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Message from the Chair of the Auditing and Assurance Standards Board Regarding Auditing in Emerging Markets

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Significant concerns have been expressed about the quality of financial reporting of some companies with operations in an emerging market country and the audits of these companies' financial statements.[1] An emerging market country is characterized as a country that currently has relatively lower levels of gross domestic product per capita but relatively higher levels of economic growth and volatility. Capital markets within emerging market countries may not be well developed or have a long operating history. As a result, the business environment and customs in these markets, and the risks of fraud, may be different from those with which a Canadian auditor is familiar. Auditors of public and private companies operating in an emerging market country should consider what additional or modified procedures might be necessary or advisable to help ensure that, in all cases, a high-quality audit is performed.

My message briefly covers three important aspects of these audits and reflects guidance in the relevant Canadian Auditing Standards (CASs):

- assigning competent and capable group engagement team members and component auditors;
- obtaining sufficient knowledge of the company's business practices and environment; and
- using this knowledge to plan and perform effective audit procedures.

The discussion that follows presumes there has been a robust consideration by the auditors to accept (or continue) the engagement to audit the financial statements of a company operating in an emerging market country. The auditor will have determined, for example, that his or her appointment is rational in the circumstances, and that the group engagement team will be able to be involved in the work of those component auditors, and have access to key people of the component, to the extent necessary to obtain sufficient appropriate audit evidence.

Assigning competent and capable group engagement team members and component auditors

Once the auditors have determined that they have or can secure the resources available to properly fulfill their audit obligations, quality control and auditing standards require that a competent and capable engagement team be assigned to perform the audit. Auditors will need

[1] Ontario Securities Commission News Release "OSC Commences Emerging Market Issuers Regulatory Review," July 5, 2011; United States Securities and Exchange Commission (SEC) News Release "SEC Issues Bulletin on Risks of Investing in Reverse Merger Companies," June 9, 2011; Public Company Accounting Oversight Board Staff Audit Practice Alerts No. 6 "Auditor Considerations Regarding Using the Work of Other Auditors and Engaging Assistants from Outside the Firm," July 12, 2010 and No. 8 "Audit Risks in Certain Emerging Markets," October 3, 2011.

to consider the levels of experience, extent of supervision and partner oversight of the engagement team to deal with the potentially higher risk environment.

Canadian auditors of a company operating in an emerging market country may use Canadian staff to do field work on the company's operations in the emerging market country, use component auditors (who may be staff from an affiliate in that country or from a different firm in that country), or various other combinations of personnel to perform the audit. Auditors need to be concerned about the composition of both the group engagement team and the component auditors' personnel. The "group engagement team" is defined as the partners, including the group engagement partner, and staff who establish the overall group audit strategy, communicate with component auditors, perform work on the consolidation process, and evaluate the conclusions drawn from the audit evidence as the basis for forming an opinion on the group financial statements. The "component auditors" are auditors who, at the request of the group engagement team, perform work on financial information related to a component for the group audit, whether or not they are part of the same network of firms.

The formation of an appropriate group engagement team will often be challenging for Canadian auditors of a company that has most, or all, of its operations located in an emerging market country. Canadian standards require the group engagement team to obtain an understanding of the group, its components and its environment, including group-wide controls, and to assess the risks of material misstatement of the group financial statements, whether due to fraud or error. The group engagement team also needs to obtain an understanding of the component auditors.

Significant factors that may affect how the group engagement team plans and performs the audit of a company operating in an emerging market country include:

- the ability to communicate effectively in the language used by the company in the emerging market country;
- a working knowledge of the business environment in which the company operates in the emerging market country, for example, obtained by work experience in the relevant country; and
- availability to travel to and within the emerging market country to conduct the audit.

While there are different ways to address these factors, ultimately the group engagement team needs to be involved in the work of the component auditors to the extent necessary to obtain sufficient appropriate audit evidence.

In the initial year of the audit and periodically thereafter, especially for a significant component operating in an emerging market country, it may be useful for senior members of the group engagement team to personally visit the component auditors in the emerging market country to discuss matters that include:

- the competence, capabilities and independence of the component auditors, including whether they are able to perform audit procedures in accordance with CASs, and know the relevant aspects of the applicable financial reporting framework used by the company in preparing and presenting its financial statements (for example, International Financial Reporting Standards);
- the breadth and depth of the component auditors' understanding of the business environment in which the company operates, including specific matters of which the component auditors are aware that may be important to the group audit as a whole; and
- the regulatory environment in the emerging market country, including whether there is active oversight of auditors.

Obtaining sufficient knowledge of the company's business practices and environment

Auditing standards require the auditors to obtain knowledge of the company being audited, its business practices, the environment in which it operates and relevant local laws and regulations. In undertaking this part of the audit, the auditors take into account potentially heightened risks of material misstatements in the company's financial statements due to fraud or error as a result of the operations in an emerging market country.

It is important to note that, in many cases, emerging market business customs and practices may differ significantly from those followed by companies in Canada. For example, in the emerging market country, there may be:

- more common use of verbal rather than written agreements;
- informal arrangements among a company and its customers and suppliers regarding the timing of invoicing to delay or avoid payment of commodity or other taxes;
- a business environment where maintaining key relationships may entail actions that would be considered unethical or even illegal in Canada;
- less development or rigorous enforcement of laws and regulations;
- governance structures and internal controls that are not as robust as would normally be expected in Canada (for example, higher prevalence of management override); and
- greater deference to those in senior positions, both within a company and organizations with which it deals, that may result, for example, in less willingness to challenge actions that may have an adverse effect on the completeness and accuracy of financial reporting.

Some companies operating in an emerging market country may have turned to the Canadian capital market for financing because they were unable to get domestic financing or they want the prestige of being a public company listed on a Canadian stock exchange. As with most public companies, there will be pressure to meet market expectations, but companies from an emerging market country may not have the same experience with Canadian standards for corporate governance, ethics and disclosure requirements. Management of some companies may be tempted to respond to the high expectations by using aggressive or even fraudulent financial reporting.

Sometimes companies operating in an emerging market country use a variable interest entity or a special purpose entity. Such corporate structures tend to be complex and management may be motivated to consolidate the variable interest entity in order to report better financial results, even though control may not exist. These, and similar types of complex corporate structures, may also call for the auditors to have access to specialized tax expertise.

Using this knowledge to plan and perform effective audit procedures

Auditors will need to apply their knowledge of the company (including its business practices) in designing and performing audit procedures to gather sufficient appropriate audit evidence. Audit procedures, as designed and applied in auditing a company operating in Canada, may not necessarily work well in the audit of a company with significant operations in an emerging market country. Modified or additional procedures may be needed in auditing the emerging market operations to provide the auditors with an appropriate basis for their opinion. Examples are set out below.

Confirmations

Investigations into recent possible accounting frauds related to some companies operating in emerging market countries indicate that bank confirmations may not always be reliable. Company personnel may be tempted to collude with bank branch personnel to provide the auditors with fraudulent confirmations. Auditing standards require the auditors to maintain control over confirmation requests. Auditors may often consider performing one or more additional procedures, such as the following, to respond to higher fraud risks:

- contact the confirming party, or visit the bank unannounced, to verify the source and contents of the response;
- ask the bank's head office, instead of the branch office used by the company, to complete the confirmations;

- view the bank balance on the online banking system (Internet banking); and;
- obtain copies of the bank statements for the month before and after year end directly from the bank and test transactions (for example, their purpose, nature, timing and who the parties to the transactions were).

Auditors should be vigilant as to the need to change their standard procedures for other types of confirmations as well, including confirmations of accounts receivable and accounts payable.

Revenue recognition

Auditing standards require the auditors to perform the audit based on a presumption that there are risks of fraud in revenue recognition. While this is the presumption regardless of the type of economy, a company with operations in an emerging market country often faces greater challenges in its market and expectations for higher growth. Auditors need to understand the types of revenue, revenue transactions or management assertions that give rise to such risks, and design audit procedures that appropriately respond to such risks, including a risk that certain customers may not, in fact, exist. In auditing a company with operations in an emerging market country, additional audit procedures that often may be performed include inspecting sales contracts, related invoices (for example, for unusual dating) and shipping documents, and confirming completeness of the terms of the contracts with the counterparties.

Related party transactions

Related parties often play significant roles in an emerging market. Identifying them may be a challenge for the auditors because, for example, close relationships may not always be formally documented and controls over the identification of related parties, and transactions with these parties, may be weak. Also, inquiries of management and others in the company may not always be adequate to identify all significant related parties. Auditing standards require the auditors remain alert for information, including fraud risk factors, that indicate that management may have inadvertently or deliberately concealed the existence of a related party. In auditing a company with operations in an emerging market country, the level of alertness often may need to be higher, for example, in identifying transactions that are unusual in nature, timing, or volume, that may indicate the existence of a related party.

In conclusion

Auditing standards require auditors to plan and perform an audit with professional skepticism, which is an attitude that includes a questioning mind, being alert to conditions that may indicate possible misstatement due to fraud or error, and a critical assessment of evidence. Recent concerns expressed by both auditing and securities regulators suggest that, for some companies operating in emerging market countries, there are numerous indicators of a high risk of misstatement due to fraud or error to which the auditors must appropriately respond. Auditors may need to modify the standard procedures they apply in an emerging market country as compared to Canada. It is not always about just doing more audit work; it may require the auditors to change the nature and timing of the underlying audit work.

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Chair, Auditing and Assurance Standards Board