

CANADIAN PUBLIC ACCOUNTABILITY BOARD
CONSEIL CANADIEN SUR LA REDDITION DE COMPTES



More Than Another Speech on Accounting

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Check Against Delivery

The views in this speech are mine and not necessarily those of any organization that I am associated with.

CPAB ECOT Speech

Not Just Another Speech on Accounting

I plan that this will not be just another speech on accounting! You will have to be the judge.

Why am I here? I believe that high-quality financial reporting, attested to by high quality audits and backed up by an effective audit regulator like CPAB, is crucial to confidence in financial markets and to a well functioning economy.

If we don't have that how can management, shareholders, counterparties, analysts and observers know what the results really are? And if we don't know what the results really are how can we take actions accordingly? Whether those actions are to buy, sell, change strategy, upscale or downsize a business, reward performance and so on.

That is why I joined CPAB, which is an organization I helped create some five years ago.

And that confidence is taking a bit of a beating currently.

So I want to let you know what CPAB is doing, what our next priorities are, and comment on a few policy issues that I think ought to concern policy makers as they sort through what the world after the financial turmoil ought to look like.

CPAB

CPAB stands for the Canadian Public Accountability Board. We are an audit regulator. That means our mission is "to contribute to public confidence in the integrity of financial reporting of public companies in Canada by promoting high quality, independent auditing."

I've already talked about the importance of confidence. As the mission says we deal with public company audits, not private companies or non-profits. And the CPAB mission relates to promoting "independent" auditing. That refers to the fact that, in addition to overseeing compliance with auditing standards, we monitor audit firms' adherence to the profession's independence standards (e.g. re rotation of auditors, managing of potential conflicts). These were materially tightened after the ENRON debacle.

It was after that debacle, in which accounting and auditing bore a good part of the blame, that audit regulators were set up in major countries. Canada was one of the first 'out of the gate' to get up and running and be effective.

There are now over 20 of us around the world and growing.

What do we do? The essence of our work starts with assessing the fundamentals and policies (that relate to audit quality) of auditing firms who are in our oversight program. Is management setting an appropriate ‘tone at the top’ by continually sending the message in the firm that the quality of the audits being performed is paramount? Do they have the quality and expertise and training for staff?

The main thrust of our work is reviewing selected individual audit files to evaluate whether the audits are being performed in accordance with high quality auditing standards. In other words, is what the auditing firm says it is doing in its policies and tone from the top evident in the field?

Appropriate remedial measures are put in place should we find deficiencies in the standard of the audit work. That may mean requiring more work by auditors. We may also identify breaches of GAAP that will require restatement of financial statements.

As a result of these efforts, we have seen improvements in the quality of audits since CPAB was formed.

Canada has a large number of public companies relative to the size of our economy than does the U.S. Some are the largest names we all know. But many are much smaller operations listed on a variety of exchanges.

The universe of audit firms in Canada auditing public companies mirrors this—the six major audit firms and others.

Our Results

CPAB’s fifth public report, which covered its 2007 inspections, was issued in February 2008. While significant progress has been made, there is room to further improve audit quality at a number of audit firms we inspected. While the large majority of audits reviewed by CPAB meet professional standards, we want to see future audits meet these standards on a more-consistent basis.

The six national firms in Canada audit companies representing more than 95 per cent of the market capitalization of Canadian reporting issuers. Senior management in all firms is committed to quality audits. Each firm has made improvements since CPAB commenced its inspections in 2004. I believe that their audits are generally sound and can be relied on.

However, of the 130 audit files that CPAB reviewed in 2007 (primarily high risk files) in the six national firms, eleven engagements had serious deficiencies in either the sufficiency of work done, documentation of work and/or evidence of review. In five other cases, deficiencies in the application of Generally Accepted Accounting Principles (GAAP) resulted in remedial action being required to either; reissue, restate or correct financial statements in the subsequent year.

Those results—about a 10% problem rate—have several explanations. Partly it’s a result of CPAB raising the bar. We can never expect a complete absence of issues. However, I think everyone should be doing better.

Last year, CPAB inspected 17 audit firms that are not in the big six group but have more than 50 reporting issuer clients.

Of the 81 audit engagements from firms in this group that CPAB selected for review (primarily high-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 a few firms’ quality control processes.

When we place formal requirements on audit firms to improve, we generally see results in short order.

We also inspect a number of audit firms with less than fifty clients. Some do a very good job. They can face a challenge in dealing with the increasing complexities of GAAP and GAAS. If we think a small firm does not have the resources to do the job well we won’t pull punches in saying so and pushing for change.

Some CPAB Issues Going Forward

As a regulator I want CPAB to keep our position as one of the very few top audit regulators in the world. That means we must get better as well. That includes:

- Better focusing our inspection work and reporting on issues that really matter
- Revising our methodology for smaller and medium-size firms to make it more streamlined
- Reviewing the cycle and scope of our reviews and enhancing our resources
- Ensuring we are ready for IFRS
- Audit regulators (who are fairly new) need to strengthen their collective oversight over the major global audit firms. Those firms increasingly set policy, methodology and quality standards globally, while many of these regulators are operating nationally. Some of these regulators need to up their game to be able to assess the quality of audits of complex financial entities.

Many ask me why the results of our individual inspections of audit firms are not public, just aggregate results. We operate with three levels of disciplinary measures. Up to the first level results are confidential between CPAB and the audit firm. At the second and

third level there is escalating disclosure to the reporting issuer involved, securities regulators and the public.

You can have full disclosure or you can have effectiveness, but you can't have both. What do I mean? Well our counterpart in the U.S. issues a public report on each firm (with a confidential section that only goes to the firm). I gather that, in part because of negotiating the language of the public part, and a lot of vetting by legal departments, their reports take materially longer to issue than CPABs. So I will be very loath to change this model fundamentally in the short term.

To get going quickly CPAB was initially set up without legislation in each province. Now we are in the process of rectifying that. As other regulators do we must have immunity for our staff and board for our actions in good faith. Without that, we are not using all the powers we have in order to meet our mandate. And we must have right of access to all documents used by the auditors to do their audit, even if they are privileged. In auditing you can't express an opinion if you don't have the information. The same is true for CPAB.

Part of this legislation will be enhanced accountability of CPAB to governments through securities commissions. I welcome that. And as part of this we will be changing our governance structure and enhancing our relations with provincial audit regulators.

In this process we are dealing with the same issue, in microcosm that has led to calls for a national securities commission. The current provincial system cannot respond in a timely way to policy changes such as CPAB needs. Legislation is passed in Quebec and passed but not proclaimed in Ontario. It was to be on the legislative agenda in Alberta this fall but is deferred to the spring. B.C. is delayed as well. It is likely that the legislation will contain at least three accountability models! I don't think they will conflict but a lot of work is yet to be done to mesh them in practice. This is just one more example of why we need the focus and drive that a national securities commission would bring.

Some Other Policy Issues

Credit Crises and Fair Value Accounting

Accounting rules have been a centre-piece of the credit crisis. Calls of "where were the auditors?" haven't really been heard yet, but I expect that will happen.

Recently, Presidents and law-makers were making comments on accounting standards! Various bankers, insurance companies and even senior politicians called for fair value (MTM) accounting to be suspended or replaced. Some believed that it had exacerbated the crisis by making it harder to determine a 'fair' value in distressed markets. So it contributed to more opaque financial statements. Opponents also believed that 'fair value' methodology in distress (or non-existent) markets lead to over-reaction in marking items down and contributed to panic selling, thus making things worse.

Others pointed out that suspension of the rules would lead to even more opacity and might further undercut confidence. They also made the telling point that, if management uses various MTM techniques to run a bank, why shouldn't shareholders and others get the same information? History is replete with crises where failure to recognize losses delayed remedial action.

The U.S. bailout bill gave the SEC authority to suspend fair value accounting and mandated an SEC study in 90 days. The standard setters, including in Canada have introduced new, and I believe overdue guidance in the last month or so. It helpfully deals with tricky issues around valuation when markets are very illiquid or non-existent.

Great care is needed in this area. The arguments in support of fair value, in principle, as opposed to historic cost or some other accounting method are strong. I support them. Suspending the rule or seriously weakening it could erode confidence in financial reporting.

However, I cannot believe that the proponents of the fair value rule can be happy with its implementation, based on recent experience. Changing very important details in the middle of a crisis is not the predictability that financial reporting needs. Having a rule where preparers have to change details of methodology regularly and the changes mean hundreds of millions of changes in net income is not a sign of a stable rule and methodology. Stability in financial reporting and good understanding of what numbers mean and don't mean, and reasonable comparability between preparers, is one factor in financial stability. I don't think analysts and preparers had as much understanding of how the rules would impact as they should.

Basing valuation of trillions of dollars of assets on indices that in turn are based on a handful of actual trades, accepting indicative broker quotes, failing to set down detailed guidance for acceptable model valuations for assets where there are no observable markets, and similar implementation issues are all not good enough. Accounting and auditing standards setters could better coordinate their efforts. I know that as a result of the recent Financial Stability Forum Report, regulators and standard setters are looking at what they could do better. I welcome that.

I believe that implementation was not as high quality as it needs to be. International accounting and auditing standard setters need to road test rules like this a lot more, to issue detailed guidance for easily-anticipated issues and to take the lead in explaining their impact.

Until recently, the international and Canadian standard setters did not see their role as being concerned with implementation of rules and responding to implementation issues with guidance. I think that attitude has to change. Perhaps it now will. Otherwise there is excessive pressure of auditors and audit regulators to police implementation of complex rules and try and achieve reasonable and consistent results. They are not likely to be as good at that as the standard setters.

The planned extension of fair value measures and a more sensible accounting model globally to insurers (the model in Canada already is good in this regard) will be an opportunity to do better.

Recently the IASB and FASB have issued clarifying guidance and have taken the major step of allowing financial firms discretion to re-allocate assets out of categories where fair value is required. As a temporary measure I support this. But it will put a lot of pressure on audit firms and audit regulators to police a reasonable comparable boundary.

CPAB and Credit Crises Issues

The disruption in credit markets, and in particular the asset-back commercial paper that became illiquid, affected CPAB's 2008 inspections since CPAB wanted to assess whether audit firms had taken appropriate steps to manage audit risk. Our inspection activity focused on the audit work done on the valuation of investments and the related financial statement disclosure. We found that improvements were needed in the disclosure of assumptions used to determine fair values. We also believe that audit firms need to ensure that appropriate rigour is applied in challenging assumptions to estimate fair values.

CPAB plans to put even greater emphasis on the impact of the credit crisis and the economic downturn when it carries out its inspections in 2009 related to 2008 accounts. CPAB will be meeting with senior management of the firms in late November to understand and assess the firms' response to the credit crisis and economic downturn with respect to the audits of public companies. In its 2009 inspections, CPAB will be fine tuning its risk-based approach to inspections to focus on the audit work on the broad array of financial statement accounts that could be impacted by the credit crisis.

Credit Crisis and Disclosure

The volume of disclosure mandated by accounting standards has increased enormously. It is less clear that this added 'data' has actually resulted in a commensurate increase in 'information'. At the same time, complex products are sold more and more to a broader range of investors either directly or indirectly through various pooled funds arrangements. Also, even supposedly sophisticated investors have claimed that they did not understand all of the features of the complex products they were buying.

Do we need a more-fundamental re-look at disclosure? Could more clarity around key risks, in one place, be part of financial statement disclosure? Maybe in some areas of disclosure less is more? Do we need more tiered formatting of disclosure—high level statements backed up by more detail that not everyone would want or have to plow through? Could more-focused requirements re explanations of risks be put in place re disclosure obligations to both sophisticated and unsophisticated investors in 'complex' products? Should the definitions of what constitutes a sophisticated investor be altered? Are disclosure obligations of various funds adequate?

Figuring out what is really useful to various groups of users is not an easy task. I am not aware that that has been a major part of development of disclosure regulation. The default of just adding more is not necessarily the way to go. Proposals to augment auditor's reports to cover not just a black-white opinion deserve serious attention.

Other Policy Issues

Does the financial crisis indicate we need more, independent, authoritative checking of financial statements? Currently, an external bank audit for a Canadian bank typically costs \$20-30 million. Is that sufficient?

Then there are several issues that seem to be on the agenda elsewhere but not in Canada. The failure of another major global audit player is one of these. It could have various serious systemic effects. And as we all saw previously with Andersen the problem may not be here in Canada and yet can cause a major issue in Canada. It needs to be looked at by policy makers and securities and audit regulators. There are recent studies in the U.S. and U.K.

Then there is the issue of limiting (but not eliminating) auditor liability. This issue is on the agenda in a number of jurisdictions and has been acted on elsewhere. It should be on the agenda in Canada too. Auditors have to be responsible for their work and liable for their actions or inactions. But if they are liable out of proportion to their share of the blame that can cause problems as well including for the viability of the firm in extremis. Others have found practical ways to balance these goals.

There are also nascent ideas in other countries about how rules could be changed to allow capital to be injected into a major audit firm in the case of a problem. That is now difficult because of restrictions on their ownership structure. This issue should also receive active consideration in Canada.

These are all issues where CPAB is not 'the driver'. But they are important.

Conclusion

Accounting and auditing, and being an audit regulator, should be 'boring and 'predictable'. But it should be done well so confidence can be maintained. We are in good shape in Canada, but there are improvements that need to be pursued. We at CPAB will be doing our part.

Thank you