ENHANCING AUDIT QUALITY

The State of Auditing in Canada

NOTES FOR REMARKS BY

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<u>CHECK AGAINST DELIVERY</u>

Introduction

Thank you and good afternoon.

My remarks today will address the state of auditing in Canada.

Let me first address the importance of high-quality auditing.

Audits play a crucial role in ensuring the integrity of financial reporting.

In turn, the integrity of financial reporting is key to the effective operation of our capital markets.

High-quality audits mean investors and other stakeholders can have confidence in the integrity of the financial statements issued by public companies in Canada.

That's why high-quality auditing is important and why we all need to make audit quality a priority.

Because we have seen what can happen when there is an audit failure.

CPAB's mandate is to effectively promote and regulate high-quality auditing of public companies.

We do this by inspecting firms that audit reporting issuers in Canada.

Every year, we inspect all audit firms that audit more than 100 reporting issuers.

This represents 99.5 per cent of the total market, when measured by market capitalization. There are now 15 firms in this category.

We also regularly inspect firms that audit 100 or fewer reporting issuers. These firms account for $6.9 billion, measured by market capitalization.

CPAB's first five public reports summarized inspection findings.

Two years ago, we altered our approach to focus on the root causes of audit deficiencies.

By focusing on the root causes, we were able to develop recommendations to address them. These recommendations, when implemented, have the greatest impact on improving audit quality.

We also enhanced our risk assessment capabilities. This helps us identify high-risk audits.

In 2010, we inspected 69 firms and 232 audit engagements.

Today we are releasing our public report on these inspections.

I would like to address with you what we found — as well as what we believe firms and audit committees need to do to enhance audit quality.

The State of Auditing in Canada

Over the seven years we have been inspecting audit firms, we have seen many examples of high-quality audit work.

Many firms have improved audit quality by implementing our recommendations.

Others have taken steps on their own to improve audit quality.

Overall, we believe audit quality in Canada continues to be sound.

Generally speaking, investors can have confidence in the integrity of public company financial statements audited in Canada.

Audit quality is generally sound for the major audit firms' largest and most complex clients.

It is also generally sound for smaller and mid-sized audit firms with clients in sectors they fully understand.

However, there is room for improvement.

Audit quality is not uniformly high across all engagements in all firms.

Even in audits conducted by major firms, there can be occasional lapses that result in reduced audit quality.

In smaller and mid-sized firms, audit quality issues tend to arise when they audit very few public companies or ones in sectors outside their comfort zone.

2010 Inspection Findings

CPAB believes that audit firms should be striving for continuous improvement in audit quality.

However, in 2010, we saw little improvement in audit quality from the year before.

As I have mentioned, audit work was generally sound.

But our inspections found examples, in firms of all sizes, of inadequate audit work.

We found examples of ineffective engagement supervision and review.

We found audits where a lack of professional skepticism was applied.

We found working papers that did not fully describe the nature and extent of the audit work carried out.

We found several instances of poor or non-existent communications with audit committees.

Some of our more serious findings led to additional audit work being required.

Some financial statements had to be reissued.

These 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 we find too many audit deficiencies and more than we would see if firms uniformly had a commitment to zero tolerance for audit deficiencies.

The deficiencies we find do not always lead to the reissuing of a financial statement.

But the risk of a restatement is there.

We are also concerned that our findings are somewhat at odds with how the firms themselves think they are doing.

We know this because, as part of our outreach activities in 2010, we commissioned third-party survey of audit partners.

The survey found that audit partners believe audit quality is uniformly high.

What explains the difference between their opinion and our findings?

We hope it is not complacency or that audit quality is becoming a lower priority.

In our view, the increasing complexity of financial reporting, the transition to international standards and our inspection results suggest that firms need to demonstrate more commitment to audit quality, not less.

A Commitment to Audit Quality

We are concerned that some firms simply react to our annual inspection findings and recommendations instead of striving for continuous improvement by proactively implementing measures to enhance audit quality.

We believe audit firms — and their clients — need to consider our recommendations in light of their own commitment to audit quality.

They must take the steps necessary to focus on continuous improvement.

What does this mean?

It means audit firm leaders need to set the appropriate tone at the top by making audit quality a priority.

They need to deliver strong messages about the importance of audit quality.

They need to provide adequate resources to support their audit practices.

This happens in many firms, but not in all.

Firm leaders need to make sure their audit practices continuously build behaviours into their processes that lead to actual improvement in audit quality.

This means going beyond the form of auditing standards.

It means implementing practices that address their spirit and intent.

Our report makes specific recommendations on how this can be done.

Enhancing Engagement Supervision and Review

We have said it in past reports and we are saying it again in this one: There must be greater partner and second partner involvement in the work carried out by audit engagement teams.

The engagement partner and the second partner —known as the engagement quality control reviewer or EQCR — are usually the most experienced professionals on the audit.

But their knowledge and expertise can only be brought to bear if they are effectively involved.

We found examples where the EQCR appeared to be only minimally involved.

Enhanced supervision and review would go a long way to enhance audit quality.

In fact, we believe most of the significant audit deficiencies we found would not have occurred if there had been greater and more timely involvement by the engagement partner and EQCR.

We understand that greater involvement by the engagement partner and EQCR may incur a financial cost.

But this would be more than offset by the efficiencies achieved as a result of better supervision — supervision designed to make sure the audit is appropriately responsive to significant risk.

As well, these investments by the firms would create additional insurance against audit deficiencies, adding value to investors and the public

Coaching, Mentoring and Real-Time Reviews

Senior practitioners bring a stronger element of professional skepticism to the audit — which we found to be lacking in some of our 2010 inspections.

It is important that less experienced staff have opportunities to learn from senior personnel.

Senior personnel should better coach and mentor their staff by completing real-time file reviews.

This is especially important in smaller firms, which often don't have the review processes that exist in large firms.

We believe real-time coaching and mentoring are more effective ways to enhance audit quality than web-based or face-to-face training.

Firms should therefore introduce coaching sessions for high-risk engagements.

They should implement ongoing quality reviews by assigned coaches throughout the audit process.

Strengthening the Role of the EQCR

I've already mentioned the important role played by EQCRs.

We believe their role should be strengthened by enhancing their accountability.

EQCRs should be accountable for significant audit deficiencies in areas subject to their review.

They should experience consequences for poor quality audit work.

Conversely, they should be recognized and rewarded for good performance.

We believe relating accountability to partner compensation would go a long way to achieving this objective.

Our US counterpart, the Public Company Accounting Oversight Board, has introduced a new standard that requires greater evidence of the EQCR's involvement in the audit engagement.

Audit firms are required to apply this new standard to audits of Securities and Exchange Commission registrants in Canada.

We believe applying it to all audits of reporting issuers in Canada would enhance audit quality.

We are aware of one firm in Canada that has adopted the new standard for all of its public company audits.

Another firm has changed its partner compensation model to make EQCRs more accountable.

We commend the leadership shown by these firms.

Quality Monitoring

Another area of concern for us is quality monitoring.

Firms appear to be placing a great deal of reliance on their own internal monitoring programs.

Given the number of deficiencies we identified in 2010, we wonder whether these programs are sufficiently robust.

In addition, some smaller firms either do not monitor audit quality at all or do not do so in a timely way.

We urge 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

Our 2010 inspections also found numerous instances where higher-risk areas of audits were not adequately communicated to audit committees.

The associated financial statement disclosures lacked transparency.

We believe communications between firms and audit committees should improve.

This is particularly important during the current uncertain economic environment and in light of the increasing complexity of financial reporting.

Audit Committees Have a Role to Play in Improving Audit Quality

These are the major recommendations we made to audit firms in 2010 to improve audit quality.

We believe audit committees also have a role to play.

Audit committees should raise the issue of audit quality with their auditors.

A high-quality audit is an audit committee’s best assurance that it is effectively carrying out its duties.

Challenging auditors and management is part of effective oversight.

For example, audit committees should ask their auditors about the application of professional skepticism and the role of the EQCR.

Fee Pressure on Firms

Audit committees should also think about the pressure being placed on audit firms to reduce their fees.

They should ask themselves what impact this pressure may have on audit quality and on public confidence in the integrity of financial statements.

To support audit quality, firms need to invest in recruiting, training and retaining senior, experienced audit staff.

Fee pressure may cause firms to reduce these investments.

Looking ahead, in five to ten years, this could result in a shortage of senior, experienced auditors and audit managers who have sufficient knowledge of business, auditing, accounting and tax.

The pressure on fees could also mean that firms may be inclined to place fewer experienced staff on an audit.

They may devote fewer hours to the engagement and reduce investments in coaching and mentoring.

Some firms may begin to move some of the more routine audit work off-shore to lower-cost jurisdictions, which could reduce learning opportunities for local staff.

Firms may also begin to place a higher priority on consulting and other non-audit services as sources of revenue growth.

Making the audit a loss leader would not bode well for audit quality.

Canada's adoption of international standards is putting even more pressure on auditors, especially during the transition period.

Increased fee pressure may lead to a reduction in audit effort at a time when increased effort is needed.

That's why audit committees demanding lower fees need to be sure they understand the implications — not only for today, but for tomorrow.

Viewing the audit as a commodity, differentiated primarily on price, has the potential to negatively affect audit quality.

We believe the interests of shareholders are best served if an appropriate audit fee is paid — one that ensures the sustainability of audit quality.

Conclusion – A Zero Tolerance Approach

In summary, we believe the integrity of financial reporting in Canada demands an attitude and approach dedicated to the continuous improvement of audit quality.

It requires audit firms to make a commitment to move to zero tolerance for audit deficiencies.

We are concerned that some firm leaders appear to be willing to accept audit deficiencies, instead of adopting 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 drive changes in behaviour that lead to continuous improvement in audit quality.

Some firms have adopted this approach.

However, 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.

Would this approach mean there will never be audit problems?

No.

But it greatly reduces the likelihood that they will occur.

CPAB will continue to work with firms, audit committees, management and other stakeholders to enhance audit quality.

Thank you for this opportunity to share our 2010 inspection results and recommendations.

I would happy to answer any questions.