



CANADIAN PUBLIC ACCOUNTABILITY BOARD
CONSEIL CANADIEN SUR LA REDDITION DE COMPTES



WORLD-CLASS AUDIT REGULATION

March 2016

ANNUAL INSPECTIONS REPORT 2015



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. A leading audit regulator, 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 in Canada, assess 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 a nine-member Board of Directors.



Employees

CPAB employs approximately 50 professionals.



Locations

CPAB operates from offices in Montreal, Toronto and Vancouver.



CPAB Annual Public Report on 2015 Inspections

This report discusses CPAB’s inspection findings for all participating firms inspected in 2015. These firms, and their foreign affiliates, audit approximately 99.5 per cent of Canadian reporting issuers by market capitalization. Each firm participating in the Protocol for Audit Firm Communication of CPAB Inspection Findings with Audit Committees (Protocol) shares their file-specific significant findings, and this report, with their clients’ audit committees. The Protocol is intended to encourage more robust discussions among management, the firm and audit committees and to support audit committees in their oversight responsibilities. For more information about the Protocol and participating firms, visit www.cpab-ccrc.ca.

2015 Inspection Findings; Consistent Quality a Challenge

C PAB's 2015 inspections of the 14 public accounting firms reviewed annually (those with 100 or more reporting issuers) indicate that, overall, audit quality was inconsistent across all firms. Inspections at nine of those firms resulted in more significant inspection findings compared to the previous year. We inspected 144 (2014:158) annual firm files and identified significant findings in 43 of these files (2014:28).



When considering this year's overall findings, it's important to note that we changed our inspections focus in 2015. In 2014 CPAB's inspections at Canada's Big Four public accounting firms (Deloitte LLP, EY LLP, KPMG LLP, PwC LLP) were weighted to reporting issuers with larger market capitalizations. In our 2014 report on those inspections we noted an overall improvement in audit quality over the previous year. To better understand if audit quality improvements seen in recent years have been fully embedded throughout the Big Four firms, we focused our inspections in 2015 on files of reporting issuers with mid to smaller market capitalizations (\$250 million or less) located in smaller business centres. The characteristics of the Big Four engagement files inspected in 2015 are similar to those of the files we inspected at the other annual firms. Overall, our Big Four findings are consistent with the types of findings in the other 10 annual firms. Our report regarding the Big Four inspections was published in November 2015.

The majority of CPAB's total significant inspection findings in 2015 required the audit firm to carry out additional audit procedures to determine the need, if any, to restate the financial statements due to material error. The remaining findings required the audit firms to add considerable evidence to the audit file to show they had obtained sufficient and appropriate audit evidence with respect to a major balance sheet item or transaction stream.

As a result of this year's inspections, and to improve and sustain audit quality, we have required firms to proactively determine the root causes of our findings and implement corrective action plans with both short and long term initiatives, including additional training, revisions to firm policies and processes, and realignment of resources to better match reporting issuer risks and ensure the industry expertise required to deliver a quality audit.

CPAB will monitor the implementation, sustainability and effectiveness of firm initiatives to improve audit quality. The degree of oversight of any individual firm, including regular ongoing reporting to CPAB and required substantive changes in firm action plans, will vary with the severity of the issues identified and risk to the capital markets, with particular focus on assessing performance where audit quality declines were experienced this year.

CPAB will continue to conduct risk-based inspections, with a particular focus on mid to smaller market cap reporting issuers, in 2016. This work will include a deeper examination of firm quality control systems, firm culture and tone at the top, organizational structure, accountability, risk identification and staffing.

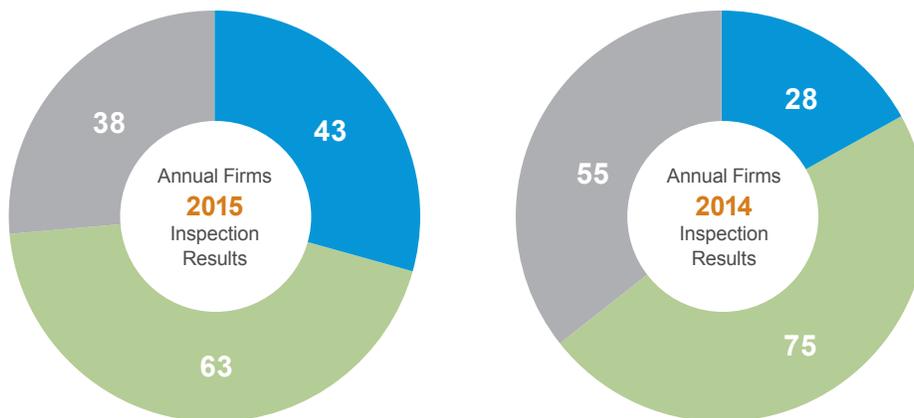
Expanding our interaction with audit committees (with a focus on mid to smaller market cap reporting issuers) will continue. We will also continue to publish information to assist audit committees evaluate the audit firm and audit risks, how to most effectively address their oversight role, and on industry-specific issues to explore with their auditors.

2015 Annual Firm Inspections Snapshot

CPAB inspected 14 annual firms in 2015 (2014:14) and 144 engagement files (2014:158):

- Big Four firms: 93 engagement files; 24 files with significant findings
- Four national/network firms: 28 engagement files; 9 files with significant findings
- Six large regional firms: 23 engagement files; 10 files with significant findings

Annual Firms 2015 – 2014 Inspection Results



* ● # Files with Significant Findings ** ● # Files with Other Findings ● # Files with No Findings

*Significant Findings – A significant deficiency in the application of generally accepted auditing standards related to a material financial balance or transaction stream where the audit firm must perform additional audit work to support the audit opinion and/or is required to make significant changes to its approach. CPAB requires firms to carry out additional audit procedures to determine the need, if any, 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 major balance sheet item or transaction stream in order to comply with auditing standards.

**Other Findings – A noted deficiency in the application of generally accepted auditing standards related to a material financial balance or transaction stream where CPAB is able to conclude that the deficiency is unlikely to result in a material misstatement without the engagement team performing additional procedures to support the audit opinion.

Big Four

Deloitte LLP, EY LLP, KPMG LLP, PwC LLP

CPAB's 2015 inspections indicate that audit quality at the Big Four firms was inconsistent. Significant findings increased across all four firms as a group compared to the prior year and improvement in the firms' quality systems is required. These four firms and their affiliates audit about 98 per cent of all Canadian reporting issuers by market capitalization.



As noted, CPAB shifted our inspection focus in 2015. Our ultimate objective was to assess the sustainability of enhanced audit quality seen across the Big Four in the past two years. CPAB inspected 93 (2014:98) Big Four engagement files and identified significant findings in 24 (2014:7) of those files. Results for two of the firms were generally comparable to 2014; two firms experienced challenges, one particularly with audits of companies with smaller market capitalizations and one more broadly. There are no restatements as a result of our 2015 inspections.

With some exceptions, firm action plans have generally helped maintain audit quality in larger engagements. However, our inspections of smaller reporting issuer engagement files show a different result. The impact of action plans on the quality of audits of companies with mid and smaller market capitalizations and conducted by smaller audit firm offices is not evident. This suggests that quality processes are not generating consistently good results for all firm audits.

As a result of our findings, we have required the Big Four firms to do the following:

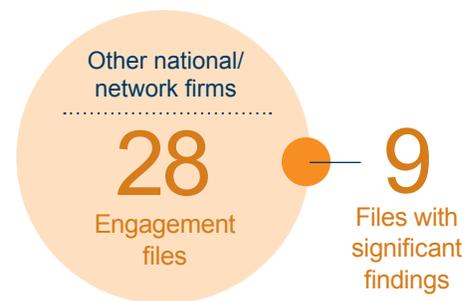
- Improve the effectiveness of their systems of quality control for medium and smaller market cap companies.
- Consider region-specific issues which may be impacting audit quality.
- Evaluate the underlying cause(s) of individual file significant findings.
- Conduct a comprehensive review of quality control systems and assess whether those systems have inherent weaknesses that result in inconsistent audit execution at the engagement file level.
- Amend training and learning curriculum as necessary to address inspection findings and key insights.
- Determine appropriate next steps, including revising and amending action plans as necessary, to continue to drive consistency and improve audit quality across all engagements.

Other national/network firms

BDO LLP, Grant Thornton LLP, MNP LLP,
Raymond Chabot Grant Thornton LLP

In 2015, CPAB inspected 28 (2014:32) engagement files across the four other national/network firms. We noted continued stability in audit quality at one firm, improvement at one firm and continuing challenges at two other firms. While existing action plans have had an impact, audit quality progress has not been adequate. These four firms, which audit about one per cent of all Canadian reporting issuers by market capitalization, account for nine of the total files with significant inspection findings (2014:6). There was one restatement as result of our inspections.

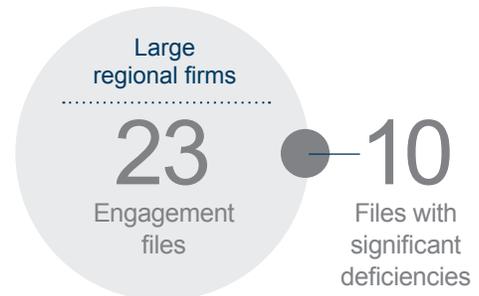
These firms are capable of delivering quality audits, however two in particular are experiencing challenges in implementing their quality initiatives consistently. We have communicated our concerns and expect each firm to undertake short term actions that will improve the quality of their next year-end audits as well as longer term actions to drive and embed required sustainable quality improvements.



Large regional firms

Collins Barrow Toronto LLP, Davidson & Company LLP, DMCL LLP,
Manning Elliott LLP, McGovern, Hurley, Cunningham LLP, Smythe LLP

As noted in our 2014 Public Report, inspection findings for the six large regional firms continue to indicate an inconsistency in audit quality. In 2015, CPAB inspected 23 (2014:27) engagement files and found that overall audit quality was stable or improved at four of these firms; however, we did not see expected improvement at two of the firms. These six firms, which audit less than one per cent of all Canadian reporting issuers by market capitalization, account for 10 of the total files with significant inspection findings (2014:15). There were three restatements as a result of our inspections.



The large regional firms deliver quality audits in areas where they have particular expertise; in these cases we typically do not have many significant inspection findings. However, when they audit companies beyond those specialties or companies with complex accounting issues or transactions, the number of significant findings increases. When accepting clients in an industry outside their specialty area, firms need to take appropriate action to support the execution of a quality audit. This could include, but is not limited to, targeted engagement team training, additional review and supervision, or consultation with outside experts.

Other firms

In addition to the 14 firms inspected annually, as part of its 2015 inspection cycle CPAB inspected 35 files at 25 other firms (2014:17 files at 28 firms) which account for 28 (2014:4) files with significant findings. In these cases, CPAB selected files where the firm seemed to have been operating outside its areas of expertise, including industry specialization. Three of the files with significant findings occurred at one firm which was sanctioned and ultimately withdrew its registration with CPAB. There were seven restatements as a result of our inspections.

Foreign jurisdictions access still a concern

During this year's inspections of the audit files of Canadian reporting issuers with operations in foreign jurisdictions, we noted that most firms have defined procedures for this kind of audit work resulting in generally improved execution and better quality audits.

However, this remains an area of concern for CPAB. While we have finalized memoranda of understanding in a number of foreign jurisdictions, we still experience limitations in accessing component audit work in certain others. (For a list of jurisdictions where CPAB is unable to access working papers, please visit our website.) This effectively results in a scope limitation: if access had occurred, additional inspections findings may have been identified. We continue to engage with the relevant Canadian securities regulators to make the changes necessary to assist CPAB in obtaining access in order to fulfill our mandate of regulating participating firms.

2015 Inspection Program Scope

CPAB's risk-based methodology for choosing files (and the specific areas of those files) for inspection is not intended to select a representative sample of a firm's audit work. Instead, it is biased towards higher-risk audit areas of more complex public companies or areas where the audit firm may have less expertise, so there is a greater likelihood of encountering audit quality issues. Our inspections do not look at every aspect of every file and are not designed to identify areas where auditors met or exceeded standards. Results should not be extrapolated across the entire audit population, but instead viewed as an indication of how firms address their most challenging situations.

At December 31, 2015, 286 audit firms were registered with CPAB. Twenty-two new firms registered (mostly foreign firms) and 26 voluntarily terminated their registration. Audit firms who voluntarily participate in the Protocol share significant file-specific inspection findings with their clients' audit committees. A significant inspection finding is a significant deficiency in the application of generally accepted auditing standards related to a material financial balance or transaction stream where the audit firm must perform additional audit work to support the audit opinion and/or is required to make significant changes to its audit approach. Twelve of the 14 annually inspected firms, including all the Big Four firms, all the national/network firms, and four of the six regional firms participate in the Protocol. A complete list of firms participating in the Protocol is available on CPAB's website at www.cpab-ccrc.ca.

The majority of CPAB's total significant inspection findings in 2015 required the audit firm to carry out additional audit procedures to determine the need, if any, to restate the financial statements due to material error. The remaining findings required the audit firms to add considerable evidence to the audit file to show they had obtained sufficient and appropriate audit evidence with respect to a major balance sheet item or transaction stream. When remediation procedures result in the identification of a material misstatement, the firm, reporting issuer, audit committee and board make appropriate communications and restate and refile financial statements as necessary. Where CPAB does not agree with conclusions reached by the firm or actions taken by the reporting issuer, CPAB communicates its concerns directly to the appropriate securities commission which then makes the final determination on whether or not the reporting issuer is required to restate and re-issue the financial statements. The results of carrying out additional audit procedures resulted in 11 restatements or six per cent of files inspected (2014:6 restatements or three per cent of files inspected).

CPAB actively managed disciplinary actions in 2015 to address audit quality matters. Effective December 31, 2015, there are Requirements on six firms (2014:2) and Restrictions on two firms (2014:2). One firm was subject to Sanction during the year and subsequently withdrew as a registered firm. No review or other proceedings were conducted in 2015.

Key Inspection Themes

The following audit quality themes noted in CPAB's November 2015 inspections report on the Big Four accounting firms also apply to the other firms we inspected this year.

Executing audit fundamentals

In the past few years, CPAB has concentrated much of our efforts on inspecting complex or difficult to audit financial statement balances and transaction streams requiring a high level of professional judgment. Aligned with the shift in our inspections efforts to determine how deep quality improvements have been embedded into the audit practice, we allocated resources to assessing firms' execution of basic audit fundamentals in routine but very material areas.

We identified significant findings in a number of files in the areas of basic revenue testing, inventory costing, inventory existence and depreciation. In more than one file, procedures performed to assess the accuracy of inventory costing were either inappropriately designed, executed, or both.



Auditors must make sure that procedures are appropriately designed and executed.

Auditors must make sure that procedures are appropriately designed and executed. If fundamental audit areas are delegated to more junior staff, firms must see to it that staff have the appropriate training to perform their assigned procedures and that their work is appropriately supervised and reviewed. Without adequate training and supervision in these areas, a firm's systems for achieving quality audits could become ineffective.

Understanding business processes relevant to financial reporting



An insufficient understanding of the client's business is the root cause behind many of the audit findings we identified.

An insufficient understanding of the client's business is the root cause behind many of the audit findings we identified. To assess risk of error and ultimately determine an effective audit strategy, the auditor needs a sound understanding of the company's business, operations, and nature and flow of accounting transactions. Otherwise, it is difficult to plan and execute an effective audit.

In a number of instances, CPAB identified gaps in the engagement team's understanding of company financial reporting and audit risks, resulting in poorly designed and ineffective audit procedures. Examples include:

- Executing a substantive audit approach in system-dependent companies. The engagement teams implicitly relied on controls which were neither specifically identified nor tested.
- Lack of understanding of customer contracts and indicators of fraud.
 - Customer contracts may ultimately determine revenue recognition for the reporting issuer and, if not understood and appropriately analyzed, errors in revenue recognition may occur.
 - In some files, CPAB noted that the engagement team's understanding and consideration of indicators of fraud was generic and did not reflect the specific structure and operating environment of the reporting issuer. In some other files where engagement teams did a good job in the planning process to identify indicators of fraud, they did not translate that understanding to effective audit procedures.

Complex accounting estimates

The appropriate application of accounting policies often involves a number of estimates and judgments. Since these can be complex, and may be influenced by management bias, CPAB often chooses these areas for inspection and frequently has findings to report.

The types of complex estimates and judgments can vary by industry. Estimates relating to impairment, and going concern evaluations in particular, often involve cash flow forecasts and specialists. Auditors need to consider the appropriateness of the forecasts being made. This can be challenging as such forecasts are based on both past experience (requiring validation of historical data inputs whether from internal or external sources) and future expectations (requiring assessment of management's assumptions on factors such as growth rates, discount rates, timing of project development and industry expectations).

Similarly, firms can face challenges in evaluating the work of external experts and in integrating their own internal experts into the audit process. The fact that a reputable firm acted as management's expert does not absolve the auditor from assessing the reasonableness of assumptions developed by that expert or conclusions drawn on the basis of those assumptions.



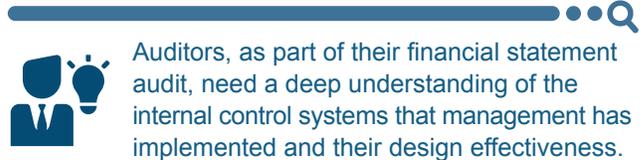
Auditors need to consider the appropriateness of the forecasts being made.

Internal controls

Given the breadth of operations, the increased reliance on information technology, and the large volume of transactions processed, it is often impractical to complete the audit of a large or complex entity just by examining a sample of the transactions. Auditors, as part of their financial statement audit, need a deep understanding of the internal control systems that management has implemented and their design effectiveness. The engagement team can do this itself or involve someone with expertise in internal controls testing. Either way, considerable experience is necessary to effectively execute an internal controls-based audit.

CPAB's inspections identified numerous instances where internal controls work was not well done, calling into question how internal controls are tested, the engagement team's execution of audit fundamentals and understanding of business processes, and the effectiveness of the audit.

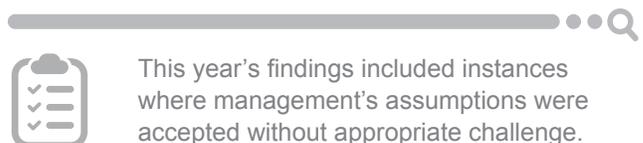
We also noted other situations where it was not practical to obtain sufficient appropriate audit evidence from substantive procedures alone and the engagement team did not test internal controls. Firms need to critically re-evaluate how they approach an internal controls-based audit and provide appropriate training and guidance to engagement teams.



Professional judgment and skepticism

Areas requiring the most professional judgment and skepticism continued to feature prominently in our 2015 inspection findings. Participation of senior engagement leaders at both the planning and issues resolution stages remains the best way to deal with these matters. To address audit team inexperience and to support the delivery of a quality audit, the timely and appropriate involvement of engagement leadership is essential. Failure to do so is a contributing factor to our most common inspection findings, especially in areas where a high degree of professional judgment is required.

A healthy degree of professional skepticism is the basis for a quality audit, and maintaining an appropriate relationship between the auditor and management. Effective auditors weigh what management tells them against what they know of the client's operation, together with their knowledge of the broader business environment. This way they can evaluate management's views in the context of both internal and external evidence and formulate an independent view which may or may not corroborate management's opinion. This year's findings included instances where management's assumptions were accepted without appropriate challenge. For example, we noted cases where the auditor accepted the company's growth rate assumptions when assessing valuations where management may not have any experience with a new line of business, or may have the experience but incorporated growth rates that are inconsistent with past performance.



Identification of accounting issues

In our inspections of non-Big Four firms, we noted a higher than expected incidence of unidentified accounting issues and inappropriate accounting for complex transactions.

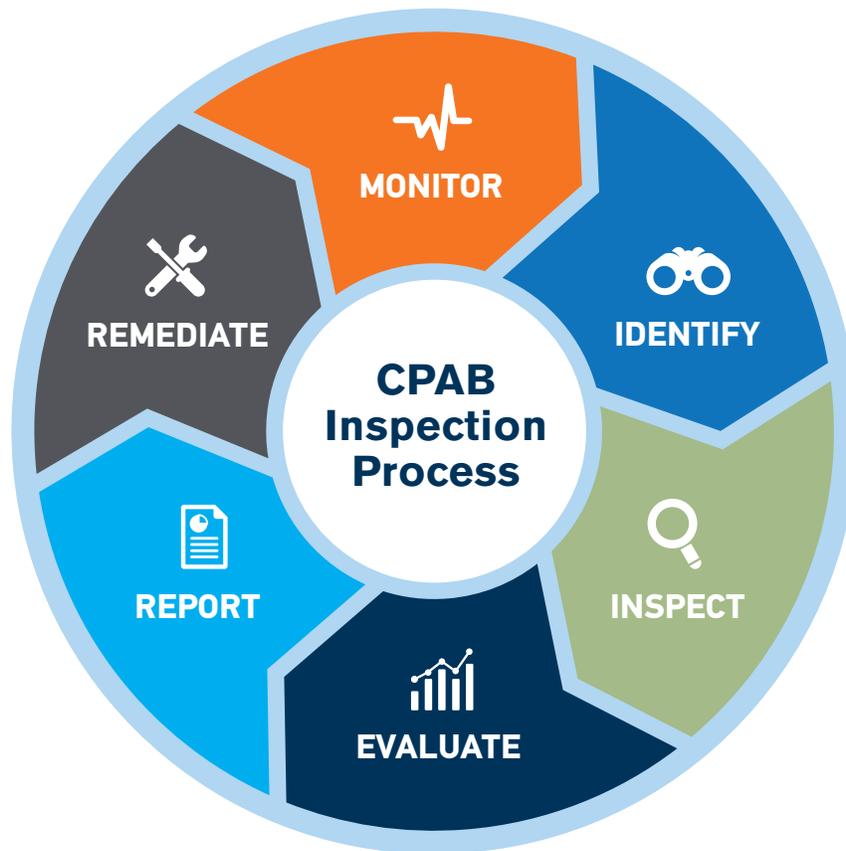
Sometimes smaller companies are considered to have straightforward accounting and in many circumstances this is true. However, CPAB is concerned that it continues to identify deficiencies in the auditor's evaluation of relatively routine accounting issues such as going concern, impairment and the phase of a resource company's activities. In other circumstances these companies, in an effort to meet specific business objectives, may enter into arrangements or transactions that create complex accounting issues related to, for example, the appropriate

recognition of revenue or compound financial instruments. CPAB's inspections of the audit files of these companies regularly identify deficiencies in the auditor's evaluation of the appropriateness or application of company accounting policies and remediation of these deficiencies can require assistance from external experts if the expertise is not available in-house.



We noted a higher than expected incidence of unidentified accounting issues and inappropriate accounting for complex transactions.

CPAB's Inspection Process



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

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

Eastern Canada

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

Western Canada

Canadian Public
Accountability Board
400 Burrard Street
Suite 1980
Vancouver, British Columbia
V6C 3A6 Canada
Phone: (604) 630-8260

Learn More

CPAB's 2015 annual inspections report, 2015 Big Four inspections report, detailed information on the Protocol, and other publications are available at www.cpab-ccrc.ca.

Join our mailing list – www.cpab-ccrc.ca>Mailing List



Follow us on Twitter – [@CPAB_CCRC](https://twitter.com/CPAB_CCRC)



This publication is not, and should not be construed as, legal, accounting, auditing or any other type of professional advice or service. Subject to CPAB's Copyright, this publication may be shared in whole, without further permission from CPAB, provided no changes or modifications have been made and CPAB is identified as the source.
© CANADIAN PUBLIC ACCOUNTABILITY BOARD, 2016. ALL RIGHTS RESERVED

www.cpab-ccrc.ca / Email: info@cpab-ccrc.ca

