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REPORT ON 2009 INSPECTIONS

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) 2009 inspection approach was proactive and focused, with increased emphasis on engagement performance. CPAB conducted risk-based inspections that paid particular attention to the audit work on items most affected by the economic downturn.

In 2009, CPAB inspected 53 firms and reviewed 212 audit engagements. These included inspections of Canada's six National firms, recurring inspections of 28 Regional and Local firms (34 inspections in total) and 19 follow-up inspections.

CPAB's 2009 inspections confirm that the state of auditing in Canada is sound, although there are areas requiring improvement. CPAB's 2009 inspection reports to audit firms identified the top three to five areas requiring firm leadership focus that, if addressed, would have the greatest impact on improving audit quality.

For firms of all sizes, CPAB identified the need to enhance the role of the Engagement Quality Control Review, improve the evaluation of unadjusted errors, improve the transparency of the information the firms communicate to audit committees and enhance the quality and transparency of financial statements.

CPAB also identified the need for Regional and Local firms to enhance their audit planning for non-routine transactions and to ask their clients to more thoroughly document complex transactions.

As a result of its 2009 inspections, CPAB placed a requirement on two firms.

While the state of auditing in Canada is sound, CPAB is concerned that several challenges have the potential to negatively affect audit quality. These include the ongoing weak economic environment, the upcoming transition to International Financial Reporting Standards (IFRS) and new Canadian Auditing Standards (CASs), and complexities surrounding fair value measurement and impairment assessments. CPAB urges audit firms to maintain their focus on high-quality audits as they deal with these issues.

CPAB is also concerned that some audit committees are pressuring firms to significantly reduce audit fees. There will always be negotiations between audit firms and audit committees regarding what constitutes appropriate and fair audit fees, however, given that one of an audit committee's key priorities should be obtaining high quality auditing services, CPAB believes that audit committees should not focus solely on fees or place unreasonable pressure on audit firms to arbitrarily reduce them.

In 2010 CPAB will expand its inspection activity to include more Regional and Local firms and extend its inspection coverage at the six National accounting firms. CPAB inspected 34 firms in 2009 and has set a target of 50 firm inspections per year by 2012. CPAB will also undertake additional inspections of foreign firms and firms inspected by the provincial audit regulators, on a risk-based targeted review. Increased inspection resources and an inspection methodology tailored to Regional and Local firms will be key to implementing this initiative. A significant part of this plan will be accomplished

through a rebalancing of current inspection staff, resulting in substantial productivity gains.

CPAB's 2010 priorities include further enhancing its risk assessment processes and focusing its inspections on audit work in high-risk areas. CPAB will also assess firms' transitions to IFRS and CASs.

In its 2009 inspections, CPAB was once again denied access to certain documents that formed part of the audit firms' working papers because of claims of solicitor-client privilege. Under *The Canadian Public Accountability Board Act (Ontario)*, which came into force on June 30, 2009, disclosure to CPAB of privileged information or documents contained or referred to in the audit firms' working papers does not constitute a waiver or negation of privilege, and a clear duty of confidentiality is imposed on CPAB and all its directors, governors, employees and agents. CPAB continues to seek legislation in all Canadian provinces and territories to give it the powers and protection it needs to fulfill its mandate, including recognition as an auditor oversight body and the ability to review privileged materials in an auditor's working papers without such privilege being otherwise negated or waived.

CPAB also continues to consult and collaborate with other regulators in Canada and around the world on how CPAB and these bodies can work together more effectively to enhance audit quality. This includes active participation in the International Forum of Independent Audit Regulators (IFIAR) and working with other regulators to achieve mutual reliance on each other's auditor oversight systems. CPAB made major progress toward this objective in January 2010, when the European Commission approved the co-operation of its Member States with Canada, Japan and Switzerland on the exchange of audit inspection working papers and inspection reports.

Introduction

CPAB's mission is to contribute to public confidence in the integrity of financial reporting of reporting issuers in Canada by promoting high-quality, independent auditing.

CPAB achieves this mission by inspecting public accounting firms that audit reporting issuers in Canada and providing the firms with feedback on audit processes, together with recommendations and/or requirements for improvement. The results of CPAB's inspections are communicated to the public in the form of an annual public report. This report covers inspections conducted in 2009 of National, Regional and Local firms as well as foreign firms outside Canada who audit Canadian reporting issuers.¹

CPAB's 2009 inspection approach was proactive and focused. CPAB met with the Big Four auditing firms in advance of the 2009 reporting period to review their plans to address the audit risks posed by the global economic downturn and to convey CPAB's expectations that firms would perform 2009 audits with an appropriate degree of professional skepticism.

¹ Details on the scope of CPAB's 2009 inspection approach are contained in Appendix A.

In January 2009, CPAB hosted a webcast that focused on the significant financial reporting challenges faced by management, board directors, audit committees and audit firms as a result of the global economic downturn. CPAB also outlined its expectations for audit firms when performing audits in an economic downturn.

CPAB's 2009 inspections continued to be risk-based, with increased focus and emphasis on engagement performance. Particular attention was given to the audit work performed on financial statement items most likely to be affected by the economic downturn.

In addition to evaluating engagement performance, CPAB reviews the other six elements of quality control, as set out in the *CICA Handbook*. The six areas, which establish the foundation for good engagement performance, are:

- Leadership responsibilities for quality within the firm
- Ethical requirements (including independence)
- Acceptance and continuance of client relationships and specific assurance engagements
- Human resources
- Engagement documentation (relating to confidentiality, custody, integrity, etc., but not content)
- Monitoring (by firms of their quality control systems and their application)

During 2009, in its inspection reports to firms, CPAB focused on identifying the possible changes to audit processes that would have the greatest impact on improving audit quality. The top three to five audit processes were specifically highlighted for attention in CPAB's inspection reports to each of the audit firms.

The results of CPAB's 2009 inspections of firms that audit reporting issuers confirm that the state of auditing in Canada is sound. However, going forward, firms will need to continue to maintain their focus on audit quality, given the ongoing challenging economic environment in Canada.

Of note is the fact that CPAB placed a requirement on two firms as a result of its 2009 inspections, a significant decrease from previous years.

As well, six firms that had requirements placed on them as a result of CPAB's 2008 inspections had follow-up inspections in 2009. These follow-up inspections resulted in CPAB lifting the requirements because it was satisfied that the issues had been addressed.

While CPAB did see many examples of excellent audit work, and noted significant progress on the part of a number of firms in improving audit quality, it still encountered examples of audit work that fell short of professional standards. This was more common in Regional and Local firms, especially those that were inspected for the first time in 2009.

This report summarizes the major findings from CPAB's 2009 inspections, including issues and areas for improvement that CPAB noted most often and that tended to be

identified at most, if not all, firms inspected. It also summarizes the recommendations CPAB made to the firms to address these issues.

Specific details of CPAB's findings are not published. The confidentiality of its inspection reports enhances CPAB's ability to be effective. CPAB sends each firm it inspected a private report that includes feedback on audit processes and its recommendations for improvements. Each recommendation requires a response from the firm within a prescribed period of time. The firms have implemented, or are implementing, substantially all of the recommendations.

Major Findings

National Firms

Overview

CPAB inspected six National firms in 2009. These inspections were risk-based, with increased focus and emphasis on engagement performance. CPAB used several external databases to identify high-risk engagements. CPAB then compared the high-risk engagements it had identified to the firms' high-risk lists and investigated any differences. Once the engagement files were chosen, CPAB conducted a detailed assessment of the financial statements and related public information to decide which specific audit risks within the financial statements would be the subject of CPAB's focused review.

Particular attention was given to the audit work performed on financial statement items that would most likely be affected by the economic downturn. As a result of this approach, CPAB selected and reviewed 118 audit engagement files.

Global Economic Downturn

The global economic downturn that began in 2008 continued to be felt throughout 2009, affecting the financial statements of many companies. Auditors, management, boards and audit committees continued to face many challenges, including determining fair values of illiquid investments, performing impairment assessments, assessing going concern considerations and providing enhanced financial statement disclosures.

The global economic downturn also affected CPAB's 2009 inspection approach, in that it placed its focus on areas most affected by the downturn and on audit work related to those areas. File selections were made based on a risk assessment and, once a file was selected, the areas looked at within the file were also selected based on risk. The areas selected were then reviewed, from planning all the way through to completion and reporting to the audit committee.

To assess their readiness to audit during the global economic downturn, CPAB arranged meetings with the senior leadership of the Big Four² firms in December 2008 and

² The Big Four firms, Deloitte & Touche LLP, Ernst & Young LLP, KPMG LLP and PricewaterhouseCoopers LLP, audit almost half of the entities that are public companies or other reporting issuers in Canada, which

January 2009. During these meetings, CPAB reviewed the firms' modifications to their audit methodologies and conveyed CPAB's expectations for the 2009 audits. CPAB is satisfied that each firm made considerable effort to be ready to deal with the accounting and auditing issues arising from the economic downturn. The firms introduced additional quality control processes and issued a great deal of internal guidance and training in response to the economic downturn and provided additional support for higher risk engagements.

These efforts were reflected in the results of CPAB's 2009 inspections. It is apparent that the Big Four firms developed and implemented effective processes and guidance for their audit engagement teams to consider in response to the business and financial reporting risks caused by the global economic downturn.

In its 2009 inspections, CPAB also placed more emphasis on engagement performance than on other elements of quality control, such as client acceptance and continuance, independence and human resources. This change was made because prior inspections showed that these elements were generally handled well and any problems relating to these other elements of quality control were likely to be reflected in engagement performance.

Major Issues Identified

CPAB saw many examples of excellent audit work in the files it reviewed in 2009.

However, there continue to be areas requiring improvement. This report summarizes the major issues and areas for improvement that CPAB noted most often in 2009. It also summarizes the feedback on audit processes and recommendations CPAB made to the firms to address these issues.

Enhancing the Role of the Engagement Quality Control Review

Enhancing the role of the Engagement Quality Control Reviewer (EQCR) or "second partner review" was a key recommendation CPAB made to nearly all firms, of all sizes, in 2009.

The purpose of an EQCR is to provide objective evaluation—before the audit report is issued—of the significant judgments the engagement team made and the conclusions reached. The EQCR can identify significant engagement deficiencies and be an effective safeguard against errors or insufficient audit work. The EQCR is a critical element of quality control and a major contributor to achieving audit quality.

CPAB's 2009 inspections indicated that many firms are implementing EQCR requirements in a minimal way. In many instances, EQCR involvement was both too little and too late. This is of particular concern to CPAB in relation to its 2009 inspections, which focused on larger, high-risk and more complex engagements. CPAB expected to find greater EQCR involvement in such audits.

represents about 92 per cent if measured by market capitalization.

Specifically, CPAB found indications that EQCRs:

- Were insufficiently involved. In many instances, time recorded was unusually low.
- Signed off after the firm had released the audit report. Late involvement by the EQCR limits the opportunity for suggestions to be implemented to improve audit quality
- Did not sufficiently challenge engagement teams on significant accounting and auditing issues
- Did not review working papers related to higher risk areas of the engagement

In many cases, it was difficult to determine the EQCR's level of involvement in the audit, other than a signature on a checklist. There was a consistent lack of documented evidence of work performed by EQCRs and it was unclear whether they reviewed the documentation to support significant judgments.

For certain files, CPAB believes that deficiencies it identified in its inspections might have been caught by the EQCRs if they had applied more rigour. Examples included going concern assessment, revenue testing and fair value determinations.

CPAB is also concerned that EQCRs are not always held sufficiently responsible for significant GAAP departures and GAAS deficiencies that can be linked to inadequate engagement quality control review.

To enhance the role of the EQCR, CPAB provided the following feedback to the firms. Firms should:

- Review their policies to ensure the EQCR is actively engaged throughout the audit and provides an effective consultation resource and substantive evaluation of audit work in areas of significant risk. Revised policies should require more robust documentation of the EQCR work performed, including the sections of the file that were reviewed
- Evaluate EQCR assignments and reassign EQCRs if appropriate. This evaluation should consider EQCRs' workloads, to ensure they have enough time to carry out their responsibilities and be available to engagement teams
- Increase EQCR accountability by considering disciplinary action for EQCRs when significant audit deficiencies can be linked to inadequate EQCR involvement

Progress on a number of these issues would contribute to audit quality. CPAB is engaging the audit profession on several of these issues both in Canada and internationally through IFIAR in order to ensure progress is achieved.

Evaluation of Unadjusted Audit Differences

CPAB found that certain engagement teams appeared to have a high tolerance for unadjusted audit differences. CPAB identified engagements with a large number of unadjusted audit differences and engagements with a large dollar amount of unadjusted audit differences.

In two instances, the total value of unadjusted errors exceeded the amount that was established as materiality (106 per cent and 199 per cent of materiality, respectively). In one engagement file, a future income tax error was adjusted prospectively in the current period income statement, when the correct treatment would have been to adjust the prior period income statement. This error was 146 per cent of materiality and 17 per cent of net income in the current period.

In each of these situations, it was not clear to CPAB that the engagement partners provided a substantive challenge to audit committees and senior management to adjust these errors, given that the unadjusted errors exceeded materiality for the audit.

CPAB also identified two instances where more than 40 unadjusted errors were included on the summary schedule of unadjusted audit differences. Most of these errors were known errors and therefore not matters of judgment. CPAB also found instances where the summary of unadjusted audit differences schedule was inaccurate or incomplete and where the evaluation of unadjusted audit differences in the context of financial reporting materiality appeared to be weak.

CPAB believes that preparers of financial statements should correct all known errors. CPAB also believes that auditors should drive changes in behaviour in this area and have a greater focus on ensuring that audit differences be adjusted. CPAB also believes that audit committees have an important role to play in ensuring that errors are corrected.

Failure to correct known errors reduces the flexibility to deal with errors that may be undetected. It can also affect the future interim and year-end financial statements, when the errors flow through to the next reporting period.

To improve audit quality and the integrity of financial reporting in this area, CPAB provided the following feedback:

- Firm leadership should send a clear message to partners and professional staff that it has a low tolerance for unadjusted audit differences, especially when these are known differences that, when accumulated, are close to or in excess of materiality
- Firm leaders should provide partners with greater support in handling often-difficult discussions with audit committees and senior management in this area. Firm leadership should consider providing partners with additional training on how to manage difficult discussions with reporting issuers without compromising the quality of audits
- Firms should monitor the number and dollar amount of unadjusted audit differences close to or in excess of materiality through their audit quality review programs, perform a root cause analysis and take corrective action as necessary

Enhancing Transparency

Audit Committees

CPAB observed a number of examples in the engagement files it reviewed where there was a lack of transparency in the information the firms communicated to audit committees.

In one firm, there was a client file in which the firm informed the audit committee that certain valuation estimates were “aggressive” while others were “conservative”. However, the firm did not disclose to the audit committee the actual dollar impact that these estimates could have on the company’s income statement. Depending on how they were incorporated, this impact could have resulted in a significant swing in the company’s income. CPAB believes the audit firm should have disclosed the dollar amounts involved in these estimates, in order that the audit committee could assess whether they were acceptable.

Audit committees are an important oversight and entity-wide control feature of corporate governance. CPAB believes continuous improvement in the two-way communications with audit committees contributes to audit quality, particularly during the current volatile economic environment and in light of the increasing complexity of financial reporting. This ongoing exchange should include communicating the auditor’s view in key judgmental areas to the audit committee, as well as a written record of the committee’s responses, questions raised and feedback provided.

CPAB noted that while some firms bring financial note disclosure deficiencies to the attention of audit committees, others do not. CPAB believes it is important to do so and notes that this will become even more important under IFRS, which call for greater financial statement disclosures.

To enhance communications with audit committees, CPAB provided the following feedback:

- Firms should implement a quality improvement program for their communications with audit committees. The objective of this program would be to enhance the transparency of these communications and enhance the related documentation provided to the audit committee. The components of such a program could include:
 - Improving the competencies of engagement partners to be more transparent in communications with audit committees regarding significant accounting and auditing judgments and to be able to articulate more strongly the firm’s concerns regarding management estimates, as well as the client’s related financial reporting
 - Increased focus on audit committee communications by the firm’s quality reviews to ensure coverage of all key matters with sufficient detail and to identify examples of lack of transparency

CPAB believes that its inspection findings and feedback in this area would also be of value to audit committees. To this end, CPAB will be holding round-table discussions with members of audit committees during 2010.

Financial Statement Disclosures

CPAB also noted a lack of transparency in the information some reporting issuers provided in their financial statements.

In one instance, inadequate disclosures were made on the nature of a significant legal claim. The reporting issuer did not provide sufficient details, such that the users of the financial statements could properly assess the nature of the risks related to the legal claim.

CPAB also noted instances in which related-party transactions were not disclosed, including those with senior management that likely would have been of interest to shareholders.

In other cases, several disclosure issues were identified too late in the process for the client to address them.

Although the responsibility for financial reporting rests with the preparers of financial statements, CPAB believes that an important public interest role served by auditors is to impress upon their clients their accountability for the quality and transparency of financial statements. This is achieved by a robust review, conducted by individuals in the firm with the appropriate expertise, of the financial statements and accompanying notes at an earlier stage in the audit process if feasible. Where this review reveals significant accounting and disclosure errors, omissions or lack of transparency in reporting, the auditor should seek their remediation by management; otherwise these matters should be reported to the audit committee.

To improve the quality and transparency of financial statements, CPAB provided the following feedback:

- Firms should conduct a root-cause analysis to determine why disclosure exceptions are not always being identified and appropriately accumulated and reported to management and audit committees
- Firm leaders should provide partners with greater support in handling often-difficult discussions with audit committees and senior management in this area. Firm leadership should consider providing partners with additional training on how to manage difficult discussions with reporting issuers without compromising the quality of audits
- Firms should conduct an independent pre-issuance accounting and disclosure review of high-risk reporting issuer financial statements by risk and accounting specialists

Other findings

In the course of its reviews, CPAB also found:

- Two audit engagements were not conducted in accordance with generally accepted auditing standards (GAAS), in that there were a number of serious GAAS deficiencies. There were also a number of engagements where improvements in the audit approach were needed to comply fully with GAAS.
- The financial statements for one engagement were not in accordance with generally accepted accounting principles (GAAP). For a few others there were potential restatements (depending on the results of additional audit work).

Regional and Local Firms

Inspections of regional and local firms

CPAB's 2009 inspections implemented a new approach designed specifically for Regional and Local firms. These firms operate in a different environment than larger firms and generally have less complex systems of quality control. This new approach allowed CPAB to review a broader range of audits, add more value from its findings and reduce the costs of reviewing Regional and Local firms.

CPAB's focus in its inspections of Regional and Local firms continued to be on engagement performance. However, for recurring inspections CPAB limited its testing of quality control elements to situations in which previous issues were identified and/or where the firm has made significant changes to its processes. For new inspections, CPAB spent more time assessing the firm's quality controls. Once again, the approach was risk-based.

Overview

CPAB inspected 28 Regional and Local firms in 2009, of which 15 were first-time inspections. CPAB also performed 19 follow-up inspections. In aggregate, CPAB reviewed 94 audit engagement files.

As indicated above, the change in approach to Regional and Local firm inspections enabled CPAB to increase the number of firms inspected. Fewer audit engagement files were inspected than in past years, due to the fact that CPAB selected more complex and higher-risk engagement files in 2009.

Major Issues Identified

Many of the major issues CPAB identified in its inspections of the National firms were also identified in its inspections of Regional and Local firms, including:

- Enhancing the role of the Engagement Quality Control Reviewer
- Evaluation of unadjusted audit differences
- Enhancing transparency in communications to audit committees and in financial statement disclosures

CPAB's recommendations on how the Regional and Local firms should address these issues were similar to its recommendations to the National firms, which are summarized earlier in this report.

CPAB also noted two additional major issues with respect to Regional and Local firms.

Audit Planning for Non-routine Transactions

While firms appear to be comfortable dealing with recurring or routine transactions, they often struggle with non-routine transactions that are outside their comfort zone. Firm methodologies tended to focus on recurring transactions, with less planning and fewer resources brought to bear on non-routine transactions. Examples of non-routine transactions that firms had difficulty with included:

- Revenue recognition with multiple deliverables
- Audit work on impairments of long-lived assets
- Bifurcation of convertible debt
- Stock-based compensation
- Audit work on asset retirement obligations
- Recognition and measurement of future income tax assets

CPAB found that firms were generally able to handle the audits of clients with no operating revenues, such as development-stage enterprises (even though the need to address potential impairment was often not adequately evidenced in the file). However, where there were revenues to be audited, CPAB noted the firms' discomfort with auditing revenues, particularly as it related to reliance on internal controls. In many instances, the firms reverted to an entirely substantive-based approach, with no reliance on controls. CPAB found the extent of testing to be insufficient and the quality of analytical review procedures to be too superficial to provide adequate audit assurance. CPAB believes that a combination of reliance on internal controls and substantive procedures would have been a more efficient and effective audit approach.

CPAB recommended that firms enhance their audit planning for non-routine transactions, in order to design more robust audit procedures and, therefore, increase the level of audit assurance.

Client Documentation of Complex Transactions

CPAB noted instances in which the reporting issuer did not adequately document the basis of accounting for complex transactions, which resulted in the audit firm having to perform a significant portion of the analysis and research to determine the appropriate accounting. CPAB believes the auditor's role is to audit the work done by the reporting issuer, not carry out the supporting work.

CPAB recommended that firms enhance their audit planning to ensure that the client completes the necessary analysis and research to support the accounting for more complex transactions in advance of the audit. In a similar vein, it would also be prudent for auditors to ask their clients to perform the necessary analysis when dealing with potential impairments of long-lived assets, rather than leaving this to the auditor. Such measures would also reduce the risk of compromising auditor independence.

Other findings

In the course of its reviews, CPAB also found:

- Five audit engagements were not conducted in accordance with GAAS. In addition, there were a number where improvements in the audit approach were needed to comply fully with GAAS.
- The financial statements for two engagements were not in accordance with GAAP. For a few other engagements, there were potential restatements (depending on the results of additional audit work).

Disciplinary Action

As a result of its 2009 inspections, CPAB placed a requirement on two firms, a significant decrease from previous years. As well, six firms that had requirements placed on them as a result of CPAB's 2008 inspections had follow-up inspections in 2009 that resulted in CPAB lifting the requirements.

Audit Challenges Ahead

As indicated above, CPAB's 2009 inspections of firms that audit reporting issuers indicate that the state of auditing in Canada is sound.

Looking ahead however, CPAB is concerned about a number of challenges that have the potential to negatively affect audit quality, such as the ongoing weak economic environment, undue pressure on audit firms to reduce fees, pressure on partners to generate more revenues, and the upcoming transition to IFRS and new CASs.

CPAB urges audit firms to maintain their focus on high-quality audits as they deal with these issues, which are discussed in more detail below.

Global Economic Downturn

The tough economic environment will continue to pose significant challenges for auditors, management, boards and audit committees for their 2009 financial statements. The audit risks that exist today are very similar to the audit risks that existed in late 2008, and some companies may be facing even greater challenges today than they were for 2008 financial statement audits. For example, a company may have had a term of 18 months remaining on its debt at December 31, 2008, which is now only six months as at December 31, 2009. This may require additional audit work with respect to assessing going concern, if there are refinancing issues.

As it did in early 2009, CPAB met with the leadership of the Big Four firms in early 2010 to assess their preparations to deal with audit risks arising from the ongoing challenging economic environment.

While the Big Four firms developed and implemented effective processes and guidance last year for their audit engagement teams to consider in response to the business and financial reporting risks caused by the global economic downturn, CPAB believes the firms must continue to be vigilant. Their processes and guidance must continue to evolve to address these ongoing and changing risks. The ongoing economic challenges will also influence CPAB's 2010 inspection approach, in that its 2010 inspections will continue to focus on areas most affected by the downturn and on audit work related to those areas.

Pressure on Audit Firms

Tough market conditions have forced many businesses to look for ways to reduce costs. CPAB has heard of several instances in which audit committees are pressuring firms to significantly reduce their audit fees. At the same time, audit firms are under increased pressure to generate revenues.

CPAB is concerned that these pressures on audit firms may create an environment that could cause the firms to lose their focus on audit quality. The potential risks to audit quality include inappropriate reductions to the extent of audit procedures in order to achieve cost savings and/or placing additional demands on audit engagement teams. As well, any reductions in firm investments in training, recruitment or audit systems are likely to negatively affect audit quality. Finally, any change in the firms' tone at the top that reduces the emphasis on audit quality poses significant risks. CPAB is pleased to note that, in its discussions with the leadership of the Big Four firms, it did not find evidence of any intention to lose focus on audit quality.

CPAB has learned that certain audit committees are pressuring firms to significantly reduce audit fees. This stance may be incompatible with the audit committees' important role in oversight, corporate governance and in helping to ensure the integrity of financial reporting. There will always be negotiations between audit firms and audit committees regarding what constitutes appropriate and fair audit fees, however, given that one of an audit committee's key priorities should be obtaining high quality auditing services, CPAB believes audit committees should not focus solely on fees or place unreasonable pressure on audit firms to arbitrarily reduce them.

While CPAB has yet to find evidence of a loss of focus on audit quality due to the pressure on firms, it remains concerned that this may become an issue in the future. CPAB is not alone in these concerns; the issue has also been raised in the United States and Europe and has been the subject of discussion among members of IFIAR.

International Financial Reporting Standards (IFRS)

IFRS takes effect in Canada for fiscal years beginning on or after January 1, 2011. IFRS is the biggest change to financial reporting in Canada in recent history, and CPAB believes companies should view the transition to IFRS as a strategic opportunity to improve their financial reporting.

While conversion to IFRS brings both risks and opportunities for companies, CPAB believes it creates opportunities for them to identify and select options that most faithfully represent their financial results and position.

To encourage companies and auditors to be proactive and to view the transition to IFRS as a strategic opportunity, CPAB and the Accounting Standards Board (AcSB) hosted a webcast on November 5, 2009³. The webcast focused on what small and mid-sized companies should be doing to ensure an effective and smooth transition to IFRS.

The webcast also outlined CPAB's expectations of audit firms in the transition to IFRS. CPAB expects firms to have technical competence in IFRS. This means firms should:

- Provide appropriate and timely technical training to their professional staff
- Develop or obtain guidance materials and tools such as financial statement disclosure checklists and IFRS 1 implementation guidance to be applied when providing assurance on IFRS financial statements
- Monitor changes in standards and assess the impact on their IFRS assignments, guidance materials and technical training
- Spread the workload, in order to avoid having to audit three IFRS balance sheets in early 2012
- Map out how they will respond to client requests for reviews of first-quarter 2011 interim financial statements under IFRS
- Revisit their tolerance for disclosure deficiencies, given the increased prominence of disclosures under IFRS
- Engage in timely dialogue with clients on issues relating to IFRS
- Consider independence issues when providing IFRS services to their audit clients

First-time adoption of IFRS creates a heightened audit risk and the audit approach must respond to those risks. CPAB urges the firms to develop consultation resources and networks to assist with IFRS conversion issues. A number of resources and tools exists to assist companies and audit firms with the conversion to IFRS, including the International Accounting Standards Board (IASB) website, www.iasb.org, the Canadian Institute of Chartered Accountants (CICA) IFRS Standards in Transition website, www.cica.ca/transition/, the AcSB website, www.acsbcanada.org, publications from the major accounting firms, industry group resources and guidance issued by the CICA Task Force on Assurance Implications of the Changeover to IFRS.

New Canadian Auditing Standards (CASs)

Canada is adopting International Standards on Auditing (ISA) as CASs. When effective, the CASs will constitute Canadian GAAS. The CASs take effect earlier than IFRS, in that they apply to audits of financial statements for periods ending on or after December 14, 2010.

Designed to facilitate high-quality audits, the CASs increase the emphasis on risk assessment and will help ensure that auditors are responsive to risks in the audit.

³ To listen to the webcast, visit CPAB's website at www.cpab-ccrc.ca

While there is significant overlap between the current and new standards, certain new standards will present challenges and auditors will be required to perform new procedures. For example, the new standards require:

- Changes to the structure and wording of the auditor's report (CAS 700)
- Changes in the requirements for group audits (CAS 600; see below for additional details)
- Detailed risk assessment procedures and performance of additional procedures for any related-party transactions outside the normal course of business (CAS 550)
- A more extensive risk assessment to be performed on accounting estimates, including auditor review of the outcome of past estimates (CAS 540)
- Increased evaluation of when to use an auditor's expert (CAS 620)

Group Audits

CAS 600 changes the requirements for group audits.

Under the existing standard, audits of group financial statements are based on the concept of reliance on another auditor. CPAB has found this to be an area that was in need of a better standard, and CAS 600 is certainly an improvement. The new standard addresses using the work of another auditor, which results in a very different approach to the co-ordination and communication between the group and component auditors. The key objective for a group auditor under CAS 600 is to obtain sufficient appropriate audit evidence regarding the financial information of components and the consolidation process to express an opinion on the group financial statements.

CAS 600 broadens the definition of component auditors, meaning more engagements will fall within its scope. The new standard will also require greater evidence of the involvement of the group auditor in the risk assessment, planning and performance of the component auditor.

Group auditors will be required by the new standard to identify significant components, based on both financial significance and risk to the group, with specific required procedures for each significant component. CAS 600 also includes required procedures related to group-wide controls and the consolidation process.

A number of the new CASs will lead to significant change in audit practice. Planning for December 31, 2010 financial statement audits may need to begin as early as the spring of 2010, and CPAB urges firms to undertake training on a timely basis. CPAB also encourages firms to map their existing policies and procedures against the new standards in order to identify and address any gaps.

To help public accounting firms prepare for the adoption of the new CASs, CPAB and the Auditing and Assurance Standards Board (AASB) are co-hosting a webcast on May 6, 2010.

The webcast will identify some of the key considerations that auditors need to address in their transition to the CASs, including how they can use the transition as an opportunity to improve the effectiveness of the audit process. It will also stress the need to apply a

strategic approach to CAS implementation to ensure that the transition is as smooth and efficient as possible.

Fair Value Measurements

Fair value determinations are challenging for preparers and auditors. This is a complex area and valuations experts will be critical to the 2009 financial statement audits, just as they were for 2008 financial statement audits. The level of imprecision in fair value determinations can often be multiples of materiality and it is important that financial statement disclosure and reporting to audit committees are transparent in this area.

CPAB is also concerned that Fair Value Measurement may provide preparers of financial statements with an opportunity to manipulate earnings through the use of assumptions that may be difficult to audit with a reasonable degree of assurance. Auditors should be alert to the risk of management bias and fraud risk when performing audits and should incorporate unpredictability into their audit approach in response to fraud risks.

CPAB Priorities for 2010

CPAB's 2010 priorities flow out of its new strategic plan and operational plan, which its Board adopted in late 2009 (the strategic plan is available on CPAB's website at www.cpab-ccrc.ca). This public report outlines in further detail four of CPAB's key priorities for 2010:

- Enhancing its risk assessment processes
- Changes in approach to the 2010 inspections
- Achieving legislation in all Canadian jurisdictions
- Continuing to build international partnerships

Risk Assessment

CPAB spends considerable time assessing the risk inherent in the inspection population.

This process begins with the participating audit firms' reporting issuer audit client lists. CPAB identifies high-risk engagements, using several external databases. High-risk engagements identified by CPAB are compared with the firms' high-risk lists and differences are investigated. Firms with high-risk engagements in relation to the size of their practice are likely to be selected for inspection.

Once the engagement files are chosen, CPAB conducts a detailed assessment of the financial statements and related public information to decide which specific audit risks within the financial statements will be the subject of CPAB's focused review.

As noted earlier in this report, CPAB's 2009 inspections noted that a number of Regional and Local firms were auditing clients that did not appear to be within the firm's comfort zone.

CPAB is continually refining and updating its risk processes. In 2010 it will continue to compare the risk within the inspection population to the proposed inspection coverage to ensure that inspection activities continue to be responsive to the risk exposures.

Change in Approach to 2010 Inspections

The challenging economic environment will affect the audits of 2009 financial statements. As mentioned above, CPAB will use its risk analysis processes to identify higher-risk firms and engagements.

As in 2009, CPAB's 2010 inspections will be focused reviews that drill deeply into the audit work in high-risk areas such as valuations, going concern and impairments.

CPAB is also planning to conduct more inspections of Regional and Local firms, which up to now, have been inspected primarily by provincial regulatory authorities. CPAB is also planning to conduct inspections of some of its 96 foreign registrants.

In 2009, CPAB's inspections of the Big Four firms focused on larger, more complex engagements. In 2010, CPAB will also focus on smaller, high-risk reporting issuers that are audited by offices outside the major centres in Canada.

CPAB will inspect files of early adopters of IFRS and will monitor how the firms are assessing their clients' readiness for conversion to IFRS. It will also monitor the firms' adoption of the new CASs.

CPAB is revamping its inspection methodology to accommodate IFRS and the new CASs in its 2011-2012 inspections. This will include a review of an appropriate software platform to handle future inspection activities.

Legislation

CPAB continues to seek legislation in all Canadian provinces and territories to give it the powers and protection it needs to fulfill its mandate. To the greatest degree possible, CPAB needs legislative consistency and uniformity, such that CPAB, audit firms and reporting issuers understand the rules under which CPAB operates.

CPAB is seeking four main provisions in such legislation:

- Recognition as an auditor oversight body
- Immunity—so long as CPAB acts within its authority and in good faith
- Protection from being compelled to provide specific information concerning the information it receives or generates
- The ability to review client materials in an auditor's working papers that are the subject of a client claim of solicitor-client privilege

Legislation in place to date includes Bill 7 in Québec, introduced in 2006, and the *Canadian Public Accountability Board Act (Ontario)*, which became effective June 30, 2009. British Columbia has amended its Securities Act in respect of CPAB, but the

amendments are not yet in force. Québec has passed Bill 74, which amends its Securities Act in respect of “an auditor oversight body”, but the amendments are also not yet in force. Other jurisdictions are considering the introduction of their own CPAB legislation.

Privilege

As mentioned above, CPAB continues to seek access in all provinces and territories to materials in audit firms’ working papers that are the subject of client claims of solicitor-client privilege. In its 2009 inspections, CPAB was once again denied access to certain materials because of claims of privilege.

CPAB’s counterpart audit regulators in the United States (US) and the United Kingdom (UK) have access to privileged information. When CPAB and its US counterpart—the Public Company Accounting Oversight Board (PCAOB)—conduct joint inspections, even in Canada, the PCAOB has the right to access privileged information and, in many instances, CPAB does not. This complicates the joint inspection process.

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

Disclosure of privileged information to CPAB under the CPAB Act in Ontario does not constitute a waiver or negation of privilege, and a clear duty of confidentiality is imposed on CPAB and all its directors, governors, employees and agents. CPAB wants privilege to be clearly protected by legislation in all Canadian provinces and territories to ensure that privilege is protected—and extended.

Partnerships

CPAB actively consults and collaborates with other regulators—in Canada and around the world—on how these bodies can work together more effectively to enhance audit quality and protect the public interest.

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

CPAB’s Chair Nick Le Pan currently chairs the Global Public Policy Committee, which includes representatives of the six largest international accounting networks and which focuses on policy issues affecting the accounting profession.

CPAB is working with other regulators around the world to get to the point where they can place reliance on each other’s work. Again, a key issue relates to confidentiality and what information CPAB can share with other regulators.

The European Union (EU) recently approved CPAB equivalency, meaning EU Member States can conclude bilateral agreements with CPAB on the exchange of audit working papers. CPAB is also pursuing an equivalency structure with Japan.

CPAB already has a bilateral agreement in place with the UK's Financial Reporting Council regarding the sharing of reports, and is currently working on similar agreements with the Netherlands, Norway and Germany.

CPAB's main international partnership is with the US PCAOB. CPAB enjoys an excellent working relationship with PCAOB and has been performing joint inspections with it since 2004. During 2009 CPAB carried out 15 joint inspections with the PCAOB.

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

Conclusion

While the state of auditing in Canada is sound, CPAB's 2009 inspections did identify a number of issues that must be addressed.

In this public report, CPAB has identified the major areas requiring improvement, such as enhancing the role of the Engagement Quality Control Reviewer, improving the evaluation of unadjusted audit errors and enhancing transparency in communications to audit committees and in financial statements. It has also, for the first time, highlighted in its inspection reports the top three to five recommendations that will have the greatest impact on improving audit quality, including suggestions of ways to implement the recommendations. CPAB believes that if the firms follow up appropriately on the major areas identified, many of the issues it has noted in its inspections would be addressed.

Many challenges lie ahead for audit firms and their reporting issuers, including the ongoing economic challenges, pressure on firms to reduce fees, and the transition to new standards. CPAB urges firms to maintain their focus on audit quality in the face of these pressures, and to be proactive to ensure that adequate training and other resources are in place to deal with them on a timely basis.

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

Appendix A: Scope of the 2009 Inspection Program

During 2009, CPAB inspected 53 firms, and reviewed 212 audit engagements, as follows:

	Number of Firms	Number of Engagements
National Firms	6	118
Other Firms – Recurring inspections	28	75
– Follow-up inspections	19	19
Total	53	212

CPAB's change in approach to Regional and Local firm inspections for 2009 increased the number of Regional and Local firms inspected from 36 in 2008 to 47 in 2009.

In addition, provincial professional accounting bodies inspected 67 firms that audit reporting issuers. This report does not cover the findings from their inspections.

Appendix B: Background on CPAB

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.

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, 2009, 198 Canadian accounting firms and 96 foreign accounting firms had completed the registration process, signed Participation Agreements with CPAB, became and continue to be participating audit firms. Since CPAB commenced operations in 2003, more than 122 accounting firms that initially registered have subsequently withdrawn their registration (approximately eight per cent of these were for merger reasons).

The seven 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 about 3,800 entities that are public companies or other reporting issuers in Canada, representing about 55 per cent of the

total market by number of clients and, CPAB estimates, more than 92 per cent if measured by market capitalization.

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, the majority of firms registered with the PCAOB are inspected. During the past six years, CPAB has inspected each of the National firms six times. CPAB has inspected each of the firms that audit more than 50 reporting issuers at least three times in this period and the majority have been inspected four times. 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 reporting issuers in Canada.