



World-Class
Audit Regulation

Innovative
Actions

Sustainable
Improvement



2013 PUBLIC REPORT



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Report on 2013 Inspections of the Quality of Audits in Canada — Ten Years of Progress

Key Insights

Inspection results show positive trend

The results of the Canadian Public Accountability Board (CPAB) 2013 inspections have improved over the prior year. It is clear to CPAB that the trend in audit quality is positive and that firms in Canada are taking the challenge to improve audit quality seriously.

The audit firms CPAB inspects annually account for over 99 per cent of the market capitalization in Canada. These firms are each in different stages in their audit quality initiatives. The Big Four¹ firms have all made significant progress since CPAB's Call to Action after disappointing inspection results in 2011 and as a group have had better than a 30 per cent improvement in each of the last two years. The Other Annual² firms started their initiatives later and are also benefiting, with a year-over-year improvement of about 18 per cent in 2013.

Sustainability is needed

It is encouraging to see audit quality improving. This can be attributed, in part at least, to the action plans many firms have adopted. These plans usually have both short and long-term elements. In the short term, actions such as additional quality/technical reviews are intended to enable the firms to achieve quick improvement, and this has been accomplished. However, the longer-term objective is a sustainable approach to audit quality that will persevere through business cycles. It is too early to conclude that this has happened. Audit committees should engage their auditors in a discussion about how they are ensuring their audits continue to be of the highest quality.

Foreign jurisdictions are an issue

Foreign jurisdictions often bring with them another language, a different set of rules and regulations, unique customs and business practices or structures that may be uncommon in Canada. Consequently, as companies enter foreign jurisdictions, challenges and/or risks to auditors increase, often disproportionately. Management, audit committees and other professional advisors need to ensure they are fully aware of the additional risks they are taking on in these jurisdictions and mitigate them effectively. Audit committees in particular may be challenged in addressing how well the audit has been done. Engaged management and effective governance are critical elements of a quality audit.

An added complexity is that CPAB is often not granted access to the audit work done in foreign jurisdictions. The financial community should be concerned when foreign laws and regulations reduce and/or impede the auditor oversight they've come to expect in Canada.

¹ Big Four firms include: Deloitte LLP, EY LLP, KPMG LLP and PwC LLP.

² Other Annual firms include: Next Four firms (BDO LLP, Grant Thornton LLP, MNP LLP and Raymond Chabot Grant Thornton S.E.N.C.R.L.) and Regional firms (Collins Barrow Toronto LLP, Davidson & Company LLP, DMCL LLP, MacKay LLP, Manning Elliott LLP and Smythe Ratcliffe LLP).

Change often increases risk

Companies are continuously challenged to increase revenues and profits. They may respond by acquiring new businesses or entering into ventures where they have little expertise and may not fully understand all associated risks. Similarly, this may lead the company into areas where their auditor has little or no experience. Business and audit risk may increase and audit committees need to understand how these risks have been addressed.

These circumstances can bring with them complex estimates and judgments which test both management and auditors. CPAB's inspection findings regularly highlight deficiencies in the most judgmental areas of the audit where the audit committee should be the most engaged and can make the most difference.

Action plans

In prior years, CPAB required many firms to develop and implement action plans to address audit quality issues. These plans have been effective and are responsible for much of the improvement noted in 2013 and 2012.

CPAB is encouraged that most firms continue to enhance their action plans and have now incorporated them into their annual cycle of continuous improvement. During 2013 CPAB expanded its requirement for action plans across all of the firms it inspects annually.



Quality is not something that can be “inspected in” immediately prior to the release of the financial statements. Similarly, other short-term fixes are just that — they don’t lead to real change and embedded quality improvements. That said, all of these initiatives can have a place in the audit quality transition process. The objective is a sustainable approach to audit quality that will persevere through both good and difficult economic times and across all audit clients.

The need for dialogue with audit committees

As part of their oversight role audit committees should regularly have conversations about audit quality with their auditors and management to ensure that they are receiving a high quality, effective audit. CPAB encourages audit committees to start an open dialogue with their auditors by asking how the firm has responded to the more systemic findings noted in this report. In 2014 CPAB will implement a Protocol which will provide greater transparency of its findings to audit committees. This should further assist them to effectively execute their mandates.

Enhancing audit quality

During 2013 the Chartered Professional Accountants of Canada (CPA) and CPAB completed the Enhancing Audit Quality initiative with the release of the final report related to auditor reporting, auditor independence and the role of audit committees.

The report called for specific steps that audit committees and audit firms should take to enhance audit quality. These included: developing guidance and tools for audit committees to conduct effective annual assessments of the external audit firm; comprehensive review of the external audit firm at least once every five years, and providing increased transparency to audit committees on CPAB’s inspection findings.

Changes are being adopted or proposed internationally, including both auditor reforms (such as mandatory rotation, tendering or comprehensive review) and changes to the auditor reporting model. Canada will not be immune to these changes in the years ahead and CPAB continues to engage all stakeholders in the audit quality process.

The CPAB approach

CPAB’s approach to regulation requires the firms to find their own solutions to audit quality issues arising from our inspections. Each firm is unique and knows best what initiatives should work in its particular environment/culture. Once these solutions are identified CPAB ensures the firms implement them, and holds the firms accountable for their results.

Furthermore, CPAB goes beyond inspections of audit firms and engages with other stakeholders, including audit committees, directors, investors, analysts and academics, creating a collaborative environment in which to improve audit quality.

This broader approach to regulation, which involves more stakeholders than just the audit firms, contributes to audit quality longer-term and makes it possible for CPAB to be more positive concerning the trend of audit quality in Canada than may be the case for regulators in other countries.

Section One — Canada's Audit Landscape

Introduction

A belief in the integrity of financial reporting is essential to public confidence in the effective operation of our capital markets³. Quality financial audits, especially during uncertain economic times, are fundamental to this belief. The greater the uncertainty, the more vigilant auditors need to be, consistently exercising their independence, objectivity and heightened level of skepticism — characteristics investors expect in quality audits. The investing public around the world needs to be able to trust auditors to attest to the integrity of financial statements. Auditors earn this trust with each audit they perform.

Ten years later

CPAB's first Public Report in 2004 only dealt with inspections of the Big Four firms. At that time CPAB stated "audit quality is now one of the top priorities of each firm, and their partners and staff are dedicated professionals who generally do a difficult job very well." This continues to be the case.

In subsequent reports CPAB recognized that "high quality work was evident throughout our inspections" and that "CPAB has seen many examples of excellent work". The challenge was and is with consistency of execution.

Most importantly, when CPAB challenged the firms to take action to improve audit quality, they responded positively. Audit quality has been a journey and as this year's report attests, the firms have made good progress.

The trend is positive

The quality of audits in Canada continues to improve. The firms generally have sound audit methodologies and are committed to audit quality. Most audits are well done. However, while CPAB's 2013 inspections resulted in four restatements of financial statements (two per cent of files inspected), the risk of restatements is still too high at some firms.

Improved inspection results

Among the firms that CPAB inspects annually⁴ (Annual Firms) there was a 36 per cent decline in audit deficiencies⁵ identified, indicating a reduced risk of restatements. In most cases, when audit firms performed additional audit work necessary to remedy deficiencies there was no restatement of the financial statements. However, this is a reflection of the reporting issuer's controls and processes and does not mean that a risk of restatement did not exist⁶. Annual Firms are taking the challenge of improving audit quality seriously and are making the necessary changes to embed quality into both how they do their audits and the way they structure and operate their audit practices.

³ This report contains important information for the investor community, audit committees and audit firms, as well as other regulators, each of whom has an important role to play in effective operation of Canada's capital markets.

⁴ In CPAB's view trends are best measured against the population of 14 Annual Firms (inspected each year – footnotes 1 and 2). These firms account for about 99.5 per cent of the market capitalization of listed reporting issuers.

⁵ An audit deficiency is defined as the failure to obtain sufficient appropriate audit evidence for a material account balance or transaction stream.

⁶ Audit quality depends on many factors, including an engaged auditor, capable management and effective governance. This is examined further in Section Two of this report.

While overall inspection results for the Annual Firms improved in 2013, not all firms are in the same place when it comes to the quality of their audits and some firms have more work to do. The firms with the best results in 2012 also had good inspections in 2013. With a few exceptions, the firms identified in 2012 as needing improvement did make progress this year. Audit quality is getting better, but the pace of improvement needs to be accelerated for some firms and the breadth of the improvement needs to be increased for others.

Big Four taking action

Each of the Big Four audit firms has introduced action plans to address CPAB's challenge to improve audit quality. In most cases, these plans have been in place for two years or more and all firms have made good progress in their audit quality objectives. While some are more advanced than others, CPAB is pleased to note that each firm is taking actions that should result in sustainable changes, rather than just short-term fixes.

CPAB believes implementation of these action plans has contributed significantly to the improvement in inspection results over the past two years. Furthermore, incorporating the plans into the annual planning cycle for the firm should benefit audit quality. While inspection results have improved for the Big Four firms overall, they have not each demonstrated the same level of improvement, with those focusing on the drivers of consistency in audit execution performing better than those concentrating on other aspects of audit quality. Action plans continue to focus on firm-specific needs to advance audit quality.

It is particularly encouraging to see initiatives firms are taking that should be successful in embedding quality throughout the audit process, rather than simply "inspecting it in" at the end. These include:

- Changing organizational structures to enhance accountability for quality.
- Redeploying resources to better support audit teams.
- Making meaningful process changes that incorporate additional quality monitoring throughout the entire audit process.

In addition to their action plans, firms are implementing CPAB's other mandatory recommendations that are contained in individual firm reports⁷. These include such measures as: reassessing workloads and/or capabilities of partners; enacting office-specific initiatives; changing audit approaches in specific areas (e.g. revenue); taking steps to improve consistency of execution (e.g. audit of estimates, controls, substantive analytics, etc.), and improving professional skepticism. CPAB will continue to monitor the implementation, effectiveness, and sustainability of these actions as part of its 2014 inspection program, and make further recommendations as appropriate.

⁷ For more information on firm reporting refer to Appendix B to this report.

Other annual national network/regional/local firms are responding

Following the 2012 inspections, CPAB required all the Next Four national network firms and six large Regional firms to either develop action plans similar to those implemented by the Big Four firms in previous years or to implement specific recommendations to improve audit quality. The timing of the 2012 inspections meant it was not possible for the plans to be fully effective for the 2013 audits. Consequently most firms introduced interim steps intended to have the greatest impact on improving audit quality in the short term, with the understanding that this would be a multi-year process. In 2013 CPAB accelerated the timing of its inspections of the Next Four firms to provide interim feedback and to ensure that future recommendations could be implemented in a timelier manner.

The Next Four and the six large Regional firms responded positively to the challenge and both groups showed improved inspection results in 2013. However, as was the case with the Big Four, not all firms have had the same level of success and some still have much work to do. These firms are assessing their progress and after considering CPAB's other recommendations will take appropriate action. Similar to the Big Four CPAB will continue to monitor the implementation, sustainability and effectiveness of these actions in 2014.

Challenges remain

Sustainable improvement

While CPAB is pleased with the progress made by all firms in enhancing audit quality, sustainability remains the challenge. The deeper changes get embedded into the culture of the firm and the longer they are in place the more sustainable they will be. Changing accountabilities within the audit practice/office, limiting who can do public company audits, making additional resources available in practice offices, and better recognizing

audit quality in performance reviews are good examples of how this can work. Results have been encouraging, but insufficient time has passed to conclude that changes are now permanent. CPAB will continue to monitor the situation in 2014, but remains optimistic that real, lasting change is taking place.

Consistent execution

While all firms are capable of executing quality audits, and do so regularly, consistent audit execution remains a challenge for firms to varying degrees. A lack of consistency leads to many of the audit deficiencies identified by CPAB inspectors.

CPAB's 2012 and 2013 inspections show the Big Four firms that focused on consistency of audit execution and provided on-site support to their people — for example, by making national resources available at the local office to address evolving audit issues, or by changing roles and accountabilities to focus on quality — showed the most improvement. CPAB encourages all firms to continue to focus on audit execution as an important way to enhance audit quality.

Canada is not alone

CPAB's 2013 inspection findings⁸ are not unique to Canada. They are comparable to prior findings by other audit regulators around the world who also raise concerns about professional skepticism, supervision and review, substantive analytical procedures (predicted results compared to actual results) and the quality of evidence in audit files.

While improvements have been noted, these areas have been consistent themes for regulators in the past and remain a challenge for the profession at large.

⁸ CPAB's 2013 Inspection Findings can be found in Section Three of this report.

Looking ahead

CPAB is pleased to note the positive trend in inspection results since its 2011 Public Report. Two years is not a long time, but there has been good progress and CPAB is encouraged by the positive manner in which the firms have responded to the challenge. That said, there is still work to do to achieve uniformly high audit quality.

Once again in 2013 CPAB believes that inconsistent application of professional skepticism, coupled with inadequate supervision and review, contributed to many of our more significant inspection findings. While firms have succeeded in reducing the number of audit deficiencies they have been less successful in getting to the root of the problem. These issues are core to the practice of auditing and it will take more time to get to a sustainable solution.

To further improve audit quality, CPAB believes firms need to:

- **Embed quality throughout the audit process:** Quality is not something that can be “inspected in” immediately prior to the release of the financial statements. Quality is a mindset. It needs to be everybody’s responsibility throughout the audit. Firms that are now doing this are having the greatest success.
- **Trust but verify:** Trust is the basis for a sound client-auditor relationship and skepticism is the foundation of a quality audit. This means engagement team members need to trust their clients and understand their businesses, but challenge them appropriately.
- **Reinforce an accountability culture:** Shared accountabilities enhance audit quality. Many factors combine to produce a quality audit and it is not realistic to hold one or two individuals solely accountable when factors may be beyond their control. Audit quality is a team effort.

- **Execute consistently:** Firms that placed a greater emphasis on drivers of consistency of audit execution showed the most improvement in audit quality. One of the key drivers of consistency is the experience of the engagement team with both the industry and the client. An experienced team is a capable, well supervised team that can execute consistently.
- **Develop and implement action plans:** The action plans that led to improved results were the ones that involved organizational changes that are essential to longer-term sustainable improvement. The firms with the most successful action plans have changed audit leadership, redeployed resources (to different offices and/or different clients) and revisited how they evaluate performance. Changes need to be real and substantive if they are to have lasting impact.
- **Balance commercialism and professionalism:** As well as being a business, audit firms are also part of a profession. Consequently, they need to strike the appropriate balance between their professional obligations and their economic business issues. For example from a business perspective firms might be tempted to do less work with fewer people or less experienced people when from a professional perspective the answer may be to do more or different work with more experienced people. Firms must always be conscious of this potential conflict and make sure it does not adversely impact audit quality.

Last year CPAB announced its strategic plan for 2013-15. This plan goes beyond the traditional inspections focus and enables CPAB to fulfill its mandate by not only engaging audit firms, but also other stakeholders who contribute to audit quality. Broader stakeholder engagement (especially focused on audit committees and reporting issuer management), along with timely communication of CPAB information on key drivers of audit quality and audit risks, will help those stakeholders perform their key roles and will lead to improved audit quality.



CPAB publicreport

During 2013 CPAB took the first steps to operationalize this plan, including:

- Significantly increasing its **outreach to audit committees** by holding discussion group meetings across Canada.
- Publishing a number of **communications** directly relevant **to audit committees**.
- **Redesigning its website** to better support and enhance relationships with key stakeholders.
- Entering into discussions with firms to develop a **protocol for sharing inspection findings** with audit committees.
- In conjunction with CPA Canada, releasing **guidance** and tools **to evaluate the external auditor**.
- Changing the **timing and focus of annual inspections**.
- **Engaging** with the Auditing and Assurance Standards Board (AASB) **on the need for implementation guidance for standards**.
- **Sharing Enhancing Audit Quality (EAQ) final reports globally**, providing Canadian viewpoints for policy makers to consider.

In implementing its strategic plan in the coming year, CPAB will build on the progress made in 2013 and will continue to focus on four priorities to further enhance audit quality: risk management; focused, effective inspections; thought leadership, and stakeholder engagement.

CPAB's 2013-15 strategic plan is available at www.cpab-ccrc.ca.

Section Two — Challenges in the Current Audit Environment

Business practices, legal and regulatory requirements, accounting rules and disclosures are all becoming more complex and contribute to greater challenges in the current audit environment.

Globalization — the need for regulator access

Many Canadian companies are expanding their operations into foreign countries. This may mean simply transacting business abroad, or, increasingly, acquiring and/or establishing operations outside Canada. Globalization of any business creates challenges for both the company and its professional advisors, including its auditor.

If the company has foreign-based operations, the Canadian parent-company auditor (group auditor) must ensure that it understands business practices and regulatory requirements applicable to each of the entities that now forms part of the consolidated financial statements of their client. Generally, the group auditor does not complete the audit of these foreign entities, instead engaging others (component auditors) to do this work on its behalf and under its direction.

To effectively direct the work of the component auditors, it is essential that the group auditor has a sound understanding of business and audit practices, customs and business structures which exist in other countries. CPAB challenged firms in this regard in its 2012 Public Report and is encouraged by the progress they have made in expanding their understanding of foreign countries. However, much more remains to be done.

While foreign audit firms may be members of the same global network as the Canadian auditor, they are not the same firm for the purposes of applying Generally Accepted Auditing Standards (GAAS). Consequently their work needs to be separately assessed and reviewed by the group auditor if it is to be relied upon for purposes of the consolidated audit opinion. Depending upon the significance of the foreign operation, it may be necessary to visit with component auditors, review their work and obtain extracts of working papers as considered necessary to support the consolidated audit opinion.

Generally speaking, the group auditor does whatever it believes is needed to satisfy itself about the suitability of the work performed by the component auditor. In many cases, the actual evidence contained in the group auditor's files of both this review and its conclusions is fairly limited, in part, on the understanding that further support can be obtained from the component auditor at a later date if needed.

To evaluate how the group auditor assessed the work of a significant component auditor, evidence of the component auditor's work and how it was evaluated needs to be available for review by CPAB. During its 2013 inspections CPAB requested access to information relating to audit files in Mexico, Tunisia and China and was denied due to limitations in local laws. This is unacceptable to CPAB and it will continue to explore how a foreign auditor based in Canada can be granted access, while an audit regulator cannot.

In CPAB's view it is the responsibility of the group auditor as a participating audit firm to ensure that sufficient and appropriate evidence is available for inspection to support its audit opinion on a Canadian reporting issuer. In CPAB's 2012 Public Report Canadian audit firms were challenged to provide this support and some have made more progress in this area than others, but overall, CPAB is disappointed with the lack of progress firms have made.

It is important for investors in Canadian reporting issuers with substantial operations in foreign countries to understand that the audit of these operations may not have been subject to inspection by CPAB or any other recognized audit regulator. Investors should be concerned about investing in countries that use legal means to deny access to the audit oversight body of the parent company.

Audit quality depends on many factors

A high quality audit is not just the result of the work of the auditor. Quality management at the company being audited and quality oversight by the audit committee are also key. Each party has a significant role to play and poor performance by any one of them can increase the risk of audit failure.

Capable management

Quality starts with the information available for audit. It is management's responsibility to maintain effective systems and processes to ensure that accurate financial information is available for audit. Similarly, management is responsible for producing the financial statements and for supporting judgments made in areas requiring significant estimates that get reflected in those statements. Capable management has good judgment and can appropriately support these to their auditor. The auditor can then focus on the issues and risks associated with the audit. If this is the case, then management has done its part to ensure a quality audit.

An engaged auditor

An engaged auditor is an important component to a high quality audit. If the auditor approaches the audit with an appropriate degree of professional skepticism, engages the right specialists, develops and implements an effective audit plan, and challenges management throughout the process, it will have done its part to ensure a quality audit.

An effective audit committee

The audit committee plays a critical role in creating the right environment for quality auditing. It is the audit committee's responsibility to create an atmosphere that accommodates an open discussion in a culture of integrity, respect and transparency between management and the auditor.

Audit committees are responsible for overseeing the work of the auditor. In so doing, they need to understand the audit strategy, be satisfied that it identifies the major risks, and that the auditor designs and executes an audit plan that addresses these risks. They must also make sure the auditor exercises appropriate professional skepticism and has an appropriately independent mindset from management. Ultimately, this will enable the audit committee to draw conclusions about the effectiveness of the audit.

Audit committees should ask their auditor what it is doing to promote consistency of audit execution, whether additional resources are available if needed to do the audit, and who in the audit firm is accountable for the quality of the work done. Audit committees should consider meeting the engagement quality control review partner (EQCR) as part of the audit process to understand what was done to ensure quality.

Audit committees are in the unique position of being able to evaluate the performance of both management and the auditor and can assess whether or not this has been appropriate. If they can conclude that it has, then they have fulfilled their role in ensuring a quality audit.

Greater transparency to improve audit quality

Sharing of inspection findings with audit committees

In 2013 CPAB consulted with stakeholders, including corporate directors through the Institute of Corporate Directors (ICD), audit firms and Canadian securities regulators (CSAs) to develop the Protocol for Audit Firm Communication of CPAB Inspection Findings with Audit Committees (Protocol). The objective of sharing inspection findings is to provide audit committees with information regarding CPAB's findings to support them in their role of overseeing and evaluating the auditor. The reporting of inspection findings to audit committees under this Protocol has two components:

- The overall findings contained in CPAB's annual Public Report.
- Significant findings specific to the individual reporting issuer, if selected for inspection.

CPAB believes the primary benefit of sharing inspection information is to improve audit quality through enhancing discussions among management, the auditor and the audit committee on the quality of the audit. This will allow the audit committee to more effectively oversee the work of the auditor and should improve its ability to evaluate the quality and effectiveness of the audit.

The Protocol was the subject of public consultation completed at the end of January 2014. The final Protocol, together with the responses to CPAB consultation, can be found at www.cpab-ccrc.ca.

The sharing of inspection findings for individual reporting issuers will begin for file reviews starting on or after March 1, 2014. All audit committees should expect to receive CPAB's Public Report directly from their audit engagement partner in 2014.

Audit firm sharing of disciplinary information with Securities Commissions

In early 2014, the CSA members finalized amendments to National Instrument 52-108 which, among other things, will increase the information that audit firms must report related to specified disciplinary actions.

The winds of change

International developments on audit policy

Over the last few years, there has been significant international discussion about the relative merits of mandatory firm rotation and/or tendering. Several countries have adopted or are considering changes to their audit regulations including:

- Netherlands: Passed legislation in 2013 to require mandatory audit firm rotation every eight years. This legislation will be effective in 2016.
- United Kingdom: The Competition Commission released a final report in October 2013 requiring mandatory tendering every 10 years.
- European Union: In December 2013 the European Union reached a preliminary agreement to require auditor rotation after 10 years, with the ability to serve for an additional 10 years if the audit has been put out for tender. In the case of joint audits the firm may serve for an additional 14 years if the audit is put out for tender.

CPAB is not aware of any compelling evidence supporting the notion that mandatory firm rotation or tendering leads to improved audit quality. It is concerned that either alternative could become a procurement exercise resulting in "a race to the bottom" on audit fees without sufficient focus on audit quality. CPAB is also concerned that the threat of a tender or auditor change can put pressure on an auditor to not challenge management, actually negatively impacting audit quality.

The questions remain: How should Canada be responding to a global trend towards mandatory rotation and tendering? Does Canada need to have a unique tailored regulatory response to international developments?

While mandatory firm rotation or tendering is not currently required, it is possible that such requirements in other jurisdictions could result in increased tendering in Canada. This could either be as a response to the perceived benefits of independence “in appearance” — regardless of regulation or so reporting issuers can be seen as having good governance practice. Either way, CPAB believes this could result in a decrease in audit quality. This is of particular concern if audit committees place a disproportionate amount of weight on the audit fee, as opposed to factors such as the experience of the engagement team, the effectiveness of the firm’s audit methodology, the audit approach proposed, the timing and extent of audit procedures, etc. when assessing audit proposals.

When pursuing an audit tender we encourage audit committees to focus on obtaining a high quality audit. CPAB believes this can be achieved through a Two Envelope approach to the audit tender. In this approach, audit firms must separate the requested audit fee from the rest of their proposal. Audit committees are then required to review the proposals without knowledge of the audit fee, and select an auditor based solely on their qualifications and ability to deliver a high quality audit. Only after the auditor has been selected should the audit fee be evaluated and negotiated.

Audit firms are not interchangeable. The audit is not a commodity whereby the lowest price should prevail. The best value for shareholders is not necessarily the lowest audit fee. This needs to be at the forefront when audit committees are evaluating tenders.

Auditor reporting model

The International Auditing and Assurance Standards Board (IAASB) issued its exposure draft on Auditor Reporting in 2013. This contained significant additions in the information presented specifically related to the publication of Key Audit Matters. CPAB engaged with stakeholders to obtain perspectives on the exposure draft in developing its response letter, which can be found at www.cpab-ccrc.ca.

Overall, CPAB:

- Supports the need for more transparency with respect to auditor reporting.
- Believes the disclosure of Key Audit Matters will focus the attention of auditors, management and those charged with governance on the areas of most significant risk. However, auditors must ensure Key Audit Matters are informative, relevant and entity-specific.
- Does not support the proposals related to going concern disclosures because these may increase, rather than decrease, the users’ expectations gap.
- Is disappointed that the IAASB has chosen not to pursue a requirement to disclose in the audit report the extent of involvement of other auditors in the audit.

Standard setting — application guidance

CPAB has noted inconsistencies in the application of certain auditing standards as well as situations where further application guidance is required to enhance audit quality and consistency of audit execution. CPAB is concerned that at the international level the IAASB has no rapid response mechanism to address standards implementation issues. For example, audit regulators around the world have raised issues with respect to the standard on group audits (ISA 600). The IAASB plans to begin gathering information in 2015 on a project to revise this standard with amendments unlikely before 2018.

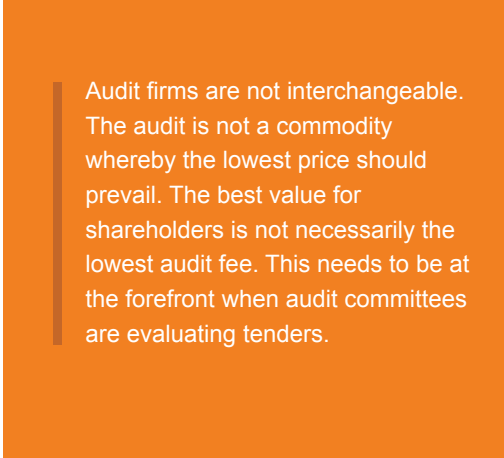
CPAB is currently working with CPA Canada to provide input into the timely development of application guidance for higher priority areas where implementation issues have been identified. Although it is CPAB's preference that application guidance be issued by CPA Canada, the Canadian Auditing and Assurance Standards Board or the IAASB, if such guidance cannot be issued in a timely manner then CPAB will address these issues in the public interest.

The future of audit

As the Enhancing Audit Quality initiative recommendations are implemented in 2014 CPAB believes there is need for a broader debate on the future of audit. Are key stakeholders receiving appropriate value from the audit? How does auditing need to change to deliver greater value to audit committees and investors? Canada should lead the way in this debate and CPAB will continue to work with key stakeholders to influence change at the global level.

Annual assessment and comprehensive review of the external audit firm

Working with a group of experienced audit committees (through the ICD) and CPAB, CPA Canada developed guidance on the annual assessment of audit firms based on the considerations provided in the EAQ final report. It also developed new guidance and tools to assist audit committees conduct a periodic comprehensive review of the audit firm.



Audit firms are not interchangeable. The audit is not a commodity whereby the lowest price should prevail. The best value for shareholders is not necessarily the lowest audit fee. This needs to be at the forefront when audit committees are evaluating tenders.

Section Three — 2013 Inspections

CPAB's mission, methodology and risk analysis

CPAB's mission is to contribute to public confidence in the integrity of financial reporting of reporting issuers in Canada by effective regulation and promoting quality, independent auditing. CPAB achieves its mission by inspecting public accounting firms that audit reporting issuers in Canada and by providing the firms with recommendations designed to improve audit quality.

Enhancing investor confidence in quality auditing

Annually, CPAB inspects all firms that audit more than 100 reporting issuers. These firms audit approximately 99.5 per cent of the total market capitalization of public companies trading in Canada. There are currently 14 firms in this category.

CPAB identifies the higher-risk clients of each firm using a proprietary risk-based model to evaluate the entire population of approximately 8,000 reporting issuers. Inspection leaders, in consultation with CPAB's Risk Management group, select the engagements to be examined from this larger population. The inspections follow a risk-based methodology and focus on the two to four higher-risk areas applicable to the individual reporting issuer as determined by the inspection leader. CPAB's inspection methodology identifies root causes of audit deficiencies with the goal of making key recommendations to improve audit quality. CPAB's inspections are designed to determine, among other things, whether the audit firm's quality control processes are operating effectively.

Elements of quality control

In addition to evaluating engagement performance, CPAB reviews the other five elements set out in the Canadian Standards on Quality Control. These five areas, which are the foundation for good audit quality, are:

- Leadership responsibilities for quality within the firm.
- Ethical requirements (including independence).
- Acceptance and continuance of client relationships and specific assurance engagements.
- Human resources (including training).
- Monitoring (by firms of their quality control systems and of their application).

Treatment of audit deficiencies

Audit firms are required to implement CPAB's recommendations to address audit deficiencies noted in their inspection. CPAB follows up each inspection to ensure that the required actions are taken. If material Generally Accepted Accounting Principles (GAAP) deficiencies are identified, this may result in the restatement of previously issued financial statements.

In the past certain audit firms have characterized CPAB's findings as resulting from "a lack of documentation" or a "difference in professional judgment." In fact, about 94 per cent of CPAB's 2013 inspection findings required the audit firm to carry out additional audit procedures to confirm there was no need to restate the financial statements due to a material error. For the remaining six per cent of findings, audit firms were required to add considerable evidence to the audit file to demonstrate they had obtained sufficient and appropriate audit support with respect to a major balance sheet item or transaction stream.

Firm inspection report recommendations

CPAB provides reports to firms inspected at both an individual engagement and overall firm level⁹. These firm reports contain recommendations to address deficiencies related to engagement performance arising from either systemic/firmwide processes or specific engagement files that were inspected. Deficiencies noted in the other elements of quality control may also result in recommendations. The inspection report separately identifies CPAB's top three to five recommendations that, when implemented, it believes would improve audit quality.

It is important to note that CPAB's mandatory recommendations must be implemented by the audit firm within 180 days of the date of the inspection report. However, for more serious findings this deadline may be much shorter. This is particularly true where there may be a potential restatement of the financial statements.

Failure to implement recommendations to CPAB's satisfaction within the time frame specified gives rise to disciplinary action¹⁰ being placed on the audit firm. When CPAB believes that the firm's quality of auditing is so substandard that the investing public is at risk, disciplinary action will also be taken. Discipline escalates, from Requirements which limit the scope of the audit work the firm can undertake until the identified deficiencies have been corrected, through to Sanctions which can prohibit the firm from auditing reporting issuers.

At the end of 2013 CPAB had Requirements/Restrictions in place on nine firms. There are currently no Sanctions on any firm.

2013 Inspections

This report summarizes the results of CPAB's inspections of the Big Four firms, Other Firms subject to annual inspection, Regional/Local Firms and Foreign Firms during 2013.

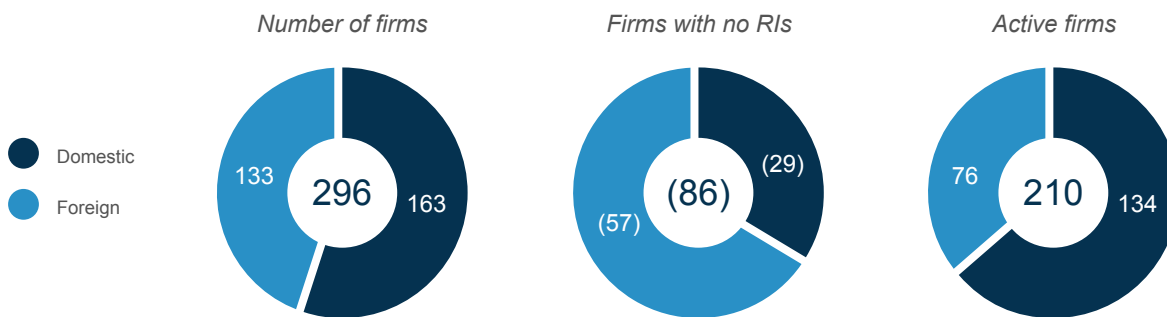
⁹ Appendix B to this report contains a comprehensive description of the CPAB reporting process.

¹⁰ A complete description of the discipline process can be found in Appendix B.

Focused, effective inspections

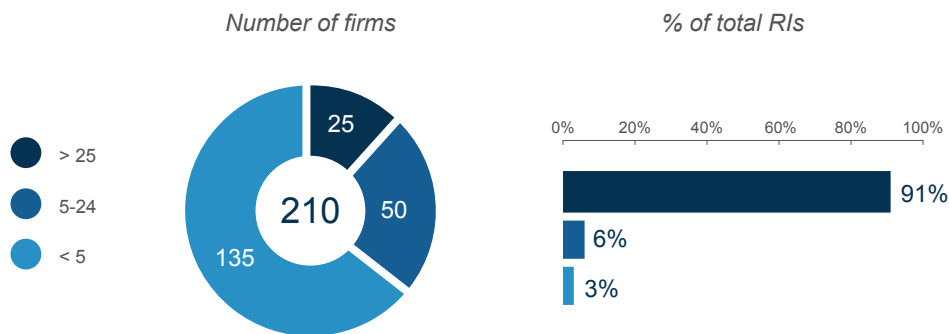
To put things in context, it is important to understand the composition of CPAB’s inspection universe. In January 2013, 296 firms were registered with CPAB. As shown in Table 1, 210 of these firms had active practices auditing reporting issuers.

Table 1: Participating Audit Firms at January 2013



While 210 firms were engaged in the practice of auditing reporting issuers many, as shown in Table 2, had very few public company clients.

Table 2: Concentration of Reporting Issuers By Firm



CPAB concentrates its resources on the 75 firms that audit in excess of 97 per cent of reporting issuers and account for over 99.5 per cent of total market capitalization. In so doing, while CPAB employs its risk model to assess 100 per cent of the population of reporting issuers, it will only inspect firms with less than five reporting issuer clients if they are identified by the model as having clients of significant risk to the investing public or they are selected by CPAB’s desk inspection program. Otherwise, provincial regulatory bodies will inspect these firms on CPAB’s behalf.

The best ways to improve audit quality

Over the past few years CPAB has required a number of audit firms to develop action plans to address audit quality issues. It is pleased to note the positive response and effort that many of these firms have demonstrated in addressing this challenge. Without sharing information of a proprietary nature, CPAB has identified a number of themes that have helped firms be successful and encourages firms to consider these when assessing how they approach audit quality issues of their own.

Appropriate tone-at-the-top

It is often said: “If it’s important to my boss, it’s important to me”. Nowhere is this truer than with respect to audit quality. However, it is not enough for firm leadership to simply talk about audit quality — they need to live it to achieve sustained improvement.

This could mean: assigning more experienced staff to work in the audit practice; moving resources out of the national office and into the practice offices to be closer to the engagement teams; limiting the staff who can work on reporting issuer clients to those with the best and most appropriate experience; rebalancing workloads to ensure people have sufficient time to do quality work, and appropriately recognizing/cultivating high quality within the audit practice.

Firms must make meaningful changes, appropriate to their own cultures, if sustainable improvements in audit quality are to take place. Each firm must decide what works best for them. There is no one right answer, but it is clear that firms can’t succeed without the support of their leaders. This becomes a shared responsibility and a shared accountability.

Embed quality throughout the audit process

In an audit there are two ways to improve quality. You can either build in quality processes throughout the audit or you can inspect it in at the end. CPAB is seeing both approaches used by firms.

In CPAB’s view, the firms that have been the most successful in transitioning to a quality culture have tried to build quality in throughout the audit process. This often starts with the tone from leadership and continues on throughout the audit methodology and into how this is applied in practice (e.g. including practice aides, allocation/deployment of resources, shared accountabilities for quality, etc.) and ultimately into how quality is recognized within the firm. In this way real, sustainable change can take place.

Firms that put additional review processes in place at the end of the audit can achieve short-term improvements. However, CPAB questions how sustainable these changes will be longer-term since they often occur too late in the process to address the cause of the quality issues themselves and, given their timing, could adversely affect the client’s view of the audit. These reviews are more “detective” controls which identify poor quality than “preventive” controls which stop poor quality before it happens. After a short period of success it is too easy to drop these reviews as having solved the problem, when in fact nothing has really changed.

CPAB recognizes firms often need to take short-term measures to get the quick wins that lead to longer-term success and acknowledges that such an approach can be effective. CPAB just cautions that these measures may not be sustainable longer-term.

Develop a supportive organization

In many firms, the engagement partner is solely accountable for quality and performance on an audit engagement. This view oversimplifies the audit process and ultimately, in CPAB's view, will not contribute to better audit quality. CPAB believes shared accountabilities are required to enhance audit quality.

There are many factors that combine to create a quality audit, not all of which are within the control of the engagement partner, but each of which is the responsibility of someone within the firm. For example, quality depends on: the skills and capabilities of staff hired by the human resources department; the experience of the staff assigned to the engagement by the scheduling group; the quality of the managers made available by leadership; the overall training provided by the training department; the timeliness and effectiveness of the advice provided by the national technical group, and the quality of the client (e.g. people and systems) itself. Any of these factors could contribute to poor audit quality.

For the process to be effective, everyone should be accountable for audit quality. This should begin with the audit firm's CEO right down to the most junior member of the audit team. Each firm must develop a supportive environment where "doing it right" is valued and actively supported and encouraged by the firm's leadership. Individuals who are held accountable must have the authority to deal with quality issues that affect audit performance.

Execute consistently

CPAB's inspections continue to indicate that a majority of audits are of high quality. This means that in most cases firms can, and do, execute quality audits. The challenge is to ensure that all audits are of a uniform high quality.

Reasons for poor audit quality are usually circumstance-specific, but in CPAB's experience are most often a function of time pressure or inadequate supervision and review. CPAB encourages firms to develop processes or systems to ensure that partners and professional staff have sufficient time to consistently complete a quality audit. Firms should also emphasize the importance of quality supervision and effective review of audit work, particularly in high-risk areas.

CPAB believes firms must effectively use the skills and knowledge of their most experienced practitioners through visibility and consultation across all audit engagements to improve audit quality overall. Specialist resources should be employed wherever practicable and their knowledge should also be shared throughout the engagement team.

Be skeptical

The foundation to any quality audit is a healthy sense of professional skepticism. This means that an audit should be approached with a questioning attitude. The auditor should not be afraid to question and challenge the client, not just accept the responses that the client provides.

In any healthy client relationship, there needs to be a sense of trust, but as has been said, the auditor must trust, but verify. In too many cases auditors are too accepting. This is often the root of many audit failures.

Inspection results

The Inspection Process, including its scope, is more fully described in Appendices A and B to this report. Appendix D elaborates on the findings described below and discusses some other common issues that may be of interest to audit committees. Throughout the inspection year CPAB has frequent, ongoing interactions with participating audit firms and these, together with written dialogue concerning identified audit deficiencies, are how it can influence meaningful, sustainable improvement in audit quality.

By its nature, the risk-based methodology used by CPAB to choose the files (and the areas of the files) to be inspected does not necessarily result in a representative sample of a firm's public company audit work. In general, for each firm inspected, CPAB's selection of audit files is biased towards higher-risk audit areas of more complex public companies or companies where the firm may have less expertise, so there is a greater likelihood of encountering audit quality issues. Simply put, CPAB's bias is towards the riskiest areas of any file inspected.

Furthermore, CPAB does not report on areas of the audit file where auditors performed to or beyond the required standards. Therefore, this report does not represent a balanced scorecard. Given the inspection process, results should not be extrapolated across the entire population, but instead be viewed as an indication of how firms address their most challenging audit situations.

Big Four inspection results

In 2013 CPAB inspected 105 engagement files at the Big Four firms and is pleased to report a continued overall improvement in audit quality. This year's inspection results showed a 43 per cent decline (33 per cent last year) in files with significant audit deficiencies.

All firms demonstrated progress and have action plans in place to continue this in 2014. While not all Big Four firms have achieved the same level of success in reaching their audit quality goals, CPAB believes their action plans will allow them to achieve these in the near term. A positive measure of what this means in practice is that none of the files inspected resulted in restatements.

Common inspection findings

The areas involving the most complexity and judgment, and requiring the involvement of the most experienced auditors continue to feature high on the list of findings among the Big Four firms. In most audits, up to 80 per cent of work is conducted by staff with less than five years' experience. This is a product of the traditional pyramid organizational structure in most audit firms. It is also a contributing factor to our most common inspection findings.

With experience comes skepticism. Less experienced staff approach the audit using checklists to ensure that all professional standards are satisfied, while more experienced auditors focus on the risks that they know to exist in the company and/or industry and ensure that these are appropriately addressed and mitigated. Experienced auditors see the big picture. Firms are challenged to keep experienced auditors appropriately engaged.

In a similar vein, experience is needed to assess complex accounting estimates and judgments. Experience is what contributes to an auditor's professional judgment and the more an auditor has, the sounder their judgment should be.

The themes of experience and skepticism are common in our 2013 inspection findings.

Lack of professional skepticism

A healthy degree of professional skepticism is the foundation of an effective, quality audit. It is not good enough for an auditor to simply accept management's views without appropriate challenge. Effective auditors weigh what management tells them against what they know of the client's business, together with their knowledge of the broader business environment. In doing so 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 position.

CPAB's inspections continue to identify a need for firms to enhance the professional skepticism of their staff. Firms must ensure their people appreciate the importance of professional skepticism and they must embed appropriate processes and behaviors in their methodologies and cultures. Specifically, CPAB believes firms need to:

- Ensure that senior members of the engagement team are rotated frequently enough to avoid complacency or the threat of familiarity. This is particularly important for non-partners not subject to mandatory rotation requirements.
- Increase the visibility and effectiveness of senior engagement team members during all audits. There is a critical need for a firm's most experienced auditors to transfer their knowledge to more junior staff. Not only does this reduce the learning curve of less experienced staff, it also enhances their effectiveness. A firm's most experienced auditors should lead from the front. This means they must: be visible to both the client and the engagement team; review all significant areas of the audit file; avoid electronic off-site reviews, which result in less face-time with other team members; engage staff in discussions about audit risk and audit quality and challenge their judgments, and never accept substandard work.

- Require engagement teams to be less accepting and more challenging in their approach to an audit. This can start with the interactions among partners and managers and their field staff.
- Enhance the training of professionals in exercising professional skepticism. This could include core training that emphasizes questioning, listening and probing skills.
- Encourage all team members to challenge the status quo, including reinforcing the danger of assuming that because the audit approach to an area has been determined in prior years, it does not need to be revisited in light of current facts and circumstances.

Audit of accounting estimates

The application of accounting policies to prepare financial statements involves a number of difficult estimates and judgments. Since these can be complex, and may be influenced by management bias, CPAB often chooses these areas for inspection.

Complex estimates and judgments commonly include impairment of long-lived assets, provisions for inventory obsolescence, warranty provisions, costs to complete for long-term construction contracts, fair values of complex financial instruments, complex revenue arrangements and accounting for business combinations. Estimates relating to impairment and going concern evaluations usually require the preparation of a cash flow forecast and frequently involve specialists.

Audit deficiencies noted by CPAB can usually be attributed to: insufficient consideration of the risks of material misstatement arising from estimation uncertainty; inadequate or inappropriate audit procedures to address those risks, and insufficient professional skepticism through a failure to either challenge management to corroborate their representations or respond to indicators of management bias by extending or modifying the planned audit procedures.

The most common audit deficiencies reported by CPAB with respect to complex accounting estimates resulted from impairment assessments which involved fair value determinations and the audit of financial projections. Frequently, fair values had been determined by valuation specialists. CPAB found numerous instances where the auditor did not apply appropriate professional skepticism to management's estimates. Instead, the tendency was to accept management's analysis, no matter how optimistic, with little consideration of plausibility and alignment with future operating plans. In many cases, audit teams do not clearly understand where they are responsible to support their own valuation experts, and often basic procedures that could support the credibility of the estimates were not completed.

CPAB believes audit work in this area would improve if more senior members of the engagement team were involved throughout the process. This involvement starts with determining the best audit approach and continues through ongoing discussion with the engagement team and a detailed review of the audit work to ensure they exercised an appropriate level of professional skepticism. Greater involvement of the engagement quality control reviewer or second partner in challenging the audit of estimates would also add a level of objectivity and oversight that is frequently missing.

Audit work on internal controls

Given the complexity of control systems in many enterprises, taking a controls approach may be the only practical way of conducting the audit and the engagement team can require the assistance of an expert in controls testing. As in most other areas of an audit, a great deal of experience is required to effectively execute a controls-based audit. However, in many cases engagement teams who don't have the expertise to effectively undertake a controls approach without assistance choose not to involve an expert to assist them. This greatly reduces the likelihood of an effective audit.

Audit deficiencies noted by CPAB often result when the engagement team does not identify the key control that must be tested. In this same vein, the control testing itself is flawed if the wrong control was tested, the testing did not cover the entire audit period, or the impact of a control not operating effectively was inadequately addressed. Frequently, CPAB encounters situations where auditors have relied on systems descriptions prepared by management without performing their own objective evaluation of those controls relevant to the audit.

Two of the most common deficiencies identified are:

- Relying on a sign-off signature as documentary evidence that a control was working, without further review of other evidence to demonstrate that the control operated effectively.
- Relying on inquiry, without examining corroborating evidence, to verify that a control was operating as designed.

CPAB believes all firms need to critically re-evaluate how they approach a controls audit and ensure that appropriate training and guidance is provided to engagement teams. Furthermore, given the complexity of this area firms should consider mandating the use of specialist controls experts on all audits where the systems are considered to be complex.

Inspections of Other Firms

In 2013, CPAB inspected 49 engagement files at 10 Other Firms inspected annually. CPAB also inspected 30 engagement files at 18 Regional/Local firms and two files at two Foreign firms.

Common inspection findings

All of the findings noted for the Big Four firms apply to the other firms. In addition, the following findings have a greater applicability to these other firms.

Group audits/foreign jurisdictions

Many firms audit reporting issuers with operations around the world. In so doing, they rely on component auditors to perform large parts of these engagements. Unlike large international firms, which have affiliates around the world with a common methodology, most non-network firms rely on foreign audit firms within loose network affiliations or non-affiliated local foreign audit firms.

CPAB has found that firms generally failed to assess their ability to act as the group auditor in situations where substantially all operations were conducted in a foreign jurisdiction. Firms also did not adequately assess the qualifications and experience of component auditors with respect to both auditing and accounting capabilities.

Firms need to perform a robust assessment of the extent of their involvement in the planning and supervision of a component auditor's work. They must also consider whether sufficient access to a component auditor's working papers can be obtained.

In situations where firms choose to undertake the work in foreign jurisdictions themselves they need to ensure that they have adequate knowledge of the customs and business practices in those countries and that they obtain all necessary licenses.

Use of management's expert

Reporting issuers frequently employ experts in other fields to determine amounts in the financial statements. This often includes experts in estimating resource reserves, valuing financial instruments or valuing tangible or intangible assets.

CPAB has noted that firms of all sizes frequently fail to assess the competence, capabilities and objectivity of experts and to understand the methodology used to develop estimates and valuations. Firms must also recognize that the reliability of the underlying source data provided to the expert must be tested by them and be consistent with their overall understanding of the business.

Impairment testing

Firms must frequently audit management's assessment of fair value for the purposes of determining possible impairment of assets. This is typically determined by analyzing cash flow projections.

CPAB has noted that firms of all sizes do not sufficiently analyze whether projections are based on reasonable and supportable assumptions and discount rates. Firms need to exercise a high degree of professional skepticism when analyzing projections prepared by management. CPAB has seen many examples where they were overly optimistic.

Reliance on internal controls

Smaller reporting issuers often lack effective controls due to limited resources and the opportunity for management override. Firms should therefore place very limited reliance on internal controls when auditing smaller reporting issuers, although they will still need to assess the design of the controls in significant areas of risk.

In limited cases, smaller reporting issuers may have effective controls which auditors may rely upon if they have been tested appropriately. When assessing the effectiveness of internal controls, firms frequently fail to identify and test controls that mitigate audit risks at the assertion level. Due to their inexperience in taking a reliance-on-controls audit approach, smaller firms must proceed with caution when they intend to rely on internal controls.

Section Four — CPAB’s 2013-2015 Strategic Plan

CPAB’s 2013-15 strategic plan focuses on four priorities:

- Risk Management
- Focused, Effective Inspections
- Thought Leadership
- Stakeholder Engagement

CPAB’s 2013-2015 strategic plan will enhance its effectiveness in the face of heightened challenges to audit quality. One of the core objectives of the strategic plan is to ensure audit firms reduce the incidence of audit deficiencies in a manner that is sustainable in the longer term.

Through this plan CPAB will undergo a strategic transition. This will enable it to achieve its regulatory mandate by enhancing its inspection methodology and reporting, and by contributing to sustainable improvement in audit quality through increased engagement with a broader range of stakeholders.

As noted in Section One of this report, significant progress has already been made in operationalizing this strategic plan, including increased outreach/interaction with audit committees (through discussion meetings, targeted communications, engagement concerning the Protocol for sharing inspection findings, etc.), liaising with CPA Canada, the AASB and other regulators and standards setters on audit quality issues, changing the timing and focus of our annual inspections, and an improved website designed to cultivate and support relationships with key stakeholders.

In assessing where this might take CPAB in the future, it is helpful to revisit the four priorities set out in the strategic plan.

Risk management

It continues to be important for CPAB to pursue leading edge risk strategies and maintain processes and systems to keep abreast of the risk factors affecting audit quality. These include: research and analysis of the reporting issuer population (specifically identifying outliers); ongoing environmental scanning; root-cause-focused inspections, and key stakeholder engagement. These measures will help embed risk discipline in the fabric of the organization.

Focused, effective inspections

CPAB’s inspection methodology provides a sound basis for evaluating audit quality. However, events in the operating environment may necessitate changes to enable CPAB to better evaluate underlying factors that are affecting audit quality. This will ensure CPAB’s regulatory actions continue to be targeted and effective.

CPAB’s inspection methodology is not static. It changes periodically to better enable it to identify the root causes of audit quality shortfalls, considering such factors as capability, accountability and organizational structure of audit firms. The inspection methodology will also evolve to include broader risk assessment and more insightful recommendations and/or requirements.

Thought leadership

Through thought leadership, CPAB will enhance audit quality and investor protection by raising stakeholder awareness of all aspects of audit quality and by engaging them in a dialogue on related issues. One way to achieve this is through research and publication of discussion papers on current issues affecting audit quality.

CPAB will actively seek opportunities to collaborate with other stakeholders on initiatives to advance audit knowledge and practice. CPAB will also leverage the information it acquires from its inspections to advise on and influence standards formulation, risk identification and business practices. Through thought leadership, CPAB is in a unique position to contribute to the state of audit quality, audit committee effectiveness and international audit regulatory development.

Stakeholder engagement

Audit firms and financial statement preparers are not the only participants in the audit process. Audit committees, institutional investors and financial analysts also play important roles. If stakeholders have better information on audit quality issues and engage in a dialogue about CPAB's inspection findings, all stakeholders, including CPAB, can perform their roles more effectively and audit quality will benefit. CPAB will continue to proactively engage other stakeholders and will clearly articulate its concerns to audit firms and audit committees.

CPAB's inspection methodology is not static. It changes periodically to better enable it to identify the root causes of audit quality shortfalls, considering such factors as capability, accountability and organizational structure of audit firms.

CPAB's 2013-15 strategic plan is available at www.cpab-ccrc.ca.

Appendix A: Scope of CPAB’s Inspection Program

2013 inspections

During 2013, CPAB inspected 49 firms and inspected 195 engagements as follows:

	Number of Firms		Number of Engagements	
	2013	2012	2013	2012
Big Four Firms	4	4		
Full scope			105	103
Special				25 ¹¹
Other Firms Inspected Annually	10	10	49	44
Other Firms	20	24	32	39
Sub-total	34	38	186	211
Follow-up inspections¹²	15	23	9	25
Total	49	61	195	236

In addition provincial professional accounting bodies inspected 71 firms in 2013 (51 in 2012) that audit reporting issuers. This report does not cover the findings from their inspections.

In 2013 the reduction in the number of firms and total files inspected reflects a combination of factors. Inspection activity cannot solely be measured by the number of firms and files inspected since CPAB is now taking a broader perspective,

assessing such factors as action plans, firm structure, internal monitoring, etc. which are necessary to get at the underlying issues related to audit quality, and resources have been redeployed to these other initiatives.

¹¹ In 2012 CPAB performed limited scope inspections to specifically assess compliance with CAS 600. In 2013 additional procedures were completed on sections of firmwide elements (e.g. quality monitoring) which were not engagement-specific.

¹² In a follow-up inspection CPAB verifies that the firm has implemented the inspection recommendations and only inspects a new audit file in a situation when there is a Requirement on the firm. Follow-ups in 2012 reflect special inspections on China-based reporting issuers in 2011.

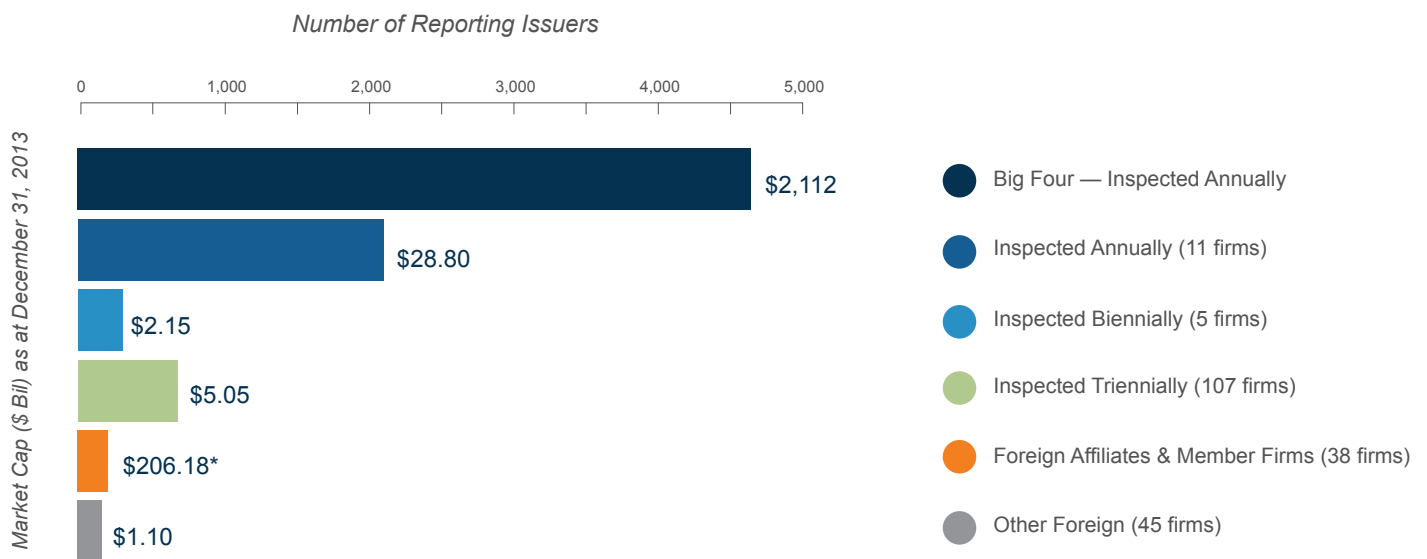
Inspection frequency and scope

As noted in Appendix B, CPAB annually inspects all firms which audit more than 100 reporting issuers. This includes the Big Four firms (which audit 98 per cent of reporting issuers by market capitalization) as well as 10 national and regional firms across Canada. Together, these annual firms account for over 99.5 per cent of market capitalization. The remaining firms are subject to either biennial or triennial inspection, depending on their number of reporting issuer clients.

In general for each firm CPAB inspects audit files relating to higher-risk audit areas of more complex public companies or companies where the firm may have less expertise so there is a greater likelihood that CPAB will identify audit quality issues.

CPAB sees many examples of quality audit work where engagement teams exhibited a high degree of professional skepticism and required management to adjust the financial statements or amend disclosures as a result of the audit, however we do not report on these results. Therefore, this report does not represent a balanced scorecard.

Distribution of Canadian RIs by Audit Firm Inspection Frequency



*Note: These RIs are primarily subject to audit regulator oversight in their own jurisdictions.

Appendix B: CPAB's Inspection Process

CPAB's mission is to contribute to public confidence in the integrity of financial reporting of public companies in Canada by effective regulation and by promoting quality, independent auditing. This is primarily achieved through the inspection of selected high-risk sections of audit files of reporting issuers and an evaluation of the elements of quality control of the firms who audit them.

Inspection cycle

Firms are subject to inspection by CPAB depending on their number of RI clients. Generally, firms with more than 100 RI clients are subject to annual inspection; those with between 50 and 100 clients are subject to inspection every two years, and other firms are subject to inspection every three years.

Risk-based approach

Risk analysis and assessment are embedded throughout CPAB. This is reflected in our overall research and analysis of the RI population, ongoing environmental scanning (including media monitoring), risk-based selection of RIs and risk-based allocation of CPAB resources to the inspections of audit firms.

CPAB has developed a Composite Risk model which is used to identify and rate the RIs and audit firms that may represent the most significant risks to the investing public. By combining the RI's risk on a standalone basis (RI Risk) with risk factors associated with the audit firm (Firm Risk) CPAB can devise overall Composite Risk rankings for both the audit firm and the RI. These are used to identify audits that have the highest risk of a material error or misstatement. This model is comprehensive, taking into account the general economy, the industry in which the RI operates, the RI's financial stability, size and foreign exposure, management's track record, the audit firm's risk profile, and the engagement partner's experience, including past inspection results.

The Firm Composite Risk assessment is used in determining the non-annual audit firms inspected each year. It is also instrumental in deciding the number of files inspected at each firm. In turn, the RI Composite Risk helps identify the specific files to be inspected at each firm. Lastly, an assessment of Composite Risks helps determine the resource allocation for all inspections.

The risk assessment process is managed by CPAB's Risk Management team (Risk), with input from the individual inspection teams and CPAB management. Risk also conducts ongoing environmental scans and RIs of interest (due to such factors as negative media coverage, questionable accounting, industry concerns, high profile, etc.) may be selected for inspection at any time during the year.

Elements of quality control

In preparing for each firm inspection, CPAB asks the audit firm for information relating to the following six elements (Elements) of quality control:

- Leadership and tone at the top.
- Independence and ethics.
- Client acceptance and continuance.
- Human resources and professional development.
- Engagement performance.
- Quality monitoring.

All Elements are not necessarily reviewed each year or in each inspection. The inspection team evaluates the information provided in light of the firm's Composite Risks, including prior inspection results, and determines the Elements to be reviewed. The team is particularly interested in changes to processes and, for firms inspected annually, maintains an evergreen document which serves as a record of procedures in respect of each Element.

The results of individual file inspections also help determine Elements to be examined. While the primary focus is on the quality of the audit work, as evidenced in the audit files, deficiencies identified may cause the inspector to look at aspects of the firm's quality control processes. For example, CPAB may ask to see performance evaluations and training taken by the staff on the engagement or if the RI is outside the audit firm's traditional client base, the client acceptance procedures that were performed.

Inspection of files

For each individual file selected for inspection, CPAB asks the engagement team to prepare a profile which describes key metrics such as the names of senior engagement team members, specialists used, the hours charged, etc. It also identifies key engagement deliverables, including dates completed. The engagement profile is usually given to CPAB two weeks prior to the commencement of the file inspection. This provides the inspector an opportunity to get familiar with the RI and its issues prior to the initial meeting with the engagement team. The inspector will review publicly available information such as the financial statements and Management's Discussion and Analysis, as well as any file-specific information identified in the profile.

Technical reviews of financial statements are mandatory for non-Big Four firm inspections. The reviews are optional for the Big Four firms, depending on the nature and extent of the firm's own internal financial statement review process and the experience of the engagement team. If a technical review is required it is conducted by a CPAB GAAP specialist prior to the commencement of the inspection. Among other things, this highlights potential accounting issues to be addressed by the inspector and specific areas to be considered for a more focused review. If the technical reviewer identifies a potential material non-GAAP issue, the inspector must follow up on the matter and resolve it to the satisfaction of the technical reviewer.

The file inspection typically begins with a meeting between CPAB inspection and the RI engagement teams. This provides CPAB with additional background on the audit engagement and includes a high-level discussion of the audit approach to the focus areas.

It is important to note that CPAB does not inspect the entire audit file (i.e. not a "cover to cover" review). Usually inspectors consider between two and four focus areas as a basis for assessing the quality of audit work in a selected file. In keeping with our risk-based approach, these areas are generally material high-risk financial statement items requiring more complex estimates and judgments (e.g., impairment of long-lived assets, fair values of financial instruments, provision for warranties, etc.) by RI management and which present the most challenge to the engagement team. The inspection of an individual focus area covers the various stages of the audit process including planning, evaluation and reliance on internal controls, execution, evaluation of results, financial statement presentation and disclosure, and reporting to the audit committee.

In addition to the focus areas, selected core areas are reviewed for each file. These include such items as materiality, risk assessment, fraud, related-party transactions and communications with the audit committee.

Findings, reporting and discipline

Significant inspection findings

Before the inspector drafts a significant inspection finding, they confirm with the engagement team that CPAB has been provided with all available audit evidence. This ensures the inspector has all the facts before coming to a final conclusion on the matter. The inspector consults with other CPAB staff as appropriate and then discusses the proposed finding with the inspection team leader.

Once the inspection team determines that a significant inspection finding has been identified, it is referred to a panel of CPAB executives for review. This serves as a quality control check and is intended to ensure consistent treatment of similar findings across all inspections. Once it is agreed that the matter is a significant inspection finding, the inspector documents the finding in writing in an Engagement Findings Report (EFR). The EFR is then reviewed and approved by the team leader and CPAB executives and presented to the engagement team.

CPAB usually expects to receive a firm's written response to a significant inspection finding within 10 business days.

The inspector reviews the engagement team's response and completes the disposition section of the EFR. In most cases, CPAB requires the engagement team to perform more audit work in the current year to be satisfied there is not a material error in the financial statements that requires restatement. The engagement team must also provide CPAB with evidence and the results of the additional audit work undertaken. If it is decided that a restatement is necessary, CPAB requires the audit firm to advise the RI, including its audit committee. The inspection team follows up to make sure the restatement has occurred. In other cases, the disposition might require the engagement team to add considerable evidence to the audit

file of the audit work that was performed but not evidenced in the audit file. Again, the inspection team follows up to ensure that this is done. Frequently, CPAB's dispositions will also require changes to the firm's audit approach going forward.

It is important to note that the audit firm is required to implement CPAB's recommendations and must do so in a timely manner. Failure to comply could lead to disciplinary action.

Inspection reporting

At the conclusion of the firm inspection, CPAB holds an exit meeting with firm leadership to discuss the overall inspection results. CPAB then issues its inspection report, which is a confidential communication between CPAB and the firm. The inspection report includes a summary of the findings arising from the inspection, as well as recommendations to improve audit quality. In particular, CPAB highlights the top three to five recommendations that it believes will have the most impact on improving audit quality.

The audit firm must implement the recommendations to CPAB's satisfaction within a prescribed period of time, which is typically no more than 180 days. Most commonly, CPAB will identify specific actions that the firm must take in connection with its audits of the upcoming calendar year ends. In all cases, CPAB follows up to ensure its recommendations have been satisfactorily implemented.

Disciplinary actions

In situations where CPAB believes the audit firm has committed a Violation Event¹³, as defined under CPAB's Rules, it will evaluate the event. If CPAB believes the audit firm is not performing up to professional standards and is therefore placing the public at risk, CPAB can impose disciplinary actions. There are three types of disciplinary actions, escalating in terms of severity — a Requirement, a Restriction or a Sanction¹⁴. CPAB's Board of Directors must approve any resolution to impose or terminate a disciplinary action on a participating audit firm.

A firm which is the subject of a Restriction or a Sanction must report same to the Canadian Securities Regulators and, in the case of a Sanction, must also provide notice of same to the audit committees of its reporting issuer audit clients.

CPAB terminates a disciplinary action only after conducting a follow-up inspection which includes inspecting an engagement file. CPAB must be satisfied that the audit firm has met the conditions imposed by the disciplinary action.

Following inspections completed in 2013, CPAB has nine outstanding disciplinary actions — two Restrictions and seven Requirements. These actions limit the practice of the firms and/or their partners in their reporting issuer audits.

If CPAB believes the audit firm is not performing up to professional standards and is therefore placing the public at risk, CPAB can impose disciplinary actions.

¹³ Violation Event means (i) an act or practice, or omission to act, in violation of the Rules or Professional Standards that may have an effect on the provision of audit services to reporting issuers, (ii) a failure to supervise appropriately a person with a view to preventing violations of the Rules or Professional Standards, and such person has committed an act or omitted to act in violation of the Rules or Professional Standards that may have an effect on the provision of audit services to reporting issuers, (iii) a failure to cooperate with the terms of an Inspection or Investigation; or (iv) a failure to comply with the terms of any requirement, restriction or sanction imposed by the Board.

¹⁴ Requirements, Restrictions and Sanctions may include one or more of the following:

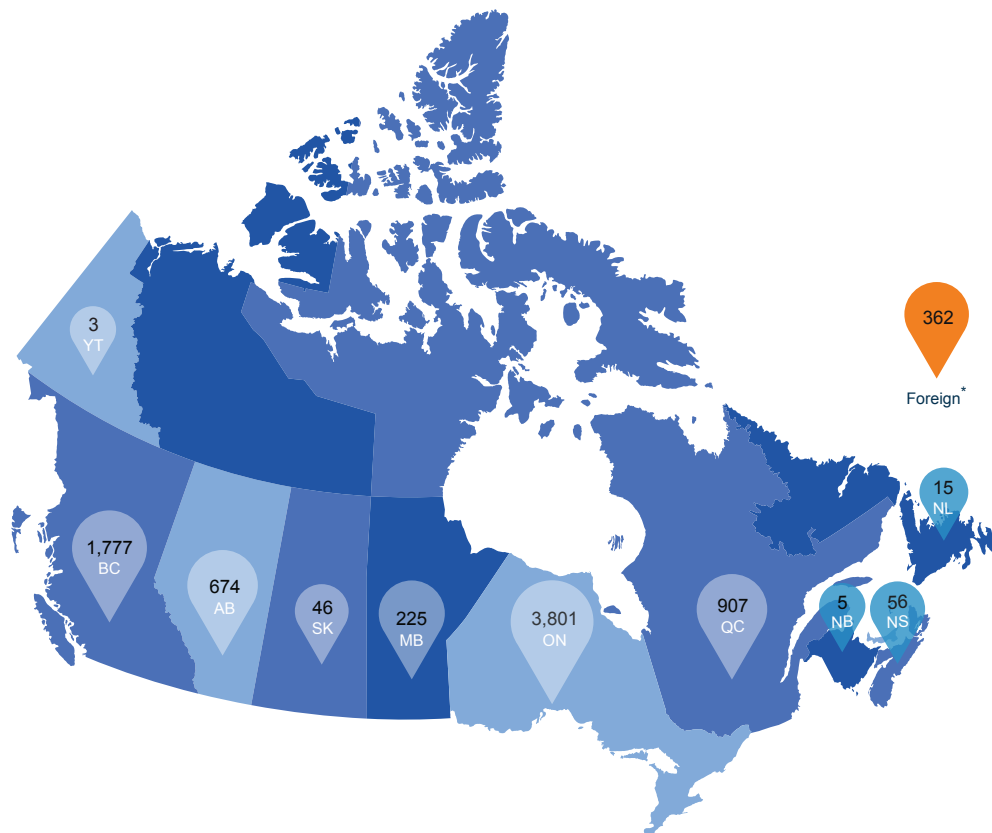
- | | |
|--|---|
| a. Additional professional education | f. Prohibition from accepting new reporting issuer audit clients |
| b. The design, adoption or implementation of policies to ensure compliance | g. Prohibition of designated individuals from doing reporting issuer audits |
| c. Assignment of a reviewer to oversee work | h. Public censure |
| d. Termination of one or more audit engagements | i. Termination as a participating firm |
| e. Appointment of an independent monitor | j. Other (as required) |

Appendix C: CPAB's Inspection Universe

As at December 31, 2013 there were 164 Canadian firms and 133 foreign firms participating in CPAB's regulatory program. These firms audit approximately 7,871 reporting issuers, including exchange traded funds and 2,626 non-exchange traded funds. Collectively, these entities had a market capitalization of approximately \$2.355 trillion.

Canadian Reporting Issuers by Geography

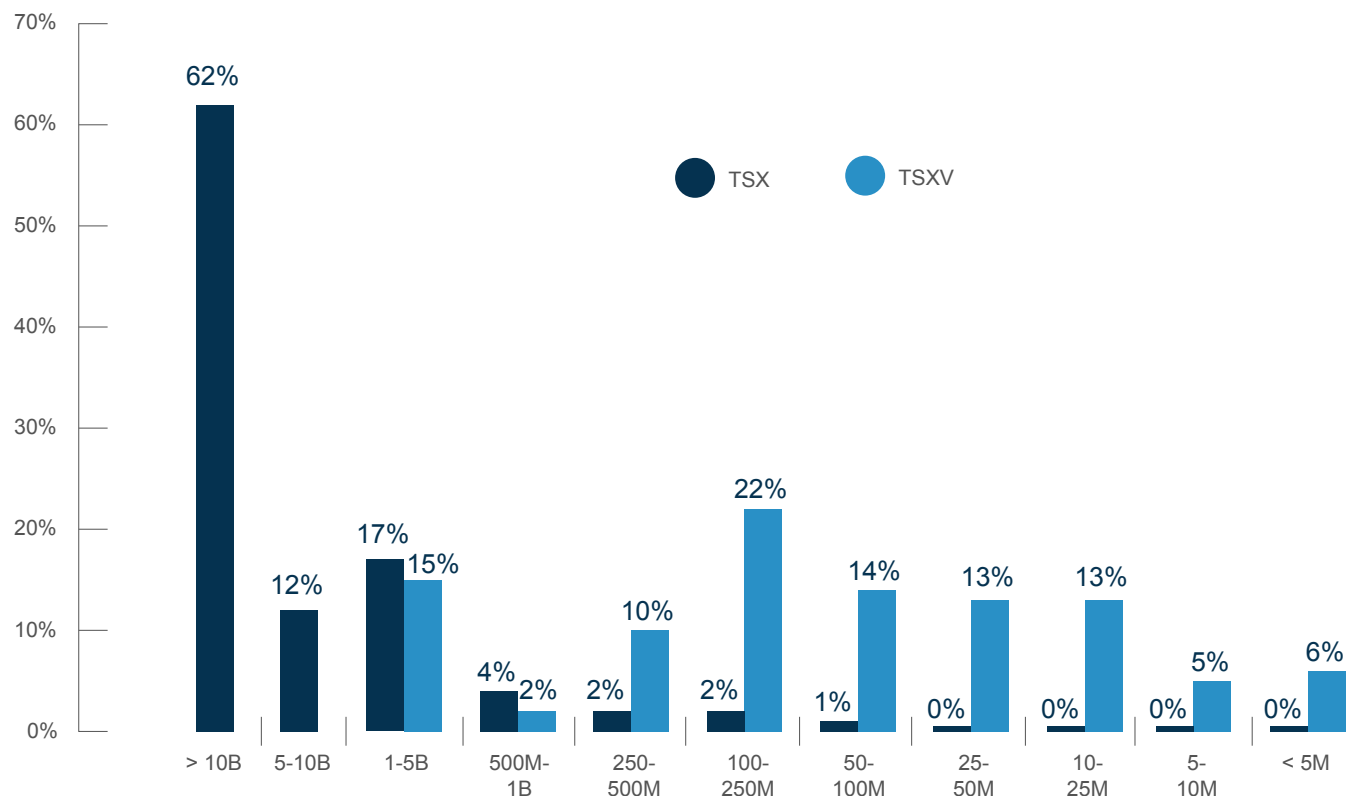
As of December 31, 2013



*Foreign RIs are Canadian reporting issuers headquartered outside Canada primarily audited by foreign participating firms.

Exchange traded reporting issuers

Market Capitalization of TSX and TSXV Exchange Issuers (\$C mil)



Market Cap \$CM

TSX	\$1,448,747 49 RIs	\$272,113 38 RIs	\$383,888 180 RIs	\$101,273 142 RIs	\$49,781 145 RIs	\$40,721 252 RIs	\$13,598 189 RIs	\$7,635 211 RIs	\$3,102 180 RIs	\$512 70 RIs	\$225 76 RIs
TSXV			\$4,846 2 RIs	\$773 1 RI	\$3,325 9 RIs	\$7,453 49 RIs	\$4,500 65 RIs	\$4,236 120 RIs	\$4,380 276 RIs	\$1,804 251 RIs	\$1,977 1,363 RIs

Percentage of market capitalization as at December 31, 2013

TSX Issuer Base: 1,532 Issuers, C\$2.3 trillion in Market capitalization

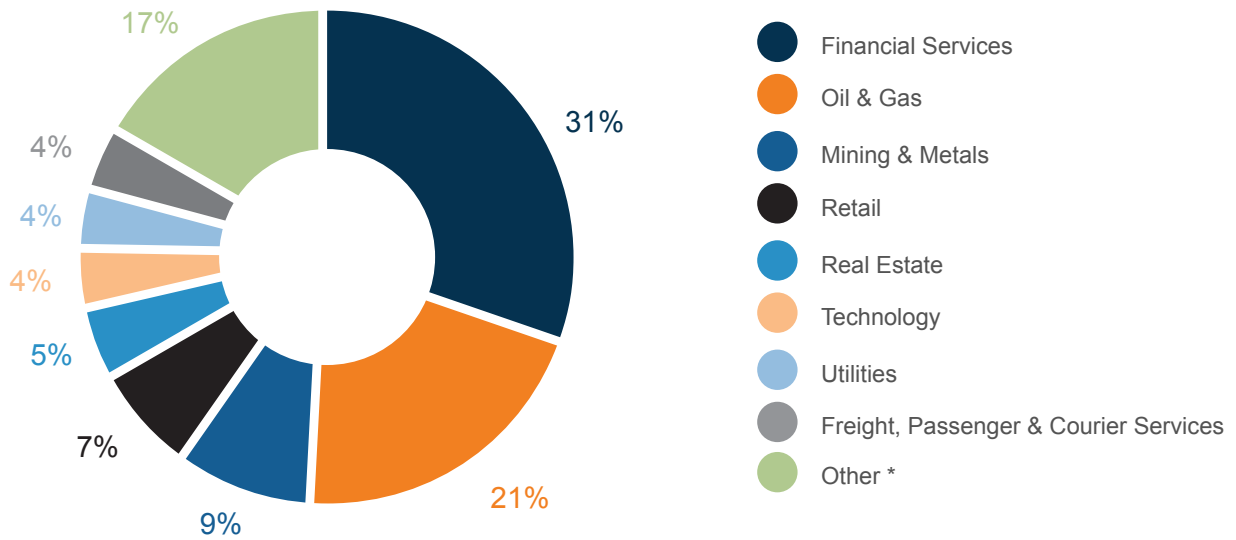
TSXV Issuer Base: 2,136 Issuers, C\$33.3 billion in Market capitalization

In addition, there are 4,203 Canadian RIs that do not trade on either the TSX or TSXV exchanges, the majority of which are non-traded funds.

These reporting issuers operate in many diverse industries that touch all aspects of business in Canada and elsewhere.

Canadian Exchange Traded RIs by Industry

Market Cap as at December 31, 2013



*Industry categories having less than four per cent of total market capitalization include Auto, Diversified Industries, Industrial Products, Life Sciences, Communications & Media, Forest Products, Entertainment, Consumer Products, Clean Technology, Capital Pool Companies and Funds.

Appendix D: CPAB's Inspection Results

Audit committees of RIs in Canada have been requesting greater transparency into CPAB's inspection findings to help them in their role of overseeing and evaluating the external auditor. Effective in 2014, the Protocol for Audit Firm Communication of CPAB Inspection Findings with Audit Committees (Protocol) was introduced. Among other things, the Protocol sets out the written communications concerning CPAB's inspections that audit committees can expect to receive from their auditors. First, audit committees of RIs inspected by CPAB will receive specific communication of the results of the inspection of their reporting issuer. Second, they will also receive a copy of CPAB's Public Report each year.

Section Three of this report highlights the most common inspection findings for the Big Four and Other Firms. This Appendix expands upon those findings where necessary and includes a number of other observations that may be of interest to audit committees. It is intended to assist audit committees in their discussions about audit quality and includes examples of themes they may wish to explore with their auditors as part of their oversight. While the themes contained in this section can relate to RIs of all sizes and across all industries, they have primarily been drawn from our inspections of firms inspected annually.

At least one significant inspection finding¹⁵ arose at most of the firms inspected in 2013. If the Protocol had been in place for the 2013 inspection cycle, these findings would have been communicated to their respective audit committees by the audit firm.

The largest number of findings came from companies with smaller market capitalization. Specifically, 42 per cent of all significant findings came from audits of RIs with less than \$25 million in market capitalization. However, significant inspection findings were identified in all sizes of companies including the TSX-60.

All findings have been evaluated and grouped by theme. In each case, some specific examples together with suggested recommendations to improve the audit quality in these areas are provided.

Auditing Accounting Estimates

Accounting estimates by their nature are imprecise and can be influenced by management. Significant judgment must be exercised by both management and auditors. This is an area where CPAB continues to identify a number of deficiencies.

Findings most typically arise where the engagement team did not demonstrate a sufficient degree of rigor and skepticism when auditing accounting estimates. Engagement partners and engagement quality control reviewers should perform thorough reviews of the audit of accounting estimates ensuring that they challenge audit team members to apply the appropriate level of professional skepticism.

¹⁵ 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.

Examples of Findings

Insufficient procedures were performed by the engagement team to assess the reasonableness of certain key assumptions used by management or experts to estimate fair value of assets either acquired in a business combination or when undertaking an impairment analysis. Specifically:

- The engagement team relied on the work of an auditor's expert but did not evaluate the adequacy of the expert's work with the appropriate level of professional skepticism. There were instances where the estimated fair value at the acquisition date and audited by the engagement team was materially adjusted with no evidence of any subsequent audit work to support the validity of the adjustments.
- There was no evidence in the file to demonstrate the appropriate depth of the engagement team's review of significant assumptions used in management's forecast.
- The engagement team did not adequately address contrary evidence questioning fair value even though such evidence was contained in the audit working papers.
- The engagement team did not perform adequate testing on the integrity of the underlying data and reports being relied upon.

Recommendations

Firms should provide additional training and/or guidance to re-emphasize the requirements for accounting estimates including:

- The importance of understanding how management arrived at their estimates.
- The need to evaluate the underlying data management relied upon, including how this data was used in the estimates and whether the data was sufficiently evaluated to permit reliance.
- The need for heightened professional skepticism.
- The requirement to perform a look-back analysis on estimates made in prior years to assess management's ability to develop reliable estimates over time.

Auditing Revenue

Revenue is often a higher risk account and has a rebuttable presumption of fraud.

Examples of Findings

Our inspections identified a number of instances where there were deficiencies in the approach to auditing revenue including where engagement teams:

- Did not demonstrate sufficient understanding of the nature of the RI's business to design effective audit procedures.
- Relied on control testing without adequately evaluating the design of the internal controls to ensure that the controls were responsive to significant risk. (See also Audit of Internal Controls below).
- Did not evidence their assessment of, and support for, the accounting positions taken by management including accounting for multiple element arrangements.
- Did not perform any audit procedures on the significant revenue stream.
- Used substantive analytical procedures (SAP) that were inadequately performed for the following reasons:
 - Not appropriately setting the precision for the procedure.
 - Not adequately assessing factors used to set their expectations including the underlying assumptions and data relied upon.
 - Not appropriately corroborating variances between the expectations and actual results. Specifically, variances were usually discussed with management with little or no verification to independent sources.

Recommendations

The engagement partners and EQCRs should be involved in the review of complex revenue recognition situations and should consult (or consider consulting) with their technical accounting experts. The engagement partner and EQCR should also review the audit approach to revenue at the planning stage to ensure the rationale for the approach is clear and well understood by all engagement team members.

While SAPs can be effective as the primary source of audit evidence of revenue, CPAB's experience is that the use of SAPs is only appropriate in limited circumstances. Firms should consider providing guidance as to when SAPs can/should be used as the primary source of audit evidence. Due to the level of judgment involved, these procedures should be conducted by audit staff with significant experience generally at the management level or above. Some firms require their engagement teams to obtain approval from national auditing standards before SAPs can be applied.

Using the Work of Others/Reliance on Experts

There are often areas of the audit where specialized skills are required. These include valuation of complex financial instruments, valuation of assets in a business combination and determination of mineral reserves. In such instances, the audit team will either rely on the work of management's expert or obtain their own expert. When placing reliance on the work of an expert (be it management's or the auditor's expert) the auditor is required to evaluate the appropriateness of the expert's work as audit evidence. This includes considering the objectivity of the expert, the relevance and reasonableness of assumptions and methods used, and the completeness and accuracy of the underlying source data.

Examples of Findings

The engagement team did not:

- Perform sufficient procedures to assess the reasonableness of certain key assumptions used by management's (or the auditor's) expert.
- Evidence the assessment of whether the ranges used by the valuation specialists were sufficiently narrow to effectively identify a potential material misstatement.
- Consider whether the level of assurance provided by the valuation expert was sufficient to meet the needs of the engagement team. Certain experts provide positive assurance and other experts only provide negative assurance. This distinction and its impact on audit assurance is not always considered by the engagement teams.

Recommendations

Firms need to communicate to their engagement teams the importance of:

- Evaluating the appropriateness of the expert's report by reading the report disclaimers, restrictions and scope.
- Understanding the methods used to develop significant estimates.
- Assessing the relevance and reasonableness of assumptions and assessing the underlying data.
- Working with the specialists to understand the level of assurance they can provide the auditors and what additional procedures would be required by the engagement team to achieve the appropriate level of audit assurance.

Audit of Business Combinations

Business combinations concepts are generally straightforward but there are often intricacies in the implementation that can cause management difficulties. In addition business combinations usually involve fair value measurements which require significant estimates and judgments.

Examples of Findings

- When auditing the value of the shares issued as consideration for an acquisition, the engagement team used the weighted average market price for five days prior to the acquisition date which is not compliant with the standard that requires consideration to be measured at the date of acquisition.
- There were instances where the fair value of assets at the acquisition date estimated by management and audited and assessed as reasonable by the engagement team were later materially adjusted by management without evidence of any audit work by the engagement team.
- There was no evidence that the engagement team had performed procedures beyond making inquiries of management for the purposes of testing the accuracy and completeness of the underlying data used in valuation models including assessment of the reasonableness of forecasts used in the valuations.
- There were unexplained inconsistencies between assumptions used in the valuation models and other sources of information. For example, tax rates used in the valuation model were inconsistent with the entity's effective tax rate with no evidence that the engagement team considered potential reasons for the difference.

Recommendations

Firms need to:

- Re-emphasize to all auditors the IFRS requirements for accounting for business combinations.
- Incorporate key accounting considerations into the audit programs used by engagement teams.

Evaluation of Accounting Policies

The evaluation of accounting policies is an essential part of an audit since the selection or application of inappropriate accounting policies can have a material impact in the current and subsequent years. Certain of these findings arise from a lack of consultation on complex accounting issues and/or incorrect consultation results due to incomplete and/or insufficient consultation analysis.

Examples of Findings

The engagement team did not address the appropriateness of accounting policies:

- Incorrect accounting treatment of contingent consideration or non-controlling interest in a business combination.
- Improper accounting for multiple element revenue arrangements.
- Improper measurement basis used in private company valuations.
- Improper identification of cash generating units for the purposes of impairment testing.
- Incorrect measurement of debt and equity components of convertible and non-convertible debentures.

Recommendations

Firms should:

- Re-evaluate their approach to auditing accounting policies and their approach to consultations including the use and adequacy of their technical resources and the need for specialized knowledge.
- Form technical topic teams who can become subject matter experts for key accounting standards to supplement their national resources.

Response to Risk Assessment

There were a number of instances where the engagement team did not adequately demonstrate its assessment of risk related to specific assertions and appropriately link this assessment to its audit response for each significant financial statement account.

Recommendations

Firms should:

- Review their methodology to determine if there are clear linkages between risks identified and related responses and amend their methodology as necessary.
- Ensure that engagement teams understand the linkages and can clearly articulate the audit responses to assessed risk. This discussion should be part of the planning process.

Audit of Internal Controls

Engagement teams continue to be challenged by the identification and testing of internal controls relevant to the audit. In part, this arises because there are many controls that are important to ensure the efficient operation of the business, but which have little or no relevance to the audit.

Examples of Findings

Inspections identified instances where the engagement team:

- Did not evidence a sufficient understanding of control activities to assess the risk of material misstatement at the assertion level to evaluate the effectiveness of their design.
- Did not perform sufficient and appropriate testing. Specifically, the testing of attributes examined as part of the test did not provide evidence that the control worked effectively.

- Inadequately assessed internal controls by relying on system-generated data that was not tested.
- Chose inadequate sample sizes in testing operating effectiveness and didn't roll-forward from interim testing.
- Was not planning on control reliance, so there was no evidence it obtained an appropriate understanding of the controls relevant to significant risks as required by auditing standards.
- Did not evidence how it assessed management's ability to detect and correct accounting errors on a timely basis. (If management has not implemented appropriate/effective controls responsive to significant risks, engagement teams should consider whether failure to do so is an indicator of a significant deficiency in internal control which would be required to be communicated with those charged with governance).

Recommendations

Firms should ensure engagement teams:

- Appreciate the importance of obtaining a sufficient understanding of the procedures by which significant classes of transactions are initiated, recorded, processed and reported.
- Benefit from real-time coaching where those with expertise and experience with internal controls perform real-time reviews of selected files to provide an independent assessment of the controls identified, testing performed and conclusions reached.
- Receive appropriate internal control training to reinforce procedures to be performed to permit reliance on system-generated data relied upon in control testing.

Response to Fraud Risk

CPAB is concerned that engagement teams do not fully appreciate the importance of the objectives of the required audit procedures to address the risk of fraud. CPAB also finds that engagement teams do not understand why journal entry testing is an effective means of detecting fraud and as such add journal entry testing as an afterthought.

Examples of Findings

Inspections identified instances where there was:

- Insufficient rationale and basis for selecting journal entries for testing.
- Insufficient rigor in the inquiries of management and others in the entity.
- Inadequate testing of the appropriateness of journal entries in response to the risk of management override.
- Inadequate consideration of the unique characteristics to be used to identify the population of journal entries to test and no reconsideration of these characteristics if the initial selection results in either a very large or very small sample.
- No journal entry testing at all.

Recommendations

CPAB believes there needs to be clear messaging from firm leadership acknowledging both the importance of and challenge in addressing the risk of fraud. Senior engagement team members should actively coach staff on responding to fraud risks which should extend beyond the planning phase and into the field audit itself. Certain firms require the engagement team to advise national office of their planned approach to journal entry testing prior to performing the procedures. Firms should consider involving forensic personnel to assist in identifying and responding to fraud risks.

Firms need to develop specific guidance and related training materials to help facilitate fraud discussions with management and those charged with governance. This guidance should:

- Be integrated with the risk assessment process to ensure that the criteria used to select journal entries to test are relevant in the RI's circumstances.
- Also include a discussion of what constitutes an appropriate level of corroboration of explanations received, including examination of source documents.

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