



CANADIAN PUBLIC ACCOUNTABILITY BOARD
CONSEIL CANADIEN SUR LA REDDITION DE COMPTES

WORLD-CLASS AUDIT REGULATION



Changing Expectations

About CPAB



The Canadian Public Accountability Board (CPAB) is Canada's audit regulator responsible for the regulation of public accounting firms that audit Canadian reporting issuers. A world-class audit regulator and a champion of audit quality, CPAB contributes to public confidence in the integrity of financial reporting, which supports Canada's 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, Quebec, 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 of 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.

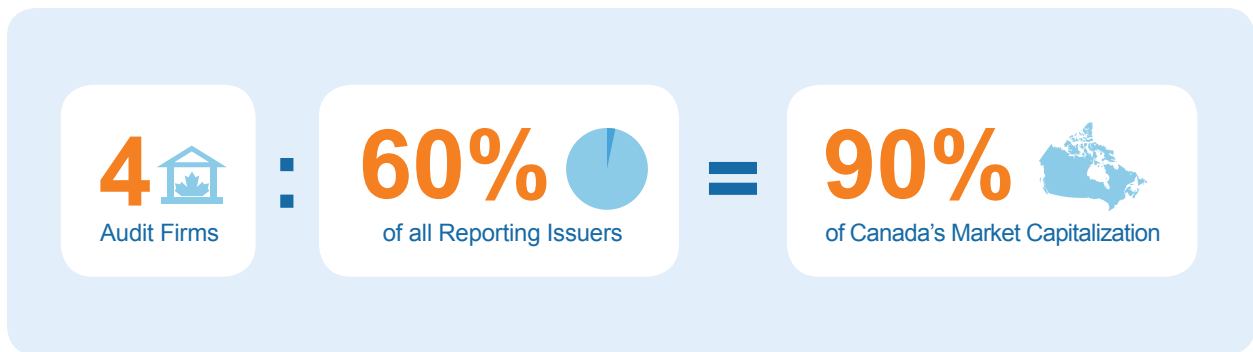
Audit Quality Improving; Expectations Are Changing

Welcome to the Canadian Public Accountability Board's (CPAB) 2014 Public Report – our first annual inspections report focused on Canada's Big Four audit firms (Deloitte LLP, EY LLP, KPMG LLP, PwC LLP).

Every year CPAB has presented its all-firm inspection findings in one report in late March. Stakeholders have told us that an earlier release would help better inform audit planning, and in particular, assist audit committees review year-end results and prepare for the coming year.

The Big Four firms audit almost 60 per cent of all reporting issuers, representing more than 90 per cent of Canada's market capitalization. Historically, the nature of findings in Big Four firms is consistent with our findings in all other firms. We believe an earlier release can also provide timely insights for the Next Four, Regional and Local audit firms.

We will combine all other firm inspection findings, together with CPAB corporate and financial information, in the Annual Report we issue in March 2015.





There is still more to do to achieve sustainable audit quality.

2014 inspection findings continue to trend positively; sustainable audit quality remains the goal

CPAB’s 2014 inspection findings show a positive trend across the Big Four firms.

We inspected 98 (2013:105) Big Four 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. Since 2011 – when CPAB issued its call to action to improve audit quality – the number of files inspected by CPAB with significant audit deficiencies has declined overall by more than two-thirds.

While the firms have responded to our call to action, there is still more to do to achieve sustainable audit quality. Even though each firm is actively pursuing audit quality goals, not all are in the same place when it comes to implementation or results.

CPAB’s 2014 inspection findings show a positive trend across the Big Four firms.



Transparency – CPAB Protocol’s first year

CPAB has increased transparency to audit committees because of their key role in the audit process and their ability to influence audit quality. Beginning on March 1, 2014, under the Protocol for Audit Firm Communication of CPAB Inspection Findings with Audit Committees (Protocol) audit firms now share significant file-specific inspection findings and CPAB’s public report with their public company audit committees.

A significant inspection finding 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 to support the audit opinion and/or is required to make significant changes to its audit approach. CPAB identified seven significant inspection findings in the 98 Big Four engagement files we examined and these were shared with audit committees. There are no restatements to date.

CPAB has received positive feedback from audit committees regarding the implementation of the Protocol. CPAB strongly encourages all audit committees to discuss this report and any file-specific findings, if applicable, with their auditor.

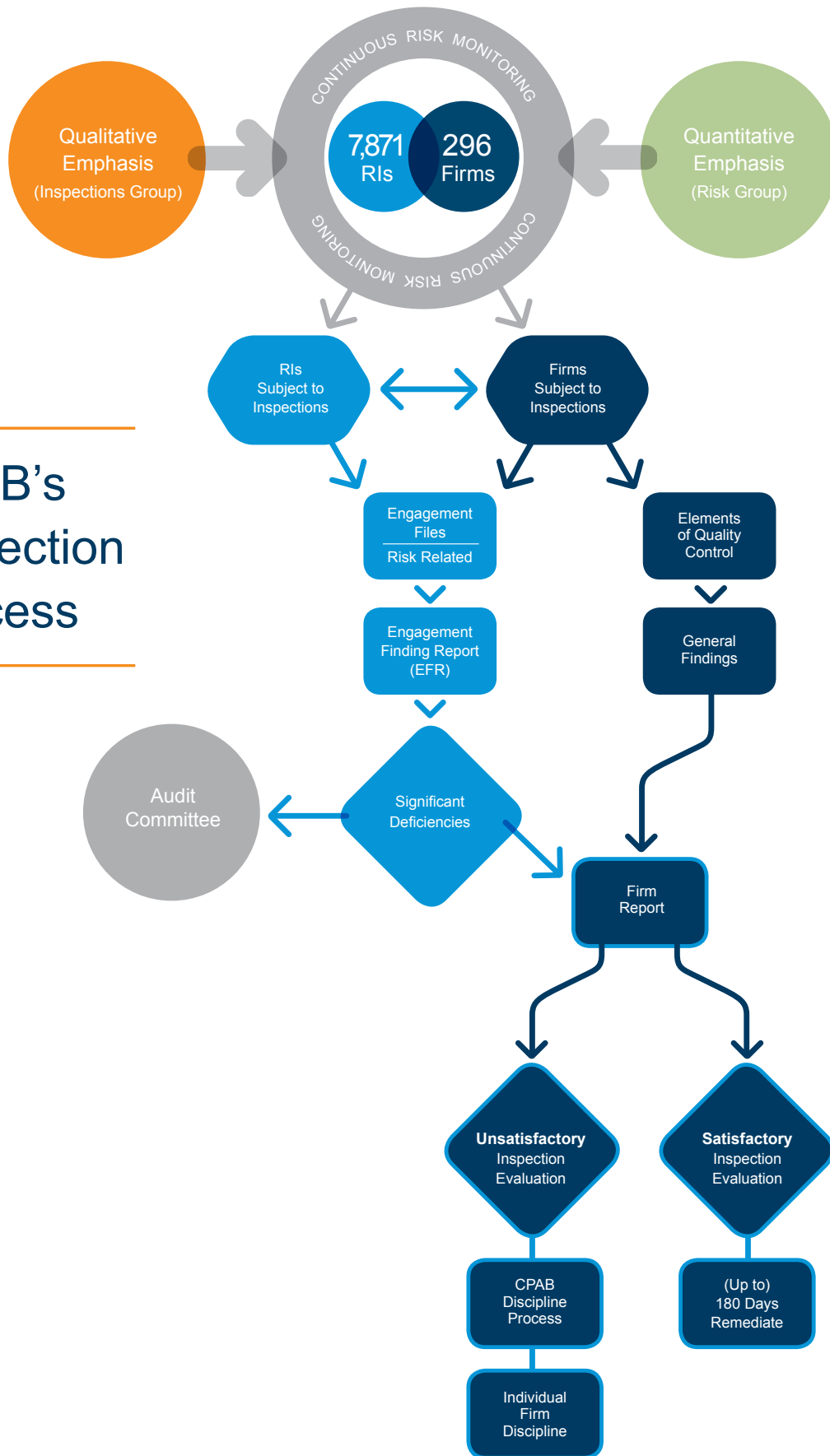
CPAB's Inspection Model – Focus is on Higher Risk Audit Areas

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 or areas where the audit firm may have less expertise, so there is a greater likelihood of encountering audit quality issues.

Our inspections do not look at every aspect of every file. Results should not be extrapolated across the entire audit population, but instead be viewed as an indication of how firms address their most challenging audit situations.



CPAB's Inspection Process



Key Insights

While no new audit quality themes emerged in 2014 among the Big Four firms, our inspections indicate that challenges persist in the areas of:



These continuing problems show us just how elusive audit quality can be and why firm action plans to address quality issues are so important to ultimately achieving it. These action plans set out longer-term activities designed to permanently change behaviors and embed quality throughout the audit process. The most effective plans focus on tone at the top, creating a culture of shared accountability, encouraging consultation, changing audit leadership to support the right culture, moving technical support into the practice offices, developing and concentrating expertise, rebalancing workloads/realigning staff, recognizing audit quality in performance reviews, and improving tools to drive consistency.

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 in particular, 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. We have seen the Big Four firms increase their focus in this area, including defining procedures for this kind of audit work, which has resulted in improved execution and better quality audits.

CPAB continues to face limitations when it comes to accessing and evaluating component auditor work in certain jurisdictions. While we are in the process of finalizing memoranda of understanding to grant CPAB access in a number of these jurisdictions, there will remain others where we will need the support of other regulators. We are actively engaging with the relevant regulators to achieve appropriate access and this process is ongoing.

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. The 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 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 large 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. Auditors, as part of their financial statement audit, need a deep understanding of the internal control systems that management has implemented and their effectiveness. The engagement team could either do this themselves or involve someone with expertise in internal controls 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 can bring both how internal controls are tested and the effectiveness of the audit into question. All 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.

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 the internal controls that the company has put in place 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

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 2014 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 can be effectively addressed in the audit and any resulting issues appropriately resolved in a timely manner.

In many cases, up to 80 per cent of the audit work is conducted by staff with fewer than five years' audit experience. This lack of experience needs to be complemented with appropriate involvement of engagement leadership to ensure 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.

How Audit Committees Can Help

Audit committees can do a number of things to help improve audit quality:

1

First and foremost, they can create an environment where the audit committee, management and the auditors can engage in an effective dialogue to enhance and sustain audit quality.

2

They are in a unique position to assess the effectiveness of the auditor/management relationship, including the degree of professional skepticism demonstrated by the auditor.

3

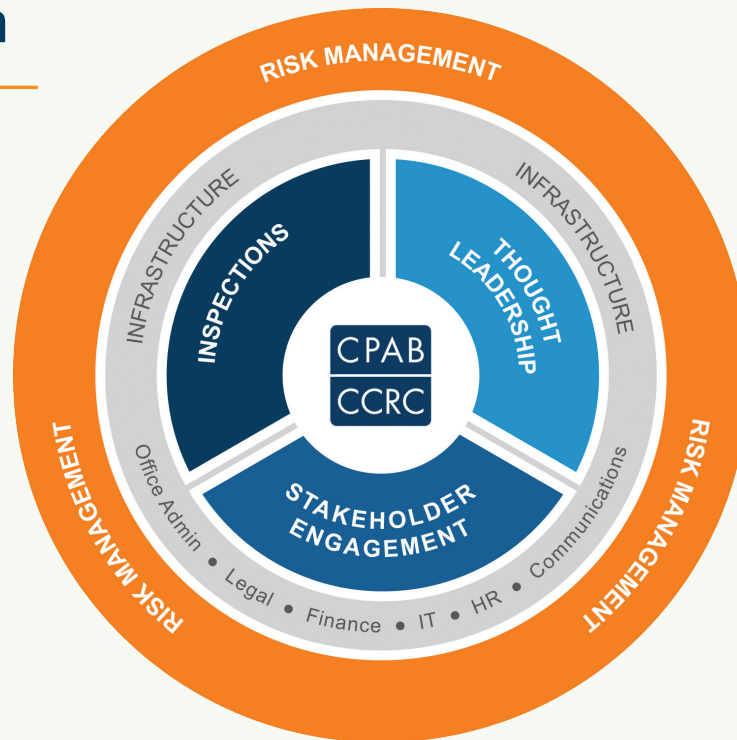
They should engage with their auditors to ensure their use of component auditors of foreign operations is more transparent so the audit committee better understands the work done by component auditors, including how it was overseen by the group auditor, and the steps being taken to provide CPAB with access to the working papers.

Many audit committees already perform these functions. CPAB will continue to assist audit committees by providing timely and insightful information on a variety of topics that will help them effectively exercise their audit quality oversight responsibilities.

Final Thoughts

Inspection results in Canada are trending positively. We urge the Big Four firms to remain vigilant in focusing on the recurring areas in this and previous CPAB reports.

CPAB's Strategic Approach



Contact Information

General Inquiries

Phone: (416) 913-8260 Toll Free: 1-877-520-8260 Fax: (416) 850-9235

Email: info@cpab-ccrc.ca www.cpab-ccrc.ca

Central Canada

Canadian Public
Accountability Board
150 York Street
Suite 900
Toronto, Ontario
M5H 3S5 Canada
Phone: (416) 913-8260

Eastern Canada

Canadian Public
Accountability Board
1155 René-Lévesque
Boulevard West, Suite 2916
Montréal, Québec
H3B 2L3 Canada
Phone: (514) 807-9267

Western Canada

Canadian Public
Accountability Board
400 Burrard Street
Suite 1980
Vancouver, BC
V6C 3A6 Canada
Phone: (604) 630-8260

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