



CANADIAN PUBLIC ACCOUNTABILITY BOARD
CONSEIL CANADIEN SUR LA REDDITION DE COMPTES

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AN UPDATE FROM THE CANADIAN PUBLIC ACCOUNTABILITY BOARD

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The 2007 Report

The Canadian Public Accountability Board (CPAB) effectively began registering and inspecting public accounting firms early in 2004. After three years of operations, a key question is whether CPAB has contributed to an improvement in the quality of auditing of reporting issuers in Canada. In its fourth public report,¹ issued earlier this year, CPAB commented on the results of its 2006 quality inspections of Canada's six national public accounting firms. These firms audit over 90 percent of the public companies in Canada if measured by market cap. The report also covered 21 firms that operate on a regional or local scale; they were reviewed by CPAB between October 1, 2005 and September 30, 2006. The report was upbeat in tone, noting that over the past three years, CPAB has inspected the public accounting firms that conduct the bulk of public company audits in Canada, and has made numerous recommendations for improvements to ensure high quality audits on a more consistent basis.

As the report describes, the CPAB sends each firm reviewed a private report that includes specific recommendations. Most of the recommendations that were made in prior years, and all the significant ones, have been implemented. This should enhance the credibility of the financial statements of public companies and provide greater confidence in Canada's capital markets. This credibility should be further enhanced by the new audit standards that have been issued regarding quality control, terms of audit engagements and management representations.

¹ Available at www.cpab-ccrc.ca

Who CPAB Inspects

CPAB has now inspected each of the six national firms either two or three times. Of the 21 other firms identified above, five of the larger ones were inspected for the second time in the period under review. It should be noted that CPAB's findings cannot be compared precisely to those contained in its last two reports, for reasons that will be discussed below.

The Most Recent Results

Despite the very real improvements that CPAB has observed in the firms inspected for the second and third times, it continues to be concerned that quality weaknesses persist. In its reviews, CPAB looks at six elements of the practice of an audit firm. CPAB was generally satisfied with the policies and procedures followed by the firms inspected in the areas of Tone at the Top, Client Acceptance, and Continuance and Human Resources. CPAB discovered a number of exceptions in the area of Independence and Ethics, particularly with regard to investments owned by partners. However, CPAB was satisfied that these were inadvertent errors and that the firms acted expeditiously to correct them when the firms' monitoring programs discovered them. In the areas of Engagement Performance and Quality Monitoring, however, CPAB believes that all firms have more work to do to achieve consistent adherence to firm and professional standards.

CPAB's findings cannot be compared precisely to those contained in its last two reports as the mix of reporting has slightly changed. Overall, the number of audits reviewed in the two periods was similar, but there was a higher percentage of deficiencies with respect to both Generally Accepted Auditing Standards (GAAS) and Generally Accepted Accounting Principles (GAAP) reported in 2006 at all levels. Although it may appear that the results are somewhat worse than the previous year, it must be noted that:

- for the six national firms, a different mix of partners and offices is reviewed each year. Despite the fact that these firms have standardized quality control and monitoring systems, these differences can and do cause variations in the reported results; and
- for the regional and local firms, the mix of firms inspected varies significantly from year to year.

The Issue of Privileged Information

As in previous years, the scope of CPAB's inspections of some individual audit engagements was restricted by a lack of access to documents because of legal privilege. While CPAB understands concerns about legal privilege, any restrictions on its reviews constitute a serious impediment to fulfilling its mission. The passage of Bill 151 in Ontario and Bill 7 in Quebec will improve CPAB's situation in this regard. CPAB continues to seek statutory authority in other jurisdictions to have access to privileged information without negating that privilege.

Some Specific Quality Concerns

For five of the files reviewed at the national firms and 13 at the other firms, CPAB found that deficiencies in the application of GAAP resulted in remedial action being required (or had been taken) to have financial statements reissued, restated or corrected in the subsequent year.

CPAB also found that just over 7 percent of the files that it reviewed at the national firms and 25 percent of the files reviewed at the regional and local firms were deficient in meeting GAAS standards. CPAB considers this number of deficiencies to be too high.

CPAB continues to have concerns regarding such important areas as:

- The extent and quality of second partner review - in several cases, the amount of time booked by the second partner was obviously insufficient to carry out the review and, in others, the documented timing of the review was much too late in the review process to be meaningful;
- Quality monitoring - cases where the findings from quality monitoring did not result in the firm taking appropriate action against the partner in charge of the file or, in the case of certain smaller firms, the complete lack of existence of such procedures; and
- Documentation of consultations - even though those consultations may have related to significant issues regarding the financial results being reported, the matters discussed were often not documented, nor were the comments of the person consulted set out in the file.

These areas require ongoing attention in order to improve performance on audit engagements overall and to address the number of deficiencies in the files CPAB

inspected.

Among the specific findings that CPAB noted were the following:

- Inadequate audit work related to the fair value valuations of start-up companies with little revenue, no history of earnings and no identifiable cash flows;
- A lack of procedures regarding the use of specialists such as valuers;
- Poor documentation of reporting to audit committees and of the discussions with those committees;
- A lack of adequate processes for carrying out reviews of subsequent events; and
- Firms not comparing the final copy of the financial statements on file to those filed on SEDAR or EDGAR.

Cases of Discipline

As a result of its reviews, CPAB placed requirements on three firms that required them not to take on additional reporting issuer clients until they had complied with CPAB's recommendations. This brings the total number of firms to which CPAB has applied this type of requirement to eight. In addition, CPAB deregistered one firm that failed to comply with CPAB's recommendations and requirements.

International Relationships

CPAB believes that there must be effective cooperation with independent audit regulators based in other countries in order to avoid duplication of effort and to control overall costs in the conduct of audit inspections with a global reach. During the past year, CPAB became a founding member of the International Forum of Independent Audit Regulators. This group of oversight bodies, representing 18 countries, is developing protocols to increase the effective and efficient conduct of audit inspections internationally.

In 2006, CPAB conducted several joint inspections with the Public Company Accountability Oversight Board (PCAOB) of firms in Canada and appreciates the cooperation that it has received from its American counterpart. CPAB led the inspection work in the nine joint inspections that it conducted with representatives of the PCAOB. During these inspections, the PCAOB inspected the files of a number of joint issuers and of a number of companies registered with the Securities and Exchange Commission in the US only.

International Standards

The Auditing and Assurance Standards Committee of the Canadian Institute of Chartered Accountants has elected to move to the use of international standards; the CPAB is in full agreement with this decision. One area where both Canadian and international standards require a major upgrade pertains to the steps that should be taken by an audit firm when it relies on the work done by another audit firm. This occurs when one firm (the primary auditor) is appointed to audit an entity's consolidated financial statements, but a different firm (the secondary auditor) may be responsible for the audit of an important domestic or overseas operation that is part of the consolidation. Current standards are somewhat imprecise as to the extent of work required in overseeing the work of the secondary audit firm. Some Canadian primary auditors are signing opinions even though most of the work is performed by the secondary auditors and this reliance is rarely disclosed to the shareholders. The International Auditing and Assurance Standards Board has issued a new exposure draft of a new International Standard on the audit of group financial statements. CPAB looks forward to the significant strengthening of this standard.

Conclusion

There is clear evidence that audit firms have made changes as a direct result of CPAB's activities. Over the last three years, the six national firms have significantly increased their combined expenditures on national offices which are responsible for overseeing audit quality, and on strengthening independence recording and monitoring systems. They have also strengthened some of their policies, particularly in the area of managing overseas audits. Many of the smaller firms have also invested through the implementation of updated manuals and systems to improve human resource management, quality and quality management. CPAB has already observed improvements at firms during second and third visits. It will undoubtedly take time for some of these changes to produce tangible results. But CPAB is optimistic the payback from all of these changes will, together with the commitment to quality by the firms' leadership, reduce the number of its concerns in the near future.

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