



**PROTOCOL
FOR AUDIT FIRM
COMMUNICATION
OF CPAB INSPECTION FINDINGS
WITH AUDIT COMMITTEES

CONSULTATION PAPER**

NOVEMBER 2013

The Canadian Public Accountability Board (“CPAB”) is requesting comments on the draft “Protocol for Audit Firm Communication of CPAB Inspection Findings with Audit Committees” which is attached as Appendix A to this paper.

The proposals in this draft Protocol may be modified in light of comments received before being issued in final form. Specific Questions for Comment requested by CPAB can be found on Page 6. Comments are requested by January 24, 2014. Earlier responses would be appreciated.

Responses should be sent by e-mail to Consultation@cpab-ccrc.ca. Comments will be made publicly available on CPAB’s website (www.cpab-ccrc.ca) unless respondents specifically request otherwise.

Background

1. CPAB was established in 2003 as Canada’s independent audit regulator. CPAB’s mission is to contribute to public confidence in the integrity of financial reporting of reporting issuers (“RIs”) in Canada by effective regulation and promoting quality, independent auditing. CPAB carries out its mission primarily by conducting inspections of the audit firms over which it has oversight responsibility.
2. The essence of CPAB’s work involves assessing the execution of methodologies, policies and quality control processes of the audit firms that participate in its oversight program. The primary focus of CPAB’s inspections is on the quality of the audit work as evidenced in the audit firm’s audit files. Following each inspection of a firm, CPAB issues a private report to the firm containing findings on their quality control processes, individual file reviews and includes recommendations to improve audit quality which must be implemented within a specified time period.
3. Annually CPAB publishes its Public Report on inspections of the quality of audits conducted by public accounting firms (“Public Report”). This Public Report provides a summary of firm level inspection themes, recurring issues, trends and emerging issues. Findings are described without identifying the audit firms or RIs whose audit files gave rise to the findings. CPAB also publishes periodic newsletters for Audit Committees. This information raises awareness of audit quality issues and should facilitate dialogue on audit quality issues among CPAB, Audit Committees and auditors, promoting a culture of continuous improvement.
4. Audit Committees of RIs in Canada have been requesting greater transparency into CPAB’s inspection findings to support them in their role of overseeing and evaluating the external auditor. A key recommendation of the Audit Committee working group of the Enhancing Audit Quality¹ initiative was that CPAB and the

¹ The EAQ initiative was a collaboration between the Chartered Professional Accountants of Canada (CPA Canada) and the Canadian Public Accountability Board (CPAB) to examine how to enhance audit quality in light of various global developments. Further information about the initiative can be found at <http://www.cica.ca/enhancing-audit-quality-canadian-perspective/item64401.aspx>

audit firms develop a protocol to increase the inspection information available to Audit Committees.

Development of the Draft Protocol

5. In 2013 CPAB consulted with key stakeholders including corporate directors, audit firms, securities regulators and legal advisors to develop the draft **Protocol for Audit Firm Communication of CPAB Inspection Findings with Audit Committees (“Protocol”)**.
6. CPAB believes the draft Protocol included in Appendix A responds to concerns raised by key stakeholders that were involved in the development of the Protocol. Key issues included ensuring the communication of the inspection findings is fair and balanced (the communication of inspection findings will include CPAB’s Engagement Findings Report – see paragraph 13), ensuring the confidentiality of the inspection findings (see the discussion of confidentiality in paragraphs 14 and 15) and retaining the effectiveness of CPAB’s current regulatory model. Appendix B includes examples of the types of communications Audit Committees can expect to receive under this Protocol.

Objectives and expected benefits of the Protocol

7. The objective of sharing inspection findings is to provide Audit Committees with relevant information regarding CPAB’s inspection findings to support them in their role in overseeing and evaluating the external auditor.
8. We believe the primary benefit of sharing inspection information is to improve audit quality by enhancing the nature and depth of discussions between the auditor and Audit Committee on audit quality. This will allow the Audit Committee to more effectively oversee the work of the auditor and promote a culture of continuous improvement.

Participation in the Protocol

9. This Protocol is a voluntary Protocol which has been developed to respond to the demand from Audit Committees for additional information about CPAB’s inspection findings. CPAB’s expectation is that all participating firms will share inspection findings as contemplated by this Protocol. Stakeholders will reap the greatest benefit if all audit firms participate in the sharing of inspection findings.

Protocol for audit firm communication of CPAB inspection findings

10. The reporting of inspection findings under this Protocol has two components:
 - Reporting to Audit Committees of the findings in CPAB’s annual Public Report (see paragraph 11); and

- The reporting of findings specific to the inspection of the audit of an individual RI (see paragraphs 12 and 13).
11. Under this Protocol audit firms will provide Audit Committees of all RIs with a copy of CPAB’s public report on an annual basis. CPAB’s public reports highlight systemic issues across inspections of audit firms and provide examples of mandatory recommendations that audit firms must implement to improve audit quality. It is anticipated that Audit Committees will read CPAB’s public report and discuss audit quality issues with their auditor to understand how the firm and audit team are responding to these issues.
 12. The reporting of findings specific to the inspection of an individual RI is seen to be of the most relevance to its Audit Committee because this can directly improve both audit quality and the Audit Committee’s oversight of the auditor.
 13. In the event that CPAB has inspected the audit file of a RI, the audit firm will provide the Audit Committee with the following information:
 - (i) A description of the focus areas selected for inspection by CPAB;
 - (ii) An indication of whether or not there are any significant inspection findings; and,
 - (iii) Any significant inspection findings as reported by CPAB per CPAB’s Engagement Findings Report (“EFR”) including a description of actions taken by the firm in response to the findings and CPAB’s disposition.

Confidentiality

14. Maintaining the confidentiality of inspection information related to the audit firms and their RI clients is critical to the effectiveness of CPAB’s regulatory oversight model.
15. Confidentiality of the information shared under this Protocol is being addressed in three ways:
 - (i) Under legislation, the CPAB Act requires inspection findings to be kept confidential.
 - (ii) Audit Committees have a fiduciary relationship with the reporting issuer and have a duty to maintain the confidentiality of all information shared with them, including any information shared under this Protocol.
 - (iii) If Audit Committees want to share the information with advisors or others who are not officers or directors of the RI they should ensure that the information will be kept confidential.

Applicability of the Protocol and effective date

16. Audit Committees of all Canadian RIs have the same responsibility under National Instrument 52-110 to oversee the work of the external auditor. As a result, this Protocol is proposed to be effective for all RIs in Canada.
17. This Protocol will be effective after the conclusion of CPAB's consultation process. We expect the Protocol will be effective for inspections of audit files commencing on or after March 31, 2014.

Post implementation review

18. CPAB will perform a post implementation review after the commencement of reporting of inspection findings under this Protocol. The objective of this review will be to consult with key stakeholders on the functioning and effectiveness of this Protocol with a view, among other things, to modifying it should that be considered necessary.

Request for comment

19. CPAB encourages all stakeholders to provide feedback on this proposed Protocol. The matters on which we would particularly welcome comments are outlined on page 6.

We request a response no later than **January 24, 2014**. Earlier responses would be appreciated.

Responses should be sent by e-mail to Consultation@cpab-ccrc.ca . Comments will be made publicly available on CPAB's website (www.cpab-ccrc.ca) unless respondents specifically request otherwise.

Any questions related to this Protocol should be directed to:

Kam Grewal

Vice President

Email: Kam.Grewal@cpab-ccrc.ca

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Specific Questions for comment

Question #1

Will the information shared under this Protocol assist Audit Committees in their oversight role and improve audit quality (see Paragraphs 10 to 13 for a summary of the information to be shared)? If not, please explain why you are of that view.

Question #2

Will the confidentiality of RI file specific inspection findings to be shared under this Protocol be appropriately protected (see paragraphs 14 and 15 for a discussion of this issue)? If not, please provide your comments on changes that can be made to improve the confidentiality protection of the inspection findings.

Question #3

Do you have other comments on the proposed Protocol?

Appendix A – Draft Protocol

**PROTOCOL
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Background

1. The Canadian Public Accountability Board (“CPAB”) was established in 2003 as Canada’s independent audit regulator. CPAB’s mission is to contribute to public confidence in the integrity of financial reporting of reporting issuers (“RI”) in Canada by effective regulation and the promotion of quality, independent auditing. CPAB carries out its mission primarily by conducting inspections of the audit firms over which it has oversight responsibility.

There are 165 Canadian audit firms and 135 foreign audit firms currently participating in CPAB’s audit regulatory program. These audit firms audit approximately 7,000 RIs (including investment funds). Annually, CPAB currently inspects 14 firms that audit 100 or more RIs. These audit firms audit 99.5% of RIs in Canada by market capitalization. The remaining audit firms, that audit 0.5% of RIs in Canada by market capitalization, are subject to periodic inspection.

2. CPAB’s work primarily involves assessing the execution of methodologies, policies and quality control processes of the audit firms that participate in its oversight program.

The main focus of CPAB’s inspections is on the quality of the audit work carried out by the audit firms. These inspections include approximately 200 – 250 audit files across 35 – 40 audit firms annually. File selections are based on the evaluation of risk factors for RIs and also consider audit firm-specific factors such as prior inspection results, partner experience, geographical distribution of offices and industry specialization. CPAB does not inspect the entire audit file. Instead, file inspection procedures cover between two and four specific focus areas which are generally material, high-risk financial statement items that require more complex estimates and judgments (e.g., impairment of long-lived assets, fair values of illiquid financial instruments, and business combinations).

Following each inspection, CPAB issues a private report which summarizes findings on the audit firm’s quality control processes, individual file reviews and includes mandatory recommendations to improve audit quality which must be implemented within a specified time period. Additional information about CPAB’s inspection process can be found at www.cpab-ccrc.ca.

3. Annually CPAB publishes its Public Report on inspections of the quality of audits conducted by public accounting firms (“Public Report”). This Report provides a summary of audit firm level inspection themes, recurring issues, trends and emerging issues. Findings are described without identifying the firms or RIs whose audit files gave rise to the findings. Audit Committee members are anticipated to read CPAB’s Public Reports and periodic newsletters issued for Audit Committees and discuss the audit quality issues with their auditor to understand how the audit firm and audit team are responding to these issues.

4. Audit Committees are key contributors to audit quality and play a critical role in creating the right environment for quality auditing. Audit Committees are responsible for overseeing the work of the external auditor and have indicated to CPAB they would like more transparency with respect to inspection findings in order to improve the effectiveness of their oversight role. This Protocol has been developed with the objective of having a positive impact on audit quality by enhancing the ability of the Audit Committee to evaluate the quality and effectiveness of the audit through an increase in the transparency of inspection findings.

Inspection findings to be communicated by audit firms to Audit Committees under this Protocol

5. CPAB findings specific to the inspection of an individual RI are of most relevance to its Audit Committee and can directly improve both audit quality and the Audit Committee's oversight of the auditor.

The reporting of inspection findings under this Protocol has two components:

- Reporting to Audit Committees of the findings in CPAB's annual Public Report (see paragraph 6); and
- The reporting of findings specific to the inspection of an individual RI (see paragraph 7).

CPAB believes that audit firm communication of RI specific inspection findings, combined with CPAB's public reporting, will assist Audit Committees in their oversight role and improve audit quality.

6. Under this Protocol, audit firms will provide Audit Committees with a copy of CPAB's annual Public Report. All RI Audit Committees will receive this information on an annual basis.
7. In the event that CPAB has inspected the audit file of a RI, the audit firm will provide the Audit Committee with the following information:
 - (i) A description of the focus areas selected for inspection by CPAB;
 - (ii) An indication of whether or not there are any significant inspection findings; and,
 - (iii) Any significant inspection findings as reported by CPAB per CPAB's Engagement Findings Report ("EFR") including a description of actions taken by the firm in response to the findings and CPAB's disposition.

A copy of this communication will concurrently be provided to CPAB by the audit firm.

8. Audit Committee members are anticipated to discuss significant inspection findings with their auditor. These discussions should include understanding:
- the nature and root cause of the audit deficiency;
 - the additional work performed by the audit firm to address the finding and related results;
 - the impact, if any, on previously issued or future financial statements; and
 - changes the auditor will be making to the audit approach to address the inspection finding.
9. CPAB encourages open and candid discussion of inspection findings between auditors and Audit Committees to assist the Audit Committee in their oversight of the auditor. Under this Protocol, CPAB waives the provisions of Rule 413 of CPAB's Rules to allow audit firms to communicate to Audit Committees whether or not there have been significant inspection findings (as defined in Section 11) and, if so, to communicate those findings, actions taken by the audit firm and CPAB's disposition.
10. It is important that Audit Committees understand the scope of CPAB's inspections, and the fact that CPAB does not inspect the entire audit file. CPAB's inspection findings are not intended to, and cannot, identify all weakness that may exist in an audit. In general, CPAB inspects higher-risk audit areas in the audit files of more complex public companies or companies where there is greater likelihood of identifying audit quality issues. CPAB does not report on areas of the audit file where auditors performed to, or beyond, required standards. As a result, CPAB's findings do not represent a balanced scorecard and cannot be extrapolated across the RI population as a whole.

The absence of significant findings in CPAB's inspection of an audit file should not be interpreted to mean that all aspects of the audit were fully compliant with professional standards, or that the RI's financial statements have been prepared in accordance with the applicable accounting standards.

The Appendix provides answers to common questions which may arise from Audit Committee members with respect to this Protocol.

Significant inspection findings

11. Under this Protocol, all significant inspection findings will be communicated to Audit Committees.

A significant inspection finding identified by CPAB is defined as 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 in the current year to support the audit opinion and/or is required to make significant changes to its audit approach. CPAB requires the audit firm to respond in writing to all significant inspection findings.

Response to significant inspection findings

12. At the completion of the inspection of an audit file, CPAB communicates its significant inspection findings (if any) to the audit firm.

In the normal course of responding to most significant inspection findings, the audit firm performs additional audit work in order to be satisfied the issued audit opinion remains appropriate.

If a potential material error in the RI financial statements is not identified, the audit firm would report the written communications required by this Protocol (see Section 7) to the Audit Committee at its next scheduled meeting. If a potential material error is identified, the audit firm will advise the RI, including its Audit Committee, on a priority basis.

The Audit Committee and the auditor should agree on the timing of when significant inspection findings should be communicated to the Audit Committee as some Audit Committees may prefer earlier notification of inspection findings.

In all cases, the audit firm will keep CPAB informed on the resolution of all significant inspection findings. As part of this process, the firm provides CPAB with evidence that the work was completed, including the results of the additional audit work. The audit firm also indicates to CPAB how its future audit approach will be changed as applicable.

Confidentiality

13. Section 11(2) of the CPAB Act provides that all documents and other information prepared for or received by CPAB in the exercise of its mandate and all deliberations of CPAB and its employees and agents, in connection with an inspection, investigation or review panel proceeding carried out under CPAB's oversight program, are confidential. Management and Audit Committee members of RIs should take steps to ensure, except to the extent required otherwise by law, that the significant inspection findings they receive are kept confidential. Before sharing information with financial and legal advisors or anyone else to whom disclosure may be appropriate, RIs should ensure that the information will remain confidential.

Amendments to the Protocol

14. CPAB will periodically review and consult with key stakeholders on the functioning and effectiveness of this Protocol with a view, among other things, to modifying it should that be considered necessary.

Effective date

15. This Protocol is effective for CPAB audit file inspections commencing on or after March 31, 2014.

Appendix – Questions and Answers related to the application of the Protocol

1. **If the audit file for my RI was not inspected in the current year, what information can I use to assist me in discussing inspection findings with my auditor?**

CPAB publishes a Public Report on the results of its inspections on an annual basis, together with periodic newsletters addressing audit quality matters, trends and emerging issues. The Public Report includes a commentary on significant inspection findings and recommendations to improve audit quality from CPAB's inspections over the past year.

Audit Committees are anticipated to review these materials and discuss the actions taken by their auditor to address these issues at the audit firm level and by the individual audit team.

2. **Who gets notified if the audit engagement team needs to do more audit work?**

CPAB would expect that the audit team would notify RI management that additional audit work must be performed and would arrange to have the audit work completed on a priority basis.

If a potential material error is identified, the Audit Committee would be informed on a priority basis. If a potential material error is not identified, the auditor would inform the Audit Committee of the issue and results of additional audit work at its next scheduled meeting.

The timing of communication of inspection findings should be discussed between the Audit Committee and the auditor as some Audit Committees may prefer earlier notification of inspection findings.

3. **What is my responsibility as an Audit Committee member if I am made aware that additional audit work is required in response to a CPAB finding and we are in the process of releasing financial results?**

The Audit Committee's responsibility is the same as in other circumstances where there is a risk of material misstatement of the financial statements. The Audit Committee should direct management to co-operate with the external auditor to support the additional work to be performed.

The Audit Committee may need to consult with legal counsel in certain circumstances to determine the appropriate actions to be taken.

4. **Why is there no communication of firm-wide issues to Audit Committees in this Protocol?**

Firm-wide issues are not specifically included in this Protocol since the intention is to focus on issues that have a direct impact on the audit of an individual RI.

CPAB's Public Report on its inspections includes a summary of systemic issues from across inspections of audit firms. Under this Protocol, all RI Audit Committees will receive CPAB's Public Report from the audit firm on an annual basis. Audit Committees should review the Public Report and discuss the actions taken by the auditor on their audit to address these issues as applicable.

The appropriateness and effectiveness of the communication of inspection findings under this Protocol will be evaluated on a periodic basis to ensure the communications are meeting the needs of all stakeholders with the goal of continuing to improve audit quality.

5. What happens when the audit firm disagrees with CPAB on a significant inspection finding?

CPAB's process in finalizing significant inspection findings includes detailed discussions with the engagement team and review of all the available audit evidence. CPAB's process also includes a rigorous consultation and review process to validate significant inspection findings before they are communicated in writing to the audit firm. We acknowledge there may be circumstances where there is a difference of opinion between CPAB and the audit firm. Irrespective of a disagreement between CPAB and the audit firm, CPAB will require, where necessary, the audit firm to perform additional audit work to reduce the risk of material misstatement.

In communicating a significant inspection finding where there is a disagreement, audit firms are expected to ensure the Audit Committee is provided with a fair and balanced summary of the significant inspection finding and the audit firm's response to the finding.

Appendix B – Examples of Significant Inspection Findings

This appendix provides stakeholders with examples of the types of findings that could be communicated to Audit Committees under this Protocol. These examples are provided for illustrative purposes.

Example #1

To the Audit Committee

Background

The audit file of ABC Inc. (the “Company”) for the year ended December 31, 2012 was included in CPAB’s inspection of Audit Firm (see appendix for an overview of CPAB’s file inspection process). The Company licenses software and provides professional services to its customers.

CPAB’s inspection of the audit of ABC Inc. included a review of three focus areas being goodwill impairment, revenue recognition and the acquisition of DEF Inc.

CPAB’s inspection identified a significant inspection finding in the area of revenue recognition which is required to be reported to you in accordance with the Protocol for sharing inspection findings.

Revenue for the Company for the year end was \$100 million of which \$50 million was in the accounting software business segment. Materiality for the audit was \$2.5 million.

CPAB Finding

The audit file included a memo that outlined the Company’s revenue recognition accounting policies. Neither this memo nor the accounting policies themselves addressed the business model in the accounting software business segment of providing online access to its software to many customers. Specifically, neither considered whether the Company is delivering a service (access to software in a cloud environment over a period of time) or a product and a service (purchase of off-the-shelf or customized software and a separate hosting service). These distinctions are critical from a revenue recognition perspective and have a material impact on revenues.

The Company and the audit team need to analyze the delivery model for all significant revenue streams (including professional services and license fees) and significant contracts to determine whether the Company’s revenue recognition accounting policy is appropriate. If the Company determines that a service is being provided, the Company would be required to recognize revenue in the accounting software business segment over the period the customer uses the software (approximately five years) with a worst case of reducing net income before taxes by \$10 million in the current year.

Audit Firm Response

We agree that our audit file did not adequately address the concerns raised regarding the RI's revenue recognition accounting policies.

We notified ABC Inc. of the issues raised and management documented the RI's revenue recognition policies for licensing fees and other significant revenue streams, including the impact of multiple element arrangements. As a result of the additional work performed, management of ABC Inc. concluded the company's revenue recognition policies were incorrect and a material error was identified in the 2012 and 2011 financial statements. On October 1, 2013, the Audit Committee of ABC Inc. approved the release of the restated financial statements.

We have performed additional analysis to validate the various revenue streams with related recognition criteria and policies, including our conclusions on the appropriateness of such policies and compliance with the applicable accounting framework and industry guidance. In addition, we have reviewed all significant contracts to ensure the identified revenue streams are complete and have audited the restatement proposed by management.

CPAB Disposition

CPAB has reviewed the work performed, including the restatement. Please add the additional audit work to the 2012 audit file.

Appendix to Example #1: CPAB process for inspection of reporting issuer audit files (To be included as an Appendix for all RI audit file specific communications to Audit Committees)

Background

The Canadian Public Accountability Board (“CPAB”) was established in 2003 as Canada’s independent audit regulator. CPAB’s mission is to contribute to public confidence in the integrity of financial reporting of reporting issuers (“RI”) in Canada by effective regulation and promoting quality, independent auditing. CPAB carries out its mission primarily by conducting inspections of the firms over which it has oversight responsibility.

The primary focus of CPAB’s inspections is on the quality of the audit work as evidenced in the audit firm’s audit files.

Risk-based approach

CPAB’s file selections are risk-based and also consider firm-specific factors such as prior inspection results, partner experience, geographical distribution of offices and industry specialization.

Inspection of an RI audit file

It is important that audit committees understand the scope of CPAB’s inspections, and the fact that CPAB does not inspect the entire audit file. CPAB’s inspection findings are not intended to, and cannot, identify all weakness that may exist in an audit. In general, CPAB inspects higher-risk audit areas in the audit files of more complex public companies or companies where there is greater likelihood of identifying audit quality issues. CPAB does not report on areas of the audit file where auditors performed to, or beyond, required standards. As a result, CPAB’s findings do not represent a balanced scorecard and cannot be extrapolated across the RI population as a whole.

The absence of significant findings in CPAB’s inspection of an audit file should not be interpreted to mean that all aspects of the audit were fully compliant with professional standards, or that the RI’s financial statements have been prepared in accordance with the applicable accounting standards.

Significant inspection findings

Under the Protocol for sharing inspection findings, all significant inspection findings will be communicated to audit committees.

A significant inspection finding identified by CPAB is defined as 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 in the current year to support the audit opinion and/or is required to make significant changes to its audit approach. CPAB requires the audit firm to respond in writing to all

significant inspection findings.

Response to significant inspection findings

In the normal course of responding to most significant inspection findings, the audit firm performs additional audit work in order to be satisfied the issued audit opinion remains appropriate.

If a potential material error in the RI financial statements is not identified the audit firm would report the finding to the Audit Committee at its next scheduled meeting. If a potential material error is identified, the audit firm will advise the RI, including its Audit Committee, on a priority basis.

The Audit Committee and the auditor should agree on the timing of when significant inspection findings should be communicated to the Audit Committee as some Audit Committees may prefer earlier notification of inspection findings.

In all cases, the audit firm will keep CPAB informed on the resolution of all significant inspection findings. As part of this process, the audit firm provides CPAB with evidence that the work was completed, including the results of the additional audit work. The audit firm also indicates to CPAB how its future audit approach will be changed as applicable.

Confidentiality

Section 11(2) of the CPAB Act provides that all documents and other information prepared for or received by CPAB in the exercise of its mandate and all deliberations of CPAB and its employees and agents, in connection with an inspection, investigation or review panel proceeding carried out under CPAB's oversight program, are confidential. RIs and their management and audit committee members should take steps to ensure, except to the extent required otherwise by law, that the significant inspection findings they receive are kept confidential. Before sharing information with financial and legal advisors or anyone else to whom disclosure may be appropriate, RIs should ensure that the information will remain confidential.

Example #2

To the Audit Committee

Background

The audit file of XYZ Inc. for the year ended December 31, 2012 was included in CPAB's inspection of Audit Firm. The Company is a clothing retailer with locations across Canada.

CPAB's inspection of the audit of XYZ Inc. included a review of three focus areas being impairment of long-lived assets (including store locations), inventories and goodwill.

CPAB's inspection identified a significant inspection finding related to the impairment assessment for long-lived assets which is required to be reported to you in accordance with the Protocol for sharing inspection findings.

The carrying value of long-lived assets was recorded at \$15 million. Materiality for audit purposes was \$2 million.

CPAB Finding

The Company had indicators of impairment and management performed an impairment analysis on long-lived assets for purposes of the audit as at December 31, 2012. Management prepared a five year forecast of operating results for purposes of impairment testing. Key assumptions used in the forecast included the following:

- (i) Sales were forecast to grow from \$75 million in 2012 (actual) to \$125 million in 2016. This included growth rates of 20% in 2014, 15% in 2015 and 10% in 2016. The engagement team performed no audit procedures to corroborate these growth rates other than discussion with management. No sensitivity analysis was performed on management's key assumptions by the engagement team.
- (ii) Gross margins were forecast to grow from 5% in 2012 to 15% for 2016.
- (iii) The discount rate applied by management in discounting the cash flows for purposes of the long-lived asset impairment testing was 10%. This contrasts with a discount rate in the range of 15-20% suggested by the audit firm's valuations specialist. There was no explanation or support in the working papers for why management's rate was appropriate and supportable.

Management's assumptions appear to be aggressive given that the Company has had several years of significantly deteriorating operating results. CPAB notes that a 10% reduction in growth rates results in a material impairment charge.

The engagement team failed to apply appropriate rigour and professional scepticism in evaluating and corroborating significant assumptions used by management in its five-year forecast. We also note that there was no written communication to the Audit Committee upon completion of the audit with respect to the impairment issues noted above.

Audit Firm Response

In responding to this point we obtained additional analysis from management to support their operating forecast. Utilizing management's analysis, we performed the following additional procedures:

- Prepared a sensitivity analysis on the impact of changes to management's key assumptions;
- Compared management's key assumptions to information released by competitors, industry comment by analysts, current operating results and other appropriate sources of information; and
- Utilized our audit firm's valuations specialist to review management's analysis and provide updated recommendations.

Based on the additional work performed we did not identify any additional unadjusted errors.

CPAB Disposition

CPAB has reviewed the additional work performed. The additional audit work performed should be added to the 2012 audit file.

Example #3

To the Audit Committee

Background

The audit file of DEF Inc. (the “Company”) for the year ended December 31, 2012 was included in CPAB’s inspection of Firm LMN.

CPAB’s inspection of the audit of DEF Inc. included a review of three focus areas being revenue, accounts receivable and the group audit.

CPAB’s inspection identified significant inspection findings in the area of revenues which are required to be reported to the Audit Committee in accordance with the Protocol for sharing inspection findings.

CPAB Finding

The Company’s revenues are based on service agreements whereby revenue is recognized in the period in which services are provided. Revenues of \$1 billion were recorded for the year ended December 31, 2012, and are made up of a high volume of low dollar amounts. The planned audit approach for revenue was high reliance on internal controls for the accuracy assertion combined with substantive analytical procedures. Substantive analytical procedures are designed to predict financial results based on independent data, and then compare the prediction to actual results.

The engagement team did not obtain sufficient appropriate audit evidence that revenues had been recorded appropriately.

Specifically, CPAB noted the following deficiencies related to the audit work performed on revenues:

- (i) The engagement team did not effectively design or execute tests of internal controls (including automated controls and management review controls) related to revenues to support the planned level of reliance.
- (ii) The engagement team performed substantive analytical procedures to assess the reasonability of revenues by considering changes in pricing and volumes from the prior year by service type and location. The following deficiencies were noted in the application of the substantive analytical procedures:
 - There was no audit work performed to validate the accuracy of the volume data used in performing the substantive analytical procedures.
 - The engagement team assumed that pricing and volumes would be comparable to the prior year without consideration of changes that resulted from numerous

new/amended contracts entered into during the year.

- The thresholds for acceptable differences were not sufficiently precise to identify a material misstatement. For example, the threshold of a 10% change in volume for one location allowed a difference of over 4x materiality not to be investigated.
- The engagement team investigated differences in excess of thresholds by making enquiries of management without appropriate corroboration to source documents.

Firm Response

We have considered CPAB’s findings on revenue and performed the following audit procedures:

- Internal controls – we selected a sample of 25 revenue transactions and tested the key controls through a combination of observation and reperformance. We found the internal controls to be designed and operating effectively to support our reliance.
- Substantive analytical procedures – we improved the substantive analytical review procedures by performing the following:
 - Tested the reports and underlying system that generated the volume data used in the analytical review;
 - Refined our estimated revenue to take into account new or amended contracts;
 - Adjusted our threshold for investigating differences to an amount not exceeding performance materiality; and
 - We performed additional tests of details to corroborate management’s explanation of differences identified in our testing.

No errors were noted in the additional audit tests performed.

CPAB Disposition

CPAB has reviewed the additional work performed. This additional audit evidence should be added to the audit file under current date.