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Enhancing Audit Quality

**Report on the 2010 Inspections of the
Quality of Audits
Conducted by Public Accounting Firms**

Subject to the

**CANADIAN PUBLIC ACCOUNTABILITY BOARD
OVERSIGHT PROGRAM
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Enhancing Audit Quality

Audits play a critical role in ensuring the integrity of financial reporting which, in turn, is crucial to the effective operation of our capital markets. High-quality audits mean investors and other stakeholders can have confidence in the integrity of financial statements issued by public companies in Canada.

An effective regulator, promoting high-quality auditing

The Canadian Public Accountability Board (CPAB) delivers value through world class audit regulation. CPAB promotes high-quality auditing of public companies through its inspection of firms that audit reporting issuers in Canada. Annually, CPAB inspects all firms that audit more than 100 reporting issuers, representing 99.5 per cent of the total market if measured by market capitalization. There are now 15 firms in this category. CPAB also regularly inspects firms that audit fewer than 100 reporting issuers. These firms account for \$6.9 billion, measured by market capitalization. CPAB's inspections are designed to determine that the audit firm's quality control processes are operating soundly. Using a risk-based approach, CPAB inspections focus on higher-risk audit engagements.

Since its incorporation in 2003, CPAB has issued seven annual Public Reports on its inspection results. The first five Public Reports summarized inspection findings. Two years ago, CPAB changed its approach to focus on the root causes of audit deficiencies and to highlight the key recommendations that, if implemented, would have the greatest impact on improving audit quality.

In the past year, CPAB has enhanced its risk assessment capabilities. The organization now uses a more robust risk analysis process to identify higher-risk firms and audit engagements, improving the effectiveness of its inspections. CPAB has also increased the frequency of its inspections of firms that audit fewer than 100 reporting issuers.

The state of auditing in Canada

2010 inspection results show little improvement, though audit quality is generally sound

In the seven years that CPAB has been conducting inspections, the organization has seen numerous examples of high-quality audit work. Many firms have significantly improved audit quality by implementing CPAB's recommendations while others have undertaken their own initiatives to improve audit quality. Overall, CPAB believes that audit quality in Canada continues to be sound.

In general, investors can have confidence in the integrity of public company financial statements that have been audited in Canada. In particular, audit quality is generally sound for the major audit firms' largest and most complex clients. But audit quality is not uniformly high across all engagements in all firms, and, even for major firms, there can be occasional lapses that result in reduced quality.

Similarly, smaller and mid-sized audit firms with focused engagement clientele in sectors that they fully understand also demonstrated sound audit quality in engagements

reviewed by CPAB. Audit quality issues for these firms are more likely to arise in instances where they either audit very few public companies or else undertake audits of reporting issuers outside their comfort zone. This can also happen in major firms where certain offices or partners may, on occasion, deal with audits that pose complexities they do not regularly encounter.

CPAB believes that public company auditors in Canada should strive for continuous improvement in audit quality. However, overall, CPAB saw little improvement in audit quality from 2009.

While audit work was generally sound, CPAB's 2010 inspections found examples, in firms of all sizes, of inadequate audit work, ineffective engagement supervision and review, a lack of professional skepticism and working papers that did not fully describe the nature and extent of the audit work carried out. CPAB also found several instances of poor or non-existent communication with Audit Committees. CPAB's more serious findings led to additional audit work being required on some files and to a number of restatements of financial statements.

CPAB's 2010 inspection findings are cause for concern, given the potentially serious implications of any reduction in audit firms' commitment to the continuous improvement of audit quality. While many firms' performance is sound, overall CPAB finds too many audit deficiencies and more than it would see if firms uniformly had a commitment to zero tolerance for audit deficiencies.

While CPAB recognizes that these deficiencies do not always result in the reissuing of a financial statement, the risk of a restatement is there.

CPAB is concerned that some firms simply react to CPAB's annual findings and recommendations instead of striving for continuous improvement by proactively implementing measures to enhance audit quality.

CPAB believes that audit firms need to consider its recommendations in light of their own commitment to audit quality, and to take the steps necessary to rigorously focus on continuous improvement in this area.

Audit firms' perceptions

An external survey of audit partners conducted on CPAB's behalf in 2010 indicates that firm partners believe audit quality is uniformly high. However, CPAB observes, based on its inspections of over 230 audit files in 2010, that audit quality could still be improved. While CPAB believes that audit quality may be sound across a wide range of engagements, this should not foster complacency relating to audit quality. Increasing complexity in financial reporting, the transition to international standards, and CPAB findings suggest that more commitment to audit quality is required by some firms, not less.

A Zero Tolerance Approach

The integrity of financial reporting, which is key to protecting investors in our capital markets, demands an attitude and approach dedicated to the continuous improvement of audit quality and a commitment on the part of audit firms to move to zero tolerance for audit deficiencies. Some firm leaders appear to be willing to accept audit deficiencies rather than adopt a zero tolerance attitude and approach. In this context, zero tolerance exemplifies a firm's commitment to excellence. It embodies a firm's determination to build in the policies, programs and methodologies required to drive changes in behaviour that result in the continuous improvement of audit quality. Some audit firms have adopted this approach uniformly, but most have not. CPAB strongly believes that all firms must embrace a commitment to zero tolerance as the cornerstone of their ongoing efforts to improve audit quality. This approach does not mean there will never be audit problems. But it greatly reduces the likelihood that they will occur.

A commitment to audit quality

CPAB encourages the leadership of audit firms to demonstrate a greater commitment to audit quality. This is a longer-term goal that requires ongoing attention and effort.

Firm leadership should make sure they are setting the appropriate tone at the top by making audit quality a priority, delivering the right messages and providing adequate resources to support their audit practices. CPAB sees this happening in many firms, but not in all firms.

CPAB urges firm leadership to ensure the audit practice continuously builds behaviours into their processes that will improve audit quality. This means going beyond the form of auditing standards to implement practices that address their spirit and intent, which will enhance audit quality. It includes enhanced engagement supervision and review, more coaching, mentoring and real-time reviews, better quality monitoring and improved communications with Audit Committees. This could also include making the Engagement Quality Control Reviewer (EQCR), also known as second partner review, more accountable. This would be added insurance that no significant audit deficiencies are overlooked due to an ineffective EQCR review. CPAB believes relating accountability to partner compensation would go a long way toward achieving the appropriate behaviour.

Enhancing engagement supervision and review

As stated in past Public Reports, CPAB believes there should be greater partner and EQCR involvement in the supervision and review of audit work carried out by engagement teams. Typically, the engagement partner and the EQCR are the most experienced professionals involved with the audit. Their knowledge and expertise can only be brought to bear if they are effectively engaged and involved in the audit. However, in a few instances the EQCR appeared to be only tangentially involved in the engagement.

CPAB believes that enhancing engagement supervision and review is essential to improving audit quality. Most of the significant audit deficiencies noted in CPAB's inspections would likely not have occurred had there been greater and more timely involvement by the engagement partner and the EQCR.

CPAB believes the additional cost of greater partner and EQCR involvement would be more than offset by efficiencies achieved by the engagement team as a result of better coaching and real-time reviews designed to help ensure the audit was appropriately responsive to significant risks. In addition, investments in coaching would have beneficial effects on other audit engagements. These investments by the firms would be added insurance against significant audit deficiencies and would therefore provide added value to investors and the public.

Involvement of senior engagement personnel

Greater supervision and review by senior engagement personnel would address many of CPAB's concerns, including the lack of professional skepticism observed in the 2010 inspections. Senior practitioners can bring a stronger element of professional skepticism to the audit and are better able to identify where audit evidence is inadequate, especially in high-risk areas. Furthermore, it is only through exposure to these senior practitioners that less experienced staff can understand how to effectively address significant audit risks.

Coaching, mentoring and real-time reviews

CPAB encourages senior personnel to be more engaged in the audit process and to better coach and mentor their staff by completing real-time file reviews. This is even more important in smaller firms, which often lack the review processes that exist in large firms.

Real-time coaching and mentoring are more effective ways to enhance audit quality than either web-based or even face-to-face training sessions. CPAB urges firms to introduce coaching sessions for higher-risk engagements and to implement ongoing quality reviews of audits by assigned coaches throughout the audit process.

Strengthening the role of the EQCR

CPAB urges firms to strengthen the role of the EQCR by enhancing their accountability. The EQCR should be accountable for significant audit deficiencies in areas subject to their review if the maximum benefit from this level of oversight is to be achieved. Enhanced accountability of the EQCR does not replace the primary accountability of the engagement partner. However, the EQCR can play a significant role in improving audit quality by providing an alternative perspective on the resolution of major issues encountered by engagement teams. In many cases, CPAB's inspections highlighted the fact that the EQCR's involvement was neither substantive nor timely. EQCRs should experience consequences for poor quality audit work and, conversely, should be recognized and rewarded for good performance.

In the past, when CPAB recommended that the EQCR role be given a higher profile in the audit engagement, including providing better evidence of their involvement in reviewing high-risk sections of the file, some firms suggested that CPAB was setting new standards for the EQCR. This is not the case. CPAB simply wants the firms to be more effective in their implementation of the existing standard and to more clearly demonstrate how they have rigorously applied it in order to address its spirit and intent.

The new US EQCR standard

The US Public Company Accounting Oversight Board (PCAOB) has introduced a new standard—AS 7—that requires greater evidence of the EQCR's involvement in the audit engagement. Specifically, among other things, it requires the EQCR to provide concurring approval before the audit report can be issued.

Audit firms are required to apply AS 7 to the audits of Securities and Exchange Commission (SEC) registrants to comply with PCAOB auditing standards. CPAB believes applying AS 7 to audits of all reporting issuers would be a logical way to more rigorously apply the existing EQCR standard, which would enhance audit quality.

CPAB is aware that one annually inspected audit firm has adopted AS 7 for its public company audits in Canada. Another firm has made changes to its partner compensation model to place more accountability with the EQCR. CPAB commends the leadership shown by these firms.

Quality monitoring

Audit firms appear to be placing a great deal of reliance on their own internal monitoring programs (which are executed after the audit opinion and financial statements have been issued) to assess audit quality. However, given the number of deficiencies identified in its 2010 inspections, CPAB questions whether these internal programs are sufficiently robust. CPAB also wonders whether these programs may be concentrating more on the form than the substance of the processes. In addition, some smaller firms either do not monitor audit quality or do not do so in a timely manner. CPAB encourages firms to apply more rigour in their monitoring programs, with greater focus on the application of professional skepticism and the role of the EQCR.

Communications with Audit Committees

In its 2010 inspections, CPAB found numerous instances where higher-risk areas of audits were not adequately communicated to Audit Committees and where the associated financial statement disclosures lacked transparency. CPAB believes communications between firms and Audit Committees should improve, particularly during the current uncertain economic environment and in light of the increasing complexity of financial reporting. CPAB encourages firms to communicate to all staff the continued importance of engaging with Audit Committees as a means of improving the quality of audits.

Audit Committees can play a role in improving audit quality

CPAB encourages Audit Committees to raise the issue of audit quality with their auditors. A high-quality audit is an Audit Committee's best assurance that it is effectively executing its duties. For example, Audit Committees may want to ask their auditors about such issues as the application of professional skepticism and the role of the EQCR. Providing appropriate challenges to auditors and management is part of effective oversight.

Audit Committees may also want to consider the pressure being placed on firms to reduce audit fees, and what impact this pressure may have on audit quality and on

public confidence in the integrity of financial statements. The interests of shareholders are best served if an appropriate audit fee is paid — one that ensures the sustainability of audit quality.

The current business environment poses challenges to improving audit quality

As indicated above, CPAB encourages firms to demonstrate a greater commitment to audit quality. However, CPAB is concerned that the current business environment may not be conducive to enhancing audit quality.

Pressure to reduce audit fees

To support audit quality, firms need to continuously invest in recruiting, training and retaining senior, experienced audit staff. However, in some cases, firms are under intense pressure from certain existing clients and potential clients to reduce audit fees. In other cases, firms are offering artificially low fees to obtain new clients, which, over the longer term, is not sustainable. Audit Committees demanding lower fees need to be sure they understand the implications for the quality of the audit engagement, and should not arbitrarily pursue lower fees if they can't be justified.

Viewing the audit as a commodity, differentiated primarily based on price, has the potential to negatively affect audit quality. For example, the pressure on fees could mean, at least from an economic perspective, that firms may be inclined to place fewer experienced staff on an audit, devote fewer hours to that engagement and generally reduce investments in training, coaching and mentoring. Some firms may even be motivated to move some of the more routine audit work off-shore to lower-cost jurisdictions, further reducing learning opportunities for their local staff. Firms may also begin to place a higher priority on consulting and other non-audit services as sources of revenue growth. This could have the effect of making the audit a loss leader, which would not bode well for audit quality.

Canada's adoption of international standards creates additional challenges for auditors, particularly during the transition period. Increased fee pressure may lead to a reduction in audit effort at a time when increased effort is required.

CPAB is working with various stakeholders to enhance audit quality

Outreach activities

In addition to its ongoing inspection program, CPAB is meeting regularly with the leadership of audit firms and Audit Committees to discuss issues that are affecting, or have the potential to affect, audit quality. CPAB expanded its outreach activities in 2010, including organizing roundtables with Audit Committees, which helped identify areas in which CPAB could enhance its transparency and more effectively explain its role.

CPAB continues to work with all stakeholders, in Canada and around the world, on a wide variety of issues. CPAB has established regional offices in Eastern Canada and Western Canada to help build relationships, increase productivity and use its resources more effectively and efficiently.

Major Findings and Key Recommendations

CPAB's mission

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

CPAB achieves this mission by inspecting public accounting firms that audit reporting issuers in Canada and providing the firms with recommendations for improvement. The results of CPAB's inspections are communicated to the public in the form of an annual Public Report. This Report encompasses CPAB's 2010 inspections of the Big Four firms, other firms subject to annual inspection, and Regional and Local Firms.¹

2010 inspection approach

CPAB uses a number of risk analysis processes to identify higher-risk reporting issuer audits and allocates its inspection resources accordingly. The 2010 inspections comprised focused reviews that drilled deeply into the audit work in such high-risk areas as valuations, impairments, complex financial instruments, revenue recognition, income taxes and going concern.

In addition to evaluating engagement performance, CPAB reviews the other six elements of quality control, as set out in the Canadian Institute of Chartered Accountants (CICA) Handbook. These six areas, which are 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 of their application).

In the 2010 inspections of the Big Four firms, CPAB once again focused on larger, more complex engagements, and increased its emphasis on smaller, high-risk reporting issuers that were audited by offices outside the major centres in Canada.

CPAB also conducted more inspections of smaller firms, which up to now had been inspected primarily by provincial regulatory authorities.

In addition, CPAB inspected files of a sample of early adopters of International Financial Reporting Standards (IFRS), monitored firm readiness for IFRS and evaluated how the firms assessed their clients' readiness for conversion to IFRS. CPAB also assessed the firms' plans for adoption of the new Canadian Auditing Standards (CASs).

¹ Details of the scope of CPAB's 2010 inspection approach are contained in Appendix A.

As they did in 2009, CPAB's 2010 inspection reports to firms identified key recommendations to enhance audit quality.

This report summarizes the major findings from CPAB's 2010 inspections, including the issues and areas for improvement CPAB noted most often and that were identified at most, if not all, the firms inspected. It also summarizes the recommendations CPAB made to the firms to enhance audit quality.

Specific details of CPAB's findings are not published. CPAB issues a private report, which includes recommendations, to each firm inspected. Each recommendation requires a response from the firm within a prescribed period of time and CPAB follows up to ensure that its recommendations have been implemented. The firms have implemented, or are implementing, substantially all of the recommendations made in 2010.

Big Four Firms

Overview

CPAB's 2010 inspections of the Big Four firms² were risk-based, with increased emphasis on larger, more complex engagements. CPAB also focused on smaller, high-risk reporting issuers that were audited by offices outside the major centres in Canada and on partners who had not been previously inspected.

CPAB used several external databases to identify high-risk engagements and then compared the engagements identified to the firm's own lists and investigated any differences. Once the engagement files were chosen, CPAB conducted a review of the financial statements and related public information to decide which specific audit risks within the financial statements would be the subject of a focused review.

As a result of this approach, CPAB selected and examined a total of 120 audit engagement files.

Major Issues Identified

CPAB saw many examples of high-quality audit work by the Big Four firms in the files reviewed in 2010.

However, there continues to be room for improvement. In particular, a disproportionately high number of the more serious audit file deficiencies occurred in the smaller offices and in the files of partners CPAB inspected for the first time.

The major recurring issues and areas for improvement that CPAB noted most often in 2010 are summarized below. Also included are certain of the recommendations CPAB made to the Big Four firms to address these issues.

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 represents about 92 per cent if measured by market capitalization.

Lack of engagement supervision and review

Engagement supervision and review by the engagement partner and the EQCR are critical elements of quality control and a major contributor to audit quality. Senior engagement personnel are able to bring a stronger element of professional skepticism to the audit and should be able to identify areas where audit evidence is inadequate, especially in high-risk areas.

To perform an effective quality control review, the EQCR needs to substantively challenge the resolution of significant accounting and auditing issues and review relevant documentation in the engagement file. The EQCR should also document, in sufficient detail, the work performed and the work papers reviewed.

In the Public Report on its 2009 inspections, CPAB stressed the need to enhance the role of the EQCR. Although isolated improvements have been made, this area still requires more attention by most firms.

Findings

CPAB found that the EQCR often has either too little involvement in the engagement or is brought in too late in the process. Specifically, CPAB found instances where there was little or no evidence of EQCR involvement at the planning stage. In these engagements, CPAB identified significant deficiencies and inconsistencies in the audit plans that the EQCR should have challenged.

CPAB Recommendations

CPAB believes that improved engagement supervision and review is essential to enhancing audit quality. Many of the audit deficiencies CPAB identified in its inspections would likely have been avoided if the engagement partner and EQCR had been more involved.

Enhanced supervision and review by senior engagement personnel would go a long way toward addressing many of CPAB's concerns, including lack of professional skepticism.

CPAB urges senior personnel to be more engaged in the audit process and to coach and mentor the audit staff by conducting real-time file reviews.

Real-time coaching and mentoring should supplement training initiatives to enhance audit quality. CPAB believes the widespread move to web-based training from face-to-face training has diminished some of the training's benefits. CPAB urges firms to conduct coaching sessions for higher-risk engagements and to implement ongoing quality reviews of audits by assigned coaches throughout the audit.

As it has in past Public Reports, CPAB advocates a stronger role for the EQCRs. The EQCR should have both a greater responsibility and a greater accountability to ensure the most benefit is derived from this level of oversight. The EQCR should play a significant role in achieving audit quality by providing an alternative perspective on the resolution of major issues encountered by engagement teams.

The US PCAOB has introduced a new standard—AS 7—that requires greater evidence of the EQCR’s involvement in the audit engagement. It also increases the accountability of the EQCR by having the EQCR provide concurring approval for the release of the audit report.

Audit firms are required to apply AS 7 to the audits of SEC registrants to comply with PCAOB auditing standards. CPAB believes applying AS 7 to audits of all reporting issuers would be a logical way to more vigorously apply the existing EQCR standard, which would enhance audit quality.

CPAB is aware that one audit firm inspected annually has adopted AS 7 for its public company audits in Canada. Another firm has made changes to its partner compensation model to place more accountability with the EQCR. CPAB commends this leadership on the part of these firms.

Lack of Application of Professional Skepticism

According to Generally Accepted Auditing Standards (GAAS), the application of professional skepticism means the auditor makes a critical assessment, with a questioning mind, of the sufficiency and appropriateness of audit evidence obtained, and is alert for evidence that contradicts or brings into question the reliability of documents or representations of management or those charged with governance. The application of professional skepticism is an integral part of an effective risk-based audit.

Findings

CPAB’s inspections noted a number of examples where the audit procedures could have been improved through the application of greater professional skepticism. Ongoing changes in accounting and auditing requirements, particularly the increased use of fair value measurements and the greater judgments involved in preparing financial statements, mean that professional skepticism, by all members of the engagement team, has become even more important for audit quality.

Additionally, due to its characteristics, the auditor’s attitude of professional skepticism is particularly important when considering the risks of misstatement due to fraud.

In the 2010 inspections, CPAB found several examples of overreliance on management representations. While some reliance on management is inherent in any audit, there is a higher risk of inappropriately reducing professional skepticism in instances where there is greater familiarity or comfort with the reporting issuer and its historical accounting policies and practices.

CPAB Recommendations

CPAB notes that the adoption of a more principles-based accounting framework under IFRS should increase the need for professional skepticism. To increase the emphasis on professional skepticism and improve audit quality, CPAB recommended that firms enhance the training, supervision, review and coaching of professionals in the exercise of professional skepticism.

This could include, among other things, a core training module specifically addressing professional skepticism with an emphasis on questioning, listening and probing skills. In addition, firms should provide staff with increased real-time coaching to ensure that senior engagement personnel emphasize the importance of professional skepticism during their field reviews and to provide support to staff to give them the self confidence to question significant areas of judgment.

Inadequate Substantive Analytical Procedures

Substantive analytical procedures can be an effective and efficient audit tool to help enhance audit quality. When using an analytical procedure as a substantive procedure, auditing standards require the auditor to consider the level of assurance and precision the procedure is intended to provide in the circumstances.

Findings

CPAB's inspections found several instances in which engagement teams did not effectively design or execute substantive analytical procedures. In some cases, auditors use analytical procedures to obtain a high degree of audit assurance, while in others they are supplementary to the primary audit procedures.

CPAB noted a number of examples where the engagement team did not set out their expectations of the analytical procedures and/or did not obtain corroboration of management's explanations for significant fluctuations identified as a result of the procedures. In executing the procedures, CPAB also found examples of computation errors. As a result, the auditor may not have achieved the desired high degree of assurance from analytical procedures.

CPAB Recommendations

To improve the quality of substantive analytical procedures, CPAB recommends that firms provide coaching in the appropriate use of substantive analytical procedures, including highlighting when such procedures should be used, the appropriate evidence that should be included in the audit file (at the planning and execution stages of the audit) and the determination of the predictive relationships and drivers that will ensure that the analytical procedures are effective. Senior engagement personnel, including the EQCR, should pay particular attention to the appropriate use of analytical procedures during their field reviews.

Insufficient or Inappropriate Audit Evidence

The importance of high-quality audit evidence cannot be overemphasized, given the fact that it demonstrates the engagement team has complied with GAAS. If reasons for significant audit decisions are not documented, it is very difficult for reviewers to conclude sufficient appropriate audit evidence has been obtained. Poor audit evidence also creates a reputational risk for firms in the event of litigation.

Findings

CPAB continues to find instances of insufficient or inappropriate audit evidence in working papers and, in almost all cases, this relates to significant risk areas of the audit.

CPAB found poorly described procedures, including inappropriate audit tests and conclusions that were not identified by firm review processes. CPAB also found instances where the details of essential audit procedures completed were not included in the engagement file.

CPAB Recommendations

Documentation continues to be a challenge for audit firms. While the nature and extent of documentation is often an area of judgment, CPAB believes the firms' leadership should communicate to partners and professional staff that there is zero tolerance for documentation deficiencies related to significant risk areas and key judgments exercised during the audit. To ensure sufficient and appropriate evidence exists in working papers, and to enhance audit quality, CPAB recommends that firms reinforce to their partners and professional staff the importance of applying appropriate rigour when completing and reviewing key working papers related to significant risk areas of the audit. They should continue to communicate the message that if it is not documented it is not done.

Lack of Communication with Audit Committees

GAAS requires the auditor to communicate with the Audit Committee both before and at the conclusion of an audit. The exchange before the audit is intended to engage the Committee in key audit planning decisions and solicit additional input from them with respect to areas of risk. The communication at the completion of the audit informs the Committee of the findings resulting from the execution of the audit plan. Open and transparent communication with the Audit Committee is an important way to enhance audit quality.

Findings

CPAB observed a number of instances where there was a lack of communication with Audit Committees and, in particular, a lack of transparency in the information the firms communicated to Audit Committees.

Specifically, important information was not communicated in written reports to the Audit Committee and frequently there was no evidence identifying key issues discussed.

CPAB Recommendations

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 enhances audit quality, particularly during the current uncertain economic environment and in light of the increasing complexity of financial reporting. This ongoing exchange should include communicating the auditor's views on key judgmental areas to the Audit Committee, a written record of the committee's responses, questions raised and feedback provided.

To improve communication with Audit Committees, CPAB recommends that firms reinforce to all audit professionals the importance of engaging with Audit Committees as

a means of improving the quality of audits. CPAB also recommends that the review of the nature and appropriateness of such communication be a key responsibility of the EQCR.

Other Firms Inspected Annually

Overview

In addition to the Big Four firms, CPAB inspected 11 other firms that audit more than 100 reporting issuers (Annual Firms). These inspections were also risk-based, with increased focus and emphasis on larger, more complex engagements.

CPAB inspected 57 audit engagement files for the Annual Firms.

Major Issues Identified

Many of the major issues CPAB identified in the inspections of the Big Four firms also applied to the Annual Firms. CPAB's recommendations on how the Annual Firms should address these issues were similar to its recommendations to the Big Four firms, which are summarized earlier in this report.

In addition, CPAB noted a few instances where the firms made inadequate risk assessment of audit areas and there was incomplete linkage to the audit work performed. In CPAB's opinion, had the risk assessments and audit responses been appropriately performed, the audit deficiencies would likely have been avoided. CPAB also noted a few instances where there was inadequate audit work on potential impairment of mineral properties, support for the recognition of future tax assets and reliance on other auditors. For a few Annual Firms, CPAB found a higher than expected number of significant GAAS deficiencies.

Reinforcing Messages on Audit Quality

CPAB recommended the senior leadership of Annual Firms strengthen their messages about audit quality. It is imperative that firm leadership interacts with partners who audit reporting issuers to set the appropriate tone, to reinforce messages about audit quality and to monitor progress. If audit quality is important to the firm leadership, it will be important to the reporting issuer engagement partner.

Lack of Resources Devoted to Audit Quality

CPAB also recommends that Annual Firms strengthen the resources devoted to audit quality in order to provide stronger technical support and oversight. With the increasing complexity of audit and accounting standards, it is important that firms have both the breadth and depth of resources needed to support engagement teams. Firms should conduct objective assessments of their current resources, including the current and future demand for specific technical skills, and prepare a gap analysis based on the results of these assessments. The firms should then prepare a plan to address these gaps in a timely manner.

Regional and Local Firms

Overview

CPAB inspected 25 Regional and Local Firms in 2010, of which 14 were first time inspections. As part of these inspections, CPAB examined 55 audit engagement files. In addition, CPAB performed 29 follow-up inspections to see whether the firms had appropriately implemented CPAB's 2009 recommendations.

Major Issues Identified

Many of the major issues CPAB identified in its inspections of the Big Four and Annual Firms were also evident in inspections of Regional and Local Firms.

CPAB's recommendations on how the Regional and Local Firms should address these issues are similar to the recommendations to the Big Four and Annual Firms, which are summarized earlier in this Report.

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

Missing Significant Issues/Completion Memos

Engagement teams should ensure that significant accounting and audit issues are sufficiently described and analyzed in issues/completion memos (or their equivalent). While the engagement team typically has a good understanding of an issue, it is often difficult for an independent reviewer to understand the issue and the engagement team's analysis from the evidence in the audit file. Without an appropriately detailed memo, there is a risk that an issue has not been properly addressed.

Findings

CPAB found a number of instances where the engagement team did not prepare memos to set out its understanding of significant transactions or significant issues. In some situations, relevant agreements or documents were not in the current year files and in some instances it appeared these documents or summaries were not in prior year audit files either.

As well, CPAB noted many instances in which the firms, rather than management, are preparing significant accounting issues memos, thus creating the threat of self-review.

The engagement partner and EQCR are critical to ensuring that these memos are prepared and included in the file. Although it is difficult to generalize regarding the amount of time that should be spent by engagement partners and EQCR partners to perform high-quality reviews, based on CPAB's findings it appears insufficient time is being spent on such reviews, with the result that not all required audit evidence is contained in the audit files.

CPAB Recommendations

To ensure significant issues memos and completion memos are being prepared, CPAB recommends that firms implement processes to ensure significant risk areas, the audit

approach and the results of the audit are summarized in a way that a reviewer can readily identify areas of significant risk and the related audit procedures performed to mitigate the risk. This would make significant issues memos and completion memos integral to the completion process and would also enable the EQCR to decide what specific sections of a file merit further, more detailed, review. In assessing the appropriateness of accounting treatments, it is particularly important that engagement teams perform adequate research and evidence consideration of alternative treatments and the basis to support resolution.

Lack of Consultation on Complex, Non-Routine Transactions

While Regional and Local 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.

Findings

CPAB noted instances in which the engagement team should have consulted on more complex non-routine transactions. In cases where there was a consultation, the documentation was not sufficient to enable a reviewer to understand the basis for conclusions.

CPAB Recommendations

To address this deficiency, CPAB recommends that firms increase the extent of their consultation on complex, non-routine transactions. They should also improve the documentation of consultations when they occur.

Current Environment

As mentioned above, CPAB has observed that there has been little improvement in audit quality over the past year. Furthermore, CPAB believes that the current business environment may not be conducive to improving audit quality, due to a number of factors, including fee pressure on firms, the uncertain economic outlook and the transition to new standards. CPAB urges audit firms to maintain their focus on high-quality audits as they address these issues, which are discussed in more detail below.

Pressure on Audit Firms

Audit fees

In recent years CPAB has seen greater fee pressures on auditors. In some cases, audit firms are being asked to significantly reduce their fees. In other cases, firms are offering artificially low fees to obtain new clients, which often puts pressure on the incumbent auditor to match the lower fee. These practices are not sustainable for the auditing profession and do not contribute to audit quality.

Viewing the audit as a commodity, differentiated primarily based on price, has the potential to negatively impact audit quality and the audit profession. Increasing complexity in financial reporting, the adoption of new auditing standards and the transition to IFRS suggests that more audit effort is required, not less. CPAB believes it is important to ensure that audit quality does not become a casualty of the pressure to reduce audit fees.

The demands that certain Audit Committees are putting on firms to reduce audit fees is also of concern to CPAB, given the Committees' important role in oversight, corporate governance and in helping to ensure the integrity of financial reporting. CPAB believes one of an Audit Committee's key priorities should be obtaining high-quality auditing services. A high-quality audit is an Audit Committee's best assurance that it is effectively executing its responsibilities.

Maintaining focus on audit quality

The difficult economic environment and increased audit fee pressure may also cause the larger firms to look to consulting and other fees as areas of revenue growth. Firm leadership should set the right tone at the top to address this challenging environment and to continue to make the necessary investment in audit quality.

CPAB is also concerned about the resources dedicated to the audit function by certain firms in certain locations. Specifically, the buoyant commodity industry in Western Canada is attracting senior staff away from public accounting firms. Shortages of qualified staff, coupled with fee pressures, may cause firms to reduce their investment in audit quality, including recruiting, training and retaining senior staff. Looking forward, in five to ten years, this could result in a shortage of senior, experienced auditors and audit managers who have a sufficient knowledge of business, auditing, accounting and tax. Furthermore, some firms are choosing to have certain more routine aspects of the audit done offshore, thereby depriving their own staff of the opportunity to learn. This too has the potential to adversely impact audit quality in the future, as staff will have been deprived of necessary learning opportunities.

Uncertain Economic Outlook

Increased potential for fraud

The uncertain economic environment continues to pose significant challenges for auditors, management, boards and Audit Committees in the preparation of their financial statements, which could lead to an increased potential for fraud. To respond to this, auditors should exercise appropriate professional skepticism in the performance of audits. This requires the auditor to obtain an understanding of the business, industry and related risks (including fraud risks related to revenue recognition) and to ensure the audit is responsive to those risks. This means more than just completing a fraud checklist. Engagement teams should ensure fraud risks identified at the brainstorming stage are adequately addressed in both the planning and in the execution of the audit.

New Standards

CASs

The new CASs, which constitute the biggest change to auditing standards in recent times, take effect for audits of financial statements for periods ending on or after December 14, 2010. The new standards should increase the rigour with which audits are performed. Many of the new requirements will impact all audits. CPAB expects firms to have technical competence in applying the new auditing standards, and assessing the implementation of the CASs will be a key area of focus for CPAB in its 2011 inspections. CPAB expects engagement partners and EQCRs will have greater involvement in audits in 2011 to ensure compliance with these new CASs.

CPAB and AASB webcast

In May 2010, CPAB and the Auditing and Assurance Standards Board (AASB) hosted a webcast that highlighted areas for focus as public accounting firms implement the new CASs. These included some of the more significant changes in requirements related to accounting estimates, group audits and communications with Audit Committees.

IFRS

IFRS take 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.

During 2010, CPAB interacted with audit firms, standard setters and securities regulators to monitor IFRS readiness across the country. CPAB was encouraged to hear that firms have been actively engaging their reporting issuer clients to assist with the transition. Firms have also been increasing their IFRS training to prepare for the transition in 2011. CPAB will continue to monitor the IFRS transition process in 2011 and will make this an area of focus in the 2012 inspections.

Disciplinary Actions

As a result of its 2010 inspections, CPAB placed requirements on three firms.

As well, requirements placed on two firms as a result of CPAB's 2009 inspections will remain in place, pending further follow-up reviews by CPAB.

CPAB Priorities for 2011

CPAB's 2011 priorities are described more fully in its strategic plan and operational plan, which the Board adopted in late 2009. This Public Report outlines in further detail the following five of CPAB's key priorities for 2011 to help enhance audit quality.

- Enhancing risk assessment processes
- Approach to the 2011 inspections
- Standards activities
- Continuing to build international partnerships
- Achieving legislation in all Canadian jurisdictions

Enhancing Risk Assessment Processes

In 2010, CPAB continued to enhance its risk assessment process for evaluating the relative risk profiles of Canadian reporting issuers.

CPAB undertook a complete review of the financial information and other factors used to assess the relative risk of reporting issuers. As a result of the review, CPAB increased the number of qualitative factors used to assess risk, upgraded data sources, increased coverage and redefined the quantitative factors used. CPAB now also validates core data through alternative sources.

CPAB's risk assessment process is designed to rank individual reporting issuers according to their relative risk score, compared to reporting issuers in the entire population and to reporting issuers within the same industry.

Higher-risk reporting issuers are those that may be at higher risk as a result of:

- Poor solvency or liquidity
- Operational issues or operations in high-risk countries
- Poor quality of earnings
- Poor quality of assets
- Financial indicators that are inconsistent with industry expectations
- Unproven business models
- Complex accounting transactions, and
- Other qualitative factors

In assessing the reporting issuer risk, CPAB considers the design and implementation of audit controls/factors at the audit firm and the operating effectiveness of these controls/factors over time.

For example, a reporting issuer audited by a firm with well-designed entity-wide quality controls over its audit processes and a history of effective operation of those controls will have a lower probability of being selected for inspection than a reporting issuer audited by a firm with poor or missing quality controls over its audit processes. As CPAB continues to develop a history of performance through the inspection process, it has become easier to assess the quality controls in place at various audit firms.

Reporting issuers are short-listed for possible inspection based on both CPAB's and the firm's risk assessment and on the results of prior years' inspections and coverage. The final selection is based on a review of financial statements, industry experience and expertise, results of the auditor's own risk ratings and other qualitative factors. Files may also be selected based on specific areas of focus identified by CPAB for that inspection year.

CPAB will continue to review and enhance its risk assessment process based on inspection results, availability of data and consideration of risk weightings.

Approach to 2011 Inspections

Risk analysis

CPAB allocates its resources to inspections based on risk. In 2011, CPAB will pay close attention to those reporting issuers where there were significant reductions in audit fees and to situations where a firm significantly outbid other firms to obtain the new audit client.

Selection of offices to inspect

In its 2010 inspections, CPAB noted a higher number of GAAS deficiencies in small and mid-market cap reporting issuers that were audited in offices outside of the major centres. In 2011, CPAB will again focus on this segment of the reporting issuer base. As well, CPAB will inspect audits led by a new partner or a partner who CPAB has not previously inspected.

In addition, CPAB will likely inspect more files at firms with resource constraints. These locations include Calgary and Vancouver where, as a result of market conditions, there is an increased demand for qualified professionals.

Monitoring the implementation of CASs

With the new CASs effective for December 31, 2010 year-end audits, CPAB will inspect how firms implemented these new standards, placing particular emphasis on those standards expected to have the most impact and be the most challenging, such as group audits, auditing accounting estimates, related-party transactions, laws and regulations and the new form of the auditor's report.

Desk inspections

In addition to its normal field inspections, in 2011, CPAB will conduct desk inspections for smaller practitioners. In this type of inspection, CPAB asks the firm to submit the audit files for selected reporting issuers to CPAB's regional office for inspection. This type of inspection is less disruptive to the firm and will generally focus solely on the quality of the audit, unless further inspection procedures are deemed necessary.

Highlighting key recommendations

In recent years, when its inspections identify deficiencies, CPAB has worked closely with the firms and engagement teams to identify the root cause of these deficiencies. CPAB will continue this practice and will also continue to identify the key recommendations that will have the greatest impact on improving audit quality.

Standards Activities

CPAB's 2010 work with audit firms, standard setters and securities regulators to monitor IFRS readiness and the transition to the new CASs is described earlier in this Report. In 2011, CPAB will continue to monitor IFRS transition. As noted above, assessing the implementation of CASs will be also a key area of focus for CPAB in its 2011 inspections.

Independence Standards Exposure Draft

During 2010, CPAB responded to the Independence Standards Exposure Draft and Consultation Paper. CPAB indicated that it would have concerns with any proposal to replace the existing Rules of Professional Conduct with the International Code of Ethics. In CPAB's view, the proposed adoption of the Code could lead to a significant weakening of the independence requirements in Canada, which is not in the public interest.

Responding to IAASB and IOSCO

In 2010 CPAB responded to International Auditing and Assurance Standards Board (IAASB) requests for comment related to auditing complex financial instruments and using the work of internal audit.

CPAB also responded to International Organization of Securities Commissions (IOSCO) consultation papers on transparency and auditor communications, and to the European Commission's Green Paper on Audit Policy.

CPAB commended the European Commission for bringing audit quality to the forefront of debate, and for engaging with stakeholders on the role of the audit and how audit quality can be further enhanced. The economic and business landscape is continually changing and it is important that the audit process evolves to keep pace with these changes and continues to provide value.

The financial crisis has led some stakeholders to question the value of the audit. To respond to this, auditors need to more effectively communicate the critical role played by the audit in sustaining capital markets. Auditors should also be looking beyond their comfort zone to identify areas where more value could be brought to the audit. In performing the audit, the auditor gains an in-depth understanding of the business and related systems and processes. This knowledge could be better utilized to bring greater value to users of financial statements. In its response, CPAB also commented on the

need for greater professional skepticism and for more forthright and transparent communication between auditors and Audit Committees, in order to improve audit quality.

CPAB's complete responses can be read at www.cpab-ccrc.ca.

IFIAR Standards Working Group

CPAB is a member of the International Forum of Independent Audit Regulators (IFIAR) Standards Working Group, which provides a forum for members to discuss standards implementation issues and to discuss proposed standards exposed for comment. CPAB is also a member of the IAASB Task Force on Audit Quality.

Outreach and Partnerships

Roundtable Discussions with Audit Committees

CPAB's 2010-12 strategic plan identifies the establishment of strong, productive stakeholder relationships as a critical success factor. In 2010, one of CPAB's key objectives was to build relationships with Audit Committees. To this end, CPAB participated in roundtable discussions with Audit Committees in Vancouver, Calgary, Toronto and Montréal. Hosted by participating audit firms, these roundtables were an excellent opportunity to discuss a variety of issues, including CPAB's role and activities, audit fees, relationships between auditors and Audit Committees, audit partner rotation and the financial literacy of Audit Committees.

During these roundtable discussions, it became clear that CPAB's role is not well understood by Audit Committees. A number of Audit Committee members requested a heightened level of communications and transparency from CPAB.

Meeting the Chief Accountants

In October, CPAB initiated its first formal meeting with the Canadian Securities Administrators Chief Accountants Committee. CPAB plans to meet quarterly with this group.

CPAB Performance Survey

To help CPAB understand its performance to date, and to help develop ways it can continue to drive value and meet its mandate, CPAB retained a professional market research firm to conduct a survey of registered audit firms. The purpose of the survey was to obtain feedback on a range of issues affecting the audit profession, but particularly on perceptions of the performance of CPAB. Specifically, the survey examined various aspects of the working relationship between CPAB and audit firms, from the firms' perspective.

Overall the survey results were positive, with 77 per cent of respondents believing that CPAB's performance as an effective regulator is high and indicating that this has increased in the past year. Respondents gave CPAB high ratings on professionalism,

communication during the inspection process, knowledge and technical competence of staff and on the opportunity for an audit firm to explain its position on an issue.

The survey responses confirm that CPAB is moving in the right direction, although more work needs to be done. The input received will help CPAB in its efforts to improve the effectiveness of the program of inspection and, ultimately, to ensure that CPAB's program of oversight contributes significantly to enhancing audit quality.

Enhanced Communications Activities

CPAB appreciates the feedback it has received from the Audit Committee roundtable discussions and from the firms via the survey. In 2011, CPAB will undertake research with certain of its other stakeholders. When this research is completed, CPAB will develop and implement a comprehensive program to enhance its communications and outreach to its stakeholders, including firms, Audit Committees, the investor community, government and other regulators.

Creation of Regional Offices

In 2010, CPAB established regional offices in Eastern Canada and Western Canada. In addition to providing direct access to CPAB staff in these regions, these offices have increased CPAB's productivity and permitted the organization to build relationships and use its resources more effectively and efficiently.

International Activities

CPAB's participation in IFIAR 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 has suggested that IFIAR consider proactively recruiting new members, given that a number of G20 countries are not IFIAR members.

At its September meeting IFIAR members discussed development of Core Principles for the Forum.

CPAB plays an active role in the Global Public Policy Committee (GPPC)/IFIAR Working Group. The Working Group, which includes members from the international networks of the largest auditing firms, as well as IFIAR members, has established a framework for discussing topics on audit quality, which are of interest to both the GPPC and IFIAR members.

CPAB continues to pursue a recognition agreement with the Japanese audit oversight body. A draft agreement prepared by the Japanese has been reviewed by CPAB and it is expected the agreement will move forward in 2011. CPAB is also in the process of entering into a memorandum of understanding with the audit regulator in Australia.

CPAB has also been helping the Cayman Islands and Bermuda establish an audit oversight body. CPAB has offered advice on draft legislation and draft regulations that have been prepared by their security commissions.

In October 2010, CPAB met in Washington with senior staff from the PCAOB. CPAB and PCAOB agreed to greater coordination of the 2011 inspections that are conducted jointly, including the Big Four firms, beginning with risk assessment, file selection and information requests. As part of this process, the nature and extent of the sharing of information between CPAB and PCAOB will be clearly defined. The result of this ongoing dialogue will be the signing of an updated memorandum of understanding that reflects a new information-sharing model in light of the *Dodd-Frank Act* in the United States.

Legislation

A robust regulatory framework is critical to CPAB's ability to perform as a strategic regulator

Ontario has passed legislation stating that CPAB, without breaking solicitor-client privilege, may require the provision of information or the production of documents that are, "the subject of solicitor-client privilege if access to the information or the documents is absolutely necessary to the purpose of the review of the audit." CPAB worked with audit firms in implementing the new legislation and appreciates their contribution. It is CPAB's view that access to privileged information in the audit working papers that supports the audit opinion is absolutely necessary to the purpose of the review of the audit. The "absolutely necessary" provision has worked very well in practice with CPAB's 2010 inspections, as CPAB obtained access to 100 per cent of the information needed to assess the quality of the audit process.

CPAB is in discussions with Québec to attain legislative amendments that would give CPAB access to privileged information in the auditor's working papers on the same "absolutely necessary" basis.

CPAB legislation is now in force in British Columbia. CPAB is working with the British Columbia Commission to finalize, in early 2011, recognition of CPAB as an auditor oversight body in that province.

CPAB has also been discussing CPAB legislation with other Canadian jurisdictions. Given the developments in Québec and British Columbia, CPAB anticipates that significant progress will be made in these other jurisdictions by late 2011 or early 2012.

Conclusion

CPAB believes that audit quality in Canada continues to be sound. However, CPAB is disappointed to note that the 2010 inspections showed no significant improvement in audit quality from the previous year.

In this Report, CPAB has identified the major areas where improvement would enhance audit quality. These include enhancing engagement supervision and review, enhancing the application of professional skepticism, improving substantive analytical procedures, providing sufficient audit evidence, improving communication with Audit Committees, preparing significant issues and completion memos and enhancing consultation on

complex, non-routine transactions. Furthermore, CPAB has highlighted the key recommendations that will have the greatest impact on improving audit quality. Action by the firms is necessary if audit quality is to continually improve.

Many challenges lie ahead for audit firms and reporting issuers, including, among others, the pressures being placed on audit firms due to the uncertain economic times and the transition to new standards.

CPAB urges firms and reporting issuers to maintain their focus on audit quality in the face of these pressures.

Appendix A: Scope of the 2010 Inspection Program

During 2010, CPAB inspected 69 firms, and inspected 232 audit engagements, as follows:

	<u>Number of Firms</u>	<u>Number of Engagements</u>
Big Four Firms	4	120
Other Firms Inspected Annually	11	57
Other Firms – Recurring inspections	<u>25</u>	<u>55</u>
Sub-total	40	232
Follow-up inspections	<u>29</u>	=
Total	69	232

In addition, provincial professional accounting bodies inspected 71 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, 2010, 189 Canadian accounting firms and 120 foreign accounting firms had completed the registration process, signed Participation Agreements with CPAB, became and continue to be participating audit firms.

The Big Four accounting firms in Canada are Deloitte & Touche LLP, Ernst & Young LLP, KPMG LLP and PricewaterhouseCoopers LLP. These firms audit more than half of the entities that are public companies or other reporting issuers in Canada, representing over 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 seven years, CPAB has inspected each of the Big Four firms six times. CPAB has inspected each of the firms that audit more than 50 reporting issuers at least four times in this period and the majority have been inspected five 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 public companies in Canada.