



What can audit committees expect to learn about CPAB quality inspections?

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The responsibilities of audit committees of public companies and other reporting issuers, as set out in Canadian Securities Administrators' Multilateral Instrument 52-110, include oversight of the work of the external auditor. This article is intended to help audit committees understand what they may expect to learn about any inspection by the Canadian Public Accountability Board (CPAB) of their audit firm.

CPAB's public and private reports

In previous articles in the ICD *Director* newsletter, I have explained the background of CPAB and that it contributes to public confidence in the integrity of financial reporting by conducting a rigorous program of quality inspections of public company auditors, either directly or in cooperation with provincial or foreign regulatory authorities. These quality inspections have two principal outputs: periodic public reports that discuss recurring findings arising from inspection results across a group of firms (available on CPAB's website), and private reports of findings and recommendations to the individual firms inspected. Audit committees should find the contents of the public reports informative and useful to the oversight of their external auditor – the next one will be issued before the end of 2006.

CPAB's private report to each audit firm inspected contains two categories of recommendations: those that address potential weaknesses in the firm's system of quality control over audits, and those requiring action with respect to one or more of the sample of the firm's completed audits selected by CPAB for review. CPAB inspection reports are not finalized until the firm has had an opportunity to comment in writing on each draft recommendation. Once a report is final, CPAB expects the firm to implement its written commitments. CPAB follows up after a 180-day implementation period has expired to see whether the promised action has been taken by the firm. If that proves to have been the case, the recommendations and the resulting action remain confidential between CPAB and the firm. A failure of a firm to implement one or more recommendations to CPAB's satisfaction may result in CPAB making public on its website the relevant

portion or portions of the inspection report, after providing notice to the firm of its intention to do so. In more egregious cases, CPAB may levy restrictions or sanctions on the firm. Fortunately, nearly all firms inspected to date have been diligent in implementing their commitments, and only once has CPAB found it necessary to name a firm that has failed to make sufficient timely progress.

CPAB inspects only a small sample of each firm's completed audit engagements. The selection of individual engagements is weighted towards the clients in the firm's portfolio that are large (measured by market capitalization), complex and/or appear to have a higher than normal likelihood of significant financial reporting issues. For each engagement selected, CPAB considers the way that the audit firm planned, supervised and completed the audit as well as the specific audit work done with respect to certain aspects of the client's financial statements that appear to be particularly significant or complex or that may require the application of considerable professional judgement.

Audit firm/audit committee communication about CPAB's inspections

CPAB has no objection to an audit firm disclosing to a client's audit committee when it was last subject to a quality inspection by CPAB and whether the audit engagement of the particular client was selected by CPAB for review as part of the quality inspection process.

As noted, if the audit firm implements CPAB's recommendations within the prescribed time period, the recommendations will remain as a private communications between CPAB and the firm. However, CPAB does not object to the audit firm informing an audit committee whether it has implemented or intends to implement all of the recommendations made by CPAB, and the audit committee can take some comfort from the fact that CPAB follows up to ensure that the firm carries out its commitments.

At the level of an individual audit engagement, recommendations normally fall into one of three categories: auditor independence issues, accounting errors in the issuer's financial statements or deficiencies in the way the audit was conducted. Any of these should be of interest to an audit committee.

Independence issues

Independence issues normally involve either an investment in the client's securities by a partner or staff member of the audit firm contrary to the accounting profession's ethical standards, or non-audit services provided to the client that could be perceived as a threat to auditor independence. Auditors are required to notify the audit committee in writing about such circumstances when the audit firm is aware of them. If CPAB becomes aware of matters that have not been reported, as has happened on occasion, it asks the audit firm to notify the audit committee in writing about the circumstances and follows up to ensure that such notification has taken place. In addition, audit committees should expect their auditor to comply with generally accepted auditing standards by providing them, at least annually, with a confirmation of the auditor's independence.

Accounting errors

In a small proportion of the engagements reviewed by CPAB, we have concluded that the audited financial statements contain one or more errors that appear to be material to reported income or cash flow. The errors encountered have been diverse including miscalculated stock compensation expense, failure to bifurcate compound financial instruments into their debt and equity components, overstated or understated liabilities, incorrect accounting for business combinations, errors in the valuation of investments carried at fair value and proceeds from investing activities being included in cash flow from operations. In such cases, CPAB asks the auditor to request its client's management to discuss the matter with the appropriate securities commission. We expect that the audit committee would be advised by management and the auditor of this request. We also expect that the auditor would participate in any discussion with the commission. We follow up with the auditor and, if necessary, with the commission to ascertain whether appropriate discussion with the commission has taken place. The issuer and the commission may agree that previously issued financial statements should be restated, that some alternative course of action is appropriate, or that no action is necessary. If the accounting error involves a misclassification on a balance sheet or income statement or a need for amendments to the notes to the financial statements, but not a material error to reported income or cash flow, CPAB secures the auditor's agreement that the matter will be raised with the client for consideration when the client next prepares interim or annual financial statements.

Audit deficiencies

Audit deficiencies mean that CPAB thinks the quality or quantity of the audit evidence is not sufficient to support the opinion that the auditor has expressed. Sometimes, this is a matter of documenting audit work that was done but not documented or of documenting the rationale for important judgements that were made by the auditors without being properly explained or supported. On other occasions, additional audit work is required to remediate the deficiency. Usually, the conclusion from any extra work is that the client's financial statements and the audit firm's opinion thereon do not require adjustment; if so, the audit firm is not required to inform the audit committee that extra audit work has been done on a completed audit. However, if the extra work reveals an accounting error, the process for accounting errors described in the previous paragraph would apply.

Is CPAB's current public disclosure sufficient?

Although independent national auditor oversight bodies have recently been established in a number of countries, only in the US, UK and Canada is there currently public reporting on inspection results. Some in Canada believe that CPAB's private reports on individual firms should be made public, either in whole or in part, similar to the practice in the US.

CPAB's counterpart organization in the UK, which currently has a dual public/private reporting model very similar to that of CPAB, is engaged in a process of public consultation on this very issue. It has identified a number of advantages and

disadvantages of extended public reporting, many of which are also relevant to CPAB in Canada.

The advantages of public reporting by CPAB at the individual firm level would include:

- Greater public transparency around individual firm inspection results;
- Additional useful information for audit committees with respect to audit firm performance;
- Additional incentive for audit firms to show improvements in the quality of their work as measured by the content of their public reports; and
- Avoidance of practical difficulties that CPAB has when doing a collective public report on a group of firms doing audit work of disparate quality.

The disadvantages would be:

- Increased risk that firms will devote substantial time and effort to challenging findings rather than responding positively to any underlying quality issues;
- A more costly and legalistic inspection system to create the level of evidentiary support necessary for public disclosure at the individual firm level;
- Much less timely reporting to firms, based on the experience of the US PCAOB, which subjects all of its firm-level inspection reports to a detailed pre-issuance legal review;
- A more costly inspection system, as a consequence of the foregoing;
- Increased risk that public reports could become so bland as to be of limited value; and
- Undermining public confidence, perhaps unfairly, in the financial statements of companies whose auditors have been criticized publicly by CPAB.

CPAB has considered these arguments for and against extended public reporting and believes, based on its accumulated experience, that the opportunity to correct weaknesses identified in a private confidential report, coupled with the possibility of public disclosure for any failure to do so, provides the strongest incentives for audit firms to make prompt improvements in overall audit quality. Our objective is to foster timely substantive cooperative improvement in audit quality and we believe that our present public/private reporting model is consistent with that objective.