CANADIAN PUBLIC ACCOUNTABILITY BOARD
CONSEIL CANADIEN SUR LA REDDITION DE COMPTES

WORLD-CLASS AUDIT REGULATION

March 2018

2017 Annual Inspections Report

www.CPAB-CCRC.ca

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. Through its annual inspections program, and stakeholder engagement and thought leadership initiatives with a focus on audit committees, 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 an 11-member Board of Directors.

EMPLOYEES

CPAB employs approximately 50 professionals.

LOCATIONS

CPAB operates from offices in Montréal, Toronto and Vancouver.

CPAB 2017 Annual Inspections Report

This report discusses CPAB's findings for all participating audit firms inspected in 2017. The 14 firms reviewed annually, and their foreign affiliates, audit approximately 99.5 per cent of Canadian reporting issuers by market capitalization.

Each firm participating in the **Protocol for Audit Firm Communication of CPAB Inspection Findings with Audit Committees** (Protocol) shares its file-level significant inspection findings (deficiencies in the application of generally accepted auditing standards that could result in a restatement of the company's financials), and this report, with their clients' audit committees. Our report includes common inspection finding themes and questions for audit committees to consider in conducting their oversight responsibilities.

CPAB encourages all audit committees to discuss this report, and any file-level findings, with their audit firm.

2017 ANNUAL FIRM INSPECTION RESULTS

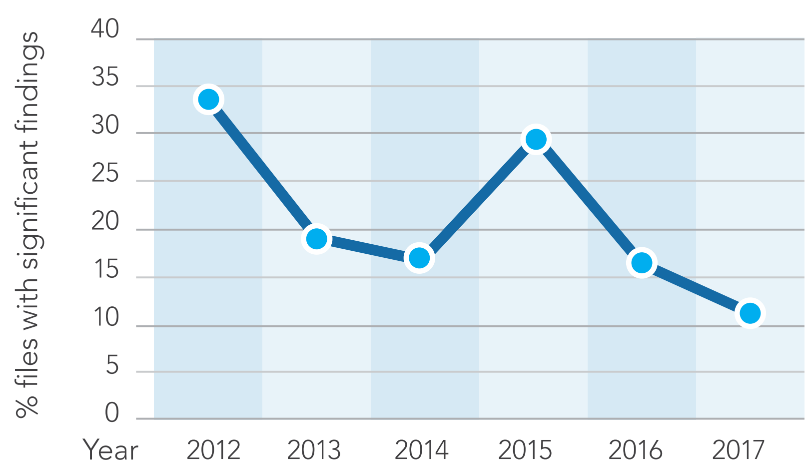
Significant inspection findings lower in 2017; CPAB views longer term consistency through a quality management systems lens

CPAB's 2017 inspections of the 14 public accounting firms reviewed annually (those with 100 or more reporting issuers) indicate that – despite an overall decrease in significant inspection findings compared to last year – audit quality continues to be inconsistent.

We inspected 128 (2016:135) annual firm audit files and identified significant findings in 15 (2016:24). The majority of our significant findings in 2017 required the audit firm to carry out additional audit procedures to determine the need, if any, to restate the financial statements due to material error. There were three restatements. The remaining findings required firms to add 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.

Firms generally have sound audit methodologies and in most cases meet standards. However, recurring inspection findings indicate the need to manage audit quality through robust and effective quality management processes, embedding quality along the full audit cycle, not just assessing it at the end through internal and external inspections. The variability of results, combined with persistent deficiencies (see 2017 Inspections Themes on page 8) year over year, makes it clear the firms need to review their approach to audit quality and enhance their focus on consistent execution across the firm.

Significant Findings: Six Year Trend



CPAB's risk-based methodology for choosing files to inspect is not intended to select a representative sample of the firm's audit work. Inspection results should not be extrapolated across the entire population.

Evaluating quality management processes to assess overall audit quality and consistency – evolving our inspection strategy

Higher quality, consistently executed audits across a firm is achievable when the right people, policies and procedures are in place – in other words, how well the firms manage their talent by matching capabilities to client and audit risk and ensuring appropriate resources are in the right place at the right time.

Defining Audit Quality

Quality can be defined as a degree of excellence or in the context of an audit, compliance with professional standards as set out in the Canadian Auditing Standards including the Canadian Standard on Quality Control (CSQC 1) – quality control for firms that perform audits and reviews of financial statements, and other assurance engagements. At the client engagement level, this translates to an auditor obtaining sufficient and appropriate audit evidence to support the opinion that the audited financial statements are presented fairly and free from material misstatement. At the firm level, this translates to a firm having quality management systems and processes enabling engagement teams to consistently obtain sufficient and appropriate audit evidence for each and every audit engagement of the firm.

CPAB's measure of audit quality at the client engagement level is relatively straightforward and is determined based on the number and severity of inspection findings in the file under review.

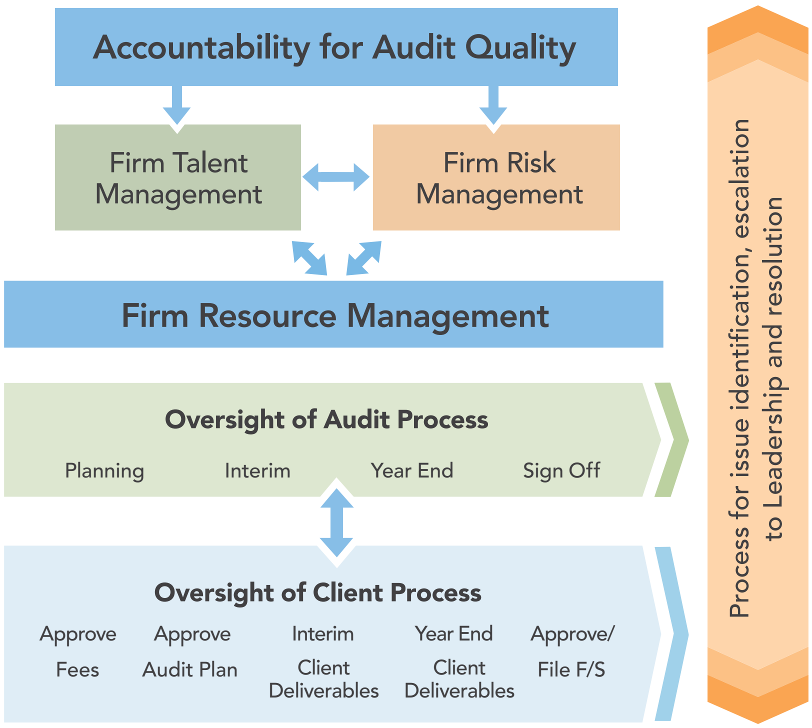
The assessment of a firm's audit quality is more challenging. Its measure is a combination of a firm's file inspection results along with an assessment of the effectiveness of the firm's quality management processes designed to support engagement teams and ensure consistency in audit execution as measured by a reduction in significant inspection findings.

Until now, CPAB's inspections have been heavily based on individual audit file reviews, with some attention to firm level quality management systems and processes. To better identify and understand impediments to improving quality management systems and consistency in how audits are performed, we have begun to evolve our Big Four firm inspections approach to incorporate additional operational reviews of the effectiveness of firm structure, accountabilities, quality management processes, and culture. We believe that strong control processes and procedures at both the firm and engagement level will be fundamental to achieving further ongoing improvements in overall audit quality.

At the engagement level, a number of files will be specifically selected to validate our findings on firm quality management processes. We will also continue to conduct risk-based file inspections. Through our evaluation of a firm's quality management processes (as evidenced by our file inspection results) CPAB will be able to better assess a firm's overall audit quality.

Our revised methodology is focused on five criteria related to key functions we believe enable audit quality through consistent execution, including proactive audit issue identification and escalation mechanisms for issues resolution. The first four criteria (Accountability for Audit Quality, Firm Talent Management, Firm Risk Management, and Firm Resource Management) are processes and procedures we expect to occur at the firm level in support of individual engagement teams. Oversight is the fifth criterion and focuses on the firm's oversight of the engagement team's interaction with the client and comprises the Audit Process and Client Process. Here we will focus on the firm's leadership ability to proactively monitor engagement level activity and the effectiveness of issue identification, escalation and intervention processes at both the firm and with the client as necessary.

CPAB's Inspection Model: Five Key Criteria for Assessing Quality



1. **Accountability for Audit Quality:**
   Accountability for audit quality is clearly defined and appropriately delegated across firm leadership, functional areas, engagement teams (including specialists and experts) and engagement partners.

2. **Firm Risk Management:**
   Systems to identify, effectively measure and monitor client risk, including audit risk, and appropriately align talent to client risk (Portfolio Management).

3. **Firm Talent Management:**
   Sufficient talent capacity from engagement partners to all levels of assurance staff, including industry experts and specialists (i.e. valuations, tax and IT), to execute quality audits.

4. **Firm Resource Management:**
   Process /ability to re-align and match talent (skills) on a proactive, timely basis, including specialists, to changing audit needs, priorities and risk profiles.

5. **Oversight:**
   Ability / systems to provide firm leadership visibility on progress of audit work and proactively initiate issue resolution, as required, compared to client requirements and deadlines.

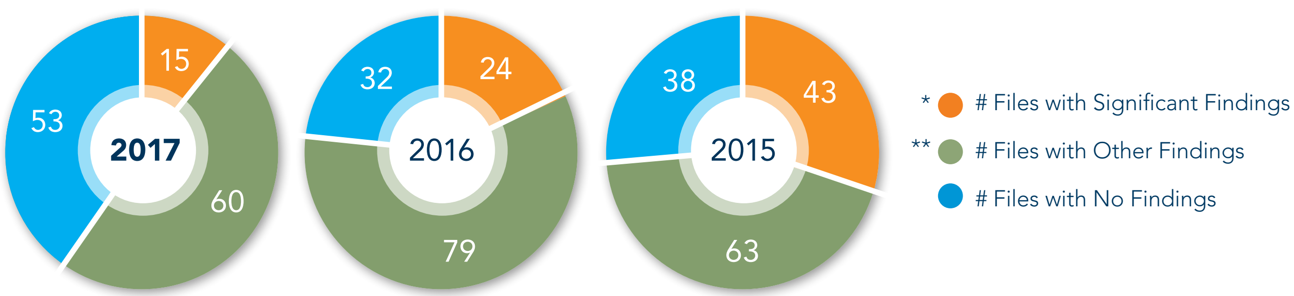
Going forward, we expect to roll out the new model to the 10 other annually inspected firms in 2019 or beyond. As with any change, we know there will be learnings along the way and the opportunity to further develop and refine the proposed methodology in future inspection cycles.

2017 ANNUAL FIRM INSPECTIONS SNAPSHOT

CPAB inspected 14 annual firms in 2017 (2016:14) and 128 engagement files (2016:135):

- Big Four firms: 86 engagement files; 6 with significant findings; 2 restatements
- Four national/network firms: 23 engagement files; 6 with significant findings; 0 restatements
- Six large regional firms: 19 engagement files; 3 with significant findings; 1 restatement

Annual Firms 2015-2017 Inspections Results



*Significant Findings – 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.

**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.

Big Four firms

Deloitte LLP, EY LLP, KPMG LLP, PwC LLP

CPAB had fewer inspection findings across the Big Four firms in 2017 compared to 2016 and 2015. We inspected 86 (2016:87) audit engagement files – six files had significant findings compared to 11 files in 2016 and 24 files out of 93 in 2015. There were two restatements.

While each firm demonstrated an acceptable level of inspection findings overall, CPAB continued to find exceptions where they did not execute consistently across the firm. The need to fully embed audit approach improvements into every practice and every engagement still requires more attention.

In 2011, CPAB required the Big Four firms to develop and implement action plans to address our most significant areas of concern and consistently enhance overall audit quality. For the most part, these action plans have resulted in measurable improvements across all four firms. Specifically in 2016 we required firms to focus on revising their guidance and methodologies to address systemic issues, identify and measure key quality controls and ensure issue escalation processes effectively manage and mitigate risk. Progress in these areas was made over the past year.

In 2017 we asked the firms to identify and articulate their key quality risks and the processes and controls they have in place (actual workflow and monitoring that workflow) to support high quality audits so we can better understand what steps might be missing, potentially contributing to continued significant findings. As noted above, in 2018 we are evolving our inspections approach at the Big Four firms to include additional operational reviews of the effectiveness of firm structure, accountabilities, quality management processes, and culture.

Other national/network firms

BDO LLP, Grant Thornton LLP, MNP LLP, Raymond Chabot Grant Thornton, LLP

Four other national/network firms
23
Engagement files
6
Files with significant findings
0
restatements

In 2017 CPAB inspected 23 (2016:24) engagement files across the four other national/network firms. The year prior, we saw improved results and these were sustained at three of these firms in 2017; one firm continued to experience challenges. We have required that firm to take immediate actions to improve audit quality and, at a minimum, implement initiatives to:

1. Assist engagement teams with better time and project management.
2. Monitor how firm leadership is driving meaningful change through culture and accountability structures.
3. Sustain good audit quality.

These four firms, which audit about one per cent of all Canadian reporting issuers by market capitalization, account for six files with significant inspection findings (2016:5). There were no restatements.

Large regional firms

Davidson & Company LLP, DMCL LLP, Manning Elliott LLP, RSM Canada LLP, Smythe LLP, UHY McGovern Hurley LLP

Six large regional firms
19
Engagement files
3
Files with significant findings
1
restatement

The six large regional firms experienced a decrease in significant inspection findings in 2017. CPAB inspected 19 (2016:24) engagement files and found that, based on the number of significant findings, overall audit quality improved over the previous year. These six firms, which audit less than one per cent of all Canadian reporting issuers by market capitalization, account for three files with significant inspection findings (2016:8). There was one restatement.

Results at these firms are encouraging, due in part to initiatives targeted at areas of recurring findings; however, we continue to identify other findings that highlight potential weaknesses in firm quality control systems. As a result, the firms need to focus on actions to ensure consistent execution, and specific processes that monitor the effectiveness of those actions in achieving sustainable quality improvements.

Other firms

As part of its 2017 inspection cycle CPAB inspected 26 files at 31 other firms (2016:32 files at 31 firms) and identified 13 (2016:19) files with significant findings. These findings were generally associated with reporting issuers either outside the predominant industries of a firm's client base or contained unique or complex transactions. There were no restatements.

CPAB has developed a model to more effectively assess quality management systems at single-office regional firms with fewer than 25 RIs – these firms typically have less complex and fewer processes and policies than other annually-inspected firms. In developing this strategy, we examined common inspection findings and potential root causes to identify the underlying factors leading to poorer audit quality as well as past recommendations that have led to quality improvements. Discussions with key individuals at these firms have further enhanced our understanding of their shared issues and concerns. Our tailored inspection methodology should lead to practical recommendations targeted at changing firm behaviors and risk assessment processes, and ultimately enable firms to improve quality.

2017 Inspection Program Scope

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.

At December 31, 2017, 286 audit firms were registered with CPAB. Twenty-one new firms registered (mostly foreign firms) and 15 firms voluntarily terminated their registration. Audit firms who voluntarily participate in the Protocol share significant file-specific inspection findings with their clients' 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 of firms participating in the Protocol is available on CPAB's website at www.cpab-ccrc.ca.

The majority of CPAB's inspection findings in 2017 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. The results of carrying out additional audit procedures resulted in three restatements or two per cent of files inspected (2016:3 or two per cent of files inspected).

CPAB actively managed disciplinary actions in 2017 to address audit quality matters. At December 31, 2017, there are Requirements on six firms (2016:9) and Restrictions on four firms (2016:3). In 2015 one firm was subject to sanction and subsequently withdrew as a Participating Audit Firm. No review or other proceedings were conducted in 2017.

Audit Quality Indicators

To date, there has been limited information available to audit committees to measure and evaluate the quality of an audit. In response, there has been increased international activity around the use of audit quality indicators (AQIs), which are quantitative measures about the audit process.

CPAB supports increased awareness, discussion and collaboration around AQIs to develop good practices. As a result, we have increased our focus on their use and benefit as quantitative measures of the audit process. AQIs complement our evolving inspection strategy and should positively impact audit quality. We encourage audit committees, management and audit firms to continue to explore how AQIs can be integrated into their audit processes.

In 2016, CPAB launched an AQI pilot project with audit committee chairs and their management teams. Participants were encouraged to select a limited number of indicators (five to 10) which could include AQIs covering audit execution, firm level metrics, management indicators, engagement team and client service indicators. Early benefits of using AQIs included a better understanding of the roles and responsibilities related to audit quality of management, audit committees and audit firms, and improved knowledge of and engagement in the audit process by all members of the audit committee.

CPAB believes that AQIs are a useful tool for audit committees to broaden and deepen the dialogue around audit quality. To help advance this effort, CPAB continued the pilot through 2017 and encourages Canadian reporting issuers and their audit committee members to engage in the dialogue.

Foreign Jurisdictions Update

CPAB's inspection activity of companies with foreign operations is often limited to engagement files accessible only in Canada because we currently have no legal means to compel access to work completed by component auditors. In many cases, the work we are able to access may represent only a small portion of the audit. (For a list of jurisdictions where CPAB is unable to access working papers, please visit www.cpab-ccrc.ca, Focus by Topic, Auditing in Foreign Jurisdictions).

As reported last year, in 2015 CPAB proposed a regulatory way forward to the relevant Canadian securities authorities for CPAB to access information and related audit working papers so we may fulfill our responsibilities. The Canadian Securities Administrators (CSA) have issued a consultation paper and are currently reviewing the responses to determine next steps. CPAB looks forward to CSA's proposals on this issue.

2017 INSPECTIONS THEMES

The majority of our findings in 2017 were related to the execution of audit fundamentals, professional judgment and skepticism, and significant accounting estimates. Examples requiring improvement follow.

Executing audit fundamentals

CPAB continued to see files where basic audit procedures were not executed appropriately on significant but non-complex account balances and transaction streams. Deficiencies in this area represented 34 per cent of our total findings (2016:29 per cent).

Not maintaining control over confirmation requests sent to third parties, selecting samples not representative of the balance being tested, and employing analytical procedures that would not identify a material error due to the nature of their design were common examples in this inspection cycle. It is unclear, if other than inadequate supervision and review, why the firms continue to face challenges in executing basic procedures, and why deficiencies in these areas are not being identified.

Professional judgment and skepticism

Auditors apply professional judgment to assess the risk of material misstatement and to determine what work they need to perform to reduce that risk. Concerns that this work was insufficient resulted in 32 per cent of our total findings (2016:32 per cent). This included instances where populations of items were not tested for completeness and accuracy or where data used in analytical procedures was either untested or not independent of the financial statement item being audited.

Auditors need to be objective when assessing the reasonableness of evidence provided by management. For example, management's explanation for unexpected differences must be corroborated and the auditor should remain alert for other audit evidence that contradicts that explanation.

Significant accounting estimates

Significant estimates continued as one of the most challenging aspects of an audit and accounted for 29 per cent of our total findings (2016: 25 per cent) this year. How precisely an estimated item can be measured depends on its complexity, the nature and number of financial inputs and sensitivity to changes in those inputs. The risk of management bias is pervasive.

Audits related to significant acquisitions feature prominently in our inspection work. These transactions require the determination of fair value of all assets acquired and liabilities assumed. In these cases almost every item is an estimate – and many require the assistance of a specialist to develop and to audit. For example, an acquired business may bring identifiable intangible assets like customer lists and licenses. To estimate fair value, management may use a third party expert. In addition, an audit firm may involve its own expert to review the work of management's expert. The auditor's expert usually assesses the appropriateness of the models and assumptions used and certain market inputs, but rarely the appropriateness of management's financial inputs or the consistency of those inputs between estimates. If this assessment is not performed by the auditor, a material misstatement in the fair value estimate might be missed.

What directors can do

Audit committees are responsible for overseeing the quality of their company's financial reporting. There is an opportunity for directors to improve this oversight through enhanced engagement with the external auditor and understanding of the quality management systems and processes in place at both the firm and file review levels.

Directors should consider discussing these questions with their engagement teams:

1. How did the auditor ensure audit procedures related to high risk areas were well executed?
2. What are the hard to assess, unique risks embedded in the company's estimates and how are they assessed by the auditor?
3. How are experts or specialists used in the audit work?
4. How did the auditor assess for bias? If management is biased, what is the risk to reported results or incentive plans?
5. What management controls did the auditor rely on? How did the auditor assess the operating effectiveness of those controls?
6. What changes in the company's operations and business environment had the most significant impact on the audit approach?
7. Did management deliver the financial statements and audit working papers to the auditor on a timely basis? Were these of a sufficient quality to support the audit? How was this measured?
8. What targets did the auditor have for the percentage of work performed during planning, interim and year end to ensure audit work was completed and issues were raised on a timely basis? How was the achievement of these targets measured by management and the auditor?

LEARN MORE

CPAB's public inspections reports and other publications regarding audit quality matters are available at www.cpab-ccrc.ca.

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