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Focus on Practice Inspection

The purpose of the Practice Inspection Program is to protect the public through assessing firms' and practitioners' compliance with professional standards and by taking appropriate follow-up or remedial action in cases of non-compliance. The Practice Inspection Program further protects the public by providing an educational experience to practitioners.

We recognize that these past eight months have likely been challenging for practitioners who may have had to significantly transition their practices. Similarly, CPAMB's Practice Inspection function has also shifted to allow inspections of all firms to be performed remotely in order to protect both the public and the health and safety of our contractors, staff and practitioners. This article will inform practitioners of key practice inspection observations from the 2019-2020 inspection year, which include the most significant areas where firms may not have met standards and areas of focus for inspections in the upcoming year.

2019-2020 Practice Inspection Results

During the 2019-20 inspection year, 93 (2018-19: 119) public practice offices were inspected and 83% (2018-19: 82%) of these practices were assessed by the Practice Inspection Committee (the "PIC") as meeting requirements of the Practice Inspection Program.

For the firms assessed as not meeting the standards of the Practice Inspection Program, there were some notable findings:

- Many firms had files which, while overall had appropriate documentation, contained material errors, resulting from either not identifying or not applying the appropriate *CPA Canada Handbook* standards to an accounting or assurance issue.
- Many firms used checklists filled in using "Y" or "N", or otherwise had insufficient or inconsistent documentation in key areas.

- Some firms had issues with the inadequate supervision or review of staff or were impacted due to the departure of a key engagement team member.
- Some firms performed engagements outside of their core area of practice or in an area where they did not have sufficient previous experience. An example of this would be a firm that primarily performs review engagements for owner-managed companies accepting an audit of a government not-for-profit client.
- Some firms performed review engagements which did not take into account the additional procedures and related documentation required under CSRE 2400.

Key Practice Inspection Observations

The items identified below may not be the most commonly identified deficiencies; however, they are considered some of the more significant items which can have a greater impact on the overall quality of work performed. The absence of sufficient evidence to support work performed in these areas commonly resulted in an office being assessed as “not meeting standards” by the Committee.

I. Audit Engagements

A. Auditing Revenue (CAS 240 and CAS 330)

Revenue is an area in audits which often has unique risks and correspondingly has a greater susceptibility to material misstatement. Risks may arise both from complex recognition requirements related to the characteristics of revenue streams and the presumptive risk of fraud when accounting for revenue. We have identified instances in which practitioners did not plan and perform appropriate audit procedures to respond to these risks. For example, audit teams may not have evaluated different types of revenue which give rise to fraud risks. As a result, procedures may not have been performed to address the risks related to each significant revenue stream in an entity.

B. Auditing Expenses (CAS 330)

We frequently identify deficiencies in our inspections relating to the nature and extent of substantive procedures performed with respect to expenses. Substantive procedures can consist of substantive analytical procedures (see next observation) or tests of details. When performing tests of details, practitioners must ensure their procedures address the risks identified by assertion. For example, when testing for completeness, expenses should be traced from source documents to the general ledger while to test cut-off, a review of expense transactions around year end should be performed.

C. Substantive Analytics (CAS 520)

Substantive analytical procedures are often used on their own or in conjunction with other substantive procedures to provide evidence to support the audit opinion. In general, substantive analytical procedures are most effective when evaluating large volumes of transactions in a highly predictable environment.

In determining which audit procedures to design to address audit risks, practitioners should carefully consider the suitability of using substantive analytical procedures. The suitability of an analytical procedure will depend upon the practitioner's assessment of how effective it will be in detecting a misstatement that may cause the financial statements to be materially misstated. The performance of simple year-over-year analytics generally do not meet the criteria of a substantive analytical procedure. Effective substantive analytical procedures require the development of expectations using reliable and accurate information, the determination of appropriate thresholds for further investigation and follow-up of outliers through discussion with management and by obtaining corroborating evidence.

D. Audit Sampling (CAS 530)

When conducting substantive procedures, an auditor commonly tests less than 100 percent of a balance or transaction stream. Instead they will test a sample. When selecting a sample, practitioners should:

- select a representative sample;
- perform appropriate audit procedures; and
- evaluate results to obtain reliable, relevant and sufficient appropriate evidence to form a conclusion on the population as a whole.

It is critical that the sample represents the population. For example, a practitioner may employ a standard sample size without regard to the nature of the population and the objectives of the procedure. Practitioners must ensure that all items in a population have an equal chance of being selected. Where populations can be disaggregated, i.e., in situations where there are multiple revenue streams, each distinct sub-population should be sampled independently.

E. Other Areas

Additional areas where audit deficiencies were identified are as follows:

- Lack of documentation and/or performance of risk assessment procedures relating to obtaining and understanding of the entity and its environment.
- No documentation of discussion of discussions with management and/or those charged with governance relating to fraud.
- Insufficient documentation and/or execution of substantive audit procedures on material classes of transactions and account balances in the following key areas:
    - Accounts payable completeness and cut-off
    - Payroll completeness, accuracy and cut-off
    - Revenue, particularly for long-term contracts and transactions with multiple elements
    - Expense completeness and cut-off
    - Accounts receivable valuation
    - Collectability of loans receivable, particularly from related companies
    - Classification of preferred shares as debt or equity
    - Inventory count procedures and valuation
    - Related party transactions

  - Contingencies, particularly with respect to review of legal expenses and consideration of confirmations
  - Journal entry testing
  - Subsequent events review
  - Going concern analysis

- Communication with those charged with governance did not include one or more of the following items (or, in some cases, there was no communication with those charged with governance):
  - The auditor's responsibilities in relation to the financial statement audit.
  - An overview of the planned scope and timing of the audit.
  - The written representations that the auditor is requesting from management.
  - Significant matters arising from the audit that were discussed, or subject to correspondence with management.
  - Other matters arising from the audit that are significant to the oversight of the financial reporting process.

II. Review Engagements

This is the second year in which the new Canadian Standard on Review Engagements 2400 (CSRE 2400) was reviewed as part of the Practice Inspection Program and due to the cyclical nature of the inspection program, most firms inspected in the current year were having their review engagements under CSRE 2400 inspected for the first time.

Although most practitioners were successful in transitioning to CSRE 2400, the following are some areas for improvement.

A. Understanding of the Accounting Systems and Accounting Records (CSRE 2400.43 & .44)

Understanding the accounting system and records used by an entity is vital to identifying areas where a material misstatement is likely to arise. This allows the practitioner to focus analysis and inquiry on these areas. We continue to identify instances where this documentation should be improved. Practitioners should ensure that their documentation of systems and records is commensurate with the complexity of the business. For example, industries with complex accounting, such as the construction industry, should include greater detail as to how the entity being reviewed records revenue.

B. Areas where material misstatements are likely to arise (CSRE 2400.45 &.46)

A critical element of CSRE 2400 is the identification of areas where material misstatements are likely to arise. If this assessment is not completed and documented, it is possible that appropriate inquiries and analytical procedures may not be designed and performed. Inquiry and analytical procedures are required for all material items in the financial statements, including disclosures. When a practitioner has identified an area where material misstatement is likely to arise, additional procedures should be performed to focus on addressing the area. For example, a transaction or event outside of the normal course of business or a subsequent event, may be considered an area where material misstatement is likely to arise requiring focused procedures. These areas may not necessarily be material items in the financial statements.

C. Related party balances (CSRE 2400.104)

Related party receivables and payables are common accounts included on the balance sheets of financial statements reviewed by practitioners. This has been an area where issues have been identified year after year as documentation with respect to classification and valuation of related party balances was an issue under both CSRE 2400 and the previous review standard. Practitioners are reminded that their procedures should not only address balances of receivables outstanding but also the likelihood of collectability. In addition, receivable balances without stated terms should be classified as long-term. Related party payables with no set terms of repayment should be classified as short term unless there are waivers obtained and included in the working paper file.

Documentation requirements for a review engagement under CSRE 2400 are specifically addressed in paragraphs 104-107 of the standard.

Checklists filled out with “Y” or “N” only are not sufficient to support procedures performed and, if no further documentation was included in a file, would result in a firm being assessed as not meeting standards. In particular, documentation should be sufficient for an experienced practitioner, having no previous connection with the engagement, to understand:

- the nature, timing, and extent of the procedures performed (including who performed the work, the date it was completed, and who reviewed the work and the date and extent of the review);
- the results obtained from the procedures performed and the practitioner’s conclusions arising from those procedures; and
- significant matters arising during the engagement, the practitioner’s conclusions, and significant professional judgements made to reach those conclusions.

The primary areas where documentation and/or performance of review engagements procedures were insufficient are as follows:

- Inter-relationship/comparison of revenues, expenses, gross margin, operating ratios and balance sheet items.
- Cut-off of accounts payable and enquiries for any unrecorded liabilities.
- Completeness of payroll and related accruals.
- Inventory valuation, client’s count procedures and cut-off, especially when there is a risk that some items are slow moving.
- Sales cut-off, particularly when an entity is a contractor or would use the percentage of completion method to recognize revenue
- Evidence of work performed to determine if the entity’s classification of preferred shares as either debt or equity was appropriate
- Discussions with management and performance of additional procedures regarding any potential contingencies, commitments and subsequent events

III. Quality Control [CSQC 1.48 and .49]

A firm’s quality control system should be designed and implemented to improve overall engagement quality and ensure that the firm does not issue financial statements that have material errors or inadequate work performed. We continue to find practitioners who have not performed an ongoing evaluation of the quality control system nor have they ensured cyclical monitoring is performed. The absence of effective monitoring can have a negative impact on quality. Although smaller firms may not have internal resources to comply with these requirements, they may consider exploring reciprocal arrangements with other practitioners to fulfill their monitoring obligations.

Practitioners should be aware that Quality Control standards are changing; see Appendix 2 for more information relating to the proposed Quality Management standards.

IV. Compilation Engagements

Most firms include working papers in their files to provide support that the information in the Notice to Reader financial statements is not false or misleading. Issues have been encountered when working papers included in files contained conflicting figures or additional information that had not been addressed or resolved.

Additional common deficiencies are as follows:

- Lack of documentation for an accountant's consideration and assessment of independence, especially if bookkeeping services were provided.
- The financial statements contained notes that explicitly referred to GAAP.

Practitioners need to be aware that a new compilation standard (CSRS 4200) has been issued that is significantly different than the current standard. One of the key changes is the new communication – the Compilation Engagement Report — which differs from the current Notice to Reader communication. See Appendix 2 for more information about the new Compilation standard.

V. Areas of Focus for the Upcoming Inspection Year

A. Consideration of COVID-19 Impact for Assurance Engagements

The COVID-19 pandemic has significantly impacted the operations of many businesses and this is expected to continue. Firms should be aware of additional accounting and assurance issues that may arise as a result of the impact on their clients' operations.

To support practitioners, CPA Canada and Financial Reporting & Assurance Standards Canada have developed accounting and assurance resources, including considerations for the impact of COVID-19 on key financial assertions and balances.

Additionally, CPA Manitoba has compiled online resources that include important information regarding COVID-19, as well as other information to support our members through such an extraordinary time.

Practitioners should ensure that they obtain a thorough understanding of their clients' operations and appropriately document areas of potential risk and the related assurance procedures to address these risks during the planning and completion stages. Failure to consider the impact of COVID-19 as it relates to potential accounting issues and changes to an organization's accounting system including internal controls, and the effect on a practitioner's assurance procedures, may result in firms inadequately addressing key areas and performing insufficient procedures. This could result in a material misstatement in the financial statements, which may result in the firm not meeting standards in their practice review and requiring a re-inspection.

B. New and Emerging Industries

Clients in the crypto-asset and cannabis industries have unique risks that may require the use of experts in order to develop and execute adequate assurance procedures.

Activities in the crypto-asset industry include trading in crypto-assets and crypto-asset mining. Trading in crypto-assets involves trading in virtual currencies such as Bitcoin. Crypto-asset mining is a process whereby a company provides computer processing power for the underlying method of accounting for crypto-asset trading. The fees earned for providing the computer processing are usually paid in a virtual currency. Audits of companies operating in these activities are complex, high-risk and involve difficult-to-verify virtual assets. As a result, information technology experts may be critical for the successful execution of these engagements.

Cannabis entities can take many forms including cultivation, production of medicinal products, or distribution and sales of related products. The most challenging issues arise with respect to the accounting for biological assets (the cannabis plants). As complex estimates are frequently used, expert valuation services are likely required. The regulatory aspects of this industry must also be considered during planning and throughout the engagement, as non-compliance with these regulations could have significant ramifications to the entity. This industry is also currently undergoing frequent mergers and acquisitions which creates unique accounting issues.

Appendix 1 – Practice Inspection Program Overview

The purpose of the Practice Inspection Program is to protect the public through assessing firms' and practitioners' compliance with professional standards, and by taking appropriate follow-up or remedial action in cases of non-compliance. The Practice Inspection Program further protects the public by providing an educational experience to firms. Practice inspections are performed on the offices of registered firms on a risk-adjusted cycle, typically every three years, and in the case of a newly registered firm, within its first year of operation.

During the inspections, Practice Inspectors may identify reportable deficiencies related to material financial statement areas, assertions, and disclosures where accounting or assurance standards were not met. Based on the nature and extent of reportable deficiencies identified, the Practice Inspection Function assesses a firm/office into one of three categories:

- **Meets requirements:** no further action is required though the firm/office is still expected to address the reportable deficiencies identified, and the firm will be reviewed in the next cycle;
- **Meets requirements with action plan:** if the firm/office provides a satisfactory action plan as to how the reportable deficiencies will be addressed, the firm will be reviewed in the next cycle; and
- **Does not meet requirements:** the firm will be required to have a follow-up review within a year at a cost to the firm, along with other potential consequences required by the PIC.

A firm/office's assessment and the related reportable deficiencies are reviewed by professional staff before being provided, on an anonymous and redacted basis, to the PIC for final approval. The Committee is comprised of nine CPA Manitoba members.

In determining the action to be taken following a practice inspection, particularly if the firm was assessed as not meeting requirements for a second consecutive time, the PIC's considerations include, but are not limited to:

- the degree to which the requirements of the Practice Inspection Program have been met;
- the nature and severity of the identified deficiencies;
- the adequacy of the firm's action plan and/or analysis for restatement and commitment towards rectification of issues identified;
- the cooperation of the member/firm and commitment towards improving overall firm quality;
- public interest; and
- on a follow-up inspection, the results of the previous practice inspection of the member/firm and the degree to which the member/firm addressed deficiencies identified in the initial inspection.

Appendix 2 – New and Upcoming Standards

I. Compilation Engagements (Newly Effective)

The new compilation standard is effective for compilation engagements for periods ending on or after December 14, 2021, with early adoption permitted. The key differences in the new standard arise in the compilation report and the requirement to disclose the basis of accounting used in the financial statements.

Though not a comprehensive list, below are some important differences in the new standard:

- The new compilation report includes responsibility paragraphs.
- Prior to or when accepting a compilation engagement, the practitioner must:
  - make inquiries of management regarding the intended use of the compiled financial information, including whether that information is intended to be used by a third party.
  - obtain an acknowledgment from management of the basis of accounting expected to be applied in the preparation of the financial information.
- If the information is intended to be used by a third party, the practitioner needs to obtain an acknowledgment from management that the third party either:
  - is in a position to request and obtain further information from the entity; or
  - has agreed with management on the basis of accounting to be applied.
- If management does not acknowledge that the third party can obtain further information or has agreed on the basis of accounting, then the practitioner cannot accept the engagement unless the basis of accounting is a general-purpose framework. It is expected that compiled financial information prepared in accordance with a general-purpose framework will be rare.
- The practitioner must obtain knowledge related to the entity's business and operations, accounting system and records and the basis of accounting used, and document this in the working paper files.
- The practitioner must obtain an acknowledgment from management of management's responsibility for the compiled financial information.

Practitioners should read the new standard to understand the additional inquiry and new documentation requirements. Practitioners need to be ready for the new standard by attending training, discussing the requirements with compilation engagement clients, preparing new engagement letters and updating policies and working paper procedures to meet the requirements. More information can be obtained from the CPA Canada website.

II. Quality Management (Issued but not yet Effective)

On February 8, 2019, the International Auditing and Assurance Standards Board (IAASB) issued an Exposure Draft on quality management at the firm and engagement level. Accordingly, the Auditing and Assurance Standards Board (AASB) followed by issuing an Exposure Draft on quality management at the firm and engagement level in Canada in April 2019. The Canadian Exposure Draft is proposing to adopt the new international standard unchanged except for an amendment to the relevant independence and other ethical requirements to allow reference to Canadian requirements.

The comment period has now closed. Based on the responses received to the Canadian exposure draft, the AASB provided the IAASB with a written response in June 2019. The IAASB continues to deliberate proposals made by its task forces based on comments received from its stakeholders.

Practitioners will need to prepare for the changes arising from the new quality management standard and those firms that only complete compilation engagements will need extra effort to ensure that they meet Canadian Standard on Quality Management 1 (CSQM 1) once it becomes effective. The inclusion of related services engagements in CSQM 1 makes a significant change to the scope of the new standard in relation to the existing CSQC 1.

Further information can be obtained from the CPA Canada website.