CPAB
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Re: Protocol for Audit Firm Communication of CPAB Inspection Findings with Audit Committees

Thank you for your letters of January 23, 2014 and February 12, 2014. We appreciate your feedback on our proposed Protocol ("the Protocol").

We are writing to provide you with an update on our consultation process and to respond to your question related to the cost of the Protocol to reporting issuers, specifically, Venture Exchange listed issuers.

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 high quality, independent 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. The 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.

CPAB is pleased to note that the Big 8 National Audit Firms in Canada (Deloitte, EY, KPMG, PwC, Grant Thornton, BDO, MNP and RCGT) have expressed their support for the Protocol and indicated their intent to voluntarily participate in the Transparency Protocol initiative. This is very significant as these firms audit approximately 98% of Canadian reporting issuers by market capitalization of reporting issuers active in the Canadian capital markets. Collectively, these audit firms also audit approximately 70% and 40% of Venture Exchange Reporting Issuers by market capitalization and number of reporting issuers, respectively. Based on feedback received we expect additional audit firms to participate in the Protocol.

In response to the feedback received during the consultation process, CPAB is planning to modify the Protocol to clarify the confidentiality of the inspection findings and the timing of reporting to audit committees. In evaluating the responses to the Protocol we considered whether it would be appropriate to provide some form of exemption (or other concession) for certain issuers either by market capitalization or by the nature of the exchange the reporting issuer is listed. In considering the overall public interest, the minimal cost to reporting issuers (see below) and the benefits to audit quality, we have concluded that the Protocol should apply to all reporting issuers.

At the conclusion of our consultation process we will publish a final Protocol together with a summary of the feedback received through the consultation.

In developing the Protocol and evaluating the responses received in our consultation process we have considered the issue of whether the implementation of the Protocol will result in material cost that will be borne, directly or indirectly, by reporting issuers. Given the current economic environment we have also paid particular attention to whether the Protocol would have a material cost to Venture Exchange reporting issuers, specifically.

Under CPAB's current regulatory model (prior to the implementation of the Protocol), when a significant inspection finding is identified, CPAB requires audit firms to perform additional audit work to reduce the risk of material misstatement. This requirement exists today and will not change when the Protocol is effective. Accordingly, the cost to the audit firm of performing additional audit procedures is not considered a cost of the introduction of the Protocol. Furthermore, we do not believe additional time spent by the audit firm to address inspection findings should be charged to the Reporting Issuer who paid for and expected to receive an audit completed in accordance with the applicable auditing standards.

Accordingly, we do not believe the implementation of the Protocol will have a material direct or indirect cost to reporting issuers. To provide greater context we have expanded on this below by considering the two elements of the Protocol being the sharing of CPAB's Public Report and the discussion of Significant Inspection Findings with audit committees.

CPAB's Public Report

Under the Protocol the audit firm will provide the audit committee with CPAB's Public Report on inspections. A discussion of the Public Report with the audit firm has the benefit of promoting a dialogue concerning common audit quality issues to help the audit committee better understand how the audit firm and audit team are responding to these issues. This supports the audit committee in its oversight of the auditor. CPAB will also prepare a 2 – 3 page summary for audit committees outlining the key messages from the Public Report to further assist them.

It is expected the Public Report would be distributed electronically together with information the auditor is required to communicate to audit committees under existing auditing standards.

We do not believe the distribution of this information or discussion of the issues noted in the Public Report will create a material cost to reporting issuers because this discussion is intended to occur as part of regularly scheduled audit committee meetings.

Significant inspection findings

CPAB findings specific to the inspection of an individual RI are of most relevance to its audit committee and has the benefit of directly enhancing both audit quality and the audit committee's oversight of the auditor. To illustrate the nature of significant inspection findings we have included a summary of inspection findings from our inspection of Venture Issuers over the past year. Given the nature and significance of these findings we believe audit committees would want to be informed of such matters.

In considering the cost of sharing RI specific significant inspection findings please note that CPAB does not identify significant inspection findings for the majority of files that are inspected. If the Protocol were in place in 2013, all audit firms (including the Big 8 National Firms) would have reported significant inspection findings to 30 Venture Exchange reporting issuers.

For those RIs where a significant inspection finding is not identified, the reporting under this Protocol would lead to no additional cost to the audit firm or the Reporting Issuer.

For those RIs where a significant inspection finding is identified, audit firms will spend additional time discussing the issue with CPAB, reviewing the wording of the significant inspection findings document and considering their approach to discussions with the audit committee. There will be additional time spent by the audit firm and the audit committee reviewing the communication and discussing the issue in the audit committee meeting. However, because the additional audit work will normally have been completed by the time the issue is discussed with the audit committee, the time spent discussing the issue will likely be limited as the issue has been resolved. Furthermore, as noted above, we do not believe additional time spent by the audit firm to address inspection findings would be charged to the Reporting Issuer who paid for and expected to receive an audit completed in accordance with the applicable auditing standards.

The 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. Our expectation is that the additional time spent by the audit firm and audit committee will not be significant for less complex issuers which make up the majority of the issuers on the Venture Exchange. Accordingly, we do not believe the communication of these issues will result in a material direct or indirect cost to the issuer.

Upon implementation of the Protocol we will actively monitor the effectiveness of the reporting to audit committees. We will keep key stakeholders including the TSX Venture Exchange fully informed of the feedback received and the effectiveness of the Protocol in meeting our objective to improve audit quality.

We welcome your comments on these items and we would be pleased to meet with you to discuss this issue should you have further concerns. We look forward to working with all stakeholders to continue to enhance audit quality.

Very truly yours,

Brian Hunt, FCPA, FCA, ICD.D
Chief Executive Officer

Cc:
Lara Gaede, Chief Accountant, Alberta Securities Commission
Carla-Marie Hait, Chief Accountant, British Columbia Securities Commission
Sonia Loubier, Chief Accountant, Autorité des Marchés Financiers du Québec
Cameron McInnis, Chief Accountant, Ontario Securities Commission
Mark Pinch, Senior Accountant, Ontario Securities Commission

CPAB - Examples of inspection findings - Venture Exchange / NEX listed companies

	Significant Inspection Findings
1.	Goodwill and intangible assets represented approximately 50% of assets (over 10 times materiality). In the company's impairment analysis, management projected growth in revenue and earnings before interest and taxes of 250% and 500% respectively over a two year period. The company was in financial difficulty in the current and prior years and the audit team did not challenge management's key assumptions in the company's projected future cash flows.
2.	The fair value of an asset retirement obligation for an oil and gas producer was based on a 50 year life vs. the 25 year term of a petroleum agreement. There was no support for the use of the 50 year life. When the liability was recalculated using a 25 year life, the liability increased from $0.5 million to $2.7 million, a change of over 3 times the auditor's calculated materiality.
3.	For a mining company, the audit team did not assess the company's conclusion that commercial production had not commenced, despite the fact that the company was generating significant revenues. Since management deemed that commercial production had not begun, this resulted in the company continuing to capitalize costs without starting amortization resulting in a material understatement of revenue, cost of sales and amortization expense. Additions to the mining asset were $7 million over two years net of $60 million of revenue.
4.	For a technology company, management and the audit team did not analyze the impact of a change in the company's business model on the company's revenue recognition policy. The segment where the business model changed included $4 million of the company’s $10 million of annual revenue. The revenue related to the change in business model was required to be recognized over a two year period instead of the previous policy to recognize all of the revenue on delivery resulting in a restatement of the prior period financial statements.
5.	For a mining company, the audit team did not perform appropriate procedures to verify the company’s ownership of certain material assets. In particular, the audit team did not verify the title on a significant amount of claims held and no audit procedures were performed on the company's legal interest in certain farm-in or joint venture arrangements. These assets comprised 90% of total assets of the company.
6.	The audit team did not modify their audit approach to respond to allegations of fraud and inappropriate activity including the payment of personal expenses of the CEO, the employment of family members of senior management and the establishment of a subsidiary without authorization of the Board.

	Significant Inspection Findings
7.	The audit team reviewed an invoice but did not obtain or review the terms of a customer contract representing 90% of revenues for a technology company. Review of the contract indicates the transaction is financing in nature and revenue should not have been recognized.
8.	The auditor did not perform procedures to verify legal interest in the company's largest mining property. Further, this mining property was in a foreign jurisdiction, increasing the risk of material misstatement. This individual asset represents over 50% of the property and 30% of total assets.