



**June 2006**

**To: All practising offices**

**FOCUS ON PRACTICE INSPECTION FINDINGS – 2005-2006**

**Background**

The practice inspection committee reviews the annual inspection results to identify those areas where adherence to the CICA Handbook recommendations could be improved. This letter reiterates many of the points raised in last year's letter to all practising offices. While the results of the 583 inspections conducted during the 2005-2006 year were generally favourable (88.9% no further action), the committee has identified the following concerns regarding the documentation of audit and review engagements that have also contributed to the committee's decision to reinspect 10.8% of all offices inspected during that year (v. 13.5% in 2004-2005).

**Audit Documentation**

Critical deficiencies with respect to audit engagements were in the following areas:

1. Audit Planning

The following aspects of audit planning, in order of frequency, were not well documented:

- *Consideration of the risk of material misstatements in the financial statements due to fraud and error.* The auditor is required to obtain an understanding of management's assessment of the risk that the financial statements are materially misstated due to fraud and error, and the internal controls in place to address such risk and to prevent fraud and error, and management's awareness of any known or suspected fraud and discovery of any material errors. Included in the planning documentation should be evidence that the engagement (audit) team has met to discuss the susceptibility of the entity's financial statements to misstatement due to fraud and error. The documentation in the file should include evidence that the auditor has made enquiries with respect to:
  - Management's assessment of the risk that the financial statements might be materially misstated due to fraud.
  - Management's processes for identifying and responding to risks of fraud and error in the entity.
  - Management's communications, if any, to the audit committee or equivalent regarding processes for identifying and responding to risks of fraud and error.
  - Management's communications, if any, to employees of its views on business practices and ethical behavior.
  - Knowledge of any actual, suspected or alleged fraud or material errors from management, internal audit, audit committee or equivalent and others within the entity.
  - Understanding how those charged with governance exercise oversight of management's processes and internal controls for identifying and responding to the risk of fraud and error.

- *Use of analysis to assist in designing the nature, extent and timing of other auditing procedures.* The degree to which analysis can be used as an audit planning tool will vary with the complexity of the client's accounting systems and the availability of preliminary information at the outset of the engagement. However, an unadjusted trial balance can often provide useful insights into potential problem areas through ratio analysis and comparison of account balances with those of the preceding period. The auditor should document such preliminary analysis and ensure that any identified areas of concern are appropriately followed up.
- *Understanding of internal control.* The auditor's understanding of internal controls assists in the identification of types of potential misstatements and factors that may affect the risk of material misstatements, as well as the determination of the nature, extent and timing of auditing procedures. Documentation may include a brief descriptive memorandum, or more extensive documentation in the form of narrative descriptions, flow charts or questionnaires. Whether a substantive or combined approach is planned, the auditor's understanding of internal control should be documented and should be updated annually.

Preliminary assessment of the components of audit risk and materiality and documentation of the knowledge of the entity's business, while not as prevalent as the above planning deficiencies, continue to be insufficiently documented in many files.

The committee considers the **documentation of audit planning procedures to be as important to small audits**, including those where a 100% substantive audit is planned, as to larger audits. The CICA Audit Technique Study, *Audit of a Small Entity, 3<sup>rd</sup> Edition* provides useful guidance for documentation of audit planning, risk assessment and internal control for small audit engagements.

## 2. Substantive Audit Procedures

Documentation of substantive audit procedures should include the test objectives, a description and quantification of the test, the test results, and conclusions drawn from the test. Completion of audit programs, or a list of audit procedures performed, with little else in the way of audit working papers to describe the details of those procedures, is not considered sufficient documentation.

The most significant area requiring improvement in the documentation of substantive audit procedures was with respect to subsequent events review. The review, enquiry and related procedures to assess whether events occurring in the subsequent period may require adjustments and/or disclosure should extend to the date of the auditor's report or as close to that date as is reasonable and practicable. These procedures should be in addition to year-end cut-off procedures that the auditor performs as part of the evaluation of specific financial statement items. Completion of the audit program for contingencies, commitments and subsequent events from the *Professional Engagement Manual (PEM)* would assist in documenting this. Section 6550 – *Subsequent Events* has been amended effective for fiscal years beginning on or after January 1, 2006.

The lack of analytical review of the overall financial statement presentation upon substantial completion of the audit, as well as documentation of audit procedures with respect to revenues/sales, payroll and expenses, whether tests of transactions or analytical procedures, continue to be a concern in many inspections.

## 3. Representation Letters

The most common representations missing from representation letters were:

- Representations related to Section 5135 – *The Auditor's Responsibility to Consider Fraud and Error* which requires that the auditor obtain representations from management:

- Acknowledging its responsibility for the implementation and operation of internal controls designed to prevent and detect fraud and error.
- Stating that it believes that those uncorrected financial statement misstatements aggregated by the auditor are immaterial, both individually and in aggregate, to the financial statements as a whole. A summary of such items should be included in the body of, or attached to, the representation letter. In situations where the auditor has made all adjustments, this representation should still be obtained, as there may have been immaterial differences that the auditor passed on adjusting without carrying them forward to a summary of unadjusted differences.
- Disclosing the results of management's assessment of the risk that the financial statements might be materially misstated as a result of fraud.
- Disclosing management's knowledge of fraud or suspected fraud:
  - Involving management, employees with significant internal control roles and others, where fraud could have a non-trivial effect on the financial statements.
  - Communicated by employees, former employees, analysts, regulators or others.
- Management representations that the significant assumptions used were reasonable and the fact that they reflected management's intent and ability to carry out specific courses of action relevant to the use of fair value measurements and disclosures as required by Section 5306 – *Auditing fair value measurements and disclosures*.

#### 4. Independence Letters

Auditors are required to communicate at least annually to the audit committee or equivalent confirming their independence and disclosing all relationships between the auditor and the entity and its related entities that may reasonably bear on the auditor's independence. In addition, for entities with public accountability, **which include not-for-profit organizations**, this communication should include disclosure of the total fees charged for audit and non-audit services provided by the auditor to the entity and its related entities.

Prior to completion of the audit, entities with public accountability are also required to communicate to the audit committee or equivalent a summary of the audit approach, the level of responsibility assumed by the auditor under Canadian generally accepted auditing standards and the audit and non-audit services to be provided to the entity and its related entities. PEM now includes a sample letter for communicating with audit committees with respect to audit planning.

#### 5. Assessment of Independence and Client Retention/Acceptance

The *ICAO Rules of Professional Conduct 204.1 to 204.8* set the new independence standards that were effective for engagements relating to reporting periods commencing after December 31, 2003. The working papers for audit engagements should include documentation that there has been an assessment with respect to the acceptance/continuance of the engagement and independence.

#### **Review Engagement Documentation**

The critical deficiencies with respect to review engagement documentation were the failure to document the following two key areas:

1. Enquiry, analytical procedures and discussion to establish plausibility

The CICA Assurance and Related Services Guideline AuG-20, *Performance of a Review of Financial Statements in Accordance with Sections 8100 and 8200*, provides specific guidance and direction with respect to various aspects of review engagement documentation. Of particular concern to the committee are the following issues:

- *Inter-relationship/comparison of revenues, expenses, gross margin, operating ratios and balance sheet items*. The lack of documentation of an analytical review of the financial statements is considered to be a serious deficiency. The committee noted that the practitioner should focus on key financial statement items or aspects of the client's business, and ensure that checklists, where used, are supplemented by further appropriate

documentation. Even if there are no unusual amounts, variances or trends, a comment on the reasonableness of key items should be included on the checklist or referenced to a specific working paper, to evidence that the practitioner gave such items due consideration.

- *Cut-off procedures – cash, sales, purchases/inventory and accounts payable.* The checklist questions often ask that additional documentation e.g. a brief note or memorandum be included in either the working papers (cross-referenced back to the checklist) or the comments column of the checklist itself. Typically, this documentation would include a description of procedures followed by the client to ensure proper cut-off, a conclusion on their adequacy and, if deemed necessary, details of any additional review procedures required to assess plausibility of the statements. Documentation of discussions with clients would include the name of the individual(s) with whom the matters were discussed and the date of the discussions. Completion of only a checklist without additional comments is not considered to be sufficient documentation of enquiry, analytical procedures and discussion.
- *Inventory – client's count procedures and valuation.* As noted with respect to cut-off procedures, completion of checklists without additional documentation is not considered sufficient. Description of inventory count procedures should include more than just the date of the inventory count; matters such as count instructions, use of count tags, supervision, segregation of obsolete and slow-moving inventory and inventory on consignment should be noted. The client's basis of determining "cost" (FIFO, LIFO, specific item, etc.) should be documented.
- *GST & PST – plausibility of amounts.* Consideration should be given to whether a copy of the year-end GST & PST returns is sufficient documentation. A recent court case found a CA firm at fault for not reviewing the reasonableness of GST and PST. The September 2004 issue of CICA's *Practice Advice* suggests that practitioners should consider performing a reasonableness test in addition to reviewing year-end GST and PST returns.

## 2. Assessment of Independence and Client Retention/Acceptance

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### **Financial Statement Presentation**

Common deficiencies in inspections with respect to financial statement presentation include: financial instruments disclosure – their nature and extent, credit risk, interest rate risk and fair value; cash flow statements – interest and income taxes paid; authorized share capital; security for short-term bank indebtedness; related party transactions, including the terms and conditions for amounts due to/from related parties and the measurement basis; and disclosure of the revenue recognition policy.

### **Keeping Current With New Standards**

The CICA's Auditing and Assurance Standards Board has introduced two new standards: *General Standards of Quality Control for Firms Performing Assurance Engagements (GSF-QC)*, and Section 5030 - *Quality Control Procedures for Assurance Engagements*. The Firm standard was to be implemented by December 1, 2005 for all firms providing assurance services, with the exception of those registered with the Canadian Public Accountability Board (CPAB), for which the implementation date was January 1, 2005.

*General Standards of Quality Control for Firms Performing Assurance Engagements (GSF-QC):* In response to concerns expressed by small and mid-sized firms, the CICA published implementation guidance in the form of a *Quality Assurance Manual (QAM)* that complements the *Professional Engagement Manual* and includes material to address issues unique to smaller firms and sole practitioners. Practitioners are reminded that each firm is required to have a single quality control manual, setting the common quality control standards for all the partners of the firm. Each partner of a firm should **not** have his or her own, individualized quality control manual. The assurance partners of each firm, regardless of its legal structure, should have come to an agreement on the common quality control standards to be adopted by all the partners and should have documented those standards. This also affects many partnerships that have been merely cost-sharing arrangements in the past. Moreover, practitioners should not just photocopy the sample manuals set out in the QAM. These sample manuals should be tailored to reflect the personal circumstances of the firm including the names of the partners assigned specific quality control responsibilities.

*Section 5030 - Quality Control Procedures for Assurance Engagements:*

The Engagement standard, Section 5030, was to be implemented by non-CPAB registrants (the vast majority of practising firms) for fiscal periods beginning on or after December 1, 2005; the corresponding date for CPAB registrants is periods commencing on or after January 1, 2005.

Section 5370 – *Management Representations* and Section 5110 – *Terms of Engagement* were effective for fiscal years beginning on or after August 1, 2005. Section 8200 – *Public Accountant's Review of Financial Statements* was amended with respect to the terms of engagement and management representations for review engagements, also effective as of August 1, 2005. The *handbook* and PEM both include sample engagement and representation letters that reflect the new standards. Offices should ensure that their templates for engagement and representation letters are updated to reflect those standards.

For fiscal years beginning on or after January 1, 2006, the assurance recommendations have been amended to reflect new and revised standards for defining the concepts of reasonable assurance and audit risk, understanding the entity and its environment, including internal control, assessing the risks of misstatement and designing audit procedures that are responsive to assessed risks and for audit evidence. Included are consequential amendments arising from the new standards, including terminology changes. The new standards apply to all audits for both small and large entities. Firms may need to make significant changes to their audit approaches, including supporting forms, programs and checklists. Both PEM and the CICA Audit Technique Study "*Audit of a Small Entity, 3<sup>rd</sup> Edition*" have been amended to reflect the new standards.

New sections added:

- Section 5095 - *Reasonable assurance and audit risk*
- Section 5141 - *Understanding the entity and its environment and assessing the risks of misstatement*
- Section 5142 - *Materiality*
- Section 5143 - *The auditor's procedures in response to assessed risks*
- AuG-41 - *Applying the concept of materiality*

Sections withdrawn:

- Section 5140 - *Knowledge of the entity's business*
- Section 5141 - *Materiality and audit risk in conducting an audit*
- Sections 5200 to 5210 - *Internal control in the context of an audit*
- Au-G-31 - *Applying the concepts of materiality and audit risk in conducting an audit*
- AuG-33 to AuG-38 - *EDP guidelines*

Sections amended:

- Section 5135 - *The auditor's responsibility to consider fraud*
- Section 5300 - *Audit evidence*
- Section 5301 - *Analysis*
- Section 5750 - *Communication with management of matters identified during the financial statement audit*
- Section 5751 - *Communications with those having oversight responsibility for the financial reporting process*

Four new PD courses – *A to Z of a Risk Based Audit* (replacing the *Auditing Refresher* course), *Assessing Risk – Understanding This New Audit Requirement*, *Audit Risk – The Basics* and *Auditing Management Override* have been developed to address the new audit risk standards.

It is our expectation that practitioners will apply the above benchmarks to their own assurance and related services engagements to ensure that they continue to meet prescribed professional standards.

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