CANADIAN PUBLIC ACCOUNTABILITY BOARD

Auditing in Foreign Jurisdictions

CPAB Special Report

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The Canadian Public Accountability Board (CPAB) promotes high-quality auditing of public companies through its inspections of firms that audit reporting issuers in Canada. CPAB issues an annual Public Report on its inspection results. This is a Special Report on CPAB's review of audit files for Canadian public companies with their primary operations in China. This report summarizes CPAB's significant findings, recommendations to improve audit quality, and CPAB's future activities relating to auditing in foreign jurisdictions.

The focus of CPAB's review

CPAB has been monitoring the extent to which Canadian reporting issuers have operations in foreign jurisdictions. Foreign operations present challenges to the performance of high-quality audits of financial statements.

While CPAB monitors reporting issuers with operations in all foreign jurisdictions, the focus of this review was Canadian public companies with their primary operations in China. This is because of the significant concerns analysts, investors, securities regulators, and other audit regulators have expressed about the quality of these companies' financial reporting. CPAB has identified reporting issuers with substantial operations in other foreign jurisdictions and will perform inspections of those audit files. CPAB will provide an additional report based on those reviews in 2012.

CPAB's internal risk analysis identified 24 higher-risk reporting issuer audits, based on the nature and extent of the reporting issuers' operations in China. Of these reporting issuers, 12 were audited by National firms and 12 by Regional or Local firms. CPAB's review was carried out between October 1 and December 31, 2011.

Overview of findings

Disappointing results

CPAB is disappointed by the results of its review. In too many instances, auditors did not properly apply procedures that would be considered fundamental in Canada, such as maintaining control over the confirmation process. CPAB's findings indicate that auditors often did not appropriately identify and assess the risks of material misstatement in the financial statements, through a sufficient understanding of the entity and its environment. CPAB also found a lack of professional skepticism when auditors were confronted with evidence that should have raised red flags regarding potential fraud risk.

CPAB does not believe this issue is unique to the audits of companies based in China. CPAB believes it is a failure on the part of auditors to recognize that the differences in the business environments of foreign jurisdictions require modification to the nature, timing and extent of their audit procedures. Specific examples are outlined in this Report.

A wake-up call for Canada's auditing profession

CPAB believes the results of this review should be a wake-up call for Canada's auditing profession. CPAB believes auditors possess the talent and the capabilities to perform audits of reporting issuers with operations in foreign jurisdictions. However, they must execute these audits with a high degree of professional skepticism and a thorough understanding of the business environment, to ensure their audit procedures adequately address risks arising from the foreign jurisdiction's business customs and practices.

Deficiencies noted

Based on the results of its review, CPAB identified 12 files that required remediation to address deficiencies as follows:

- One financial statement that will require restatement and the appropriate securities regulators have been informed of this. Two additional financial statements will require restatement of comparative information in future public filings.
- Seven instances in five files where CPAB has required additional audit work to be performed to address significant deficiencies in the audit work reviewed.[1] These deficiencies could have resulted in restatements. However, based on the additional audit work, CPAB is satisfied that a restatement was not necessary. An inability of one firm to perform additional audit work, concurrent with CPAB's inspection of the prior year's audit file, led to the firm resigning as auditor. Shares of this company are currently cease traded.
- Seven instances in six files where CPAB required firms to add evidence of the audit procedures performed to the file to fully support the opinion issued.
- Nine instances in five files where CPAB required improvements to be made in the quality of audit evidence effective for December 31, 2011 and later year-end audits of the reporting issuers.

Nine of the files requiring remediation were audits performed by Regional or Local firms.

As a result of the review, CPAB has placed a Requirement[2] on one firm restricting its ability to perform audits of reporting issuers with operations in China. This Requirement will remain in place until CPAB has carried out a follow-up inspection, the firm has implemented all of CPAB's recommendations, and the firm can demonstrate it is performing audits to the required standards.

[1] CPAB considers a significant deficiency to be a failure either to perform adequate audit procedures or to obtain sufficient, appropriate audit evidence to support a material account balance or transaction stream.

[2] A Requirement is a disciplinary action under CPAB's rules.

Restriction on access to files

CPAB is also concerned that, for six audits performed by National firms, it was unable to review the audit work performed by affiliated firms in the foreign jurisdiction. It was therefore impossible to fully evaluate the quality of the work performed by the affiliated firms. CPAB has asked the firms' leadership to develop a solution that is acceptable to the firms and to CPAB, recognizing there may be constraints—such as confidentiality and privacy laws—that make it difficult to obtain a complete set of the affiliates' audit working papers for review. CPAB hopes a reasonable solution can be found, as the lack of access to the work of auditors outside Canada represents an unacceptable restriction on CPAB's ability to fulfill its mandate. CPAB continues to work with a number of foreign jurisdictions to coordinate regulatory activity. In the interim, CPAB has requested that all firms relying on component auditors in the audits of reporting issuers with substantial operations in foreign jurisdictions document in their files how they were satisfied that the component auditor responded to any additional audit risks, including fraud, or risks arising from the laws and regulations, business practices and customs in the foreign jurisdiction.

For files with significant deficiencies, CPAB will perform a follow-up inspection to ensure the firm took appropriate remedial action. CPAB will also use its risk analysis process to identify reporting issuers with substantial operations in foreign jurisdictions and plans to expand the scope of reviews in 2012 to include inspections of those audit files.

CPAB's recommendations must be implemented

CPAB's inspection reports to participating firms include recommendations of actions to be taken to remediate an audit engagement file deficiency and/or to improve audit quality control processes going forward.

CPAB's recommendations must be implemented by the audit firm within 180 days of the date of the audit firm receiving CPAB's inspection report. CPAB recommendations can be file-specific or can involve the firm's quality control processes. Failure to implement the recommendations to CPAB's satisfaction would result in disciplinary action in the form of a requirement, restriction or sanction on the firm. Depending on the severity of the finding, such as a situation where CPAB requires further audit work to be performed in case there may be a potential restatement of the financial statements, the deadline for implementing CPAB's recommendation can be much shorter than 180 days. CPAB follows up to ensure its recommendations, whether file specific or quality control process related, have been implemented satisfactorily. If applicable, this would include verifying that any required restatement was filed and communicated to the appropriate provincial securities regulator.

Significant findings

Failure to control the confirmation process

Maintaining control over confirmations sent and received is fundamental to ensuring confirmations are a reliable source of audit evidence. CPAB noted that auditors often allowed management to control all or part of the external confirmation process, without considering the negative impact this would have on the reliability of the confirmations. Auditors also failed to validate confirmation responses received electronically by performing procedures to verify the sender and the information received.

Reliance on confirmations with questionable reliability

CPAB is concerned about the excessive reliance on confirmations as the sole source of audit evidence. While written confirmation from a knowledgeable third party can be a reliable source of audit evidence, auditors need to be alert to factors that raise doubts about the reliability of the response and the need to perform alternative procedures as corroborating evidence.

CPAB noted many instances of factors that should have raised doubts about the reliability of the confirmation response. However, no additional audit procedures were performed to resolve these doubts. These factors included: confirmation of a total balance or the transactions for the entire period without supporting detail being provided; responses to all confirmation requests received within an unusually short time; and all confirmation responses received without any differences being identified.

Insufficient evidence to support the ownership or existence of significant assets

CPAB noted many instances where auditors failed to obtain sufficient and appropriate evidence with respect to ownership and existence assertions because they relied solely on information provided by management. In the most extreme cases, photocopies of official certificates were accepted as evidence of ownership and existence. Even in cases where the auditors examined original copies of official certificates, there was no consideration that these certificates had been in the custody of management, meaning the auditor should have corroborated their authenticity.

Inadequate audit procedures to identify related-party transactions

The existence of related parties and transactions invariably raises the risk associated with an audit of financial statements, particularly when foreign operations are conducted via an extensive and complex range of relationships and business structures. CPAB observed that auditors often limited their audit procedures with respect to related parties to those identified by management as having had transactions in the period or balances at period-end. However, some auditors did recognize the risk and designed appropriate audit procedures to identify related parties and transactions not previously identified by management.

Insufficient evidence to support the recognition of revenue

CPAB has observed through its regular inspections that many auditors fail to obtain sufficient audit evidence to support the pattern of revenue recognition in the financial statements. Auditors failing to appropriately analyze a reporting issuer's revenue recognition policy is therefore not unique to entities operating in foreign jurisdictions. However, certain business practices in foreign jurisdictions create additional challenges to auditing revenue. These business practices include: a prevalence of verbal agreements; verbal amendments to written contracts; and billing practices that often result in delaying invoices to defer sales taxes, even if the performance obligations have been met. This practice makes the aging of accounts receivable much more challenging.

Insufficient evidence to support the appropriateness of the income tax rate used

To encourage investment, many local tax authorities in China grant qualifying companies reduced tax rates for specified periods of time. CPAB observed that, in many cases, auditors were relying solely on management's representation as to the appropriate tax rate for that entity without performing procedures to validate the reduced tax rate.

Recommendations to improve audit quality

In this Special Report, CPAB has identified several recommendations that, when implemented, would have the greatest impact on improving auditing in foreign jurisdictions. CPAB therefore believes that audit firms must implement these recommendations as part of their commitment to audit quality, and must take the steps necessary to rigorously focus on continuous improvement in this area.

Auditors must understand business customs and practices in foreign jurisdictions

Auditors are required by professional standards to gain an understanding of the entity and its environment. This is particularly critical when auditing an entity with operations in a foreign jurisdiction. What is normal business practice in Canada cannot be assumed to be the norm in a foreign jurisdiction. Therefore, the risk assessment and the planned audit response must reflect this reality. CPAB believes the primary root cause of many of the significant audit deficiencies it noted is a failure to understand the business customs and practices in the foreign jurisdiction and to consider their impact on the audit approach.

That being said, it can be difficult to gain an understanding of relevant business customs and practices. This is because the barriers to effective communication extend beyond language to include business etiquette, social expectations and personal relationships. Other differences can stem from the fact that laws and regulations may be evolving with less reliance on precedents than the Canadian environment. As well, contracts may be less formal, with more verbal than written agreements.

To understand the environment of an entity in a foreign jurisdiction, CPAB believes auditors must develop appropriate competencies, either through direct experience or through the shared experience of other engagement team members.

A rigorous client acceptance and continuance process is necessary

A rigorous client acceptance and continuance process is necessary when auditing in foreign jurisdictions. This ensures there has been adequate consideration of all the risks involved and whether the firm has the competencies, capabilities and resources to perform the audit. Part of this consideration should include whether the underlying business model makes sense and is sustainable. The consideration of client acceptance and continuance must be made with an objective mind. This objectivity recognizes that not all risks can be mitigated, particularly the risk of management override. For example, if a single person, often the CEO, negotiates all significant contracts and has a history of amending those contracts with verbal agreements, it may indicate that the governance structure does not adequately address the risk of management override. Auditors must also consider management's integrity, as issues or concerns in this area would most likely require the auditor to decline or discontinue the engagement.

Auditors must have a heightened awareness of fraud risk

Auditors are required to exercise professional skepticism throughout the audit and to remain alert to the risk of fraud. There is an added challenge when auditing in foreign jurisdictions because fraud risk factors may be different from those the auditor has previously encountered. Auditors must therefore have a heightened awareness of potential evidence of fraud. CPAB is particularly concerned that auditors who rebut the presumption that revenue recognition is a fraud risk are not properly assessing the risks.

In response to the risk of fraud, auditors need to change the nature, timing and extent of the audit procedures performed. CPAB is concerned that auditors typically modify only the extent of audit procedures performed. They do not appreciate that to effectively address the risk of fraud they must also modify the nature and timing of the audit procedures.

Auditors should implement special procedures for bank confirmations

Fraud risk factors in foreign jurisdictions also affect the quality of the audit evidence available and may require auditors to perform additional audit procedures to confirm the reliability of the evidence. For example, bank confirmations in Canada are completed by financial institutions, following a protocol established by the Canadian Bankers Association. In the absence of such a protocol, auditors may need to deliver the confirmation in person and have the bank representative complete the confirmation in their presence. Additional procedures could include having banks show auditors online balances or provide auditors with copies of bank statements.

Auditors must exercise caution when using external confirmations as audit evidence

The use of confirmations in such areas as the audit of revenue and accounts receivable or purchases and payables may also require additional audit procedures to increase the reliability and quality of the evidence. In foreign jurisdictions, a higher level of management involvement in the confirmation process may be necessary to obtain a satisfactory response rate. However, CPAB notes that auditors are not adjusting the confirmation control procedures to compensate for this higher level of management involvement. Maintaining control over the confirmation process in these circumstances may involve the auditor delivering the confirmation in person or confirming the couriers used are independent of management. Responses received by fax or e-mail are particularly susceptible to manipulation, so additional procedures should be performed to establish the credibility of the respondent and the reliability of the response. The design of confirmations also affects the quality of the response, so auditors should consider whether it is reasonable for a respondent to confirm a total balance or total transactions for a year without being provided the detail supporting the components of the balance. Auditors must respond to unusual response patterns—such as all confirmations being returned quickly with no differences being noted—by performing additional audit procedures. If there are doubts about the reliability of the confirmation responses, the additional audit procedures could include agreeing on the details of the underlying transactions to supporting documentation or seeking other corroborating evidence.

Auditors should have a heightened awareness of related-party transactions

The existence of related parties and transactions are more likely to represent an audit risk for operations in foreign jurisdictions when the legal or regulatory environment requires reliance on complex business structures or when dominant shareholders are involved in the operations of the business. As well, the identification of related parties may also be more difficult in foreign jurisdictions. It is therefore important that auditors have a heightened sensitivity to possible related-party transactions by performing procedures to determine the ownership and management structure of significant customers and suppliers. Auditors also need to consider the business rationale of transactions outside the normal course of operations, as the lack of a valid business rationale is often a red flag that the transaction is in fact a related-party transaction.

Auditors must verify income and commodity taxes

Income and commodity taxes present significant challenges to audits in foreign jurisdictions. To minimize income tax, companies often establish complex legal structures involving multiple countries and tax jurisdictions. In such cases, auditors must ensure the engagement team possesses the technical knowledge and experience to fully understand the implications of these tax structures in order to effectively evaluate the risk of material misstatement. Sufficient technical knowledge and experience is also required to assess the appropriateness of the tax rate used by management, particularly in jurisdictions where management has represented that reduced tax rates exist to encourage investment. As the significance of the risk arising from the use of a non-statutory rate increases, the quality of the audit evidence obtained to support the rate cited by management must also increase. Auditors must also consider such business practices such as delaying or avoiding issuing invoices to manipulate the payment of commodity taxes. This includes considering the potential impact on the financial statements as well as the nature and extent of the audit procedures that must be performed to obtain sufficient appropriate audit evidence to support the valuation and collectability of the unbilled receivables.

Future activities

As noted earlier, CPAB has identified reporting issuers with substantial operations in other foreign jurisdictions and will perform inspections of those audit files. These reviews will be part of CPAB's normal inspections of registered firms and may also include file reviews of selected reporting issuers outside the normal inspection cycle.