



CANADIAN PUBLIC ACCOUNTABILITY BOARD
CONSEIL CANADIEN SUR LA REDDITION DE COMPTES

CPAB Webcast
The Integrity of Financial Reporting in an Economic Downturn
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Speaker Notes

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Slide 1 - Global Economic Downturn

We are experiencing the worst financial crisis since the Great Depression. Most of us have never experienced anything like this in our lifetimes. What started as a subprime mortgage crisis in the United States, became a global credit crisis and has now morphed into a global recession.

It is estimated that in 2008 over \$30 trillion of stockmarket value was wiped out around the world.

In 2008 we saw rescue packages and bankruptcy filings for a number of global companies.

Canada has not been immune to this crisis.

Across Canada all industries including the automotive, resource, financial and retail sectors have been impacted by the downturn. You only have to watch the news to see how pervasive the impact is.

In our webcast today we will be considering the implications of the downturn for financial reporting and auditing.

Slide 2 – Agenda

As you can see from the agenda we will be covering several areas affected by the global economic downturn in the next hour starting with remarks from the CPAB Chairman Nick Le Pan.

Kam Grewal and Malcolm Gilmour will be covering financial reporting and audit considerations related to Valuations issues, Impairments, Counterparty non-performance risk, Going concern and consideration of Fraud risk. They will also address the importance of transparent financial statement disclosure in the current environment. Their comments will highlight matters for consideration by Directors, Audit Committees, Management as well as auditors.

Near the end of the webcast I will cover CPAB's expectations of audit firms in the current environment.

At the conclusion of the webcast we hope you will have a better appreciation of the significant financial reporting challenges faced by Management, Board Directors, Audit Committees and Audit Firms in these turbulent times. We are aware that they are addressing many of these financial reporting and auditing issues. Of course our webcast today will NOT provide complete coverage of all the issues related to the economic downturn. Our objective is to raise awareness of the more pressing issues as we all navigate the way forward in these challenging times.

I would also like to point out that the views expressed today by all our presenters are their own and are not necessarily those of the CPAB Board.

Slide 3 - Chairman's Remarks

Economic Uncertainty & Risk Assessment

I am setting the stage for the presenters who follow. Canadian companies are facing a time of much higher economic uncertainty. With economic uncertainty comes increased risk.

Challenges facing companies include:

- Decreased demand for products
- Constraints on liquidity, credit and access to capital
- Unprecedented volatility in the financial markets
- Greatly reduced demand for commodities and falling prices

Financial statements of many companies will be affected by the economic downturn. Whether it involves determining fair values for illiquid investments, recording impairments, assessing the financial condition of counterparties or providing enhanced financial statement disclosures related to material uncertainties or any combination of these, companies face significant issues in preparing their current financial statements.

We are aware that reporting issuers and their audit firms are addressing these issues but we wanted to remind all involved of the importance of these issues going forward. Recall that we have over 250 audit firms registered with CPAB who may be affected in one way or other by the issues we are raising today.

Boards and Audit Committees and Auditors are and should be asking questions such as:

Which areas of our financial reporting are especially impacted by the economic downturn?

How is this company determining significant estimates given the economic uncertainties and increased use of judgement that will be required for this reporting period?

Use of Estimates

Let me turn to estimates for example.

Audit Committees in consultation with management and auditors should be reviewing changes to key estimates and assumptions in light of current market conditions, for example changes to forecasted results, forecasted cash flows, ability to refinance borrowings, impairment assessments, allowances for receivables and inventory.

Auditors, senior executives, Boards and Audit Committees should ask themselves about the appropriateness of significant estimates determined by management and whether the analysis has been performed with appropriate rigour.

Audit Committees may wish to reconfirm that reporting and internal control systems are functioning effectively and that resources are in place to provide support when determining estimates that may require significant use of judgement.

If companies have made management lay-offs how do the staff reductions impact internal controls and financial reporting?

Financial Statement Disclosure

In times of uncertainty financial statement disclosure assumes greater significance. Given current market conditions, financial statement users and regulators will seek increased transparency in companies disclosures regarding risks, key judgements, use of estimates and uncertainties to name a few.

Auditors' Professional Scepticism

Finally, I'd like to talk about the need for appropriate professional scepticism.

The landscape for audit firms is also very different from a year ago.

Audits will be tougher and there will be more challenges related to valuations, impairments and going concern assessments than in prior years.

Many audit partners will have never audited in an economic downturn before. Given the heightened risk of material misstatement in the financial statements it is critical that audit procedures are responsive to these risks and that audits are performed with appropriate professional scepticism.

Slide 4 - Valuation Issues

I would like to start our discussion of specific financial reporting areas impacted by the economic downturn by looking at valuation issues.

In the current environment obtaining reliable information relevant to fair value will be one of the biggest challenges faced by financial statement preparers and their auditors. Previously routine valuation matters may now become sources of significant risk.

Valuation methods companies apply now may differ significantly from methods used to value financial instruments when first purchased. One example of this would be the frozen non-bank sponsored asset backed commercial paper for which the restructuring plan was recently approved.

The use of fair values is widespread in financial reporting and includes not only financial assets and liabilities but is also seen with regard to management's determination of pension assets and liabilities, valuation of goodwill and intangibles and share based payments to name a few.

Companies and their auditors need to assess whether they have the necessary expertise to undertake challenging valuations. This may require increased use of specialists including valuers, financial instrument experts, actuaries and impairment specialists.

Fair value estimates should be based on reasonable supportable assumptions that a third-party market participant would use when quoted prices are not available. Estimates should appropriately consider relevant risks including credit risk, counterparty non-performance risk and liquidity risk. Default risk and Collateral value risk would be examples of counterparty risks.

Management's internal assumptions about future cashflows and required rates of return when relevant observable data does not exist need to be consistent with assumptions market participants would use to price financial instruments in a current transaction.

The more sensitive management assumptions may include growth rates, discount rates and earnings multiples.

Market information may be available that provides an indication of market participants current assumptions regarding the pricing of risk (for example credit risk or liquidity risk). This information can be useful in assessing management's internal assumptions about market participant assumptions and in calibrating internal models.

Many of the problems with internal models, for example models used to assign credit ratings to subprime mortgage securities, arose due to the failure to appropriately take account of the relevant risks and in particular liquidity risks and models have to be appropriately calibrated. Events that actually happened in 2008 were "ten standard deviation events" in many models.

In estimating fair values and calibrating models the evaluation of whether individual transactions in the marketplace are forced (that is one of the parties is forced or otherwise compelled to

transact) depends on the facts and circumstances and may also require the use of significant judgement.

Audit Committees and Boards will likely want to better understand the key judgements made and the methodology used by management to determine fair values and how assumptions and results were corroborated.

Auditors will need to obtain sufficient appropriate audit evidence recognizing that the evidence likely will be different from what has been available to them previously.

Slide 5 - Valuation Issues

I would now like to discuss the cashflow forecast.

Nick referred to economic uncertainty in his opening remarks. Many companies are having difficulty forecasting out their results for the next 3 months let alone 12 months or more from the balance sheet date due to economic uncertainties.

Cashflow forecasting may not have been an area that required much attention in times of growth when sales and profits were increasing and financing was relatively cheap and easy to access. However, in an economic downturn and given the economic uncertainties in the marketplace the cashflow forecast now takes on increased significance.

Going concern and impairment assessments will be driven off detailed cash flow forecasts.

Audit Committees/Boards should be asking how expected changes in market conditions, changes in sales volume, pricing and costs have been incorporated into cashflow forecasts. Are the projected margins reasonable in the current environment? How much room does the company have with its debt covenants? What is the company's cash burn rate?

Have appropriate risk adjustments been made to cashflow forecasts for risks such as counterparty risk, credit risk, liquidity risk, market risk and so on.

Will existing borrowing arrangements be adequate to meet peak funding requirements in the cashflow forecast?

It is critical that cash flow forecasts are appropriately stress tested. Sensitivity analysis should be performed for changes in sales volume, pricing and costs as examples. What if scenarios such as a 10-15% decrease or more in sales are not far-fetched in the current environment given the economic uncertainties.

Companies and their auditors should ensure that cashflow forecasts are consistent i.e. if the forecast used for impairment purposes is different from the budget that is presented to senior management and the Board this should be followed up and understood. Disclosure in the financial statements of material uncertainties is also critical.

Auditors should ensure that they appropriately challenge the key assumptions behind cashflow forecasts and projections. The review of cashflow forecasts needs to be performed by senior members of the audit team given the heightened risks in this environment and should not be delegated to junior members of the audit team.

The smaller the cushion in the cashflow forecast related to going concern and impairment assessments the more testing of data we would expect from the auditors.

Slide 6 - Valuation Issues

Now let me turn to some other areas impacted by valuation issues.

Fair value determination will be challenging for companies with defined benefit pension plans.

Given the steep decline in equity markets in 2008 many pension plans will likely report significant actuarial losses on the revaluation of pension plan assets at year-end. These losses will need to be recognized in future years based on companies' amortization policies.

Depending on the nature of the investments held by the plan the determination of fair values for these investments could be challenging.

The assumed rates of return on pension plan assets should reflect current expectations about the long term rates of return on plan assets.

On the pension liability side the employer's obligation needs to be discounted. The determination of the appropriate discount rate will be a significant area of judgement. The discount rate is usually based on interest rates on high quality corporate bonds and given that spreads on corporate bonds have widened during 2008 it may be that the discount rate used in measuring the obligation at year-end will be higher than the rate used at the beginning of the year.

Actuarial valuations are required to be performed periodically with extrapolations in years between valuations.

Management may need to consult with their actuaries and consider the events of the past year and determine whether the significance of the changes means an extrapolation is no longer appropriate and a new valuation may be required.

Another area in which fair value determination is required is stock based compensation. Modifications of stock based awards, such as re-pricing options to a lower exercise price or removing vesting conditions, may result in additional compensation cost as the fair value of the modified award is now greater.

Similarly any changes to awards that now provide cash settlement features may result in the classification of those awards as liabilities on the balance sheet.

Slide 7 – Impairments

The dramatic declines sales volumes, commodity and share prices in the last half of 2008 should cause companies to consider whether certain assets have become impaired. In the next couple of slides we will provide an overview of some of the more significant impairment issues starting with impairments in financial assets.

There are a number of distinct classes of financial assets and the accounting rules for the recognition and measurement of impairment can vary between these classes.

The first class we would like to touch on are accounts and notes receivable. Companies who faced challenges in accessing their historic sources of liquidity may have been forced to delay payment of their liabilities. Since one company's accounts payable is another company's accounts receivable this may create a potential impairment issue for the company holding the receivable. Management may need to change their normal process for evaluating the recoverability of accounts receivable when determining an appropriate allowance as historical loss rates may no longer be indicative of losses in current portfolios.

We have only begun to see the impact of the economic downturn on corporate and other loans that companies may be holding. Management will need a process to review the company's loan portfolio to ensure that impairments are recognized when there is no longer reasonable assurance of the timely collection of the full amount of principal and interest. Depending on a company's circumstances, the audit committee may want to understand what process management has put in place. It should also be noted that payments do not have to be in arrears for a loan to be impaired as the critical consideration is the need to have reasonable assurance of timely collection. In contrast to accounts and notes receivable the realizable amount for loans is based on discounted expected future cash flows unless these cannot be reasonably estimated in which case the underlying collateral is taken into consideration.

A third class of financial assets to consider are investments in debt and equity securities, other than those classified as held for trading. An assessment must be made at each balance sheet date to determine whether there is objective evidence that an impairment of the asset has occurred. Guidance has been published that contains examples of what might represent objective evidence of impairment and these are worthy of researching. However for these financial assets an impairment would only be recognized if it is considered other than temporary. The challenge here is that there are no bright line tests for what represents other than temporary impairment and so professional judgment must be exercised.

One final comment on financial assets. In October 2008 the Canadian Accounting Standards Board approved amendments to allow reclassifications, under specific circumstances, of financial assets out of categories that require fair value changes to be recognized immediately in net income. These amendments were made to ensure consistency of Canadian standards with International and U.S. Financial Reporting Standards.

Slide 8 - Impairments

Moving on from financial assets I would like to briefly discuss some other assets that may have suffered impairment.

Whether or not a company recognizes a future income tax asset is one of the more difficult estimates that management must make. In making this estimate management must assess at each balance sheet date whether it is more likely than not that the asset will be realized.

Companies with current year losses will need to assess whether it is appropriate to set up a future tax asset for those losses. For future tax assets recognized in prior years companies will need to assess the adequacy of the valuation allowance. While not specifically an impairment issue, liquidity concerns may cause companies to consider repatriation of earnings from foreign operations and these transfers could have tax implications.

Long lived assets such as property, plant and equipment and intangible assets with definite lives are only tested for impairment when there is a triggering event. There are many potential triggering events that could be related to the current economic environment. An event could be as simple as a current period operating or cash flow loss combined with a projection or forecast of continuing losses associated with the asset's use. Also, if a company responds to the current environment by restructuring, shutting down locations, rearranging expenditure priorities or cutting back on plans to develop certain products these could be considered triggering events requiring impairment tests. It should also be noted that if a company decides to restructure there are very specific accounting rules on what can be included in a restructuring accrual and the criteria that must be met to record the accrual in the current period.

Goodwill and indefinite life intangibles are assets that must be tested for impairment on an annual basis but may need to be tested at an interim date as well if there is evidence of a potential impairment. Many companies have seen their market capitalization fall below the book value of their equity which is often considered a signal that an impairment of goodwill has occurred and may trigger an interim impairment test. An important consideration whenever goodwill is being assessed for impairment and the goodwill has been allocated to reporting units that are below the level of the consolidated company is that the fair values of the reporting units should be reconciled with the company's overall market capitalization.

Hopefully it is becoming clear from the discussion of impairments that for some companies the current economic environment is going to trigger a substantial increase in the number and rigour of impairment tests that management will need to perform in preparing financial statements. Therefore, audit committees will want to be comfortable that management has anticipated this need and has planned appropriately so that they have the time and the resources available to complete the impairment tests within the company's reporting timeline. Audit committees will also want to be comfortable that the assumptions that management have used and conclusions they have reached are consistent between impairment tests and with other analysis such as the assessment of the going concern assumption.

Slide 9 - Counterparty non-performance risk

Counterparty non-performance risk goes to the core of the current economic crisis and is the risk that a party to a contract will not be able to meet its contractual obligations.

This risk is pervasive and affects every company and it can be impacted by customers, suppliers, providers of financing, derivative arrangements, hedging arrangements, insurance arrangements and guarantees to name a few.

Let me start my talking about customers. Customers may be struggling to make payments leading to additional provisions being required for receivables. This risk could also impact the timing of revenue recognition. Companies should consider the adequacy and frequency of procedures to assess the credit worthiness of their customers in the current environment. Procedures in place from prior years may no longer be adequate.

We are entering a global recession. Canada will be particularly impacted by reduced demand from the United States. Markets for many products and services are beginning to contract which will mean many companies will be hit by a reduction in customer demand and increased pricing pressures. This may have implications such as excess or obsolete inventory and write downs may be required if carrying value of inventory exceeds net realizable value.

Companies may also be providing additional incentives to customers to sustain revenues which again has financial reporting implications.

A reduction in demand for a company's products and services may also be an impairment indicator requiring a company to evaluate the recoverability of its long-lived assets and goodwill.

If companies rely on a few major customers for a large part of their revenues the conditions of these customers should be carefully monitored to identify any issues that may require recognition or disclosure for financial reporting purposes. Concentrations may also arise related to specific countries, markets or products and services.

Slide 10 - Counterparty non-performance risk

I have talked so far about customers and now I would like to address some other areas impacted by counterparty non-performance risk.

A company's suppliers may be experiencing financial difficulties. If suppliers are unable to make good on commitments this could mean companies have to source inventory from elsewhere at potentially higher prices with implications for inventory valuation and this could lead to disruption of a company's supply chain and could be an impairment indicator. Major equipment may not be serviced on a timely basis or at all leading to business disruptions.

Parties that provide financing can also create significant counterparty risks.

Companies that historically had little difficulty in renewing debt facilities may now find this more challenging or may not be able to refinance at all. Debt covenants may be breached or have less of a cushion than in previous periods which could have implications for balance sheet classification of debt.

Companies unable to renegotiate borrowing arrangements or obtain waivers for debt covenant breaches may find themselves with significant going concern issues.

A default on one borrowing may trigger cross-default provisions in a company's other financing arrangements. Agreements will need to be carefully reviewed to understand rights and obligations.

Guarantors of debt may also be experiencing financial difficulties and may not be able to perform. Again making it difficult for a Company to renew borrowings. It should also be noted that Guarantors providing financial support or guarantees may have a variable interest in the entity to which they have provided the support and could potentially have to consolidate such an entity or provide additional disclosures in financial statements.

Such commitments to provide financial support or guarantees could be buried in contractual arrangements and companies should have processes to identify these exposures.

Development stage enterprises may be particularly hard hit as financing dries up and companies find it increasingly difficult to raise cash to fund their operations. This may have implications for impairment and going concern disclosures.

I would now like to touch on some other areas of counterparty risk. For example derivatives. If the counterparty to a derivative is experiencing credit deterioration this could have implications for fair value measurement and hedging. In fact just last week the CICA emerging issues committee reached a consensus in EIC-173 stating that when determining the fair value of financial assets and financial liabilities, including derivative instruments, an entity should take into account its own credit risk as well as the credit risk of the counterparty.

Other counterparties arise in leasing arrangements, arrangements with joint ventures and equity investments, purchase and sales commitments and insurance arrangements and the list goes on. So hopefully you can see how pervasive counterparty risk is in today's environment.

So what questions should those charged with Corporate Governance be asking related to counterparty risk?

Appropriate questions might include:

Who are the counterparties that the company deals with?

What process has management followed to identify and evaluate counterparty risks?

What debt is expected to be refinanced and how?

Have risks and uncertainties related to counterparties been appropriately disclosed in the financial statements?

Slide 11 - Counterparty non-performance risk

I talked earlier about how customers can impact counterparty risks. In an economic downturn companies and their customers may change business practices that could impact revenue recognition.

Companies may face increased pressure to meet revenue and analysts targets and therefore additional attention may be warranted in the area of revenue recognition.

So let's look at some potential risk areas:

A company's historical returns experience may not be predictive of future returns due to increased returns given the economic downturn and customers may also be demanding expanded rights of return. If companies agree to these new or expanded rights of return, management must re-evaluate whether a higher allowance for returns should be recorded or whether future returns can even be reasonably estimated.

The guidance for the recognition of revenue under bill and hold arrangements identifies many factors that must be considered in order to conclude that the risks and rewards of ownership have been transferred and revenue can be recorded. If these types of arrangements are new for a company or if the terms of the bill and hold arrangements change then such arrangements will need careful examination by management and auditors.

Customers may request payment terms that extend beyond a vendor's normal or standard payment terms. A change in payment terms may indicate that the revenue associated with the arrangement is not fixed and determinable or that there is uncertainty regarding the ultimate collectability of the amounts owed. Management and auditors should evaluate the effect of any change in payment terms on the timing of revenue recognition.

Now let me turn to side agreements.

Side agreements are agreements that are separate from the main contract. Such agreements may be documented or could be undocumented and they can have a significant impact on the recognition of revenue. The potential for side agreements is greater for complex transactions or multiple element arrangements.

If the terms and conditions of side agreements are not known to a company's finance function then this could also increase the risk of inappropriate revenue recognition.

Next I would like to talk about the risk of channel stuffing.

Companies that have sold to distributors and retailers may find that those customers are now finding it more difficult to sell thru' to end customers. Changes to the rights of return or delay in payments until products are sold thru' to end customers could mean these represent consignment arrangements where revenue would not be recognized until the delivered products are sold thru' to end customers.

On a related matter one of the themes of our presentation is to highlight the importance of significant estimates. Companies accounting for revenues for long term contracts on a percentage completion basis need to ensure that significant estimates are evaluated with appropriate rigour and even whether percentage completion accounting is appropriate given the current economic uncertainties.

Audit committees, Boards and auditors should be asking how the company's business practices have been impacted by the economic downturn and how this may impact revenue recognition and the ability to determine significant estimates.

Slide 12 - Going concern

There is no question the current economic environment creates an increased risk of corporate failure and audit failure.

Some of the largest names in Corporate Canada have filed for bankruptcy protection. One interesting phenomenon that has emerged with the global credit crisis is that companies may no longer be waiting for their cash to run out before filing for bankruptcy. This is because delays in filing may lead to difficulties in accessing financing for restructuring purposes.

In the current environment we would expect more disclosures in financial statements of material uncertainties related to events or conditions that may cast significant doubt upon an entity's ability to continue as a going concern.

Boards and Audit Committees should review processes followed by management to identify conditions that could affect a Company's ability to continue as going concern. The borrowing facilities available to the company should be reviewed and compared to the detailed cash flow forecasts for the next 12 months from the balance sheet date, as a minimum.

Forecasts, budgets, borrowing requirements, breaches of covenants, cash burn rates and a company's products and markets should all be areas of focus for Board Directors and Audit Committee members in forming their conclusions on going concern and in assessing material uncertainties and the integrity of going concern disclosures in the financial statements.

If plans to overcome financial difficulties include disposal of assets or equity issuances- Are these plans feasible in the current environment?

If an entity is dependent on guarantees provided by another party that party may no longer be either able to or prepared to provide the guarantee. So what are the implications of this for the company?

Canadian GAAP requires disclosure of material uncertainties related to the going concern assumption. Examples of uncertainties that may need to be disclosed include continued and expected operating losses, negative operating cash flows, significant declining demand for products, an inability to obtain or renew financing and breaches in covenants.

Going concern is also an area that will likely require significant involvement from senior members of the audit engagement team.

Auditors will need to review management's cash flow forecasts and challenge the reasonableness of the assumptions in order to assess a company's ability to continue as a going concern. Auditors should consider whether management has appropriately factored in events and conditions affecting the company and its industry.

If there are going concern issues auditors should challenge companies that maintain that their goodwill and other intangibles are not impaired.

Slide 13 - Financial Statement Disclosures

We would like to focus now on the impact of the current economic environment on the disclosures in the financial statements.

The accounting standards define fair presentation in financial statements as the provision of sufficient information about transactions or events having an effect on the entity's financial position, results of operations and cash flows for the periods presented that are of such size, nature and incidence that their disclosure is necessary to understand that effect. What the standards are trying to say is that the key to good financial reporting is transparency and good financial reporting is the responsibility of management and the audit committee. Having said that it is important to also remember that good disclosure cannot compensate for bad accounting. Accounting treatments that are not in accordance with generally accepted accounting principles are not rectified either by disclosure of the accounting policies used or by information provided in notes or supporting schedules.

The following are just some of the items to consider when evaluating the impact of the current economic environment on the disclosure provided in the financial statements.

The requirement to disclose measurement uncertainty often generates a number of very general “boiler plate” statements. However the measurement uncertainty standard is very clear in stating that disclosure is required “when it is reasonably possible that the recognized amount could change by a material amount in the near term” which in the current economic environment will most likely encompass more items than in the past.

Many of the accounting standards that provide guidance on the determination of impairments also require specific disclosure of both the amount and the method used to determine the impairment. Securities regulations also have specific disclosure requirements for the management discussion and analysis regarding the reasons and business circumstances related to impairments.

Appropriate disclosures should be made of covenant violations and any waivers obtained related to loan agreements. Also, if a company's projections and forecasts indicate that it will likely violate its covenants at future compliance dates within the next year it must disclose this likely failure and the adverse consequences.

I have already discussed Going concern disclosures in the previous slide.

Slide 14 - Financial Statement Disclosures

Last year there were incremental changes to the financial instruments disclosure standards and this year there are more changes. The most recent changes increase the disclosure in areas such as reclassifications, collateral, allowance for credit losses, compound financial instruments with multiple embedded derivatives, and defaults and breaches. The standards also require more extensive disclosure about the extent to which the entity is exposed to credit risk, liquidity risk and market risk where market risk includes currency risk, interest rate risk and other price risk. While the disclosures related to fair value are not substantially different if there is an increase in the number of fair values that are determined on a basis other than by reference to published price quotations in an active market the incremental disclosures this year could be significant.

Consideration must also be given to whether contingent liabilities, including guarantees of the indebtedness of others, have been appropriately identified and adequately disclosed.

While there is no change in the disclosure requirements for a company that holds an interest in a variable interest entity, or “VIE” that it has not consolidated, there is a risk that the structure of some entities may have been significantly changed in response to the economic downturn and this may trigger a reconsideration of the VIE analysis.

The current economic environment could also have an indirect impact on certain disclosures such as economic dependence if the potential customer base for a company changes to the point where the company cannot easily find alternative customers for its products.

The rapid pace at which financial conditions are changing means events subsequent to the reporting period must be monitored and consideration given to the need to either revise the amounts recorded in the financial statements or make additional disclosures as appropriate.

Finally, as companies prepare financial statements that will provide users with information in a manner that clearly conveys the nature and extent of significant transactions and events there is the potential for the use of non-GAAP financial measures. While users of the financial statements may find these measures useful, they should not appear in the GAAP financial statements and management and audit committees should consider the specific guidance provided by the securities regulators on their use in other disclosure documents.

Finally on the topic of disclosures, I would like to note that the Canadian Securities Regulators have also recently released CSA Staff Notice 51-328 that specifically addresses the continuous disclosure considerations related to current economic conditions.

Slide 15 - Fraud Risk Considerations

I would now like to talk about fraud risk considerations.

Financial difficulties create pressures on management and can create incentives to engage in fraudulent financial reporting. This could, for example, be done to protect bonuses, hide management error or avoid a breach of debt covenants.

Even if there is no fraudulent intent there may be a temptation to bias significant estimates requiring judgement to the more favourable end of a range.

Frauds often involve management override of controls. Given the valuation challenges I discussed earlier increased use of internal models and lack of market comparisons may also present opportunities for bias and manipulation.

Questions to ask when evaluating a transaction would be- Does the transaction make sense based on the economics of the arrangement and does it have commercial substance when you consider the risks and rewards and rights and obligations of the transaction?

If documentation related to a particular transaction looks unusual again appropriate follow up and corroboration should be performed.

I would now like to discuss examples of areas that may have an increased risk of fraud.

- I'll start with Revenue recognition which has historically been one of the most common areas for fraudulent financial reporting

Other examples of areas at risk of fraud that merit careful scrutiny include:

- Internal assumptions used for significant estimates
- Classification of assets/liabilities
- Omitted or inaccurate financial statement disclosures related to significant matters & uncertainties and
- Related party transactions

Audit Committees and Boards should understand how internal controls mitigate the fraud risks in their organizations.

The auditor is also required to consider the risk of material misstatement due to fraud. Audit procedures should be responsive to the risks identified.

Engagement teams should conduct fraud brainstorming sessions during audit planning with appropriate professional scepticism and partner involvement. This should not be treated just as a checklist completion exercise.

Engagement teams should be asking themselves how their audit approach is responsive to the heightened risk of fraud in the current environment.

Significant management estimates should be appropriately corroborated by engagement teams.

Another risk that boards, audit committees and auditors might want to consider is the possibility of companies recording “big bath” write downs in the current environment. There is a need to be alert for write downs that may not be sufficient as well as cases where write downs may be too aggressive.

I would like to note that we have only touched on some of the financial reporting issues impacted by the economic downturn. There are clearly others that we could not get to in the limited time we have today.

Slide 16 - CPAB Expectations for Audit Firms

The most striking features of the current economic crisis are: the speed at which it developed; the pervasiveness of its impact on all aspects of the economy; and the fact that the crisis is global. No country and no industry seem immune from its effects. The overall expectation of CPAB is that auditors will carefully evaluate the impact of the current economic environment on their audit clients to identify and respond to the significant risks that the environment has fostered. Some of the specific elements to consider are as follows:

Leadership of the firm

I believe that firm leadership or “tone at the top” will have major impact on how firms manage audit risk in this environment. Firm leadership should be identifying their highest risk audit client exposures and ensuring that engagement teams are supported with access to appropriate experts and specialists. Training and guidance should be provided to partners and staff on the financial reporting and auditing implications of the economic downturn. For example, I think that additional guidance may be needed this year on auditing cash flow forecasts given the uncertainties that exist.

In the current environment firms may experience fee pressure- firm leadership should stress the paramount importance of audit quality and that quality should not be compromised in light of any fee pressure. Independence should also be considered as firms may be providing more non-audit services to their audit clients in this environment.

Impact on audit planning

Audit planning is another area that will need to be revisited. Audit plans for fiscal 2008 financial statements may have been developed earlier in the year before the “credit crunch” turned into a global economic downturn. As a result it is likely that most audit plans will need to be re-evaluated before starting significant final field work. Repeating what was done last year likely will not be responsive to the increased risk of material misstatement in this environment.

Each of the topics we have touched on today, and the list is by no means complete, are all potential significant risks that may not have been significant risks in the past or the controls that mitigated those risks in the past may no longer be effective. For each significant risk of material misstatement identified the auditor must consider the impact on: the assigning of partners and staff; the nature, timing and extent of the audit procedures and the direction and supervision of the engagement team members.

We discussed fraud earlier. The requirement to consider the incentives, pressures and opportunities that increase the risk of fraud within an entity is one of the cornerstones of the audit planning process.

Materiality

As far as materiality is concerned, many companies will have experienced weaker results in 2008. As a result, management and auditors will need to reassess materiality for financial reporting purposes. What users of financial statements consider to be material misstatements may differ significantly from prior years.

If materiality has decreased from the prior year management and the auditors will need to consider the impact of unadjusted errors from the previous year on the current year. Similarly auditors will need to consider if additional procedures need to be performed on the opening balance sheet if materiality has decreased significantly from the prior year.

Remember, materiality applies not only to the financial results reported but also to the disclosures provided in the financial statements.

Role of the engagement partner & concurring review partner

The involvement of engagement team leaders such as the engagement partner, the concurring review partner and other senior members of the engagement team, who generally possess the most technical knowledge of accounting matters and experience in auditing, will be crucial. As the number and significance of identified risks increases there is an expectation that the level and extent of involvement in the direction, supervision and review of the audit engagement by the engagement partner as well as time incurred by the concurring review partner will increase.

Modifications of audit procedures

CPAB would expect to see modifications of audit procedures. In an effort to cope with the economic downturn companies may eliminate jobs. This could increase the risk of deficiencies in the internal control system due to a lack of segregation of duties or a lack of effective monitoring controls. Auditors must consider the impact of any personnel changes on the company particularly if reliance is being placed on internal controls.

Substantive procedures may need to be modified to rely more on evidence provided by independent third parties rather than parties or documentation within the company. Given the

pace at which the economic environment is changing, more substantive procedures may need to be performed at year end rather than at an interim date. As well, increased audit risk may necessitate a change in the extent of substantive tests requiring the use of larger sample sizes and may call into question the use of substantive analytical procedures performed in previous audits when the economic environment was more stable.

Slide 17 - CPAB Expectations for Firms

Consultation

Now more than ever, consultation will be key. CPAB has observed during its inspections that many firms have cultures that encourage consultation with others who are recognized for their knowledge and experience in specific technical accounting or auditing matters. However, CPAB continues to observe failure to consult or if consultation does take place, a failure to properly document the nature and/or scope of alternatives considered or conclusions reached and to obtain the written agreement from the party consulted. As auditors will likely encounter a higher proportion of issues this year that either require significant judgment or are contentious, it is imperative that consultations follow an orderly, structured, process which is clearly documented and the conclusion agreed to by all those involved in the consultation.

Use of specialists

As noted earlier, the use of specialists will be required. Auditors should use specialists when his or her subject matter expertise is insufficient to appropriately understand and assess a significant aspect of the engagement. In the current environment we would expect increased use of specialists such as valuers, actuaries and specialists in financial Instruments, forensics, going concern, impairments and taxation. The auditor must also ensure that there is an appropriate understanding between the auditor and the specialists of their respective roles and responsibilities.

Documentation

Moving to documentation, the key to the professional standards regarding documentation is that an experienced auditor with no prior connection to the engagement should be able to understand what procedures were performed, why they were performed, the results of the procedures and the evidence obtained, the significant findings or issues and the basis for the conclusions reached. CPAB in its review of engagement files consistently finds this is not achieved and requires firms to improve the documentation in the file. Engagement teams should be reminded of the importance of proper documentation.

Reporting to audit committees

Reporting to audit committees should have a high priority this year. Auditors have a professional responsibility to communicate matters that have a significant effect on the qualitative and quantitative aspects of the entity's financial reporting. These matters include the selection of new or changes to accounting policies, significant unusual transactions and the judgments made by management in formulating particularly sensitive accounting estimates and disclosures. CPAB has noted from its reviews that while the audit working papers often

document the information the engagement team presented to the audit committee, they do not always document what questions were asked, how these were answered, or particulars of any other audit-related discussions that took place.

It will be critical for auditors to have open and continuous dialogue with audit committees this reporting season.

I would also mention that the staff of the CICA's Auditing and Assurance Standards Board have recently issued a Risk Alert entitled "Auditing Considerations in the Current Economic Environment" that I think you will find very useful. I encourage you to read this.

This audit season, given the complexities in financial reporting and the impact of the global economic downturn, auditors need to ensure that they perform audits with appropriate professional scepticism.

Slide 18 - Concluding Comments

In closing today's webcast I would like to thank everyone for your participation and I hope that our presentation today has helped to highlight some of the financial reporting challenges that will be faced by financial statement preparers, boards, audit committees and auditors as we all navigate our way through these times of economic uncertainty.

Auditors should view the current environment as an opportunity to step back and reconsider their audit approach from previous years and assess whether improvements should be made to make the audit more responsive to the risks in the current economic climate.

CPAB is confident that, financial statement preparers and those charged with corporate governance oversight will rise to the challenges they are facing in today's economic environment. This, augmented by high quality audits will go a long way towards achieving integrity in financial reporting.