June 2016 *Practice Inspection Program*

**To: All Practising Offices**

## FOCUS ON PRACTICE INSPECTION REPORTABLE DEFICIENCIES – 2015-2016

The purpose of Practice Inspection is not only protection of the public, but also to provide an educational experience, which can help practitioners improve their professional standards, where necessary.

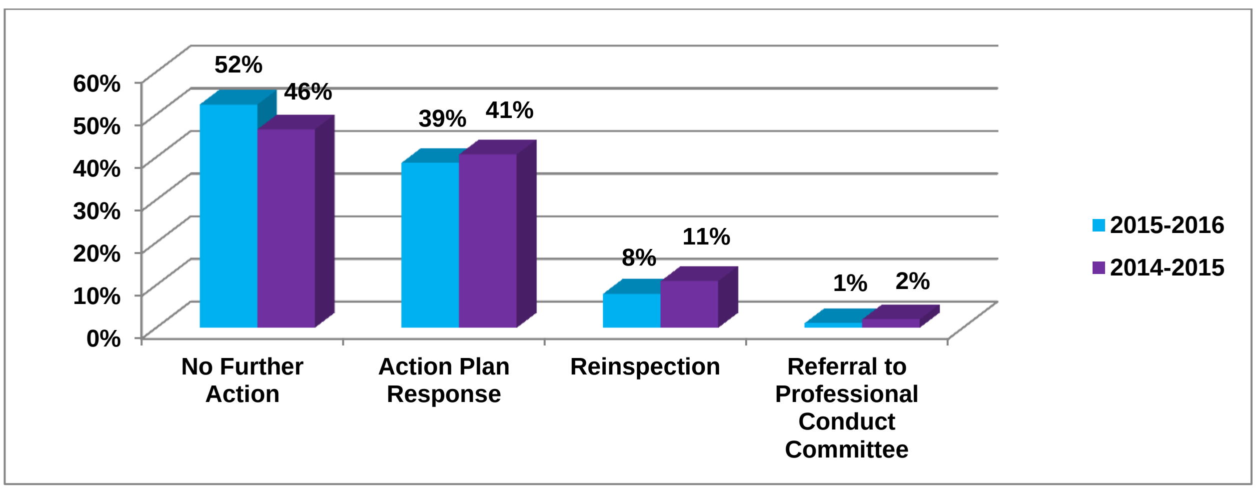
As such, the Practice Inspection Committee reviews the annual inspection results to identify those areas where adherence to the *CPA Canada Handbook* recommendations could be improved, and issues this summary to provide guidance to practitioners.

### Background

As noted, the objective of Practice Inspection is "the protection of the public by assessing the compliance with professional standards of members/firms that perform assurance, compilation and other specified engagements, and by taking appropriate follow-up or remedial action in instances of non-compliance. The public is further protected by practice inspection providing an educational experience to members/firms." (Harmonized Practice Inspection Evaluation Methodology)

During the 2015-2016 year, 564 (512 in 2014-2015) assurance-based practices were inspected, of which:

- 91% resulted in the committee requiring no further action or only the submission of an acceptable action plan response from the office (87% in 2014-2015);
- 8% resulted in the committee requiring a reinspection of the office (11% in 2014-2015); and
- 1% resulted in the committee referring a member to the Professional Conduct Committee for its independent assessment (2% in 2014-2015).




The above results do not include the inspection of 636 (282 in 2014-2015) practices which only perform compilation engagements.

The committee identified the common deficiencies in compliance with professional standards set out in Appendix 1 regarding the documentation of audit, review and compilation engagements, financial statement presentation, and the documentation and implementation of quality control policies and procedures. It is important to note that Practice Inspection does not set standards; members/firms are expected to adhere to the professional standards set out in the *CPA Canada Handbook* and *Member's handbook*.

## AREAS OF FOCUS FOR PRACTITIONERS

### Documentation in audit engagements

The deficiency identified most often in audit engagements related to the documentation of substantive audit procedures on material classes of transactions and account balances.

If audit work is not documented, there is no basis on which to conclude that the work has been performed. Auditing standards require sufficient documentation so that an experienced auditor can understand: the nature, timing and extent of the audit procedures performed; the results of those procedures and the evidence obtained, and; significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions. (CAS 230, paragraph 8)

In particular, the documentation was often found to be weak for audit sampling, and the use of substantive analytic procedures. Areas of concern included:

- For audit sampling, a lack of documentation of the basis for the sample used; failure to investigate deviations or misstatements found in the results of the sample; and failure to project errors found in the sample onto the population as a whole, where appropriate. (CAS 530)
- For substantive analytical procedures, insufficient rigour in the analytics being used to warrant reliance when substantive analytics were intended to be primary audit evidence (i.e., without also performing tests of details or tests of controls). In many instances, a fluctuation analysis (comparison of prior year to current year results) was used as a substantive analytical procedure without consideration of the requirements of CAS 520, paragraphs 5 and 7.

There were also many deficiencies relating to the planning of an audit. Of particular concern were deficiencies relating to the following:

- Risk assessment and responses to risks
  - Inappropriate assessments of risk of material misstatement at the assertion level for classes of transactions, account balances and disclosures (either no documentation or all risks identified as low when other factors imply that this conclusion is inappropriate for the entity);
  - No or little consideration of potential fraud risks;
  - No determination of whether any of the risks identified are significant risks. In exercising this judgment, the auditor shall exclude the effects of identified controls related to the risks;
  - No linkage of audit procedures performed to the assessed risks at the assertion level;
  - No documentation of tests of operating effectiveness of relevant controls when the assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively, or when substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.

- Internal controls
    - No documentation of an understanding of the entity's internal controls relevant to the audit, which is required on all audits;
    - No documentation of an evaluation of the design of controls relevant to the audit and determining whether they have been implemented, by performing procedures in addition to inquiry of the entity's personnel. This documentation should be updated for each audit.

**Documentation in review engagements**

The lack of adequate documentation of the inquiry, analytical procedures and discussion to establish plausibility remains the number one deficiency for review engagements.

While checklists are a good tool for performing a review engagement, the completion of only a checklist without additional comments is not considered to be sufficient documentation of the public accountant's inquiries, analytical procedures and discussions. Documentation of inquiries, analytical procedures and discussions may be included in either the working papers (e.g. memos) that are cross referenced back to the checklist or the comments column of the checklist itself. Documentation of discussions with clients would also include the name of the individual(s) with whom the matters were discussed and the date of the discussions.

Of particular concern are the following issues:

- *Inter-relationship/comparison of revenues, expenses, gross margin, operating ratios and balance sheet items.* The practitioner should focus on significant financial statement items, or key aspects of the client's business. Unless there is documentation that no unusual amounts, variances or trends are expected, an assessment of the plausibility of significant items should be included to evidence that the practitioner gave such items due consideration.
- *Cut-off procedures – cash, sales, purchases/inventory and accounts payable.* Typically, 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 related balances.
- *Inventory – client's count procedures and valuation*. Typically, documentation would include a description of the client's inventory count procedures, including the date of the inventory count, count instructions, use of count tags, supervision, segregation of obsolete and slow-moving inventory and inventory on consignment, to assess whether the procedures are designed to arrive at a proper and consistent count. The client's basis of determining "cost" (FIFO, specific item, etc.) and whether that basis is consistent should also be documented.
- *Contingencies, commitments and subsequent events*. Typically, documentation would include matters discussed with the client, including name and title of the individual with whom inquiries were made and the date thereof (which should be either on or before the date of the review engagement report).

### Compilation engagements

It was found that while compilations generally had fewer deficiencies, the following matters arose most often and should be considered by practitioners when completing these engagements.

There were instances when documentation on the public accountant's consideration as to whether there were any matters that would impair his/her independence was not in the file. If any matters have been identified, the nature and extent of the impairment will need to be disclosed in the notice to reader communication.

It was noted that in many files, the financial statements were not arithmetically correct, and therefore did not balance. These were normally caused by rounding errors. In addition, the supporting documentation frequently did not agree to the final figures presented in the financial statements, presumably due to working papers not being updated for journal entries.

The public accountant should recognize that he or she is responsible to the client for any work performed and, as with all engagements, is required to exercise due professional skill and care.

### Quality controls

Improvement has been noted in the documentation and implementation of the requirements of the CSQC 1 standards; however, there were still issues noted with respect to the cyclical monitoring of completed assurance files. This included the suitability of the monitor performing the cyclical inspection (e.g., the monitor's qualifications; for internal monitoring, whether they had the appropriate authority), the quality of the monitoring (e.g., appropriateness of the files selected for monitoring, the depth and rigor of the monitoring process and its scope), and the documentation of the monitoring.

### Audit quality

Audit firms should focus on identifying root causes of findings from their own quality reviews and audit inspections and developing and implementing action plans to address those findings. Action plans will vary from firm to firm, taking into account the circumstances of each firm and its assessment of the underlying causes of any deficiencies in audit quality. The firms should be monitoring and revising those action plans to ensure that they are effective.

## IMPROVEMENTS NOTED

While occurrences of identified deficiencies vary from year to year, mainly due to the mix of firms inspected, there were fewer issues identified relating to the following:

- Errors found in the format and content of the auditor's report;
- The appropriate dating, by audit firms, of the written representation letter received from management. Written representations are necessary audit evidence; as such, the auditor's opinion cannot be expressed, and the auditor's report cannot be dated, before the date of the written representations. Furthermore, because the auditor is concerned with events occurring up to the date of the auditor's report that may require adjustment to or disclosure in the financial statements, the written representations are dated as near as practicable, but not after, the date of the auditor's report on the financial statements.
- The separate disclosure, either on the balance sheet or in the notes, of amounts payable at the end of the period with respect to government remittances;

- The correct segregation of current liabilities, whether on account of a loan or otherwise, owing to directors, officers, shareholders, the parent company and other affiliated companies;
- The incorrect inclusion in current assets of an amount of cash which was subject to restriction preventing its use for current purposes. This amount should be excluded from current assets since it cannot be utilized to satisfy obligations during the current period.

## PRACTICE INSPECTION EVALUATION METHODOLOGY

As part of the harmonized evaluation methodology of the practice inspection programs across Canada, the inspector provides the inspected office solely with matters identified during the course of the inspection as either reportable deficiencies (reportable to the Practice Inspection Committee) or non-reportable matters (items brought only to the attention of the inspected office and not to the committee). The office is strongly encouraged to respond to the committee by stating how it will address the reportable deficiencies identified by the inspector. To facilitate this response, an “Action Plan” template is provided to offices and is available on CPA Ontario’s website. The committee will then assess the reportable deficiencies and the office’s response to determine if any further action is required.

## Questions

Should you have questions and/or require more information on any of the above, please contact: pracinsp@cpaontario.ca.

Janet L. Allan, FCPA, FCA – Chair
Practice Inspection Committee

Michael Walker, CPA, CA
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Appendix 1: List of the more common deficiencies in compliance with professional standards (in order of frequency)

# Appendix 1 Common Deficiencies in Compliance with Professional Standards

## Audit Engagements

- The auditor did not document the design and performance of substantive audit procedures for each material class of transactions, account balance, and disclosure.

  *CAS 330 paragraphs 18 and 25-28; CAS 500 paragraph 6*

- The auditor did not document the design and performance of audit procedures to test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements.

  *CAS 240 paragraph 32; CAS 330 paragraph 20*

- When the auditor uses audit sampling to provide a reasonable basis to draw conclusions about the population from which the sample is selected, the documentation did not reflect how the auditor met the requirements of the standard. The auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level and select items for the sample in such a way that each sampling unit in the population has a chance of selection. The auditor shall perform audit procedures on each item selected for the sample, with a replacement item selected if the procedure is not applicable to the selected item, or treat it either as a misstatement in a test of detail if the auditor is unable to apply the designed audit procedure on it (and project the misstatements found to the population) or as a deviation in a control test. The auditor shall then evaluate the results of the sample and whether it was provided a reasonable basis for conclusions about the population that had been tested.

  *CAS 530 paragraphs 6-8 and 12-15*

- As part of the risk assessment procedures, there was no documentation of discussion with those charged with governance regarding an understanding of how those charged with governance exercise oversight of management's processes and internal controls for identifying and responding to the risks of fraud and their knowledge of any actual, suspected or alleged fraud.

  *CAS 240 paragraphs 20-21 and 46; CAS 315 paragraph 6*

- In determining overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level, the auditor did not incorporate an element of unpredictability in the selection of the nature, timing and extent of audit procedures.

  *CAS 240 paragraph 29*

- When obtaining an understanding of controls that are relevant to the audit, the auditor did not evaluate the design of those controls and determine whether they were implemented.

  *CAS 315 paragraph 13*

- The auditor did not evaluate whether unusual or unexpected relationships that have been identified in performing analytical procedures, including those related to revenue accounts, may indicate risks of material misstatement due to fraud. When assessing risk, the auditor shall consider whether unusual or unexpected relationships exist.

  *CAS 240 paragraphs 16 and 22; CAS 315 paragraph 6*

- The auditor did not make inquiries of management regarding management's assessment of the risk that the financial statements might be materially misstated due to fraud and their knowledge of any actual, suspected or alleged fraud affecting entity.

  *CAS 240 paragraphs 17 and 18*

- The auditor did not communicate with those charged with governance an overview of the planned scope and timing of the audit.

  *CAS 260 paragraph 15*

- When designing and performing substantive analytical procedures, either alone or in combination with tests of details, the auditor did not evaluate the reliability of data from which the auditor's expectation of recorded amounts or ratios is developed, taking account of source, comparability, and nature and relevance of information available, and controls over preparation.

  *CAS 520 paragraph 5*

- The auditor did not identify and assess the risks of material misstatement at the financial statement level, and at the assertion level for classes of transactions, account balances and disclosures.

  *CAS 240 paragraph 25*

- The auditor did not perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report or as near as practicable thereto, that require adjustment of, or disclosure in, the financial statements have been identified.

  *CAS 560 paragraphs 6-7*

### REVIEW ENGAGEMENTS

- The public accountant did not adequately document whether the information being reported on is plausible in the circumstances within the framework of appropriate criteria. Such a review should consist of inquiry, analytical procedures and discussion; and additional or more extensive procedures when the public accountant's knowledge of the business carried on by the enterprise and the results of the inquiry, and analytical procedures and discussion cause him or her to doubt the plausibility of such information.

  *Section 8100 paragraph 15*

- Management's written representations were not effective as of the date of the review engagement report.

  *Section 8200 paragraph 35*

- There was no documentation that the public accountant had formed a conclusion on compliance with independence requirements or whether appropriate procedures regarding the acceptance and continuance of the client relationship and the specific assurance engagement had been performed and the conclusions reached.

  *Section 5030 paragraphs 10, 15 and 18*

- There was no documentation to support the date of the public accountant's report. Because the reader is entitled to assume that the public accountant has performed sufficient procedures to that date to support the conclusion expressed in his or her report, the public accountant's report cannot be dated until the financial statements have been completed and management has acknowledged responsibility for them.

  *Section 8100 paragraph 30; AuG-47*

- There were no working papers describing the major aspects of the business, normal types of transactions, major suppliers and customers, or types of risk in the business. Sufficient knowledge of the client's business would enable the public accountant to make intelligent inquiries and a reasonable assessment of responses and other information obtained.

  *Section 8100 paragraphs 15, 17 and 24; AuG-20*

- The written agreement documenting the terms of the engagement did not describe all the elements of the responsibility of the client's management.

  *Section 8200 paragraphs 18 and 19; AuG-20*

- There was no representation letter obtained from the client. The public accountant should obtain management's written representations regarding matters that are important to support the content of his/her report for all financial statements reported on. The letter should include management's representations on matters that are:

  a) directly related to items that are material, individually or in aggregate, to the financial statements;

  b) not directly related to material items but are significant, individually or in aggregate, to the engagement; or

  c) relevant to management's judgements or estimates that are material, individually or in aggregate, to the financial statements.

  *Section 8200 paragraphs 31 and 33*

## Compilation Engagements

- There was no documentation that the public accountant had considered whether there were any matters that would impair his/her independence. If any matters have been identified, the nature and extent of the impairment will need to be disclosed in the notice to reader communication.

  *Code of Professional Conduct, Rule 204.10 (formerly Rules of Professional Conduct, Rule 204.8)*

- The Notice to Reader communication was on a separate page of the financial statement package: however each page of the financial statements was not conspicuously marked "Unaudited – See Notice to Reader".

  *Section 9200 paragraph 25*

- The public accountant did not document in the file that an understanding and agreement with the client had been reached as to the services to be provided.

  *Section 9200 paragraph 16*

## Financial Statement Presentation

- An enterprise did not disclose all the required information about its transactions with related parties including, but not limited to, a description of the relationship between the transacting parties, the measurement basis used, the terms and conditions for the amounts due to or from related parties, a description of the transaction(s), including those for which no amount has been recognized and the recognized amount of the transactions classified by financial statement category.

  *Part II Section 3840 paragraph 51*

- An entity did not disclose the carrying amount of any financial liabilities that are secured, together with the carrying amount of assets it has pledged as collateral for liabilities and the terms and conditions relating to its pledge.

  *Part II Section 3856 paragraph 44*

- When an enterprise applied the taxes payable method of accounting for income taxes, the financial statements did not disclose a reconciliation of the income tax rate or expense related to income or loss for the period before discontinued operations 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, and the amount of unused income tax losses and unused income tax credits carried forward.

  *Part II Section 3465 paragraph 88*

- For issued share capital, an enterprise did not disclose the number of shares for each class, giving a brief description and the par value (if any), the dividend rates on preference shares and whether or not they are cumulative, and the redemption price of redeemable shares.

  *Part II Section 3240 paragraph 20*

- For a preferred share issued in a tax planning arrangement, an entity did not disclose the amount for these preferred shares, described as redeemable at the option of the holder, on a separate line item in the equity section of the balance sheet, together with the total redemption amount for all classes of such shares outstanding on the face of the balance sheet and the aggregate redemption amount for each class of such shares.

  *Part II Section 3856 paragraphs 23 and 47*

- The accounting policy used to account for income taxes was not disclosed. An enterprise shall use the taxes payable method or the future income taxes method to account for income taxes.

  *Part II Section 1505 paragraph 6; Section 3465 paragraph 3*

- A guarantor did not disclose, for each guarantee, or each group of similar guarantees, even when the likelihood of the guarantor having to make any payments under the guarantee is slight: the nature of the guarantee, including the approximate term of the guarantee, how the guarantee arose and the events or circumstances that require the guarantor to perform under the guarantee; the maximum potential amount of future payments (undiscounted) the guarantor could be required to make under the guarantee; the current carrying amount of the liability, if any, for the guarantor's obligations under the guarantee; the nature of any recourse provisions that enable the guarantor to recover from third parties any of the amounts paid under the guarantee;~~,~~ and the nature of any assets held as collateral or by third parties that, upon the occurrence of any triggering event or condition under the guarantee, the guarantor can obtain and liquidate to recover all or a portion of the amounts paid under the guarantee.

  *Part II AcG-14 paragraph 9*

- An entity did not disclose the accounting policies adopted in measuring inventories, including the cost formula used, together with the total carrying amount of inventories and the carrying amount in classifications appropriate to the entity, and the amount of inventories recognized as an expense during the period.

  *Part II Section 3031 paragraph 35*

- An enterprise that prepares its financial statements in accordance with Canadian accounting standards for private enterprises did not state this basis of presentation prominently in the notes to its financial statements.

  *Part II Section 1400 paragraph 16*

- There was no disclosure of the carrying amount of impaired financial assets, by type of asset, and the amount of any related allowance for impairment.

  *Part II Section 3856 paragraph 42*

- Future minimum lease payments in the aggregate and for each of the five succeeding years under operating leases were not disclosed.

  *Part II Section 3065 paragraph 77*

- For revenues of a not-for-profit organization, other than revenues from contributions, the revenue recognition policy was not disclosed.

  *Part II Section 1505 paragraphs 3 and 6; Section 3400 paragraphs 4 – 6; Part III Section 4410 paragraph 01*

- An organization that prepares its financial statements in accordance with Canadian accounting standards for not-for-profit organizations did not state this basis of presentation prominently in the notes to its financial statements.

  *Part III Section 1401 paragraph 17*

- An enterprise did not disclose the policy that it adopts in determining the composition of cash and cash equivalents and present a reconciliation of the amounts presented in its cash flow statement with the equivalent items presented in the balance sheet.

  *Part II Section 1540 paragraph 43*

CHARTERED PROFESSIONAL ACCOUNTANTS ONTARIO

## Quality Control Policies and Procedures

- The firm did not establish a monitoring process that included, on a cyclical basis, inspection of at least one completed engagement for each engagement partner.

  *CSQC 1 paragraph 48*

- The firm did not perform an ongoing consideration and evaluation of the firm's system of quality control.

  *CSQC 1 paragraph 48*

- The firm established policies and procedures setting out the nature, timing and extent of an engagement quality control review. Such policies and procedures did not require that the engagement report not be dated until the completion of the engagement quality control review.

  *CSQC 1 paragraph 36*

- The firm did not establish policies and procedures for engagement teams to complete the assembly of final engagement files on a timely basis after the engagement reports have been finalized.

  *CSQC 1 paragraph 45*

- The firm did not establish policies and procedures which set out criteria for determining the need for safeguards to reduce the familiarity threat to an acceptable level when using the same senior personnel on an assurance engagement over a long period of time.

  *CSQC 1 paragraph 25*