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CPAB REPORTS ON 2005 QUALITY INSPECTIONS OF BIG FOUR ACCOUNTING FIRMS

By

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The Canadian Public Accountability Board (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 quality inspections of the accounting firms subject to its oversight.

CPAB is committed to periodic public reporting of the results of our work, which should be of interest to anyone who serves on an audit committee.

In December 2005, CPAB issued its third public report, covering its 2005 quality inspections of the four largest public accounting firms in Canada: Deloitte & Touche LLP, Ernst & Young LLP, KPMG LLP and PricewaterhouseCoopers LLP. Together, these firms audit over 60% of Canadian public companies by number of clients and, we estimate, more than 90% if measured by the market capitalization of the entities audited. Our complete public report is available on the CPAB website at www.cpab-ccrc.ca.

We found that each firm had implemented substantially all of the recommendations made to it following our initial quality inspection in 2004. Before addressing areas where improvement is necessary, it is appropriate to report some very positive findings.

All four firms have a number of strategic priorities that, as we would expect, include an emphasis on audit quality. The leaders of all of the firms, in their internal communications to partners and staff, emphasize the need to make an uncompromising effort to do the highest quality work on every audit engagement. Furthermore, we are satisfied that each firm's leadership is prepared to take strong action where necessary to deal with serious quality shortcomings.

All of the firms have effective controls to approve new or continuing audit engagements. Clients are rated as to the risk that the client is likely to prepare financial statements containing material error. Each firm's senior management is giving increasing attention to ensuring that higher risk clients are acceptable to the firm and to the way that engagement teams manage the risks of audit engagements for such clients.

CPAB encourages participating audit firms to be selective about the clients they accept and retain. An independent audit is an important part of the securities regulatory process. By requiring clients to have satisfactory levels of ability and willingness to comply with securities regulation and other laws, auditors can make an important contribution to investor protection.

All of the firms have extensive policies and procedures related to their human resources, and their HR systems appear in general to be operating effectively. In particular, compared to 2004, the firms made progress with respect to the timeliness and effectiveness of their performance evaluation systems. Two of the firms were recently included in a list of Canada's top 100 employers.

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. The effectiveness of this quality monitoring activity varies from firm to firm. In two firms, quality monitoring is done with evident rigour, there is transparent reporting of results to senior management of the firm, there are action plans with clear accountability and timely follow up and there are consequences for those responsible for work judged to be unsatisfactory. For these firms, we had no recommendations for further improvement. A third firm made great improvements to its quality monitoring program following the results of our initial review in 2004, but we identified several opportunities for further enhancement and made recommendations accordingly. The fourth firm's program is effectively designed, but appears to be the least effective in terms of implementation; we have made more substantive recommendations to this firm.

In two areas, all the firms have more work to do to improve quality and achieve consistent adherence to firm and professional standards. One is auditor independence, where all firms are testing the investment holdings of their partners and senior staff for compliance with their policies and procedures and, in 2005, was finding an unacceptable rate of exception.

While high-quality audit work was evident throughout our inspections, there is also a need for continued improvement with respect to performance on audit engagements. Out of a total of 87 audit engagements selected by us for review in the four firms, there were five (one in each of three firms and two in the fourth firm) where we concluded that the audit was not conducted in accordance with generally accepted auditing standards. In all five cases, the common shortcoming was insufficient appropriate audit evidence to support the unqualified audit opinion that was given. One of these cases involved a material misstatement in the financial statements. The relevant securities commission was familiar with this case and had taken the action with respect to the issuer that it considered to be necessary.

In addition to the five unacceptable audits, there were other engagements where, although CPAB was able to accept the file in its totality, the quality of some aspect of the work was below standard. For a number of these engagements, CPAB recommended that appropriate remedial action be taken, such as obtaining further evidence to support the firm's audit report, and that, when completed, the file be cleared by a relevant partner of

the firm with quality responsibilities.

CPAB made a number of other recommendations to one or more of the firms (in most cases, to more than one firm) with respect to engagement performance improvement in general, or by reference to specific engagements. Among the issues covered by our recommendations were the following:

- All four firms have cultures that encourage consultation with technical accounting or auditing experts wherever appropriate on judgmental or contentious matters. However, we noted failures to document properly the nature, scope or conclusions reached from some consultations when they occurred, and even more frequent failures to secure the written agreement of the party consulted, which is a requirement of auditing standards.
- There is a need to improve the analysis of errors in the financial statements detected during the course of the audit. Such analysis should include not only the errors that were corrected, but the ones that were not, including known errors, most likely errors and the impact of prior period errors that had a reversing error effect on the current year.
- In some cases, we had concerns that the amount of unadjusted errors, while not material to the income statement for the year subject to audit, had over several years accumulated to an amount that would be material to income if the cumulative errors in opening equity were corrected all at once.
- There is a need to improve compliance with the requirements of the auditing standard that deals with the auditor's responsibility to consider fraud. The standard has a number of prescriptive requirements that at times were being done by engagement teams in a cursory manner or, in a few cases, not at all.
- There is at times a need to improve compliance with firm procedures and auditing standards when substantive analytical procedures are used as a form of audit evidence. Too often, we noted cases where analytical procedures were so superficial as to be of little evidential value.
- There is a need to improve compliance with the auditing standard applicable to the use of specialists in audit engagements, such as actuaries, petroleum and mining engineers, environmental assessment specialists and asset valuation specialists. Engagement teams at times seemed unaware of their obligations with respect to the work done by the specialists.
- There is a need to improve compliance with the auditing standards for using the work of a client's internal auditors and for reliance on another auditor.
- While the quality of reporting by all four firms to audit committees is generally satisfactory, there is one area that does need to be improved, namely the reporting of corrected and of 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 to determine the effectiveness of the issuer's controls over financial reporting.

- There is a need to improve the documentation of discussions at meetings with audit committees. Normally the audit working papers 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.

Each firm inspected has received a private report from CPAB that includes specific recommendations. Each has accepted CPAB's recommendations and provided written commitments that problems identified will be remedied. CPAB expects the firms to implement the recommendations and will conduct further quality inspections of all four firms in 2006 to ensure that they have done so. CPAB is encouraged by the firms' acceptance that the public interest requires them to "get it right" every time, with no tolerance for substandard performance.

Over the past two years, CPAB has inspected over 40 public accounting firms that collectively perform the vast majority of the audits of public companies in Canada and has made recommendations for improvements that are needed to achieve high quality audits more consistently. These improvements are now being implemented and should enhance the credibility of financial statements of public companies and confidence in Canada's capital markets.