



Canadian Public
Accountability Board
Conseil canadien sur
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MARCH 2020



CPAB Audit
Quality Insights
Report:
2019 Annual
Inspections
Results



Audit quality insights: 2019 annual audit quality assessments

All public accounting firms that audit a reporting issuer must register with CPAB. Securities legislation defines what constitutes a reporting issuer; each of the 13 Canadian securities commissions maintains a list of the reporting issuers in their jurisdictions. At December 31, 2019, 267 public accounting firms were registered; 95 of those firms do not currently audit reporting issuers.

Each year, CPAB inspects all firms that audit 100 or more reporting issuers. There are currently 14 firms in this group which audit over 7,000 reporting issuers. These firms, and their foreign affiliates, audit approximately 99.5 per cent of all reporting issuers as measured by market capitalization.

Based on our inspections findings, we provide mandatory recommendations to improve audit quality which the audit firm must implement within a defined period – usually 180 days; this deadline is much shorter for more serious findings, particularly where there may be a potential restatement of the financial statements. Our Rules provide a framework of remediation and disciplinary mechanisms to address audit quality deficiencies at the firm and file levels (see CPAB Discipline Overview on page 9).

During 2019 CPAB inspected 35 firms (2018:32) and 142 engagement files (2018:139).

Quality management systems assessments: strengthening audit quality

CPAB expects firms to have quality management systems that manage risk, emphasize strong governance and accountability, and deploy highly trained professionals with skillsets tailored by industry and areas of expertise.

In alignment with this expectation, and to help accelerate improvement, CPAB has evolved our audit oversight methodology (supplementary to our audit engagement file inspections) to assess the effectiveness of the quality management systems at the country’s four largest public accounting firms (Deloitte LLP, Ernst & Young LLP, KPMG LLP and PwC LLP).

CPAB’s FIRM QUALITY MANAGEMENT SYSTEMS MODEL: CRITERIA FOR ASSESSING QUALITY





Progress made in 2019

In 2019, each firm made a significant effort to address our observations related to their quality management systems including documenting, amending and in certain cases, implementing new controls and processes, and linking them to our assessment criteria. The journey to establish robust quality management systems takes time and each firm is at different stages of maturity with respect to the formality of their systems, how closely existing processes and controls align to CPAB’s evaluation criteria, and the quality of evidence available to demonstrate the identified controls are operating effectively.

Our 2019 assessments focused on firm process documentation specific to CPAB’s criteria, evaluating firm assessments of risk, evaluating control design and where possible, firm testing to support operating effectiveness. We considered the objective, resources, methodologies, type of risk, frequency and robustness of the process or control relative to the risk, and severity of findings related to each control.

Because many firm processes and controls were implemented in 2019 or were still being developed at the time of our assessments, not all gaps previously identified have yet been fully addressed and newly implemented controls could only be assessed for design but not operating effectiveness. Below we provide a range for our assessments by criteria to illustrate the progress firms have made in certain areas while recognizing it will take time to fully embed these changes to achieve consistently executed, high quality audits.

RANGE OF QUALITY MANAGEMENT SYSTEMS RATINGS BY CRITERIA

	Acceptable	Acceptable with opportunities for enhancement	Needs improvement	Requires significant improvement
Accountability for audit quality				
Risk management				
Talent & resource management				
Oversight				

2019 QUALITY MANAGEMENT SYSTEMS ASSESSMENTS BY CRITERIA

ACCOUNTABILITY FOR AUDIT QUALITY

Why it’s important

Clearly defined roles with responsibilities for audit quality at the leadership and engagement levels supports a culture of shared accountability and responsibility for audit quality that encourages escalation of issues.

CPAB assessment

The four firms have been evaluated as **acceptable with opportunities for enhancement**. Improvements in the development and communication of detailed roles and responsibilities to include accountability for audit quality (at all levels) have been observed and the firms are implementing organizational changes to build a more consultative and collaborative culture.

Enhancements recommended

The firms are continuing to develop and refine leadership roles and integrate them into their performance management processes. For controls and processes which require issue escalation to leadership there is a need for formalized structure rather than relying on informal communications.



RISK MANAGEMENT

Why it's important

Robust policies, procedures and controls to identify, monitor and respond to risks identified across the firm's portfolio supports informed decision-making, including the initial acceptance or the decision to continue with existing clients. Leadership monitoring and intervention ensures that reporting issuer clients are allocated sufficient resources with the appropriate capabilities and experience, including specialists.

CPAB assessment

Evaluations ranged from **acceptable** to **acceptable with opportunities for enhancement**. Of each of CPAB's criteria, risk management processes and controls were the most established at all firms, particularly related to monitoring risk and the decision to accept new or continue with existing clients.

Enhancements recommended

Certain firms had challenges providing suitable evidence to demonstrate the operating effectiveness of controls regarding the identification, review and intervention of high-risk engagements and evidence of challenge of annual continuance assessments.

TALENT AND RESOURCE MANAGEMENT

Why it's important

Strong controls and processes to support firm leadership's monitoring of talent capacity and competency help improve the timeliness and effectiveness of intervention to support engagement teams when there are changes in scope, risk, and staff availability and client delays. Timeliness and effectiveness of interventions by leadership is critical to supporting the execution of quality audits by engagement teams.

CPAB assessment

Evaluations ranged from **acceptable with opportunities for enhancement** to **requires significant improvement**. In general, firms have mature controls and processes to manage assignments and re-alignments from a capacity and competency perspective for audit partners and senior managers, however the processes and controls for audit managers, staff and specialists are less robust.

Enhancements recommended

Certain firms have designed and implemented new controls for the 2019 year-end audits to help address these findings, such as more formalized and timely monitoring and intervention for team members with excessive overtime. These controls will be evaluated for design and operating effectiveness in 2020.

OVERSIGHT

Why it's important

Systems that provide leadership with visibility into the progress of audit work and quickly initiate issue resolution are critical to audit quality. Effective oversight includes both monitoring by leadership and escalation mechanisms that support engagement teams when circumstances arise that may require additional resources or the decision to delay the issuance of the audit opinion.

CPAB assessment

Evaluations ranged from **acceptable with opportunities for enhancement** to **requires significant improvement**. All firms have developed or are developing systems to provide leadership with more visibility into the status and changes in risks of individual engagements, which allows the firm to initiate intervention, where necessary.

Enhancements recommended

There is a need for formal escalation and oversight mechanisms at certain firms to provide sufficient evidence to demonstrate operating effectiveness.



Looking forward

We expect that strong, well-executed quality management systems will lead to long term sustainable audit quality and improve the overall consistency of audit execution. We have seen improvement in the firms' quality management systems compared to last year; however, in many cases our file-related significant inspection findings continue to indicate deficiencies exist in the firms' quality management systems.

In our 2019-21 strategic plan CPAB commits to measuring firm progress based on our file inspections and our assessment of firm quality management systems using two indicators:

1. Percentage of firm quality management systems with a rating no lower than 'acceptable with opportunity for enhancement' (phased implementation with a target of 90 per cent of the firms' quality systems components achieving this rating by 2021).
2. Percentage of audit files inspected with no significant findings (target of 90 per cent with no significant findings by 2021).

Our 2019 quality management system assessments are a positive indicator that the first target is achievable; firms are currently meeting the target for two of the four criteria. However, it is important they continue to evolve processes, demonstrate controls are operating effectively and advance their self-assessment processes for all of CPAB's assessment criteria.

With respect to the second target, improvement is required at three firms to reduce the findings to an acceptable level.

QUALITY MANAGEMENT SYSTEMS – CREATING A DIALOGUE

To improve the dialogue on how the firm's quality management systems support audit quality, audit committees could consider these illustrative questions for the engagement team.

- 1. Does the audit team expect to consult with the firm's national office or experts outside the engagement team?**
- 2. If your company operates in a new or emerging industry, how does the auditor ensure all relevant risks to the financial statements are identified and appropriately mitigated?**
- 3. If the firm uses automated audit tools (data analytics, machine learning, etc.) are there sufficient firm resources to support the engagement team in implementing and interpreting the outputs of these tools to maintain audit quality?**
- 4. What actions have been taken at the firm and engagement team levels to align and re-align, where necessary, talent to respond to new circumstances or changes in risk?**
- 5. How does the firm support engagement teams so that talent with sufficient capacity and competency at all staff levels, including industry experts and specialists (i.e. valuations, tax and IT), is assigned to execute on quality audits?**



Audit engagement file assessments

Twenty-seven per cent of the files we inspected at the 14 public accounting firms reviewed annually had significant findings (2018:28 per cent).

SIGNIFICANT FINDINGS: NINE YEAR TREND

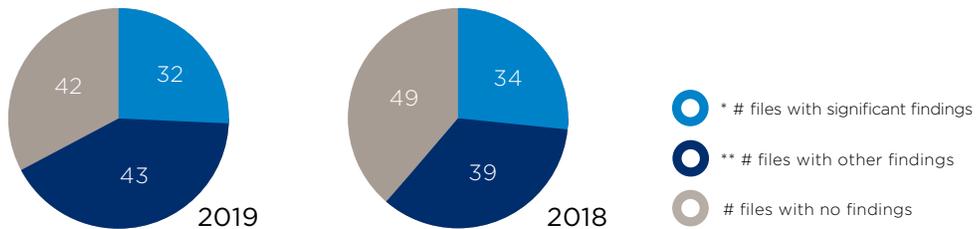


The level of total findings at certain firms was impacted by the expansion of the number of reporting issuers in the crypto-asset and cannabis sectors and associated audit challenges presented that were not appropriately addressed. In response, we inspected 24 files in these sectors (2018:13) and identified significant findings in 14 of those files (2018:8). Firms that choose to audit reporting issuers operating in these industries need to invest in enabling tools, training and resources so that the competencies required to achieve an acceptable level of audit quality are in place.

2019 ANNUAL FIRM INSPECTIONS SNAPSHOT

CPAB inspected 14 annual firms in 2019 (2018:14) and 117 engagement files (2018:122) and identified significant findings in 32 (2018:34). Improvement is required by 11 of the firms to achieve the target of 90 per cent of files with no significant findings.

- Four largest firms: 72 engagement files; 12 with significant findings.
- Ten other annual firms: 45 engagement files; 20 with significant findings.



*Significant findings - A significant inspection finding is defined as a 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 requires firms to carry out additional audit procedures to verify there was no need to restate the financial statements due to material error, or to substantiate that they had obtained sufficient and appropriate audit evidence with respect to a material balance sheet item or transaction stream to support their audit opinion.

**Other findings - A noted deficiency in the application of generally accepted auditing standards related to a material balance sheet item or transaction stream where CPAB is able to conclude, without the engagement team performing additional procedures to support the audit opinion, that the deficiency is unlikely to result in a material misstatement. These findings, while not significant, indicate areas for improvement.



Firm-specific results

Deloitte LLP, Ernst & Young LLP, KPMG LLP, PwC LLP

CPAB inspected 72 (2018:80) audit engagement files across Canada's four largest public accounting firms – Deloitte LLP, Ernst & Young LLP, KPMG LLP, PwC LLP – and identified significant inspection findings in 12 (2018:16) of those files. Results at three firms, including the two with a higher level of significant findings in 2018, improved in 2019 with one firm having met the target of 90 per cent of files with no significant findings for both years; one firm experienced an increase in significant findings over the prior year.

The two firms with increased findings in 2018 acted upon CPAB's recommendations and developed or updated detailed action plans to address their quality issues. Successful implementation of longer-term initiatives, including planned enhancements to the firms' quality management systems, will be critical to achieving improved sustained audit quality.

The firm with increased findings in 2019 had met the target of 90 per cent of files with no significant findings in the previous year. CPAB has recommended the firm perform a root cause analysis on this year's findings to identify underlying factors impacting audit quality and consider the implications on the effectiveness of its quality management systems to develop specific action items to address this year's results.

Remediation work being performed by audit firms has either been completed or is in process; no restatements have been required since our 2018 annual report. Where a restatement is required, the firm works with the reporting issuer and its securities legal counsel to effect the restatement as soon as possible – usually within the next quarterly reporting period.

BDO LLP, Davidson & Company LLP, DMCL LLP, Grant Thornton LLP, Manning Elliott LLP, McGovern Hurley LLP, MNP LLP, Raymond Chabot Grant Thornton LLP, RSM Canada LLP, Smythe LLP

In 2019, CPAB inspected 45 (2018:42) audit engagement files across these ten annually inspected firms; 20 had significant findings (2018:17). Twelve of those 20 significant findings were in the crypto-asset and cannabis sectors which contributed to the overall unacceptable inspection results for four firms. These firms had significant findings in over 50 per cent of files inspected in both 2019 and 2018. We have recommended a number of actions to these firms in order to achieve acceptable audit quality.

Four other firms had significant findings in over 25 per cent of the files inspected in both 2019 and 2018. These firms need to do more to understand the underlying factors leading to an increase in significant inspection findings and identify targeted actions to ensure consistent high-quality auditing across their reporting issuer audit practice.

CPAB will continue to monitor the progress of the eight firms in addressing and resolving the factors that impacted their respective 2019 inspection results. Specific recommendations for improvement have been provided to each of these firms, with actions including completing an in-depth root cause analysis of the inspection findings, enhanced training and supervision, hiring more staff or staff with greater expertise, additional quality reviews and completion of audit quality action plans. We are encouraging these firms to begin early implementation of the new international quality management standards.

Failure to address our recommendations and improve audit quality will result in an escalation of our regulatory intervention and may result in the disciplinary mechanisms outlined in the CPAB Discipline Overview on page 9 of this report.

Two firms continued to have stable inspection results, with zero or one significant finding in both 2019 and 2018.

These ten firms audit about one per cent of Canadian reporting issuers by market capitalization (approximately 1,650 public companies). Two restatements have been required since our 2018 annual report.



Non-annual firms

CPAB identified 15 (2018:8) files with significant findings out of the 25 files (2018:18) inspected across the 21 non-annually inspected firms (2018:18) in 2019. Five of the files inspected were in the cannabis sector, four of which had significant findings. No restatements have been required since our 2018 annual report.

CPAB executes a tailored inspection methodology to assess quality management systems at non-annual firms. Common inspection findings and potential causal factors leading to significant findings are incorporated into our risk analysis of these firms and the companies they audit. This facilitates proactive outreach to understand how the firms will manage these risks along with strategic intervention through select file inspections.

Failure to implement our recommendations or continued unacceptable levels of significant findings will result in an escalation of our regulatory intervention, as outlined in the CPAB Discipline Overview section on page 9 of this report. Actions taken on certain firms include Restrictions limiting the acceptance of new reporting issuers, required enhanced engagement quality control reviews or in-flight reviews, requirement to undertake additional training for specific accounting or audit topics, and required action plans to improve audit quality and hiring additional resources.

Common inspection findings

Emerging industries

Auditors must design audit procedures that respond to emerging industry risks, including rapid growth and innovative cultures; many traditional audit procedures can be less effective in these kinds of business environments.

In November 2019, CPAB published [Auditing in the crypto-asset sector](#) outlining the five most common engagement file deficiencies in this sector and highlighted the technical challenges that need to be addressed.

Cannabis company inspection findings were primarily related to insufficient understanding of complex business arrangements. Estimating fair value of biological assets is complicated by market uncertainty and volatility related to volume and price of expected sales — the fair value amounts are often highly sensitive to relatively small changes in these key inputs and auditors are not always appropriately assessing the potential impact of such changes.

Auditing estimates remains a challenge

More than half the significant findings in 2019 were related to the audit of estimates. Auditors did not adequately address the risks associated with auditing financial statement amounts that could not be directly observed. Revisions to the auditing standards to help auditors better respond to the risks will be effective for audits of financial periods beginning on or after December 15, 2019.

Assessing estimates of fair value continues to be a challenge for auditors. We observed this most often in the audits of fair value estimates of asset acquired, liabilities assumed, and non-cash consideration transferred in business combinations. Fair values of biological assets and investments were also common findings as noted above.

As in prior years, the audit of revenue recognition based on the percentage of work completed continues to be a concern; we are finding that some auditors do not obtain sufficient and appropriate evidence to support the estimate of progress achieved.

Responding to changes in the business

The current business environment requires companies to constantly evolve the nature of their products and services or internal operations. Our inspection findings are often in areas where there has been a significant change at the reporting issuer in the year. For example, a business may decide that instead of performing a full inventory count at a point in time it is more effective to count small portions throughout the year. To respond to this business process change, the auditor is required to perform different audit procedures and to perform them throughout the year. Significant inspection findings arose when auditors did not make the appropriate audit procedure changes.



2019 INSPECTIONS SCOPE

How CPAB chooses files to review

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 and are not designed to identify areas where auditors met or exceeded standards. Results should not be extrapolated across the entire audit population, but instead viewed as an indication of how firms address their most challenging situations.

Registered firms

At December 31, 2019, 267 audit firms were registered as a Participating Audit Firm with CPAB. During the year, twenty-three new firms registered (five Canadian and 18 foreign firms). Twenty-eight firms withdrew from registration with CPAB and one firm's registration was terminated for failing to comply with administrative requirements. Audit firms who voluntarily participate in the Protocol for Audit Firm Communications of CPAB Inspection Findings with Audit Committees (Protocol) share significant file-specific inspection findings with their reporting issuers' 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. Twelve of the 14 annually inspected firms participate in the Protocol – a complete list is available at www.cpab-ccrc.ca.

How firms respond to CPAB findings

The majority of CPAB's inspection findings in 2019 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 14 annually inspected firms, two restatements have been required since our 2018 annual report or one per cent of files inspected (2018: five restatements or four per cent of files inspected).



CPAB DISCIPLINE OVERVIEW

CPAB actively engages with firms throughout the inspections cycle to resolve issues as they arise during our reviews. Our Rules provide a framework of remediation and disciplinary mechanisms to address audit quality deficiencies at the firm and file levels. This allows us to respond quickly when we believe more work is required to support the audit opinion. For example, CPAB operates under the principle that, within 10 days of determining a file deficiency, we notify the firm; we then require their remediation plan within another 10 days. CPAB expects that firms will remediate file deficiencies before their reporting issuer's next quarterly report or next audit committee meeting.

CPAB also has the authority to commence an investigation when it considers that a Violation Event may have occurred, and it wishes to seek information and the cooperation of the firm with respect to such matters. A Violation Event is defined in CPAB's Rules as: (i) an act or omission in violation of CPAB's Rules or chartered professional accountant standards; (ii) a failure to supervise a person to prevent such violations, and the person has committed the act or omission; (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 CPAB. No investigations were conducted in 2019.

What happens when a firm does not show improvement?

If a firm fails to improve, CPAB has the authority to impose discipline at three levels: Requirement, Restriction and Sanction. This can include publicly naming a firm and restricting it from auditing public companies and helps to ensure that firms act quickly and appropriately to resolve deficiencies. Finally, where CPAB imposes a disciplinary action related to a defect in the firm's system of quality control, and the firm fails to address it to CPAB's satisfaction within a specified time period, the firm must notify the audit committees of all its reporting issuers.

Requirements typically involve CPAB mandating the firm to take an action to make a change to its audit practices to improve audit quality. Requirements are generally private, unless notification is required by the securities commissions. If audit quality has not improved during a follow-up inspection with an audit firm with a Requirement on it, or if CPAB feels the performance of the firm and the severity of the lack of audit quality in the first instance requires so, CPAB would impose a Restriction.

Restrictions characteristically involve CPAB limiting the audit firm's practice in some way, and CPAB will specifically notify the securities commissions of the Restriction, in addition to the notification that may be required otherwise under National Instrument 52-108. If there is demonstrated continued lack of improvement of audit quality with an audit firm with discipline already in place, or if in the first instance there is demonstrated egregious behavior, CPAB would impose a Sanction.

With the imposition of a Sanction, CPAB would severely limit the audit firm's practice and obligate the firm to notify the audit committees of its reporting issuer clients. CPAB would also notify the securities commissions.

The power of public censure

CPAB's power to impose a Requirement, Restriction or Sanction includes a public censure in the event that CPAB considers a Violation Event has occurred. A public censure is intended to be a strong public statement of disapproval of a firm's conduct. While CPAB has not yet publicly censured a Participating Audit Firm, CPAB may impose this sanction when commensurate with the circumstances of the case. CPAB considers the seriousness of the Violation Event, the firm's response and risk of harm to the investing public.





A public censure may be published on CPAB's website or, in serious cases, announced via a news release. CPAB would only impose a public censure while respecting the confidentiality obligations imposed on it by its Rules or legislation. CPAB will not identify any individual, except insofar as those names are part of a Participating Audit Firm name. CPAB will not share specific information relating to a reporting issuer, or the business, affairs or financial condition of a Participating Audit Firm or the client of any such firm.

Participating Audit Firms have the right to petition for a review hearing before a public censure is imposed, as is the case with all Requirements, Restrictions or Sanctions.

2019 disciplinary actions

As at December 31, 2019 there were Requirements on one firm (2018:3) and Restrictions on one firm (2018:2). Of the two firms operating with Requirements or Restrictions, CPAB has limited the acceptance of new reporting issuers for both firms, and for one or both firms required enhanced engagement quality control reviews or in-flight reviews, additional training for specific accounting or audit topics, and action plans to improve audit quality and consider hiring additional resources. There were no Sanctions in 2019.

How does a firm request a review proceeding?

A firm may petition for a review proceeding in the following three situations: 1) when CPAB intends to make public the weaknesses, deficiencies and recommendations in the system of quality control, or deficiencies in specific engagements, not addressed or remedied to CPAB's satisfaction; 2) when CPAB proposes to impose Requirements, Restrictions and Sanctions in the case of a Violation Event; 3) in connection with an application for membership not accepted by CPAB.

● No review proceedings were conducted in 2019.

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