



CANADIAN PUBLIC ACCOUNTABILITY BOARD
CONSEIL CANADIEN SUR LA REDDITION DE COMPTES

WORLD-CLASS AUDIT REGULATION

March 2017



2016 Annual 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 2016 Annual Inspections Report

This report discusses CPAB's findings for participating firms inspected in 2016. The 14 firms inspected 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 their file-specific significant findings, and this report, with their clients' audit committees. The report includes common 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 2016 annual inspections report, 2016 Big Four inspections report, detailed information on the Protocol, and other publications are available at www.cpab-ccrc.ca.

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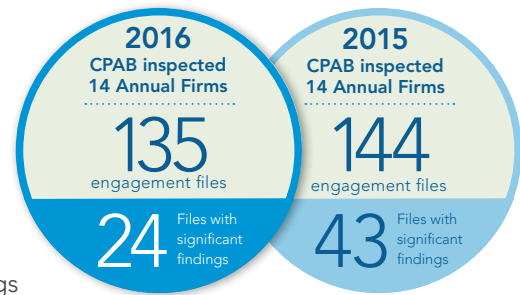
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SIGNIFICANT FINDINGS DECREASE IN 2016; HOWEVER, CONSISTENT AUDIT EXECUTION IS STILL A CHALLENGE



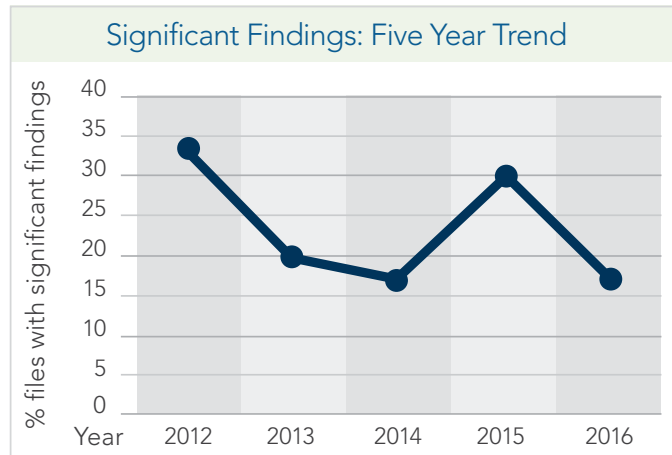
The Canadian Public Accountability Board’s (CPAB) 2016 inspections of the 14 public accounting firms reviewed annually (those with 100 or more reporting issuers) indicate an overall decrease in significant findings compared to last year; however, audit quality continues to be inconsistent. We inspected 135 (2015:144) files and identified significant findings in 24 (2015:43) of these files.

The majority of significant findings in 2016 required the audit firms to carry out additional audit procedures to determine the need, if any, to restate the financial statements due to material error. 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 to support their audit opinion. There have been four restatements to date.

The road to sustainable audit quality: CPAB and firms to focus on systems and processes to drive consistent execution

Looking back to 2011, based on poor inspections results that year, CPAB required the Big Four firms to implement action plans to improve the consistency of audit quality. In subsequent years, all other annually inspected firms were required to develop and implement action plans. Overall, these initiatives have enhanced audit quality; most public company audits in Canada are well done.

Still, the impact of variations in firm quality systems and execution is evident in our findings pattern over the past several years (see Significant Findings: Five Year Trend graph related to the 14 annual firms). While firms have sound audit methodologies and quality systems and, in most cases, engagement teams execute in compliance with them, we continue to find exceptions where firms do not execute consistently. There has been 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.



To further enhance audit quality in 2017 and beyond – with an emphasis on consistency of execution – we have explored what the firms and CPAB should do differently to drive quality improvements deeper into firm practices. Firms with larger numbers of findings have implemented action plans mandated by CPAB. 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 the effectiveness of firm structure, accountabilities, quality processes, and culture. At the same time, we will continue to conduct file inspections to validate quality systems findings. We plan to develop and launch our new approach over the next two years beginning with the Big Four firms and expanding to the other annual firms over time.

Smaller firm inspections approach

In assessing our existing inspections process, CPAB considered the notable differences in the nature of audit quality among the firms we regulate. For example, those firms inspected annually are further ahead on consistency of audit quality than those we inspect less frequently. Given the variations in our inspections population, we identified the need for a scalable approach to assessing quality systems, regardless of firm size, to allow inspectors to review the effectiveness of those systems whether at a large multi-office firm with multiple integrated policies, processes and controls or a smaller one-office regional firm with simpler and fewer processes and policies. As a result, in 2016 we launched our Smaller Firm Strategy (focused on firms with fewer than 25 reporting issuers). This strategy includes an assessment of the underlying factors leading to poorer audit quality and actions to drive improvements. Our analysis will help us determine how to better leverage inspection resources and advance audit quality through a tailored inspections approach to this population of firms in 2017-18.

Foreign jurisdictions update

Most firms have implemented policies and procedures aligned with Canadian standards regarding auditing Canadian reporting issuers with operations in foreign jurisdictions. However, the work of component auditors outside of Canada is still an area that presents significant challenges for our inspection program. 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.

As reported last year, CPAB has memoranda of understanding with a number of audit regulators in 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-crc.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.

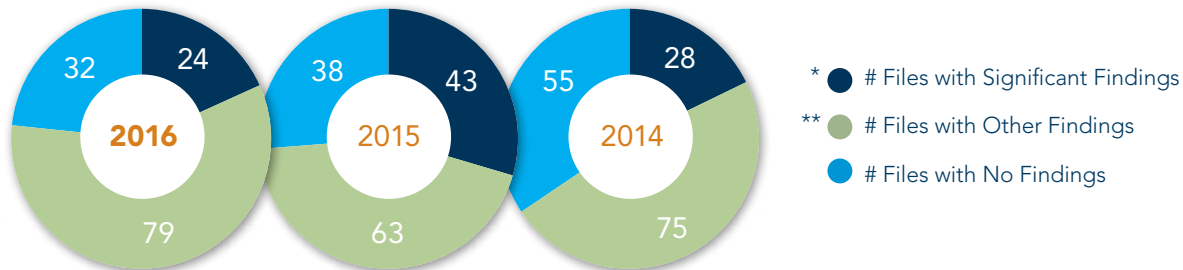
The Canadian Securities Administrators (CSA) are examining CPAB's proposal to determine whether legislative amendments should be considered. We look forward to working together with securities authorities and other stakeholders to address these limitations as quickly as possible.

2016 ANNUAL FIRM INSPECTIONS SNAPSHOT

CPAB inspected 14 annual firms in 2016 (2015:14) and 135 engagement files (2015:144):

- Big Four firms: 87 engagement files; 11 with significant findings; no restatements.
- Four other national/network firms: 24 engagement files; 5 with significant findings; one restatement.
- Six large regional firms: 24 engagement files; 8 with significant findings; one restatement.

Annual Firms 2014-2016 Inspections Results



*Significant Findings

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 approach. CPAB requires firms to carry out additional audit procedures to determine the need, if any, 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 major balance sheet item or transaction stream in order to comply with auditing standards.

**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

In 2016, CPAB inspected 87 (2015:93) Big Four 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 been completed; no restatements have been required.





Based on last year’s inspections results, CPAB required the Big Four 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, we expect it will take more than one year for the firms to fully embed these initiatives.

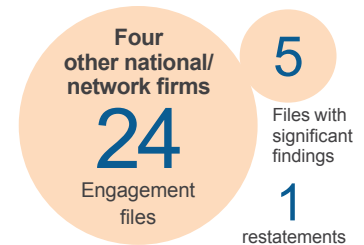
This year, in addition to completing procedures to identify if restatements are required, evaluating underlying cause(s) of significant findings, updating action plans and revising tools, templates, and internal training as appropriate, CPAB has required the firms to focus on:

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.

Other national/network firms

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

In 2016, CPAB inspected 24 (2015:28) engagement files across the four other national/network firms. Results at three of these firms improved, including at the two firms that experienced challenges in 2015. One firm showed a slight decline.



In 2015, we concluded that, while existing action plans were driving improvements, audit quality progress was still not adequate. To address this concern, firms were required to undertake short term actions to improve the quality of their next year-end audits and this work appears to have had a positive impact. These four firms, which audit about one per cent of all Canadian reporting issuers by market capitalization, account for five of the total files with significant findings (2015:9). There was one restatement as a result of our inspections.

While we are encouraged by the overall improvement in audit quality in the short term, the challenge remains to ensure quality improvements in the past year are supported by longer term sustainable actions. These four firms must continue to focus on the longer term initiatives within their action plans to support the consistent execution of quality audits.

Large regional firms

**Collins Barrow Toronto LLP, Davidson & Company LLP, DMCL LLP,
Manning Elliott LLP, McGovern, Hurley, Cunningham LLP, Smythe LLP**

CPAB’s inspections of the six large regional firms continue to show challenges in achieving consistent audit quality. In 2016, CPAB inspected 24 (2015:23) engagement files and found that overall audit quality was stable at four firms and improved at two of the firms compared to 2015. These six firms, which audit less than one per cent of all Canadian reporting issuers by market capitalization, account for eight of the total files with significant findings (2015:10). There was one restatement as a result of our inspections.



The large regional firms have made improvements in audit quality but more needs to be done to ensure that the quality initiatives are effective in supporting consistent execution. All firms are required to perform a root cause analysis of their inspection findings to identify the issues that quality initiatives must address. This analysis is critical in ensuring that the quality processes take into consideration the unique needs of the firm, including proactively managing client engagements in industries outside the firm’s area of specialization and supplementing technical resources not available internally.

Other firms

In addition to the 14 firms inspected every year, as part of its 2016 inspection cycle CPAB inspected 32 files at 31 other firms (2015:35 files at 25 other firms) and identified 19 (2015:28) files with significant findings. As with the large regional firms, the significant findings were generally associated with reporting issuers that were either outside the predominant industries of the firm’s client base or contained unique or complex transactions. There were two restatements as a result of our inspections.

2016 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, 2016, 281 audit firms were registered with CPAB. Eighteen new firms registered (mostly foreign firms) and 22 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 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, including all the Big Four firms, all the national/network firms, and four of the six regional firms participate in the Protocol. A complete list of firms participating in the Protocol is available on CPAB's website at www.cpab-crcr.ca.

The majority of CPAB's inspection findings in 2016 required the audit firms 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 four restatements or two per cent of files inspected (2015:11 restatements or six per cent of files with findings) to date.

CPAB actively managed disciplinary actions in 2016 to address audit quality matters. At December 31, 2016 there are Requirements on nine firms (2015:9) and Restrictions on three firms (2015:2). Requirements typically involve CPAB mandating the firm to take an action, or to make a change to its audit practices, to improve audit quality. If audit quality has not improved during a follow-up inspection of a firm with a Requirement or if CPAB feels the firm's performance and the severity of the lack of audit quality in the first instance requires so, CPAB will impose a Restriction. Restrictions characteristically involve CPAB limiting the audit firm's practice in some way. If there is demonstrated continued lack of improvement of audit quality with an audit firm with discipline already in place, or if in the first instance there is demonstrated egregious behavior, CPAB would impose a Sanction. In 2015 one firm was subject to Sanction and subsequently withdrew as a Participating Audit Firm. No reviews, investigations or other proceedings were conducted in 2016.

2016 INSPECTIONS THEMES

The majority of our 2016 findings at the 14 annual firms related to the following audit quality themes: professional judgment and skepticism, executing audit fundamentals, significant accounting estimates, understanding business processes relevant to financial reporting, and internal controls.

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 32 per cent of our total findings in 2016 (2015:31 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 example, the risk that inventory will not be sold for more than its carrying value may be low 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.

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?

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.

Deficiencies in this area represented 29 per cent of our total findings (2015:34 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).

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.

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?



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 25 per cent of our total findings in 2016 (2015:25 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.?

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 seven per cent of our total findings in 2016 (2015:3 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?

Internal controls



Management implements internal controls to safeguard company assets and the integrity of its financial reporting. Our findings in this area – four per cent of our total findings (2015:5 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?

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