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British Columbia Securities Commission
Alberta Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan
Manitoba Securities Commission
Ontario Securities Commission
Authorité des marché financiers
Financial and Consumer Services Commission (New Brunswick)
Superintendent of Securities, Department of Justice and Public Safety, Prince Edward Island
Nova Scotia Securities Commission
Securities Commission of Newfoundland and Labrador
Registrar of Securities, Northwest Territories
Registrar of Securities, Yukon Territory
Superintendent of Securities, Nunavut

Dear Sirs and Mesdames:

NATIONAL INSTRUMENT 52-108 *AUDITOR OVERSIGHT*

Thank you for the opportunity to comment on "CSA Notice and Request for Comment Proposed Repeal and Replacement of National Instrument 52-108 *Auditor Oversight*" ("Request for Comment")[1]. This comment letter is restricted to issues relating to the proposed Amended Auditor Oversight Rule, as defined in the Request for Comment.

1. Introduction

1.1 The subject matter of the Current Auditor Oversight Rule and of the Amended Auditor Oversight Rule covers only notice requirements by a participating audit firm after an inspection by the Canadian Public Accountability Board ("CPAB") has found an "audit deficiency" in the audit firm's quality control systems or in a

[1] (2013), 36 OSCB 10147 (2013-10-17).

failure to comply with professional standards. Notwithstanding the heading, "Auditor Oversight", these Rules have only a very limited scope in addressing the broad and important topic of regulation, supervision, oversight and accountability of auditors of reporting issuers across Canada. These *post hoc* notice requirements by an audit firm are only the tip of the iceberg in considering the current multi-jurisdictional and cooperative system of the regulation of auditors of reporting issuers across Canada. The goal of enhancing public confidence in the integrity of financial reporting in Canada requires further regulatory supervision that extends well beyond the adoption of the Amended Auditor Oversight Rule, the text of which is only a modest upgrade from the original version of the 2004 Current Auditor Oversight Rule.

1.2 The Amended Auditor Oversight Rule does not deal with the regulation, supervision, accountability or transparency of the underlying operations of the CPAB, issues which are central to the CPAB's declared mandate of protecting the investing public's interest as Canada's audit regulator.[2]

2. CPAB

2.1 The mandate, role, function, transparency and accountability of the CPAB are essential and underlying core matters to the broad question of the effectiveness of the important subject of 'auditor oversight' that is raised by the Request for Comment. Established without legislative empowerment by the Canadian Securities Administrators, the Office of the Superintendent of Financial Institutions and the Canadian Institute of Chartered Accountants as a private, self-regulatory, not-for-profit organization, the CPAB has taken on the important national responsibility for the regulation of auditors of public companies. CPAB's Letters Patent mandate it to "contribute to public confidence in the integrity of financial reporting of public companies by promoting high quality, independent auditing … ." The by-laws of CPAB, which were approved by the Council of Governors, which is effectively controlled by the Canadian Securities Administrators, direct CPAB, among other things, to "promote, publicly and proactively, the importance of high quality external audits of Reporting Issuers; … report publicly on the means taken to oversee the audit of Reporting Issuers and the results achieved; … ensure appropriate transparency in the conduct of [CPAB's] activities;"[3] CPAB states that it is "the national body responsible for the regulation of public accounting firms that audit Canadian reporting issuers."[4] CPAB's website declares that it "is Canada's audit regulator, protecting the investing public's interest." CPAB expresses that its "mission is to contribute to public confidence in the integrity of financial reporting of reporting issuers in Canada by effective regulation and promoting quality,

[2] CPAB website. The CPAB describes itself as providing "world-class audit regulation".

[3] CPAB By-Law No. 1 – Amended and Restated (approved by the CPAB board on January 7, 2009), s. 3.1.

[4] CPAB "Statement of Accountability and Governance Practices", p. 1.

independent auditing".[5] The CPAB accepts that "public confidence in the integrity of financial reporting is fundamental to the effective operation of our capital markets. This confidence depends on quality financial audits. … The investing public trusts auditors to attest to the integrity of the financial statements. …"[6]

2.2 From its inception as a private, not-for-profit company incorporated under the federal *Canada Corporations Act* in April 2003, and denied any federal authority or recognition, the CPAB has sought auditor oversight legislation and regulatory recognition from provincial and territorial assemblies in order to acquire the empowering jurisdiction necessary to carry out its self-declared mission throughout Canada. As the CPAB has acknowledged: "A robust regulatory framework is critical to CPAB's ability to perform as a strategic regulator."[7]

2.3 At its inception, the CPAB commenced operations with only a veil of authorization and scant formal accountability. By the end 2012, the CPAB had evolved into a pro-active regulator undertaking annually root-cause-focused, risk-based inspections of 15 participating audit firms who audited the financial statements of 6,703 Canadian reporting issuers with an aggregate market capitalization of $2 trillion. With a budget of only about $16 million, in 2013 the CPAB inspected 61 audit firms, examined complex parts of the files of 236 audit engagements, and required five restatements of financial statements.[8]

2.4 In Ontario, the CPAB subsequently received legislative authorization under a statute "to promote the integrity of financial reporting in Ontario's capital markets", and to "oversee the audit of financial statements of reporting issuers." The *Canadian Public Accountability Board Act (Ontario) 2006*, S.O. 2006. c. 33, Schedule D ("CPAB Ontario Act"), which became effective June 30, 2009, provides that the CPAB, in carrying out its mandate and exercising its powers and duties under that Act, is "accountable to" the Ontario Securities Commission ("OSC") and "the Government of Ontario as set out in this Act" (s. 5(2)). In addition, the CPAB is required under the CPAB Ontario Act, "subject to this Act, its by-laws and its rules", to "account to the [OSC] and the Government of Ontario on its activities in the manner set out in this Act" (s. 6(2)(f)). (In several of its documents, the CPAB describes the CPAB Ontario Act as the "CPAB Act".)

2.5 The Council of Governors[9] of the CPAB, which is effectively controlled by the Canadian Securities Administrators, has the authority to appoint the 11 members of

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[5] CPAB 2011 Public Report, p. 3.

[6] CPAB 2012 Public Report, p. 3.

[7] CPAB 2011 Public Report, p. 28.

[8] Brian Hunt, CEO of the CPAB, presentation to Conference for Audit Committees, November 28, 2013, p. 4.

[9] The Council of Governors of the CPAB is effectively controlled by the Canadian Securities Administrators. The letters patent dated April 14, 2003 of the CPAB as a not-for-profit company under Part II of the *Canada Corporations Act* adopted by-laws filed with the application for letters

the board of directors of the CPAB, subject to providing notice to and receiving comments and suggestions from the Provincial Audit Regulatory Members of the CPAB.[10]

2.6 The CPAB Ontario Act requires the CPAB's Council of Governors to "certify" to the OSC that "the [CPAB] Board has carried out its mandate in a manner that is consistent with the public interest in maintaining the integrity of financial reporting by reporting issuers and the objectives of" the [Current Auditor Oversight Rule] or such other instrument that may be named by regulation (s. 9(3)). The OSC is then required to assess CPAB's annual report, determine if there are any issues arising therefrom that require action and to provide a copy of CPAB's annual report and the OSC's assessment thereon to the Ontario Minister of Finance, who is the Minister responsible for the CPAB Ontario Act (s. 9(6)). The Ontario Minister of Finance is required to lay the reports before the Ontario Assembly by delivering them to the Clerk (s. 9(8)).

2.7 On March 30, 2013, the Council of Governors of the CPAB issued its certificate to the OSC that in its view, based on the review it made, the CPAB carried out its mandate in 2012 "in a manner consistent with the Public Interest[11] and the 52-108 Objective." The certificate was signed by Howard Wetson, Chair, Council of Governors of the CPAB. Mr. Wetson is also the Chair of the OSC and as such is a member of the Council of Governors under the by-laws of the CPAB. This perceived conflict is statutorily recognized and sanctioned.[12]

2.8 On April 30, 2013, the OSC reported its assessment to the Minister of Finance of Ontario on the 2012 Annual Report of the CPAB. The OSC relied, among other things, on the certificate of the Council of Governors signed by the Chairman of the OSC in his capacity as the Chair of the Council of Governors. The OSC reported to the Ontario Minister of Finance that its assessment was that there were no issues

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patent. The CPAB has not disclosed the by-laws filed with its application for letters patent. Under the CPAB's By-Law No. 1 - Amended and Restated and approved by the CPAB board on April 20, 2004, a majority of the then five Governors of the Council of Governors were members of or selected by the Canadian Securities Administrators. Under what appears to be the current situation, under By-Law No. 1 – Amended and Restated and approved by the CPAB board on January 7, 2009, a majority of four of the six Governors are members of or selected by the Canadian Securities Administrators (s. 8.1).

[10] The Council of Governors must "consult" with the Provincial Auditor Regulatory Members of the CPAB in "respect of the composition of the Board and candidates to be considered for appointment as a Director, Chair or Vice-Chair… ". The Council of Governors may by a resolution approved by four Governors remove any director.

[11] The "Public Interest" was defined in the certificate as "maintaining the integrity of financial reporting by reporting issuers".

[12] The CPAB Ontario Act permits the Chairman of the OSC to be a member of the Council of Governors, notwithstanding that the CPAB is accountable to the OSC in Ontario: s. 4. The CPAB Ontario Act also provides that the Chairman of the OSC shall not participate in the OSC's assessment of the CPAB's annual report submitted to the OSC: s. 9(7).

arising from the CPAB 2012 Annual Report that required action, and that the OSC had no recommendations to the Minister arising from its assessment.

2.9 On July 12, 2013, the Ontario Minister of Finance filed the CPAB 2012 Annual Report and the assessment report of the OSC with the Clerk of the Legislative Assembly of Ontario, as required under s. 9(8) of the CPAB Ontario Act.

2.10 The CPAB Ontario Act also requires the CPAB to conduct its oversight program in accordance with its rules (s. 10(1)). The CBAB rules include regulations made under the Act "which specify that they shall be deemed to be rules of the [CPAB] Board for the purposes of this Act (s. 10(3)(d)). The Minister of Finance may make regulations "prescribing rules in relation to the oversight program of the [CPAB] Board and providing that they shall be deemed to be rules of the Board" (s. 16(1)(c)). These regulations prescribing rules of the CPAB have effect only in Ontario. The Ontario Government thereby has the authority to regulate the oversight operations of the CPAB in Ontario regarding the audit of financial statements of reporting issuers in Ontario.[13]

2.11 The CPAB Ontario Act has a section regarding confidentiality that is publicly referred to frequently by the CPAB as a factor for its inability to disclose its inspection results of participating audit firms of reporting issuers. The Act provides that the CPAB board is entitled to obtain all documents and information that an audit firm obtained or prepared in order to perform its audit of a reporting issuer. This includes the production of documents that are the subject of solicitor-client privilege if access "is absolutely necessary to the purpose of the review of the audit."[14] S. 11(2) of the CPAB Ontario Act provides that:

> "All documents and other information prepared for or received by the [CPAB] Board in the exercise of its mandate and all deliberations of the Board and its agents and employees and agents, in connection with an inspection, investigation or review panel proceedings carried out under the Board's oversight program, are confidential and may not be disclosed without,
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> (a) *the written consent of all persons whose interests might reasonably be affected by the disclosure*; or
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> (b) a court order authorizing the disclosure." [emphasis added]

This provision does not apply to the CPAB providing information, other than privileged information, to a "foreign audit oversight body" that is relevant to that

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[13] CPAB notes that the scope of its investigations is limited as it does not inspect the entire audit file of an audit firm subject to an inspection. It reviews only between two and four specific focus areas which are generally material, high-risk financial statement items. CPAB's inspection findings are not intended to identify all weaknesses that may exist in an audit. CPAB's findings do not represent a balanced scorecard.

[14] CPAB Ontario Act, s. 11. The disclosure of solicitor-client privilege documents does not constitute a waiver of any privilege that continues for all other purposes: s. 11(5).

body's review of an audit carried out on a reporting issuer that carries on business in that body's jurisdiction.[15]

2.12 British Columbia has relied on Ontario for British Columbia's oversight and accountability with respect to the operations of the CPAB and has recognized the CPAB as a self-regulatory body until July 31, 2014. British Columbia's recognition is dependent, among other things, on CPAB's compliance with the CPAB Ontario Act.[16] CPAB has also been formally recognized in Manitoba and New Brunswick on the same terms as British Columbia.

2.13 On May 21, 2013, in Montreal, the CPAB entered into a "*Cooperation agreement between the Ordre des comptables professionnels agréés du Québec and the Canadian Public Accountability Board*", CQLR c C-48.1, r 15.1 ("Quebec-CPAB Agreement"). The Quebec-CPAB Agreement, entered into by the Ordre of Quebec professional accountants under the authority of the *Professional Accountants Act* (Quebec), acknowledges that CPAB may operate a program in Quebec to monitor, inspect and investigate participating audit firms. The Quebec-CPAB Agreement provides that the parties will exchange confidential and other information between them and that the Quebec chartered professional accountants may disclose information to CPAB despite the professional secrecy to which they are subject under Quebec law, in order that the receiving party may execute independently its separate inspection, discipline, review proceeding, dispute resolution process and any investigation or inquiry functions under its respective mandate.

3. OSC-CPAB MOU

3.1 Effective as of November 27, 2013, the OSC and the CPAB entered into a "*Memorandum of Understanding Concerning Consultation, Cooperation and the Exchange of Information*" ("OSC-CPAB MOU").[17] Irrespective of and beyond the legal requirements to provide notifications to the OSC under the Current Auditor Oversight Rule or the Amended Auditor Oversight Rule, by private agreement, referred to in the OSC-CPAB MOU as "a statement of intent", the OSC and the CPAB agreed to share information, including "Confidential Information", relating to public accounting firms and reporting issuers. With respect to the CPAB, "Confidential Information" is defined in the OSC-CPAB MOU as information "reasonably identified as confidential" by the CPAB and "is not information that is, at the time of disclosure, or has become, part of the public domain. …" The OSC-CPAB MOU does state that it is a 'statement of intent' to exchange information "in connection with the inspection, supervision, investigation and oversight of Public Accounting Firms and Reporting Issuers in a manner consistent with and permitted by the Law that governs" the CPAB and the OSC (s. 9).

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[15] CPAB Ontario Act, s. 14.

[16] *Canadian Public Accountability Board (Re)*, 2011 BCSECCOM 357 (CanLII, July 20, 2011).

[17] OSCB, Issue 36/49 (2013-12-05).

3.2 Presumably, the terms of the OSC-CPAB MOU requires compliance by the OSC and the CPAB with the confidentiality constraints of s. 11(2) of the CPAB Ontario Act. There may be several problematic legal issues arising out of applicable multiple statutory and other confidentiality provisions of different jurisdictions that will be raised with respect to the sharing of "confidential information" between these two authorities and with third parties.

3.3 In addition to the legal obligations of audit firms to report to the regulators under the Current or Amended Auditor Oversight Rules, following findings of "audit deficiencies" by the CPAB, the CPAB agreed in the OSC-CPAB MOU to provide directly to the OSC a notice and a particulars of any "requirement" (which is not required to be disclosed under the Current Auditor Oversight Rule) that the CPAB imposed on a participating audit firm.[18] A small loophole closed with respect to the secrecy of the CPAB's operations, but only for the non-public benefit of this single though important regulator, and not for sharing with audit committees or the reporting issuers involved. (It is unclear whether the CPAB has or will enter into similar MOUs with the other provincial and territorial regulators, beyond Quebec, or whether the OSC intends, or is permitted by the other regulators to act, as the "principal jurisdiction" in collecting and sharing information and cooperating with the CPAB on behalf of the other members of the Canadian Securities Administrators, subject to legal confidentiality issues.) Strikingly, the OSC-CPAB MOU does not impose on the CPAB an obligation to share a "mandatory recommendation" with the OSC that the CPAB has required an audit firm to comply with.[19]

3.4 Of further broader interest than the contractual commitment to provide privately to the OSC particulars of "requirements" imposed by the CPAB, the CPAB has agreed to share with the OSC notice and particulars of:

> "… a situation where CPAB has identified, or becomes aware of a violation, or a series of violations, of Professional Standards or CPAB Rules at a Participating Audit Firm, relating to an audit or audits of one or more Reporting Issuers performed by a Participating Audit Firm, which violation, or series of violations, *creates a heightened risk to the investing public."*[20] [emphasis added]

Interestingly, for an undisclosed reason, the OSC made a determination under s. 153 of the *Securities Act* (Ontario) that the information it receives under paragraph 12(a)

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[18] OSC-CPAB MOU, s. 12(c).

[19] The CPAB generally makes "recommendations" to an audit firm following an inspection "arising from deficiencies related to engagement performance. These recommendations are applicable to either systemic/firm-wide processes or specific engagement files that were inspected. Deficiencies noted in the other elements of quality control may also result in recommendations." A "mandatory recommendation" is a significant 'remedial action' imposed by the CPAB because it "must" be implemented within 180 days of the inspection report to CPAB's satisfaction, the failure of which would give rise to 'disciplinary action' on the audit firm. CPAB 2012 Public Report, p. 16.

[20] OSC-CPAB MOU, s. 12(a). Under s. 12, the CPAB has undertaken other new and additional information sharing obligations to the OSC, all of which are beneficial to protecting the public interest.

of the OSC-CPAB MOU "shall be maintained in confidence" for the next three years.[21] That 'confidence determination' does not apply to the other confidential and non-confidential information received by the OSC from the CPAB under the MOU.

3.5 The CPAB takes the position publicly that it does not wish to intervene in the client relationship between the audit firm and the reporting issuer, and that it would be "rare" and "unusual" for the CPAB to agree to meet with a reporting issuer or its audit committee. In any such meeting, the CPAB stated that it would not share its inspection findings of the reporting issuer's audit firm with the reporting issuer because of the confidentiality restraints. It would be the audit firm and not the CPAB who would advise the reporting issuer that the CPAB was inspecting the audit files of its external auditor.[22]

3.6 It is interesting to note s. 12(d) of the OSC-CPAB MOU which provides that the CPAB will share with the OSC notice of situations "in which the CPAB has required a Reporting Issuer to seek the views of the [OSC] regarding a matter in question." This implies a direct communication between the CPAB and the reporting issuer. It is not clear when and under what circumstances that the CPAB would or has "required" a reporting issuer to seek the views of the OSC, or under what provision the CPAB has the authority to so "require". From a practical point of view, if the CPAB advised the reporting issuer to do so, there would be little reason for a reporting issuer, so requested, if not "required", not to follow the advice of the CPAB. (If the CPAB cannot "require" a reporting issuer to seek the views of the OSC, does paragraph 12(d) have any effect?)

3.7 The OSC-CPAB MOU is a positive development for the OSC to allow it, through this non-statutory consensual agreement, to increase its visibility and information into the inspection, supervision, investigation and oversight of public accounting firms. That such an agreement with a regulator was appropriate reflects, however, a lack of effectiveness resulting from a fragmentary and disjointed scheme and the absence of a national uniform regime to provide for proper regulatory supervision, accountability and transparency of an agency mandated or recognized, in the public interest, by multiple provincial and territorial authorities to regulate and oversee auditors of public issuers across Canada with the very important mission to instill public confidence in the integrity of financial reporting.

3.8 Interestingly, the CPAB has entered into a cooperation agreement with the United States Public Company Accounting Oversight Board ("PCAOB"), but the terms of the statement of protocol have not been disclosed and remained private. Memoranda and protocols of cooperation that the PCAOB has entered into with, among others, China, the United Kingdom, Japan, Israel, Dubai, and Switzerland have

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[21] OSC-CPAB MOU, s. 22.

[22] CPAB webcast held on January 8, 2014 on the "*CPAB Protocol for Sharing Information with Audit Committees".*

been publicly disclosed by the PCAOB with the consent of those contracting jurisdictions.

4. CPAB Supervision and Accountability

4.1 A fundamental question for the Canadian Securities Administrators is whether the Amended Auditor Oversight Rule, or another future National Instrument, should contain provisions that are more specific than the general terms of the CPAB Ontario Act regarding the supervision, oversight, accountability and transparency of the conduct of CPAB in fulfilling its important mandate and role as "Canada's audit regulator" which include responsibilities to regulate public accounting firms in the public interest.

4.2 On the other hand, in light of the disappointing decision of the Supreme Court of Canada dealing with the legislative authority of the Canadian Parliament to regulate Canada's efficient national and interprovincial securities markets under its trade and commerce power[23], if the mission of the Canadian Securities Administrators does not extend to effective and *de facto* supervision and oversight of the important functions of "Canada's audit regulator", should the Province of Ontario and the OSC, which have the responsibility to regulate the largest and most robust capital market in Canada, not accept that leadership responsibility through the exercise of its provincial jurisdiction?[24]

4.2 The Amended Auditor Oversight Rule does not deal with the effective oversight, supervision, assessment, review, public reporting requirements or regulation of the critical role of the CPAB in the fulfillment of its important mandate to act in the public interest which the CPAB has been granted and its board of directors has accepted.

(a) To whom is the CPAB accountable?[25]

(b) To what extent is the CPAB accountable to the Canadian Securities Administrators, and how are the Canadian Securities Administrators

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[23] *Reference re Securities Act*, 2011 SCC 66; [2011] 3. S.C.R. 837.

[24] The market capitalization of TSX-listed reporting issuers was $2.1 trillion as at December 31, 2012: CPAB 2012 Public Report, p. 13. The majority of reporting issuers in Canada have headquarters in Ontario, with the next largest number, which is less than half of the number registered in Ontario, being headquartered in British Columbia. Over 75% of Canadian reporting issuers headquartered in Canada are in Ontario and British Columbia: CPAB 2011 Public Report, p. 5. British Columbia has already effectively delegated its supervision of the CPAB to Ontario: *Canadian Public Accountability Board (Re)*, 2011 BCSECCOM 357 (July 21, 2011).

[25] The OSC states that the CPAB's authority in Ontario to carry out its inspections and audit oversight program is set out in the CPAB Ontario Act: OSC-CPAB MOU, s. 2. Under the CPAB Ontario Act, the CPAB is accountable, in Ontario, to the OSC and the Ontario Minister of Finance: s. 5(2). To whom is the CPAB accountable in the rest of Canada?

fulfilling their responsibility to supervise and assess the performance of the CPAB as Canada's national audit regulator?

a. How does the Canadian Securities Administrators exercise its clear and effective control of the business and affairs of the CPAB that is provided to them through the authority of the CPAB's Council of Governors?[26]

b. How are directors of CPAB that are nominated by the Canadian Securities Administrators through the Council of Governors identified, reviewed, and selected?[27]

(c) The CPAB is "accountable" to the OSC under the CPAB Ontario Act. How does the OSC exercise its oversight responsibility under the terms of the CPAB Ontario Act? Is the nature, scope and extent of that supervision disclosed in and reflected by the OSC's assessment of the CPAB's annual report that the OSC delivers to the Ontario Minister of Finance?

(c) Is there adequate transparency and reporting to the public of the operations, activities and inspection results undertaken by the CPAB?

5. Deficiencies of the Current Auditor Oversight Rule

5.1 Following an inspection of an audit file, CPAB holds an exit interview with the audit firm and later provides a private inspection report to the audit firm, as well as an overall report on the firm. These are private communications between the CPAB and the audit firm. Inspection findings during an inspection are set out in an Engagement Findings Report ("ERF") that identifies audit deficiencies, which are separated into two types of findings, EFR 1 and EFR 2. An EFR 1 finding is "a significant GAAS or GAAP [audit] deficiency that - relates to a material financial balance or transaction stream, - has the potential to result in a material misstatement in the financial statements, - will be included as a file-specific finding in the inspection report." EFR 1 findings require the audit engagement team to respond to the CPAB in writing setting out how it plans to address the identified audit deficiencies. An EFR 2 is a significant finding communicated to the firm that does not require a written response.[28] The inspection report to the audit firm accumulates all EFR and element findings and generally contains non-reportable

[26] The 11 member board of directors of the CPAB is appointed by the six member Council of Governors, a majority of whom are members of or appointed under the control of the Canadian Securities Commissioners. The identification of potential directors and the selection and nominating process for directors of the CPAB by the Canadian Securities Administrators have not been disclosed.

[27] In the case of a member of the United States Public Company Accounting Oversight Board ("PCAOB"), the five members are appointed to staggered five year terms by the Securities and Exchange Commission, after consultation with the Chairman of the Board of Directors of the Federal Reserve System and the Secretary of the Treasury of the United States federal government.

[28] CPAB 2012 Public Report, p. 19.

"recommendations" to improve audit quality based on the firm-specific 'deficiencies related to engagement performance' and 'quality control'. Before moving to disciplinary actions, the CPAB's private report to an inspected audit firm would provide three to five "major recommendations" to improve audit quality. If there are "serious deficiencies", CPAB would provide additional non-reportable "*mandatory recommendations*" that the audit firm is "*required to implement to retain its registration status*".[29] [emphasis added] These "recommendations" are to be implemented by the audit firm within 180 days. Where there may be a potential restatement of the financial statements, the deadline for implementing the CPAB's 'recommendations' may be much shorter than 180 days. Failure to implement a mandatory recommendation would be escalated to give rise to disciplinary action on the audit firm in the form of "requirements, restrictions or sanctions". Disciplinary action arises where the CPAB finds that "the number and nature of audit deficiencies is unsatisfactory and that the investing public could be at risk".

5.2 The disciplinary action usually starts with a non-reportable "requirement", which limits the scope of the audit work the firm can undertake until the identified deficiencies have been corrected within a time frame determined by the CPAB. The most common "requirement" restricts the firm from taking on any new reporting issuer audits until the CPAB conducts a follow-up inspection and is satisfied with the quality of the audit work. More serious cases require a reportable "restriction" on the firm. The third level of discipline is a "sanction". CPAB By-Law No. 1 empowers the CPAB to oversee a system "for the imposition of requirements, restrictions and sanctions directly on" participating audit firms.[30]

5.3 Under s. 3.1 of the Current Auditor Oversight Rule, a participating auditor firm is required to provide notice to the regulator in the limited circumstances where CPAB "imposes *restrictions*" on the firm "intended to address defects in its *quality control systems*". [emphasis added]

5.4 Unfortunately, the Current Auditor Oversight Rule omitted any disclosure obligation when the CPAB imposed "mandatory recommendations" or "requirements" where the CPAB found that the number and nature of "audit deficiencies" were unsatisfactory and that the investing public could be at risk. Many "requirements" are in substance *de facto* "restrictions". The CPAB advised that, when it "believes that the *quality of auditing in an audit firm is so substandard that the investing public is at risk*, CPAB places a *Requirement* on the firm that *restricts* the manner in which it operates its reporting issuer practice. A Requirement is between CPAB and the audit firm."[31] [emphasis added – note: the CPAB confirms that a "requirement" "restricts".] There was no transparency to the reporting issuer or its audit committee in these situations regarding defects in quality control systems.

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[29] CPAB 2012 Annual Report, p. 16.

[30] CPAB By-Law No. 1 – Amended and Restated, s. 3.1(k).

[31] CPAB 2012 Public Report, p. 17.

5.5 Under s. 3.2 of the Current Auditor Oversight Rule, where a participating firm is "subject to CPAB restrictions intended to address defects in its *quality control systems*" [emphasis added] and is informed by the CPAB that it has failed "to address [not the higher standard of 'failing to correct' – one can 'address' but not 'correct'] defects in its quality control systems", the participating firm must provide a notice to the audit committee of its reporting issuer and to the regulator.

5.6 Under s. 3.3 of the Current Auditor Oversight Rule, where a participating audit firm is subject to "sanctions imposed by the CPAB", it must provide notice to the audit committees of the reporting issuers with which it is involved and to the regulator.

5.7 Sections 3.1 and 3.2 of the Current Auditor Oversight Rule require limited notice where the audit firm is subject to "restrictions" to address defects in its "*quality control* systems". Where, however, a "restriction" may be imposed on an audit firm that failed to meet *"professional standards*" in conducting the audit of the financial statements of the reporting issuer involved, there is not any third party disclosure required under the Current Auditor Oversight Rule, neither to the regulator, to the reporting issuer involved or its stakeholders or to the investing public. Nor is there any obligation on the CPAB to disclose in a report to the public that an external audit firm had defects in its quality control systems, nor a summary of such defects, even where the identity of the reporting issuer involved is not disclosed.

5.8 Under the Current Auditor Oversight Rule, if an accounting firm had "restrictions" imposed on it by the CPAB that were intended to address "defects in its quality control systems", the auditor is simply required to notify the securities commission of the "restrictions" imposed and a description of the "defects in the quality control systems identified by the CPAB." The audit firm is not required to inform any reporting issuer or its audit committee, notwithstanding that, after an inspection, the CPAB considered it appropriate, in light of the "audit deficiencies" the investigation produced, to discipline the auditor by imposing "restrictions" on its activities. An auditor, however, who is subject to CPAB "restrictions" but who fails to address the defects in its quality control systems, to the satisfaction of the CPAB, is then required to notify the audit committee of each reporting issuer for which it was appointed auditor describing the defects in its quality control systems identified by the CPAB, the "restrictions" imposed by the CPAB to address such defects, and the reasons the auditor was unable to address the defects to the satisfaction of the CPAB.[32]

5.9 During the last nine years ended in 2013, the CPAB has disclosed that it imposed disciplinary measures, many of which were not reportable under the Current Auditor Oversight Rule, as follows:

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[32] Current Auditor Oversight Rule, ss. 3.1 and 3.2.

(a) 2005: five firms were "required" not to take on any new reporting issuer clients; five firms were "required" to have an external firm review their files before issuing audit reports; and one firm was "required" to take additional training;

(b) 2006: one firm was "required" not to take on any new reporting issuer clients; two firms were "required" to have an external firm review their files before issuing audit reports; one firm, Moen & Company LLP, had its participation status terminated pursuant to CPAB Rule 601; Moen & Company had failed to implement 'recommendations';

(c) 2007: six firms were "required" not to take on any new reporting issuer clients; two firms were "required" to have an external firm review their files before issuing audit reports;

(d) 2008: the CPAB reported that no "restrictions" and no "sanctions" were imposed, but did not disclose "requirements" that it may have issued;

(e) 2009: two "requirements" were issued;

(f) 2010: five "requirements" were issued;

(g) 2011: seven "requirements" were issued";

(h) 2012: five "requirements" and two "restrictions" were issued;

(i) 2013: required five restatements of financial statements out of the 236 audit engagements examined in that year.

Following the 2011 inspections, the CPAB had "requirements" on seven firms (2010 - 5), one of which was converted to a "restriction" in 2012. No "sanctions" were placed on participating firms in the last five years of inspections.[33] (In 2011, when no "restrictions" or "sanctions" were imposed, the CPAB determined that its inspection results were "unacceptable" and expected that the high deficiency rate would not be tolerated by audit committees or the investment community.)

5.10 Following the 2012 inspections, the CPAB had placed "requirements" on five firms (2011 – six) and "restrictions" on two firms.[34]

5.11 The Ontario Securities Commission ("OSC") has not received any notice in the past five years ended 2012 of a "restriction" or "sanction" pursuant to s. 3.1(1), s.

[33] CPAB 2011 Annual Report, p. 14.

[34] CPAB 2012 Annual Report, p. 15.

3.2(1)(b) and s. 3.3(1)(b) of the Current Auditor Oversight Rules.[35] No one, not even this regulator, let alone the reporting issuers involved, received notice of a "requirement" or "restriction" when the investing public was at risk.

6. Amended Auditor Oversight Rule

6.1 The Amended Auditor Oversight Rule attempts to address the extremely narrow reporting obligations contained in the Current Auditor Oversight Rule that have existed since March 30, 2004 when NI 52-108 became effective.

6.2 There is no definition of a "remedial action" for the Part 3 Notice of the Amended Auditor Oversight Rule. A "remedial action" is … [an action in response or in relation to what]?

6.3 The CPAB Ontario Act imposes an obligation on the CPAB that the CPAB "shall", subject to that Act, its by-laws and rules, "require *remedial action* by participating audit firms when necessary or appropriate, following an inspection." [emphasis added] This levies an objective standard on the CPAB to "require remedial action … when necessary or appropriate". The CPAB Ontario Act also provides that the CPAB "shall … impose, where indicated, restrictions, sanctions or requirements to upgrade supervision, training or education" and recognizes that the CPAB can make "recommendations" which can be contested by the audit firm.[36]

6.4 While there is no definition of a "remedial action" in that statute, it is suggested that there should be a broad one in the Amended Auditor Oversight Rule, which would be consistent with the CPAB Ontario Act and could include, without limitation, the cited 'remedial actions' in that Act. A broad definition would also prevent the avoidance of reporting requirements such as occurred under the Current Auditor Oversight Rule when the CPAB imposed a "requirement" and not a "restriction". Proposed Companion Policy 52-108CP, Annex B, "Subsection 5(1)-Remedial Action Imposed by CPAB" attempts to deal with this point; however, it would be preferable to have a definition in the National Instrument, rather than express a "view" in a policy.

(a) One way to think about a definition for a "remedial action" is to consider is as a "cure", or a "*remedialis*" (Latin), of a situation, namely, an action, means, process, plan or approach: to respond to a recommendation[37] or

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[35] Correspondence from the Ontario Securities Commission dated 2013-10-25.

[36] CPAB Ontario Act, ss. 6(2)(c)(ii), 6(2)(d) and 6(2)(e).

[37] The word or concept of "recommendation" is important to include in the definition of "remedial action" as the CPAB acknowledges that, after it issues a "private report" to the audit firm following an inspection, it "includes [mandatory] recommendations to improve audit quality which must be implemented within a specified time period." CPAB, "*Protocol for Audit Firm Communication of CPAB Inspection Findings with Audit Committees, Consultation Paper*" (November 2013), p. 2, and Appendix A, s. 2. A mandatory "recommendation" is meant to cure a defect that will "improve audit quality"

a finding; to correct or cure a deficiency, a failure to comply, a defect, mistake or fault; to lessen the impact or effect of a deficiency, failure, defect, decision, action or event; or to remove a cause, threat or source to a future deficiency or failure.

6.5 There are only four "remedial actions" specified in s. 5(1)(a) which requires a mandatory notice. S. 5(2)(a) implies that a "remedial action" in this section is related to failure to comply with "professional standards", which are defined in Section 300 of the Rules of the CPAB. "Professional standards" include auditing standards, ethical standards, auditor independence, and quality control standards and procedures.

(a) Is it clear or intended that a "remedial action" in s. 5(1) only refers to a failure to comply with professional standards?

(b) Is a "requirement", "condition", "request" or a "recommendation" that is put forward by the CPAB to an audit firm to deal with any of the "professional standards" referred to in Section 300 of the Rules a "remedial action", including recommendations to upgrade supervision, training or education?[38]

(c) The CPAB has defined an "audit deficiency".[39] When "audit deficiencies" are noted in inspection findings, audit firms are required to implement CPAB's "recommendations to rectify them."[40] Why not include in s. 5(1)(a) of the Amended Auditor Oversight Rule all Engagement Findings Report 1 (EFR 1) "audit deficiencies", which are file-specific significant GAAS or GAAP deficiencies that require the audit firm to respond in writing and which have the potential to result in a material misstatement in the financial statements?[41]

6.6 There are many additional "remedial actions" that the CPAB may require a participating audit firm to undertake other than the four specific ones cited in s. 5(1)(a). As currently drafted, in the case of the many other "remedial actions", the audit firm is not required to notify the regulator unless the CPAB decides that the audit firm must do so.

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and which "must be implemented within a specified time period." It should also be clear that any "requirement", "restriction" or "sanction" is a "remedial action".

[38] The CPAB notes that items recommended or imposed on audit firms include additional professional education, the design, adoption or implementation of policies to ensure compliance, prohibition of designated individuals from doing reporting issuer audits, and 'other (as required)': CPAB 2012 Public Report, p. 17.

[39] An audit deficiency is defined as the failure to obtain sufficient appropriate audit evidence to support a financial statement assertion for a material account balance or transaction stream: CPAB 2011 Public Report, p. 3.

[40] CPAB 2012 Public Report, p. 16.

[41] CPAB 2012 Public Report, p. 19.

(a) Why is this discretion left to the CPAB under s. 5(1)(b)? What are the principles, policies, procedures and processes pursuant to which the CPAB will exercise its discretion in this paragraph (b)?

a. Proposed Companion Policy 52-108CP, Annex B, "Paragraph 5(1)(b)-Notice at Discretion of CPAB" cites one example when the CPAB "may" exercise its discretion.

i. The Canadian Securities Administrators should consider adding to the items in paragraph 5(1)(a) requiring mandatory notice (including the failure of an audit firm to comply with a remedial action within the time period specified by the CPAB and the suggested failure and defects referred in (b) immediately below), as well providing supervisory and governance principles to the CPAB when the CPAB is to exercise its discretion un paragraph 5(1)(b).

(b) What are not **all** "remedial actions" relating either to failure to comply with professional standards or to a defect in quality control provisions that the CPAB imposes on an audit firm required to be notified to the regulator? Would this accumulated information in the hands of the regulator not be an effective risk management tool to attempt to lessen injury to the investing public?

(c) Why is the CPAB not obligated to require the audit firm to notify the regulator (as well as the reporting issuer) at the time that the CPAB identifies a defect in the audit firm's "quality control systems", as referred to in s. 6(1), and imposes a "remedial action" on the audit firm to "address" the defect?

(d) Are the four specific "remedial actions" in s. 5(1)(a) sufficient? Why only these four?

(e) Of the 25 "requirements" imposed by the CPAB in the five years ended 2012, how many would be encompassed within s. 5(1)(a) and in the future would become reportable and how many would not be specifically covered by paragraph (a) and remain secret?

6.7 The CPAB is given broad discretion in s. 6 of the Amended Auditor Oversight Rule in respect of a defect in the audit firm's "quality control systems". The fact that the CPAB has identified that a defect in the "quality control systems" of the audit firm exists is, regrettably, itself not made a reportable item by the audit firm to the audit committee or the reporting issuer, even on a confidential basis.

6.7 The CPAB also has the authority in s. 6 to determine the time period for the audit firm to "address" the defect. This is in an appropriate 'business judgment' for the CPAB to make depending on the circumstances. This time period, however, may overlap a year-end or quarter financial reporting period of the reporting issuer. The reporting issuer and its audit committee are in the dark and unaware that the audit firm has a defect in its "quality control systems" at the time the reporting issuer is preparing, approving and releasing its financial statements to its shareholders and the public and filing them with the regulator. The defect in the "quality control systems" of the audit firm may pose a significant risk of a material financial misstatement by the reporting issuer with resulting legal liabilities, reputational impairment and loss of investor confidence. It is only after the period determined by the CPAB and only if the audit firm "has not *addressed* the defect in its quality control systems" [emphasis added] that the reporting issuers for whom the audit firm has been appointed to prepare an auditor's report are required to be notified of this material fact.

(a) If public confidence in the integrity of financial reporting is fundamental to the operation of our capital markets and the mandate of the CPAB is to promote, publicly and proactively, high quality external audits of reporting issuers, which the CPAB says is the basis of the public's confidence in the integrity of financial reporting, is it not in the public interest that the reporting issuer and its audit committee be informed at the time when the CPAB has identified a defect in its audit firm's "quality control systems"?

(b) Is it in the public interest that the CPAB may set a time period for the audit firm to "address" an identified defect in its quality control systems that overlaps and extends beyond a financial reporting period of the reporting issuer, without informing the reporting issuer and its audit committee?

(c) What does it mean in s. 6(1) that the audit firm "has not addressed" the defect in its quality control systems with the time period set by the CPAB? "Addressing" is ambiguous and is a low level of response. A recommendation can be "addressed" even though the failure or defect in question is not cured for some period of time.

Yours very truly,

(Signed) "HG Emerson"

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