Canadian Public Accountability Board
Conseil canadien sur la reddition de comptes

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CPAB Audit Quality Insights Report: 2020 Annual Audit Quality Assessments

Audit quality insights

2020 audit quality assessments overview

During 2020, we inspected 119 audit files and identified significant findings in 35 files. This 29 per cent finding rate compares to 33 per cent across 142 files in 2019. The pandemic caused us to initially delay some inspections as we adjusted to a remote working environment. As a result we deferred inspections of smaller audit firms to early 2021.

Three of the four largest firms had inspection results that improved or were consistent with the prior year, meeting the target of no more than 10 per cent of files inspected with significant findings. One large firm did not meet the target and continued to have finding levels in excess of 10 per cent. While we saw some strengthening of quality management systems, there is still more work to be done to achieve the target of 90 per cent of criteria rated as either acceptable or acceptable with opportunities for enhancement by 2021. We continue to be concerned about the elevated finding rates at one of the large firms and a decision regarding additional regulatory intervention will be made in 2021.

Of significant concern is the increase in findings at many of the other annually inspected firms, where the aggregate significant finding rate was 63 per cent (22 of 35 engagement files), compared to 54 per cent (20 of 37 engagement files) in the prior year.

CPAB's assessment landscape

All public accounting firms that audit a Canadian reporting issuer must register with CPAB[1]. At December 31, 2020, 248 (2019: 267) audit firms were registered; 87 (2019: 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 11 firms (2019: 14) in this group which audit almost 6,700 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, discipline and enforcement mechanisms to address audit quality deficiencies at the firm and file levels. We conduct incremental risk assessments of firms subject to potential disciplinary/enforcement action to ensure the level of intervention matches the risk profile of the firm and the risk that significant findings pose to the investing public. We use a graduated approach to regulatory intervention that starts with recommendations, monitoring and remedial actions and escalates in severity in proportion to the seriousness of the significant findings.

[1] 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.

Targeted remediation and enforcement action has either been completed or is in progress to address firms with unacceptably high levels of significant findings. We have increased our monitoring of firms with unacceptable levels of significant findings including action taken on our recommendations. Coming into the year two firms were operating under restrictions, requirements or sanctions; two non-annually inspected firms increased this number to four in 2020. Two investigations were commenced and are ongoing. Further details of enforcement action undertaken in 2020 and the escalation of our regulatory intervention is outlined in the **Enforcement Overview** on **page 9** of this report.

Two restatements have been required since our 2019 annual report, one at an annually inspected firm and one at a non-annually inspected firm. Where a restatement is required the firm must work with the reporting issuer and its legal counsel to effect the restatement as soon as possible — usually within the next quarterly reporting cycle.

The move to remote work and the economic upheaval has created a number of new audit risks. We have interacted extensively with the audit firms this year on their approach to addressing these risks. While we have inspected some audit files that were completed during the pandemic, including 14 engagement files with March 31, 2020 or later year ends, files where both the reporting issuer financial reporting process and the audit were performed remotely will not be available to inspect until 2021.

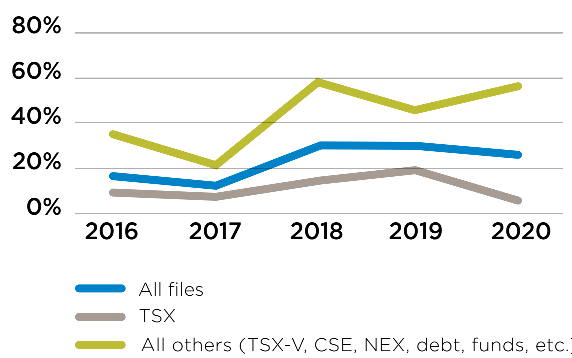
Common inspection findings and trends

Twenty-six per cent of files inspected at the 11 annually inspected firms had significant findings (2019: 29 per cent). In the past five years, the overall level of inspection findings has remained unacceptably high. While we have seen improvement related to audits of entities listed on the Toronto Stock Exchange (TSX), we have observed a steady increase in the number of findings in audits of other reporting issuers. In 2020 our annual inspections included 64 audit files of TSX listed entities and 43 other non-TSX listed entities (2019: 66 TSX; 43 other).

One restatement has been required across the annually inspected firms since our 2019 annual report. We also observed, not in connection with our inspections, a general increase in the number of restatements in 2020 compared to 2019.

PER CENT OF FILES WITH SIGNIFICANT FINDINGS

Five-year trend



The most common findings were related to auditing estimates involving significant assumptions and judgments about future conditions or events. Deficiencies included:

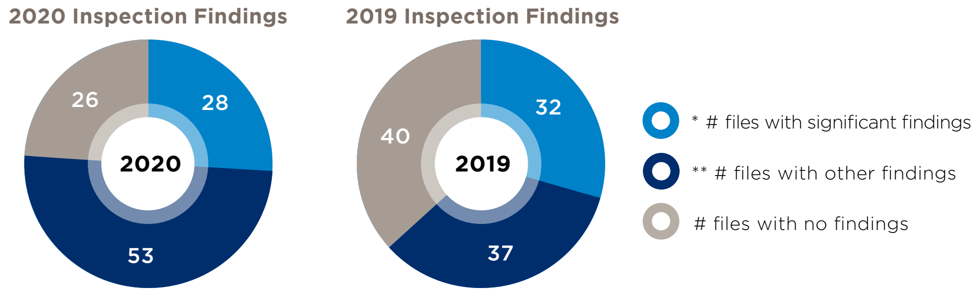
- Insufficient procedures to assess management's selection and application of methods, assumptions and data used in developing fair value estimates.
- Lack of retrospective reviews of management judgments and assumptions.
- Insufficient evidence to demonstrate how inconsistent information was considered and resolved by the engagement team.
- Over-reliance on management representations without corroboration with third party evidence.
- Lack of evaluation to assess whether significant deficiencies in internal control exist when management has not taken appropriate steps to understand or address estimation uncertainty.

We also identified concerns over the quality of audit evidence obtained to address the risks of material misstatement and the effectiveness of supervision and review by more senior engagement team members. Audit firms must incorporate a greater level of professional skepticism through all stages of the audit. Effective challenge of management on key judgments requires engagements to be staffed with sufficient resources at all levels, including specialized expertise where needed. Firm leadership must ensure senior team members have sufficient time to invest in each audit engagement to effectively supervise and review the work of those with less experience.

2020 ANNUAL FIRM INSPECTIONS SNAPSHOT

CPAB inspected 11 annual firms in 2020 and 107 engagement files (2019: 109) and identified significant findings in 28 files (2019: 32).

- Four largest firms: 72 engagement files; six with significant findings.
- Seven other annually inspected firms: 35 engagement files; 22 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 assessments

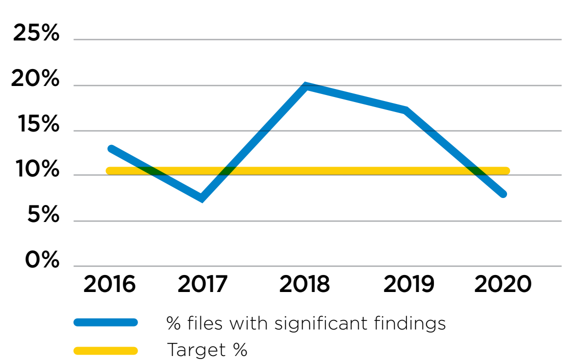
The firm-specific assessments for Deloitte LLP, Ernst & Young LLP, KPMG LLP and PwC LLP include the results of our engagement file inspections and our evaluation of the firms' quality management systems. The firm-specific assessments for the other seven annually inspected firms include our engagement file inspections; we have not evaluated the quality management systems of these firms.

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

Significant inspection findings have declined in the past two years. We inspected 72 files (2019: 72) and identified significant findings in six of those files (2019: 12). Two firms improved over the prior year and three firms met the target of no more than 10 per cent of files with significant findings.

SIGNIFICANT FINDINGS VS TARGET

Five-year trend



The firm that did not meet the 10 per cent target, (and did not meet the target in previous years), must perform a number of procedures to identify underlying factors observed this year that continue to impact audit quality, including the implications on the effectiveness of its quality management systems. Mandatory development and implementation of specific actions that will result in meaningful improvement to audit quality will be undertaken by the firm. A decision regarding additional regulatory intervention will be made in 2021.

The three firms that did not meet the target in 2019 acted on 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.

Remediation work being performed by these audit firms has either been completed or is in process. No restatements have been required since our 2019 annual report.

We evaluated the quality management systems at each firm. The table below indicates the number of firms within each rating by criteria for each of 2020 and 2019. Firm progress against the target of 90 per cent of firm quality management systems criteria rated as acceptable or acceptable with opportunities for enhancement by 2021 was mixed.

		Acceptable	Acceptable with opportunities for enhancement	Needs improvement	Requires significant improvement
Accountability for audit quality	2020	1	3		
	2019		4		
Risk Management	2020	2	2		
	2019	2	2		
Talent & Resource Management	2020		1	3	
	2019		1	2	1
Oversight	2020	1	1	1	1
	2019		2	1	1

Each firm made progress in responding to CPAB's 2019 observations including amending existing or implementing new processes and controls and linking them to our assessment criteria.

However, firm leadership needs to commit sufficient resources to respond to deficiencies, integrate CPAB's quality management systems framework into their implementation plan for the new international standards on quality management effective in 2022 and continually evaluate the nature, timing and extent of monitoring controls to ensure they remain appropriate. Quality management systems that clearly document key processes and controls and identify risks and the development of responses that recognize the iterative nature of the new international quality management standards and CPAB's assessment criteria will be critically important.

2020 QUALITY MANAGEMENT SYSTEMS ASSESSMENTS BY CRITERIA

The following is a summary of our assessment and recommendations for each criterion. Not all assessments or recommendations apply to all firms.

ACCOUNTABILITY FOR AUDIT QUALITY

Responsibility and accountability for audit quality is clearly defined, delegated and monitored across firm leadership.

Assessment

- All firms improved in response to our 2019 recommendations.

Recommendations for improvement

- Refine performance management processes to demonstrate how leadership is held accountable for audit quality.
- Define how responsibility and accountability for experts is delegated and monitored, including ongoing review of availability to carry out assigned responsibilities.

RISK MANAGEMENT

Client and audit risk are identified and effectively measured, monitored and responded to.

Assessment
- Controls and processes to monitor decisions to accept new or continue with existing clients are established at all firms.

Recommendations for improvement
- Provide evidence to demonstrate the operating effectiveness of controls related to identification, review and intervention in high-risk engagements and challenge of decisions to continue with existing clients.

TALENT & RESOURCE MANAGEMENT

Competency and capacity at all levels of talent, including experts, is proactively aligned to address changing needs, priorities and risks.

Assessment
- All firms made improvements to respond to deficiencies identified in 2019 but more work is necessary.
- Significant inspection findings indicate controls to ensure partners and staff have enough time to dedicate to specific audits are not designed appropriately or operating effectively.

Recommendations for improvement
- Implement changes to controls that ensure all engagements are assigned resources with the appropriate competency and capacity to execute quality audits.
- Proactively monitor assignment of technical resources so that specialized expertise is assigned to support engagement teams.
- Monitor excessive hours and document actions by leadership to support engagement teams.

OVERSIGHT

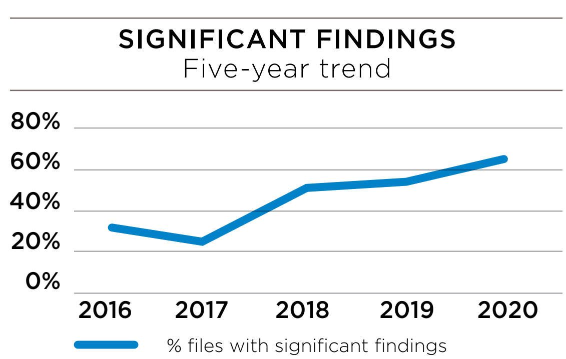
Leadership has visibility on the progress of audit work and changes in risk to initiate proactive issue resolution.

Assessment
- All firms made improvements to respond to deficiencies identified in 2019 but more work is necessary.
- Significant inspection findings indicate that controls related to leadership oversight may not be appropriately designed or operating effectively.

Recommendations for improvement
- Retain evidence of ongoing monitoring controls to identify material changes in engagement scope, risk or other matters where intervention may be required.
- Establish a defined milestone program to provide leadership with visibility into the progress of engagements.
- Formalize escalation and oversight mechanisms.

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

Significant inspection findings have increased over the past five years. We inspected 35 files (2019: 37) and identified significant findings in 22 of those files (2019: 20). Four firms (2019: three) had significant inspection findings in more than 50 per cent of files inspected and two firms (2019: four) in more than 25 per cent of files inspected. One firm (2019: none) had no significant findings thereby meeting the target of no more than 10 per cent of files with significant findings.



Targeted remedial and enforcement action[2] is in place for firms with unacceptably high levels of significant findings. Enhanced regulatory intervention was undertaken to address specific breaches of professional standards including entering into formal undertakings and increased monitoring of firms with high levels of significant findings to ensure timely action on recommendations for improvement. The undertakings included actions such as the preparation of comprehensive audit quality action plans, additional staff and partner training, enhanced client acceptance and continuance processes, cultural assessments and in some instances agreements to limit the reporting issuers audited or partners involved in the public company audit practice. Further regulatory intervention as a result of our 2020 inspection findings is being considered and decisions will be made in 2021.

In 2021 we will complete preliminary evaluations of quality management systems at select annually inspected firms taking into consideration the level of significant inspection findings and number and market capitalization of reporting issuers audited by the firm; all other annually inspected firms will be assessed in conjunction with implementation of the new international quality management standards. We are encouraging these firms to begin early implementation of these standards.

Non-annually inspected firms

We execute a tailored inspection methodology to assess non-annually inspected 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. We inspected 12 audit files (2019: 33) and identified significant findings in seven (2019: 15) of these across eight non-annually inspected firms (2019: 24). One restatement has been required since our 2019 annual report. The balance of our 2020 non-annual inspections will be completed during the first quarter of 2021.

The level of inspection findings at these firms is unacceptably high. In 2020, we imposed restrictions and requirements on two firms. Follow up inspections will be performed to assess the effectiveness of the actions in response to our recommendations and determine whether further regulatory intervention is necessary.

Overseeing audit quality in a global pandemic: heightened vigilance is essential

Unpredictability and volatility will affect the complexity and measurement uncertainty surrounding many accounting estimates, including going concern evaluation, complex valuations, impairment of assets and allowances for expected credit losses. We expect audit challenges will be more prevalent for engagement files inspected in 2021. When assessing the risk of material misstatement, auditors must be alert to the subjectivity of accounting estimates, ineffective internal controls, management bias and events and conditions that increase the risk of fraud. Heightened vigilance will be essential as audit work continues to be performed remotely in 2021.

Firms should have processes and controls in place to monitor the progress and changes in the risks of individual engagements to enable firm leadership to provide support as needed:

- **Supervision and review:** Sufficient staff with the appropriate level of experience and time must be assigned to execute quality audits. Identification and assessment of risks, either due to fraud or error, and designing procedures that are responsive to those risks, will require increased professional skepticism and involvement of more senior members of the engagement team throughout all stages of the audit.
- **Sufficiency of resources:** Firms must be alert to circumstances that may impact the ability to issue audit opinions in line with previously agreed timelines, including remote working conditions, staff illness or other factors that cause resource limitations.
- **Specialized expertise:** Experts must understand their responsibility and accountability for audit quality; firms must have processes and controls to proactively monitor the assignment of experts. We anticipate an increased need for specialized expertise, particularly in the areas of liquidity, valuation, accounting, auditing and forensics.
- **Oversight:** Increased oversight is needed so that firm leadership can effectively assess the progress of audit work and changes in risk to support engagement teams in a timely manner. This could include additional monitoring at the firm level to identify declines in the financial condition of reporting issuers that cast significant doubt on their ability to continue as a going concern and delays in audit work.

[2] Enforcement or disciplinary action may include mandating the firm to change its audit practices, provide additional training, restricting a firm from taking on new clients or auditing public companies altogether and other remedial actions. See section 600 of CPAB's Rules for a comprehensive list.

Engagement teams must sharpen their focus in these areas:

- **Increased fraud and error risk:** Historically, economic upheaval has resulted in increased financial fraud. Auditors should understand the impact of the pandemic on the reporting issuer and its environment, particularly any changes to internal controls and indicators of management bias. Areas that could be more susceptible to fraud include revenue recognition and impairment. Remote working conditions that result in changes to the control environment may also create an increased risk of errors going undetected or opportunities for misappropriation of assets and cyberattacks.
- **Going concern:** Management may need to consider a range of factors related to current and expected profitability, debt repayment schedules and sources of replacement financing to demonstrate the reporting issuer's ability to continue as a going concern. Auditors must increase professional skepticism when evaluating management's assessment, including consistency with information obtained throughout the audit and being alert to contradictory information. We expect additional circumstances where management needs to perform a more detailed assessment to support that the going concern basis of accounting is appropriate.

Continued focus on designing and implementing strong quality management systems will be critical for firms to improve audit quality as the profession navigates an unprecedented level of uncertainty. We are also:

- Requiring certain annually inspected firms to develop processes and controls to respond to CPAB's quality management systems assessment criteria.
- Encouraging other annually inspected firms to begin early implementation of the international standards on quality management (ISQM 1) and engagement quality reviews (ISQM 2, as well as International Standard on Auditing 220, Quality Control for an Audit of Financial Statements).
- Developing a scalable model to evaluate quality management systems of the other annually inspected firms in conjunction with the required implementation date of the new international quality management standards in 2022.

Foreign jurisdictions access

In 2020 we obtained access to review component auditor working papers located in foreign jurisdictions for four engagement files selected for inspection. For a fifth file, we were precluded due to local law impediments from obtaining access to the component auditor working papers.

Certain foreign auditors and countries continue to prevent CPAB from inspecting audit work of Canadian public companies conducted in those foreign jurisdictions. We are concerned about the potential impact of this on auditor oversight, integrity of financial reporting and, ultimately, the investing public. With CPAB's assistance the Canadian Securities Administrators have tabled proposed amendments to National Instrument 52-108 and the Companion Policy 52-108 (Auditor Oversight) which, if passed, will assist CPAB in accessing audit work performed outside of Canada. CPAB expects the proposed amendments will come into force in 2021.

(For a detailed list of jurisdictions where CPAB has been unable to access audit working papers, please visit www.cpab-ccrc.ca).

2020 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 reporting issuers 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, 2020, 248 audit firms were registered as a Participating Audit Firm with CPAB. During the year, 17 new firms registered (three Canadian and 14 foreign firms). Thirty-four firms withdrew from registration and two firms' registration was terminated for failing to comply with administrative requirements. Audit firms that 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. In 2020, 24 of the 35 files with significant findings were shared by the audit firm with the relevant audit committee (2019: findings shared with 35 of 47 reporting issuer audit committees).

Nine of the 11 annually inspected firms participate in the Protocol — a complete list is available at **www.cpab-ccrc.ca**. We strongly encourage all audit firms to share significant file-specific inspection findings with their reporting issuers' audit committees.

How firms respond to CPAB findings

The majority of CPAB's inspection findings in 2020 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 firm to add considerable evidence to the audit file to show it had obtained sufficient and appropriate audit evidence with respect to a major financial statement item. For the 11 annually inspected firms, one restatement has been required (2019: two).

Enforcement Overview

Throughout the inspection cycle CPAB expects the firms to resolve issues as they arise during our reviews.

Our Rules provide a framework of remediation and enforcement 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 written response within the next 10 days. Remediation must be completed 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. CPAB expects firms to remediate file deficiencies before their reporting issuer's next quarterly report or next audit committee meeting.

What happens when a firm does not show improvement?

If a firm fails to improve audit quality deficiencies, CPAB has the authority to escalate its regulatory intervention by imposing requirements, restrictions and sanctions. This can include restricting a firm from taking on new clients or auditing public companies altogether. Such regulatory intervention helps to ensure that firms act quickly and appropriately to resolve deficiencies.

Requirements typically involve CPAB mandating the firm to change its audit practices, conduct culture assessments or provide additional training, for example, to improve quality. If audit quality has not improved during a follow-up inspection of an audit firm operating under a requirement, 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 will impose a restriction.

Restrictions typically involve CPAB limiting the audit firm's practice in some way. If there is demonstrated continued lack of improvement of audit quality at an audit firm with a requirement or restriction already in place, or if in the first instance there is demonstrated egregious behavior, CPAB will impose a sanction.

With the imposition of a sanction, CPAB would typically severely limit the audit firm's practice and obligate the firm to notify the audit committees of its reporting issuer clients. Other forms of intervention at this level may include assignment of an independent monitor to observe and report on a firm's compliance with the professional standards, termination of one or more audit engagement and/or public censure.

2020 enforcement actions

As of December 31, 2020, there were restrictions imposed on two firms. CPAB has restricted the acceptance of new reporting issuers and required an external professional to act as engagement quality control reviewer on all public company audits for both firms. One of the two firms is also required to engage an external professional to perform quality monitoring of the firm's system of quality control and of completed reporting issuer assurance engagements. Both firms will continue to operate under these requirements and restrictions until each has demonstrated improved audit quality. There were no sanctions imposed in 2020.

When does CPAB initiate an investigation?

In addition to the power to impose requirements, restrictions and sanctions as a consequence of an inspection, such actions may also be imposed as a consequence of an investigation. An investigation is commenced when CPAB considers that a Violation Event[3] may have occurred, and it wishes to seek additional information.

Investigation activity is prioritized to address areas of emerging or significant risks to the investing public and risks associated with quality control deficiencies. In 2020, two investigations were initiated.

Are CPAB's enforcement actions publicly available?

Although public disclosure is not mandatory under our Rules, CPAB has the authority to publicly hold firms to account by ordering disclosure of various requirements, restrictions and sanctions to a firm's reporting issuer clients or the public. Disclosure may be imposed to address issues that pose the greatest risk to the investing public and to deter other firms from engaging in similar conduct. For example, a public censure may be published on CPAB's website or, in serious cases, in a news release. CPAB considers the seriousness of the Violation Event and the risk of harm to the investing public when making this determination. In 2020, there were no such disclosures.

Can a firm challenge CPAB's regulatory intervention?

Firms have the right to petition for a review proceeding before any requirements, restrictions or sanctions are imposed by CPAB. An independent panel of hearing officers appointed by the Council of Governors presides over these proceedings. There were no such challenges in 2020.

[3]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.

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