



CPAB Audit Quality Insights Report: 2018 Fall Inspections Results

WORLD-CLASS AUDIT REGULATION

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What we do



The Canadian Public Accountability Board (CPAB) oversees public accounting firms that audit Canadian reporting issuers. Charged with protecting the investing public's interests, we advance high quality, independent auditing through robust inspections and quality management system assessments, stakeholder collaboration and practicable thought leadership. A champion of audit quality, CPAB contributes to public confidence in the integrity of financial reporting which supports a robust and trusted capital market in Canada.

Audit Quality Insights Report: 2018 Fall Inspections Results



Every November CPAB publishes inspections results for public accounting firms Deloitte LLP, Ernst & Young LLP, KPMG LLP, and PwC LLP. These reports provide perspective on the overall quality of public company audits in this country, and enhance stakeholder information and audit planning needs. While readers have appreciated this approach, audit committees in particular say they'd like to receive our insights even earlier in the audit cycle.

We listened. As a result, we're sharing our findings related to these four firms earlier. Our intent is to provide even timelier information to better assist audit firms and directors of their public company clients as they begin to plan for the next audit cycle. Our 2018 inspections of all other annually inspected firms continue and we will release those results in our public report in March 2019.

Each firm shares its file-specific significant inspection findings, remediation action taken, and this report with its reporting issuer's audit committee as per their participation in the Protocol for Audit Firm Communication of CPAB Inspection Findings with Audit Committees (Protocol). Audit committees should discuss this report, and any file-specific findings, with their audit firm.

Audit quality in Canada: engagement file findings continue to reflect inconsistent execution



To date, CPAB has inspected 77 out of 80 planned (2017:86) audit engagement files across Deloitte LLP, Ernst & Young LLP, KPMG LLP, and PwC LLP and identified significant inspection findings (deficiencies in the application of generally accepted auditing standards that could result in a restatement of the company's financials) in 14 (2017:6) of those files.

Remediation work has either been completed or is in process; no restatements have been required to date. Where a restatement is required, the firm works with the reporting issuer and its securities legal counsel to effect the restatement as soon as possible – usually within the next quarterly reporting period.

Two of the firms continued to demonstrate an acceptable level of audit quality – their inspections results were generally comparable to 2017. The other two firms experienced an increase in findings. One firm with increased findings must fully review our inspections findings to determine if the current year results are an anomaly or an early indication of a shift in audit quality and amend its action plan as needed. The other firm with increased findings must provide a detailed action plan to CPAB, including targeted communications of quality expectations to the partnership at large and a root cause analysis, to address these unacceptable results.

It's important to note there were no changes to CPAB's file inspections processes or methodology in the 2018 review cycle. These results tell us firms need to do more to fully embed audit quality across the whole assurance portfolio.

CPAB Discipline Overview

CPAB actively engages with firms throughout the inspections cycle to resolve issues as they arise during our reviews. Our Rules provide a robust framework of remediation and disciplinary mechanisms to address audit quality deficiencies at the firm and file levels. This allows us to respond quickly when we believe more work is required to support the audit opinion. For example, CPAB operates under the principle that, within 10 days of determining a file deficiency, we notify the firm; we then require their remediation plan within another 10 days. CPAB expects that firms will remediate file deficiencies before their reporting issuer's next quarterly report or next audit committee meeting.

If a firm fails to improve, CPAB has the authority to impose discipline at three levels: Requirement, Restriction and Sanction. This can include publicly

naming a firm and restricting it from auditing public companies; this helps to ensure that firms act quickly and appropriately to resolve deficiencies. Finally, where CPAB imposes a disciplinary action related to a defect in a firm's system of quality control, and the firm fails to address it to CPAB's satisfaction within a specified time period, the firm must notify the audit committees of all its reporting issuers.

In addition, CPAB shares information with the relevant securities commissions when a firm is not meeting our quality or remediation expectations.



Examples of common inspections findings

Deficiencies related to auditing fair values in business combinations, impairment of assets and revenue recognition represented approximately half the significant findings in our 2018 inspections cycle. Similar to prior years, the other half were related to significant but non-complex account balances and transactions streams where basic audit procedures were either not performed (e.g. inventory counts not attended) or not performed appropriately (e.g. testing of inventory costing was insufficient).

Auditing fair values in business combinations

Acquired assets and liabilities must be recorded at their estimated fair values. Estimates can be provisional at year end if management is still seeking information regarding the business combination. These provisional amounts may be adjusted before the end of the measurement period in the following year if additional information improves the precision of the estimate. However, the auditor still must perform sufficient procedures to assure the balances are not materially misstated based on information available at year end.

CPAB identified instances where minimal or no audit procedures were performed to understand how management made the estimate and what additional information might be required, or to assess the reasonableness of the underlying assumptions. As a result, the auditor would not have identified a material misstatement in the estimate, if any existed.

Impairment of assets

Assets are frequently tested for impairment to determine if they need to be written down to their recoverable amount. There are various acceptable methods for estimating this amount – the most common incorporates a projected discounted cash flow model. However, determining appropriate inputs to this model can be difficult. For example, the conditions that triggered the impairment test are often related to uncertainty about future value and cash flows.

In a number of cases, engagement teams accepted the inputs to management's cash flow model without sufficiently testing if those inputs were reasonable and supportable. It is a concern if auditors do not test the reasonability of the inputs and consider contradictory evidence of possible variations in the amount or timing of the cash flows or other factors (such as illiquidity) that a potential buyer would reflect in valuing the future cash flows. If inputs are not reasonable and an impairment loss is not recognized the financial statements are misstated. Investor confidence could be compromised if the impairment is not recognized in the appropriate period.

Revenue recognition

A company that earns revenue from the construction of assets in accordance with a contract may recognize that revenue as the work progresses provided key elements can be reliably measured (e.g. total contract revenue, costs incurred, cost to complete and stage of completion). While understanding management's process for estimating these amounts is a critical first step, inquiry of management alone is not sufficient without corroborating evidence.

Engagement teams are often challenged to obtain sufficient audit evidence to support both the measurement and reliability of the key elements. This challenge increases when there are complicating factors like modifications to the contract without formal approval or outstanding claims against the customer for costs related to delays or specifications changes. Errors result in incorrectly recorded revenue, gross margins and earnings, and can significantly impact investors' evaluation of company performance.

Quality management system reviews: engagement file deficiencies are indicative of quality system gaps



While most audits we inspect comply with the required standards, recurring inspection themes indicate that weaknesses in quality management systems persist, leading to inconsistent audit execution. Firm policies and processes – at both the leadership and engagement team levels – that manage risk and get the right people working on the right things at the right time are essential to delivering high quality audits, consistently. In response to these issues, in 2018 CPAB began to introduce a new methodology to assess existing quality management systems and to help accelerate improvements.

This new assessment approach requires firms to demonstrate the effectiveness of their quality systems. It emphasizes the need to systemically embed audit quality processes (preventative and detective) into ongoing operations across the entire assurance portfolio so that audit deficiencies are identified and corrected in real time or, at a minimum, before the audit opinion is rendered. Monitoring and inspecting audit quality after the fact is not enough.

To provide some context, Canadian securities commissions require reporting issuers to document and certify their controls (and underlying processes) over financial reporting that management uses to assess operating effectiveness – known as certification. We took a similar approach to beginning our assessment of the firms' audit quality processes. We expect firms to fully document their firm-wide quality systems and control processes, including the testing of the effectiveness of each control. And, just like the early days of certification, while progress has been made, we found a lack of robust documentation and formalized self-assessment mechanisms across the firms.

Each firm has made and continues to make a significant effort to improve, better articulate and document its quality management processes and controls, and to link them to CPAB's five assessment criteria: accountability for audit quality, risk management, talent management, resource management, and oversight. This foundational work was driven by the global network centre in some firms, and by the Canadian firm's national office in others. Either way, CPAB acknowledges that the firms are rethinking how they manage their operations to deliver higher audit quality and more consistent execution across offices and practices, and that is positive.

So far, CPAB's quality management systems review work has focused on assessing firm risks, control design and operating effectiveness, and reviewing firm documentation of each process. We considered the objective, resources, methodologies, type of risk, and severity of finding(s) related to each control. All firms have considerable work to do before we can fully complete our assessment (they are at various stages of documenting, assessing and linking all quality management processes to our assessment criteria).

Firm leadership and CPAB have identified specific weaknesses and gaps, and every firm needs improvement. In particular, certain controls did not do what they were intended to do or may not have been operating effectively. We often noted testing was compliance-driven (i.e. reviewed or not reviewed), rather than assessing whether the control was actually effective or not (i.e. the review was robust and covered the relevant points to determine whether issues existed).

Of note, in many cases our file-related significant findings were indicative of deficiencies in the firms' quality management systems.

All firms must advance their assessment work where not complete, remediate deficient processes and implement new controls. We will continue our review and reassess the firms' progress in 2019.

Accelerating audit quality: what directors should consider



CPAB continues to work with stakeholders on several critical audit quality matters that should also be top of mind for directors of public companies, including regulatory access to audits done in foreign jurisdictions, the growing number of reporting issuers with crypto-assets in the Canadian market, and the automation of the audit.

Foreign jurisdiction audits – access improving but some barriers persist

Investors should be concerned when foreign laws and regulations impede or reduce the auditor oversight they have come to expect in Canada; CPAB must have direct access to work performed by component auditors. We've made good progress working with Canadian securities regulators to amend legislation to improve this level of access, and most audit firms cooperate where we need access to working papers outside



of Canada. While discussions are ongoing, we have yet to obtain access in China.

Where a Canadian reporting issuer has operations outside the country, directors should make sure the group auditor has assessed and independently reviewed, if necessary, the work of foreign affiliates before relying on it in the audit of the consolidated entity.

Crypto-assets – auditing in a new frontier

CPAB is aware of approximately 50 Canadian reporting issuers that either hold crypto-assets or are contemplating crypto transactions. This is a growing new frontier for most of us. There is an urgent need for guidance on how auditors should be responding to typical audit risks associated with these clients. We are assisting CPA Canada in the development of resources for auditors in this area.



Directors of reporting issuers holding crypto-assets should consider the experience the engagement team has with those assets, whether the auditor used a crypto-assets expert to assist in the audit, and what, if any, audit procedures were performed to address risks unique to this industry (e.g. verifying rights and ownership).

Data analytics and other emerging technologies – disruptive enablers

To date CPAB has seen a modest level of this activity in our inspections but we expect that to change soon. We will continue to watch the development and implementation of new tools and procedures, and provide our perspective on how they can enable better quality over time. For example, we are working to understand what is being done to ensure the completeness and integrity of client data used in data analytics audit routines.



Directors should consider asking their auditor if changes will be made to the audit approach to incorporate emerging technology tools (data analytics, artificial intelligence, machine learning, etc.), and if so, what are the benefits and challenges. Other points for query could include the purpose of the data analytic, and how company data is stored, secured and validated for accuracy.

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