Focus on Practice Review Reportable Deficiencies 2020

January 2021

CPA Alberta's Practice Review program plays an essential role in protecting the public by assessing firms' compliance with professional standards, taking appropriate follow-up action or remedial action in instances of non-compliance, and providing one-on-one education to firms.

In this report, the results of practice reviews and observations and suggestions for improvement are highlighted to assist practitioners in performing high-quality engagements.

BACKGROUND

The Practice Review Committee (Committee) is comprised of twelve CPA members and one public member who are appointed by the CPA Alberta Board. Geographic location and practice size are considered in determining Committee membership. As well, the Committee collectively possesses experience and technical knowledge on a broad range of sectors, including accounting and auditing relating to reporting issuers, local governments, not-for-profit organizations, pension plans, and private enterprises. This also includes assurance and compilation engagements.

Practice reviews of firms are undertaken not less than once every three years, providing that a firm complies with the practice review cycle. If a practice review does not result in a comply assessment, a follow-up practice review is done within one year from the initial review. The practice review cycle is also adjusted by considering risk indicators, including date of registration with CPA Alberta and the Canadian Public Accountability Board (CPAB), significant changes in scope of practice, type of clients or composition of registrant, failure to meet CPD requirements, previous practice review results, disciplinary information, and any other information warranting an increased rate of practice review.

The Committee assesses practice review reports and any comments received from a firm on an anonymous basis. The Committee determines whether each practice review complies in whole or in part with the *Rules of Professional Conduct* and practice standards and ensures a final practice review report is sent to the firm whose practice was reviewed. The Committee may also determine to do one or more of the following:

- Direct a follow-up practice review;
- Direct the establishment and implementation of a professional development plan, or a plan to maintain and improve professional standards;
- Direct that courses, examinations, tutorial or other forms of CPD or skills training be taken;
- Recommend practice improvement, practical experience or the engagement of a mentor;
- Make a complaint to the Complaints Inquiry Committee (CIC).

Factors considered by the Committee in determining the action to be taken following a practice review may include but are not limited to:

- The nature and severity of identified deficiencies;
- The number of identified deficiencies;
- The firm's response to identified deficiencies, including those requiring remedial action;
- The firm's quality control systems and whether monitoring was performed;
- The cooperation of the firm;
- The public interest; and
- In a follow-up practice review, the results of the initial review and the degree to which the firm addressed identified deficiencies.

Referral to the CIC occurs when the Committee concludes its directed remedial action has not been effective and other consequences are required to protect the public. Matters referred to the CIC include:

- Breaches of the *Rules of Professional Conduct*;
- Non-cooperation with the practice review process;
- Choosing not to take the CPD directed by the Committee;
- Performing engagements the firm is not registered to perform; and
- Continual lack of success adhering to professional standards.

This past year, 564 practice reviews were completed (prior year 536), of which 36 required a follow-up practice review (prior year 39). The Committee directed 55 professional development courses to be attended (prior year 50) and made four complaints to the CIC (prior year two).

COVID-19 IMPLICATIONS FOR FIRMS

The year 2020 saw unprecedented disruption created by the COVID-19 pandemic, causing firms to significantly and rapidly adjust their practices. CPA Alberta's Practice Review program also quickly adapted and moved to performing almost all practice reviews remotely.

As the COVID-19 pandemic continues, Practice Review continues to perform all practice reviews remotely. All firms are asked to provide electronic files through a secure file transfer system. If a firm does not have electronic files, they are asked to convert files selected for review to electronic files. In the rare cases firms are not able to convert paper files to electronic files, staff reviewers review these files in the Edmonton/Calgary office.

Exit interviews and discussions with practitioners take place securely through videoconferencing.

The COVID-19 pandemic has significantly impacted the operations of all entities. When performing assurance engagements, firms should be aware of additional accounting and assurance issues that may arise as a result of the impact on their clients' operations.

Although not exhaustive, specific areas to consider performing assurance engagements during and after the pandemic include going concern, subsequent events, impairments, inventory observations, and obtaining sufficient appropriate evidence. Given the unusual circumstances, practitioners should also heighten their professional skepticism when relying on electronic or scanned evidence rather than original documents, and perform additional procedures to obtain comfort as to the authenticity of evidence.

Numerous resources are available to support firms and are listed in Appendix 2.

PRACTICE REVIEW OBSERVATIONS

Below are critical deficiencies identified during the practice review process. These include material misstatements identified in financial statements and, with respect to engagement performance, the most significant deficiencies that may have a great impact on the quality of work performed. Given the seriousness of these deficiencies, the Committee requires the firm's remedial action plan when making its assessment on compliance. If the firm's remedial action plan is not satisfactory to the Committee, it may consider the firm a serious risk to the public, resulting in an assessment of non-compliance with professional standards and related consequences.

It is important to note that Practice Review does not set standards. Professional standards are set out in the *CPA Canada Handbooks*, the *Chartered Professional Accountants Act (Alberta)* and CPA Alberta's Bylaws, Regulations and *Rules of Professional Conduct*. Tax management standards are approved by the CPA Alberta Board and set out in the Directives.

I. FINANCIAL STATEMENT PRESENTATION

Financial statements with material misstatements are concerning since users may be inappropriately relying on incorrect financial information. These misstatements may be as a result of an error or of a financial statement misclassification.

When such deficiencies are identified during the practice review process, practitioners are encouraged to carefully consider not only the actions the firm will take on a go-forward basis, but also whether the financial statements need to be restated.

While highlighted in previous years, the following three deficiencies continue to be frequently seen and are reemphasized again this year.

DEBT DUE ON DEMAND

Callable debt includes any amount owing to another party when the creditor has the unilateral right to demand repayment of the debt. This includes loans from financial institutions and loans from related parties. Classification of these debts is based on facts existing at the Balance Sheet date, rather than on future expectations. If the creditor has waived, in writing, or subsequently lost the right to demand payment for more than one year from the Balance Sheet date, then it is appropriate to present the debt as long-term. However, if the creditor has not waived, in writing, the right to demand repayment, then the debt should be classified as current. In the example of loans from related parties, even if these loans are subordinated to a financial institution, the creditor must still waive, in writing to the entity, the right to demand repayment in order to support the long-term classification.

When performing review or audit engagements, practitioners must perform and document their procedures to support the classification of debt due on demand. This may include reviewing loan agreements and the creditor's waiver of its right to demand repayment. In a review engagement, this may also include enquiring with the entity regarding its loan agreements and the creditor's waiver.

Practitioners must perform procedures with professional skepticism. For example, if a related party loan has no terms of repayment and in fact continues to be partially repaid during subsequent years, long-term classification may not be appropriate for the entire balance. This is the case even if the creditor has waived, in writing, its right to demand repayment as the partial repayment seems to contradict the written waiver. In this instance, it may only be appropriate to partially classify a current and long-term portion.

[CPA Canada Handbook – Accounting Part II; 1510.12-.13 and CPA Canada Handbook – Accounting Part III; 4400.21]

RECEIVABLES WITH NO TERMS OF REPAYMENT

Current assets include those assets ordinarily realizable within one year from the date of the Balance Sheet. Therefore, practitioners must carefully consider whether it is appropriate to classify receivables with no terms of repayment as current assets. In many instances, it is more appropriate to classify as long-term assets. For example, consider a related party receivable with no terms of repayment, showing no repayments during the year and for which management represents the timing of future payments as unknown. In this instance, the amounts should be classified as long-term assets since they will not be realizable within one year from the date of the Balance Sheet.

When performing audit or review engagements, practitioners must perform and document their procedures to support the classification of receivables with no terms of repayment. This may include reviewing loan agreements and enquiring with the entity.

[CPA Canada Handbook – Accounting Part II; 1510.03 and CPA Canada Handbook – Accounting Part III; 4400.21]

OTHER ASSETS

Current assets include those assets ordinarily realizable within one year from the date of the Balance Sheet. In many instances, it is appropriate to classify other assets as long-term. For example, consider prepaid expenses or deposits which will be realized in more than one year from the date of the Balance Sheet: these must be presented as long-term assets instead of current assets.

Another example to consider is investments with maturities greater than one year from the date of the Balance Sheet. Examples of such investments would include treasury bills, investment certificates, and call loans. These must also be presented as long-term assets instead of current assets if the assets are not capable of prompt liquidation and maturities are greater than one year from the date of the Balance Sheet.

When performing audit or review engagements, practitioners must perform and document their procedures to support the classification of all assets. This may include reviewing supporting documentation and enquiring with the entity.

[CPA Canada Handbook – Accounting Part II; 1510.03-.07 and CPA Canada Handbook – Accounting Part III; 4400.21]

II. AUDIT ENGAGEMENTS

AUDITING REVENUE

Revenue is an area which often has unique risks and 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. In all but the simplest environments, revenue recognition should generally be considered a significant risk in the audit, and substantive procedures and/or control testing performed to mitigate the risk.

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 that may give rise to fraud risks. As a result, procedures may not have been performed to address the risks related to each significant revenue stream.

Practitioners are reminded that there is a rebuttable presumption of significant risk in revenue. Where the practitioner has determined that, due to the nature of the revenue (e.g., non-complex, single revenue stream, etc.) there is no such significant risk, the reason for this assessment should be documented in the file.

[CPA Canada Handbook – Assurance; CAS 240 and 330]

AUDITING EXPENSES

Practice Review frequently identifies deficiencies 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, auditors 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.

[CPA Canada Handbook – Assurance; CAS 330]

SUBSTANTIVE ANALYTICS

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 the procedure 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 does 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 the follow-up of outliers through discussion with management and by obtaining corroborating evidence.

When using substantive analytical procedures for audit evidence, documentation should clearly identify how the expectation is calculated, the threshold for further investigation, the explanation for any deviations from threshold, and the conclusions reached.

[CPA Canada Handbook – Assurance; CAS 520]

AUDIT SAMPLING

When conducting substantive procedures, an auditor commonly tests less than 100 per cent 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, for example in situations where there are multiple revenue streams, each distinct sub-population should be sampled independently.

When using audit sampling in an engagement, documentation should allow an experienced practitioner to replicate the test and reach the same conclusions. To meet the re-performance expectation, documentation should indicate the population being tested, how the sample size was determined, how the sample was selected, extrapolation of any errors, and the conclusions reached.

[CPA Canada Handbook – Assurance; CAS 530]

III. REVIEW ENGAGEMENTS

The review engagement standard (*Canadian Standard on Review Engagements, CSRE 2400*) is effective for reviews of financial statements for periods ending on or after December 14, 2017. Three years after this effective date, Practice Review continued to see a number of firms which performed review engagements under the old standard. If the old standard is applied instead of the CSRE 2400 standard, the Committee determines the firm to be in non-compliance with professional standards, resulting in related consequences.

Specific areas within CSRE 2400 where deficiencies were most frequently observed are described below.

UNDERSTANDING THE ACCOUNTING SYSTEMS AND ACCOUNTING RECORDS

The client's accounting systems and records form the basis of the financial statements and provide information relied upon during the review engagement. Therefore, understanding the accounting systems and records used by an entity is vital to performing a review engagement. This helps to identify areas where a material misstatement is likely to arise and the procedures to be performed, allowing the practitioner to focus analysis and inquiry on the right areas. Practitioners should document accounting systems and records in sufficient detail to enable an experienced practitioner having no previous connection with the engagement to understand the systems and records. For example, brief and superficial documentation of accounting systems and records does not result in a meaningful analysis.

[CPA Canada Handbook – Assurance; CSRE 2400.43-.44]

AREAS WHERE MATERIAL MISSTATEMENTS ARE LIKELY TO ARISE

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.

[CPA Canada Handbook – Assurance; CSRE 2400.45-.46]

INQUIRIES OF MANAGEMENT AND OTHERS WITHIN THE ENTITY

Evidence obtained through inquiry is often the principal source of understanding concerning the entity's activities, management's actions during the year, and their plans. CSRE 2400 includes an extensive list of required inquiries of management and others within the entity.

Application of professional skepticism in evaluating responses provided by management is important to enable the practitioner to evaluate whether there are any matters that would cause the practitioner to believe the financial statements may be materially misstated. This analysis should not be performed as a perfunctory exercise. For example, one-word responses are not sufficient for inquiries that clearly require a more detailed response.

Enquiries regarding going concern and the existence of any actual, suspected, or alleged fraud or illegal acts and non-compliance with provisions of laws and regulations are particularly important. Management's responses to these enquiries may result in disclosure in the financial statements or changes to the measurement of amounts in the financial statements. The practitioner may also be required to perform additional procedures and communicate the matter with the appropriate level of senior management or those charged with governance.

[CPA Canada Handbook – Assurance; CSRE 2400.47, .51-.53]

Related party transactions are sensitive and important for users of the financial statements to understand. Therefore, enquiry regarding the identification of related parties and related party transactions, including the purpose of those transactions, is critical. It is also important the practitioner remain alert throughout the engagement for related party transactions that management may not have identified or disclosed to the practitioner.

[CPA Canada Handbook – Assurance; CSRE 2400.47, .49-.50]

IV. QUALITY CONTROL

A well-thought-out and executed quality control system is required and reinforced with remedial action. If designed and implemented effectively, overall quality improves and deficiencies decrease with a quality control system.

The most frequent quality control deficiencies observed by Practice Review are described below.

LACK OF MONITORING

One of the most effective components of quality control is the completion of monitoring as required by *Canadian Standards on Quality Control (CSQC 1).* This monitoring is vital to ensure that the firm identifies and corrects any breakdown in quality controls in a timely manner. Practitioners should assess overall quality control annually and review completed assurance engagements on a cyclical basis. Monitoring should be performed in sufficient depth and by appropriate individuals. The absence of effective monitoring greatly impacts quality and is often a significant factor in whether firms comply with the practice review cycle.

CSQC 1 requires cyclical monitoring of completed assurance engagements to be completed by someone not involved in the engagement. A common challenge for sole practitioners or smaller partnerships is the lack of independence within the practice to perform cyclical monitoring activities. In these instances, practitioners may fulfil their cyclical monitoring obligations by engaging an external monitoring service provider.

To have a positive effect on quality, it is essential that monitoring results are shared within the practice and that any corrective action is planned and executed in a timely manner. To achieve the benefits of monitoring, it is not enough to simply record the results—it is critical to develop and execute a plan of action.

[CPA Canada Handbook – Assurance; CSQC 1.48-.54]

NOTE: The Quality Control standards are changing. Please see Appendix 1 for more information.

LACK OF ENGAGEMENT QUALITY CONTROL REVIEW

A firm's Quality Assurance Manual establishes its policies and procedures on engagement quality control review (EQCR). An EQCR is not the same as cyclical monitoring. Cyclical monitoring is designed to provide reasonable assurance that policies and procedures relating to the system of quality control are relevant, adequate, and operating effectively. An EQCR is part of completing the audit or review engagement and must be completed before the engagement report is dated.

In order to demonstrate compliance with the firm's Quality Assurance Manual, a firm must complete an EQCR when the criteria it established are met.

[CPA Canada Handbook – Assurance; CSQC 1.35-.42]

V. COMPILATION ENGAGEMENTS

The compilation engagement standard *(Canadian Standard on Compilation Engagements, CSRS 4200*) was issued in February 2020 and is effective for compiled financial information for periods ending on or after December 14, 2021, with early adoption being permitted.

The lengthy time period until effective date provides firms with an opportunity to carefully review the new standard and consider the impact on their practices. There are significant differences in CSRS 4200 compared to the old standard *(CPA Canada Handbook – Assurance; Section 9200)*, and careful review and consideration by a firm is required before implementation.

Practice Review has seen very few firms early adopting this new standard. The handful of engagements Practice Review reviewed under CSRS 4200 were generally poorly performed and did not meet the minimum standards.

Appendix 1 summaries some important differences in the new standard and Appendix 2 lists resources available to support firms in this area.

The majority of compilation engagements reviewed by Practice Review last year followed Section 9200, and the most frequent significant deficiencies include the following.

FALSE OR MISLEADING FINANCIAL STATEMENTS

When performing a compilation engagement, if there are matters which would cause the financial statements to be false or misleading additional information should be requested in order to complete the statements. For example, if there is documentation in the file which indicates a financial statement balance is misstated then additional information must be obtained or the client asked to adjust the financial statements.

Another example indicating the financial statements may be false or misleading is if a note to the financial statements indicates the financial statements do not include all the disclosures required under ASPE. This statement implies the measurement and presentation is under ASPE, and unless the practitioner requests additional information to confirm this the financial statements may be false or misleading.

[CPA Canada Handbook – Assurance; 9200.20]

INDEPENDENCE THREAT NOT DISCLOSED IN THE NOTICE TO READER REPORT

When performing a compilation engagement, a firm is not subject to the independence requirements of CPA Alberta *Rules of Professional Conduct*, Rules 204.1 to 204.8. However, if independence matters are identified the nature of the activity or relationship and the nature and extent of the interest shall be disclosed in the practitioner's written report accompanying the financial statements.

[CPA Alberta Rules of Professional Conduct, Rule 204.1 and 204.9]

EMERGING INDUSTRIES

Practitioners are increasingly engaging clients in emerging industries, including cryptocurrency and cannabis. These industries have unique risks that require careful consideration of the auditor's ability to develop and execute assurance procedures to obtain sufficient, appropriate audit evidence, including the potential for the use of experts or highly specialized training.

Practitioners who engage cryptocurrency clients may have little or no experience in this field. It is challenging to obtain evidence to support the existence, ownership, and valuation of crypto assets, and it is likely that a controls-reliance approach is required. It is expected that valuation experts will be required in many of these engagements. Revenue generated through cryptocurrency transactions rely on blockchain technology, which is a new and complex electronic recording system. As a result, information technology experts may be necessary.

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.

QUESTIONS

Should you have questions and/or require more information on any of the above, please contact Erin Wallish, CPA, CA, Director of Practice Review, at ewallish@cpaalberta.ca**.** General questions on other issues related to professional services should be directed to Larry Brownoff, CPA, CA, Director, Member Relations, at lbrownoff@cpaalberta.ca.

APPENDIX 1 – NEW STANDARDS RECENTLY ISSUED OR NOT YET EFFECTIVE

QUALITY MANAGEMENT

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 Accounting 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 comment period has now closed, and the IAASB approved the final standards in September 2020. The AASB approved adoption of these standards in Canada at its January 2021 meeting.

Firms will need to prepare for the changes arising from the new quality management standard. Firms that only complete compilation engagements will need to ensure they are able to meet CSQM 1 by the time 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:

- https://www.cpacanada.ca
- https://www.frascanada.ca/en/csqc

COMPILATION ENGAGEMENTS

The new compilation engagement standard is effective for compiled financial information for periods ending on or after December 14, 2021.

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

- New compilation engagement report;
- Requirement to disclose the basis of accounting used in the financial information;
- 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; and
    - 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 not 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, such as ASPE, 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.

Further information can be obtained from https://www.cpacanada.ca/en/business-and-accounting-resources/audit-and-assurance/standards-other-than-cas/publications/new-compilation-standard-guidance-resources.

APPENDIX 2 – RESOURCES

In addition to the CPA Canada Handbooks on Accounting and Assurance (which can be found at Knotia.ca, www.knotia.ca, and are free for all CPA Canada members), there are many other resources available at no charge to Alberta CPAs.

COVID-19 RESOURCES

To assist CPAs in addressing challenges arising from COVID-19, CPA Alberta and CPA Canada have a number of resources and services available. Please see:

- https://www.cpaalberta.ca/Services/Online-Resource-Centre/COVID-19-Online-Resources
- https://www.cpacanada.ca/en/members-area/covid-19-resources

The Canadian Public Accountability Board (CPAB) also has various resources available at https://cpab-ccrc.ca/insights/covid-19.

AUIDT AND ASSURANCE RESOURCES

The CPA Canada website has various audit and assurance resources at https://www.cpacanada.ca/en/business-and-accounting-resources/audit-and-assurance.

The Financial Reporting & Assurance Standards Canada website (www.frascanada.ca) contains useful guidance on all the Canadian accounting frameworks and assurance standards, along with information on developing issues and discussions on proposed new standards.

COMPILATION ENGAGEMENT RESOURCES

The CPA Canada website has various compilation resources at https://www.cpacanada.ca/en/business-and-accounting-resources/audit-and-assurance/standards-other-than-cas/publications/new-compilation-standard-guidance-resources