2016 Big Four Inspections Report

Highlights for Audit Committees

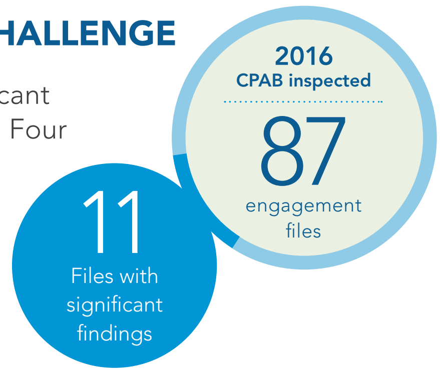
November 2016

CPAB PUBLIC REPORT ON 2016 INSPECTIONS OF CANADA'S BIG FOUR ACCOUNTING FIRMS: HIGHLIGHTS FOR AUDIT COMMITTEES

CPAB's 2016 annual inspections report for Canada's Big Four public accounting firms (Deloitte LLP, EY LLP, KPMG LLP, PwC LLP) is now available (www.cpab-ccrc.ca). Each firm shares their significant file-specific inspection findings, and this report, with their clients' audit committees as per their participation in the Protocol for Audit Firm Communication of CPAB Inspection Findings with Audit Committees (Protocol).

CPAB encourages all audit committees to discuss the report and any file-specific findings, if applicable, with their audit firm. We are also pleased to provide the following highlights for audit committee members, including common findings and questions for audit committees to consider in conducting their oversight responsibilities.

SIGNIFICANT INSPECTION FINDINGS DECREASE IN 2016; HOWEVER, CONSISTENT AUDIT EXECUTION IS STILL A CHALLENGE



CPAB's 2016 inspections indicate that – despite an overall decrease in significant inspection findings compared to last year – audit quality across Canada's Big Four public accounting firms continues to be inconsistent.

In 2016, we inspected 87 (2015:93) engagement files – 11 of those had significant findings (2015:24). Results at one firm were consistently good (and comparable with prior years); results at one firm were stable year over year, and results improved for the two firms that experienced challenges in 2015.

In addition to completing procedures to identify if restatements are required, evaluating underlying cause(s) of significant findings, updating action plans and revising tools, templates, and internal training as appropriate, CPAB has required the firms to focus on:

1. Revising or amending firm guidance and methodologies to address systemic issues.
2. Identifying key quality controls and determining metrics to monitor and measure effectiveness.
3. Ensuring effective issue escalation processes to manage and mitigate firm risk are in place.

Quality systems: The road to sustainable audit quality

Most public company audits in Canada are well done; however, consistency of execution remains an ongoing theme. While we have generally seen improvement at the larger engagement file-specific level, more effort is needed to fully embed the audit quality improvements seen in recent years in the firms' approach to every engagement.

CPAB has explored what we, and the Big Four, might do differently to drive quality improvements deeper into the firms. As a result, to better identify and understand impediments to improving firm quality systems (actual workflow and monitoring of that workflow) we will begin shifting our inspections focus to operational reviews of firm structure, accountabilities, culture and quality processes. We will continue to conduct file inspections to validate systems findings. We plan to develop and implement our new approach over the next two years, engaging with the firms and other stakeholders as we go along.

Foreign Jurisdictions Update

CPAB has memoranda of understanding with a number of foreign jurisdictions; however we continue to face limitations in accessing component audit work in certain others. (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).

We have proposed a regulatory way forward to the relevant Canadian securities authorities to access information and related audit working papers so we may fulfil our mandate. The Canadian Securities Administrators (CSA) are examining CPAB's proposal to determine whether legislative amendments should be considered.

2016 INSPECTIONS THEMES

Ninety-six per cent of our total significant findings occurred in the following five areas.

Significant accounting estimates

All estimates risk management bias and this area accounted for 27 per cent of our total findings in 2016 (2015:29 per cent).

Example: Resource companies typically capitalize the costs to explore and evaluate resources on their balance sheets – they do so assuming these costs will be offset by future production revenue. If a full recovery is not likely, the estimated excess costs will be written off as an expense. To make this assessment management often hires an expert, such as a qualified engineer, to prepare a technical report that includes an economic analysis of the project. Auditors may use the work of management's expert if the auditor independently assesses the appropriateness of the financial input provided by management and the reasonableness of the expert's assumptions or models used. If this assessment is not performed, a material misstatement in the result/value due to error or bias may not be identified.

Audit Committee Considerations:
Are there unique risks embedded in the company's estimates that are challenging to assess? Is the work of experts or specialists used in any of the audit work? If so, how is their work effectively integrated into the audit procedures so that all relevant factors are considered and there is no management bias or errors in logic, models, inputs, judgments, etc.?

Executing audit fundamentals

Deficiencies in this area represented 28 per cent of our total findings (2015:29 per cent).

Example: In certain cases, the auditor's selection of samples is not representative of the balance being tested or there are performance issues with account-specific testing (e.g. procedures performed when attending physical inventory counts; testing on the existence of additions to property, plant and equipment or the accuracy of depreciation expense). Appropriate staff training and supervision and review by senior audit team members are key quality controls which, if operating effectively, should reduce these types of deficiencies.

Audit Committee Considerations:
Audit committees should ask how their auditor ensures basic audit procedures are well executed. For example, errors in inventory quantities or costing could have a significant impact on profitability. How has the auditor ensured testing was effectively executed?

Professional judgment and skepticism

Areas requiring professional judgment and an objective analysis accounted for 30 per cent of our total findings in 2016 (2015:30 per cent).

Example: Audit risks will vary from high to low, but a risk can never be low enough for a material balance sheet item or transaction stream to eliminate the need for all audit procedures. For example, the risk that inventory will not be sold for more than its carrying value may be low for a stable, profitable manufacturer; however, the risk of material misstatement still exists for companies that carry significant inventory balances and should be tested. Inadequate testing, or the absence of testing, underlies many of CPAB's inspection findings.

Example: Auditors should not accept management's evidence without corroborating its reliability (e.g. using the fair value of a forward contract provided by a broker without validating it against an independent source.) More extreme cases occur when auditors do not challenge information provided by management when there is conflicting evidence (e.g. accounts receivable confirmations where the responses from the company's customers identify differences).

Audit Committee Considerations:
Did the auditor rely on management's representation when they could not get sufficient independent audit evidence? Was there any conflicting evidence? If management is biased, what is the risk to reported results or to incentive plans?

Internal controls

Our findings in this area – six per cent of our total findings (2015:8 per cent) – raise concerns about how internal control testing is performed, particularly for management review controls.

Example: Auditors must evaluate if reviews are performed in a way that would identify material errors. If appropriate testing is not performed, the auditor may miscommunicate to the audit committee that controls are operating effectively when they are not. In other circumstances, the auditor may need to rely on internal controls where a significant amount of information is only available electronically. Inspection findings indicate that auditors often avoid testing the controls by 'auditing around' the computer system which is very difficult to do effectively.

Audit Committee Considerations:
Company operations are highly system dependent and management relies heavily on a well-established control environment. How could the auditor complete the audit without testing the operating effectiveness of at least some of management's controls? Did the auditor ensure they did not inherently rely on system-generated information?

Understanding business processes relevant to financial reporting

This area of focus accounted for five per cent of our total findings in 2016 (2015:4 per cent).

Example: Sometimes the auditor does not fully understand the terms of a service contract and how those services will be performed and invoiced. In these circumstances, key performance obligations that must be met before revenue can be recognized may be missed. In other cases, the auditor may incorrectly assess the value of audit evidence. If an auditor relies on a confirmation from a third party service provider to support the revenue reported but that third party obtains the underlying information from the company itself, the confirmation is not independent evidence.

Audit Committee Considerations:
How does the auditor keep up to date on the company's changing operations and business environment? How do operational changes and challenges year over year impact the audit strategy?

AUDIT COMMITTEE CONSIDERATIONS

1 › Significant accounting estimates

Are there unique risks embedded in the company's estimates that are challenging to assess? Is the work of experts or specialists used in any of the audit work? If so, how is their work effectively integrated into the audit procedures so that all relevant factors are considered and there is no management bias or errors in logic, models, inputs, judgments, etc.?

2 › Executing audit fundamentals

Audit committees should ask how their auditor ensures basic audit procedures are well executed. For example, errors in inventory quantities or costing could have a significant impact on profitability. How has the auditor ensured testing was effectively executed?

3 › Professional judgment and skepticism

Did the auditor rely on management's representation when they could not get sufficient independent audit evidence? Was there any conflicting evidence? If management is biased, what is the risk to reported results or to incentive plans?

4 › Internal controls

Company operations are highly system dependent and management relies heavily on a well-established control environment. How could the auditor complete the audit without testing the operating effectiveness of at least some of management's controls? Did the auditor ensure they did not inherently rely on system-generated information?

5 › Understanding business processes relevant to financial reporting

How does the auditor keep up to date on the company's changing operations and business environment? How do operational changes and challenges year over year impact the audit strategy?

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CPAB's 2015 annual inspections report, 2016 Big Four inspections report, detailed information on the Protocol, and other publications are available at **www.cpab-ccrc.ca**.

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