



THE PRACTITIONER'S VIEW

Vol. 7, Issue 1 January 2006

AUDITING AND ASSURANCE STANDARDS IN CANADA – A NEW STANDARD SETTING APPROACH

AASB Wants Your View on Standard Setting

The Auditing and Assurance Standards Board (AASB) has issued an Invitation to Comment on its proposed new standard-setting approach for the period April 1, 2006 - March 31, 2009. The proposed new approach envisions the convergence of Canadian Auditing and Assurance standards with the International Standards on Auditing (ISAs) and pronouncements of the International Auditing and Assurance Standards Board (IAASB) in the medium term. Note: The Invitation to Comment, which includes an Executive Summary, can be viewed at www.aasb.ca/planning. **The deadline to comment is March 14, 2006.**

The Invitation to Comment describes the consequences, potential benefits and risks of the proposed standard setting approach. It also provides an overview of the proposed transition from current Canadian standards to new or revised Canadian standards that are converged with ISAs. If the comments received on exposure agree with this approach, there will be a major change in how the AASB fulfills its standard-setting mandate. In setting its new strategic direction, the AASB is considering small practice issues raised by practitioners, including standards overload and the need for implementation guidance.

In addition to posting the Invitation to Comment and other related information on its website, the AASB will hold a series of roundtable meetings across Canada to present and discuss the proposed new standard-setting approach with interested parties. **In Halifax, the AASB will hold two meetings on February 1, 2006: (location TBD) from 8:30 to 10:30 am and again from 12:00 to 2:00 pm.** Note: A light meal will be served at both. Plan to attend, regardless of whether you wish to participate or you simply want to be informed of the proposed strategic direction.

Registration for the roundtable meetings is through CICA at www.cica.ca/index.cfm/ci_id/29382/la_id/1.htm. If you have questions, please contact Wenda Bennett, CA at (902) 425-3291 or at wbennett@icans.ns.ca.

FEDERAL ELECTION GUIDES FOR AUDITORS

Members involved in the upcoming federal election will be interested in the following revised guides published by CICA. Electronic copies are also available on the CICA website:

Guide for Auditors of Registered Electoral District Associations Appointed Under the Canada Elections Act (March 2005)

The Guide sets out the eligibility requirements for the auditor and comments on a number of issues that the auditor is likely to face, including auditor independence and objectivity, audit of opening balances, contributions received, and the GAAP requirement for the association's financial statements, etc. Samples of a consent letter, engagement letter and representation letter, as well as an auditor's report that is considered appropriate for this type of engagement, are also included in the Guide.

www.cica.ca/index.cfm/ci_id/25636/la_id/1.htm

Practitioner's View is a regular publication of the Institute of Chartered Accountants of Nova Scotia to inform and to serve members who are involved in public accounting in Nova Scotia.

A Guide for the Auditor of a Candidate in a Federal Election (April 2004)

This Guide provides practical guidance to auditors reporting on the "Electoral Campaign Return" of a candidate in a federal election, and to candidates and their official agents on the significant accounting and financial reporting requirements of the *Canada Elections Act*. It also provides guidance in determining the auditing procedures required to enable auditors to report on the Return.

www.cica.ca/index.cfm/ci_id/20857/la_id/1.htm

Also available is a supplement to the Guide for the Auditor of a Candidate in a Federal Election: *Audit of Third Party Advertising in a Federal Election*. This supplement provides practical guidance to auditors on issues relating to third party election advertising.

Members should also be familiar with the requirements of Council Interpretation **CI 204 B, Audit Appointments under the Canada Elections Act**, which can be viewed on the ICANS website at www.icans.ns.ca.

QUALITY CONTROL STANDARDS NOW IN EFFECT

Frequently Asked Questions (FAQs)

Practitioners were undoubtedly busy this fall developing a quality control manual for their practice based on the new quality control standards for firms (GSF-QC) and individual engagements (Section 5030) that came into effect December 1, 2005.

To provide implementation guidance, ICANS held five, well-attended, workshops during the fall. However, practitioners with lingering questions about quality control may refer to a list of "frequently asked questions" prepared by the Institute of Chartered Accountants of Ontario (ICAO) for its members, which are reprinted as *Appendix A*. If you have additional questions, please contact Wenda Bennett at www.icans.ns.ca.

Quality Assurance Manual (QAM) CD - Word Documents

Many practitioners were concerned that forms and checklists included in the initial QAM CD, issued by CICA, were in pdf format and more difficult to revise without the full version of Adobe Acrobat. As a result CICA has reissued the CD and all forms, etc. and the appendices are now in Word format.

PRACTICE REVIEW DEFICIENCIES

Practice reviews carried out in 2005 brought to light several common areas of non-compliance with standards, which are listed in *Appendix B*.

Practitioners who recognize some of these findings in their own firm have several resources available for guidance, in addition to the CICA Handbook:

- Model Financial Statements, included in the Professional Engagement Manual (PEM)
- Sample letters, forms, checklists – PEM and CaseWare
- ICANS Practice Advisory – contact Wenda Bennett at wbennett@icans.ns.ca

CICA NEWS

Have You Seen the Latest Newsletters?

CICA issues several newsletters throughout the year to keep practitioners updated on current issues and new standards. In addition to CA Magazine, you should have seen the following recent releases:

FYI – Special Edition (December 2005) http://www.acsbcanda.org/index.cfm/ci_id/4340/la_id/1.htm

Issued by the Accounting Standards Board (AcSB); covers financial statement considerations for 2005 and 2006.

AASB Update (December 2005) http://www.cica.ca/index.cfm/ci_id/216/la_id/1.htm

Issued by the Auditing and Assurance Standards Board (AASB); reviews new and proposed changes in standards.

Practice Advice (September 2005) www.cica.ca/index.cfm/ci_id/222/la_id/1.htm

Some of the feature articles include:

- Compilation engagements – a Task Force is being recruited to review the wording in the Notice to Reader report to ensure it reflects the level of work performed;
- Derivative reports – you will want to read this article if you are providing reports on detailed information required by regulatory or other funding bodies (such as a report on detailed schedules of financial information related to federal government funding provided to Indian Bands);
- New and proposed auditing and assurance standards;
- New and proposed accounting standards;
- Practice inspection issues; and
- Paperless office

For other articles on the “paperless office”, check out:

- *Paper Cuts, CA Magazine* (September 2005)
www.camagazine.com/index.cfm/ci_id/27801/la_id/1.htm
- *5 Tips for a Paperless Office*, Microsoft Small Business Center
www.microsoft.com/smallbusiness/accountants/articles/5_tips_for_a_paperless_office.aspx?xid=c0007
- *The Paper Chase, CMA Management* (March 2005), which visited two firms to see how it changed their operation

Risk Alert (December 2005) www.cica.ca/index.cfm/ci_id/222/la_id/1.htm

Be sure to read the article on *Fraud - the Auditor's Documentation*, written in response to concerns of the Practice Inspection departments of the Provincial Institutes/Ordre that documentation in this area is weak.

Practice Advantage (January 2006) www.cica.ca/index.cfm/ci_id/25538/la_id/1.htm

A free, quarterly newsletter for CAs in public practice; it contains information about trends and views, standards and regulations, client development, technology, marketing your services, professional resources, events and other information relevant to CAs in public practice — with links to the web-based sources.

IMPACT OF NEW “RISK-BASED” CONSOLIDATION RULES ON PRIVATELY HELD BUSINESSES

The following is adapted from an article included in the May 2005 issue of News 'N Views, a publication of the Institute of Chartered Accountants of BC.

If you have questions about the application of *Aug-15, Consolidation of Variable Interest Entities*, in small owner managed businesses or other private enterprises, you are not alone. An article written by BC Institute member Gord Cummings, CA, explores this complex area and is reprinted in this newsletter as *Appendix C*.

As noted in the article, it's not the accounting treatment that's problematic; the trick is identifying whether your client has an investment in a variable interest entity. For example, if family members of a family-run business are providing guarantees to each other, a variable interest entity may have been created that needs to be consolidated by one of the parties. Members are encouraged to read the article to gain a better understanding of the topic.

RETENTION OF ELECTRONIC RECORDS

The following article appeared in the December 2005 issue of Interim Report, a publication of the New Brunswick Institute of Chartered Accountants and is reprinted with the permission of NBICA.

Meeting CRA Requirements

CRA advises it is initiating a program to increase the business community's awareness of the importance of maintaining proper books and records.

According to the CRA, taxpayers, in general, understand they have a responsibility for the retention of proper books and records. With the increase usage of more sophisticated software packages however, many are unaware of the problems that may be encountered with these new systems.

One of the primary problem areas that CRA has noted is the capability of some accounting packages to allow for the overwriting of the previous year's accounting data upon commencement of record keeping activities for the new year. A related problem is the retention of only summary data for a particular year, with the line-by-line

detail having been deleted. The end result of these problems is that the books and records of the business for tax purposes are, in the opinion of CRA, incomplete.

In the past, paper copies of books and records were sufficient to meet the requirements of the Income and Excise Tax Acts. Presently, where electronic records are utilized, paper copies are no longer considered to be the original record. Consequently, CRA requires that all business records in an electronic format be retained. In addition, the records must be in a readable and retrievable format, and provide the information necessary to establish your tax liability or entitlements for each year, subject to the six-year limitation period for keeping records.

A number of businesses, although aware of their obligations to retain electronic data, have inadvertently lost their electronic records through faulty retention procedures or hardware failure. In these cases, the businesses were left with no electronic records and, in some cases, no hard copies. Businesses finding themselves in this position are required to report the situation to the CRA, and recreate the files within a reasonable period of time.

CHANGES TO INDEPENDENCE RULE

The following was adapted from an article that appeared in the November 2005 issue of News 'N Views, a publication of the Institute of Chartered Accountants of British Columbia.

In the autumn of 2003, when the new independence standard was approved, it was recognized that further study was required with respect to "public interest entities", such as municipalities and not-for-profit organizations. The Task Force study* was completed in 2004 and, after consultation, the final recommendation was that the requirements relating to auditors of "listed entities" should be extended, as appropriate, to the auditors of reporting issuers, including mutual funds.

Consequently, the provincial institutes in Canada, except the Quebec Ordre, passed new bylaws to implement the recommendation. The term "listed entity" has, therefore, been replaced with the term "reporting issuer". As well, the definition of "affiliate" has been deleted and "related entity" redefined. The existing size test has been maintained. Accordingly, an entity is not a reporting issuer for the purposes of the independence rules if its market capitalization and total assets in respect of a particular fiscal year are less than \$10 million. The amendments take effect for engagements no later than the first reporting period commencing after December 31, 2005.

**The Task Force considered the types of entities that might be considered to be of significant public interest and recognized that such entities vary considerably in terms of size, complexity and sophistication. The Task Force also noted that the independence standard, which requires identification and analysis of threats to independence and the application of safeguards to eliminate such threats or reduce them to an acceptable level, applies to the auditors of public interest entities.*

Accordingly, the Task Force concluded that extending the listed entity requirements to all such entities was not required to protect the public interest. The Task Force also noted that no other jurisdiction had imposed such requirements on the auditors of public interest entities and concluded that there were no unique Canadian circumstances that would necessitate such requirements.

GOT MAP?

Did you know that Microsoft offers a "10-for-1" license deal as part of its Microsoft Action Pack (MAP) subscription for public accounting, bookkeeping and consulting firms?

For \$469 (CDN) the first year and \$369 per year for subsequent years, you get a Microsoft Action Pack subscription which includes:

- 10 Windows XP
 - 10 Office Professional 2003
 - 10 Front Page 2003
 - 10 Project 2003
 - 10 OneNote 2003
 - 1 Small Business Server with 10 licenses
 - 1 Exchange Server with 10 licenses
 - 1 ISA Server 2004
- CRM, Project and marketing and instructional material

For further information, go to www.microsoft.com/partner/actionpack/.

PD OPPORTUNITIES

Get started on your 2006 Mandatory Professional Development hours, there are a limited number of available spots in the following sessions:

Assurance — Accounting, Auditing and Professional Practice Update;

Finance — Advanced Business Valuations, Analysis, Financing and Completion of Acquisitions, Corporate Treasury (Cash) Management, Current Trends of the Financial Executive, Due Diligence in an Investment Context, What You Want To Know About The Real Estate Industry, and Business Succession for the Owner Manager;

Financial Reporting — Accounting Update for CAs in Industry, Advanced Accounting Issues, and Bridging the GAAP;

Management — Environment Issues - Assess and Minimize Risk;

Other — Speed Reading & Memory Techniques, and Taking Control: Enhance Your Communication and Manage Your Stress;

Taxation — Advanced Tax Planning Strategies, Corporate Reorganization, Corporate Tax Returns – Workshop, GST/HST and Real Property - Tips & Traps, Personal Tax Returns, Personal Tax Returns – Workshop, Research and Development Tax Credits, RIP: Tax Compliance Matters Related to Terminal Filing Preparation, Tax and Real Estate: "What Do You Need To Know?," Tax Issues for the Private Corporate Groups, and;

Distant Learning — Auditing Refresher, CICA Handbook Accounting Refresher, Income Tax Refresher: Corporate, and Income Tax Refresher: Personal.

To get an early start on your 2006 PD hours, click on (if you do not receive this as a link, copy and paste into your internet explorer): www.icans.ns.ca/media/documents/PDFallCalendars.pdf

SUGGESTIONS FOR THE NEXT ISSUE?

Contact **Wenda Bennett, CA** at the Institute wbennett@icans.ns.ca or (902) 425-3291.

AUDITING AND ASSURANCE BOARD (AASB) ROUNDTABLE

February 1, 2006
8:30 – 10:30 am and 12:00 – 2:00 pm
Halifax (location TBD)

Information and registration at www.cica.ca/index.cfm/ci_id/29382/la_id/1.htm

APPENDIX A

QUALITY CONTROL – FAQ's

The following information is provided to members as part of the Member Services program of the Institute of Chartered Accountants of Ontario and is reprinted with the permission of ICAO.

The quality control FAQ's refer primarily to the reference materials listed below.

- CICA Handbook section GSF-QC, *General Standards of Quality Control for Firms Performing Assurance Engagements*, which applies to a firm performing assurance engagements (as defined in GSF-QC.008 (b));
- CICA Handbook Section 5030, *Quality Control Procedures for Assurance Engagement*, which outlines procedures and responsibilities to be followed by the practitioner/assurance engagement team on a specific engagement;
- The *Quality Assurance Manual* (QAM) published by the Canadian Institute of Chartered Accountants (CICA), 2005; and
- The *Professional Engagement Manual* (PEM) published by the CICA

Effective Date

The "Firm" standard (GSF-QC) is to be implemented by December 1, 2005 for firms that are not registered with the Canadian Public Accountability Board (CPAB), and by January 1, 2005 for firms that are CPAB registrants. The effective implementation date for the "Engagement" standard (Section 5030) is for engagements with fiscal periods beginning on or after December 1, 2005 for non-CPAB registrants, and for fiscal periods beginning on or after January 1, 2005 for CPAB registrants.

Q: I'm a sole practitioner. Will the new Quality Control standards, including the need for an engagement quality control review, preclude me from performing assurance engagements?

A: Sole practitioners can continue to perform assurance services, including both audit and review engagements. The new Quality Control Standard (GSF-QC) outlines recommendations for all to follow to ensure quality of performance of assurance engagements. More specifically, the firm should establish policies and procedures:

- To provide it with reasonable assurance that consultation at the appropriate professional level, inside the firm or external, takes place on difficult or contentious matters; that consultations are appropriately documented; and that conclusions resulting from consultations are implemented.
- To require that an engagement quality control review be completed before the issuance of the practitioner's report for all audit engagements to report on the financial statements of a public enterprise; and for other assurance engagements based on an assessment against criteria established by the firm, such as: the number of stakeholders relying upon the practitioner's report; the extent to which the subject matter and the practitioner's report thereon are of interest to the public; and the potential sources of risk associated with accepting or continuing with an engagement.
- To monitor compliance with quality control policies and procedures, including a periodic inspection of a selection of completed assurance engagements. Per paragraph .093 of this standard: "A small firm or a sole practitioner may wish to use the services of a suitably qualified external person or another firm to carry out assurance engagement inspections and other monitoring procedures. Alternatively, they may wish to establish arrangements to share resources with other appropriate organizations and thereby facilitate monitoring activities."

To assist members in implementing and documenting these new standards for their own practices, the CICA has developed a *Quality Assurance Manual* with sample manuals for various sizes of firms. [MARCH 2005, amended OCTOBER 2005]

Q: What is my additional risk exposure when hiring consultants and file quality reviewers as required by the new Quality Control Standard for firms?

A: The firm needs to make sure that the external provider is suitably qualified. The engagement of the consultant or file reviewer should be documented upfront, including matters such as: discussion of the roles and responsibilities, the scope of the engagement, any specific requirements and issues, and the procedures for dealing with any differences of opinion. Sample engagement letters have been included in *QAM*. Practitioners are, however, strongly encouraged to seek their own legal and professional advice, including a review of their errors and omissions professional liability policy to determine whether there is coverage for services provided. Note that it may be a simple matter to add an external consultant or engagement file quality reviewer as an additional insured. [JULY 2005]

Q: Do I need to have an engagement quality control file review completed for all assurance engagements?

A: A firm is required to have an engagement quality control (“EQC”) review completed before issuance of an audit report on the financial statements of a public enterprise¹. For all other assurance engagements, the firm should establish criteria (such as those listed in GSF-QC.069) to determine whether an EQC review should be conducted before the issuance of the practitioners report.

Note that a firm that performs assurance engagements must also establish a monitoring process which includes periodic/cyclical reviews of a sample of completed assurance engagements for practitioners² to ensure that an effective system of quality control is in place and being complied with.

1 This is not the same as the definition of a “publicly accountable enterprise”, a term used in various sections of the CICA Handbook. A “public enterprise” (as defined in GSF-QC.008 (m)) is “an enterprise that has issued debt or equity securities that are traded in a public market...”

2 A “practitioner” is defined in CICA Handbook section GSF-QC.008 (k) as the person with overall responsibility for the performance of the assurance engagement and issuance of the report. [OCTOBER 2005]

Q: The QAM includes various sample versions of a Quality Control manual (see Part B). Which version should be used by a sole practitioner who employs a full-time technician and no CAs, assuming the firm does not have any public company audit clients?

A: The QAM includes two versions of sample quality control manuals for use by sole practitioner 1) for a sole practitioner with no professional staff; and 2) for a sole practitioner with professional staff. The staff should have extensive experience performing and reviewing assurance engagement functions at senior levels, should be technically competent and up-to-date on the application of professional accounting and assurance standards, and should be able to fill a monitoring role. [OCTOBER 2005]

Q: Are there forms you recommend for completing independence and conflict of interest assessments?

A: An independence assessment involves reviewing circumstances that influence being able to maintain an objective state of mind (as outlined in Rule of Professional Conduct 204) and then evaluating whether these circumstances impact the ability to accept or continue with an engagement. A conflict of interest assessment involves reviewing whether the firm is in a position where the firm’s interests conflict with that of any clients or potential client, or whether the firm position puts one client in conflict with another (as outlined in Rule of Professional Conduct 210). *QAM*¹ provides sample forms/checklists to assist with an independence assessment; see the forms below. Separate forms are not provided for conflict of interest assessments; the firm should document in the planning section of the engagement file that this assessment has been completed and what conclusions were made.

Section 5.01, *Assurance Engagement Acceptance Form*
Section 5.02, *Assurance Engagement Retention Form*

1 PEM includes separate checklists for review engagements and audit engagements are very similar to the combined assurance engagement forms listed above. (See *Sample Forms* in PEM Section B (for Reviews) and Section C (for Audits)). [OCTOBER 2005]

Q: Do you need to complete a risk assessment for existing assurance clients as well as new assurance clients obtained after December 1, 2005?

A: A firm should complete a risk assessment¹ as part of the assessment process when making a decision to accept a new engagement or to continue to provide assurance services to an existing client. The engagement should not be undertaken if there are risks that would prevent professional standards, regulatory and legal requirements from being met (see GSF-QC.029). Once the decision is made to accept a new client, or retain an existing client, a further risk analysis is required at the planning stage to assess whether a file quality review should be completed for the engagement.

1 A sample form for making this assessment is included in QAM (Part B, Appendix E, *Engagement Acceptance/Retention Risk Tolerance Worksheet*). [OCTOBER 2005]

Q: Does an assessment of the need for consultants and specialists need to be completed for existing clients (obtained pre-December 1, 2005)?

A: As part of the planning process for each assurance engagement (whether the client is new or existing), the practitioner should make an assessment¹ as to whether any of the following additional resources are required for an engagement, and also whether the resources are inside the firm or must be hired externally. (Sample engagement letters for each role are included in QAM).

- Specialists may be brought in to supplement the skills of the assurance engagement team.
- Consultants may be required to help resolve a difficult or contentious issue.
- Monitors may be hired to assess that an effective system of quality control is in place and being complied with.
- Engagement/File Quality Reviewers may be required to review whether contentious issues have been identified and dealt with in an appropriate manner, therefore preventing an inappropriate opinion from being issued.

1 In order to assist with this assessment, the QAM includes a *Consultation/Specialist Risk Tolerance Worksheet* (see Appendix F in Part B). [OCTOBER 2005]

Q: Where can I find an engagement letter for an external specialist?

A: The QAM includes a sample engagement letter in Part B, Appendix I. (For other types of specialists, refer to the previous FAQ). The practitioner is strongly recommended to get legal advice on wording for a firm's specific circumstances, as well as contacting the firm's insurance broker to ensure that the firm's errors and omissions professional liability insurance policy provides coverage for the services provided. [OCTOBER 2005]

Q: Some firms are registered as partnerships, with two or more partners, but in reality the partners only share space with each other and each effectively operates a sole proprietorship. How does implementation of firm level quality control standards impact the operation of the firm?

A: If partners are operating independently or with a high level of autonomy, it is not possible to have a uniform tone at the top; "tone at the top" is an important firm-level quality control consideration. Clients and employees will get mixed messages if the partners each operate under their own quality control manual. Firms in this position that perform assurance engagements need to decide whether to create a common set of quality control policies (that is, one manual), or whether to officially split the practice and practice as independent firms. Note that in the latter situation, it may still be possible to share space, and make mutually beneficial arrangements to consult with each other, monitor each other's firm, and/or conduct engagement file quality reviews. [OCTOBER 2005]

PRACTICE REVIEW: COMMON FINDINGS – 2005

FINANCIAL STATEMENT PRESENTATION

- Not-for-profit organizations - no disclosure of method of accounting for contributions (deferral or restricted fund method), net assets invested in capital assets
- Demand loans with repayment terms – not appropriately described or classified (per EIC-122)
- Long-term debt – inadequate disclosure of maturity dates
- Revenue recognition – no disclosure of accounting policy (per EIC-141)
- Goodwill – inappropriate accounting treatment (can no longer be amortized), inadequate disclosure re impairment test (must be tested for impairment annually or apply differential reporting and disclose that impairment test not performed)
- Income taxes – inappropriate accounting treatment; “deferred taxes” are no longer an option (either “future income tax assets/liabilities” or apply differential reporting)
- Financial instruments – inadequate disclosure of nature and extent of financial instruments, credit risk, interest rate and authorized amount of line of credit, or fair value
- Differential reporting – no reconciliation of the income tax rate or expense to the statutory income tax rate or the dollar amount
- Related party transactions – inadequate disclosure re transactions, nature of relationship, measurement basis used
- Cash flow statement – no disclosure of interest and taxes paid
- Authorized share capital – incomplete/incorrect disclosure

AUDIT

The following areas were not well documented:

Audit planning

- Client acceptance/retention and assessment of independence
- Consideration of risk of material misstatements in the financial statements due to fraud and error. Auditors are now expected to perform some audit procedures with the sole intent of finding 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.

Effective for periods ending on or after December 15, 2004, Section 5135 – *The Auditor’s Responsibility to Consider Fraud and Error* was amended to include the following:

- Members of the engagement team to discuss the entity’s susceptibility to fraud and error (documentation of team meeting)
- Engagement partner to determine which matters are communicated to members of the engagement team
- More specific guidance on enquiries of management and others within the entity
- Certain mandatory procedures to address the risk of management override
- A presumption that there is ordinarily a risk of fraud in revenue recognition
- Requirement to document reasons when revenue recognition is not deemed a risk
- Requirement to incorporate an element of unpredictability in response to risks
- Significantly more detailed documentation requirements
- Removal of the assumption of management’s good faith

Additional reading on this topic can be found in the June 2004 issue of the newsletter *Focus on PEM* and the December 2004 issue of *The Practitioner’s View* at www.icans.ns.ca (see Publications). Also, see CICA Section 5135, *Appendix B, Examples of Possible Audit Procedures to Address the Assessed Risks of Material Misstatements Due to Fraud*. PEM forms were revised (#34, October 2004) for this significant change.

- Preliminary assessment of the components of audit risk - among the most significant made in the course of the audit because it is used in determining the extent of auditing procedures to be performed. Consequently, it is important to address and document such decisions during the planning stage.
- Understanding of internal control – required regardless of audit approach and must be updated annually. Documentation may include a brief descriptive memo or be more extensive (narratives, flowcharts, questionnaires)
- Use of analysis to assist in designing the nature, extent and timing of other audit procedures – document and identify areas of concern at the planning stage; an unadjusted trial balance can highlight potential problem areas through ratio analysis and comparison of account balances with the previous year

Documentation of audit planning procedures is required for audits of all sizes, including those where a 100% substantive audit is planned. In addition to Professional Engagement Manual (PEM) forms and checklists, the CICA Audit Technique Study, *Audit of a Small Business* provides useful guidance for documentation of audit planning, risk assessment and internal control for small engagements; it is currently being updated to reflect changes in assurance standards.

Substantive audit procedures

- Subsequent events review
- Analytical review of financial statements – upon substantial completion of the audit (including balance sheet)
- Revenue/sales, payroll and expenses – procedures performed, including test objectives, description and quantification of test, test results and conclusions

Completion of audit programs, or a list of audit procedures, with little else in the way of audit working papers to describe the details of those procedures, is not considered sufficient documentation.

Representation letters

The most common representations missing from representation letters included:

- Confirmation that management is not aware of any illegal or possibly illegal acts, or that all facts related to illegal or possible illegal acts have been disclosed
- Representations related to Section 5135 - *The Auditor's Responsibility to Consider Fraud and Error*. CICA 5135.51 requires that the auditor obtain representations from management:
 - 1) Acknowledging it's responsibility for the implementation and operation of internal controls designed to prevent and detect fraud and error
 - 2) 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
 - 3) Stating that it has disclosed to the auditor all significant facts relating to any frauds or suspected frauds known to management and the results of its assessment of the risk that the financial statements may be misstated as a result of fraud

Other Documentation Issues

- Communication with those having oversight responsibility for the financial reporting process – prior to completion of the audit, the auditor must communicate annually to the audit committee or equivalent of **not-for-profit organizations and other entities with public accountability** (municipalities, etc), a summary of the audit approach, the level of responsibility assumed by the auditor under Canadian GAAS and the audit and non-audit services to be provided to the entity and its related entities. This communication can be done in writing (see sample letter included with PEM update #35, issued July 2005) or orally; if the latter, there should be documentation in the audit file that this was done. Alternatively these matters could be addressed in the engagement letter.

REVIEW ENGAGEMENTS

Enquiry, analytical procedures and discussion to establish plausibility

- 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 and often results in reinspection. Practitioners 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 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.

- HST - plausibility of amounts.

Consideration should be given to whether a copy of the year-end HST return is sufficient documentation, or, whether a reasonableness test for the entire period should be done. A recent court case found a CA firm at fault for not reviewing the reasonableness of HST.

Other Documentation Issues

- Confirmation of independence – not documented
- Client acceptance/retention and assessment of independence - not documented
- Differential reporting – consent of all shareholders not obtained

APPENDIX C

IMPACT OF NEW “RISK-BASED” CONSOLIDATION RULES ON PRIVATELY HELD BUSINESSES

by Gord Cummings CA CPA (ILLINOIS)

The following article appeared in the May 2005 issue of News 'N Views, published by the Institute of Chartered Accountants of BC and is reprinted with permission of ICABC.

A new US “risk-based” consolidation model has been imported into Canadian practice. Accounting Guideline 15 “Consolidation of Variable Interest Entities” (AcG-15) is the accounting profession’s response to the financial services industry’s ingenuity and creativity in creating ever more complex financial structures. The new standard extends consolidation requirements beyond entities subject to voting control, making it possible for one entity to consolidate another without holding any voting shares. AcG-15 greatly expands the circumstances under which consolidation is required.

Remember Enron’s use of “special purpose entities” (which are included within the concept of “**variable interest entities**”) to remove depreciable assets and indebtedness from its consolidated financial statements? Enron was able, under the rules existing at that time, to avoid consolidating these net assets while remaining exposed, by contract, to some or all of the risks associated with them. Though the non-consolidation of its special purpose entities wasn’t the singular cause of Enron’s ultimate failure, there seems to be a consensus that Enron’s consolidated financial statements did not reflect - fairly, and in all materials respects - its financial position, results of operations, and/or cash flow.

Practitioners who don’t have experience with structured financial arrangements will likely find AcG-15 a very difficult standard to read and understand. This is partly due to the fact that the language in the standard is vague and highly generalized; but, while easy to criticize, this aspect of the standard is necessary to ensure the adequacy of the standard’s scope.

The following article is an attempt to give small and mid-size practitioners some practical guidance on the impact AcG-15 will have on privately held businesses. It is by no means a comprehensive analysis of the standard.

Understanding the Impact of AuG-15

The best way to understand AcG-15’s implications is to look at its impact on a couple of simple fact patterns:

Example #1

Consider a case where a husband runs a successful business owned by a corporation he controls (let’s call it “Opco”). Suppose that the husband’s corporation loans a large sum of money—say \$100,000—without security to a corporation (“Lossco”) wholly owned by a corporation controlled by his wife (“Spouseco”). Lossco is doing poorly and needs financing. Spouseco’s interest in Lossco is limited to \$100 of share capital and a \$20,000 loan, all of which has been lost in the normal course of business.

Using the traditional understanding of consolidation, Opco would not consolidate Lossco, as it holds no Lossco shares; Spouseco, holding 100% of Lossco’s shares, would consolidate Lossco. However, under the new risk-based concept of consolidation, Opco **must** consolidate Lossco because Opco is the primary beneficiary of a variable interest entity. Understanding why this is so requires a careful review of the AcG-15 fundamentals.

Variable Interest Entities (VIEs)

What is an “interest”?

The term “interest” in the context of this standard includes loans, shares, and just about any other contractual relationship with another entity; however, this is merely a working definition given the virtually unlimited degree of complexity inherent in the standard.

For privately held enterprises, interests include the four most common relationships: common shares, redeemable preferred shares, loans, and loan guarantees.

What is a “variable” interest?

The concept of a variable interest is better understood when contrasted with that of a fixed interest. Though not defined in AcG-15, a fixed interest has a value (“fair value”, which means how much you could sell it for) that does not change, irrespective of the activities of the borrower or investee; for example, a loan secured by land would normally be viewed as a fixed interest.

Common sense would indicate that most interests are not fixed interests, as the value of most loans, shares, and other interests will vary over time.

Fixed interests are likely to be rare in the context of privately held businesses—limited to interests supported by substantial security, such as loans secured by land or meaningful guarantees, where the guarantor is unlikely to default. But even in these cases, the circumstances would have to be carefully considered on a case-by-case basis; for example, a loan secured by land could be a variable interest if the value of the land is insufficient to repay the loan.

What is a “variable interest entity”?

Variable interests are commonly encountered in the business world, whether by design or circumstance.

Variability alone does not trigger a requirement to consolidate. Consolidation becomes a possibility when one of the following three criteria (which turn a variable interest into an interest in a VIE), are met:

- 1) The entity has insufficient equity capital at risk to fund its operations without additional financing; or
- 2) The equity holders as a group do not possess one of three fundamental characteristics: a) control, b) the obligation to absorb expected losses, or c) the right to receive expected residual returns; or
- 3) Some equity holders participate in control, losses, or profits out of alignment with their equity interest (per a rule aimed at contrived financial structures), and the activities conducted by the entity are strongly connected with an equity holder that holds disproportionately few voting rights (this could be viewed as the Enron anti-avoidance rule).

What is an “expected loss”?

This is the most difficult AcG-15 concept to grasp. The standard requires each interest holder to form an estimate of future cash flow related to its interest, and to probability-weight this expected cash flow in order to determine an expected return and to identify variability both above and below that expectation. In this context, an “expected loss” isn’t necessarily a loss in the usual sense, but rather a return that is below expectation. Conversely, an “expected residual return” is a return above the expected amount—not just a profit.

It’s difficult to imagine what to do in cases where one cannot form a cash flow estimate. Outside the realm of structured financial arrangements, where cash flows are defined by contract and are relatively predictable, forming expectations about future cash flow is very challenging. A simple approach—one that seems to work for loans—is to consider two scenarios: recovery of the loan plus agreed interest, and non-recovery of the amount lent. The “expected loss” in this case is then simply the amount of the loan. While it’s difficult to say

how one would assign probabilities to these two outcomes, doing so is actually unimportant, as one only needs to determine which party will absorb the “expected loss~” if it were to occur, in order to apply the standard.

When do we have to consolidate a VIE?

Every holder of an interest in a VIE must consider whether consolidating the VIE is necessary. The interest holder that will either absorb the majority of the expected losses of the VIE or receive a majority of the expected residual returns - or both - must consolidate the VIE. If different interest holders will absorb the expected loss and the expected residual returns, then the one with exposure to the expected loss must consolidate the VIE. Using the simplified approach discussed above, the interest holder with the majority of the risk of loss is considered the “primary beneficiary”—in other words, the party required to consolidate the VIE.

Example #1 continued...

Why would Opco be required to consolidate Lossco when it holds no Lossco shares?

First, Opco’s loan is not a fixed interest, as its fair value will vary according to Lossco’s operating results; therefore, the loan is a variable interest. Second, Lossco has inadequate equity to fund its operations without additional financing. Third, once the loan is made, Opco will absorb Lossco’s negative variability - essentially its future losses if any should occur - as Spouseco has nothing more to lose and Opco’s loan will lose value if Lossco incurs future operating losses.

The potential impacts here are significant. Opco will either be required to: a) consolidate, as a subsidiary, a corporation in which it holds no shares, or b) elect to apply the available differential reporting option - assuming Opco otherwise qualifies - and disclose the existence of a non-consolidated subsidiary. Furthermore, being deemed by AcG-15 to control Lossco, Opco may need to consider whether it is associated with Lossco for income tax purposes, as this could have significant income tax implications.

Suppose that at the time Opco advances its loan, Lossco has \$100,000 of retained earnings. This equity at risk, attributable to Spouseco’s interest, will absorb negative variability before Opco’s loan will lose any value; therefore, while Opco will still hold a variable interest in Lossco, it will not be the “primary beneficiary.” Also, if this \$100,000 in retained earnings is viewed as an adequate amount of equity capital at risk to fund Lossco’s operations, Lossco will not be considered a variable interest entity when the loan is advanced.

Example #2

Consider a second case. A corporation (“Moneyco”) purchases 40% of the voting shares of another corporation (“Newco”). The remaining 60% of the voting shares are held by an arm’s-length party (“Brainco”). Moneyco and Brainco contribute \$100 in cash for their shares. Moneyco loans Newco \$100,000 and promises to loan up to an additional \$650,000 as needed. Newco is a development-stage software company that has just started to work on a revolutionary software program. Brainco licenses Newco the rights to computer code in exchange for a royalty to be paid from future revenue, if any. While Moneyco and Brainco together believe that the software product will be very profitable if successfully developed, a lot of technical hurdles must be addressed before its commercial roll-out. There is no contractually agreed sharing of control; this is not a joint venture.

Under the old consolidation rules, Moneyco would view itself as exercising significant influence over Newco, and would either use the equity method to account for its investment or elect to apply differential reporting to avoid this complication; Brainco would consolidate Newco because it holds a majority of the voting shares and, therefore, exercises control.

Under the new risk based rules, however, the opposite is true: Newco was designed to have inadequate equity and Moneyco’s loan is a variable interest that will absorb the majority of Newco’s negative variability—the potential non-recoverability of the loan; therefore, Moneyco will have to consolidate Newco.

Determining how Brainco should account for its interest in Newco is an added wrinkle. Brainco is expected to do its own analysis of the situation in order to determine its required accounting treatment. Based on the voting interests, Brainco could be seen as a 60% non-controlling interest—a very curious outcome indeed. Brainco holds \$100 of \$100,200 initially at risk, and therefore holds a 0.1% interest in the equity at risk. Brainco will need to determine whether to use the cost or the equity method; in the latter case, it will also need to determine the appropriate basis on which to apply the equity method if it believes it exercises significant influence.

Practically speaking, this case would actually result in the accounting outcome that's economically correct—Moneyco **should** consolidate Newco, as it does have the majority of the financial risk; financially, Brainco is just along for the ride.

An additional consideration is what to do if Newco's venture becomes a commercial success. The standard provides trigger points where consolidation must be re-evaluated. These triggers widely encompass changes in the entity's contractual relationships and economic circumstances. If, in this hypothetical example, the software product is successfully rolled out and Moneyco's loan is fully repaid, it seems logical that at some point Moneyco would cease to consolidate Newco and Brainco would begin to consolidate due to its voting control. The point at which this shift would occur depends entirely on the specific facts and circumstances; in this case, it appears to occur either where Moneyco is repaid or where Newco builds up enough retained earnings that Brainco becomes exposed to the majority of the risk.

Differential Reporting

Privately held corporate groups generally do not have ready access to the public capital markets and, in many cases, have difficulty obtaining traditional bank debt. These circumstances regularly force privately held enterprises to enter into novel investment, loan, and loan-guarantee arrangements where the underlying values are difficult to assess. In many cases, these kinds of arrangements will create variable interests, making AcG15 applicable to many private companies.

AcG-15 provides a differential reporting option that allows qualifying entities to avoid consolidation; however, in order to apply this option, qualifying entities must identify the existence of one or more variable interests and identify a primary beneficiary. **Note:** if the differential reporting option has previously been elected for pre-existing subsidiaries, we must ensure that fair disclosure is provided in connection with variable interest entities. In cases where "non-consolidated financial statements" are presented and where the entity holds no voting interests in traditional subsidiaries, some explanatory disclosure about variable interest entities is appropriate—otherwise, users will find the financial statements confusing.

To Sum Up

AuG-15 provides a laundry list of possible circumstances where variable interests can be created, including: equity and debt investments, guarantees, certain types of lease arrangements, derivatives, and even some types of service contracts. For privately held enterprises, the most common types of interests—common shares, redeemable preferred shares, loans, and loan guarantees - are all potentially variable interests.

The VIE rules are effective for fiscal years beginning on or after November 1, 2004. Given that variable interests are common, we must all familiarize ourselves with the rules and be alert to their applicability.

Endnote

¹The term "borrower or investee" is used here for simplicity - AuG-15 contemplates many other types of positions between entities.

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