2015 Annual Inspections Report:

Highlights for Audit Committees

March 2016

CPAB 2015 Public Report on Annual Inspections of the Quality of Audits in Canada: Highlights for Audit Committees

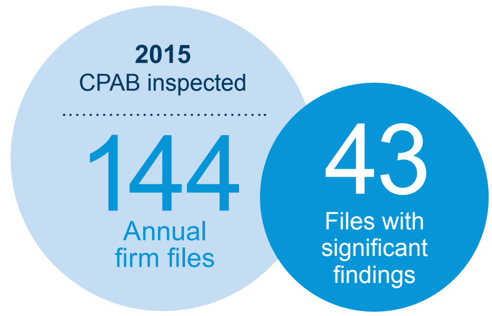
The Canadian Public Accountability Board (CPAB) is Canada's audit regulator responsible for the regulation of firms that audit Canadian public companies. By promoting audit quality, CPAB contributes to investor confidence in the integrity of financial reporting and in Canada's capital markets.

Our 2015 Public Report on Inspections is now available (www.cpab-ccrc.ca). Under the Protocol for Audit Firm Communication of CPAB Inspection Findings with Audit Committees (Protocol), audit firms who participate in the Protocol now share their significant file-specific inspection findings and CPAB's public reports with their clients' audit committees.

As we believe the information contained in the report is of interest to audit committees, CPAB is pleased to provide the following highlights. We also encourage audit committees to discuss the full report and any file-specific findings with their auditor.

2015 Inspection Findings; Consistent Quality a Challenge

CPAB'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).

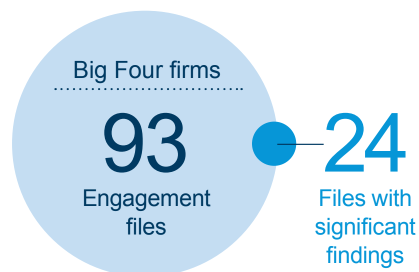


CPAB changed our inspections focus in 2015. In 2014, inspections at Canada's Big Four public accounting firms (Deloitte LLP, EY LLP, KPMG LLP, PwC LLP) were weighted to reporting issuers with larger market capitalizations. In our 2014 report on those inspections we noted an overall improvement in audit 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 our findings in the other 10 annual firms.

Big Four

Deloitte LLP, EY LLP, KPMG LLP, PwC LLP

Significant inspection findings increased across all four firms as a group compared to the prior year. 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. These four firms and their affiliates audit about 98 per cent of all Canadian reporting issuers by market capitalization. There are no restatements as a result of our 2015 inspections.

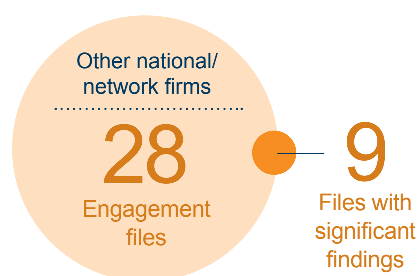


Our full report regarding the Big Four inspections was published in November 2015 and can be found on our website.

Other national/network firms

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

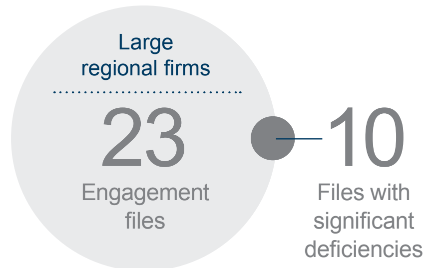
CPAB inspected 28 (2014:32) engagement files across the four other national/ network firms in 2015. We noted continued stability in audit quality at one firm, improvement at one firm and continuing challenges at two other firms. While existing action plans have had an impact, audit quality progress has 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.



Large regional firms

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

CPAB inspected 23 (2014:27) engagement files across the six large regional firms in 2015 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.



Next Steps

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.

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.

Foreign jurisdictions access still a concern

Inspections of the audit files of Canadian reporting issuers with operations in foreign jurisdictions remains an area of concern for CPAB. While we have finalized memoranda of understanding in a number of foreign jurisdictions, we still face limitations in accessing component audit work in certain others. 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 enable access in order to fulfill our mandate of regulating participating firms.

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

We identified significant deficiencies 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.

If fundamental audit areas are delegated to more junior staff, the firm 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 deficiencies we identified. 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.

Complex accounting estimates

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.

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.

Internal controls

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.

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.

Identification of accounting issues

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.

What to Ask Your Auditor

1 Executing Audit Fundamentals

For those less complex audit areas executed by more junior staff, how have you ensured that those audit procedures were effective and executed as designed?

2 Business Processes

How do you update your knowledge of the business risks and processes impacting our financial reporting?

How do you ensure that this knowledge is effectively incorporated into your audit plan and transferred to your engagement team members?

3 Complex Accounting Estimates

What was the most difficult estimate you had to deal with, and how would you characterize the estimate within the range of possibilities?

How effective was the company's methodology for preparing the estimate?

What was your methodology for evaluating the estimate?

4 Internal Controls

How much did you rely on the company's internal controls and how would you rate them? Did you identify areas for enhancement?

5 Professional Judgment and Skepticism

How did you demonstrate skepticism during our audit, and how did management respond when you challenged them?

6 Identification of Accounting Issues

We had a number of new and unusual transactions during the year. What did you do to assess the appropriateness of our accounting for these transactions and compliance with our accounting policies?

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Learn More

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

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