CPAB Regulatory Oversight Report:
2021 Annual Inspections Results
Regulatory Oversight

Our regulatory oversight of public accounting firms that audit Canadian reporting issuers includes the inspection of completed audits of financial statements and the system of quality management, and regulatory intervention.

This year we reached a record number of enforcement decisions arising from 2020 audit firm inspections and investigations. During our 2021 regulatory assessments we observed some improvements in file inspection results and the systems of quality management at some audit firms. However, the quality of audit files continues to be inconsistent, and in some cases significant improvement is required. We expect a continued high level of enforcement and other regulatory intervention in 2022.

2021 regulatory assessments

CPAB’s assessment landscape

All public accounting firms that audit a Canadian reporting issuer must register with CPAB. At December 31, 2021, 267 (2020: 248) audit firms were registered; 92 (2020: 87) 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 (2020: 11) in this group which audit approximately 7000 reporting issuers. These firms, and their foreign affiliates, audit approximately 97.1 per cent of all reporting issuers as measured by market capitalization.

Engagement file inspections

In 2021 we inspected 134 audit files and identified significant findings in 38 files. This 28 per cent finding rate compares to 29 per cent across 119 files in 2020. Audit files inspected are not intended to be a representative sample, an overview of our review selection process is on page 8.

Two of the four largest firms met the target of no more than 10 per cent of files inspected with significant findings. One large firm that met the target in the prior year did not meet the target in 2021. None of the four largest firms had significant findings of more than 15 per cent.

Of serious concern is the high level of significant findings at many of the other annually inspected firms where the aggregate finding rate was 54 per cent (22 of 41 engagement files), compared to 63 per cent (22 of 35 engagement files) in the prior year. The findings rate at many of these firms is substantially above our target of no more than 10 per cent of files inspected with significant findings.

One restatement at a non-annually inspected firm has been required since our 2020 annual report. Where a restatement is required the firm must work with the reporting issuer to effect the restatement as soon as possible — usually within the next quarterly reporting cycle.

1 The inspection of the system of quality management for all annually inspected firms includes an evaluation against CPAB’s quality management systems (QMS) assessment model (Quality Management Systems assessments: Strengthening Audit Quality) for the four largest annually inspected firms and one other annually inspected firm; and an evaluation of compliance with the Canadian standard on quality control (CSQC 1) for firms that perform audits and reviews of financial statements, and other assurance engagements. Collectively referred to as system of quality management.

2 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.
System of quality management evaluations

Two of the four largest firms met the target set for quality management systems (QMS) assessment ratings of acceptable or acceptable with opportunities for enhancement set for 2021; one firm missed the target related to talent and resource management and one firm missed the target related to oversight.

Enforcement actions

Requirements were placed on one of the four largest firms in 2021 in response to the level of significant findings in our 2020 inspection.

Requirements and restrictions were placed on four of the seven other annually inspected firms in 2021 in response to the level of significant findings in our 2020 inspections. These types of enforcement actions can arise from our regulatory assessments or as a consequence of an investigation. Further details of enforcement actions undertaken in 2021 and the escalation of our regulatory intervention is outlined in the Enforcement Overview on page 9 of this report.

Common inspections findings and trends

Twenty-five per cent of files inspected at the 11 annually inspected firms had significant findings (2020: 26 per cent). In 2021 our annual inspections included 73 audit files of Toronto Stock Exchange (TSX) listed entities and 43 other non-TSX listed entities (2020: 64 TSX; 43 other). In the past five years, the overall level of significant findings in other non-TSX listed entities has remained unacceptably high.

No restatements have been required across the annually inspected firms since our 2020 annual report.

The audit areas most frequently reviewed in 2021 include revenue and related accounts, inventory, goodwill and intangible assets, business combinations and investments. These areas were selected because they were generally significant to the reporting issuer’s financial statements or included complex issues or judgment. The most common recurring findings related to auditing estimates involving significant assumptions or judgments about future conditions or events. In September 2021 we published Auditing accounting estimates: Strengthening audit quality and in March 2022 we published Audit evidence: Strengthening audit quality, communications to all audit firms registered with CPAB with more detail on the nature of deficiencies, CPAB’s expectations and the practices observed in audit files with no inspection findings.

New or evolving business models and emerging industries, such as crypto and cannabis, create different risks, for example those due to potential fraud or error, that need to be identified and assessed, so that appropriate responses can be designed and implemented. Some examples of significant findings related to emerging industries and complex or unusual transactions observed at other annually inspected firms include:

- Auditors of reporting issuers holding crypto-assets did not always obtain sufficient evidence to support the existence and ownership of digital currencies. In the cannabis industry, significant findings included insufficient fraud risk assessment and audit response when a significant portion of revenues and expenses was transacted in cash and insufficient evidence to support key inputs used to estimate the fair value of biological assets.
• Auditors did not demonstrate an understanding of the business rationale for unusual transactions and contradictory evidence, when identified, was either dismissed or rationalized. Auditors need to be open and alert to the possibility that unusual material transactions may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets. There were increased significant findings in situations where the transaction consideration was paid through the issuance of shares. These findings most often related to non-cash consideration and fair value measurement in business combinations, asset acquisitions and investments by investment entities. Significant unusual transactions require more persuasive audit evidence to obtain reasonable assurance that the financial statements are not materially misstated.

• In many instances third party service providers are involved in running a significant portion of the reporting issuer’s operations, processing transactions or holding assets. Auditors did not always obtain sufficient evidence to evaluate the design and implementation of relevant controls at the reporting issuer over the activities undertaken by the service organization. A sufficient understanding of the significance of the services provided and their effect on the reporting issuer’s internal control is necessary to ensure risks of material misstatement are identified, assessed and appropriately addressed.

2021 annual firm inspections snapshot

CPAB inspected 11 annual firms in 2021 and 116 engagement files (2020: 107) and identified significant findings in 29 files (2020: 28).

• Four largest firms: 75 engagement files; seven with significant findings.
• Seven other annually inspected firms: 41 engagement files; 22 with significant findings.

Inspection Findings

*Significant findings — A significant 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 include the inspections of completed audits of Canadian reporting issuers and their system of quality management. Reviews of the latter incorporate an evaluation of compliance with current quality management standards for all annually inspected firms and an assessment against CPAB’s QMS assessment criteria for the four largest firms and one other annually inspected firm.

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

We inspected 75 files (2020: 72) and identified significant findings in seven of those files (2020: six). One firm that met the target of no more than 10 per cent of files with significant findings in the prior year missed the target with 12.5 per cent of files with significant findings in the current year.

The firm that did not meet the target in 2020 showed improvement but missed the target in the current year with 12 per cent of files with significant findings. We will continue to track the firm’s inspection results and quality initiatives. Requirements were imposed on this firm in 2021 and a decision regarding the modification and removal of existing requirements on this firm will be made in 2022.

We required the two firms not consistently meeting the target to update their quality action plans. Action plans are developed by the firm and include strategies to respond to our recommendations and targeted actions identified by the firm through their root cause analysis. These plans prioritize the steps the firm believes will have the greatest impact on improving audit quality and may include cultural assessments, improvements to firmwide controls and processes to support engagement teams, enhanced training and supervision, hiring more staff with greater expertise and in-flight quality reviews.

Remediation work being performed by these audit firms has either been completed or is in progress. No restatements have been required since our 2020 annual report.

All QMS assessments resulted in ratings of acceptable or acceptable with opportunities for enhancement, with two exceptions; one firm was rated as needs improvement for talent and resource management and one firm as needs improvement for oversight. No criteria were rated as needs significant improvement. Significant findings at one firm indicate that certain controls over talent and resource management to ensure partners and staff have enough time to dedicate to specific audits are not designed appropriately or operating effectively.

The table below indicates the number of firms in each rating by criteria for 2021 and 2020.
Davidson & Company LLP, DMCL LLP, Manning Elliott LLP, McGovern Hurley LLP, MNP LLP, Raymond Chabot Grant Thornton LLP, Smythe LLP

We inspected 41 files (2020: 35) and identified significant findings in 22 of those files (2020: 22). Four firms (2020: four) had significant findings in more than 50 per cent of files inspected and three firms (2020: two) in more than 25 per cent of files inspected. No firm (2020: one) met the target of no more than 10 per cent of files with significant findings.

Enforcement action is in place for four firms with unacceptably high levels of significant findings over several years. Further details of enforcement actions undertaken in 2021 and the escalation of our regulatory intervention is outlined in the Enforcement Overview on page 9 of this report.

Decisions regarding the escalation of regulatory intervention and the modification and removal of certain existing enforcement actions will be made in 2022.

In 2021 we completed the first evaluation against CPAB’s QMS assessment model at a fifth annually inspected firm. The firm made progress in documenting existing processes and implementing new controls and processes and linking them to our assessment criteria. As many controls and processes were implemented in 2021 or were still being developed, our assessment is that significant improvement is needed to comply with CPAB’s QMS assessment model.

We required all other annually inspected firms to provide an implementation plan for the new quality management standards\(^4\) that considers the nature and circumstances of the firm and its public company audit engagements. These plans prioritize the key areas of the new quality management standards that align with CPAB’s QMS assessment model and that we believe will have the greatest impact on improving quality. We are obtaining updates on each firm’s progress against its plan.

Non-annually inspected firms

We execute a tailored inspection methodology to assess non-annually inspected firms. Common inspections 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 18 audit files (2020: 12) and identified significant findings in nine (2020: seven) of these across 13 non-annually inspected firms (2020: eight). One restatement has been required since our 2020 annual report. Significant findings mostly related to new or evolving business models and emerging industries (see common inspection findings and trends discussed on page 2).

The level of inspections findings at these firms is unacceptably high. In 2021, we imposed restrictions and requirements on one firm and three firms continued to operate under requirements and restrictions from previous years. In 2021, follow-up inspections for two firms were performed to assess the effectiveness of the actions in response to our recommendations and to determine whether further regulatory intervention is necessary. Decisions regarding the escalation of regulatory intervention and the modification and removal of certain existing enforcement actions will be made in 2022.

\(^4\)The Canadian standard on quality management (CSQM 1), quality management for firms that perform audits or reviews of financial statements, or other assurance or related services engagements (required to be designed and implemented by December 15, 2022), CSQM 2, engagement quality reviews and CAS 220, quality management for an audit of financial statements (effective date for CSQM 2 and ISA 220 is for audits and reviews of financial statements for periods beginning on or after December 15, 2022).
Evolution of the audit

We have observed an increased use of automated tools and techniques in audits including in substantive procedures associated with testing revenue recognition. Refer to our Technology in the Audit publication for more on this topic.

Advancements in audit technology are allowing auditors to analyze larger data sets to obtain deeper insights, identify unusual trends and to more effectively challenge management’s assertions, which enhances the ability of auditors to exercise professional skepticism.

However, care is also required by auditors to avoid automation bias, which is a tendency to favour output generated from automated systems, even when human reasoning or contradictory information raises questions as to whether such output is reliable or fit for purpose. The use of technology does not make data inputs inherently more relevant or reliable, or the output of technology inherently more valuable or trustworthy. We have identified concerns in our inspections with the adequacy of audit work associated with testing the following:

- The accuracy, completeness and validity of data inputs used by auditors in their automated tools and techniques.
- Exceptions or outliers identified by the automated tools and techniques to ensure that they do not represent material misstatements of the financial statements.

Outsourcing

We continue to monitor a decades-long trend of reporting issuers outsourcing an increasingly broader range of their business activities to service organizations. That shift has meant, among other things, that internal controls over the outsourced operations are designed and implemented by service organizations and not by reporting issuers (i.e., user entities). This has elevated the prominence of the work performed by auditors of service organizations (i.e., service auditors) in audits of the financial statements of user entities and has increased the importance of the service auditor’s work and related reports (i.e., System and Organization Controls reports (SOC reports)).

As described in CPAB’s 2022-24 strategic plan, we will focus increasingly on evaluating the auditor’s use of the work of specialists outside the engagement team, and specifically on the use of SOC reports as their reliance grows in certain industries such as fintech and where business models have changed.
Looking forward

We have seen advances in audit quality and improvement in systems of quality management at the four largest firms. Strong systems of quality management will be essential to respond to the current environment and drive consistent levels of audit quality.

In our 2022-24 strategic plan CPAB commits to measuring firm progress based on our audit quality assessments using two indictors:

1. At least 90 per cent of audit files reviewed by CPAB have no significant findings at each of the annually inspected audit firms.

2. No findings or only minor areas for improvement from CPAB’s evaluation of each of the annually inspected participating audit firm’s compliance with system of quality management standards by the end of 2024.

Review of component audit work in foreign jurisdictions

In 2021 we obtained access to review component auditor working papers located in foreign jurisdictions for eight engagement files selected for inspections (2020: four). For one engagement file, we were precluded due to local law impediments from obtaining access to the component auditor working papers (2020: one). We identified significant findings in two foreign component auditor working papers (2020: none).

CPAB has historically been concerned with certain foreign auditors and countries preventing us from inspecting audit work conducted in those foreign jurisdictions for Canadian public companies. With CPAB’s assistance the Canadian Securities Administrators (CSA) passed amendments to National Instrument 52-108 and the Companion Policy 52-108 (Auditor Oversight) in 2022 which will assist CPAB in accessing audit work performed outside of Canada. These amendments require reporting issuers to direct audit firms who complete a significant portion of audit work for a reporting issuer’s audit to enter into an agreement with CPAB to access their files and inspect their work if those firms will not provide access to CPAB voluntarily upon request. It is our perspective that the changes will be to the benefit of the investing public, audit firms, reporting issuers and regulators.

(For a detailed list of jurisdictions where CPAB has been unable to access audit working papers, please visit www.cpab-ccrc.ca).
2021 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, 2021, 267 audit firms were registered as a participating audit firm with CPAB. During the year, 29 new firms registered (five Canadian and 24 foreign firms). Nine firms withdrew from registration and one firm’s 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 2021, 36 of the 38 files with significant findings were shared by the audit firm with the relevant audit committee under the Protocol (2020: findings shared with 24 of 35 reporting issuer audit committees).

Ten of the 11 annually inspected firms participate in the Protocol — a complete list is available at www.cpab-ccrc.ca. While we strongly encourage all audit firms to share significant file-specific inspection findings with their reporting issuers’ audit committees, we currently cannot compel the firms to do so. In 2021 CPAB conducted a public consultation on our disclosures which included a proposal to make the reporting of inspection findings to audit committees mandatory.

How firms respond to CPAB findings

The majority of CPAB’s inspection findings in 2021 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. No restatements at the 11 annually inspected firms have been required (2020: one) and one restatement at a non-annually inspected firm has been required (2020: one).
2021 Regulatory Intervention

Enforcement actions and investigations are an integral part of CPAB’s regulatory intervention and have increasingly been applied to improve audit quality and protect the investing public. This year CPAB completed one investigation of an annually inspected audit firm and imposed, among other enforcement actions, a public censure.

In 2021 we conducted a broad public consultation to obtain feedback on how CPAB could modify and expand the disclosure of our regulatory results, including enforcement actions and investigations. The majority of respondents supported some level of increased disclosure aligned with the level of significance of the enforcement action taken.

Enforcement actions

The chart below shows the requirements, restrictions and sanctions imposed or in force in 2021 compared to 2020. While the restriction on accepting new reporting issuers may relate to a firm’s overall practice, there are also instances in which firms have been restricted from accepting reporting issuers that are high risk or operating in specific high-risk industries. These types of restrictions are imposed when CPAB believes there is a risk to the investing public. Recovery of enforcement compliance costs is a standard aspect of all enforcement actions.

Enforcement actions imposed or in force by year

<table>
<thead>
<tr>
<th>CPAB Enforcement Actions</th>
<th>Four largest firms</th>
<th>Other annually inspected firms</th>
<th>Non-annually inspected firms</th>
<th>Total imposed during 2021</th>
<th>Total imposed or in effect 2021</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Imposed and in effect in 2021</td>
<td>Imposed and in effect in 2021</td>
<td>Imposed or in effect in 2021</td>
<td>Imposed or in effect in 2021</td>
<td>Imposed or in effect 2021</td>
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<tr>
<td>Restrictions</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Restricted from taking on new higher risk reporting issuers</td>
<td>-</td>
<td>3</td>
<td>-</td>
<td>-</td>
<td>3</td>
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<tr>
<td>Restricted from taking on new reporting issuers</td>
<td>-</td>
<td>1</td>
<td>3</td>
<td>4</td>
<td>2</td>
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<tr>
<td>Requirements</td>
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<td>Enhanced reporting to CPAB</td>
<td>1</td>
<td>4</td>
<td>1</td>
<td>1</td>
<td>5</td>
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<tr>
<td>Additional training and/or coaching</td>
<td>2</td>
<td>4</td>
<td>1</td>
<td>1</td>
<td>6</td>
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<td>Enhanced engagement quality control review</td>
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<tr>
<td>Mandated firm client portfolio review</td>
<td>-</td>
<td>4</td>
<td>-</td>
<td>-</td>
<td>4</td>
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<tr>
<td>Mandated partner and manager portfolio review</td>
<td>-</td>
<td>4</td>
<td>-</td>
<td>-</td>
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<tr>
<td>Appointment of an independent monitor</td>
<td>1</td>
<td>2</td>
<td>-</td>
<td>-</td>
<td>3</td>
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<tr>
<td>Enhanced disclosure of CPAB inspection findings and recommendations to partners within the firm</td>
<td>1</td>
<td>2</td>
<td>-</td>
<td>-</td>
<td>3</td>
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<tr>
<td>External professional to review the firm’s system of quality control and completed audit engagements</td>
<td>-</td>
<td>2</td>
<td>1</td>
<td>1</td>
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<td>Cultural survey</td>
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<td>1</td>
<td>-</td>
<td>-</td>
<td>2</td>
</tr>
<tr>
<td>Provide engagement findings reports to audit committees</td>
<td>-</td>
<td>1</td>
<td>-</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>Other (including completing inflight reviews, revising policies)</td>
<td>6</td>
<td>2</td>
<td>-</td>
<td>1</td>
<td>9</td>
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<tr>
<td>Sanction</td>
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<td>Public censure</td>
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<td>-</td>
<td>-</td>
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<tr>
<td>Number of firms or discrete enforcement actions</td>
<td>13</td>
<td>31</td>
<td>9</td>
<td>12</td>
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</table>

There were no requirements, restrictions or sanctions imposed or in effect for the four largest firms or the other annually inspected firms in 2020. The trend of significant inspection findings over the past three years at certain firms has resulted in the increase in enforcement actions in 2021. We expect a continued high level of enforcement and other regulatory intervention in 2022.
**Investigations**

In 2020 we commenced two investigations resulting from conduct self-reported by the firms involved. Our investigation into the conduct of personnel at Deloitte LLP (Canada) was settled in 2021; the second investigation at PwC (Canada) was settled in 2022.⁵

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**CPAB’s regulatory intervention process**

CPAB expects firms to resolve audit quality issues as they arise during an inspection. CPAB’s Rules provide a framework of regulatory intervention mechanisms to address audit quality deficiencies at the file and firm levels.

Throughout the inspection process engagement teams and the audit firm are given the opportunity to provide their perspectives and written responses in relation to the facts, findings and recommendations arising from the inspection. Once the inspection has concluded, to protect the investing public and promote audit quality, unresolved matters may be escalated to regulatory intervention which can include enforcement actions and investigations.

CPAB commences an investigation when we consider that a Violation Event may have occurred and we wish to seek additional information. A Violation Event includes conduct that breaches CPAB Rules or standards of professional conduct for the audit profession and may have an impact on the provision of audit services. This includes a failure to comply with enforcement actions imposed on a firm.

**Enforcement and investigations**

CPAB escalates our regulatory oversight by proposing that a firm be subject to an investigation or enforcement actions including undertakings, requirements, restrictions or sanctions. Such regulatory intervention is designed to encourage sustained improvements to audit quality.

An undertaking is a contractual agreement between the firm and CPAB setting out specific components of a remediation plan targeted to address concerns emanating from an inspection or investigation. Requirements typically involve CPAB mandating the firm implement targeted actions or change certain practices to improve audit quality, such as conducting a culture assessment or providing additional training, etc. Restrictions typically involve CPAB limiting the audit firm’s practice including restricting the firm from taking on new reporting issuer clients, high risk reporting issuer clients or reporting issuer clients in particular industries. Sanctions include but are not limited to a public censure and termination of a firm’s status as a participating audit firm.

The initial decision to propose the imposition of enforcement actions is determined by CPAB’s Enforcement Screening Committee where each matter is reviewed and a recommendation is formulated and brought to CPAB’s board of directors for approval.

Following a decision by the board to propose enforcement actions formal notice is provided to the firm. The firm can challenge the proposed enforcement actions by petitioning for a review proceeding. If the firm does not petition for a review proceeding, the enforcement actions will come into effect and the firm must comply with them immediately. There were no such challenges in 2021.

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⁵ Details of the orders are available on our website.
CPAB disclosures consultation

In 2021 we conducted a public consultation to gather stakeholder input and to invite dialogue on potential changes to the information we disclose.

We were specifically interested in the investing public’s feedback on our disclosure principles, what and how we communicate to audit committees and what we share publicly about our regulatory assessment results and intervention actions.

The consultation ran from July 19, 2021 to September 30, 2021. CPAB issued a consultation paper to solicit feedback. Stakeholders submitted written responses, completed a consultation survey and participated in 1:1 meetings with CPAB. We heard from corporate directors, audit firms, investors, other regulators and reporting issuer management; feedback is posted on CPAB’s website at www.cpab-ccrc.ca/insights/disclosures.

Stakeholders for the most part supported increases to CPAB’s disclosures across each of the three areas we consulted on — communication to audit committees, disclosure of the results of CPAB’s regulatory oversight activities, and disclosures related to CPAB’s enforcement actions. The strongest support was for moving from voluntary to mandatory sharing of significant file-specific findings with the relevant reporting issuer’s audit committee, and increased disclosure of enforcement actions and investigations depending on the level of significance of the enforcement or investigation.

CPAB will complete its assessment of all stakeholder feedback in 2022. Changes to make the communication to audit committees mandatory and to allow us to disclose the results of our regulatory oversight activities by individual firm will require revisions to CPAB’s rules and securities legislation. If regulatory change is warranted, additional consultation and regulatory approvals will likely be necessary. Any proposed modifications will be made public on CPAB’s website.
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