



CANADIAN PUBLIC ACCOUNTABILITY BOARD
CONSEIL CANADIEN SUR LA REDDITION DE COMPTES

WORLD-CLASS AUDIT REGULATION

November 2017



2017 Big Four Inspections Report

ABOUT CPAB

The Canadian Public Accountability Board (CPAB) is Canada's audit regulator responsible for the oversight of public accounting firms that audit Canadian reporting issuers. Through its annual inspections program, stakeholder engagement initiatives and outreach to audit committees, and thought leadership activity, CPAB contributes to public confidence in the integrity of financial reporting, which supports effective capital markets.



VISION

Contribute to public confidence in the integrity of financial reporting of public companies in Canada by effective regulation and by promoting quality, independent auditing.



MISSION

Effective regulation: Proactively identify current and emerging risks to the integrity of financial reporting of public companies in Canada by assessing how auditors effectively respond to those risks, and engage those charged with governance, regulators, and standard setters to develop sustainable solutions.



BOARD OF DIRECTORS

CPAB has an 11-member Board of Directors.



EMPLOYEES

CPAB employs approximately 50 professionals.



LOCATIONS

CPAB operates from offices in Montreal, Toronto and Vancouver.

CPAB report on 2017 inspections of Canada's four largest public accounting firms

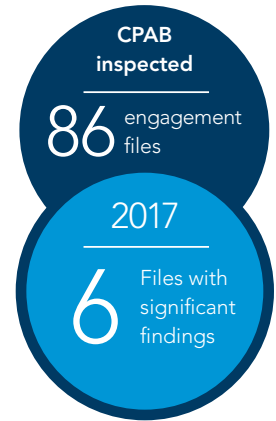
CPAB's 2017 Big Four Inspections Report provides an overview of the annual inspections findings for Canada's four largest public accounting firms (Deloitte LLP, EY LLP, KPMG LLP, PwC LLP). These firms, and their foreign affiliates, audit approximately 98 per cent of all Canadian reporting issuers by market capitalization.

Each audit firm shares its file-level significant inspection findings (deficiencies in the application of generally accepted auditing standards that could result in a restatement of the company's financials), and this report, with their clients' audit committees. This report includes common inspection finding themes and questions for audit committees to consider in conducting their oversight responsibilities. CPAB encourages all audit committees to discuss this report, and any file-level findings, with their audit firm.

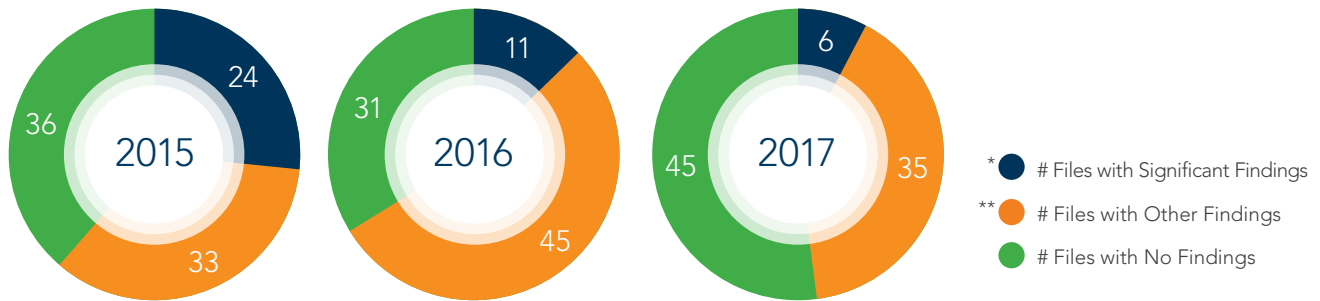
SIGNIFICANT INSPECTION FINDINGS LOWER IN 2017; CPAB VIEWS LONGER TERM CONSISTENCY THROUGH A QUALITY SYSTEMS LENS

CPAB had fewer inspection findings across Canada’s largest public accounting firms in 2017 compared to 2016 and 2015. We inspected 86 (2016:87) audit engagement files – six of those files had significant findings compared to 11 files in 2016 and 24 files out of 93 in 2015. There are two restatements to date.

While each Big Four firm demonstrated an acceptable level of inspection findings overall, CPAB continued to find exceptions where they did not execute consistently across the firm. The need to fully embed audit approach improvements into every practice and every engagement still requires more attention.



2017 Big Four Inspections Results: Engagement File Findings



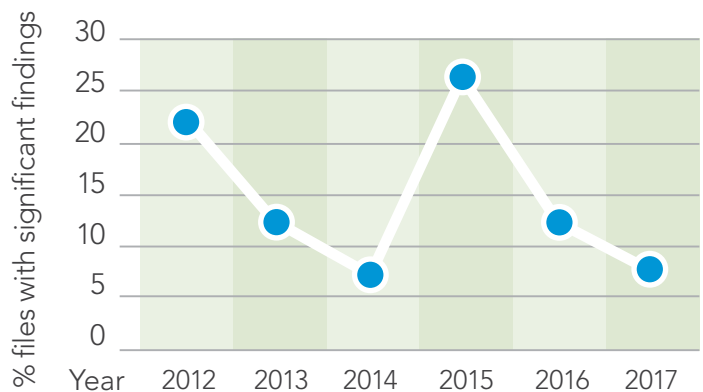
***Significant Findings** – A significant inspection finding is defined as a deficiency in the application of generally accepted auditing standards that could result in a restatement. CPAB requires firms to carry out additional audit procedures to verify there was no need to restate the financial statements due to material error, or to substantiate that they had obtained sufficient and appropriate audit evidence with respect to a material balance sheet item or transaction stream to support their audit opinion.

****Other Findings** – A noted deficiency in the application of generally accepted auditing standards related to a material balance sheet item or transaction stream where CPAB is able to conclude, without the engagement team performing additional procedures to support the audit opinion, that the deficiency is unlikely to result in a material misstatement. These findings, while not significant, indicate areas for improvement.

High quality, sustainable audits

Firms have sound audit methodologies and in most cases we see compliant execution. However, recurring inspection findings indicate the need to manage audit quality through robust and effective quality processes, embedding quality along the full audit cycle, not just assessing it at the end through internal and external inspections. The variability of results, combined with persistent deficiencies in the areas of audit fundamentals, significant accounting estimates and professional judgment and skepticism (see 2017 Inspections Themes on page 5) year over year, makes it clear the firms need to continue to develop and strengthen their approach to audit quality and enhance their focus on consistent audit execution.

Significant Findings: Six Year Trend



CPAB’s risk-based methodology for choosing files to inspect is not intended to select a representative sample of the firm’s audit work. Inspection results should not be extrapolated across the entire population.

Firm focus: Building and embedding quality systems and processes

In 2011, CPAB required the Big Four firms to develop and implement action plans to address our most significant areas of concern and consistently enhance overall audit quality. For the most part, these action plans have resulted in measurable improvements across all four firms. Since then, we have continued to ask the firms to update their action plans based on our annual findings, complete procedures to identify if restatements are required, evaluate the underlying causes of our findings, and update and revise tools and internal training as appropriate, among other things.

Specifically in 2016, we required firms to focus on revising their guidance and methodologies to address systemic issues, identify and measure key quality controls and ensure issue escalation processes effectively manage and mitigate risk. Progress in these areas was made over the past year.

In 2017 we are asking the firms to identify and articulate their key quality risks and the processes and controls they have in place (actual workflow and monitoring that workflow) to support high quality audits so we can better understand what steps might be missing, potentially contributing to continued significant findings.

CPAB focus: Evaluating quality processes to assess overall audit quality and consistency – an evolution in our inspection strategy

Higher quality, consistently executed audits across a firm is achievable when the right people, policies and procedures are in place – in other words, how well firms manage their talent by matching capabilities to client and audit risk and ensuring appropriate resources are in the right place at the right time. From that perspective, in 2016 we explored what CPAB and the firms might do differently to advance improvements in audit quality (see box for quality definition).

Defining Audit Quality

Quality can be defined as a degree of excellence or in the context of an audit, compliance with professional standards as set out in the Canadian Auditing Standards including the Canadian Standard on Quality Control (CSQC 1) – quality control for firms that perform audits and reviews of financial statements, and other assurance engagements. At the client engagement level, this translates to an auditor obtaining sufficient and appropriate audit evidence to support the opinion that the audited financial statements are free from material misstatement. At the firm level, this translates to a firm having quality systems and processes enabling engagement teams to consistently obtain sufficient and appropriate audit evidence for each and every audit engagement of the firm.

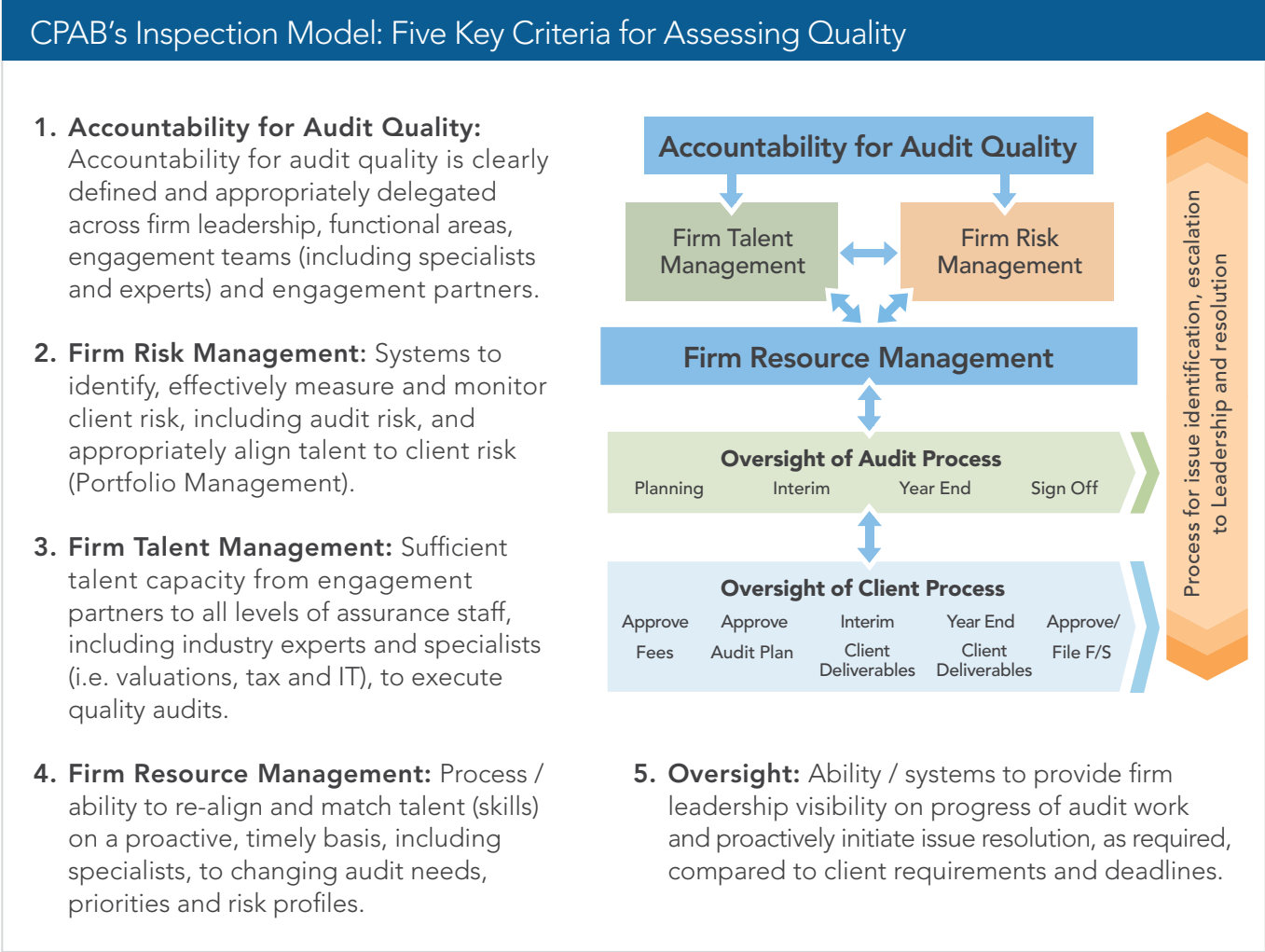
The measure of audit quality at the client engagement level is relatively straightforward and is determined based on the number and severity of inspection findings in the file under review.

The assessment of a firm's audit quality is more challenging. Its measure is a combination of a firm's file inspection results along with an assessment of the effectiveness of the firm's quality processes designed to support engagement teams and ensure consistency in audit execution as measured by a reduction in significant inspection findings to an acceptably low level.

Until now, CPAB's inspections have been heavily based on individual audit file reviews, with some attention to firm level quality systems and processes. To better identify and understand impediments to improving firm quality systems and consistency in how audits are performed, we plan to evolve our inspection approach in 2018 to incorporate additional operational reviews of the effectiveness of firm structure, accountabilities, quality processes, and culture. We believe that strong control processes and procedures at both the firm and engagement level will be fundamental to achieving further ongoing improvements in overall audit quality.

At the engagement level, a number of files will be specifically selected to validate our findings on firm quality processes. We will also continue to conduct risk-based file inspections. Through our evaluation of a firm’s quality processes (as evidenced by our file inspection results) CPAB will be able to better assess a firm’s overall audit quality.

Our revised methodology will concentrate on five criteria related to key functions we believe enable audit quality through consistent execution, including proactive audit issue identification and escalation mechanisms for issues resolution. The first four criteria (Accountability for Audit Quality, Firm Talent Management, Firm Risk Management, Firm Resource Management) are processes and procedures we expect to occur at the firm level in support of individual engagement teams. Oversight is the fifth criterion and focuses on the firm’s oversight of the engagement team’s interaction with the client and comprises the Audit Process and Client Process. Here we will focus on the firm’s leadership ability to proactively monitor engagement level activity and the effectiveness of issue identification, escalation and intervention processes.



We plan to launch this new approach in March 2018 at the Big Four firms. We’ll run a limited number of pilots in the fall of 2017. Going forward, we expect to apply the new model to the 10 other annually inspected firms in 2019 or beyond. As with any change, we know there will be learnings along the way and the opportunity to further develop and refine the proposed methodology in future inspection cycles.

Audit quality indicators

CPAB has increased its focus on the use and benefit of audit quality indicators (AQIs) as quantitative measures of the audit process. AQIs complement our evolving inspection strategy and should positively impact audit quality. We encourage audit committees, management and audit firms to continue to explore how AQIs can be integrated into their audit processes.

In 2016, CPAB launched an AQI pilot project with audit committee chairs and their management teams. Participants were encouraged to select a limited number of indicators (five to 10) in the first year of the pilot covering audit execution, firm level metrics, management indicators, engagement team and client service indicators. Early benefits of using AQIs included a better understanding of the roles and responsibilities related to audit quality of management, audit committees and audit firms, and improved knowledge of and engagement in the audit process by all members of the audit committee.

CPAB believes that AQIs are a useful tool for audit committees to broaden and deepen the dialogue around audit quality and supports increased awareness, discussion and collaboration regarding AQIs to develop good practices. To help advance this effort, CPAB continued the pilot through 2017 and encourages Canadian reporting issuers and their audit committee members to engage in the dialogue.

FOREIGN JURISDICTIONS UPDATE

CPAB's inspection activity of companies with foreign operations is often limited to engagement files accessible only in Canada because we currently have no legal means to compel access to work completed by component auditors. In many cases, the work we are able to access may represent only a small portion of the audit. (For a list of jurisdictions where CPAB is unable to access working papers, please visit www.cpab-ccrc.ca, Focus by Topic, Auditing in Foreign Jurisdictions).

As reported last year, in 2015 CPAB proposed a regulatory way forward to the relevant Canadian securities authorities for CPAB to access information and related audit working papers so we may fulfill our mandate. The Canadian Securities Administrators (CSA) have issued a consultation paper and are currently reviewing the responses to determine next steps. CPAB looks forward to CSA's proposals on this issue.



2017 INSPECTIONS THEMES

The majority of our findings in 2017 were related to the execution of audit fundamentals, significant accounting estimates and professional judgment and skepticism. Examples requiring improvement follow.

Executing audit fundamentals



CPAB continued to see files where basic audit procedures were not executed appropriately on significant but non-complex account balances and transaction streams. Deficiencies in this area represented 29 per cent of our total findings (2016:28 per cent).

Not maintaining control over confirmation requests sent to third parties, selecting samples not

representative of the balance being tested, and employing analytical procedures that would not identify a material error due to the nature of their design were common examples in this inspection cycle. It is unclear as to why the firms continue to face challenges in executing basic procedures, and why deficiencies in these areas are not being identified.

Significant accounting estimates



Significant estimates continued as one of the most challenging aspects of an audit and accounted for 29 per cent of our total findings (2016:27 per cent) this year. How precisely an estimated item can be measured depends on its complexity, the nature and number of financial inputs and sensitivity to changes in those inputs. The risk of management bias is pervasive.

Audits related to significant acquisitions feature prominently in our inspection work. These transactions require the determination of fair value of all assets acquired and liabilities assumed. In these cases almost every item is an estimate –

and many require the assistance of a specialist to develop and to audit. For example, an acquired business may bring identifiable intangible assets like customer lists and licenses. To estimate fair value, management may use a third party expert. In addition, an audit firm may involve its own expert to review the work of management's expert. The auditor's expert usually assesses the appropriateness of the models and assumptions used and certain market inputs, but rarely the appropriateness of management's financial inputs or the consistency of those inputs between estimates. If this assessment is not performed by the auditor, a material misstatement in the fair value estimate might be missed.

Professional judgment and skepticism



Auditors apply professional judgment to assess the risk of material misstatement and to determine what work they need to perform to reduce that risk. Concerns that this work was insufficient resulted in 32 per cent of our total findings (2016:30 per cent). This included instances where populations of items were not tested for completeness and accuracy or where data used in analytical procedures was either untested or not independent of the financial statement item being audited.

Auditors need to be objective when assessing the reasonableness of evidence provided by management. For example, management's explanation for unexpected differences must be corroborated and the auditor should remain alert for other audit evidence that contradicts that explanation.

What directors can do

Audit committees are responsible for overseeing the quality of their company's financial reporting. There is an opportunity for directors to improve this oversight through enhanced engagement with the external auditor and ensuring appropriate quality systems and processes are in place at both the firm and file review levels.

Directors should consider discussing these questions with their engagement teams:

1. How did the auditor ensure audit procedures related to high risk areas were well executed?
2. What are the hard to assess, unique risks embedded in the company's estimates and how are they assessed by the auditor?
3. How are experts or specialists used in the audit work?
4. If management is biased, what is the risk to reported results or incentive plans? How did the auditor assess for bias?
5. What management controls did the auditor rely on? How did the auditor assess the operating effectiveness of those controls?
6. What changes in the company's operations and business environment had the most significant impact on the audit approach?

LEARN MORE

CPAB's public inspections reports and other publications regarding audit quality matters are available at www.cpab-ccrc.ca.

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CONTACT INFORMATION

General Inquiries

Phone: (416) 913-8260
Toll Free: 1-877-520-8260
Fax: (416) 850-9235
Email: info@cpab-ccrc.ca
www.cpab-ccrc.ca

Central Canada

150 York Street
Suite 900
Toronto, Ontario
M5H 3S5 Canada
Phone: (416) 913-8260

Eastern Canada

1155 René-Lévesque
Boulevard West, Suite 2916
Montréal, Québec
H3B 2L3 Canada
Phone: (514) 807-9267

Western Canada

510 Burrard Street
Suite 1080
Vancouver, British Columbia
V6C 3A8 Canada
Phone: (604) 630-8260

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