of all sizes to monitor audit quality by verifying that their systems of quality control are appropriately designed and operating effectively. This is accomplished 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.
72. The regional and local firms varied significantly in the extent and quality of quality monitoring policies. Five of the mid-size firms and one small firm did not have a quality monitoring program in place at the time of the inspections.
73. Where CPAB did not find the design of policies and procedures to be as comprehensive as expected, those firms received recommendations on how to improve the quality monitoring function. The recommendations included directing firms to:
  - Appoint a quality monitoring leader
  - Establish the frequency of monitoring reviews and a process for selecting files for review
  - Evaluate the abilities and performance of quality monitoring program team members
  - Communicate the results of the monitoring reviews to partners and staff on a timely basis
  - Incorporate the results of monitoring in performance evaluations
  - Establish sanctions for non-compliance with professional or firm standards
  - Develop a process to ensure monitoring activities result in action plans and timely follow-up
  - Improve the level of documentation for the monitoring process

74. Even where firms had established a formal quality monitoring program, several have not been implementing their programs in a disciplined manner. Two of the mid-size firms and some small firms have developed a program but had done nothing to implement it. Some other firms had not completed their quality monitoring reviews as planned at the time of the inspection or had merely conducted a few informal reviews. Many of the implementation problems stemmed from the fact that there are gaps in the firm's policies and guidance regarding the monitoring activity, as described above. There is still a significant amount of room for improvement in the implementation of monitoring programs.
75. Another area of concern continues to be the amount of time some firms spend on their quality monitoring activities. Firms must devote a sufficient amount of time to reviewing individual files in order to carry out an effective monitoring program. Superficial examinations of files may result in a failure to: identify areas where additional training or coaching is needed; detect individual practitioners who lack the necessary skills or experience to be auditing reporting issuer audit clients; identify issues that could lead to a restatement of the financial statements; and recognize firm-wide approaches and practices that need to be changed or improved. Because the primary purpose of monitoring is to improve overall audit quality, CPAB has asked some firms to reconsider the amount of time they invest in monitoring.

## **Enhancement of Canadian Generally Accepted Auditing Standards (GAAS)**

76. The Auditing and Assurance Standards Board (AASB) is responsible for setting GAAS in Canada and it has been following an ambitious agenda to enhance GAAS. Various significant new or improved standards have recently been approved. Among these are standards dealing with quality control (effective January 1, 2005) and management representations (effective for fiscal periods commencing on or after August 1, 2005). These will be enhanced again by the standards on audit risk (effective for fiscal periods commencing on or after January 1, 2006) and audit documentation (effective for fiscal periods commencing on or after November 1, 2006). CPAB strongly supports the work that the AASB is doing to develop new and improved auditing standards and

believes the implementation of these new or improved standards will significantly enhance the level of audit quality in these key areas. CPAB participates in the public oversight of the AASB through membership on the Auditing and Assurance Standards Oversight Council (AASOC). In addition, CPAB provides comments to the AASB on each exposure draft that it publishes.

77. One area where Canadian auditing standards require a major upgrade pertains to the precautions that should be taken by an audit firm relying on work done by another audit firm. For example, one firm (the primary auditor) may be appointed to audit an entity's consolidated financial statements, but a different firm (a secondary auditor) may be responsible for the audit of an important domestic or overseas operation that is part of the consolidation. The two firms may or may not be part of the same global network of accounting firms. Some Canadian primary auditors are signing opinions on consolidated financial statements while relying on one or more secondary auditors to do substantially all of the audit work on the underlying assets and revenues. This reliance is rarely disclosed to shareholders. Where the primary and secondary auditors are part of the same global network of accounting firms, use the same audit methodology and are subject to substantially the same quality control policies and procedures, this reliance may not present a serious problem for the primary auditor. However, where the firms are not so closely linked, it can be difficult for the primary auditor to gain enough assurance to sign the opinion on the consolidated financial statements. Typically, the six national accounting firms will not accept an audit of consolidated financial statements unless they and their affiliated network firms audit the majority of consolidated assets and revenues. The International Auditing and Assurance Standards Board (IAASB) has issued a re-exposure draft of a new International Standard on Auditing (ISA) on the audit of group financial statements. The AASB is in the process of adopting international auditing standards and CPAB looks forward to the significant strengthening of this standard.

## Conclusion

78. 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, as discussed in paragraph 10, and some difficulties accessing working papers for a secondary auditor, as discussed in paragraph 11, CPAB received the information requested and all firms were forthcoming in responding to questions.
79. CPAB's 2006 quality inspections of the firms showed that nearly all of its 2004 and 2005 recommendations have been implemented effectively. 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 designed effectively. Quality monitoring is operating as designed in three 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 disappointing level 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. 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.
80. There also continues to be room for improvement in the performance of audit engagements at all levels. CPAB is encouraged by the firms' understanding that the public interest requires them to place greater emphasis on audit quality and on "getting it right" every time, with no tolerance for substandard performance. CPAB expects the firms to implement its recommendations and will conduct further quality inspections of many of these firms in 2007 to ensure that they have done so, or are doing so, to its satisfaction within the prescribed time period.

January 30, 2007