



**CANADIAN PUBLIC ACCOUNTABILITY BOARD
CONSEIL CANADIEN SUR LA REDDITION DE COMPTES**

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SIXTH PUBLIC REPORT

Inspections of the Quality of Audits Conducted by Public Accounting Firms

**Subject to the
CANADIAN PUBLIC ACCOUNTABILITY BOARD
OVERSIGHT PROGRAM
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Executive Summary

Over the five years of carrying out inspections of public accounting firms, with a heavy emphasis on the audit files, CPAB has seen many examples of excellent audit work. However, CPAB still encounters examples of audit work that falls short of professional standards. Even though CPAB reviews all the elements of quality control during the course of an inspection, the primary focus of this report is on engagement performance, since it is the ultimate test of audit quality.

National firms

National firms audit over 95% of Canadian reporting issuers by market capitalization. Their clientele generally have more complex operations, many with global reach. More and more audits these days inevitably involve the use of specialists, such as income tax, information technology and valuations. CPAB has generally found the quality of audit work to be high, although there are pockets or regions where quality needs to be improved. Also, improvements are needed in certain areas such as the role of the concurring partner, the need to more fully document consultations, the rigour applied to the use of specialists and the need to continually work towards improving documentation. CPAB believes that senior leadership at the National firms is firmly committed to maintaining the highest level of audit quality.

Regional and Local firms

CPAB has found considerable improvement in the audit work performed by Regional and Local firms. The most improvement occurs when firm leadership or “tone at the top” stresses the importance of audit quality. Regional and Local firms operate in a different environment from the National firms. Their clients generally do not have operations that are as complex. On the other hand, their clients may not have as robust a corporate governance regime as that of larger public companies.

The big difference between National and Regional and Local firms is the greater resources such as standards departments, guidance and training that are available to National firms. CPAB finds that, in general, Regional and Local firms have more difficulty auditing unusual, non-recurring transactions. This means that these firms need to make an effort to develop consultation networks, for ready access to additional guidance. In common with National firms, the concurring partner represents an important quality control element, but CPAB often finds the concurring partner review to be too close to the finalization of the audit and not sufficiently thorough. Since many audits of Regional and Local firms do not involve reliance on internal controls, CPAB finds extensive use of substantive analytical review procedures, but in those situations the procedures are not always robust enough to provide the desired level of audit assurance.

Global Economic Downturn

Financial statements of many companies will be affected by the global economic downturn. Whether it involves determining fair values of 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, management, Boards and Audit Committees, as well as auditors, face many challenges this reporting season.

CPAB decided to take a proactive approach and arranged meetings with senior leadership of the Big Four firms in early December 2008 in order to assess their readiness for auditing in a global economic downturn. Based on these and subsequent follow-up meetings, CPAB was satisfied that each firm had made considerable effort to be prepared to deal with the accounting and auditing issues that will arise as a result of the global economic downturn.

On January 22, 2009 CPAB held its first webcast, "The Integrity of Financial Reporting in an Economic Downturn", to raise awareness of financial reporting and auditing challenges in the current economic environment. In addition to auditors, the target audience was financial statement preparers, Audit Committees and Boards of Directors. CPAB's website (www.cpab-ccrc.ca) contains a link to the archived webcast and a copy of the speakers' notes.

The global economic downturn will affect CPAB's inspection approach in 2009. Inspections will continue to be risk-based, but with more emphasis on engagement performance and less emphasis on other elements of quality control, such as client acceptance and retention, independence and human resources. CPAB will continue to focus on leadership responsibilities for quality within the firm ("tone at the top") and on quality monitoring, since these play a significant role in promoting and assessing audit quality.

In this demanding environment CPAB expects auditors to perform audits with an appropriate degree of professional scepticism in 2009.

Introduction

Since its incorporation in 2003, the mission of the Canadian Public Accountability Board (CPAB) has been:

To contribute to public confidence in the integrity of financial reporting of public companies in Canada by promoting high quality, independent auditing.

CPAB's prime means of achieving this mission is to conduct inspections of public accounting firms that audit reporting issuers in Canada. This process involves providing audit firms with feedback, recommendations or requirements for improvement. The frequency of inspections depends on the number of reporting issuers audited by the firm, as discussed later in this report.

More recently, CPAB has also adopted other proactive approaches, including review of firms' preparation for dealing with the economic downturn and more public communications to firms about its expectations.

In the course of its inspections, CPAB sees many examples of excellent audit work: audits where generally accepted auditing standards (GAAS) were fully complied with by professionals, who appear from the files they have prepared to have a sound knowledge of generally accepted accounting principles (GAAP) and to take pride in their work. These persons bring credit to the public accounting profession in Canada.

Having said that, CPAB also encounters examples of audit work that fall short of professional standards. This report summarizes the major findings from inspections conducted in 2008. Under CPAB's rules, details of these findings are not published; rather, CPAB sends each firm inspected a private report that includes recommendations to deal with inspection findings, each of which requires a response. The firms have implemented, or are implementing, substantially all of the recommendations.

In most of its inspections, in addition to reviewing engagement performance – primarily by reviewing selected audit engagement files - CPAB reviews the other six elements of quality control, as set out in the *CICA Handbook*:

- *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 their application).

These six elements are means to an end: good engagement performance. The primary focus in this report is therefore on the findings from reviews of audit engagement files.

Scope of 2008 Inspection Program

Statistics on firms inspected and engagements reviewed

During 2008 CPAB inspected 42 firms, and reviewed 224 audit engagements, as follows:

	Number of firms	Number of engagements
National firms	6	123
Other firms – Recurring inspections	15	69
- Follow-up inspections	21	32
Total	42	224

The 224 engagements reviewed in 2008 appears to represent a sharp reduction from the number reviewed in 2007. This is because the reporting year changed in 2007, and the period covered then was 15 months.

In addition, 45 firms that audit reporting issuers were inspected by provincial professional accounting bodies. This report does not cover the findings from their inspections.

Differences in structure/processes from size of firm

The purpose of every CPAB inspection is to contribute to public confidence in the integrity of financial reporting of reporting issuers in Canada by promoting high quality, independent auditing, but the inspection approach followed varies, depending on the size of the firm.

At the one end of the spectrum, a firm with four partners, ten professional staff and one location will not need, for example, comprehensive human resources systems for appraising staff and monitoring professional development requirements: the partners know the staff and their training needs, and so can take a less structured approach. At the other end, a national firm, with hundreds of partners and thousands of staff operating out of numerous offices, needs such systems, and CPAB reviews key aspects of them in its inspections.

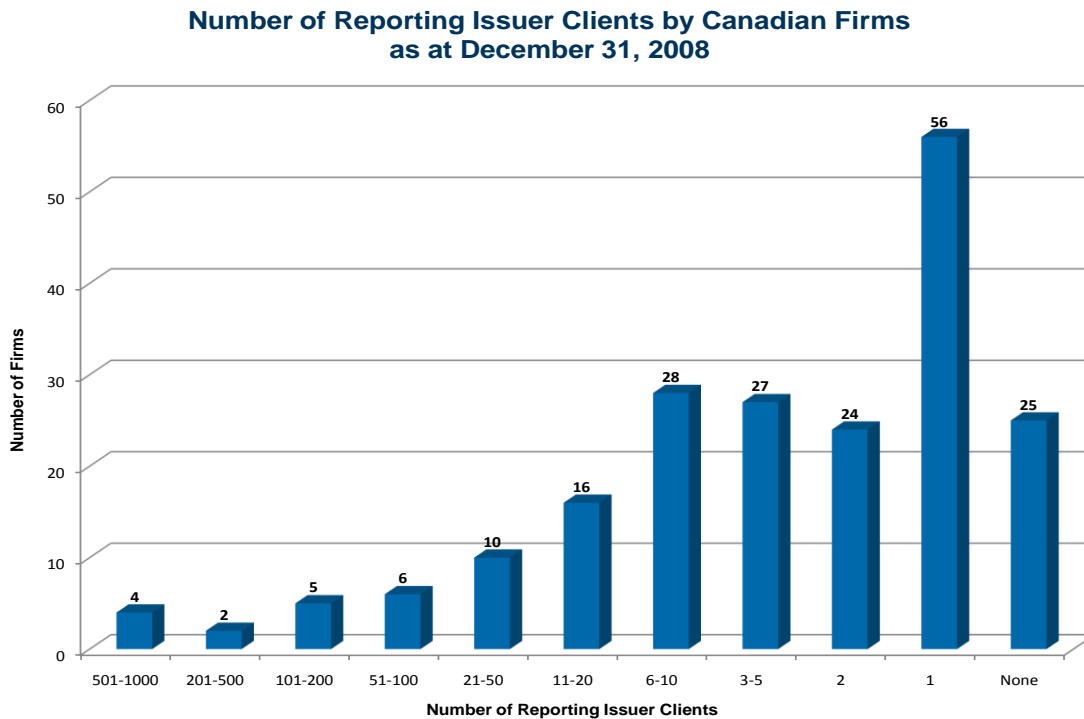
Accordingly, while all public accounting firms performing assurance engagements are required to follow “General Standards of Quality Control for Firms Performing Assurance Engagements” in the *CICA Handbook*, CPAB does not expect all of the more than 250 firms registered with CPAB (the substantial majority of which audit fewer than five reporting issuers) to follow the same procedures. Indeed, this section recognizes the need for differences:

“The nature, extent, timing and documentation of the policies and procedures developed by firms to satisfy the requirements of these Recommendations will vary and depend on many factors, including the size and nature of the practice of the firm and its operating characteristics”.

As discussed later in this report, CPAB is currently refining its approach to inspecting smaller firms, based on experience over the past few years.

Recurring inspections

The following table shows the number of reporting issuer clients audited by Canadian firms. CPAB’s inspections focus primarily on those with a higher number of reporting issuer clients.



The frequency of recurring inspections depends on the number of reporting issuers audited by the firm: those firms with 100 or more reporting issuers are inspected each year. Special follow-up visits are seldom needed to check on implementation of recommendations, as this checking can best be performed during the next inspection. However, where a significant issue needs to be dealt with urgently, e.g. a potential withdrawal and reissuance of financial statements due to a potential GAAP restatement, a prompt follow-up visit is scheduled.

Firms with between 50 and 99 reporting issuer clients are usually inspected every second year, and those with fewer than 50 reporting issuer clients are usually inspected every third year. Between those visits, CPAB conducts follow-up inspections to see that appropriate actions have been taken with regard to the recommendations made. The majority of inspections of firms with very few reporting issuer clients are carried out by the relevant provincial professional accounting bodies, who share their findings with CPAB.

During recurring inspections CPAB reviews selected audit engagement files. These selections are not made randomly; rather, CPAB uses several criteria, including size, complexity, level of risk, and a balance between companies that also report to the SEC and those that do not. In addition, an attempt is made to cover, over a reasonable period, all partners who work on reporting issuer audits.

The level of risk was an important selection criterion in 2008 and, with the current economic environment, will become even more vital in 2009. CPAB uses external data bases to assess risk, based on key performance indicators: cash flows, liquidity, market capitalization, changes in market capitalization, default probability, etc. This leads to the preparation of a CPAB risk rating that ranks reporting issuers based on a combination of risk factors. Some firms do their own risk analyses and prepare a list of “high risk” clients, which CPAB compares to its list.

Reviews of selected audit files are of two types:

- **Full reviews** cover several general matters relating to the audit, and selected financial statement items, such as investments, revenue and business combinations, which are susceptible to misstatement and other factors (reviewing every aspect of an audit would be prohibitively expensive). Full reviews cover the overall engagement planning, the execution as it applies to selected financial statement areas, the review of the summary of key issues addressed in the audit (the “engagement completion document”) and the overall reporting to the Audit Committee.
- **Focused reviews** cover a limited number of selected financial statement items, again based on susceptibility to misstatement and other factors such as significant estimates and judgments inherent in the financial statement item. In focused reviews, CPAB reviews the planning, execution and reporting to the Audit Committee for selected financial statement items.

Follow-up inspections

Follow-up inspections are generally much briefer than recurring inspections, in that they focus on matters that have previously been identified as problem areas.

- **Normal re-inspections** are conducted to check on whether the firm has responded to the recommendations made after a recent inspection – firms are given 180 days after release of a CPAB report to take previously-agreed action to rectify problems, and CPAB follows up to see this is done.
- **Inspections after requirements** are conducted where CPAB’s Board of Directors has imposed *requirements* on a firm. The most common requirement is that the firm may not accept any new reporting issuer clients until remedial action has been taken to CPAB’s satisfaction. Others include (a) the need for audit working papers on reporting issuers to be reviewed by an external firm before issue, and (b) the need for additional training for specified partners/staff. Again the purpose of the inspection is to see that the agreed action has been taken, and to consider whether the requirement should be lifted. In most cases it is.

“Credit crunch” impact (ABCP)

In the 2008 inspections, CPAB focused on the impact of the illiquidity of asset-backed commercial paper on reporting issuers and the related audit work. CPAB conducted focused reviews of the audit work performed on the valuation of ABCP and the financial statement disclosures of assumptions used in determining fair value. This involved the review of work performed by specialists retained by the auditing firms as well as by management. As noted later in this report, CPAB found issues relating to the use of specialists for assessing recorded impairments of ABCP and financial statement disclosure deficiencies regarding various assumptions that were used to value these investments. CPAB found that financial statement disclosures improved compared to earlier financial statements prepared by companies holding ABCP.

CPAB’s access to privileged information

The scope of CPAB’s reviews of some individual audit engagements continues to be restricted by lack of access to documents because of claims of legal privilege. While CPAB understands concerns about legal privilege, any restrictions on its reviews are contrary to its mandate. They also prevent CPAB from expressing a complete view on the quality of audits done by certain audit firms.

CPAB’s mandate is to oversee the auditors of reporting issuers to provide reasonable assurance that audits of reporting issuers are being conducted in accordance with professional standards. This oversight, as noted above, includes reviews of selected audit files, with a focus on high-risk engagements, these generally being the most challenging. CPAB cannot fulfill this mandate properly without access to all of the information the auditors had to express their opinion. Information that has been withheld from CPAB includes letters from legal counsel and related working papers in significant risk areas such as environmental liabilities, asset retirement obligations, litigation, and tax contingencies and accruals. This means that there

could be material GAAS or GAAP deficiencies that CPAB would not be aware of without access to privileged information. Also, CPAB needs full access to working papers to determine whether the auditor appropriately consulted with experts where issues are contentious or complex.

CPAB's counterpart audit regulators in the US (Public Company Accounting Oversight Board, or PCAOB) and the UK (Financial Reporting Council, or FRC) are able to access privileged information. When CPAB and the PCAOB conduct joint inspections, even in Canada, the PCAOB has right of access to privileged information but CPAB does not. This makes the performance of a joint inspection unduly complicated.

The passage of the Canadian Public Accountability Board Act (Ontario) 2006 and An Act to amend the Chartered Accountants Act in Quebec will significantly improve CPAB's situation. CPAB continues to seek statutory authority in all jurisdictions to have access to privileged information without negating that privilege.

Changes over the Five Years of Inspections

From its inception, CPAB has seen some excellent audit work being performed, and based on audit files reviewed in 2008, it appears that more audits now meet a high standard of audit quality than did so five years ago.

Within the National firms, the main challenges seem to lie within a few offices, where shortcomings in audit work are more evident and prevalent than in the majority of offices. In the Regional and Local firms, audit quality varies between firms; those with a strong “tone at the top” focused on audit quality usually have a higher standard of quality.

In CPAB’s experience, inspections of most firms move through a cycle. The first inspection is something of a wake-up call with some of the quality control elements either not having been addressed or processes for them not having been developed. The second inspection shows a marked improvement, with all elements having received attention. From the third inspection the element on which most attention is focused is engagement performance, as evidenced by the quality of work in the engagement files. From the third inspection there are fewer significant findings in areas other than engagement performance: it is the ultimate test of audit quality, and CPAB focuses on recommendations that will result in quality improvements.

CPAB has also seen an evolution in its own procedures. It has steadily increased its use of specialists – valuation, tax and information technology – and has developed a more rigorous approach to selection of both files and specific sections of files to review, based on thorough risk analysis as part of the planning process. Also, it has gained more experience with file reviews, and has moved to a greater use of focused reviews. As a result, CPAB has become more adept at identifying potential issues.

Over the past five years both GAAS and GAAP have become more complex, making it more difficult for auditors (and reporting issuers) to comply fully with the standards.

One of the biggest changes over the past five years resulting from CPAB’s oversight has been a significant increase in the rigour of internal quality monitoring carried out by the firms, particularly the National firms.

Disciplinary Actions

Firms are required to implement CPAB’s recommendations within a prescribed period. When CPAB believes disciplinary action is necessary to protect the public interest, generally due to substandard audit work, or if it is not satisfied that the recommendations have been implemented appropriately, CPAB imposes requirements. Such measures usually reflect CPAB’s concerns about the number and severity of GAAS and GAAP departures in the engagements reviewed.

The table below shows the number of firms where requirements have been imposed over the last three years and the number and types of requirements. In 2008 one of the firms challenged the requirements imposed, and this matter is currently the subject of a review proceeding in accordance with CPAB’s rules. CPAB is disappointed that the number of firms that had requirements imposed in 2008 was not significantly reduced from 2007. In most situations requirements are lifted after CPAB performs a follow-up inspection, but this is not always the case: requirements continue until CPAB is satisfied that the firm is performing audit work in accordance with professional standards (follow-up procedures are discussed on Pages 9 and 10).

Requirements Placed on Firms

	2008	2007	2006
Number of firms receiving requirements	9	11	7
Requirements most commonly imposed:			
Firm or a specified partner cannot accept any new reporting issuer clients	9	7	7
Audit working papers to be reviewed by an external firm or professional standards group before issuance of audit report	4	3	2
Specified partners required to take additional training	3	2	-

Six National Firms

Overview of firms inspected and files reviewed

As shown in the table on Page 7, CPAB inspected six National firms in 2008, and reviewed 123 audit engagement files. In the course of these reviews CPAB found that:

- a) Five audit engagements were not conducted in accordance with GAAS in that there were a number of significant GAAS deficiencies. There were also a number of engagements where improvements in the audit approach were needed to comply fully with GAAS.
- b) The financial statements for one engagement were not in accordance with GAAP. For a few others there were potential restatements (depending on the results of follow-up investigations).

Where CPAB identifies GAAS deficiencies, it may require the firm to extend its auditing procedures, add documentation to the audit file, or take some other action. Several of the files in which CPAB considered improvements were needed to comply fully with GAAS were in high-risk areas where complex judgments were needed, but the thought process that went into those judgments was not documented adequately.

Where it appears to CPAB that the reporting issuer's financial statements were not in accordance with GAAP, this generally means one or more reasonably significant GAAP departures were noted in the review of the audit file. In certain instances, however, the GAAP departures may not be material enough to require a restatement of the financial statements. Where it is determined that the GAAP departure is so significant as to make the financial statements misleading as a whole, CPAB will request the audit firm to contact the reporting issuer to have the financial statements restated, either currently or, if considered appropriate, when the next public reporting of financial information takes place. In a situation where a potential GAAP departure is identified, but its significance cannot be evaluated, CPAB requests the audit firm to perform more work to ascertain the extent of the GAAP departure, and to immediately advise CPAB of the results. CPAB will then take additional steps, up to and including requesting the audit firm to contact the reporting issuer to have the financial statements restated, depending on the results of the additional work performed.

Examples of these GAAS and GAAP findings are set out in Appendix A.

Major findings

As mentioned earlier, CPAB sees some excellent audit work in the files it selects for review.

However, there are still issues, which tend to be more prevalent in certain offices rather than being common in all offices. The most important of these issues relate to the role of the concurring partner, consultations, the use of specialists, and documentation.

- **Role of concurring partner**

The involvement of the Engagement Quality Control Reviewer (EQCR or concurring partner) is a vital element of quality control in the audit of a reporting issuer. If a suitably qualified and objective EQCR reviews the planning when the audit is started, acts as a sounding board for the Engagement Partner and other members of the engagement team as the audit progresses, and reviews the team's key judgments and conclusions reached in formulating the audit report when the audit draws to a conclusion, the audit will be of higher quality than it would otherwise have been.

EQCR-related problems noted by CPAB included:

1. The time spent by EQCR often appeared to be too little, too late – the EQCR was not involved in planning, and review of main audit findings and judgments was delayed until close to statement finalization and approval. Also, in the first year EQCRs are assigned to engagements, insufficient time often appeared to have been spent to familiarize themselves with the client.
2. Shortcomings that should have been evident to the EQCR were sometimes missed; it was not always clear whether, under the firm's monitoring, the EQCR would be penalized for having missed points that should have been evident.

The role of the EQCR does not always appear to be well understood, and additional guidance and training may be needed.

- **Consultations**

Under GAAS, the auditor is required to undertake "appropriate consultation on difficult or contentious matters", either within or outside the audit team, and to document the nature, scope and conclusions of these consultations.

In CPAB's review of National firms' audit files, it appeared that:

1. Some partners are reluctant to consult on difficult issues, either with other practice office partners or with National Office.
2. Consultations were often not well documented, with the person consulted not being asked to concur with the conclusions reached. This is especially critical since the consultation usually related to very complex accounting or auditing judgments.

- **Use of specialists**

Situations in which specialists are needed by audit teams have increased in recent years, particularly those involving the use of fair values, usually in connection with business combinations, impairments and valuation of financial assets. Also, with the global economic downturn, situations involving potential impairments will become more prevalent.

In this area, CPAB noted the following in its file reviews in 2008:

1. Some partners appeared to be reluctant to use specialists in difficult areas.
2. Where specialists were used, the reasonableness of the data used by the specialists was not always validated by the engagement team.
3. The work of some specialists lacked rigour, e.g. assumptions used in valuations were not subjected to careful assessment. This is usually most evident where valuations were made by management and reviewed by the firms' valuations specialists.
4. Documentation of specialists work sometimes did not describe the thought processes followed to arrive at conclusions.

In summary, professional standards governing the use of specialists in audit engagements were not fully adhered to.

- **Documentation**

During its file reviews CPAB saw several examples of documentation that did not permit an experienced auditor, having no previous connection with the engagement, to understand procedures performed, results obtained and significant findings, as is required under professional standards. Unfortunately, CPAB did not note an improvement over the prior year in this area.

CPAB wonders whether some of the documentation deficiencies arise from Partners and Senior Managers reviewing electronic working papers away from clients' offices where field staff are working, with a consequent lack of on-the-job training and review. Also, tight deadlines may have led to less thorough reviews.

- **Independence reporting**

CPAB has responsibility for assessing audit firms' compliance with rules of professional conduct, including independence rules. In addition, individual audit firms may have firm-specific policies and procedures designed to avoid independence infractions.

Over the past few years CPAB has observed a significant improvement in the documentation, monitoring and checking of investments held by partners and staff of National firms. The largest firms, under SEC rules, conduct audits of their partners' independence portfolios. Violation of the profession's rules of professional conduct is rare.

The most significant shortcoming in this area is that partners and staff are not reporting investments made personally or by immediate family members as promptly as they should, thereby increasing the risk of audit independence problems. This shortcoming relates primarily to the policies and procedures of individual firms, rather than to violation of the profession's stringent rules of professional conduct.

- **Statement presentation and disclosure**

The presentation and disclosure of financial statements are becoming increasingly complex, and CPAB still sees several sets of statements which do not comply fully with professional standards. These suggest that neither the audit engagement team nor the EQCR pay adequate attention to detail in reviewing the statements.

Some of the most common shortcomings lie in complex new areas, such as fair value assumptions. Also, CPAB finds that presentation and disclosure deficiencies are not always reported to the audit committee so they can assess the implications of disclosure deficiencies.

- **Reliance on other auditors**

Many reporting issuers have significant subsidiaries in other countries; indeed, the foreign operations of some reporting issuers account for almost all of the operations of the issuer. These subsidiaries are usually audited by affiliates of the parent company auditor, who relies on that audit work.

While the parent company auditor has access to the audit files for these subsidiaries, CPAB does not, and the parent company auditor often does not have sufficient documentation on file regarding the work of the secondary auditor to enable CPAB to assess whether Canadian standards have been met for the overall consolidated financial statements. This represents as severe a scope restriction as a lack of access to privileged information. The present Canadian standard covering reliance on other auditors is weak, and the proposed standard would be an improvement, although it provides little guidance on documentation.

- **Inconsistency between offices**

In its inspections of National firms CPAB has noted that the quality of audit work in some offices is noticeably lower than in others – the shortcomings summarized above occur more frequently in those offices. This may be caused by one or more of staffing constraints, type of clientele, lack of on-site expertise, and a greater reluctance to consult (either within the office or with the firm’s National Office).

Having said that, CPAB has noted distinct improvements where, following CPAB’s inspection, the firm has made changes to key personnel in an office or a region.

Regional and Local Firms

Overview of firms inspected and files reviewed

As shown in the table on Page 7, CPAB made recurring inspections of 15 Regional and Local firms in 2008, and also performed 21 follow-up inspections. As part of these inspections CPAB reviewed 101 audit engagement files.

In the course of these reviews CPAB found that:

- a) Thirteen audit engagements were not conducted in accordance with GAAS. In addition, there were a number where improvements in the audit approach were needed to comply fully with GAAS.
- b) The financial statements for ten engagements were not in accordance with GAAP. For a few others there were potential restatements (depending on the results of follow-up investigations).

Examples of these GAAS and GAAP findings are set out in Appendix A.

These findings led to requirements being placed on nine different firms.

Major findings

Despite the results of file reviews summarized above, CPAB found many examples of excellent audit work. Such work was most often found in firms where there was a strong “tone at the top”, with an emphasis on audit quality.

The Regional and Local firms do not have some of the resources of the National firms. For example, there is usually no National Office to provide guidance or consultation, to develop audit programs or training materials, or to co-ordinate quality monitoring. However, any needed changes can often be implemented more quickly than in a National firm.

Eight areas of GAAS and GAAP commonly noted by CPAB in its inspections of Regional and Local firms in 2008 are summarized below; in addition, many of the issues mentioned in relation to National firms also apply to Regional and Local firms.

- **Auditing outside “comfort zone”**

In a smaller practice some complex transactions may seldom be encountered, so the engagement team may not be familiar with the appropriate accounting. Examples of such transactions which were found to have been accounted for incorrectly by firms’ clients include:

- discontinued operations
- reverse take-overs
- business combinations
- future income tax assets and liabilities
- business reorganizations
- non-recurring related party transactions
- revenue arrangements with multiple elements

The auditor who is unfamiliar with a particular type of transaction may be less likely to challenge the client. CPAB noted instances of insufficient evidence of scepticism by the audit team, e.g. valuations and certain other assertions were not challenged rigorously.

- **Review by partner and concurring partner**

In some cases the review by the Engagement Partner and/or the EQCR was not thorough or timely: issues were missed, including errors in the auditor's report and the financial statement presentation and disclosure, and the review was performed too close to the statement release date to suggest it was sufficiently meaningful or could have dealt with any issues that might have arisen.

In other cases, all significant findings or issues were either not summarized in an engagement completion document (as required under professional standards), or the document was incomplete.

- **Linkage of risk assessment to substantive audit procedures**

CPAB noted instances where the risk assessment was not taken fully into account in designing audit procedures. Also, there were examples of the audit approach being little changed under the risk-based standards. In other words, the application of the risk-based approach did not show the linkage between the risk of misstatement by financial statement assertion to the audit procedures designed to mitigate that risk,

- **Substantive analytical review**

Where the auditor is using substantive analytical review procedures as a primary means of obtaining audit evidence, rigorous procedures must be performed. However, CPAB noted substantive analytical reviews that were superficial, or included unsupported assumptions.

In some cases the procedures performed were simply year over year fluctuation analyses, which are not contemplated under professional standards as providing sufficient audit evidence.

- **Documentation**

The professional standards for documentation are now demanding. However, CPAB saw many examples of documentation that was incomplete, unclear or did not otherwise meet these standards.

- **Initial audit**

An auditor taking over an audit from a predecessor is required to perform certain procedures. In some cases these were not carried out, or were carried out ineffectively.

- **Statement presentation and disclosure**

With the increasing complexity of financial statement presentation and disclosure, it is very difficult to remember all the requirements without an aide-memoire. Some firms still try to manage without a GAAP checklist, which results in items being overlooked.

Also, it is important that the Engagement Partner and the EQCR pay careful attention to detail in reviewing the statements, to avoid unnecessary errors.

- **Some quality control elements not covered by quality monitoring**

The quality monitoring programs of some firms focus on engagement performance, neglecting one or more of the other six elements of quality control. While engagement performance may be the most important, the quality control standards require all the elements to be covered.

CPAB Priorities for 2009

Global Economic Downturn

Financial statements of many companies will be affected by the global economic downturn. Whether it involves determining fair values of 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, management, Boards and Audit Committees, as well as auditors, face many challenges this reporting season.

CPAB decided to take a proactive approach and arranged meetings with senior leadership of the Big Four firms (who audit over 90% of public companies in Canada by market capitalization) in early December 2008, in order to assess their readiness for auditing in a global economic downturn. Based on these meetings and subsequent follow up meetings to discuss refinements in each firm's approach, CPAB was satisfied that each firm had made considerable effort to be prepared to deal with the accounting and auditing issues that will arise as a result of the global economic downturn. CPAB shared its proactive approach with international audit oversight regulators and was commended for its efforts.

CPAB held its first webcast entitled "The Integrity of Financial Reporting in an Economic Downturn" on January 22, 2009. The webcast was designed to raise awareness of financial reporting and auditing challenges in the current economic environment. In addition to auditors, the target audience was financial statement preparers, Audit Committees and Boards of Directors. CPAB's website (www.cpab-ccrc.ca) contains a link to the archived webcast and a copy of the speakers' notes. The speakers' notes, which provide guidance on financial reporting and auditing issues, have received widespread circulation; certain firms have posted them on their website or distributed them to their professional staff across Canada.

The global economic downturn will affect CPAB's inspection approach in 2009. Inspections will continue to be risk-based, but there will be more emphasis on engagement performance and less emphasis on other elements of quality control, such as client acceptance and retention, independence, human resources. CPAB will continue to focus on leadership responsibilities for quality within the firm ("tone at the top") and on monitoring, since these play a significant role in promoting and assessing audit quality.

For engagement performance, CPAB is using data bases to identify high-risk reporting issuers and is reviewing the audit work on selected financial statement items within those financial statements. In 2009, CPAB will pay particular attention to the use of specialists, consultations and the role of the EQCR, since they will be critical in the current environment.

Smaller Firm Inspection Methodology

CPAB is trying to manage its resources devoted to the inspection of smaller firms in order to be more efficient and effective. CPAB is therefore refining its methodology and in 2009 will implement an inspection approach designed specifically for the smaller firm. The focus will continue to be on engagement performance, since that is the primary indicator of audit quality. It is expected that more use will be made of enquiry, and the testing of quality control elements will be limited to situations where issues were identified in prior inspections and/or significant changes were made to the firm's processes. The new small firm inspection methodology will allow CPAB to carry out inspections in less time and thus be able to visit more firms.

Measurements of Audit Quality

While audit quality is subjective, CPAB intends to continue its efforts to measure factors that impact audit quality. In 2009 CPAB will be obtaining statistical data on what it believes are indicators of audit quality. This will enable CPAB to compare changes to these indicators annually and to perform cross-firm comparisons of these measures. Ultimately, CPAB would like to be able to correlate these indicators of audit quality to engagement performance to identify the root causes of breakdowns in audit quality.

Conclusion

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.

Appendix A: Examples of Departures from GAAS and GAAP

National Firms

Three types of departures were noted in reviewing engagement files of National firms: GAAS departures, GAAP departures and Potential GAAP departures – those which appear to be GAAP departures, but further work is required to determine whether they represent a material GAAP departure. CPAB did not find as many GAAP departures as in the past.

1. GAAS Departures

- a) **Accounts receivable subledger:** No audit procedures were performed on a write-down of the accounts receivable balance in the general ledger to bring it into agreement with the total of the accounts in the subledger, although the write-down exceeded materiality.
- b) **Dilution gain or loss on reduction of ownership in subsidiary:** A wholly-owned subsidiary issued shares to third parties, reducing the parent company's interest to 89%, but there was no evidence that the audit team considered whether a dilution gain or loss resulted from the transaction.
- c) **Documentation of confirmation process:** There was insufficient documentation of the confirmation process to evidence control by the audit team of the process for selecting, preparing and mailing confirmation requests, or of the confirmation replies being sent direct to the auditor.
- d) **Variable Interest Entity (VIE):** Inadequate audit work was performed to analyse the risks/rewards and rights/obligations related to the VIE's activities and to assess the impact on the appropriateness of the accounting treatment.
- e) **Valuation by a third party:** A valuation specialist was engaged by the reporting issuer to support the fair value assigned to assets acquired, but the auditors did not document their conclusions on (i) the reasonableness of the source data and the assumptions and methods used by him; or (ii) the specialist's findings.
- f) **Work of valuation specialist:** There was little evidence in the audit file to indicate that the assumptions used in valuing ABCP investments were challenged with sufficient scepticism.
- g) **Audit work on foreign subsidiaries:** The engagement team did not review the work of the firm's foreign affiliates who audited 100% of the company's operations, nor did the team visit the locations at which the operations were conducted.

2. GAAP Departures

- a) **Comparative figures not provided after a reorganization:** The reporting issuer underwent a reorganization that was accounted for using continuity of interests accounting and also changed its year end. The balance sheet was presented on a comparative basis, but the other statements were not. As a result, the financial statements did not meet the requirement that when continuity of interests accounting is applied the statements of the combined company presented for prior periods are to be presented as if the companies had been combined since their inception.

3. Potential GAAP Departures

- a) **Goodwill impairment test:** A key assumption in the discounted cash flow calculations prepared by the client to support the impairment test of goodwill was the assumed EBITDA margin. However, this margin was significantly higher than the assumption used by an external valuer in the prior year, and the file did not address why the projected increase was realistic in comparison.
- b) **Identity of purchaser of a subsidiary:** A subsidiary with a significant income tax liability, but no assets, was sold to an apparent arm's length purchaser for a nominal amount. The reporting issuer treated this transaction as the extinguishment of a liability, and reflected the amount of the liability as a gain in the income statement. However, the auditors did very little to verify that the purchaser was an arm's length party, despite the unusual nature of the transaction.

Regional and Local Firms

1. GAAS Departures

- a) **Bank confirmation not obtained:** No bank confirmation for a material cash balance was requested, and much of the balance was not traced to a bank statement.
- b) **Inventory and cost of goods sold:** The audit file did not include audit evidence to support the completeness and accuracy assertions for a number of account balances, of which two of the more significant were inventory and cost of goods sold.

- c) **Opening balances in an initial audit:** In an initial audit the file did not include sufficient appropriate audit evidence in relation to the opening balances.
- d) **Intangible assets in a business combination:** The audit file did not adequately address the identification and valuation of intangible assets acquired in a business combination.

2. GAAP Departures

- a) **Inappropriate basis of accounting used:** The reporting entity was formed as a result of the amalgamation of two companies under common control, at the beginning of the new entity's fiscal year. The comparative figures presented were those of just one of the parties to the amalgamation, whereas under the continuity of interests method, which should have been applied, all periods presented should have been based on the assumption that the two companies had been combined since their inception.
- b) **Incorrect amount allocated to share purchase warrants:** The proceeds of units containing both common shares and warrants were accounted for incorrectly – the amount allocated to the warrants was more than twice the proceeds of the units, resulting in a material error.
- c) **Cheques written but not sent:** Cheques totalling a material amount were accounted for as if they had been sent, resulting in an understatement of cash and accounts payable.
- d) **Environmental obligation not disclosed:** A material environmental obligation with regard to a mineral property was not disclosed in the financial statements, although it was known at the time of their release.

3. Potential GAAP Departures

- a) **Confirmation of exploration rights:** The licence covering the exploration rights of a foreign property had expired, and the extension could not be confirmed due to client management being unavailable.
- b) **Valuation of outstanding commodity derivatives:** The reporting issuer's financial institution valued outstanding commodity derivatives, but disclaimed an opinion on this valuation. An independent valuation is needed to determine whether any adjustments to the statements will be needed.

Appendix B: Background to CPAB

1. 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.
2. Canada has approximately 6,000 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, 2008, 203 Canadian accounting firms and 69 foreign accounting firms have completed the registration process, signed Participation Agreements with CPAB, become and continue to be participating audit firms. Since CPAB commenced operations in 2003, over 90 accounting firms that initially registered, have subsequently withdrawn their registration (approximately 10% of these were for merger reasons).
3. The six national public accounting firms in Canada are BDO Dunwoody LLP, Deloitte & Touche LLP, Ernst & Young LLP, Grant Thornton Canada (practicing as Grant Thornton LLP and Raymond Chabot Grant Thornton LLP), KPMG LLP and PricewaterhouseCoopers LLP. These firms audit more than 3,800 entities that are public companies or other reporting issuers in Canada, representing more than 95 per cent if measured by market capitalization.
4. 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 five years CPAB has inspected each of the six National Six firms five times; CPAB has inspected each of the firms that audit more than 49 reporting issuers at least twice in this period and the majority three 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.
5. 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.