### 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. CPAB contributes to public confidence in the integrity of financial reporting, which supports effective capital markets.

<table>
<thead>
<tr>
<th>Vision</th>
<th>Contribute to public confidence in the integrity of financial reporting of public companies in Canada by effective regulation and by promoting quality, independent auditing.</th>
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<tr>
<td>Mission</td>
<td>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.</td>
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<td>Board of Directors</td>
<td>CPAB has a nine-member Board of Directors.</td>
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<td>Employees</td>
<td>CPAB employs approximately 50 professionals.</td>
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<td>Locations</td>
<td>CPAB operates from offices in Montreal, Toronto and Vancouver.</td>
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### CPAB Report on 2015 Inspections of Canada’s Big Four Accounting Firms

The Canadian Public Accountability Board’s 2015 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). This is intended to encourage more robust discussions among management, the firm and audit committees and to support audit committees in conducting their oversight responsibilities. For more information about the Protocol and participating firms, visit [www.cpab-ccrc.ca](http://www.cpab-ccrc.ca).
Audit quality was inconsistent across the Big Four firms; significant inspection findings increase overall

The Canadian Public Accountability Board’s (CPAB) 2015 inspections indicate that audit quality across Canada’s four largest public accounting firms (Big Four – Deloitte LLP, EY LLP, KPMG LLP, PwC LLP) was inconsistent. Significant inspection findings increased across all four firms as a group compared to the prior year and improvement in the firms’ quality systems is required.

In 2014, CPAB’s inspections were weighted to reporting issuers with larger market capitalizations, with a particular focus on audit work undertaken in foreign jurisdictions. In our report on those inspections, we noted an overall improvement in audit quality, as well as the continued need for consistent execution across all engagements.

To better understand if audit quality improvements seen in recent years have been fully embedded throughout the firms and in their approach to all engagement files, CPAB shifted our inspections attention in 2015 to files of reporting issuers with mid to smaller market capitalizations ($250 million or less) located in smaller centres. Our ultimate objective was to assess the sustainability of enhanced audit quality seen across the Big Four firms in the past two years.

CPAB inspected 93 (2014:98) engagement files and identified significant inspection findings in 24 (2014:7) of those files. 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 the firm’s audit work. Instead, it is biased towards higher-risk audit areas of more complex public companies, so there is a greater likelihood of encountering audit quality issues. Results for two of the firms were generally comparable to 2014. Two firms experienced challenges, one particularly with audits of companies with smaller market capitalizations and one more broadly.

With some exceptions, firm action plans have generally helped maintain audit quality in larger engagements. However, our inspections of smaller reporting issuer engagement files show a different result. The impact of action plans on the quality of audits of companies with mid and smaller market capitalizations and conducted by smaller audit firm offices is not evident. This suggests that quality processes are not generating consistently good results for all firm audits.

As a result of our findings, we have required the firms to do the following:

- For those files not yet remediated, complete planned procedures to identify if restatements are required (no restatements have been identified to date).
- Improve the effectiveness of their systems of quality control for medium and smaller market cap companies.
- Consider region-specific issues which may be impacting audit quality.
- Evaluate the underlying cause(s) of individual file significant findings.
- Conduct a comprehensive review of quality control systems and assess whether those systems have inherent weaknesses that result in inconsistent audit execution at the engagement file level.
- Amend training and learning curriculum as necessary to address inspection findings and key insights.
- Determine appropriate next steps, including revising and amending action plans as necessary, to continue to drive consistency and improve audit quality across all engagements.

CPAB will monitor the implementation, sustainability and effectiveness of these initiatives in improving audit quality. The degree of our oversight of any individual firm will vary with the severity of the issues identified, with particular focus on assessing improvement efforts where audit quality declines were experienced this year.
CPAB will continue to conduct risk-based inspections, with a particular focus on mid to smaller market cap reporting issuers, in 2016. This work will include a deeper examination of firm quality control systems, and in particular a review of firm culture and tone at the top, organizational structure, accountability, risk identification and staffing.

Expanding our interaction with audit committees, with a focus on mid to smaller market cap reporting issuers, will continue. We will also publish information on how to evaluate the audit firm and audit risks, how audit committees are most effectively addressing their oversight role, and on industry-specific issues to explore with their auditors.

**A shift in inspections focus shows gaps in consistency of execution**

In 2015, forty-eight or 51.6 per cent of files inspected (2014: 27 or 27.5 per cent) were for companies with market capitalizations of $250 million or less. File selections were also biased towards certain of the firms’ smaller offices and audit partners working on engagements outside their area of industry expertise.

Compared to 2014, each firm experienced an increase in the number of engagement files with significant findings (see chart below). Of the 24 engagement files with significant findings, 14 (2014:1) were in companies with market capitalizations of $250 million or less out of a sample of 48 files (2014: 27).

At three of the firms, at least one out of every four files inspected for companies with a market capitalization of $250 million or less had significant findings (see chart below), with one of these firms having multiple significant findings. In another one of these three firms, significant findings were also noted in files of companies with market capitalizations greater than $250 million, more so than in the other firms.
Foreign jurisdictions access still a concern

During this year’s inspections of the audit files of Canadian reporting issuers with operations in foreign jurisdictions we noted that the firms have defined procedures for this kind of audit work resulting in generally improved execution and better quality audits.

However, this remains an area of concern for CPAB. While we have finalized memoranda of understanding in a number of foreign jurisdictions, we still 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 our website.) We continue to engage with the relevant Canadian securities regulators to make the changes necessary to assist CPAB in obtaining access in order to fulfill our mandate of regulating participating firms.

Key Insights

This year we identified two audit areas that appeared to be more prominent than in previous inspection cycles: executing audit fundamentals, and understanding business processes relevant to financial reporting. We also continued to see issues in the auditing of complex accounting estimates and internal controls, including the application of professional judgment and skepticism.
Executing audit fundamentals

In the past few years, CPAB has concentrated much of our efforts on inspecting complex or difficult to audit financial statement balances and transaction streams requiring a high level of professional judgment. Aligned with the shift in our inspections efforts to determine how deep quality improvements have been embedded into the audit practice, we allocated resources to assessing firms’ execution of basic audit fundamentals in routine but very material areas.

We identified significant findings in a number of files in the areas of basic revenue testing, inventory costing, inventory existence and depreciation. In more than one file, procedures performed to assess the accuracy of inventory costing were either inappropriately designed, executed, or both.

Auditors must make sure that procedures are appropriately designed and executed. If fundamental audit areas are delegated to more junior staff, the firm must see to it that staff have the appropriate training to perform their assigned procedures and that their work is appropriately supervised and reviewed. Without adequate training and supervision in these areas, a firm’s systems for achieving quality audits could become ineffective.

Understanding business processes relevant to financial reporting

An insufficient understanding of the client’s business is the root cause behind many of the audit findings we identified. To assess risk of error and ultimately determine an effective audit strategy, the auditor needs a sound understanding of the company’s business, operations, and nature and flow of accounting transactions. Otherwise, it is difficult to plan and execute an effective audit.

In a number of instances, CPAB identified gaps in the engagement team’s understanding of company financial reporting and audit risks, resulting in poorly designed and ineffective audit procedures. Examples include:

- Executing a substantive audit approach in system-dependent companies. The engagement teams implicitly relied on controls which were neither specifically identified nor tested.

- Lack of understanding of customer contracts and indicators of fraud.
  - Customer contracts may ultimately determine revenue recognition for the reporting issuer and, if not understood and appropriately analyzed, errors in revenue recognition may occur.
  - In some files, CPAB noted that the engagement team’s understanding and consideration of indicators of fraud was generic and did not reflect the specific structure and operating environment of the reporting issuer. In some other files where engagement teams did a good job in the planning process to identify indicators of fraud, they did not translate that understanding to effective audit procedures.

Complex accounting estimates

The appropriate application of accounting policies often involves a number of estimates and judgments. Since these can be complex, and may be influenced by management bias, CPAB often chooses these areas for inspection and frequently has findings to report.
Auditors need to consider the appropriateness of the forecasts being made. This can be challenging as such forecasts are based on both past experience (requiring validation of historical data inputs whether from internal or external sources) and future expectations (requiring assessment of management’s assumptions on factors such as growth rates, discount rates, timing of project development and industry expectations).

Similarly, firms can face challenges in evaluating the work of external experts and in integrating their own internal experts into the audit process. The fact that a reputable firm acted as management’s expert does not absolve the auditor from assessing the reasonableness of assumptions developed by that expert or conclusions drawn on the basis of those assumptions.

**Internal controls**

Given the breadth of operations, the increased reliance on information technology, and the large volume of transactions processed, it is often impractical to complete the audit of a large or complex entity just 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 design effectiveness. The engagement team can do this itself 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 identified numerous instances where internal controls work was not well done, calling into question how internal controls are tested, the engagement team’s execution of audit fundamentals and understanding of business processes, and the effectiveness of the audit. We also noted other situations where it was not practical to obtain sufficient appropriate audit evidence from substantive procedures alone and the engagement team did not test internal controls. Firms need to critically re-evaluate how they approach an internal controls-based audit and provide appropriate training and guidance to engagement teams.

**Professional judgment and skepticism**

Areas requiring the most professional judgment and skepticism continued to feature prominently in our 2015 inspection findings. Participation of senior engagement leaders at both the planning and issues resolution stages remains the best way to deal with these matters. To address audit team inexperience and to support the delivery of a quality audit, the timely and appropriate involvement of engagement leadership is essential. 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 healthy degree of professional skepticism is the basis for a quality audit, and maintaining an appropriate 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. This year’s findings included instances where management’s assumptions were accepted without appropriate challenge. For example, we noted cases where the auditor accepted the company’s growth rate assumptions when assessing valuations where management may not have any experience with a new line of business, or may have the experience but incorporated growth rates that are inconsistent with past performance.