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Canadian Public Accountability Board
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PROTOCOL FOR AUDIT FIRM COMMUNICATION OF CPAB INSPECTION FINDINGS WITH AUDIT COMMITTEES

Dear Sirs/Mesdames:

Thank you for the opportunity to comment on the consultation paper, "*Protocol for Audit Firm Communication of CPAB Inspection Findings with Audit Committees*" ("Protocol"), issued in late November 2013 by the Canadian Public Accountability Board ("CPAB"). These comments are made in recognition and support of the important and vital mission of CPAB's role as Canada's audit regulator and its dedicated public interest mandate to improve the public's confidence in the integrity and quality of financial reporting.

Recommendation I

> "Audit committees have a critical role to play in achieving audit quality, and integrity of financial reporting. Accordingly, audit committees need to receive high quality, relevant and timely communication from the auditor in order to effectively evaluate the quality of the audit."[1]

[1]Brian Hunt, CEO of CPAB, comment to Public Company Accountability Board on PCAOB Rulemaking Docket Matter No. 30, (2012-03-05).

It is this commentator's submission that, order to achieve "*high quality, relevant and timely communication from the auditor in order to effectively evaluate the quality of the audit*", the audit committee must have the right to require that its audit firm communicate to and discuss with it (1) information of the results of CPAB's investigation of any review of the engagement of the audit firm with the reporting issuer as part of the CPAB's overall inspection of the audit firm, and (2) information of the audit firm's responses and remedial actions to the CPAB's findings and the CPAB's determinations with respect thereto.

Recommendation II

The right of audit committees to receive the information and communications from their audit firms referred to in Recommendation I should be legally secured and enforced by amendment to CPAB's rules and by a National Instrument of the Canadian Securities Administrators or under the regulatory authority of the *Canadian Public Accountability Board Act (Ontario) 2006* (the "CPAB Ontario Act").[2]

Recommendation III

Compliance with the Protocol should not be voluntary by participating audit firms in CPAB's regulatory regime and they should be required to adopt and comply with the final Protocol by the CPAB and by the Canadian Securities Administrators or regulatory authority under the CPAB Ontario Act.

Recommendation IV

Participating audit firms in CPAB's regulatory regime should be required by the CPAB and by the Canadian Securities Administrators or regulatory authority under the CPAB Ontario Act to communicate to audit committees the actual text of the inspection findings of CPAB specific to its inspection of that audit firm's engagement with the reporting issuer, the audit firm's actions and responses to those findings, and the CPAB's determinations with respect thereto.

1. Introduction

1.1 Compared to National Instrument 52-108 *Auditor Oversight*[3], which is designed to require, in limited cases, the audit firm to report its audit deficiencies to the regulator, and, in even more limited cases, to the audit committee of the reporting issuer involved, the Protocol is drafted to deal with audit firm communications of file level information directly to audit committees. While these different channels of conveying information do not overlap, each is nevertheless bound by a shared public interest to "contribute to public

[2] S.O. 2006, Ch. 33, Schedule D. The CPAB refers to this Act as the "CPAB Act".

[3] The Canadian Securities Administrators have the original NI 52-108 under reconsideration: (2013), 36 OSCB 10147 (2013-10-17), the 90 day comment period for which expired January 15, 2014.

confidence in the integrity of financial reporting of public companies by promoting high quality, independent auditing … ."[4]

1.2 While the CPAB has, to date, abstained from sharing, or allowing audit firms to share, important information from its inspections directly or indirectly with reporting issuers and its audit committees and, in contra distinction to national audit regulators in the United States and the United Kingdom, does not issue public reports on audit firms, the CPAB is still subject to a mandate, approved by the Canadian Securities Administrators, 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."[5] The CPAB has acknowledged 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] In Ontario, the CPAB Ontario Act, the purpose of which is to "promote the integrity of financial reporting in Ontario's capital markets", authorizes the CPAB to fulfill its Letters Patent mandate in that province, and makes the CPAB "accountable to the [Ontario Securities] Commission and the Government of Ontario as set out in this Act."[7]

1.3 The critically core work of the CPAB, Canada's national audit regulator dedicated to protecting the investing public's interest in the integrity of financial reporting, has remained cloistered for too long. Sharing the results of CPAB's inspection reports privately with only participating audit firms has drawn an opaque veil of secrecy over those audit deficiency findings for public stakeholders who are directly concerned. Sheltering the outcome of the CPAB's valuable work, which is undertaken in the public interest with regulatory sanction and recognition, has prevented the directly affected key stakeholders, particularly audit committees of the reporting issuers in question, from contributing to the further advancement of the enhancement of the audit quality of financial statements issued to investors in Canada's capital markets.

1.3B The sheltering of this important information by the audit regulator and the audit firms prevent those directly affected stakeholders from their due share of the benefit from CPAB's operations which are carried out in the public interest, from being able to exercise their responsibilities to the fullest extent and from contributing adequately to the continuous improvement of audit quality and financial disclosure. The public's confidence in the audit quality of financial statements of public companies in Canada is restrained because of the inability of reporting issuers to be appropriately informed of the specific inspection findings and remedial actions that the CPAB has required of the audit firms that audit their financial statements for the benefit of their stakeholders, investors and other users of the financial statements of their public companies.

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[4]CPAB letters patent dated April 14, 2003.
[5]CPAB By-Law No. 1 – Amended and Restated (approved by the CPAB board on January 7, 2009), s. 3.1.
[6]CPAB 2012 Public Report, p. 3.
[7] CPAB Ontario Act, s. 3 and s. 5(2).

1.3 The past and current private scope of the disclosure of the operations of CPAB may be viewed as overly protective of the interests of the participating audit firms and not to balance, fairly and appropriately, the CPAB's public interest accountabilities to other affected participants in Canada's capital markets, namely, reporting issuers (board, audit committee, management) which are required to prepare, approve and issue financial statements to and for the benefit of its security holders, investors and other users.

1.5 CPAB's findings from its 2012 annual inspections of 236 audit engagement files of 61 audit firms (including the Big Four firms, which audit 98 per cent of reporting issuers by market capitalization, and 10 other firms that each audited more than 100 reporting issuers[8]) are, as a matter of CBAB's policies, not available to key stakeholders, even on request. This lack of disclosure has continued since the CPAB commenced operations in late 2003.

1.6 In its 2012 Annual Report, which provides high-level generic and not specific information, the CPAB noted that inspection results for that year indicated an overall 30 per cent decline in "audit deficiencies"[9] from 2011. The CPAB 2012 Annual Report noted, however, that the CPAB's findings did not result from "a lack of documentation", nor a "difference of professional judgment". "More than 80 per cent of CPAB's 2012 inspection findings required the audit firm to carry out additional audit procedures to verify there was no need to restate the financial statements due to material error." This requirement for additional audit procedures resulted in "five restatements, of which two were in files inspected at Big Four firms." The 2012 inspections resulted in CPAB placing "requirements" on five firms and "restrictions" on two firms.[10]

1.7 The 2011 inspection results of the participating audit firms were, in CPAB's words, "disappointing and demonstrate [that] a greater focus is needed on execution, especially in higher-risk areas of the audit. CPAB is particularly concerned that, in many cases, the same systemic inspection findings are identified year after year without significant improvement." The CPAB found deficiencies in Generally Accepted Auditing Standards (GAAS) in firms of all sizes. The Big Four Firms, which audited 94 per cent of reporting issuers by market capitalization in 2011, had a GAAS deficiency rate of 20-26 per cent on the files inspected. The rate was considerably higher on other national, regional and local firms (47 per cent for the other 10 firms annually inspected). Because of the high risk of restatement of financial statements as a result of these deficiencies, the CPAB concluded that these inspection results were "unacceptable"."[11]

1.8 With respect to the 2011 year, the CPAB concluded that the results of its 2011 audit inspections found "audit deficiencies" that exceeded "tolerable limits". The CPAB commented on the high deficiency rate of 20-26 per cent of the 114 audit engagement

[8]These 14 audit firms audited more than 100 reporting issuers each, representing 99 per cent of the total market capitalization audited by CPAB participating firms in 2012.
[9]"Audit deficiencies" are defined by the CPAB as a "failure to obtain sufficient appropriate audit evidence to support a financial statement assertion for a material account balance or transaction stream."
[10]CPAB 2012 Annual Report, p. 15.
[11]CPAB 2011 Public Report, p. 3.

files of the Big Four firms that it inspected that year:

> "These deficiencies arose on the audits of TSX60 companies, the mid-tier and small market reporting issuers. CPAB has told the firms that this deficiency rate exceeds what CPAB considers to be a tolerable limit. The firms concur with CPAB's assessment and, as a result, are implementing short-term and long-term action plans to improve audit quality."[12]

1.9 The CPAB said it "is disconcerting to note that most GAAS deficiencies occurred in what one would normally consider to be basic auditing procedures, not in the audit of complex transactions".[13] The CPAB concluded that it "would not expect Audit Committees and the investment community to tolerate such a high deficiency rate."[14] Unfortunately, the affected stakeholders were not provided with the facts related to the audit firm auditing their financial statements.

1.10 The CPAB acknowledged that management, audit committees, and boards, as well as auditors, are responsible for financial statements and should remain vigilant to ensure audit quality, but noted that audit committees "have little or no awareness of CPAB".[15]

2. <u>Public and Audit Committee Outreach by the PCAOB</u>

2.1 The Public Company Accounting Oversight Board ("PCAOB") was established by the *Sarbanes-Oxley Act of 2002* enacted by the United States Congress on July 30, 2002 and received Securities and Exchange Commission ("SEC") determination on April 25, 2003 that it was appropriately organized, with the capacity to carry out the Act's requirements. PCAOB inspects registered public accounting firms to assess compliance with the *Sarbanes-Oxley Act of 2002*, the rules of the PCAOB, the rules of the SEC, and professional standards, in connection with the firm's performance of audits, issuance of audit reports, and related matters. The PCAOB prepares a written report on each inspection and provides it, in appropriate detail, to the SEC and to certain state regulatory authorities. The five member board of the PCABO is appointed by the SEC.

2.2 PCAOB inspection findings are contained in two of the four parts of an inspection report. Part I describes audit deficiencies where inspection staff found that the auditor failed to gather sufficient audit evidence to support an audit opinion. These audit deficiencies may relate to the audit firm's opinion that the financial statements are fairly stated or to its opinion that the company's internal control over financial reporting is effective. Part I findings are made public and are available on the PCAOB's web site and accordingly accessible to reporting issuers and audit committees in the United States. Part II of the PCAOB's inspection report typically describes deficiencies in the audit

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[12]CPAB Report on the 2011 Inspections, p. 17.
[13]*Ibid*.
[14]The CPAB 2011 Annual Report commented that "[t]hese deficiencies indicate too high a risk of material financial misstatements" (p. 5). The CPAB noted that "the firms recognize that the status quo is not acceptable and have responded positively" to its recommendations" (p. 6).
[15]CPAB 2011 Annual Report, p. 10.

firm's overall system of quality control where PCAOB has doubts that the system provides reasonable assurance that professional standards are met. PCAOB is prohibited by law from publicly releasing these Part II findings unless the firm fails to remediate these findings to the PCAOB's satisfaction within twelve months of issuance of the inspection report. The audit firms themselves have copies of this part of the report and are not prohibited by law from releasing this information at any time, though there may be other reasons they decline to do so.[16]

2.3 The Part 1 report of the 2012 inspection of PricewaterhouseCoopers LLP, headquartered in New York ("PwC U.S."), was publicly released on August 20, 2013, and included reviews of 52 public company audit engagements of which PwC U.S. was the principal auditor. The PCAOB publicly characterized 21 of those engagements as "audit failures", namely, situations in which, in the view of the PCAOB's inspection staff, PwC U.S. "failed to obtain sufficient appropriate audit evidence to support its audit opinion on the financial statements and/or on the effectiveness of internal control over financial reporting". In one of the 21 deficient engagements, the company involved restated its financial statements. [17]

2.4 PCAOB publicly re-released its 2010 report on its 2009 inspection of PwC U.S. This amended release included portions of the nonpublic Part II section of the original full report that was not included in the initial release that contained only Part 1. The Part II related to PwC U.S. quality control issues and PCAOB's concerns about potential defects in PwC U.S.'s quality control systems based on field work concluded in October 2009. The quality control issues discussed included deficiencies in the categories of auditing fair value measurements and assets in connection with impairment tests; and sufficiency of audit evidence in the areas of use of work of others, controls testing and evaluation, and auditing estimates.[18]

2.5 PCAOB also publicly disclosed the Part II quality control criticisms of PwC U.S. arising out of its 2008 inspection of PwC U.S. in a revised report.[19]

2.6 The PCAOB 30-page Part 1 inspection report of KPMG LLP, headquartered in New York ("KPMG U.S."), for 2012 and released July 30, 2013, reviewed 50 KPMG U.S. public company audits (in 48 of which KPMG U.S. was the principal auditor). PCAOB considered that 17 of those principal auditor engagements (35 per cent) were "audit failures", namely, where certain of the identified deficiencies were of such significance that it appeared that KPMG U.S., at the time it issued its audit report, had

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[16]PCAOB Release No. 2012-003, "*Information for Audit Committees about the PCAOB Inspection Process*", (2012-08-01).

[17]"*Report on 2012 Inspection of PricewaterhouseCoopers LLP (U.S.),* PCAOB Release No. 104-2013-148 (2013-10-20).

[18]"*Report on 2009 Inspection of PricewaterhouseCoopers LLP (U.S.)*", PCAOB Release No. 104-2010-131A (includes portions of Part II of the full report that were not included in PCAOB Release No. 104-2010-131).

[19]"*Report on 2008 Inspection of PricewaterhouseCoopers LLP (U.S.)*", PCAOB Release No. 104-2009-038A (includes portions of Part II of the full report that were not included in PCAOB Release No. 104-2009-038).

failed to obtain sufficient appropriate audit evidence to support its audit opinion on the financial statements and/or the effectiveness of internal control over financial reporting. The 17 issuers in question were not identified, and were referred to as "Issuer A" through "Issuer Q", with the identified audit deficiencies in each of those audit engagements identified and described. In one case, after the inspection team's primary inspection procedures, KPMG U.S. revised its opinion on the effectiveness of the issuer's internal control over financial reporting to express an adverse opinion. In another case, the issuer announced an intention to restate its financial statements.[20]

2.7 Deloitte & Touche LLP ("Deloitte U.S.") received a private Part II report dated April 16, 2009 from PCAOB on its 2008 inspection of Deloitte U.S. The Part II nonpublic report contained certain quality control criticisms of Deloitte U.S. Deloitte U.S. was provided a one year remediation period to 'address' the criticisms. At the end of the remediation period, PCAOB determined that Deloitte U.S. had not addressed five of the quality control criticisms to the satisfaction of PCAOB. On November 21, 2013, the PCAOB publicly released that portion of the report containing its Part II criticisms of the quality control defects of Deloitte U.S. The Deloitte U.S. audit quality control areas in which the PCAOB found inadequate remediation include auditing management estimates; use of service organizations and the work of specialists; exercise of due care and professional skepticism when performing audits; and supervision and review to assure audits are performed thoroughly and with due care.[21]

2.8 On September 27, 2012, PCAOB released Part I of its 2011 inspection report of Deloitte & Touche LLP, headquartered in Toronto ("Deloitte Canada"), which was conducted in cooperation with the CPAB. With respect to PCAOB's inspection of certain of Deloitte Canada's 2011 audit engagement files, the PCAOB identified audit deficiencies including failure to perform, or to perform sufficiently, certain necessary audit procedures. "The deficiencies identified included deficiencies of such significance that it appeared to the inspection team that, in six of the audits performed by [Deloitte Canada], the Firm, at the time it issued its audit report, had not obtained sufficient appropriate audit evidence to support its opinion on the issuer's financial statements or ICFR [internal control over financial reporting]." The deficiencies included the failure, in three audits, to perform sufficient procedures to test revenue; the failure, in two audits, to perform sufficient procedures to test the effectiveness of controls relating to revenue; and the failure to perform sufficient procedures to test the estimated useful lives of property, plant and equipment. The PCAOB's inspection findings with respect to Deloitte Canada's practices, policies and procedures relating to its quality control system and audit quality were set out in the nonpublic Part II portion of its report, which were to remain nonpublic unless Deloitte Canada failed to address them within 12 months to the satisfaction of PCAOB.[22]

[20] "*Report on 2012 Inspection of KPMG LLP (U.S.)*", PCAOB Release No. 104-2013-147 (2013-07-30).
[21] "*Re Deloitte & Touche LLP's Quality Control Remediation Submission*", PCAOB Release No. 104-2013-191 (2013-11-21).
[22] "*Report on 2011 Inspection of Deloitte & Touche LLP (Canada)*", PCAOB Release No. 104-2012-245 (2012-09-27).

2.9 The Part I portion of the report of the 2009 inspection of Raymond Chabot Grant Thornton L.L.P., headquartered in Montreal ("Raymond Chabot Canada"), was released by PCAOB on February 24, 2011. The inspection was undertaken with the cooperation of the CPAB. The inspection reviewed the financial statements of two reporting issuer audit clients and audit work on one other issuer where Raymond Chabot Canada played a role but was not the principal auditor. The audit deficiencies reported were the failure to perform sufficient audit procedures to evaluate the adequacy of deferred income tax valuation allowance and the failure to perform adequate audit procedures related to revenue.[23]

2.10 On February 2, 2012, the PCAOB issued its public Part I report on its 2009 inspection of BDO Canada LLP, headquartered in Toronto ("BDO Canada"). PCAOB's inspection was performed in cooperation with the CPAB. PCAOB reviewed six issuer audit clients, and identified significant audit deficiencies in five of them, in that it appeared to the inspection team that BDO Canada did not obtain sufficient competent evidential matter to support its opinion on the issuer's financial statements. The deficiencies listed by the PCAOB included the failure to identify, or address appropriately, a departure from GAAP relating to a potentially material misstatement in the audited financials concerning non-disclosure of related party loans; failure to perform sufficient audit procedures to evaluate whether there was sufficient doubt about the issuer's ability to continue as a going concern; and failure in two audits to perform sufficient audit procedures to test revenue. Four of the audit deficiencies related to auditing an aspect of an issuer's financial statements that the issuer revised in a restatement subsequent to PCAOB's inspection.[24]

2.11 The Part 1 public inspection report of Ernst & Young LLP, headquartered in Toronto ("E&Y Canada"), for 2012 was released by PCAOB on October 1, 2013. The inspection was conducted in cooperation with CPAB. PCAOB reported that in three of its 2012 audits, E&Y Canada, at the time it issued its audit report, had not obtained sufficient appropriate audit evidence to support its opinions on the issuer's financial statements or its internal controls over financial reporting.[25]

2.12 PCAOB also issued its Part 1 public inspection report of PricewaterhouseCoopers LLP, headquartered in Toronto ("PwC Canada"), for 2012 on October 1, 2013. PCAOB's inspection was performed in cooperation with CPAB. The PCAOB cited one instance of a significant audit deficiency where PwC Canada failed to perform sufficient procedures to test revenue.[26]

2.13 The CPAB does not issue public reports on its participating audit firms, including a summary of its inspection results. The nature and scope of the information released by

[23]"*Inspection of Raymond Chabot Grant Thornton L.L.P. (Canada)*", PCAOB Release No. 104-2011-088 (2011-02-24).
[24]"*Inspection of BDO Canada* LLP", PCAOB Release No. 104-2012-072 (2012-02-02).
[25]"*Report on 2012 Inspection of Ernst & Young LLP (Canada)*", PCAOB Release No. 104-2013-203 (2013-10-01).
[26]"*Report on 2012 Inspection of PricewaterhouseCoopers LLP (Canada)*", PCAOB Release No. 104-2013-231 (2013-10-01).

the PCAOB relating to Canadian audit firms is not available from the CPAB, even though the CPAB cooperates with the PCAOB in its inspection of the Canadian audit firms.

3. PCAOB's Initiatives for Audit Committee Communications with the External Auditor

3.1 In the United States, as in Canada, the audit committee of a public company will annually review and evaluate the external auditor. As part of that discussion between an audit committee of a U.S. reporting issuer and the external auditor, the audit committee will be able to question the audit firm with respect to the results and implications of the audit firm's most recent inspection report by the PCAOB. The inquiry will include whether the audit firm has been inspected and, if so, whether the PCAOB made comments on the quality or results of the audit. The audit committee will also want to know how the audit firm responded, or plans to respond, to the PCAOB's comments in its inspection report, generally and to any internal findings regarding its quality control program.

3.2 A former SEC General Counsel, a founding member of the board of the PCAOB and the PCAOB's Acting Chairman (2009-2011) discussed PCAOB inspections and the audit committee, emphasizing the importance that the PCAOB places on the work of the audit committee and the goal of *Sarbanes–Oxley Act of 2002* to strengthen the role of the audit committee. To this end the PCAOB commenced two initiatives to support audit committees: updating and expanding the information that auditors are required to communicate to audit committees, and making sure that audit committees understand PCAOB inspections and how those inspections can assist audit committees in their oversight and evaluation of their external auditors. With respect to the latter, he suggested four broad but important questions that audit committees need to ask their external auditors about PCAOB inspections.[27]

a) Is the PCAOB reviewing your engagement with us to audit our financial statements as part of its inspection of your firm?[28]
b) Did the PCAOB identify issues with our audit in your inspection report?[29]
c) If the PCAOB did find a problem with the company's audit, what is the audit firm's response?[30]

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[27]Daniel L. Goelzer, "*Audit Committees and the Work of the PCAOB*", 2011 NACD Board Leadership Conference, (2011-10-02).

[28]The PCAOB does not notify the company that its audit is being reviewed. While sometimes the PCAOB interviews the chair of the audit committee as part of assessing the audit firm's relationship and communications with the committee, the audit committee and the reporting issuer may not be aware that its audit is or has been under review.

[29]As the PCAOB does not identify issuers by name in its public Part I report on audit deficiencies and does not communicate with the issuer, the audit committee can only learn of a problem with its audit from the external auditor. In Canada, audit firms refuse to answer this importantly critical question from audit committees, as well as the question whether their audit is or has been reviewed by the CPAB, on the ground that they are bound by confidence with the CPAB.

[30]Additional audit work may be required under professional standards if the PCAOB identifies a deficiency in the audit. The audit committee should understand what the audit firm intends to do to address the deficiency, especially if it says it intends to do nothing. Caution and skepticism are to be exercised by the

d) Did the PCAOB identify any issues with your audit firm's quality controls that could affect our audit?[31]

3.3 With respect to the other significant initiative undertaken by the PCAOB of expanding communications and information to be provided to audit committees by the external auditors, PCAOB issued a new enhanced audit standard which is effective for audits of fiscal years beginning on or after December 15, 2012. PCAOB Auditing Standard No. 16, "*Communications with Audit Committees*", requires the audit firm to communicate with the audit committee regarding specified important matters related to the conduct of the audit.[32]

3.4 In October 2013, the Office of the Chief Auditor of the PCAOB issued a Staff Audit Practice Alert because of the significant audit practice issues observed by the PCAOB in the past three years relating to deficiencies in audits of internal control over financial reporting ("audits of internal control"). While the practice alert deals mainly with auditing standards and procedures for audits of internal control, the alert also offers guidance to audit committees.

> "Audit committees of companies for which audits of internal control are conducted might wish to discuss with their auditors the level of auditing deficiencies in this area identified in their auditor's internal inspections and PCAOB inspections, request information from their auditors about potential root causes of such findings and ask how they are addressing the matters discussed in this alert. In particular, audit committees may wish to inquire about the involvement and focus of senior members of the firm on these matters."[33]

4. Weaknesses in CPAB's Current Regulatory Model

4.1 Audit regulators outside Canada have progressed measurably in improving and enhancing the scope and quality of the disclosure and transparency of significant issues affecting the integrity of financial statements of public companies for the benefit of stakeholders and their capital markets. In addition there are initiatives to improve the communications and reporting by audit committees of public companies to their

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audit committee if the audit firm replies that the deficiencies are only a failure to document or are merely a 'matter of professional judgment'.

[31]Audit committees need to know if their audit engagement is included in the audit firm's nonpublic Part II report containing deficiencies in its quality control, how the audit firm intends to satisfy the PCAOB on these quality control matters and how changes in firm procedures and controls will affect audits in the future.

[32]PCAOB Auditing Standard No. 16, "*Communications with Audit Committees*", Final Rule: PCAOB Release No. 2012-004 (2012-08-15).

[33]PCAOB Staff Audit Practice Alert No. 11, "*Considerations for Audits of Internal Control Over Financial Reporting*", (2013-10-24), p. 36.

stakeholders to increase investor confidence, including by expanding the report of the audit committee in proxy statements.[34]

4.2 The CPAB has publicly expressed its recognition of the important contribution that audit committees can make. "CPAB believes that audit committees can – and should – be key contributors to audit quality. Effective audit committees and auditors build confidence in the integrity of financial reporting. By doing so, they reduce financing cost and contribute to an efficient allocation of capital to fuel economic growth."[35] Before, however, audit committees in Canada are in a position to strengthen their oversight process and reporting responsibilities, the CPAB has to act to provide them with needed and relevant information concerning their audit firm.

4.3 Currently, in Canada, audit committees have inadequate information from the CPAB and their external auditors to evaluate properly and to oversee effectively their external auditor. Without that base information, audit committees need to consider the degree to which they can effectively comply with the responsibilities that National Instrument 52-110 "*Audit Committees*" has mandated that they carry out, namely, that an "audit committee must be directly responsible for overseeing the work of the external auditor engaged for the purpose of preparing or issuing an auditor's report or performing other audit, review or attest services for the issuer… ."[36] This question of the current effectiveness of the audit committee's annual assessment of the external auditor and the audit committee's oversight responsibilities were noted in Chapter 4 of the 2013 joint report of the CPAB and the Chartered Professional Accountants of Canada ("CPA Canada"), "*Enhancing Audit Quality: Canadian Perspectives*". The recommendation on "Annual oversight responsibilities" in that Chapter was only that CPA Canada "would undertake a project to further develop the guidance on overseeing the work of the external auditors, including performing annual assessments of the external auditors.[37]

4.4 The knowledge that its external auditor may have failed to attain professional standards and/or is operating with quality control defects and incurred "audit deficiencies" in performing an audit of the financial statements of a reporting issuer, as well as the nature and type of such deficiencies, is a critical piece of information that the audit committee, the board and the management of the reporting issuer need to know. The risk that financial statements of a reporting issuer that have been publicly released and filed may have to be publicly restated because of an audit deficiency in the conduct of the attest audit by the shareholder-appointed auditor is meaningfully increased where the CPAB becomes aware of a defect(s) in the audit quality of an audit and that critical fact is not disclosed by the auditor to the key stakeholders of the reporting issuer involved.

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[34]"*Enhancing the Audit Committee Report – A Call To Action*", Audit Committee Collaboration (National Association of Corporate Directors; NYSE Governance Services, Corporate Board Member; Tapestry Networks; The Directors' Council; Association of Audit Committee Members, Inc.; and The Center for Audit Quality) (2013).

[35]CPAB 2012 Public Report, p. 9 (2013-04-04).

[36]Section 2.3(3).

[37]Page 17.

4.5 Where there has been a finding of an audit deficiency by the CPAB that remains undisclosed, audit committees, boards and management proceed unknowingly to review, recommend, approve and issue to its shareholders financial statements that are reviewed and reported on by an auditor who had failed to obtain sufficient audit evidence in a particular audit file. Not only are the audit committee, the board and management unaware that an audit has been found to have had an audit deficiency, these key stakeholders are also in the dark with respect to the type, nature and scope of the audit deficiency and audit quality issue, the short and long term 'action plans', 'requirements', 'remedial actions' or any 'restrictions' that the CPAB may have imposed on the auditor to upgrade to professional standards, and, importantly, whether the auditor has implemented and effectively complied with any CPAB 'recommendations', 'requirements' or 'restrictions' imposed on the audit firm.

4.6 Unlike the situation in the United States, referred to earlier, Canadian audit committees are constrained from having annual discussions with the external auditor of the results of its most recent inspection report by the CPAB. Audit committees in Canada should have the clear right and unambiguous ability to review with the audit firm issues including whether any audit deficiencies identified in the inspection report impact on the company's audit and the nature and outcome of any findings of defects in the audit firms' quality control systems. Audit committees would be better able to undertake their responsibilities, not only more efficiently but also move effectively for the benefit of the reporting issuer's stakeholders and investors, if they are provided with the relevant information from CPAB's inspection report on the audit firm. Such discussions between an informed audit committee and the auditor would contribute significantly to the improvement of audit quality and financial statement integrity.

5. <u>CPAB's Intentions for Transparency of Inspection Findings</u>

5.1 While CPAB acknowledges the need for increased transparency of its inspection results to audit committees, it has conservatively qualified its direction to that end.

> "One issue raised by various stakeholders and by the EAQ [Enhanced Audit Quality] initiative is the need to increase the transparency of CPAB's inspection results.
>
> "CPAB understands and supports the desire for greater transparency. Enhanced transparency in the communication of our inspection results, and about the key drivers of audit quality, would help key stakeholders in the audit process perform their roles more effectively. That being said, it is essential that transparency be enhanced in a way that preserves the effectiveness of CPAB's regulatory approach and does not create unintended consequences for audit quality or for reporting issuers. This issue will be a high priority for us in 2013."[38]

[38]Nick Le Pan, Chairman, CPAB 2012 Annual Report, p. 3.

5.2 The CPAB 2012 Annual Report outlined its new strategic plan and vision for 2013-2015 and four priorities for that period. One of the methods to operationalize these priorities, the CEO wrote in that Annual Report, was by:

> "Providing greater transparency in CPAB's communication of inspection results and the key drivers of audit quality and audit risks, to help key stakeholders in the audit process perform their roles more effectively."[39]

5.3 The theme of "enhanced stakeholder engagement" was specifically identified by the CPAB in its 2012 Annual Report. This new thrust was expanded further in the report of the CEO which seemed to acknowledge that the interests of investors were also protected by other participants in the process of preparing and approving financial statements and that knowledge by those other participants of the results of the CPAB inspections of the quality of the audits was a critical factor in the procedures to prevent material defects and deficiencies and to benefit investors. The CEO of CPAB wrote:

> "Audit firms and financial statement preparers are not the only participants in the audit process. Audit committees, institutional investors and analysts also play important roles. By providing all stakeholders with better information on audit quality issues, and by engaging them in a dialogue about CPAB's findings, all stakeholders, including CPAB, can perform their roles more effectively.
>
> "To address the core issue of enhanced audit quality, CPAB must communicate more strategically with key stakeholders to better influence the changes required to drive sustainable improvement in audit quality. Specifically, we must engage with key stakeholders on the implications of challenges to audit quality and the range of appropriate responses.
>
> "Feedback from CPAB roundtables with audit committees in 2012 indicated that more transparent reporting of inspection results could help audit committee members exercise their audit oversight responsibilities more effectively, improving audit quality.
>
> "Audit committees want to know if there are any audit quality issues with the audits of their reporting issuers."[40]

However, these statements indicating a move towards transparency were qualified, as was the Chairman's statement quoted above, with cautions that increasing transparency of CPAB's findings could not undermine CPAB's "regulatory approach" or cause "unintended consequences for audit quality or for reporting issuers."

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[39]Brian Hunt, CPAB CEO, p. 7.
[40]*Ibid*., p. 9.

5.4 Some understanding of the hesitancy of CPAB to recommend clearly that audit committees have access to inspection findings, both in relation to a review of their auditors engagements of their financial statements and in terms of areas of systemic quality concerns, is reflected in a comment letter of the CPAB to the U.K. Competition Commission. While stating that the CPAB was "supportive of increased transparency" to improve audit quality, it continued:[41]

> "However, there needs to be appropriate balance between transparency and the publication of inspection findings and trust and confidence in auditing in the capital markets. Such reporting should be balanced to ensure that the information provided to the public and audit committees enhances audit quality while also allowing audit regulators flexibility to make private impactful recommendations to regulated firms that have the greatest potential to improve audit quality. Transparency should be enhanced in a way that preserves the effectiveness of the regulatory approach and does not create unintended consequences for audit quality or for reporting issuers (RIs)."

5.4B In CPAB's Report of the 2012 Inspections, the CPAB acknowledged that the audit committee is a true contributor to audit quality.[42] The CPAB also understood the requests of audit committees for information on the CPAB's inspection findings. It commented in this section of the Report:

> "Audit committees have told CPAB they want more transparency with respect to inspection findings in order to improve the effectiveness of their oversight role. In 2013 CPAB will be reviewing how it can increase transparency of inspection findings to audit committees in a way that will have a positive impact on audit quality."

6. <u>Enhancing Audit Quality: Canadian Perspectives</u>

6.1 The CPAB and the Chartered Professional Accountants of Canada ("CPA Canada") issued a final report, "*Enhancing Audit Quality: Canadian Perspectives*", dated May 30, 2013, for its Enhancing Audit Quality 'stakeholder consultation' initiative (the "EAQ Report"). Chapter 5 dealt with "Communication of Inspection Results".

6.2 In noting that in the past and currently the CPAB inspection reports on quality control processes, individual file review findings and recommendations for improvement are provided only to the audit firms on a private basis, and are not available for audit committees nor the reporting issuers audited by such firms, even on a confidential basis, the EAQ Report acknowledged that although "access to CPAB inspection insights would boost the ability of audit committees to oversee and evaluate their audit firms, CPAB's annual public report does not permit audit committees to learn what findings, if any,

[41]Brian Hunt, CEO of CPAB, letter to the U.K. Competition Commission, p.3 (2013-08-12).
[42]CPAB Report of 2012 Inspections, pp. 9-10.

pertain to their auditors or their entities if they were selected for inspection in a particular year."[43]

6.3 In addition to recommending modestly enhanced disclosure of the CPAB's inspection findings in its Annual Report to include a more specific summary of key issues identified during the most recent inspections, the Audit Committee Working Group recommended that the CPAB, audit firms and audit committees "should develop a protocol for increasing the inspection information made available to audit committees." That protocol would address, among other things, that the auditors provide the audit committee, "on a confidential basis", with "a summary of any significant findings of the inspection" and the auditors response to those findings.

7. Consultation Paper – Protocol for Audit Firm Communication of CPAB Inspection Findings with Audit Committees

7.1 Allowing participation by an audit firm in the Protocol on a voluntary basis puts the shoe on the wrong foot. There is clear and compelling evidence that sharing CPAB's inspection findings with audit committees, on a confidential basis, has substantial public interest benefits, among other things, by strengthening audit committees' effectiveness in evaluating external auditors and in overseeing the audits of their financial statements, thereby increasing audit quality and public confidence in the integrity of the audit process. In Canada, audit committees do not have the information and capacity to assess the quality of the audit. This is the important role of the CPAB. Audit committees need to be able to see the CPAB's report on its inspection of their company's audit and related quality control systemic issues concerning their audit firm in order for audit committees to carry out their regulatory responsibilities. The public interest in making this information accessible to audit committees, as of right, outweighs the audit firm's interest in maintain control over the inspection findings.

7.2 Audit committees should not have to negotiate with their external auditors to obtain this information. As the CPAB inspects the audit firms, the audit firms are in a conflict of interest if they are allowed to decide whether or not to communicate the CPAB's inspection findings with the audit committees concerning their compliance with professional, auditing and assurance standards and their own quality control systems.

7.3 All audit firms participating in CPAB's audit regulatory program and over which it has oversight responsibility should be subject to the requirement to provide designated information from the CPAB's inspection report of their audits to the requisite audit committees of the reporting issuers they audit and to discuss such information, and their responses and actions to such findings, with the audit committees.

7.3 The draft Protocol is too ambiguous and subject to varying interpretations of the nature, scope and extent of the specific findings of an inspection of an audit file of a

[43]"*Enhancing Audit Quality: Canadian Perspectives-Conclusions and Recommendations*", (May 2013), p. 23.

reporting issuer that the audit firm is to communicate to the audit committee. Paragraph 7 says that the audit firm will provide:

- "*a* __*description*__ *of the* __*focus areas*__ *selected for inspection by the CPAB*";
- "*an* __*indication*__ *of whether or not there are any* __*significant*__ *inspection findings*"
- "*any* __*significant*__ *inspection findings*" as reported by the CPAB in its EFR and the audit firm's response to the findings and CPAB's disposition. [emphasis added]

7.4 There are broad and unclear interpretations for "a description" of "focus areas" and "an indication". Paragraph 11 does set forth a definition of a "significant inspection finding" as: "a *significant* deficiency in the application of *generally accepted auditing standards* related to a material financial balance or transaction stream where the audit firm must perform additional audit work in the current year to support the audit opinion and/or is required to make significant changes to its audit approach." [emphasis added]

(a) Does a "significant deficiency" arise only from a defect in the application of GAAS?

(b) Does a "significant inspection finding" or a "significant deficiency" include a failure in the application of GAAP, a defect in the audit firm's quality control systems, and a failure to comply with "professional standards"?

(c) How is "significant" interpreted and by whom?

(d) Will the CPAB's EFR to the audit firm for the purposes of the Protocol include "insignificant" inspection findings or other categories or types of "audit deficiencies" that will not have to be reported to the audit committee under the Protocol?

(e) Will the terms, definitions, scope, classifications and categories of the findings in the inspection reports of CPAB change as a result of the implementation of the Protocol?

7.5 The CPAB Ontario Act requires the CPAB, among other things, to conduct inspections of participating audit firms to assess the compliance of each audit firm "with professional standards, [CPAB's] rules and the firm's own quality control policies" for the issuance of audit reports, to evaluate reports and require "remedial action" by the audit firm where necessary. The CPAB is required to account to the Ontario Securities Commission and the Government of Ontario on these activities.[44]

7.6 The Protocol and the CPAB rules should require the audit firm to make the report of CPAB's investigation of the firm's audit of a reporting issuer, which must be made in accordance with the CPAB Ontario Act, available to the audit committee of that reporting issuer.

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[44]CPAB Ontario Act, s. 6(2).

7.7 A “significant inspection finding” for purposes of the Protocol and reporting to the audit committee appears different from an “audit deficiency” that has been previously reported in the CPAB’s annual Public Report. An “audit deficiency” has been defined “as the failure to obtain sufficient appropriate audit evidence to support a financial statement assertion for a material account balance or transaction stream”.[45]

(a) Is there a difference between the formerly reported “audit deficiencies” in the Public Reports and a “significant inspection finding” for the purposes of reporting to audit committees under the Protocol?

7.8 To keep it simple, why not require the audit firm to provide the actual and unchanged EFR that the CPAB has provided to the audit firm to the audit committee? There should be no ambiguity, interpretation or ‘translation’ of the inspection findings that the CPAB makes to the audit firm from those that the audit firm communicates to the audit committee. With full disclosure, there can then be a candid and open discussions between the audit firm and the audit committee.

Respectfully submitted.

Yours very truly,

(signed) HG Emerson

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[45]CPAB 2100 Public Report, p. 16.