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The Regulation of Public Auditing in Canada and the United States: Self-Regulation or Government Regulation?

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Executive Summary

Auditors play an important role as gatekeepers to public capital markets. By attesting to the accuracy of a company's financial statements, the auditor lends its credibility to that company and its financial health.

Both market and legal mechanisms play a role in ensuring that auditors perform high quality audits. Reputation is critical in the market for auditors. In addition, potential legal liability to issuers and investors arising from contract, tort, and statutory securities laws creates incentives for auditors to conduct high quality audits. Potential discipline by professional self-regulatory bodies also plays a part. Striking the appropriate balance among market-based, legal, and self-regulatory mechanisms is a delicate task.

Canada and the US have both established oversight bodies for the auditors of public companies in an effort to enhance the quality of audits for those companies: the Canadian Public Accountability Board (CPAB) and the Public Company Accounting Oversight Board (PCAOB) in the United States. The two countries deviate, however, in their allocation of regulatory responsibility in relation to the accounting profession, with Canada continuing to rely on a largely self-regulatory model and the US relying almost exclusively on government regulation.

This study compares these two approaches to the regulation of public auditors in Canada and the US and offers concrete suggestions for improvement. In particular, this study analyzes and compares the CPAB and the PCAOB, looking at the structure, operation, and governance of the two boards, and analyzing their effectiveness and making recommendations for how they might be improved.

Our central theme is that carefully circumscribed statutory authorization for the CPAB could enhance its efficiency and effectiveness, without sacrificing the advantages of self-regulation. In our view, statutory authority for the CPAB would enhance its legitimacy. Properly circumscribed statutory authorization would also provide the CPAB with powers that are normally granted to governmental regulators, such as immunity and subpoena powers, without undermining the virtues of self-regulation: adaptability and responsiveness to current conditions.

We also recommend greater independence for the CPAB. The CPAB is less independent than PCAOB, which could result in actual or perceived conflicts of interest that could be detrimental to the integrity of the institution and more generally to investor confidence in the capital markets. In particular, the CPAB governance structure gives significant influence to the accounting industry. To enhance the independence of the CPAB from the accounting profession, the voting rights of Industry Members (who are all from the accounting profession) should be removed and the number of accountants on the board of directors should be reduced. Neither of these reforms would eliminate valuable input from the accounting industry, but they would help alleviate concerns that self-regulation was being administered in the interests of the accounting industry at the expense of the interests of investors.

The independence of the CPAB is also called into question by the fact that many members of the CPAB board of directors also fill influential roles in public companies that are themselves subject to public audits. A reasonable argument could be made that these are activities that affect or reasonably create the appearance of affecting the board member's independence or objectivity. Combining the predominance of accounting industry representatives on CPAB with public company executives raises doubt about the rigor that the CPAB will bring to accounting regulation. As such, consideration should be given to heightening the independence requirements for the CPAB board of directors.

The funding source and structure of CPAB are also a concern. CPAB is funded directly by accounting firms whereas PCAOB is funded by public companies. Consideration should be given to changing the funding structure so that accounting firms do not directly control the financial viability of the CPAB and also to avoid any perceived conflict. This would require legislation to provide the CPAB with a more secure source of funding. Whether the funds continue to come from the accounting profession directly or instead from public companies is less important than ensuring that the funding is guaranteed.

A more secure source of funding might allow the CPAB to expand the scope of its inspections to cover all firms auditing public companies. Under the current regime, provincial self-regulatory bodies conduct inspections of small companies, raising questions about the consistency of inspections.

In respect of enforcement, the CPAB's effectiveness would be enhanced by statutory protection providing immunity for staff, which would allow them to pursue the board's mandate without fear of retaliatory litigation. In addition, the deterrent force of sanctions available to the CPAB would be enhanced if it were provided with statutory authority to impose fines on accounting professionals who choose to abandon the auditing of public companies rather than pay fines imposed by the CPAB. At this point, both PCAOB and CPAB have limited track records of sanctioning firms; any further recommendations for enforcement policy must await longer history in order to evaluate the two boards' relative performance in enforcing their rules.

Finally, by making their activities more transparent to the public, the accountability of both the CPAB and PCAOB should be enhanced. The boards need to be able to disseminate their findings candidly and promptly, so that market participants can weigh those findings in their assessments of audit quality. This recommendation must be tempered against the litigation risk faced by inspected audit firms, so we also recommend making the reports inadmissible in court. Litigation concerns should not dilute the informational value provided by the PCAOB and CPAB reports.

Summary of Recommendations

Recommendation 1: CPAB should be provided with statutory authority to enhance its legitimacy. Properly circumscribed statutory authorization would provide the CPAB with powers that are normally granted to governmental regulators, without undermining the virtues of self-regulation: adaptability and responsiveness to current conditions.

Recommendation 2: To enhance the independence of the CPAB from the accounting profession, consideration should be given to revising the governance structure of the CPAB such that industry members do not have voting rights. Consideration should also be given to limiting the number of accountants on the board of directors. Proportionate representation from the CGAs and CMAs as industry members also warrants further consideration.

Recommendation 3: Consideration should be given to heightening the independence requirements for CPAB directors, many of whom fill influential roles in public companies that are themselves subject to public audits.

Recommendation 4: Consideration should be given to amending the structure and source of CPAB's fees so as to minimize the direct influence of accounting firms that are inspected by the board as well as to ensure a stable and guaranteed funding stream.

Recommendation 5: CPAB should consider undertaking inspections of smaller participating firms which are currently inspected by provincial self-regulatory bodies. Otherwise, it may be subject to criticism that it is not truly living up to its mandate of providing independent inspections of all accounting firms that audit public companies.

Recommendation 6: CPAB's enforcement effectiveness would be enhanced by statutory protection providing immunity for its staff. Such immunity would allow them to pursue the board's mandate without fear of retaliation. In addition, the deterrent force of sanctions available to the CPAB would be enhanced if it were provided with the statutory authority to impose fines on accounting professionals who chose to abandon the auditing of public companies rather than pay fines imposed by the CPAB. Both PCAOB and CPAB have limited track records of sanctioning firms, so we recommend that their relative performance in enforcing their rules be evaluated at a later point when they both have longer track records.

Recommendation 7: The activities of the CPAB and PCAOB should be made more transparent to the public to enhance their accountability. This recommendation must be tempered against the litigation risk faced by inspected audit firms, so we also recommend making the reports inadmissible in court.

I. Introduction: How Do We Ensure High Quality Audits?

Auditors play an important role as gatekeepers to public capital markets. The auditors' job is to promote investor confidence, i.e., auditors are in the integrity business. Essentially, auditors earn their living by renting their reputation (Puri and Ben-Ishai, 2004, pp. 127-130). By attesting to the accuracy of a company's financial statements (more precisely, that the company's financial statements conform to generally accepted accounting principles), the auditor lends its credibility to that company.

The certification of a company's financial reports that an accounting firm provides is only as good as the accounting firm's reputation for doing a thorough audit unhampered by conflict of interest.[1] An auditor's reputation is built upon the quality of the audits that it performs, so basic economic theory tells us that an auditing firm should have the incentive to refine its audit methodologies until the marginal increase in the cost of the audit equals the marginal benefit conferred on the client company. That marginal benefit takes the form of enhanced credibility for the client company's financial statements with a correspondingly lower cost of capital and better terms in other contractual relationships.

Although market-based reputation arguments have a role to play in enhancing the quality of audits, other mechanisms also push accounting firms to provide high quality audits: contractual liability to the public companies, potential tort liability to investors and other stakeholders, statutory liability under securities laws, as well as oversight and discipline by professional self-regulatory bodies.

The quality of the accountant's audit may not be readily apparent to the intended audience for the auditor's attestation, i.e., creditors, suppliers, customers, and most of all,

1 Fung and Gul (2005) provide evidence that firms that provide higher quality audits are able to charge higher fees.

investors. Evaluating the quality of audit services is a difficult task, requiring highly-specialized expertise and access to an accounting firm's work records.

For this reason, the *ex post* revelation of an audit failure can send a very ambiguous signal. Were the auditors complacent, or were they duped by a concerted effort among the insiders? Short of a full-blown forensic audit (an expensive proposition), insiders will be able to sneak some percentage of deceptions past their auditors even when the auditors have done their job properly. We should not leap from the fact of fraud in a financial statement to the conclusion that the auditors were asleep at the switch. Indeed, one study comparing Arthur Andersen's performance relative to its peers finds no significant differences (Eisenberg and Macey, 2004, p. 263). And Deloitte & Touche, which conducted the audit quality peer review of Arthur Andersen just prior to Andersen's implosion, found that Andersen's systems were adequate to provide reasonable assurance that its audits complied with professional standards (Chaney and Philipich, 2002, pp. 1221-1223, discussing the Deloitte & Touche report of its peer review).

Notwithstanding the messiness of the signal conveyed by an audit failure, publicity regarding auditing problems can have severe consequences in addition to the loss of reputation. Most prominent among these consequences, at least in the US and increasingly so in Canada, is the risk of a securities fraud class action, with potentially ruinous damages. Auditors also face a risk of litigation from their corporate clients and those company's creditors.

Auditing firms therefore have two strong incentives to perform thorough audits: to maintain and enhance their reputations; and to reduce their litigation risk. These incentives must be balanced, of course, against competitive pressures to keep the costs of audits down, which necessarily stand in opposition to maximizing audit quality. The question is whether the reputation and litigation incentives are sufficient to maintain acceptable audit quality.

There are reasons to question the efficacy of both reputation and litigation. As discussed above, both incentives are far from precise in practice, which undermines their deterrent force. In addition, both operate only retrospectively, after the audit failed to uncover the fraud. The risk of litigation, in particular, may undermine the incentive of audit firms to discipline their partners. As George Benston explains:

> Should the firms fire or otherwise punish a partner for having supervised and approved an incompetent or inadequate audit or for having agreed too readily to a client's demands, the firm would be admitting its collective guilt to regulators and present, or potential, plaintiffs. (Benston, 2003, p. 1345)

Worse still, the threat of litigation has potentially perverse consequences for users of financial statements. To stave off litigation, auditing firms push for more and more detailed rules, so that they can defend themselves against charges of a negligent audit by demonstrating that the financial statements were prepared in accordance with generally accepted accounting principles. (More detailed standards also bolster the auditor's willingness to resist pressure from the client to fudge the numbers—if the rules are clear, no independent auditor is likely to sign off on their violation, so "shopping" for a more compliant auditor is pointless.) The problem is that as accounting principles become more detailed, financial statements may become so complex that they are rendered opaque to even the informed user, much less the average investor. The bottom line is that we would like to be able to evaluate the quality of an audit firm's work in a more nuanced way than the assessment afforded by reputation and litigation.

Regulation may offer additional insight into audit quality, in addition to establishing a minimum floor below which audit quality will not be permitted to go. Canada and the US have both established oversight bodies for the auditors of public companies in an effort to enhance the quality of audits for those companies: the Canadian Public Accountability Board (CPAB) and the Public Company Accounting Oversight Board (PCAOB) in the US. The two countries deviate, however, in their allocation of regulatory responsibility, with Canada relying on a largely self-regulatory model and the US relying almost exclusively on government regulation.

The purpose of this study is to compare those two approaches to the regulation of public auditors and offer concrete suggestions for improvement. We proceed as follows. Part II canvasses the theoretical debate on self-regulation versus the traditional governmental model in the context of the regulation of auditors. Parts III and IV outline the regulation of auditing in the US and Canada. Part V then analyzes and compares the PCAOB and CPAB, looking at the structure of the two boards, examining their operation and governance, analyzing their effectiveness, and making recommendations for how they might be improved. Our central theme is that carefully circumscribed statutory authorization for the CPAB could enhance its efficiency and effectiveness, without sacrificing the advantages of self-regulation. Part VI concludes with a brief summary of our findings and recommendations.

II. Self-regulation and Government Regulation

Regulation of auditing

Does regulation have a role to play in ensuring audit quality? The need for specialized expertise and access to the auditor's work papers suggests that it might. An expert in accounting with such access might provide a more precise evaluation of the quality of an auditor's work than the signal provided by an audit failure. An audit firm with confidence in its procedures and employees might be willing to commit itself to a review regime with sanctions, if the review were conducted and the sanctions determined by an expert. Under such a regime, audit firms would be confident that sanctions would only be imposed when it had done an inadequate job. And auditors would presumably welcome *ex ante* advice on their audit methods if it helped them avoid the damaging loss of reputation and costly lawsuits provoked by an audit failure. This analysis suggests that there may be two useful roles for regulation. The first is looking at the outcome of a particular audit engagement in hindsight. The second is looking at an audit firm's procedures more generally to determine if those procedures are likely to produce a credible attestation of the company's financial statement. Oversight boards such as PCAOB and CPAB may have an important role to play in these tasks.

Self-regulation

Recognizing that there may be a role for regulation does not answer the question of who should do the regulating. The customary answer is that the government should regulate. The long-standing tradition in the field of accounting, however, has been self-regulation. Professional trade associations for accountants have developed standards for audits, conducted inspections in Canada, adopted systems of "peer review" for their members in the US, and imposed sanctions on auditors who fell short of professional standards.

Benefits of self-regulation

Self-regulation offers a number of advantages, expertise foremost among them. Accounting is a technical field, and its rules and standards are difficult for the layman to grasp. Accountants are also more likely to be attuned to the subtleties of the relationship between auditor and client and how things are likely to go awry in that relationship. Critically, a fellow accountant is more likely to be able to assess whether the auditor has been duped by its client despite the auditor's best efforts, or the auditor's independence has been compromised because one or more of its employees have fallen under the sway of a valuable client.

Related to expertise is the notion that self-regulation may be more responsive to developments in the field. One of the most difficult challenges facing an accounting regulator is the need to keep abreast of changes in many diverse businesses, as well as the development of entire new industries, both of which may pose problems for existing auditing standards. A practitioner may have an advantage in staying on top of such developments.

Another advantage of self-regulation is that it imposes the cost of financing regulation on members of the regulated industry. The premise of regulating auditors is that it makes the service provided by auditors more valuable, which should increase the demand for those services. Self-regulation forces auditors to internalize the cost of regulation from which they benefit by being able to charge higher fees.

Costs of self-regulation

Self-financing of regulation raises the concern that an industry that regulates itself may be tempted to skimp on regulation if it produces benefits primarily for third parties. In the accounting context, regulation that produces reliable audits may aid competitors of an auditors' client if the audited financial statements allow competitors to determine the most profitable components of a company's business or better evaluate the company's cost structure. Clients will not be anxious to bear the expense of tipping their hands to their competitors.

Self-financing can also be wielded as a threat if the self-regulator deviates too far from the preferences of the regulated industry. In the US, accounting firms badly undermined the credibility of self-regulation by threatening to withdraw funding for self-regulation because of a dispute over auditor independence. This bullying greatly undermined the argument that the accounting industry's self-regulator was independent and could therefore be trusted to regulate in the interest of investors.[2]

A less frequently voiced concern is that regulation can be a way of cartelizing an industry. There is some evidence that the regulation of auditing has created substantial barriers to entry in the auditing of public companies, with the field being dominated by the Big Four accounting firms. In the same vein, regulation can be a means for agreeing on gold-plated

2 As Arthur Levitt, former chairman of the Securities and Exchange Commission (SEC), puts it, "The lesson of this episode is crystal clear: self-regulation by the accounting profession is a bad joke… The firms would never subject themselves to scrutiny unless forced to do so" (Levitt, 2002, p. 127).

auditing standards that exceed the auditing intensity that would be demanded by the marginal company. Regulation can compel companies with relatively straightforward businesses that are easily evaluated by investors to buy more rigorous audits than they, or their investors, need. Thus, auditing standards can be a means of artificially increasing the demand for auditing services.

Another concern sometimes raised with self-regulation is that accountants might be unwilling to sanction their peers who failed to adhere to industry standards because it would create bad publicity for the industry as a whole. This criticism has a certain intuitive appeal, but it likely underestimates the ability of sophisticated institutional investors to distinguish quality differences among auditors. There are a finite number of "brand name" auditors from which public companies can choose. Market analysts and other investors have some sense of which auditing firms have the greatest expertise in a particular industry. Informed investors, at least, would avoid the error of assessing collective blame on the auditing industry for the shortcomings of one member of that industry.

A practical concern with self-regulation is that the self-regulator may lack the power to obtain information from third parties. Because their disciplinary power arises from a member firm's consent to be disciplined, a self-regulator can coerce the consent of the member to cooperate with an investigation by threatening expulsion, but the self-regulator has no comparable threat to wield against non-members. A complete and thorough investigation, however, may require cooperation from third parties, such as the clients of the member firms. But the clients may have good reasons not to cooperate, such as litigation risk. There is unlikely to be a problem with an audit if there is not an underlying problem with the client corporation's accounting, and the corporation faces substantially greater litigation exposure than the auditors.

Government regulation

The need for government regulation is typically invoked when a self-regulating industry is not regulating "enough." Determining how much regulation is "enough," much less what form of regulation is likely to be most effective, is a daunting task. As well, politicians are not inclined to be interested in the regulation of accounting. The topic seems rather dry and unapproachable until an accounting scandal creates public demand for heightened regulation by way of legislation. Politicians will want to "do something" in response to accounting scandals, even if the proposed "something" may prove to be unnecessary, ineffective, or even counter-productive.

Government regulation also poses the risk that well-organized interest groups may exert undue influence over policy makers. Critics of self-regulation commonly complain that market participants may be lax in regulation because of the need to respond to client pressure. Compared to what? The forces demanding less stringent regulation of auditors will demand the same from government. Governments respond to those groups because they are well organized, well financed, and have a strong interest in lobbying politicians. Government regulation should not be confused with the absence of self-interested policymaking.

Government regulation also raises the opposite concern: that members of the regulated industry will lobby the government to set the quality standard higher than economic efficiency would dictate. As noted above, self-regulation also poses this risk, but government enforcement of the cartel may be substantially more effective. High standards may be an effective barrier excluding new entrants from the market, thereby allowing incumbent firms to charge supra-competitive rates.

III. Accounting Regulation in the United States

Regulation of accounting and auditing in the US prior to the Sarbanes-Oxley Act

Until 1933 in the United States, the contents of financial statements included in public companies' prospectuses and annual reports were regulated only by some state laws and listing agreements from exchanges (Benston, 2003, p. 1325). With the adoption of the federal securities laws in 1933 and 1934, auditing of public companies in the United States was placed under the supervision of the SEC.[3] The SEC has generally used that authority sparingly until recently, choosing instead to delegate to the accounting profession the formulation of generally accepted auditing standards (GAAS) (Seligman, 1985). In practice that meant delegation of the promulgation of auditing standards to the accounting industry's trade association, the American Institute of Certified Public Accountants (AICPA), and its predecessors.[4]

3 Securities Act of 1933, § 19(a), 15 U.S.C. § 77s(a) (1933). The accounting authority now held by the SEC was held briefly by the Federal Trade Commission until the SEC was created by the Securities Exchange Act of 1934. See Securities Exchange Act of 1934, §§ 4(a), 210, 15 U.S.C. 78d(a) (1934) (creating SEC as an independent commission and vesting it with authority previously held by the Federal Trade Commission under the Securities Act of 1933). The Exchange Act also authorizes the SEC to require audited financial statements in public company's periodic filings. Securities Exchange Act of 1934, § 12(b)(1)(J) & (K), § 13(a)(2), 15 U.S.C. § 78l(b) & § 78m(a)(2).

4 The SEC has also delegated the formulation of accounting principles to the accounting industry. The AICPA eventually delegated the promulgation of generally accepted accounting principles (GAAP) to the Financial Accounting Standards Board (FASB), a part of the non-profit Financial Accounting Foundation (FAF) (Financial Accounting Standards Board, 2005).

The AICPA delegated the promulgation of auditing standards to what eventually became the Auditing Standards Board (American Institute of Certified Public Accountants, 2002). The Auditing Standards Board was originally overseen directly by the AICPA, but oversight was briefly shifted in 2001 to the Public Oversight Board (POB), an independent entity that was funded by the AICPA (Nagy, 2005). The POB was created in 1977 to administer a self-regulatory system for auditors, in part to head off the threat of government regulation of the accounting industry.[5]

Sarbanes-Oxley and the Public Company Accounting Oversight Board

Self-regulation of the accounting industry increasingly came in for criticism. These concerns came to a head in 2002 in the wake of a number of high-profile accounting scandals, highlighted by the Enron meltdown. The number of accounting problems relative to the number of US public companies was small, to be sure, but the prominence of the Enron fiasco suggested to at least some observers that US public companies had a pervasive audit failure problem. After the implosion of WorldCom amidst a particularly bald-faced accounting fraud, Congress rushed to get tough on accountants with the Sarbanes-Oxley Act. The Sarbanes-Oxley Act created a new quasi-governmental regulator for auditors of public companies, the Public Company Accounting Oversight Board (PCAOB or Board).

A non-profit corporation, the PCAOB is charged with: “protect[ing] the interests of investors and further[ing] the public interest in the preparation of informative, accurate, and independent audit reports” for public companies (Sarbanes-Oxley Act, § 101(c), 15 U.S.C. § 7211(c)). In furtherance of these goals, Congress assigned the PCAOB four principal tasks:

1. registering public accounting firms;
2. establishing “auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports” for public companies;
3. conducting inspections of registered accounting firms;
4. investigating and disciplining registered accounting firms and persons associated with those firms (Sarbanes-Oxley Act, § 101(c), 15 U.S.C. § 7211(c)).

5 Securities and Exchange Commission (2002), p. 12. (Hereinafter, SEC, *Framework*.) The Public Oversight Board disbanded in early 2002 after the SEC announced its intention to create a new oversight body for the accounting profession (Nagy, 2005, p. 995).

In sum, Congress assigned to the PCAOB the comprehensive regulation of the accounting industry, at least the sector of that industry that audits public companies. Accounting firms auditing public companies are all required to register with the PCAOB (Sarbanes-Oxley Act, § 102, 15 U.S.C. § 7212). Once registered, the accounting firms are subject to the auditing, quality control, and ethics standards adopted by the PCAOB (Sarbanes-Oxley Act, § 103, 15 U.S.C. § 7213). To ensure that registered firms are following its standards, the PCAOB is charged with conducting periodic inspections of registered accounting firms (Sarbanes-Oxley Act, § 104(a), 15 U.S.C. § 7214(a)). The board is also empowered to investigate possible violations by registered accounting firms of the Sarbanes-Oxley Act, the securities laws, and the PCAOB's own rules (Sarbanes-Oxley Act, § 105(b)(1), 15 U.S.C. § 7215(b)(1)).

The PCAOB performs these functions under the close oversight of the SEC. Congress followed the existing statutory framework for self-regulatory organizations (SROs), making it explicit that the PCAOB would be subject to the SEC's direction and control.[6] Thus, despite the PCAOB's nominal status as a non-profit corporation, it is effectively an arm of the government.

VI. Accounting Regulation in Canada

Accounting and auditing in Canada prior to recent reforms

Canadian corporate law statutes and provincial securities legislation require audited financial statements by independent auditors, but do not directly regulate auditors. These statutes generally defer to the relevant self-regulatory bodies on standards of accounting and auditing, as well as independence rules.

In Canada, chartered accountants ("CAs") have been regulated almost exclusively through their self-regulatory bodies: the Canadian Institute of Chartered Accountants (CICA) and the provincial self-regulatory bodies for chartered accountants ("the provincial institutes"). Various committees of the CICA promulgate accounting standards, auditing and assurance standards, and independence standards. The provincial insti-

6 The most important of the SROs in the United States are the New York Stock Exchange (NYSE) and the National Association of Securities Dealers. Membership in an SRO—with its attendant membership obligations—is a prerequisite for trading as a broker or a dealer in the US (Exchange Act § 15(a)(1)), so virtually all brokerage houses belong to either the NYSE or the NASD and many belong to both.

tutes have historically been responsible for enforcing the rules and standards and also for periodically inspecting accounting firms.

Auditing and assurance standards are set by the Auditing and Assurance Standards Board (AASB) of the CICA. [7] Generally Accepted Assurance Standards (GAAS) govern the conduct of independent audits by CAs in Canada (Smith, Caron, and Hunt, 2002, pp. 2-3). The voting members of the AASB are staffed entirely by accountants working in various accounting firms and in industry (see *http://www.cica.ca/index.cfm/ci_id/19621/la_id/1.htm*). The AASB is subject to the oversight of the Auditing and Assurance Standards Oversight Council (AASOC)—an independent body established in October 2002 by the CICA to oversee the activities of Canada's Chartered Accountants. AASOC consists of prominent leaders from business and regulators and is responsible for reporting to the public, appointing AASB members and ensuring the standard setting process is responsive to the public interest (see *http://www.cica.ca/index.cfm/ ci_id/204/la_id/1.htm*). Finally, standards of practice and ethics standards for accountants, including independence rules, are set by the CICA. Those standards are then adopted and enforced by the provincial accounting self-regulatory bodies across the country (Smith, Caron, and Hunt, 2002, pp. 2-3).

Certified General Accountants ("CGAs") and Certified Management Accountants ("CMAs"), two other categories of professional accountants in Canada, are also regulated by their respective self-regulatory bodies (see *http://www.cga-online.org/servlet/custom/publicView?region=ca* and *http://www.cma-canada.org/index.cfm/ci_id/45/la_id/1.htm*). Until recently, only CAs were permitted to perform public audits in Canada, but some provinces have recently passed legislation allowing CGAs and CMAs to engage in public accounting if appropriately qualified.[8]

7 In a model similar to that used in the US, GAAP, the authoritative standards for financial accounting and reporting are set by the Accounting Standards Board (AcSB) of the CICA. The Accounting Standards Oversight Board (AcSOC) provides public oversight of the AcSB. The AcSOC is an independent body that was established in September 2000 by the CICA to oversee the activities of the AcSB (Smith, Caron, and Hunt, 2002, pp. 2-3).

8 See, for example, Public Accounting Act, 2004 (Ontario) which was proclaimed into force November 2005. The Act creates a new "Public Accountants Council" (PAC), which is to oversee a public accounting standard for Ontario benchmarked against existing standards for public accounting. Under the Act, CMAs and CGAs would be eligible to obtain a public accounting licence if their SROs demonstrate to PAC that they meet the existing standards for public accounting.

Canadian response to the Sarbanes-Oxley Act and the Canadian Public Accountability Board

In response to the corporate governance scandals noted above and the swift passage of the Sarbanes-Oxley Act in the US in the summer of 2002, Canadian regulators also faced the task of how to respond to maintain investor confidence in the Canadian capital markets.[9] Canadian securities authorities worked to elevate corporate governance, as well as financial reporting rules and practices, by introducing rules on audit committees and CEO/CFO certification, for example.[10] The CICA adopted new requirements for auditor independence, reflecting updated global standards. The federal government also indicated its willingness to use the criminal law to address corporate misconduct by creating Integrated Market Enforcement Teams (IMETs) and by passing Bill C-13 (Government of Canada, 2004). The goal of these reforms was to signal to investors at home and internationally that Canada is a safe place to invest in the capital markets.

Various initiatives were also announced and introduced with respect to financial accounting and reporting. In the summer of 2002, it was announced that the Canadian Public Accountability Board (CPAB) would be created to oversee accounting firms that audit Canadian public companies. The CPAB's mandate is to promote high quality, independent auditing, thereby contributing to public confidence in the integrity of financial reporting (CPAB Rule 101). The CPAB oversees auditors of Canadian public companies through an inspection program to ensure high quality and independent audit processes. National Instrument 52-108 requires that public accounting firms that participate in the CPAB's inspection program audit the financial statements of reporting issuers.

The structural changes in the regulation of accounting and auditing resulting from the creation of the CPAB appear to be less drastic than in the US. Most notably, the CPAB is not subject to direct oversight by a government agency, as the PCAOB is subject to oversight by the SEC. The CPAB's mandate and scope of inspections are also narrower than its US counterpart. Unlike the PCAOB, the CPAB has not been assigned the task of overseeing and regulating the entire accounting industry. Most importantly, the CPAB does not set auditing standards as the PCAOB does; this function remains the purview of the relevant accounting self-regulatory bodies. In practice, the CPAB also does not oversee all accounting firms that audit public companies, leaving the inspection of smaller auditing firms to the provincial institutes. Thus, the CPAB adheres much more to a self-regulatory model than does the PCAOB.

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9 See *http://www.fin.gc.ca/toce/2003/fostering_e.html#ANNEX* for a summary of legislative changes.

10 See, for example, Multilateral Instrument 52-110 Audit Committees and Companion Policy; see also, Multilateral Instrument 52-109 Certification of Disclosure in Issuers' Annual and Interim Filings and Companion Policy; see also National Instrument 58-101 Disclosure of Corporate Governance Practices and National Policy 58-201 Corporate Governance Guidelines.

V. Analysis and assessment of PCAOB and CPAB

Statutory authority

Recommendation 1

CPAB should be provided with statutory authority to enhance its legitimacy. Properly circumscribed statutory authorization would provide the CPAB with powers that are normally granted to governmental regulators, without undermining the virtues of self-regulation: adaptability and responsiveness to current conditions.

As discussed in Part III, the PCAOB is established pursuant to, and its duties dictated by, the Sarbanes-Oxley Act (Sarbanes-Oxley Act § 101, 15 U.S.C § 7211). In contrast, provincial securities commissions, the Federal Superintendent of Financial Institutions, and the Canadian Institute of Chartered Accountants jointly created the CPAB (CICA) through a memorandum of understanding (CPAB *2003 Annual Report*, p. 1). The CPAB then enters into contractual agreements with participating audit firms empowering the CPAB to oversee them (CPAB *2003 Annual Report*, p. 5). The duties of the CPAB are found in its own rules and in its bylaws. Effectively, the CPAB defines its own scope of responsibility, subject to the acquiescence of the bodies that created it.

One could argue that the PCAOB may lack the flexibility and responsiveness to meet changing circumstances. The PCAOB's structure and regulatory system are largely ensconced within a statutory framework that can only be amended by Congress. Given Congress's indifference to capital market reform unless a financial crisis has captured the headlines, a legislative fix may be slow in coming. Indeed, allowing Congress to deflect responsibility for regulatory failures was undoubtedly a principal motive for establishing the PCAOB as a nominally "*private*" regulator.[11]

As the CPAB has broad powers to create or amend its own rules, the CPAB has great flexibility in adjusting its duties in order to meet current challenges. This flexibility, however, may create the appearance of uncertainty in the board's mandate. The CPAB can also be criticized as not having the same legitimacy as the PCAOB because it is not a creature of statute or legislative action.[12] That lack of statutory authority may also raise

11 Nagy, 2005, p. 1061 (arguing that "the pursuit of policy through a public/private regulator significantly lessens Congress's and the President's accountability to the public because it obscures responsibility for unpopular decisions or unwise policies").

12 The Certified General Accountants of Ontario (CGAO) has questioned CPAB's institutional legitimacy because the board lacks legislative authority and oversight (Buckstein, 2005, p. 23). Similarly,

concerns about the possibility of arbitrary actions unchecked by fair administrative procedure.

The CPAB's position is that its lack of statutory authorization is a by-product of Canada's constitutional structure, which precludes an auditor oversight agency from being created by federal legislation (CPAB, 2003, p. 4). The CPAB's lack of statutory authority is certainly related to Canada's current fragmented system of provincial securities regulation, but it is by no means a forgone conclusion that Canada's constitutional structure precludes the federal legislature from creating an auditor oversight agency.[13] A federal securities regulator would allow for easier statutory creation of national organizations such as CPAB, but provincial legislatures could also pass legislation to allow CPAB to have the necessary and appropriate authority. In the US, entities such as the PCAOB and NASD function within the statutory framework created for the SEC and are therefore more directly controllable by Congress.

Aside from the legitimacy issue, the lack of a statutory foundation for CPAB creates more practical problems. As a creature of contract, the CPAB lacks the powers and protections that are normally provided to government regulators (CPAB, 2004, p. 3). The board may be denied access to confidential information about reporting issuers that may be in working papers of auditors, and member firms may claim legal privilege in respect of private communications between auditors and their reporting issuer clients (CPAB, 2004, p. 3).[14] In addition, the CPAB and its directors, officers, and staff are not protected for actions taken in good faith in carrying out the CPAB's mandate (CPAB, 2004, p. 3), which is a concern that has been highlighted by the board in its most recent annual report. These concerns should be addressed immediately by providing the CPAB with access to needed documentary evidence and appropriate immunity.

New York Congressmen John Sweeney claimed the CPAB is not an appropriate partner for a reciprocity agreement because it lacks, among other things, direct statutory authority (Buckstein, 2005, p. 23). Even David Scott, the CPAB's current CEO believes that it would be preferable for the CPAB to be enshrined in law (Buckstein, 2005, p. 23).

13 In fact, Canada has recently engaged in a vigorous debate on the optimal regulatory structure for the securities industry in Canada. Legal opinions suggest that the federal government could legislate in the securities field (Wise Persons Committee, 2003). See also constitutional opinions prepared for the Wise Persons Committee at *http://www.wise-averties.ca/report_en.html*.

14 See also *International Accounting*, 2004, in which it is noted that CPAB inspectors "were unable to examine certain client engagement files as these were subject to legal privilege."

Governance structure, oversight and accountability

Recommendation 2

To enhance the independence of the CPAB from the accounting profession, consideration should be given to revising the governance structure of the CPAB such that industry members do not have voting rights. Consideration should also be given to limiting the number of accountants on the board of directors. Proportionate representation from the CGAs and CMAs as industry members also warrants further consideration.

The PCAOB is comprised of five members, one of whom is the chairperson (Sarbanes-Oxley Act § 101(e)(1), 15 U.S.C. § 72111(e)(1)). The influence of the accounting profession over the PCAOB is limited by the stricture that "[t]wo members, and only 2 members, of the board shall be or have been certified public accountants ..." (Sarbanes-Oxley Act, § 101(e)(2), 15 U.S.C. § 7211(e)(2)). A certified public accountant may only act as chairperson if he or she has not practiced for at least five years prior to his or her current appointment to the board (Sarbanes-Oxley Act § 101(e)(2), 15 U.S.C. § 72111(e)(2)). The SEC appoints board members after consultation with the board of governors of the Federal Reserve System and the secretary of the treasury (Sarbanes-Oxley Act § 101(e)(4)(a), 15 U.S.C. § 72111(e)(4)(A)). Board members serve staggered five-year terms.[15]

Although Congress ensured that the PCAOB would be independent of the accounting profession, the board is plainly subservient to the SEC. The PCAOB is required to make an annual report of its activities to the SEC and to Congress (Sarbanes-Oxley Act § 101(h); 15 U.S.C. § 7211(h)). Although the PCAOB is not directly answerable to Congress, the SEC is. If Congressmen have complaints about the PCAOB's functioning, they can be addressed to the SEC, which is highly responsive to Congress (see generally Pritchard, 2005, p. 1073).

In addition to appointing the PCAOB's members, the SEC has extensive oversight authority over the board analogous to that exercised by the Commission over the SROs (Sarbanes-Oxley Act, § 107(a), 15 U.S.C. § 7217(a)).[16] The SEC can review disciplinary

15 They are, however, subject to removal by the SEC "for good cause shown" (Sarbanes-Oxley Act, § 101(e)(5) & (6), 15 U.S.C. § 7211(e)(5) & (6)).

16 Despite the practical necessity of belonging to an SRO, the SROs maintain the veneer of being "voluntary" "self-regulatory" organizations. The SROs are "voluntary" only in the sense that a firm could choose to go out of business rather than become a member. And they are self-regulatory in the sense that they are free to devise rules for their membership and enforce those rules as they see fit—as long as the SEC agrees with those rules and the SROs' enforcement policies. Not only does the SEC have the final authority to approve SRO rules, it can amend directly the rules of the SROs

actions taken by the board, either at the behest of an aggrieved party (i.e., an accounting firm or an accountant) or on the SEC's own motion (Sarbanes-Oxley Act, § 107(c)(2), 15 U.S.C. § 7217(c)(2)). The SEC can not only overturn disciplinary proceedings if they are not conducted in accordance with law, it can also review the sanctions imposed by the board and reduce, modify, or increase the sanction (Sarbanes-Oxley Act, § 107(c)(3), 15 U.S.C. § 7217(c)(3)). Moreover, the SEC can censure the board itself, or rescind its authority, if the SEC is not satisfied with how the board does its job (Sarbanes-Oxley Act, § 107(d), 15 U.S.C. § 7217(d)). In addition to SEC oversight, the PCAOB has created its own system of internal monitoring, called Internal Oversight and Performance Assurance (IOPA).[17]

The SEC must approve all rules proposed by the PCAOB (Sarbanes-Oxley Act, § 107(b)(2), 15 U.S.C. § 7217(b)(2)). More intrusively, the SEC can amend any PCAOB rule (Sarbanes-Oxley Act, § 107(b)(5), 15 U.S.C. § 7217(b)(5)). The PCAOB seeks comment of its proposed rules by posting them on a rulemaking docket ("How to Comment on Board Rulemaking" from PCAOB web site, *http://www.pcaobus.org/rules/rulemaking_docket.aspx*). The board has also convened a Standing Advisory Group (SAG) for this purpose composed of approximately 30 people representing the auditing profession, public companies, investors, and others, and has granted four organizations (the FASB, the Government Accountability Office, the International Auditing and Assurance Standards

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and it can sanction the SROs if they are not enforcing their rules as vigorously as the SEC would like (Exchange Act § 19). If the SEC thinks that new rules are needed, the SROs promulgate new rules for the SEC's approval.

17 The IOPA provides internal examination of the programs and operations of the PCAOB for the purpose of ensuring the efficiency, effectiveness, and integrity of all PCAOB activities. The PCAOB web site contains the IOPA Charter in "Mission and Scope of Work" (see *http://www.pcaobus.org/Internal_Oversight/Charter.pdf*). Specifically, IOPA conducts annual and special reviews and inquiries to help ensure that the PCAOB is aware of and properly addressing any risks to the integrity and effectiveness of its operations, that the PCAOB consistently seeks to improve the effectiveness or efficiency of its operations, that its reports are conducted in a fair, complete, reliable, and timely manner, that it complies with applicable laws, regulations, and policies, and encourages and enforces such compliance by PCAOB employees, that its resources are used efficiently and protected from improper uses, that the PCAOB conducts itself in a manner that protects and promotes the public interest in the integrity of audits. The main mechanism for meeting these goals is reports issued by the IOPA pursuant to their reviews, which often will include recommendations to enhance board operations. The IOPA Charter provides that the IOPA should be "free in fact and appearance from personal, external, and organizational impairments to independence." In order to promote the objectivity of the IOPA, the director reports directly to the governing board, which has the exclusive authority to hire, fire, and establish the compensation and other terms of employment of the director. The IOPA has unrestricted access to the records, offices, and employees of the board. Outside stakeholders or interested parties are able to provide information relating to a PCAOB employee by directly contacting the IOPA (PCAOB web site, *http://www.pcaobus.org/Internal_Oversight/index.asp*.

Board, and the SEC) observer status with speaking rights at all meetings of the SAG ("Standard Setting" from PCAOB web site, *http://www.pcaobus.org/Standards/Standards_Setting.asp*).

The CPAB's governance structure is somewhat more complicated. It is divided into the council of governors, the board of directors, and industry members. The hierarchy of these three bodies is roughly equivalent to the directors, officers, and shareholders of a corporation.

The five-member council of governors has the primary oversight role for the CPAB. It is comprised of the chair of the CSA, the chair of the Ontario Securities Commission, the chair of the Québec Autorité des Marchés Financiers, the federal superintendent of financial institutions and the president and CEO of the CICA (CPAB Bylaws article 8.1). The council of governors votes on bylaw amendments, and has the sole right to vote for the appointment of the independent directors on the board and the sole right to appoint the chair and the vice-chair of the board of directors (CPAB Bylaws article 8.2). The council also has the power to remove the chair, vice-chair, and board members. The council periodically reviews the effectiveness of the CPAB and is charged with taking appropriate action to improve its effectiveness ("Structure" from CPAB web site, *http://www.cpab-ccrc.ca/dynamic.php? first=412a3e3729b6c&second=412b4d03b750d&language=English*).

The council of governors chooses the board of directors, which undertakes the bulk of CPAB responsibilities (see specifically CPAB bylaws article 3.17). The board of directors has been structured to contain a majority of members from outside the accounting profession and to provide a broad range of perspectives from all across Canada. It is composed of eleven members, four of whom are from the accounting profession. A member of the accounting profession is precluded from occupying the CPAB chair. Currently, three of the four members from the accounting profession are required to be the CEOs of the provincial Institutes of Chartered Accountants in Alberta and Ontario and the CEO of the Ordre des comptables agréés du Québec (CPAB Bylaws article 3.2). Board members are appointed for a term of up to three years and are eligible for reappointment up to a total tenure of six years ("Structure" under CPAB web site, *http://www.cpab-ccrc.ca / dynamic.php?first=412a3e3729b6c&second=412b4d03b750d&language=English*). All board members are entitled to vote.

Because CPAB is incorporated as a not-for-profit corporation, it has members rather than shareholders. In addition to the council of governors, its members include industry members, with a representative coming from each of the ten provincial Institutes/Ordre of Chartered Accountants (CPAB Bylaws article 9.1). The BC CGAs were recently granted one seat as an industry member, increasing the total number of industry members to eleven. Industry members vote on bylaw amendments and appoint auditors of the CPAB and the ex-officio directors.

Although not required to do so, CPAB has indicated that it will publicly report at least annually on its activities. The CPAB also releases proposed rules on its web site and solicits public comment. The CPAB has, on at least two occasions, modified and clarified certain aspects of its proposed rules in response to communications received by the CPAB, including a joint response of the seven largest accounting firms operating in Canada ("Additions and Amendments of Rules" from CPAB web site, *http://www.cpab-ccrc.ca/dbdocs/421ce74da639e.pdf*).

We see four significant differences between the CPAB and PCAOB governance structures. First, the PCAOB governance structure contains outside oversight in the rulemaking process which is absent from the CPAB. PCAOB rules are subject to SEC approval—and alteration if deemed deficient—whereas CPAB rules are only officially subject to scrutiny from within the organization. In addition, the PCAOB is subject to stringent oversight by the SEC. In contrast, the CPAB is monitored internally by its council of governors. It is true that four of the five members of the council of governors are provincial and federal government regulators, but the lines of accountability in relation to legislative oversight are much blurrier than with PCOAB. Unlike the PCAOB, which must answer to the SEC, and thus, indirectly, to Congress, the CPAB is not subject to legislative supervision in the same way. Whether one views this as a good thing depends on whether legislative oversight is likely to enhance the regulation of auditors. Given the lack of expertise of the average legislator in this area, the value of legislative oversight is open to serious question. In any event, if the CPAB falls down in performing its responsibilities, the implicit threat of legislation to strip the body of those responsibilities is there. The absence of an explicit threat of legislative intervention does not seem to be a fundamental difference.

Second, the five-member PCAOB is considerably more compact than the 27-member CPAB. In this regard it must be considered that with a board of this size, assuming a diversity of opinion, the CPAB must rely more heavily on cooperation and compromise than its American counterpart. The CPAB is structured to include perspectives from the provinces, likely a practical necessity given Canada's provincial system of securities regulation. A national or consolidated securities regulator in Canada would allow for a smaller and more nimble board structure. This defect is ameliorated somewhat by the more manageable size of the board of directors, which has responsibility for most of the day-to-day functioning of the CPAB. However, consideration should be given to reducing the number of members.

Third, new CPAB appointments either are made by people currently serving on the CPAB, or are automatic *ex-officio* appointments based upon attaining positions in outside organizations. PCAOB members, in contrast, are appointed by the SEC. In this regard, the CPAB appointment process appears to be less transparent than its American counterpart.[18]

Last, on the spectrum of direct governmental regulation to self-regulation, the CPAB has much greater industry involvement and participation. The council of governors includes the President of the CICA, the Canadian self-regulatory body for chartered accountants, suggesting that the CPAB—unlike the PCAOB—is still very much premised on self-regulation with some oversight or involvement of provincial securities regulators. The national and provincial self-regulatory bodies for accountants are involved in CPAB in ways that are absent in the structure of the PCAOB, where it is clear that the federal securities regulator—the SEC—oversees the board. The CPAB contains a greater percentage of accountants on the board than the PCAOB. The PCAOB has two public accountants, or 40 percent of its membership, while the CPAB is staffed by 16 accountants or approximately 59 percent of its membership—four on the board of directors, one on the council of governors, and all 11 of the industry members.

Another cause for concern is that the representation of the accounting industry on CPAB is currently limited to CAs. The CPAB's mandate, however, is to oversee and inspect *all* accounting firms that audit public companies, and, as noted above, CAs are no longer the only group of accountants in Canada accredited to engage in public company auditing (Public Accounting Act, 2004 (Ontario); *International Accounting*, 2005; *The Accountant*, 2005). The board has the authority to extend eligibility for membership as an Industry Member to a wider group. At its November 2005 meeting, the board did in fact grant the BC CGAs one industry member seat. The time is ripe to consider allowing proportionate representation to CGAs and CMAs as industry members on CPAB. This would help reduce the tendency for self-regulation to operate as a barrier to entry.

A board dominated by industry members will inevitably be perceived as being saddled with an inherent conflict of interest. Accountant-representatives may block bylaw changes that may be costly to the industry. Accountant-representatives may also be somewhat less zealous in recommending enforcement against accountants in consideration of the self-image of the profession[19]. Little mention is made, however, of the possibility that the opposite might be true—that accountants might be tempted to treat their

18 The transparency of the PCAOB's appointment process was apparent from its inception with the controversy over the initial selection of William Webster to be the new PCAOB chairman. Webster withdrew before confirmation after his service on the audit committee of a company with serious accounting problems came to light. The controversy over Webster's appointment eventually led to the resignation of then-SEC Chairman Harvey Pitt (Cummings *et al.*, 2004).

competitors harshly in order to gain a competitive advantage. It is not clear which concern should predominate.

Greater independence also must be traded off against expertise. Non-accountants will be free of conflicts, but they will also lack the in-depth knowledge of the industry that can only be acquired through actual practice as an accountant. Perhaps because of its greater representation from the accounting industry, the CPAB appears to be more proactive than the PCAOB in soliciting industry response and input. In this regard, the CPAB's self-regulatory orientation allows it to be more responsive to industry.[20] It may be that eliminating the conflict of interest will lead to sounder regulation, but where the line should be drawn between eliminating conflict and preserving expertise is by no means obvious.

Nonetheless, consideration should be given to revising the governance structure of the CPAB to eliminate the voting rights of industry members. Consideration should also be given to limiting the number of accountants on the board of directors. Neither of these reforms would eliminate valuable input from the accounting industry, but they would help alleviate concerns that self-regulation is being administered in the interests of the accounting industry at the expense of the interests of investors. Some proportionate representation from the CMAs and CGAs at the CPAB's industry member level also warrants further consideration, as it would allow input from other accounting bodies and also address concerns that the system is being administered largely for the benefit of the CAs.

Independence

Recommendation 3:

Consideration should be given to heightening the independence requirements for CPAB directors, many of whom fill influential roles in public companies that are themselves subject to public audits.

PCAOB members are required to be full-time employees and may not be employed in any other professional or business activity. In contrast, CPAB members serve part-time and are permitted to concurrently engage in other positions. Many members of the

19 On the efficiency of enforcement by self-regulatory organizations generally, see DeMarzo, Fishman, and Hagerty, 2005.

20 Note that both the PCAOB and CPAB are meeting with relevant stakeholders to determine their role in relation to overseeing foreign accounting firms that audit public companies in the US and Canada respectively.

CPAB board of directors fill influential roles in public companies that are themselves subject to public audits, and a reasonable argument could be made that these are activities that affect or reasonably create the appearance of affecting the board member's independence or objectivity.[21]

Post-Enron corporate governance reforms have relied on the notion that making outside monitors more independent will reduce instances of misconduct or fraud in the capital markets.[22] The empirical evidence for this proposition is somewhat thin, but the intuition behind it appeals to common sense. Independent monitors, however, may not be as knowledgeable. In the context of a board overseeing accountants, it can be argued that without substantial industry influence in an accounting oversight board that the outsider directors will end up relying on insider knowledge, effectively negating their influence. Ignorance is the countervailing threat to the lack of independence. Though the Sarbanes-Oxley Act has provided that the members of the PCAOB must be knowledgeable, a lack of immediate connection to the burdens imposed by regulation relating to accounting may impede board effectiveness.

The less stringent independence requirements for the CPAB must be assessed, however, in light of the heavy participation of industry participants in its governance. If there were fewer members of the accounting industry among the CPAB's members, the presence of members from public companies would be less of a problem in terms of creating the perception of a lack of independence. Combining the predominance of accounting industry representatives with public company executives unnecessarily raises doubt about the rigor that the CPAB will bring to accounting regulation.

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21 Members of the PCAOB and CPAB are subject to very similar ethics codes. The codes are principles-based providing that when a situation is not covered by the code's specific standards, board members and staff shall nonetheless follow the spirit of the code. The codes seek to maintain the highest standards of ethical conduct among board members and staff and to provide the public with confidence in the objectivity of the board's decisions by seeking to avoid both actual and perceived conflicts of interest. However, considering that CPAB members are permitted to hold influential roles on public companies, it would appear that the CPAB provisions are given a less stringent reading than those of the PCAOB.

22 The push for greater independence has resulted in requiring a majority of independent directors on public company boards in the US and instituting the best practice of a majority of independent directors on public company boards in Canada. See, for example, Ontario Securities Commission (OSC), 2004a, "National Instrument 58-101, Disclosure of Corporate Governance Practices" and OSC, 2004b, "National Policy 58-201." This has also been the rationale for the requirement of entirely independent audit committees in Canada and the US. See, for example, OSC, 2004c, "Multi-Lateral Instrument 52-110 and Companion Policy" and relevant amendments.

Funding and potential conflict of interest

Recommendation 4:
Consideration should be given to amending the structure and source of CPAB's fees so as to minimize the direct influence of accounting firms that are inspected by the board as well as to ensure a stable and guaranteed funding stream.

Whereas the fees charged by the PCAOB are subject to approval by the SEC and are overwhelmingly collected from reporting issuers, the CPAB is funded directly by the accounting firms that it regulates and its fees are not subject to any outside approval. This was the practice in the US under the prior self-regulatory regime and it opened that regime to criticism when the accounting industry threatened to withhold funding over a dispute over the regulation of auditor independence (see Levitt, 2002, p. 127).

In passing the Sarbanes-Oxley Act, Congress was anxious to preserve the independence of the PCAOB from the accounting profession. In addition to the structural protections of that independence discussed earlier, the PCAOB's independence is further bolstered by its funding sources. Registered public accounting firms are required to pay a small fee to PCAOB, but the much more substantial source of funding is the annual accounting support fees that public companies pay based on their market capitalization (Sarbanes-Oxley Act, § 109, 15 U.S.C. § 7219). The SEC must approve these fees (Sarbanes-Oxley Act § 109(b), 15 U.S.C. § 7219(b)). For 2005, the board adopted a $137.1 million budget of which $136.1 million was raised from annual accounting support fees (PCAOB, 2004). Thus, public companies now pay the overwhelming share of the cost of regulating accountants, rather than accountants, who used to pay the cost of the prior self-regulatory regime.

In contrast, the CPAB is funded directly by accounting firms that audit public companies in Canada. The CPAB also collects two types of fees, but both come directly from accounting firms. The one-time "Intent to Participate" fee is based on the number of clients the accounting firm audits annually (CPAB, 2003, p. 16).

The CPAB also collects annual participation fees, which are a prescribed percentage of each firm's revenue derived from auditing the financial statements of reporting issuers.[23] For 2004, the CPAB's operating expenses were $6.4 million, which were served by the collection of annual participation fees. It is difficult to compare this amount with that collected by the PCAOB, given the much larger number of companies audited by the US firms and the apparent wider scope of responsibilities imposed on the PCAOB.

23 For 2004, the annual fee was set at 1.6 percent of the audit fees charged by a participating firm to its reporting issuers (CPAB, 2004, p. 14).

Other features of the boards' fee structures, however, can be compared. Both boards collect higher fees from larger entities. The fee structure allocates costs in an equitable manner. The higher fee charged to the larger issuer is considered equitable in that larger issuers generally require a more complex audit ("Accounting Support Fees" on PCAOB web site, *http://www.pcaobus.org/Support_Fees/index.asp*).

We are concerned, however, about the stability of the CPAB's funding source. At a practical level, the difference between funding by issuers and funding by auditors probably is not critical, given the contractual relationship between the issuers and the auditors, and the fact that auditors can pass the cost of regulation along to their clients.

But the lack of *guaranteed* funding may matter. Currently, the CPAB enjoys the support of the auditing industry as that industry endeavours to polish its reputation. But as the self-regulatory experience in the US shows, the industry's support can be withheld in a confrontation. As well, the direct source of funding from the accounting profession also creates a perception of a conflict of interest in the eyes of many observers. Industry funding should not be used as a tool for forcing submission by the CPAB in a dispute over the proper scope of regulation. The PCAOB is protected from this threat because it gets the bulk of its funding from public companies, rather than the accounting firms that it regulates. A statute guaranteeing funding would greatly enhance the credibility of the CPAB's brand of self-regulation. Such a statute could require public firms to pay for the cost of regulation (assessed based on market capitalization) or require the accounting firms to pay the cost (based on the number and size of public companies audited). The important point to be addressed would be ensuring that funding for the CPAB could not be withheld in the event of a dispute.

Quality Control

Observation

The US has assigned much of the responsibility for setting auditing standards to the PCAOB, or mandated these standards by statute, while the CICA continues to exercise this authority. Further experience is needed to assess whether the greater expense of the US approach is cost-justified.

In the US, standards for independent audits are governed by generally accepted auditing standards (GAAS), which were historically the responsibility of the Auditing Standards Board (ASB), a committee of the American Institute of Certified Public Accountants (AICPA). The PCAOB, however, has now taken responsibility for those standards of independent audits, as authorized by the Sarbanes-Oxley Act (Sarbanes-Oxley Act §

101(c)(2), 15 U.S.C. § 7211(c)(2)).[24] The PCAOB has also taken over the development and implementation of quality control and ethics standards for auditors, as authorized by the Sarbanes-Oxley Act.[25] PCAOB rules include auditing and related professional practice standards, forms, and the board's *Bylaws and Ethics Code*.[26] Currently, public accounting firms involved in the preparation or issuance of audit reports are to follow the ethics standards and independence standards as set out in the AICPA's *Code of Professional Conduct* to the extent that those standards have not been superseded or amended by PCAOB rules. The PCAOB adopted the AICPA's standards as its own on an interim basis (PCAOB *Professional Standards*, rules 3200T, 3300T, 3400T & 3500T), but going forward the responsibility for revising those standards lies with the PCAOB (Sarbanes-Oxley Act, § 103, 15 U.S.C. § 7213(a)(3)(A)). The PCAOB has taken up the task, issuing standards on audits of internal controls, audit documentation (PCAOB, 2004b), and the evaluation of efforts to correct weaknesses in internal controls (PCAOB, 2005a).

The CPAB, in contrast, has left the responsibility for setting auditing control standards with the CICA. Accounting standards are set by the CICA's Accounting Standards Board (AcSB), which is overseen by the Accounting Standards Oversight Board (AcSOC). Auditing and assurance standards in Canada are set by the CICA's Auditing and Assurance Standards Board (AASB), which is subject to the oversight of the Auditing and Assurance Standards Oversight Council (AASOC). The CPAB has secured representation on the boards of the CICA that are responsible for accounting standards and audit and assurance standards to provide comments and input from its perspective (CPAB, 2004). Recently, the AASB issued "General Standards of Quality Control for Firms Per-

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24 The Sarbanes-Oxley Act authorizes, but does not require, the PCAOB to designate a professional group of accountants to propose standards. The PCAOB, however, determined that developing standards themselves with the assistance of qualified accountants would best serve the protection of investors. The ASB is therefore no longer responsible for GAAS (Public Company Accountability Oversight Board, 2003, p.10).

The principles governing the manner in which financial statements are produced remains under the authority of the Financial Accounting Standards Board (FASB), an independent private sector body that receives a majority of its funding from accounting firms. The CPAB has similarly left the standards for financial statements with the CICA.

25 The act specifies that the board's rules are required to include seven year retention of work papers, peer review of audits, disclosure of auditors' testing of issuers internal controls, monitoring of ethics and independence, consultation within auditing firms, supervision, hiring, acceptance of engagements, and internal inspection (Sarbanes-Oxley Act § 103(a)(1&2), 15 U.S.C. § 7213(a)(1&2)).

26 In meeting its duties to establish auditing and ethical standards, the PCAOB seeks the counsel of a Standing Advisory Group composed of industry people and allows the Financial Accounting Standards Board, the Government Accountability Office, the International Auditing and Assurance Standards Board, and the Securities and Exchange Commission observer status with speaking rights at all meetings of the Standing Advisory Group. This process allows the PCAOB to gather a broad spectrum of viewpoints as it fashions various standards.

forming Assurance Engagements," which the CPAB requires participating auditing firms to follow.[27]

Similarly, the CPAB permits ethics standards for auditing firms to be set by the CICA and the provincial institutes across the country (Smith, Caron, and Hunt, 2002, pp. 2-3). Though the CPAB maintains discretion to impose additional ethical standards, it does not appear to have used such authority. Thus, regulation of accounting in Canada has a much greater self-regulatory content at present than it does in the US.

In sum, the creation of the PCAOB has led to a model of more direct government oversight of auditing and ethical standards, while CPAB continues to operate on a self-regulatory model following rules set by the CICA and provincial self-regulatory bodies. The most obvious difference resulting thus far from these diverging approaches has been the dramatic increase in the cost of audits for public companies in the US. This spike in auditing costs, however, appears to be the result not of PCAOB rulemaking so much as the statutory mandate imposed by Congress in the Sarbanes-Oxley Act.[28] Section 404 of that law requires that "each registered public accounting firm that prepares or issues the audit report for the issuer" shall attest to the management's assessment of the firm's system of internal controls for financial reporting (Sarbanes-Oxley Act § 404(b), 15 U.S.C. § 7262(b)). Auditors are now required to not only certify the integrity of their client's financial statements, but also assess the mechanisms that their corporate clients have adopted to generate the financial information that goes into those statements. Smaller companies in particular have complained about the new costs imposed by this requirement. Their complaints have been reinforced by recent work by Eldridge and Kealey, who find an average increase in audit fees paid by a sample of 97 public companies from $3.5 million to $5.8 million (Eldridge and Kealey, 2005). They find that increase is largely attributable to § 404 compliances costs and smaller companies bear a disproportionately greater burden of those costs.[29] The SEC recently delayed implementation of the § 404 requirements for smaller companies in response to a recommenda-

27 The CPAB has required participating auditing firms to have a system of quality control that conforms to such standards by January 1, 2005 in respect of audits of reporting issuers, even though AASB has established an effective date of December 1, 2005 (CPAB rule 204).

28 The Sarbanes-Oxley Act also imposes a variety of additional requirements on auditors and public companies to help promote audit quality. Auditors must adopt procedures to detect "illegal acts that would have a direct and material effect" on financial statements and identify material related party transactions (Exchange Act § 10A(a)(1) & (2), 15 U.S.C. § 78j-1(a)(1) & (2)). Auditors are also required to evaluate the ability of the client to continue as a going concern through its next fiscal year (Exchange Act § 10A(a)(3), 15 U.S.C. § 78j-1(a)(3)). These duties were added to existing responsibilities to report illegal acts to management and the audit committee or entire board of directors (Exchange Act § 10A(b), 15 U.S.C. § 78j-1(b)). A board of directors receiving such a report must notify the SEC; if it fails to do so, the audit firm must provide notice to the SEC itself.

tion from the agency's Advisory Committee on Smaller Public Companies (Bologna, 2005).

The increase in audit costs for US public companies may prove to be cost justified if it results in significantly greater credibility for their financial statements, but it is still too early in the process to determine if this will be the case. There is at least anecdotal evidence that there may be some spillover effect, with audit costs rising in Canada as well, despite the fact that Canada has not yet implemented more demanding internal control requirements. Canadian securities regulators recently announced that they will delay implementation of proposed Multi-Lateral Instrument 52-111 "Reporting on Internal Controls over Financial Reporting"—the Canadian response to § 404 of the Sarbanes-Oxley Act—as they monitor the criticisms over the US rule.

Inspection process

Recommendation 5

CPAB should consider undertaking inspections of smaller participating firms which are currently inspected by provincial self-regulatory bodies. Otherwise, it may be subject to criticism that it is not truly living up to its mandate of providing independent inspections of all accounting firms that audit public companies.

The PCAOB's inspection process is premised both upon its rules and upon the Sarbanes-Oxley Act. The CPAB inspection process is premised only on its own rules. Therefore, PCAOB inspections are subject to minimum requirements according to statute while the CPAB has greater flexibility in setting out the content of its inspections. Both PCAOB and CPAB have created detailed methodologies for their inspections. Both boards inspect and review selected audit and review engagements and evaluate the sufficiency of the quality control system of the auditing firm.

With respect to the frequency of inspections, the PCAOB must conduct inspections every year for firms auditing more than 100 issuers and at least every three years for firms auditing fewer than 100 issuers (Sarbanes-Oxley Act § 104(b), 15 U.S.C. §

29 William McDonough, chairman of the PCAOB, in a recent interview attempted to shift the blame for this spike in costs to the auditors and their fear of litigation:

> Auditors have to use judgment. They have a great deal of leeway. But in a litigious society, there's no question that some auditors may be protecting themselves by doing work that all of us might think objectively is excessive. That I want to see eliminated. The leadership of the firms agrees. But [auditors] have to be convinced that their leaders will not be pleased by excessive work. (*Business Week*, 2005, p. 56)

7214(b)). In 2005, only eight firms were auditing over 100 reporting issuers and there were 650 audit firms with under 100 reporting issuers (Gullapalli, 2005). In contrast, CPAB conducts annual inspections of auditing firms that perform audits for 50 or more reporting issuers per year, while firms engaging in 50 or fewer audits per year are subject to a regular inspection at least once every three years (CPAB, rules 403-404). As of April of 2004, only 12 firms in Canada were auditing more than 50 issuers (CPAB, 2003, p. 14). On its face, this suggests that the CPAB is taking on a greater burden of inspection relative to the smaller Canadian capital market. However, the CPAB has allowed provincial accounting self-regulatory bodies to continue to inspect smaller participating firms on behalf of the CPAB and in accordance with CPAB rules and procedures (CPAB, 2003, p. 4). The stated rationale is that provincial accounting self-regulatory bodies have developed a measure of expertise and accumulated knowledge that renders their oversight more appropriate. We question, however, whether the CPAB is truly living up to its mandate of providing independent inspections of all accounting firms that audit public companies. With inspections being conducted by different regulators, investors are left in the dark about whether all auditing firms are being subjected to the same level of scrutiny.

Enforcement mechanisms

Recommendation 6

The CPAB's enforcement effectiveness would be enhanced by statutory protection providing immunity for its staff. Such immunity would allow them to pursue the board's mandate without fear of retaliation. In addition, the deterrent force of sanctions available to the CPAB would be enhanced if it were provided with the statutory authority to impose fines on accounting professionals who chose to abandon the auditing of public companies rather than pay fines imposed by the CPAB. Both PCAOB and CPAB have limited track records of sanctioning firms, so we recommend that their relative performance in enforcing their rules be evaluated at a later point when they both have longer track records.

Authority

The PCAOB has broad-ranging enforcement authority. The board is empowered to investigate possible violations by registered accounting firms of the Sarbanes-Oxley Act, the securities laws, and the PCAOB's own rules (Sarbanes-Oxley Act, § 105(b)(1), 15 U.S.C. § 7215(b)(1)). In implementing this authority, the board is authorized to establish, by rule, fair procedures for investigating and disciplining registered public accounting firms and persons associated with these firms (Sarbanes-Oxley Act, § 105(a), 15 U.S.C. § 7215(a)). In conducting its investigations, the PCAOB can compel registered firms and persons associated with those firms to testify and produce documents, including audit work papers (Sarbanes-Oxley Act, § 105(b)(2)(A) & (B), 15 U.S.C. § 7214(b)(2)(A) and (B)). The rules also permit the board to seek information from other persons, including clients of registered firms (Sarbanes-Oxley Act, § 105(b)(2)(C) 15 U.S.C. § 7214(b)(2)(C)). Critically, the PCAOB can also call on the SEC to exercise its wide-ranging subpoena authority to compel others to testify and produce documents (Sarbanes-Oxley Act, § 105(b)(2)(D), 15 U.S.C. § 7215(b)(2)(D)).

Firms that refuse to cooperate in the board's investigation can have their registration suspended or revoked (Sarbanes-Oxley Act, § 105(b)(3)(A)(ii), 15 U.S.C. § 7215(b)(3)(A)(ii)). Persons associated with the registered accounting firms can be suspended or barred from associating with the firm; the firm can be required to fire a person who does not cooperate (Sarbanes-Oxley Act, § 105(b)(3)(A)(i), 15 U.S.C. § 7215(b)(3)(A)(i)). Lesser sanctions are also available for non-cooperation (Sarbanes-Oxley Act, § 105(b)(3)(A)(iii), 15 U.S.C. § 7215(b)(3)(A)(iii)). The board recently exercised its authority to sanction firms that fail to cooperate for the first time, revoking the registration of a public accounting firm and barring its managing partner for having falsified documents in an audit file in an effort to conceal a violation of the independence rules (PCAOB, 2005b).

Inspections are conducted pursuant to CPAB rules. Inspectors are granted great leeway in performing their inspections, as CPAB rules afford broad authority to "take such steps, and perform such procedures, as the board determines are necessary or appropriate" (CPAB, rule 402). Firms subject to inspection are required to provide all documents requested. Furthermore, all persons are required to provide information either by oral interview, written response, or otherwise (CPAB, rule 406).

Comparing the scope of the two board's authority, one principal difference is that the enforcement powers of the PCAOB come from the Sarbanes-Oxley Act (and the PCAOB rules authorized by that act) while CPAB enforcement authority is derived from the CPAB rules. Given that CPAB enforcement powers can be changed by the procedures for amending CPAB rules as opposed to the procedure for amending a statute, one could argue that PCAOB enforcement powers are more stable and further insulated from the pressure of interest groups. On the other hand, the insulation enjoyed by the PCAOB also creates concerns that the temptation of regulators to regulate excessively will not be countered by resistance from the regulated industry.

Another more substantial difference is the PCAOB's ability to call on the SEC's subpoena authority. The CPAB's lack of subpoena power means that it must depend entirely on the cooperation of the audit firms that it regulates. Even for the work papers in the possession of auditors, the CPAB may be denied access if the papers are deemed to contain confidential information about reporting issuers. The broad statutory authorization enjoyed by the PCAOB means that it has access to all of the information needed for a complete inspection and/or investigation. Moreover, it can demand documents from third parties as needed.

Consequences

According to the PCAOB rules, if the board determines that there was a potential malfeasance on the part of the participating audit firm, it is to inform the SEC and the appropriate state regulatory authority, and it is also entitled to investigate (PCAOB, rule 4004). Firms subject to a report shall be provided with a draft of the inspection report. The firm is entitled to respond to the draft within 30 days indicating for which portions of the report they request confidentiality (Sarbanes-Oxley Act § 104(f), 15 U.S.C. § 7214(f)). After receiving and reviewing any response, the PCAOB can adopt the report as its final report or continue to revise the draft as necessary (PCAOB, rule 4007). Once the final report is issued, it shall be released to the relevant firm and appropriate state regulatory authority (PCAOB, rule 4008). If a final report identifies quality control defects, the firm may demonstrate to the director of the Division of Registration and Inspections that it has remedied the defects within twelve months. If the defects are successfully remedied, they will not be made public (PCAOB, rule 4009). However, at all times the board is empowered to publish information from its inspections as the PCAOB deems appropriate, so long as the firm itself is not identified (PCAOB, rule 4010).

When PCAOB staff detect violations, the party being inspected is entitled to notification of the specific charges to which they are subject, and a record shall be kept of the proceeding (Sarbanes-Oxley Act, § 105(c)(1), 15 U.S.C. § 7215(c)(1)). The board will provide an opportunity for a hearing (Sarbanes-Oxley Act, § 105(c)(2), 15 U.S.C. § 7215(c)(2)), and in appropriate cases, impose sanctions designed to deter a possible recurrence and to enhance the quality and reliability of future audits.[30]

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30 Sarbanes-Oxley Act, § 105(c)(4), 15 U.S.C. § 7215(c)(4).
The board is empowered to impose a wide range of sanctions, including:

- money penalties of up to $100,000 for associated persons and $2 million for firms;
- censure;
- required education or training; and
- other penalties provided for in the board's rules.

More stringent penalties can be imposed for intentional or knowing misconduct or repeated negligence:

- temporary or permanent suspensions of registration of firms or bars of their associated persons;
- limits on the operations and activities of the firm and its associated persons; and
- money penalties of up to $750,000 for associated persons and $15 million for firms.

Sarbanes-Oxley Act, § 105(c)(4) & (5), 15 U.S.C. § 7215(c)(4) & (5).

The CPAB process for producing inspection reports is similar. Pursuant to the information gleaned from the inspection, the board produces a draft inspection report noting any significant problems and remedial recommendations. The report also states whether the board intends to impose any requirements, restrictions, or sanctions on the firm. The firm is then required to submit a response to the draft report within 30 days indicating whether it accepts the report and reasons for its acceptance or lack thereof (CPAB, rule 409). The CPAB and the firm may continue in correspondence in the manner contemplated above, though with only 15 days response time for the firm, until the CPAB adopts a version of the report as the final report. At this point, the board may take such action as it deems appropriate (CPAB, rule 410). If a final inspection report identifies significant weaknesses or makes recommendations for improvement of systems of quality control, the firm is given 180 days from the issuance of the final report in which to show they have implemented or remedied these deficiencies to the satisfaction of the board (CPAB, rule 414). If the board does not remedy the problems identified in the time given, it may publicize this fact after notifying the firm. The firm is entitled to appeal such a finding (CPAB, rule 416).

If violations are found in the course of an inspection, the CPAB is empowered to order an investigation of said event or order requirements, restrictions, or sanctions (CPAB, rule 418). Potential requirements include requiring a firm to expand its professional development program, to craft and implement certain policies, or to engage an independent monitor to report on the firm's compliance with professional standards. Examples of restrictions include temporary or permanent limitations on firm activities or the activities of a person. In severe cases, the CPAB may declare a firm to no longer be in good standing with the CPAB, thereby precluding that firm from conducting audits of public companies in Canada (CPAB Rule 601). Though these coercive mechanisms are available, the CEO has stated that, "our intent is to work with the participating firms in a cooperative non-adversarial way to bring about audit quality improvements where they are appropriate" (CPAB, 2003, p. 10).

The PCAOB, as a quasi-governmental entity, is subject to more extensive procedural requirements than the CPAB. The PCAOB can only sanction a registered accounting firm or associated person after a hearing and the release of a report. These procedural safeguards, while undoubtedly increasing the accuracy of the PCAOB's determinations, create the risk that the auditing firm will tie the PCAOB up in legal manoeuvring. This difference, however, may not be all that substantial, as the CPAB's rules also allow for the possibility of a hearing prior to the imposition of a requirement, restriction, or sanction proposed by the board (see CPAB, rule 701).

Both the PCAOB and the CPAB are given wide disciplinary authority. Both boards employ the threat of publicizing the misconduct of the offending firm in order to coerce them into meeting the recommendations supplied in the private report that was produced based on the inspection of the respective board. The PCAOB gives firms 12 months to meet their recommendations while the CPAB only gives 180 days. CPAB and PCAOB sanctions are quite similar in range with both boards capable of precluding a firm from conducting audits of public companies in severe cases and otherwise imposing fines and remedial measures for lesser offences. Statutory authorization could also provide the CPAB with authority to impose fines on accounting professionals who chose to abandon the auditing of public companies rather than pay the fines imposed by the CPAB. This would bolster the deterrent force of the sanctions available to the CPAB.

The PCAOB's statutory authorization also means that the PCAOB members and staff clearly enjoy the immunity from legal actions afforded to regulators. The CPAB's lack of similar immunity raises questions about how aggressively it will perform its duties. So far, the PCAOB has only sanctioned one firm, and that was for obstructing its inspection (see PCAOB, 2005b). The CPAB has a similarly limited track record, having only recently imposed its first sanctions, limiting three firms from accepting new audit clients until they have implemented CPAB recommendations, and limiting the partners eligible to do quality control reviews at a fourth firm (CPAB, 2005, p. 7). A longer track record is needed before we can assess the two bodies' relative performance in enforcing their rules.

Transparency and predictability of activities

Recommendation 7

The CPAB's and PCAOB's activities should be more transparent to the public, so as to enhance their accountability. This recommendation must be tempered against the litigation risk faced by inspected audit firms, so we also recommend making the reports inadmissible in court.

Both the CPAB and PCAOB provide copies of their final inspection report to the participating audit firm. The PCAOB is *required* to provide a report to professional regulatory authorities and the SEC, while the CPAB *may* provide a copy of the report to the professional regulatory authority with jurisdiction over the firm in question. Neither organization will provide other third parties with copies of the report. Both boards adhere to the principle that only those portions of the report that have not been dealt with to the satisfaction of the board shall be publicized. Both the CPAB and PCAOB have further discretion to release information gleaned from their inspections, but the boards do not publish information that would identify the relevant accounting firm unless the information was previously and lawfully made public.

The PCAOB issued "Limited Inspection Reports" in August 2004 for the Big Four firms (PCAOB, 2004c), and the full inspection reports are now available on the PCAOB's web site (see *http://www.pcaobus.org/inspections*). Similarly, in October 2004, the CPAB issued a public report on the results of its initial quality inspections of the four largest accounting firms, and outlined the scope of the inspections and the recommendations made without identifying the firms inspected by name. It found that there "were no systemic problems with the quality of the firms' audits, but there was room for improvement" (CPAB, 2004.) In its second inspection report released in August 2005, the CPAB indicated that the recommendations from its October 2004 inspection report were being implemented by the relevant firms. At the release of its second inspection report, CPAB has now inspected firms auditing more than 80 percent of Canada's public companies (more than 90 percent by market capitalization) (CPAB, 2005, p. 3) and identified five principal areas of concern:

1. Inadequate implementation of revised independence rules, including internal controls to detect independence problems;

2. Lack of effective internal quality controls, with partners operating autonomously without firm oversight;

3. Accepting or retaining unacceptably risky clients, with the CPAB noting "*instances where firms retained clients despite clear evidence form the audit work that the integrity of management was in significant doubt*";

4. Failure to evaluate staff for audit quality, with "*little evidence of effective counselling and evaluation of staff members*";

5. Inadequate, "*ad hoc*" training (CPAB, 2005, pp. 3, 7-8).

In the four most problematic cases, the CPAB placed requirements on the firm's practice, restricting it from accepting new clients until the CPAB's recommendations were implemented, or on their personnel, restricting certain partners from performing quality control reviews (CPAB, 2005, p. 7). Notably, the CPAB's concerns were mainly raised by its inspections of smaller audit firms as larger firms were reported to have put in place sophisticated quality control systems (CPAB, 2005, pp. 6-7).

Although the two boards have made public reports related to the conclusions of their inspections, it is questionable how useful that information is to relevant stakeholders in assessing the effectiveness of the oversight boards. We believe that greater publicity of findings of material weaknesses in audit procedures would provide more of a deterrent for audit firms to do a good job with their audits. Reputation is critical to auditors. The loss of reputation is an important deterrent against both negligence and affirmative wrongdoing, particularly in a business like accounting, in which firms are effectively "renting" their reputations to their clients. A public censure from the accounting regulators would seriously compromise an audit firm's reputation.

Particularly in the US, however, providing the public with information to assess the adequacy and thoroughness of the auditor's work has to be balanced against the audit firms' litigation concerns. Public airing of weaknesses in their audit procedures could provide fodder for litigation. Similarly, making public the documents available to the PCAOB or CPAB would be very tempting to current and prospective private litigants.

The CPAB also seems to be concerned about its own litigation risk, apart from the litigation faced by accounting firms subject to their inspections. Unlike public authorities (including the PCAOB), CPAB directors, officers, and staff are not protected for actions taken in good faith in carrying out the board's mandate (CPAB, 2004, p. 3), such that their release of inspection deficiencies of member firms (or omission to do so) may also result in potential liability of the board, officers, and staff to member audit firms, reporting issuers, investors, and other stakeholders.

Accordingly, we believe that greater transparency for PCAOB and CPAB reports should be accompanied by a privilege making them inadmissible in court actions, whether the defendants in such actions are the auditing firms or the boards themselves. We should not let litigation concerns dilute the informational value provided by the PCAOB and CPAB reports. The boards need to be able to disseminate their findings candidly and promptly, so that market participants can weigh those findings in their assessments of audit quality. Prompt dissemination also holds regulators to account through the release of detailed and timely information.

Conclusion

Striking the appropriate balance among market-based, self-regulatory, and legal mechanisms for promoting audit quality is a delicate task. The CPAB and the PCAOB are both charged with overseeing the auditors of public companies in an effort to enhance the quality of audits for those companies. The two boards diverge primarily on the division of regulatory effort between self-regulation and governmental regulation, with the PCAOB being much more of a governmental regulator.

The PCAOB, a quasi-governmental agency created by federal legislation, is not dependent upon the accounting industry for direction or funding. The PCAOB has both considerable independence from the accounting industry and a reliable source of funding, primarily from public companies. The PCAOB is also insulated from accounting industry influence by SEC oversight of its functions. This insulation carries a cost, however, in terms of pushing the PCAOB toward intrusive regulation to avoid antagonizing the SEC and its legislative overseers.

As a self-regulator, the CPAB is vulnerable to charges of capture by the auditing industry. The CPAB currently has a substantial complement of accountants among its members and is funded by the auditing firms that it regulates. This dependence on the accounting industry could result in actual or perceived conflicts of interest that could be detrimental to the integrity of the institution and more generally to investor confidence in the capital markets. The CPAB could protect itself from charges of industry capture by making itself more independent.

Greater independence for the CPAB could be achieved by eliminating the voting power of its industry members over bylaw changes, making those members more of an advisory body. Greater independence would also be promoted by limiting the number of accountants serving on the board of directors. This change would put non-accountants more firmly in control of the CPAB's day-to-day operations. Both of these changes would have the collateral benefit of making the CPAB's decision-making bodies more compact. Neither of these reforms would eliminate valuable input from the accounting industry, but they would help alleviate concerns that self-regulation was being administered in the interests of the accounting industry at the expense of the interests of investors.

The independence of the CPAB is also called into question by the fact that many members of the CPAB board of directors also fill influential roles in public companies that are themselves subject to public audits. These activities could create the appearance of affecting the board member's independence or objectivity. Combining the predominance of accounting industry representatives on CPAB with public company executives raises doubt about the rigor that the CPAB will bring to accounting regulation. As such, consideration should be given to heightening the independence requirements for CPAB board of directors.

The CPAB's current funding is also a concern. CPAB is funded directly by accounting firms, whereas PCAOB is funded by public companies. Consideration should be given to changing the funding structure so that accounting firms do not directly control the financial viability of the CPAB and also to avoid any perceived conflict. This would require legislation to provide the CPAB with a guaranteed source of funding, whether it continue to be directly from the accounting profession or alternatively from public companies.

A more secure source of funding might allow the CPAB to expand the scope of its inspections to cover all firms auditing public companies. The CPAB's lack of statutory authorization, most notably its lack of subpoena power, also has potential adverse consequences for its enforcement authority. The broad statutory authorization that the PCAOB enjoys means that it has access to all of the information needed for a complete inspection and/or investigation. Statutory authorization could also provide the CPAB with authority to impose fines on accounting professionals who chose to abandon the auditing of public companies rather than pay the fines imposed by the CPAB. Finally, the PCAOB members and staff clearly enjoy immunity for their acts as regulators. The CPAB's lack of similar immunity raises questions about how aggressively it will perform its duties. The CPAB's enforcement effectiveness would be enhanced by statutory protection providing immunity for staff, which would allow them to pursue the board's mandate without fear of retaliatory litigation.

Both the CPAB's and PCAOB's activities should be made more transparent to the public, so as to enhance their accountability. This recommendation must be tempered against the litigation risk faced by inspected audit firms, so we also recommend making the reports inadmissible in court. Litigation concerns should not dilute the informational value provided by the PCAOB and CPAB reports. The boards need to be able to disseminate their findings candidly and promptly, so that market participants can weigh those findings in their assessments of audit quality.

Providing statutory authority for CPAB will be challenging in the current context of securities regulation by provincial authorities in Canada. Statutory authorization also carries the risk for the CPAB of a potential for a governmental takeover of its regulatory function, as has happened in the US with the adoption of the Sarbanes-Oxley Act. The statute was a strong signal of reform, but it has proved to be expensive for US public companies, not to mention lucrative for the auditing profession. Moreover, the regulatory burden imposed by the Sarbanes-Oxley Act has fallen disproportionately on the smallest issuers, creating the risk that some of these firms will "go dark," removing their securities from public trading, and that other firms will remain closely-held rather than pursuing growth through an initial public offering.

Self-regulation promises to be more carefully tailored to the needs of Canadian companies than direct government regulation, but the self-regulators need the tools to ensure the credibility of that self-regulation. Appropriately tailored legislation could give the CPAB greater power and independence than it now has, but it should not require the CPAB to take over the standards for audits currently set by the CICA. An even greater worry is that legislation validating the CPAB's role might tempt legislators to experiment themselves in the field of setting auditing standards, a task for which most of them are very poorly equipped. Any statute legitimizing the CPAB would need to be narrowly drawn to bolster its efficacy and credibility, without putting the regulation of auditors directly under government control.

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