



CANADIAN PUBLIC ACCOUNTABILITY BOARD
CONSEIL CANADIEN SUR LA REDDITION DE COMPTES



WORLD-CLASS AUDIT REGULATION

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About CPAB



The Canadian Public Accountability Board (CPAB) is Canada’s audit regulator, protecting the investing public’s interests. As a world-class regulator focused on excellence, we deliver value by promoting quality, independent auditing. A champion of audit quality, CPAB contributes to public confidence in the integrity of financial reporting, which supports our capital markets.

Vision

Effective regulation: Proactively identify current and emerging risks to the integrity of financial reporting in Canada, assess how auditors effectively respond to those risks, and engage those charged with governance, regulators, and standard setters to develop sustainable solutions.



Mission

Contribute to public confidence in the integrity of financial reporting of public companies in Canada by effective regulation and by promoting quality, independent auditing.



Board of Directors

CPAB has an 11-member Board of Directors appointed by the Council of Governors.



Employees

CPAB employs approximately 50 professionals.



Locations

CPAB operates from offices in Montréal, Québec, Toronto, Ontario and Vancouver, British Columbia.



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Changing Expectations

Expectations of the audit are changing. As greater focus has been placed on audit quality, the responsibilities of participants have changed, causing closer examination and different expectations of those that are involved in financial reporting. CPAB, other regulators, audit firms, audit committees and management need to understand the impact on their respective roles and responsibilities.

2014 Inspection Findings

Audit quality has improved year over year

Overall, results for all firms inspected by the Canadian Public Accountability Board (CPAB) in 2014 improved over 2013, largely due to the effectiveness of action plans implemented by the Big Four firms beginning in 2012, and later on by the 10 other annually inspected firms.

CPAB's assessment is based on the incidence of significant inspection findings, the nature of systemic findings, and the firms' attitude towards audit quality in 2014. Our evaluation combines quantitative and qualitative factors, including progress measured against pre-determined audit quality objectives.

Inspection results positive overall across firms

The audit firms inspected by CPAB annually account for roughly 99.5 per cent of the total market capitalization of all public companies trading in Canada.

The Big Four firms (Deloitte LLP, EY LLP, KPMG LLP, PwC LLP), and their foreign affiliates, audit approximately 98 per cent of all Canadian reporting issuers by market capitalization.



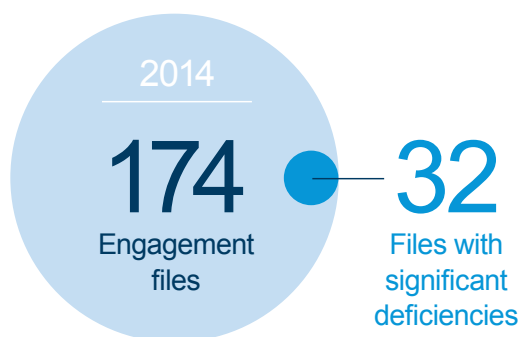
As a group, these firms continue to progress, in large part by augmenting their action plans and embedding them into their annual cycle of continuous improvement. A focus on enhancing processes, addressing organizational structure issues, and assigning clear accountability for audit quality within the firm contributed to their progress. While not all Big Four firms are in exactly the same place when it comes to implementation or results, our inspections indicate that, overall, these firms are taking appropriate action.

The 10 other annually inspected firms – comprising four national/network firms and six large regional firms that collectively audit slightly more than one per cent of all Canadian reporting issuers by market capitalization – have also worked to address audit quality gaps through action plans. These firms are capable of executing quality audits, particularly in areas where they have specialized expertise. They need to take action to ensure that quality execution is more consistent across all reporting issuer clients.

Inspection results for the four national/network firms generally improved in 2014. Challenges exist among three of the six large regional firms whose results declined overall. These firms vary in terms of how far along they are in implementing their action plans, leaving some with more work to do than others. We are assessing their progress and, based on CPAB's recommendations, these firms will take action. CPAB will continue to monitor the implementation, sustainability and effectiveness of their action plans in 2015.

Under the Protocol for Audit Firm Communication of CPAB Inspection Findings with Audit Committees

(Protocol), audit firms who voluntarily participate in the Protocol now share significant file-specific inspection findings with their clients' audit committees. A significant inspection finding is 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 to support the audit opinion and/or is required to make significant changes to its audit approach. CPAB identified a total of 32 files containing significant inspection findings in the 174 engagement files we examined in 2014.



Ten of the 14 annually inspected firms, including all Big Four firms, all national/network firms, and two of the six regional firms participate in the Protocol (one additional regional firm joined in 2015; others are currently discussing joining). Of the other firms inspected in 2014 with significant findings, one firm did not participate and two were inspected before the Protocol was in place. A complete list of firms participating in the Protocol is available on CPAB's website at www.cpab-ccrc.ca.

The majority of CPAB's total inspection findings in both 2014 and 2013 required the audit firm to carry out additional audit procedures to verify there was no need to restate the financial statements due to material error. The remaining findings required the audit firms to add considerable evidence to the audit file to show they had obtained sufficient and appropriate audit evidence with respect to a major balance sheet item or transaction stream. For the 2014 inspections cycle, carrying out additional audit procedures resulted in six restatements or three per cent of files inspected (2013: four restatements or two per cent of files inspected).

The Big Four firms shared CPAB's 2014 inspections report released in November with their clients' audit committees, as per their participation in the Protocol. All other participating firms will share this all-firm report with their clients' audit committees. CPAB encourages audit committees to discuss this report and any file-specific findings, if applicable, with their auditor.

Big Four:

Deloitte LLP, EY LLP, KPMG LLP, PwC LLP

As noted in our November 2014 inspections report on Canada's Big Four audit firms, (available at www.cpab-ccrc.ca), CPAB inspected 98 (2013:105) engagement files and found an overall improvement in audit quality, including a 36 per cent decline (2013:43 per cent) in files with significant audit deficiencies. These firms, together with their foreign affiliates, audit 98 per cent of all Canadian reporting issuers by market capitalization and account for seven of the total number of files with significant inspection findings in 2014 (2013:12).



All Big Four firms are capable of executing quality audits and CPAB saw many examples of this throughout our inspections. At the same time, different industries, clients and geographies bring their own unique challenges and high quality, consistent execution of audit methodologies across the board remains the longer term goal. While tone at the top has improved, there is a continued need to drive consistency deeper into the organization in all four firms.

Four other national/network firms:

BDO LLP, Grant Thornton LLP,
MNP LLP, Raymond Chabot Grant
Thornton LLP



In 2014, CPAB inspected 32 (2013:28) engagement files across the four other national/network firms and found an overall improvement in audit quality, including a 42 per cent decline (2013:55 per cent) in files with significant audit deficiencies. Specifically, two of the four firms improved, one remained the same, and one had poorer results. While progress is being made, not all firms are where they need to be when it comes to audit quality – there is still more work to do. These firms, which audit about one per cent of all reporting issuers by market capitalization, account for six of the total number of files with significant inspection findings in 2014 (2013:nine)

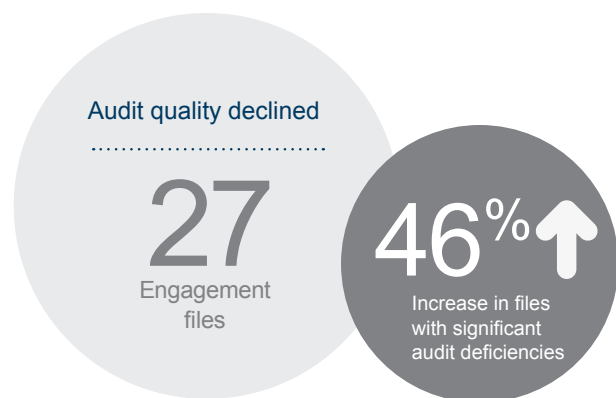
The pace of progress for these firms mirrors that of the Big Four, reflecting the fact that they initiated their audit quality action plans up to three years later. And while all four firms are capable of delivering quality audits, some are experiencing challenges in implementing their quality initiatives. Based on CPAB's recommendations in their individual firm reports, those firms will take appropriate action and CPAB will monitor their progress during the 2015 inspection cycle.

Six large regional firms:

Collins Barrow Toronto LLP, Crowe MacKay LLP, Davidson & Company LLP, DMCL LLP, Manning Elliott LLP, Smythe Ratcliffe LLP

Inspection findings for the six large regional firms indicate an inconsistency in audit performance. CPAB reviewed 27 (2013:21) engagement files and generally found that audit quality has declined, as demonstrated by a 46 per cent increase (2013:nine per cent decrease) in files with significant audit deficiencies. Three of the six firms did demonstrate improvement. These firms are capable of executing quality audits in areas where they have particular expertise; in these cases we typically do not have many significant inspection findings. When they audit companies beyond those specialties, the number of significant deficiencies increases and firms need to be more diligent in these cases. These firms, which audit about one half per cent of all Canadian reporting issuers by market capitalization, account for 15 of the total number of files with significant inspection findings in 2014 (2013:eight).

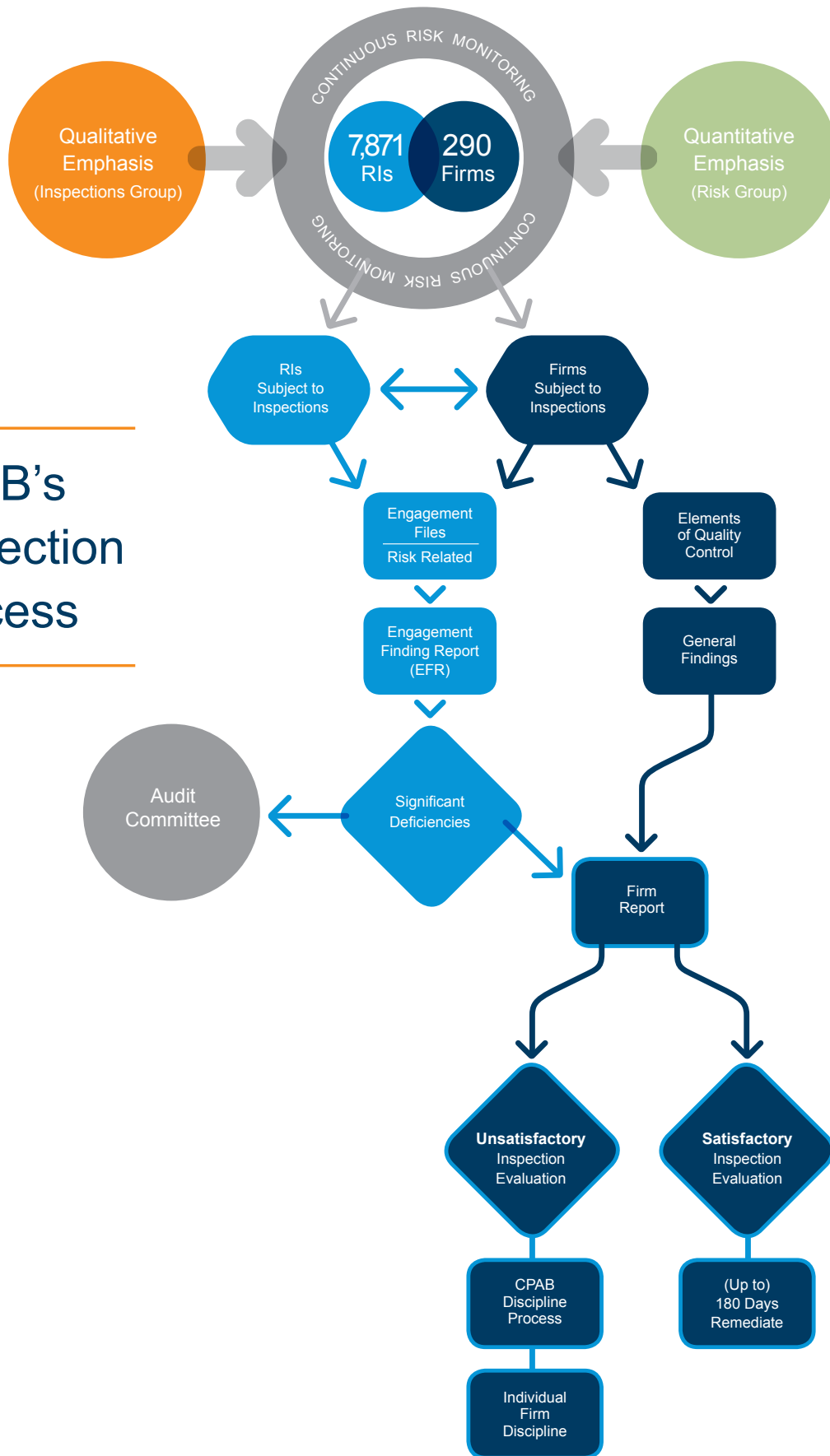
Firms in this category generally have one office and audit a large number of reporting issuers that specialize in one or two industries. As with the four other national/network firms, these firms are at different stages of action plan implementation, leaving room for continued improvement. Their audit quality initiatives are not where they need to be and are not having the timely impact we have seen in other firms. We will monitor how they execute on our mandatory recommendations in 2015.



Other firms:

CPAB inspected 28 other firms as part of its 2014 inspection cycle which account for four files with significant inspection findings.

CPAB's Inspection Process



Total annual number of firms/engagements



Inspection Methodology

CPAB’s risk-based methodology for choosing files (and the specific areas of those files) for inspection is not intended to select a representative sample of a firm’s audit work. Instead, it is biased towards higher-risk audit areas of more complex public companies, so there is a greater likelihood of encountering audit quality issues. Our inspections do not look at every aspect of every file and are not designed to identify areas where auditors met or exceeded standards. Results cannot be extrapolated across the entire audit population, but instead viewed as an indication of how firms address their most challenging audit situations.



Key Inspection Themes

The following audit quality themes noted in CPAB’s November 2014 inspections report on the Big Four firms also apply to the other firms we inspected this year:



Complex accounting estimates

Auditors need a strong experience base from which to consider the appropriateness of the forecasts being made.

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

The types of complex estimates and judgments can vary by industry and 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, accounting for business combinations, as well as industry-specific issues such as the evaluation of reserve reports in the resource sectors.

Estimates relating to impairment, and going concern evaluations, often involve cash flow forecasts and frequently involve specialists. Auditors need a strong experience base from which to consider the appropriateness of the forecasts being made. This can be challenging since such forecasts are based on both past experience and future expectations. Similarly, firms can face challenges in evaluating the work of external experts and in integrating their own internal experts into the audit process.

WHY ARE ESTIMATES SO CHALLENGING?

A. Many estimates involve a high degree of measurement uncertainty:

For example, costs to complete long-term construction contracts inherently have a great deal of uncertainty given variables such as weather, geographic conditions, performance of sub-trades, etc. which are often beyond the control of the company. Similarly, estimates involving forecasts are challenging because you are dealing with the uncertainty of the future – the longer the timeframe for the forecast the more difficult the process.

B. Past results may not be any indication of future performance:

This is especially true when companies enter into new products or geographies and may not have any directly relevant experience to draw from.

C. Complex financial instruments are evolving almost daily:

Few people may actually have any first-hand experience with valuing such instruments.

Foreign jurisdictions

CPAB continues to face limitations when it comes to accessing and evaluating component auditor work in certain jurisdictions.

Auditing of Canadian reporting issuers with operations in foreign jurisdictions has been a challenge for a number of years.

The Big Four firms have increased their focus in this area, including defining procedures for this kind of audit work, which has improved execution and audit quality. The other annually inspected firms have also initiated changes in this area, but we noted numerous instances where firms were challenged to understand the foreign environment.

CPAB continues to face limitations in accessing and evaluating component auditor work in certain jurisdictions. These limitations are not firm specific. We are finalizing memoranda of understanding to gain access in a number of these jurisdictions, however, there will remain others where we will need the support of local regulators. We are actively engaging with the relevant regulators to improve our access.

WHY IS AUDITING IN FOREIGN JURISDICTIONS A CHALLENGE?

- A. Each country has its own unique rules, regulations, business practices and customs:**
What you understand to be true in your own country isn't necessarily the case abroad, so you can't assume audit procedures that are effective in Canada will be in a foreign jurisdiction. Firms need to adjust their procedures accordingly.

- B. Even the largest international auditing firms are associated networks, not a single legal entity:**
There is no assurance that the quality of audit work in a foreign jurisdiction is the same as it is in Canada. The group auditor must independently review and assess the work of foreign affiliates before using the work in the audit of the consolidated entity.

Internal controls

Considerable experience is necessary to effectively execute an internal controls-based audit.

Given the breadth of operations and the volume of transactions processed, it is often impractical to complete the audit of a large or complex entity only by examining a sample of the transactions. As part of their financial statement audit, auditors need a deep understanding of management's internal control systems and their effectiveness. The engagement team can do this work itself or involve an expert in internal controls evaluation and testing. Either way, considerable experience is necessary to effectively execute an internal controls-based audit.

CPAB's inspections of higher risk audit areas identified numerous instances where internal controls work was not well done, which brings the effectiveness of the audit into question. Firms need to critically re-evaluate how they approach an internal controls-based audit and ensure that appropriate training and guidance is provided to engagement teams.

Non-Big Four firms have more limited experience with internal controls since they generally perform substantive audits with no controls reliance. This approach is logical given the nature and typical size of their client base but creates additional challenges when control reliance is required.

WHY DO YOU NEED TO LOOK AT INTERNAL CONTROLS?

A. The volume of transactions makes any other approach impractical:

In many instances the company executes such a high volume of relatively homogeneous transactions that the auditor can't appropriately evaluate these individually and needs to assess the population as a whole. In these cases, it is best to evaluate using management's internal controls to process and monitor the transactions.

B. This may be the most effective way to conduct the audit:

The company may have such an effective internal control environment that looking at internal controls is the best way to mitigate audit risk.

Professional judgment

In some firms, up to 80 per cent of the audit work is conducted by staff with fewer than five years' audit experience.

Areas requiring the most professional judgment and needing involvement of the most experienced auditors featured prominently in our inspection findings. Effective supervision and review, together with participation of senior engagement leaders at both the planning and issues resolution stages, remains the best way to deal with these matters. Risks must be identified early so they are effectively addressed in the audit and any resulting issues resolved.

In some firms, up to 80 per cent of the audit work is conducted by staff with fewer than five years' audit experience. This needs to be complemented with appropriate involvement of engagement leadership to support the delivery of a quality audit. Failure to do so is a contributing factor to our most common inspection findings, especially in areas where a high degree of professional judgment is required.

A sound understanding of the client's business and processes is an essential part of the audit, and the basis for effective risk identification and audit strategy development. Using these fundamentals, the auditor applies experience, judgment and professional skepticism to execute a high quality audit. CPAB noted a number of instances where the fact that the auditor did not have a sufficient understanding of the client's business was the root cause behind the audit deficiency.

WHAT AREAS REQUIRE THE MOST PROFESSIONAL JUDGMENT?

A. Risk identification and mitigation:

Each audit has its own unique challenges. A quality audit identifies these audit risks early in the process and devises an appropriate strategy to mitigate concerns.

B. Assessing management's estimates:

Not all entries in the accounting records result from exact calculations. Many, such as the allowance for doubtful accounts, provisions for the decline in value of inventory, estimates of costs to complete in long-term construction contracts, accruals for liabilities incurred but not yet invoiced, and estimates of future income streams, together with discount rates, etc., when valuing certain long-lived and intangible assets require management to exercise their own judgment which in turn must be critically assessed by the auditor.

C. Testing of journal entries:

Errors and frauds can be covered up through journal entries, so the auditor is challenged to develop a strategy for effectively testing and evaluating these entries.

D. Consistent execution:

Most firm audit methodologies are effective if they are appropriately executed. The nature and extent of testing and how the methodology gets applied often depends on the experience, training and judgment of the auditor.

Professional skepticism

With experience comes skepticism.

With experience comes skepticism. Experienced auditors see the big picture, while less experienced staff often use checklist-like processes which ensure that all professional standards are satisfied, but may not direct efforts effectively. More experienced auditors focus on the risks they know exist in the company and/or industry and ensure they are addressed. High quality audits result from appropriate risk identification and effective mitigation by experienced professionals.

A healthy degree of professional skepticism is the basis for a quality audit, and a productive relationship between the auditor and management. Effective auditors weigh what management tells them against what they know of the client's operation, together with their knowledge of the broader business environment. This way 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 opinion.

CPAB's inspections continue to identify a need for firms to enhance the professional skepticism of their staff, ensuring their people appreciate its importance and embedding appropriate processes and behaviors into their methodologies and cultures.

WHAT EXACTLY DO YOU MEAN BY PROFESSIONAL SKEPTICISM?

A. Does it make sense:

Through their knowledge of the business environment, other clients and past experience on your engagement, the auditor is well equipped to assess whether what they are seeing is what they expected to see. If not, why not?

B. Show me your support:

An effective auditor should ask their client to explain and justify their position. It is not enough to accept this position without independently evaluating it.

C. Trust, but verify:

It is fundamental in any audit relationship to trust your client, but that doesn't mean blind acceptance.

While the following themes were also identified in the Big Four firms, they were more prevalent among the other firms inspected in 2014:



Journal entry testing

Journal entries may not always be what they appear to be.

Reviewing journal entries – a fraud detection procedure – was the most common inspection finding noted in the other annually inspected firms in 2014. In many cases, the engagement team did not sufficiently consider specific characteristics of journal entries that may indicate fraud. In other cases, the engagement team only selected entries above a threshold amount – often a percentage of materiality.

There were also instances where engagement teams did not ensure they had the complete population of journal entries or did not go beyond enquiries of management to validate the journal entries.

Overall, this means auditors are not effectively assessing journal entries. Procedures are not as comprehensive as they should be and opportunities to identify errors or fraud may be missed and financial statements may be misstated as a result. Further guidance is needed to ensure that audit staff understands the objectives and application of journal entry testing.

WHY IS JOURNAL ENTRY TESTING SUCH A CHALLENGE?

A. Not all journal entries are the same:

Journal entries may be either manually or systems-generated. They may be standard/routine or the result of complex calculations or management intervention. Many accounting systems produce hundreds or thousands of journal entries in a typical year. The challenge is to devise an appropriate audit strategy to evaluate these entries based on their specific characteristics.

B. Journal entries may not always be what they appear to be:

Descriptions in the general ledger may not truly reflect the underlying entry. It is necessary to go to source documents to understand the rationale for the entry which can be very time consuming.

C. Journal entry testing is delegated to junior staff:

Staff doing the journal entry testing may not have adequate experience to identify issues or concerns. They also may not have sufficient knowledge of the client or industry to effectively execute the testing strategy.

D. Risks associated with journal entries can be many:

Numerous audit plans focus solely on the cash/asset misappropriation aspects of journal entries. However, journal entries can also be used to improve the financial statements without immediate cash consequences to the company. Such entries are often not appropriately considered in the testing plan.

Decommissioning obligations

Determining decommissioning obligations involves significant estimation and a great deal of judgment.

Many resource companies incur decommissioning obligations related to costs necessary to deal with the environmental impact of their operations. A number of inspection findings related to insufficient or inappropriate audit work performed on the judgments regarding liability recognition. The assessments of the applicable laws and regulations or a company's constructive obligations are sometimes deficient, as is the quality of the audit evidence to support the measurement of the obligations, including the work done to rely on management's experts.

WHAT MAKES DECOMMISSIONING OBLIGATIONS SO DIFFICULT TO AUDIT?

- A. The decommissioning laws and regulations are often hard to understand and interpret:**
Often foreign laws and regulations are unclear and the auditor must rely on foreign experts.

- B. Determining decommissioning obligations involves significant estimation and a great deal of judgment:**
Management often does not perform the appropriate analysis to assist the auditor in addressing the risk of material misstatement.



Use of management's experts

Experts are not the auditor.

CPAB noted divergent practices in how firms assess and audit the work of management's experts, most often as applied to value mining, and oil and gas properties and related goodwill balances for impairments and business combinations, as well as for depletion calculations. The most common findings relate to inadequate audit of source data and not challenging data that is inconsistent with other information known to the company or the auditor.

WHY DO WE NEED TO AUDIT THE EXPERTS?

A. Experts accept source data provided by management in formulating their conclusions:

Source data used in estimates must be consistent with other information used in the financial statements and with the information used by management to operate the business. If it's not, the expert's opinion could change significantly.

B. Experts are not the auditor:

The auditor needs to understand and evaluate the basis for any significant estimates in the financial statements. The auditor cannot rely on the expert without appropriate evaluation of both their credentials and their work.

Materiality

Materiality is critical when deciding the extent of testing and the evaluation of identified misstatements.

In its simplest form, materiality is a reflection of the extent of work carried out by the auditor — audits don't look at every individual transaction or disclosure. Instead, the auditor makes a determination of an amount that is likely to be significant to the majority of financial statement users and scopes its procedures accordingly.

Materiality is critical when deciding the extent of testing and the evaluation of identified misstatements. We noted instances where engagement teams determined materiality on a basis that was inconsistent with the business context. If materiality is not appropriately determined, sample sizes might be too small and, as a result, insufficient audit work may be performed.

WHAT IS MATERIALITY?

A. Materiality can be determined in different ways:

In a revenue-generating, profit-making enterprise materiality is most commonly stated as a percentage of net income before taxes. In development stage entities, it may be based on costs incurred, capital expended or a combination of the two. In some industries revenues may be the key factor. Industry, company maturity and performance trends are factors that also influence materiality. The auditor must use their best judgment to determine materiality in each audit.

Final Thoughts

The quality of Canadian audits has improved compared to 2013; inspections results continue to trend positively year over year since 2011.

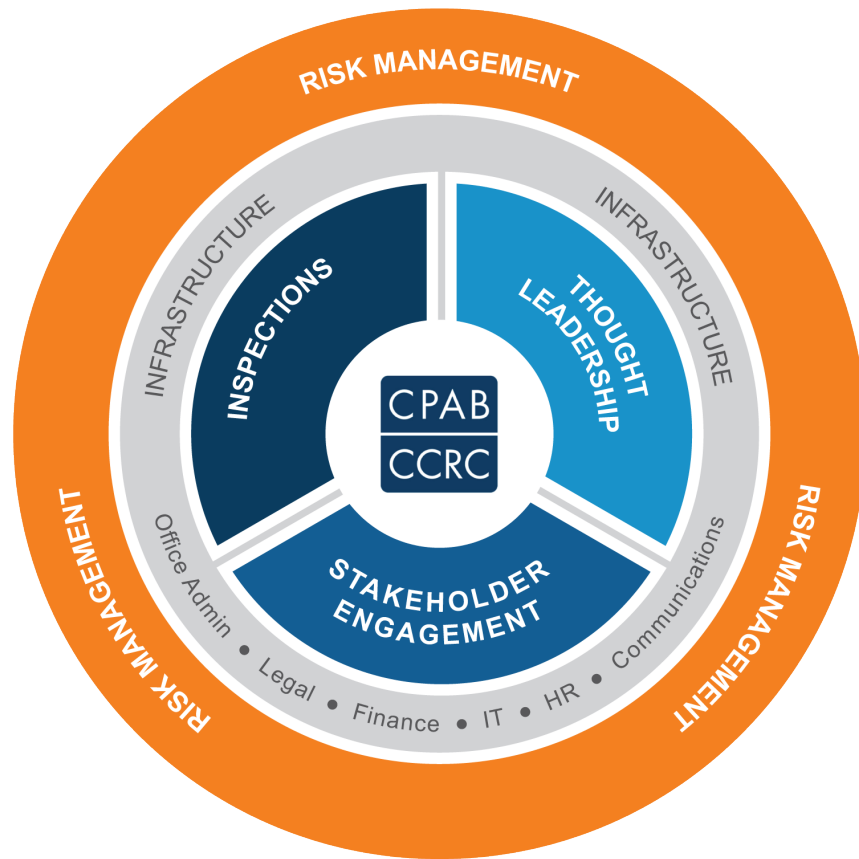
We encourage all firms to commit to continuous improvement at every level of their organization to safeguard this positive trend and, ultimately, investor confidence. Firm action plans will play a critical role, as will addressing the recurring inspection themes in this report and in individual firm reports. Action plans set out longer term activities designed to permanently change behaviors and embed quality throughout the audit process. Over time, they have brought about measureable improvement.

Awareness is essential to building quality systems. In 2015, CPAB will expand our conversations with key stakeholders, and with audit committees in particular to assist them in executing their oversight role most effectively, including evaluation of the audit firm and audit risks, and industry-specific questions to explore with their auditors.

CPAB is encouraged that our annual inspections results are moving in the right direction. At the same time, there is still more to be done if firms are to deliver consistent, sustainable high quality audits over the long term. In 2015, we'll continue to monitor quality initiatives and seek action where we see the greatest need for improvement.



CPAB's Strategic Approach



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Learn More

CPAB's 2014 annually inspected firms report, 2014 Big Four inspections report, detailed information on the Protocol, and other publications for audit committees are available at www.cpab-ccrc.ca.

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