



THE PRACTITIONER'S VIEW

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ACCOUNTING and ASSURANCE STANDARDS

CICA Handbook Section 5600

Previous issues of this newsletter reminded practitioners of the introduction of the new CICA Handbook Section, *Auditor's Report On Financial Statements Using A Basis Of Accounting Other Than Generally Accepted Accounting Principles*, effective for all auditor's reports dated on or after October 1, 2003. This section will be of particular interest to auditors of school boards and co-operative housing societies.

Section 5600 **does not apply to general purpose financial statements**. However, an article in the January/February 2004 issue of *caMagazine* clarified that 'general distribution' does not equal 'general purpose' financial statements. This means that auditors may report on non-GAAP statements even if they are the only set of financial statements prepared by the entity. Specifically, if the non-GAAP statements are prepared in accordance with regulatory or legislative requirements, or written contractual requirements, then the auditor will report under Section 5600 using the special wording provided. (Example D has been expressly prepared to assist auditors of co-operative housing societies). If, on the other hand, the non-GAAP statements are prepared for reasons other than those set out in paragraph 5600.09, then the auditor will report using the reservations as provided for in Section 5510.

Practitioners are reminded that they are permitted to accept an engagement under 5600.07 only when it is **confirmed, in writing**, by the entity that the financial statements reported on are not general-purpose financial statements.

For more information, be sure to read the "New Reporting Framework" article in then January/February 2004 issue of *caMagazine* at www.camagazine.com/index.cfm/ci_id/19251/la_id/1.htm. Additional guidance is provided in the bulletin "Section 5600: Does it apply to me?" recently issued by the Auditing and Assurance Standards Board. It can be accessed at www.icca.ca/index.cfm/ci_id/18728/la_id/1.htm.

Non-Consolidated Financial Statements

What happens when your client prepares non-consolidated financial statements but does not qualify for Differential Reporting? The AASB noted it is very common for such financial statements to be prepared for income tax purposes. It decided an audit report under Section 5600 would be appropriate for such statements. Accordingly, Section 5600 indicates that non-consolidated financial statements prepared for income tax purposes are considered to be financial statements prepared in accordance with regulatory or legislative requirements for the purposes of the section.

Describing in the notes that the financial statements have been prepared "in accordance with GAAP except for..." is no longer acceptable and will not comply with the requirements of Section 5600, which requires a description of all significant accounting policies. Section 5600 provides examples of financial statement note disclosure that use the phrase: "The basis of accounting used in these financial statements materially differs from GAAP because..."

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.

Paragraph 5600.17 prescribes the form and content of the auditor's report, which includes an additional paragraph after the opinion paragraph that states:

- the financial statements were not prepared in accordance with GAAP; and
- are prepared solely for the use of specified users.

For sample wording, refer to Section 5600, Example C.

One other point to note – each page of the financial statements should be described as non-consolidated.

Financial Statements of Local Governments

In a letter recently issued to all municipal CAO's, Directors of Finance, clerks and registered municipal auditors, Service Nova Scotia and Municipal Relations addressed financial reporting for municipalities for the current year. The Municipal Accounting and Reporting Manual, a regulation of the *Municipal Government Act*, currently requires municipalities to comply with its provisions, which may vary from PSAB Recommendations. The Department will be considering changes to the regulation so that municipalities can comply with PSAB without being in violation of the legislation. However, amended regulations will not be finalized for the current reporting period.

The Department "expects that all municipalities and their registered auditors will strive to prepare and audit PSAB compliant financial statements for the 2003/04 fiscal year". It is prepared to work with municipalities in the development of financial statements that are as close to PSAB as possible with the goal of obtaining an unqualified audit report.

Municipal auditors should refer to and familiarize themselves with the recommendations in Section PS 5200, *Audit of Government Financial Statements*, which also applies to local governments. This Section deals with expression of an opinion on the fair presentation of the financial statements in accordance with a disclosed basis of accounting under a legislated mandate. Auditors should be mindful of paragraphs PS 5200.06 - .08 which require the auditor to assess the appropriateness of the accounting policies used, having regard to Public Sector Recommendations.

Differential Reporting - Income taxes

If your client has elected to use the taxes payable method under CICA 1300, *Differential Reporting*, only its current taxes for a period are reported. However, there are additional disclosure requirements:

- a **reconciliation** of the income tax rate or expense to the statutory income tax rate or the dollar amount that would result from its application, including the nature and amount of each significant reconciling item.
- The amount and expiry date of **unused income tax losses carried forward and unused income tax credits**,
- The amount and timing of capital gains reserves and similar reserves to be included in taxable income within 5 years;
- The portion of income tax expense (benefit) related to capital transactions that is charged (or credited) to equity (see paragraphs 3465.72, .83).

Sample note disclosure of these items is included in *Focus on PEM*, January 2003.

Materiality

AuG 31, *Applying Materiality and Audit Risk Concepts in Conducting an Audit*, issued in January 2002, revisited the concept of materiality and replaced AuG 7 (May 1992). The new guideline suggests "applying a percentage numerical threshold as an initial step in assessing materiality; for example, **five percent of income from continuing operations (i.e., after-tax income before discontinued operations and extraordinary items)**". This represents a change from previous guidance, which suggested that materiality for financial statements of profit-oriented enterprises, might be considered in terms of a range between **5% and 10% of income before income taxes**. Of course, there are other factors to consider, such as adjusting or normalizing for non-recurring items, industry-specific measures and above all, professional judgment.

However, practitioners should be aware that since both the base and percentage have changed, the result might be lower materiality which could impact opening unadjusted errors.

PEM forms were updated for these changes in March 2003. For those practitioners not using PEM or an older version, a thorough review of the guideline is recommended.

CORRECTIONS TO THE PROFESSIONAL ENGAGEMENT MANUAL (PEM)

Letter of Representation for Review of Financial Statements

The January 2004 issue of *Focus on PEM*, a newsletter published by CICA Member Services Group, noted the following **correction** to representation letters for review engagements:

The revised letter of Representation for Review of Financial Statements (see PEM Appendix B of Chapter 3, page 3B-10) that was released in Update #32 incorrectly refers to "Canadian generally accepted auditing standards" in the second paragraph. The paragraph should read as follows:

"We understand that your review was made in accordance with Canadian generally accepted standards for review engagements and accordingly included such tests of the accounting records and such other review procedures as you considered necessary in the circumstances for the purpose of expressing a review opinion on the financial statements. We also understand that such a review would not necessarily disclose misstatements and irregularities should there be any".

The sample letter will be corrected and included in PEM Update #33.

Model Financial Statements

Discussions with a member recently pointed out a discrepancy in financial statement presentation of preferred shares between the model financial statements included in the PEM and required disclosure in the CICA Handbook under 3860.97. A non-publicly accountable profit-oriented enterprise that qualifies under differential reporting to present, as equity, preferred shares issued in tax planning arrangements should **disclose on the balance sheet**:

- the shares as a separate line item in the equity section; and
- the total redemption amount for all classes of such shares outstanding.

Focus on PEM, issued in January 2003, included an example of proper balance sheet and note disclosure. The balance sheet included with model financial statements has not yet been revised for the new requirements.

Thanks to Wanda Leese, CA of *WBLI, Chartered Accountants* and Harley Hemeon, CGA of *Marsden J. Anthony, Chartered Accountant* for raising these matters.

APPLYING THE NEW INDEPENDENCE STANDARD

Since the new Rule 204 was adopted in November, practitioners have been assessing their current practices and client relationships to ensure that they are compliant with the new requirements. This process has resulted in far greater understanding of the implications of the new requirements and, in many cases, recognition and relief that some of the earlier concerns were not warranted.

This review and adoption of the new standard will continue to take some time, and ICANS will continue to bring matters to members' attention to assist them in compliance. The following items are some relevant sources of additional guidance:

Effective Date and Transitional Provisions

(Adapted from an article in the October 2003 issue of *News 'N Views*, a publication of the Institute of Chartered Accountants of BC)

The new independence Rule 204 takes effect no later than:

- for an assurance engagement in respect of a particular reporting period for a client, the first reporting period commencing after December 31, 2003;
- for any other assurance engagement or specified auditing procedures engagement, where the engagement is commenced after December 31, 2003.

A good rule of thumb is to carefully consider whether you can continue to act for each client prior to the beginning of each client's fiscal year. Assess potential threats to independence immediately and ensure that appropriate safeguards are either already in place or can be put in place to reduce these threats to an acceptable level.

There are also a number of transitional issues to consider when reviewing clients and determining whether any prohibitions apply. With respect to non-assurance services, the transitional provisions will permit otherwise prohibited services to be provided on an interim basis, so long as:

- a binding contract for the services exists at December 31, 2003
- the services are completed before December 31, 2005
- the services would not have contravened Rule 204.1 as it read prior to January 1, 2004

In the absence of a contract at December 31, 2003, the prohibitions came fully into force on January 1, 2004.

Assess Impact of Specific Prohibitions On a Time Process

Some of the prohibitions contained in Rule 204 are not time sensitive – they are never permitted (ownership, interest, loans, guarantees, etc). Others are prohibited during the fiscal year plus the engagement period (non-assurance services, employment, etc.). Thus it's very important to ensure that the firm is not providing a prohibited service in the early part of a new fiscal period or until the engagement period is completed.

Practice Aids

A special issue of *Focus on PEM*, issued by the CICA in January 2004 to PEM subscribers, is intended to help practitioners respond to the new independence standard for assurance providers under the new Rules of Professional Conduct 204.1, which became effective January 1, 2004. The article "Assessing Independence" includes additional guidance to assist practitioners in **revising their engagement and representation letters to incorporate the new independence rules.**

- Notice to Reader

The new independence rules require the practitioner to assess independence de facto, since this fact must be disclosed in the Notice to Reader communication where independence is impaired.

- Review/Audit Engagement Letter

Since the new independence rules require the auditor to assess independence before and during an assurance engagement, the practitioner should alert the client in the engagement letter that the practitioner may need to withdraw from the engagement if independence becomes impaired.

- Bookkeeping Services

Subject to Section 204.4(23), a member, firm or network firm may provide an audit or review client that is not a listed entity with accounting and bookkeeping services provided that any resulting self-review threat so created is reduced to an acceptable level. Practitioners must now ensure that management approval is obtained for all journal entries, reclassifications and adjustments. Suggested wording has been provided to revise your engagement and representation letters to formally incorporate such approvals.

Four sample forms were also provided as "transitional" practice aids:

- **Form 4.1S — Review engagement independence checklist**

This new form is provided to supplement your existing engagement acceptance checklist (Form 4.1) to incorporate the new independence rules.

- **Form 5.1 — Review engagement planning checklist**

This form has been revised to include references to assessing independence, assessing risk and gathering sufficient information about the client.

- **Form 4.2 — Engagement client retention checklist**

This new form is provided to incorporate the assessment of independence and risk for existing audit and review clients. It is no longer sufficient to assess only the appropriateness of continuing the relationship with the client.

- **Form 4.15 — Audit engagement independence checklist**

This new form is provided to supplement your existing engagement acceptance checklist (Form 4.1) to incorporate the new independence rules.

To access the newsletter and download the forms (PDF files), go to www.focusroi.com.

Other Assistance

Practitioners are advised to refer to the independence material on the Institute website at www.icans.ns.ca. For a good overview of the new standard, start with the Guide to New Canadian Independence Standard and the FAQs. In considering a specific situation, however, you will obviously need to refer to Rule 204 and the Council Interpretations.

If you have fully reviewed all available material, and still have questions about its application to a specific situation, discuss the situation with a colleague or with the Director of Professional Standards. Please remember that the ultimate decision on an independence matter rests with the member, and the Institute staff members are unable to assume any responsibility, or provide approval, for a specific situation. As a member service, however, we will direct members to relevant Rules, Council Interpretations, and other available guidance that the member should consider in arriving at a conclusion.

PRACTICE MANAGEMENT AND DEVELOPMENT

Practice Advisory on Minimum Fees and Fee Collection

The following article appeared in the Winter 2004 issue of CheckMark, a publication of the Institute of Chartered Accountants of Ontario and is reprinted with the permission of ICAO.

How Low Can You Go?

Is there a minimum dollar fee that you are required to charge an assurance client, such as a not-for-profit organization?

You may be in a situation where an assurance client has asked you to provide an assurance opinion (review or audit) at no cost, or you may be preparing a fee proposal which includes a fee that is significantly lower than that charged by the incumbent accountant. Rule 204.4(34) provides that this will not impair independence as long as you can demonstrate that:

- the work will be performed by qualified individuals who will devote an appropriate amount of time to the engagement; and
- you have followed all applicable assurance standards, guidelines and quality control procedures.

Remember also that Rule 214 prohibits you from quoting a fee for any professional engagement without first obtaining adequate information about the engagement.

How Can You Improve Fee Collection?

It may be appropriate to discuss with your clients not only the specific services you will be providing to them but to also remind them how your fee will be determined, when you will issue your invoice(s) and when you expect payment. This discussion will help your client budget for your services. Invoicing and payment arrangements should be clearly set out in your engagement letter.

For larger clients, it is not uncommon to issue interim bills as the engagement moves along. You may consider this for smaller clients as well, perhaps billing them on a monthly basis. This will allow the client to manage their cash outlays, provide cash resources for you, and minimize the “surprise factor that can occur when a large invoice is rendered at the end of an engagement.

Timing is everything. Experience shows that it is easier to collect a bill when the invoice can be directly related to the service provided, so ensure that your invoice is prepared on a timely basis and not as an afterthought, long after the work has been performed and your effort forgotten by the client. Also, remember that fee disputes and collection difficulties are often a result of unexpected problems encountered during the engagement. You should notify the client when extra work has been required or the work has taken longer than anticipated due to unforeseen circumstances, so that the client is not surprised when you present your invoice.

Now might also be a good time to review the format of your invoice — does it clearly itemize the work performed? A more detailed invoice provides the opportunity to describe the services you have performed and can make collection easier.

If you find yourself in the rare situation where a client refuses to pay and chooses to change public accountants, remember the guidance contained in the *Council Interpretation to Rule of Professional Conduct 302*, which states: "On the part of the incumbent, there must be readiness to cooperate with the successor recognizing that the client's interests are paramount *whether or not there are fees owing to the incumbent by the former client.*" (emphasis added) In other words, you cannot withhold source documents or completed work product from a client in an attempt to influence the timeliness of the payment of their account.

LOOKING TO FAIL YOUR INSPECTION? HERE'S HOW

The following article appeared in a January 2004 issue of Inf@CA, a weekly newsletter published by the Ordre of Chartered Accountants of Quebec and is reprinted with the permission of OCAQ.

Note: The Ordre's Professional Inspection Committee uses various means to make CAs aware of the importance of being well prepared for an inspection. Despite its efforts, the Committee notes each year that a number of members seem determined to jeopardize the inspection's success. This humorous article is therefore intended to capture CAs' attention and inform them about how to avoid failing their inspection.

While most practicing members (90%) meet the standards of professional inspection, some seem determined not to. This article is intended for this minority of members.

You want to be different, be noticed, incur additional costs, lose your training employer status, take mandatory courses or even have your work supervised? You are well within your rights and your quest for failure will be rewarded if you follow these simple tips. And remember, you only need to act on one of these suggestions to fail your inspection.

Do not audit payroll in an audit engagement

This very popular method consists in comparing payroll from one year to the next or, better yet, in only reconciling T4 slips to the client's payroll journal. Proponents of these inadequate and insufficient procedures seem to favour this approach for not-for-profit organizations. Of course, you can also audit payroll without documenting the procedures applied, a sure-fire way to fail your inspection. While this article, as mentioned before, is intended for a minority of practicing members, the others may be interested in an article entitled "[Audit of salaries](#)" (reproduced below).

Do not audit significant income items

Another popular method used in audit engagements consists in not auditing other significant income items like revenues, purchases or other expenses. Auditing balance sheet items does not provide the required audit evidence for income items. So go ahead and conduct your audit without documenting your work — failure is guaranteed.

Cyclical audits

If you like to follow the latest trends, a relatively new method that may appeal to you is the cyclical audit. Here, you don't audit significant income items like sales or purchases on the pretext that audit procedures were applied to them the previous year and no errors were detected.

To wrap things up, your auditor's report can be the same as that issued by practicing members who really did audit the income items, i.e.: " I have audited the balance sheet of XYZ as at (date) and the statements of income.. .for the year then ended," which of course isn't true. After all, it would be somewhat embarrassing to write: "I have audited the income items for the previous year and half of the income items for the current year."

Do not audit inventory in stock

Do not audit inventory in stock or the cost. Simply applying these procedures without documenting your work is just as effective. Although it isn't very original, this method works every time.

A last piece of advice

If you don't have audit engagements, don't despair. Just don't analyze significant variances in the income statement or balance sheet when you perform a review engagement, the purpose of which is to determine whether the financial statements seem plausible in the circumstances, or don't document your findings in the working papers. This simple yet effective method is sure to help you attain your objective, which is to fail your inspection.

The Professional Inspection Committee hopes these few tips will be useful to you.

Note: ICANS does not impose supervision or automatically recommend reinspection if there is non-compliance in only one of the above areas.

AUDIT OF SALARIES

The following article was prepared by the Ordre of Chartered Accountants of Quebec for practitioners in March 1999 and is reprinted with the permission of OCAQ.

During our inspections, we have noted that some firms do not apply the required *audit* procedures when auditing salaries. Instead, they base their audit on items that provide little, or even very little, assurance respecting the various assertions they are attempting to substantiate.

Some practitioners mistakenly consider that the fact of reconciling salaries with T4s and reconciling deductions at source provides the audit evidence necessary for auditing salaries. These practitioners present inspectors with "interesting" arguments such as: "The Revenue Department audits the T4s" or "The CSST regularly conducts audits at my client's." However, this doesn't solve the auditor's problem since:

- our Auditor's Report states "I audited," not "they audited" or, worse still, "they will audit." We thus cannot expect someone else to do it for us.
- comparing the payroll journal to the T4s - two internal documents generally issued by the same department - does not prove anything much, apart from the fact that we know how to add and transcribe figures. Would these practitioners audit accounts receivable by comparing the summary of accounts receivable to the accounts receivable ledger? The quality of the evidence would be approximately the same as that obtained by comparing the T4s to the payroll journal.
- even if the Revenue Department discovers material errors, our Auditor's Report would probably already have been signed and issued by the time we were notified.

Another audit approach that causes problems respecting the audit of salaries is comparing payroll with that of the previous year. Although this comparison is indispensable, it alone does not provide the necessary audit evidence. Analytical procedures such as comparison only provide the required assurance when the results can be anticipated with relative accuracy. For instance, if the management has remained unchanged and everyone has received a 4% raise, the results may be anticipated as far as comparison from one year to another is concerned. Simply comparing the client's total payroll from one year to the next and adding the comment "reasonable variation" does not provide the auditor with the necessary audit evidence.

To conclude, if you decide not to conduct traditional samplings for salaries, you should ensure that the compensating procedures are well documented and that they provide sufficient appropriate audit evidence needed to express your audit opinion.

SUGGESTIONS FOR THE NEXT ISSUE?

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