



CANADIAN PUBLIC ACCOUNTABILITY BOARD  
CONSEIL CANADIEN SUR LA REDDITION DE COMPTES

WORLD-CLASS AUDIT REGULATION

November 2016



# 2016 Big Four Inspections Report

## ABOUT CPAB

The Canadian Public Accountability Board (CPAB) is Canada's audit regulator responsible for the oversight of public accounting firms that audit Canadian reporting issuers. A leading audit regulator, CPAB contributes to public confidence in the integrity of financial reporting, which supports effective capital markets.



### VISION

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



### MISSION

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



### BOARD OF DIRECTORS

CPAB has a nine-member Board of Directors.



### EMPLOYEES

CPAB employs approximately 50 professionals.



### LOCATIONS

CPAB operates from offices in Montreal, Toronto and Vancouver.

## CPAB Report on 2016 Inspections of Canada's Big Four Accounting Firms

CPAB's 2016 Big Four Inspections Report discusses the annual inspection findings for Canada's four largest public accounting firms (Deloitte LLP, EY LLP, KPMG LLP, PwC LLP). These firms, and their foreign affiliates, audit approximately 98 per cent of all Canadian reporting issuers by market capitalization.

Each firm shares their file-specific significant inspection findings, and this report, with their clients' audit committees as per their participation in the Protocol for Audit Firm Communication of CPAB Inspection Findings with Audit Committees (Protocol). The report includes common inspections findings and questions for audit committee consideration to encourage more robust discussions among management, the firm and audit committees and to support audit committees in their oversight responsibilities.

### LEARN MORE

CPAB's 2015 annual inspections report, 2016 Big Four inspections report, detailed information on the Protocol, and other publications are available at [www.cpab-ccrc.ca](http://www.cpab-ccrc.ca).

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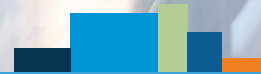
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## SIGNIFICANT INSPECTION FINDINGS DECREASE IN 2016; HOWEVER, CONSISTENT AUDIT EXECUTION IS STILL A CHALLENGE

### CPAB and firms to focus on systems and processes to drive sustainable audit quality

The Canadian Public Accountability Board’s (CPAB) 2016 inspections indicate that – despite an overall decrease in significant inspection findings compared to last year – audit quality across Canada’s largest public accounting firms (Big Four: Deloitte LLP, EY LLP, KPMG LLP, PwC LLP) continues to be inconsistent.

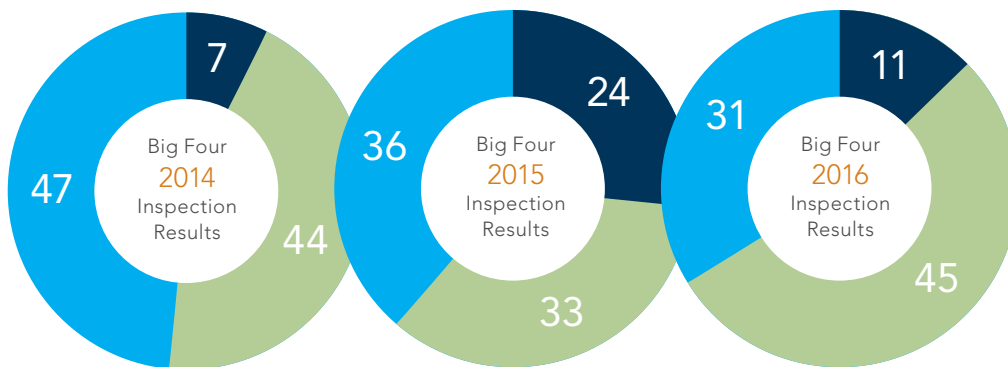
In 2016, CPAB inspected 87 (2015:93) engagement files – 11 of those had significant findings (2015:24). Results at one firm were consistently good (and comparable with prior years); results at one firm were stable year over year, and results improved for the two firms that experienced challenges in 2015. Remediation work has either been completed or is in process; no restatements have been required.

#### What is a significant inspection finding?

A significant inspection finding is defined as a deficiency in the application of generally accepted auditing standards that could result in a restatement. 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.

Prior to 2015, CPAB’s inspections were focused primarily on the audits of larger reporting issuers. In 2015 and 2016, we shifted focus to audit files of smaller reporting issuers. Results in these files varied in 2016 but were better overall than in 2015. Unlike last year, there was no concentration of significant findings in reporting issuers with market capitalizations of \$250 million or less, or notable multiple findings per file in any firm.

### 2016 Big Four Inspections Results: Engagement File Findings



\*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.

● # Files with Significant Findings    ● # Files with \*Other Findings    ● # Files with No Findings

## How does CPAB select files for inspection?

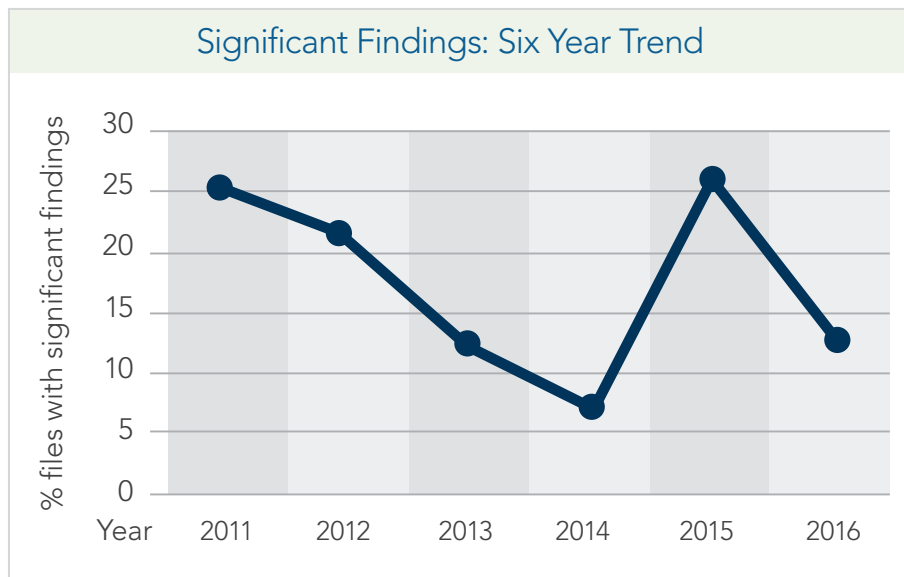
CPAB's risk-based methodology for choosing files (and the audit work in those files) for inspection is not intended to select a representative sample of the firm's audit work. Instead, it is biased towards higher-risk audit areas of public companies, so there is a greater likelihood of encountering audit 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 should not be extrapolated across the entire audit population, but instead viewed as an indication of how firms addressed the situations CPAB considers the most challenging.

## Quality systems: The road to sustainable audit quality

Based on our 2011 inspections results, CPAB required the Big Four firms to implement action plans to consistently improve audit quality. Overall, these initiatives have enhanced audit quality; most public company audits in Canada are well done.

Still, inconsistent audit execution remains an ongoing theme. Firms have sound audit methodologies and quality systems and, in most cases, engagement teams execute in compliance with them; however, we continue to find exceptions where firms do not execute consistently.

The impact of variations in firm quality systems and execution is evident in our findings pattern over the past several years (see Significant Findings: Six Year Trend chart below). In 2015, significant findings increased substantially over the 2013-14 cycle. 2016 findings were lower (but still higher than in 2014 and closer to 2013 levels). We have generally seen improvement at the larger engagement file-specific level; however, inconsistency across firm practices and clients means that more effort is needed to fully embed the audit quality improvements seen in recent years in their approach to every single engagement.



Prior to 2015, CPAB's inspections were focused primarily on the audits of larger reporting issuers. In 2015 and 2016, we shifted focus to audit files of reporting issuers with medium to smaller market capitalizations (\$250 million or less).

Based on last year's inspections results, CPAB required the firms to address the issues underlying our findings and develop ways to improve their quality systems for medium to smaller market capitalization client engagements. While it appears this approach has helped enhance quality, it will take more than one year for the firms to fully embed these initiatives.

This year, in addition to completing procedures to identify if restatements are required, evaluating underlying cause(s) of significant findings, updating action plans and revising tools, templates, and internal training as appropriate, CPAB has required the firms to focus on:

1. Revising or amending firm guidance and methodologies to address systemic issues.
2. Identifying key quality controls and determining metrics to monitor and measure effectiveness.
3. Ensuring effective issue escalation processes to manage and mitigate firm risk are in place.



To further enhance audit quality in 2017 and beyond – with an emphasis on consistency of execution – CPAB has explored what we, and the Big Four, might do differently to drive quality improvements deeper into the firms. Our risk-based model of inspecting specific files for significant deficiencies and identifying systemic issues has been effective in enhancing audit quality; yet consistency across firm practices and client engagements remains elusive.

As a result, to better identify and understand impediments to improving firm quality systems (actual workflow and monitoring that workflow) we will begin shifting our inspections focus to more operational reviews of firm structure, accountabilities, culture and quality processes. We will continue to conduct file inspections to validate systems findings. We plan to develop and implement our new approach over the next two years, engaging with the firms and other stakeholders as we go along.

## Foreign Jurisdictions Update

The Big Four firms have implemented policies and procedures aligned with Canadian standards regarding auditing Canadian reporting issuers with operations in foreign jurisdictions.

The work of component auditors outside Canada is still an area that can negatively impact execution of quality audits.

As reported last year, CPAB has memoranda of understanding with a number of foreign jurisdictions; however we continue to face limitations in accessing component audit work in certain others. (For a list of jurisdictions where CPAB is unable to access working papers, please visit [www.cpab-ccrc.ca](http://www.cpab-ccrc.ca), Focus by Topic, Auditing in Foreign Jurisdictions). We have proposed a regulatory way forward to the relevant Canadian securities authorities to access information and related audit working papers so we may fulfil our mandate.

Our inspection activity of companies with foreign operations is often limited only to engagement files accessible in Canada – in many cases this may only represent a small portion of the audit work.

The Canadian Securities Administrators (CSA) are examining CPAB's proposal to determine whether legislative amendments should be considered. We look forward to working together with securities authorities and other stakeholders to address these limitations.



## 2016 INSPECTIONS THEMES

Last year we reported five key inspections themes. Ninety-six per cent of our total findings related to these areas again in 2016: significant accounting estimates, executing audit fundamentals, professional judgment and skepticism, internal controls, and understanding business processes relevant to financial reporting.

### Significant accounting estimates



As business becomes more complex and accounting rules evolve to improve consistency and relevance of financial reporting, the use of accounting estimates continues to grow. Because estimates often require significant judgment and have a number of possible outcomes, they are arguably the most challenging aspect of an audit. This area accounted for 27 per cent of our total findings in 2016 (2015:29 per cent).

Each estimate carries its own unique risks of material misstatement. Some are significant because of the large dollar amounts involved. Others incorporate sophisticated models that may make them more susceptible to error. Either way, all estimates allow for management bias.



Complex estimates may involve a third party with specific technical expertise. For example, resource companies typically capitalize the costs to explore and evaluate resources on their balance sheets – they do so assuming these costs will be offset by future production revenue. If a full recovery is not likely, the estimated excess costs will be written off as an expense. To make this assessment management often hires an expert, such as a qualified engineer, to prepare a technical report that includes an economic analysis of the project. In preparing the report the expert uses both historical and prospective financial input provided by management as well as their own assumptions related to the project.

Auditors may use the work of management’s expert if the auditor independently assesses the appropriateness of the financial inputs provided by management and the reasonableness of the expert’s assumptions or models used. If this assessment is not performed, a material misstatement in the result/value due to error or bias may not be identified.

**Audit Committee Considerations:**

Are there unique risks embedded in the company’s estimates that are challenging to assess? Is the work of experts or specialists used in any of the audit work? If so, how is their work effectively integrated into the audit procedures so that all relevant factors are considered and there is no management bias or errors in logic, models, inputs, judgments, etc.?

## Executing audit fundamentals



CPAB often chooses significant but non-complex account balances and transaction streams to review – an area that requires the execution of basic audit procedures and provides some insight into how well audit quality has been embedded across the firm.

Appropriate staff training and supervision and review by senior audit team members are key quality controls which, if operating effectively, should reduce these types of deficiencies.

Deficiencies in this area represented 28 per cent of our total findings (2015:29 per cent) and examples included selecting samples that were not representative of the balance being tested and performance issues with account-specific testing (e.g. procedures performed when attending physical inventory counts; testing the existence of additions to property, plant and equipment or the accuracy of depreciation expense).

**Audit Committee Considerations:**

Audit committees should ask how their auditor ensures basic audit procedures are well executed. For example, errors in inventory quantities or costing could have a significant impact on profitability. How has the auditor ensured testing was effectively executed?

## Professional judgment and skepticism



Auditors determine the level of audit work required by assessing the risk of material misstatement. This requires significant professional judgment and an objective analysis, and accounted for 30 per cent of our total findings in 2016 (2015:30 per cent).

Audit risks will vary from high to low, but a risk can never be low enough for a material balance sheet item or transaction stream to eliminate the need for all audit procedures.

for a stable, profitable manufacturer; however, the risk of material misstatement still exists for companies that carry significant inventory balances and should be tested. Inadequate testing, or the absence of testing, underlies many of CPAB’s inspection findings.

For example, the risk that inventory will not be sold for more than its carrying value may be low

Auditors should not accept management’s evidence without corroborating its reliability. Examples include using the fair value of a forward contract provided by a broker without validating it against an independent source or accepting management’s projections of future sales without assessing whether there is a reasonable basis for the projection.

More extreme cases occur when auditors do not challenge information provided by management when there is conflicting evidence (e.g. accounts receivable confirmations where the responses from the company's customers identify differences).

**Audit Committee Considerations:**

Did the auditor rely on management's representation when they could not get sufficient independent audit evidence? Was there any conflicting evidence? If management is biased, what is the risk to reported results or to incentive plans?

## Internal controls



Management implements internal controls to safeguard company assets and the integrity of its financial reporting. Our findings in this area – six per cent of our total findings (2015:8 per cent) – raise concerns about how internal control testing is performed, particularly for management review controls. Obtaining evidence that management reviewed the financial information is not enough; the auditor must also evaluate the review was performed in a way that would identify material errors. If appropriate testing is not performed, the auditor may miscommunicate to the audit committee that controls are operating effectively when they are not.

In other circumstances, the auditor may need to rely on internal controls where a significant amount of information is only available electronically.

Inspection findings indicate that auditors often avoid testing the controls by 'auditing around' the computer system. This is difficult to do effectively and auditors end up relying on system-generated information which has not been properly tested.

**Audit Committee Considerations:**

Company operations are highly system dependent and management relies heavily on a well-established control environment. How could the auditor complete the audit without testing the operating effectiveness of at least some of management's controls? Did the auditor ensure they did not inherently rely on system-generated information?

## Understanding business processes relevant to financial reporting



Without an accurate or complete understanding of underlying business and accounting processes the auditor may not identify and respond to significant audit risks. The outcome is often insufficient or ineffective audit procedures, or reliance on audit evidence of limited value. This accounted for five per cent of our total findings in 2016 (2015:4 per cent).

For example, if the auditor does not fully understand the terms of a service contract and how those services will be performed and invoiced, key performance obligations that must be met before revenue can be recognized may be missed. As a result, the testing may not provide evidence that revenue was recorded according to accounting requirements.

In other cases, the auditor may incorrectly assess the value of audit evidence. For example, if an auditor relies on a confirmation from a third party service provider to support the revenue reported but that third party obtains the underlying information from the company itself, the confirmation is not independent evidence.

**Audit Committee Considerations:**

How does the auditor keep up to date on the company's changing operations and business environment? How do operational changes and challenges year over year impact the audit strategy?

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