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Director Alert

New Canadian Auditing Standards – questions for directors to ask

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Introduction

Your upcoming audit will be different. Is your organization prepared?

In any organization whose financial statements are subject to audit, the board of directors is responsible for overseeing the audit process. In many organizations, this responsibility is delegated to the audit committee or other committee of the board.

The audit process in Canada is changing, and directors need to have an understanding of the changes and work with their auditors to ensure a smooth transition. New Canadian Auditing Standards (CASs), which are based on international standards, will be in effect for audits of financial statements for periods ending on or after December 14, 2010.

The new auditing standards apply to audits of all entities, whether public or private, for profit or not-for-profit, and in both the public and private sectors. They will be used to audit financial statements prepared in accordance with any acceptable financial reporting framework, including International Financial Reporting Standards, accounting standards for private enterprises, accounting standards for not-for-profit organizations and others.

In other words, if an organization's calendar year financial statements for 2010 and beyond are being audited, whatever the organization's size and nature, the auditor will be using the new CASs.

But there is no need to panic. The CASs are similar in many ways to the standards auditors have been using up to now. For instance, the main engine room of the audit – the way the auditor gains an understanding of the organization, assesses risks of misstatement of the financial statements and develops responses to those risks (including the risk of fraud) – is substantially unchanged.

However, there are some changes that may come as a surprise to boards of directors. A key area where boards will notice a change, for example, is the communications about the audit, whether with management, the audit committee or externally to the organization's stakeholders. Further, the CASs have some significant benefits, not only for auditors but also for boards of directors and the organizations they oversee. In preparation for their next audit, directors and their auditors should discuss the move to the CASs and what it means in the specific circumstances of their audit.

This Director Alert highlights some of the key changes taking place and presents possible questions that directors or audit committee members might ask to get a better understanding of the CASs and how they affect the audit. Some questions are intended for directors to ask management, while others are questions for directors to discuss among themselves or with their auditors.

A. Understanding the Scope and Impact of the Changes

As early in the process as possible, the audit committee or board of directors should discuss with the auditor the potential differences in the audit resulting from the new standards.

The nature and extent of differences that management and the board of directors may notice from prior year audits will depend on the circumstances of the organization. The CASs contain several new or significantly changed standards that may have implications for management and the board to the extent they are relevant to the audit of that particular organization. Further, the CASs often contain requirements that were previously best practice but not specifically required, and eliminate some choices that auditors may have had under the previous standards.

As a result, the degree of difference in the conduct of the audit of a particular organization will depend in part on the organization and in part on the practices previously followed by the auditor.

Increased emphasis on the responsibilities of management and the board

One initial point that may attract the attention of both directors and management is the increased emphasis under the new standards on the responsibility of management and the board of directors for the financial statements.

The audited financial statements are the responsibility of the organization. Their preparation is the responsibility of management under the oversight of the board of directors. Although the auditor may provide assistance in the preparation of the financial statements, the statements remain the responsibility of management and the board. The audit of the financial statements cannot relieve management or the board of their responsibilities.

Responsibility for the financial statements has always been a fundamental responsibility of corporate governance. However, the new standards require this to be specifically acknowledged by management and the board. The premise is reflected in many of the communications between the auditor and the organization under the new standards, including the audit engagement letter, the management representation letter, and the auditor's report.

In smaller organizations and those with limited accounting expertise, this may come as a surprise. In these organizations the financial statements may be thought of as "the auditor's financial statements". Directors will need to ensure that both the board and management understand the nature and extent of their responsibilities for the financial statements and are comfortable explicitly acknowledging that responsibility.

Changes to the auditor's engagement letter

In addition to the increased emphasis on the responsibilities of management and the board of directors, the engagement letter is likely to look different in other respects. The auditor is required to include in the audit engagement letter reference to the expected form and content of the report to be issued by the auditor. As both the form and the content of the auditor's report will be different under the new standards (see below), it is important that management and the board or audit committee carefully review the new engagement letter.

Questions for directors to ask:

1. **Have management, the audit committee and the auditor discussed the impact of the CASs on this year's audit?**
2. **What significant changes are expected to the audit process?**
3. **In what specific areas are communications with the board expected to change as a result of the new standards?**
4. **Do management and the board understand their respective responsibilities for the financial statements?**
5. **Has the audit committee reviewed the new audit engagement letter?**

B. Enhancing Communication between the Auditor and the Board

The new CASs set out an overarching communications framework that emphasizes the importance of effective two-way communication between the auditor and the board or audit committee during all phases of the audit. The communication requirements and guidance are more extensive and detailed than before.

There are four key areas of communication. The auditor must:

- inform the board of the auditor's responsibilities on the audit;
- discuss with the board the timing and scope of the audit;
- obtain from the board information relevant to the audit; and
- inform the board on a timely basis of matters arising from the audit that are likely to be of interest or concern to the board.

CASs with enhanced communication requirements with the board

A number of the new standards include specific requirements for the auditor to communicate with the board or audit committee. Directors of some organizations may note an increase in communications from the auditor, as the auditor is now required to report to the board in some situations in which there was previously an option not to do so. Here are a few examples:

Related parties: The auditor is required to communicate with the board non-disclosure by management of related parties or significant related party transactions. In the past, where management did not disclose related party transactions, but corrected the oversight when requested by the auditor, the matter may not have been reported to the board. Under the new standards, the auditor is required to do so. The auditor is also required to obtain written representations at the end of the engagement with respect to related party relationships and transactions and their accounting and disclosure in the financial statements. Previously, representations were obtained only from management. The auditor may now consider it appropriate to obtain representations from the board as well, for example, when the board has approved specific related-party transactions involving management.

Correcting misstatements: The auditor is required to keep track of all non-trivial misstatements identified during the audit. The auditor must now request that management correct the misstatements. Previously, the auditor was not required to request correction of misstatements, provided that they were below the auditor's materiality threshold. The auditor is required to advise the board of all misstatements which have not been corrected by management, regardless of materiality. Under the new auditing standards, the auditor will also advise the board or audit committee of the effect that the uncorrected misstatements may have on the auditor's opinion, and will request that the board take action by requiring that management correct the misstatements.

Going concern: Financial statements are prepared under the going concern assumption (that the business will continue for the forseeable future). The new standards require enhanced communication between the auditor and the board about the use of this assumption for the organization's financial statements. Management is responsible for assessing the organization's ability to continue as a going concern for at least the next twelve months. This determination affects the way the financial statements are prepared. The auditor will question management and make investigations during the course of the audit to test the basis for the determination. Under the new standards, the auditor is required to inform the board of any events or conditions identified during the audit that cast significant doubt on the entity's ability to continue as a going concern, including whether the events or conditions constitute a material uncertainty, whether the going concern assumption is appropriate in the preparation of the financial statements, and the adequacy of related disclosures in the financial statements.

As a result of these and other enhanced communication requirements, boards and audit committees may receive more information from the auditor than they have in the past, particularly where there are areas of concern. Audit committees would be well-advised to take advantage of this additional information to enhance their understanding of the organization and their ability to oversee its financial condition, identify red flags and other warning signals and direct management in taking appropriate action.

B. Enhancing Communication between the Auditor and the Board (continued)

Auditor evaluation of the two-way communication with the board

Another key change which boards should be aware of under the new standards is that when preparing the auditor's report, the auditor is now specifically required to consider the quality of communication and interaction with the board. The auditor is directed to consider whether communications with the board have been adequate for the purpose of the audit: that is, whether the objectives of such communications have been achieved.

Inadequate communications may have significant consequences. For example, they may indicate an unsatisfactory control environment and influence the auditor's assessment of the risks of material misstatements, such that the auditor may need to perform additional audit procedures in forming the audit opinion.

The following are items the auditor may observe during the audit that affect the auditor's evaluation of the two-way communication with the board:

- The appropriateness and timeliness of actions taken by the board in response to matters raised by the auditor. Where significant matters raised in previous communications have not been dealt with effectively, it may be appropriate for the auditor to inquire as to why appropriate action has not been taken, and to consider raising the point again.
- The apparent openness of the board in their communications with the auditor.
- The willingness and capacity of the board to meet with the auditor without management present.
- The apparent ability of the board to fully comprehend matters raised by the auditor, for example, the extent to which the board probes issues, and questions recommendations made to it.
- Difficulty in establishing with the board a mutual understanding of the form, timing and expected general content of communications.
- Where all or some of the board of directors are involved in managing the entity, their apparent awareness of how matters discussed with the auditor affect their broader governance responsibilities, as well as their management responsibilities.
- Whether the two-way communication between the auditor and the board is sufficient to meet any other applicable legal and regulatory requirements.

This has important implications for the board of directors. The board should ensure that it is organized in a way that allows for effective engagement with the auditor. This may affect whether or not the board chooses to have an audit committee, the directors who should sit on the committee, and the number and timing of meetings. It may also indicate a need for additional education for directors regarding the organization's finances and their own governance responsibilities.

Boards should consider discussing with the auditor prior to the audit their specific expectations regarding communications, and taking the time after the audit to look back and evaluate the process and identify areas to work on in order to continually improve their communications.

Questions for directors to ask:

1. **How effective has the communication process with the auditor been in the past?**
2. **Are there improvements that should be made to the communications process?**
3. **Is the board / audit committee organized so as to facilitate the required communications?**
4. **Do we have a clear understanding of the auditor's expectations regarding communications?**
5. **How can we ensure that we continually improve our communications with the auditor?**

C. Dating of the Auditor's Report

The date of the auditor's report is likely to change under the new standards. The auditor will now be unable to complete (and date) the report until those with the recognized authority for the financial statements (generally the board of directors) have asserted that they have taken responsibility for them.

The date of the auditor's report is intended to signify to the reader the date as of which the auditor has considered the effect of events and transactions of which the auditor became aware and that occurred up to that date. The new standards require the report to be dated *no earlier than* the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements, including evidence that:

- all the statements that comprise the financial statements, including related notes, have been prepared; and
- those with the recognized authority have asserted that they have taken responsibility for those financial statements.

Delays in the completion of the auditor's report may be due to:

Management factors relating to the preparation of the financial statements- when the financial statements are not complete because some adjustment or disclosure that could be material to the financial statements is still to be made. This may include, for example, the finalization of the organization's income tax provision or the updating of the financial statements for subsequent events that require adjustment or disclosure. If the organization is still in the process of completing the financial statements (for example, the finalization of the entity's income tax provision), the related audit procedures on the financial statement items or notes that remain to be completed will not yet have been performed by the auditor. The auditor's report must not be dated before the auditor has performed sufficient audit procedures to support the content of his or her report based on the completed financial statements.

Board of directors approving the financial statements – In Canada, most incorporating or other governing legislation requires the board of directors to approve the financial statements.[1] This is generally done at a meeting of the board. In many organizations, there may be a significant delay in the approval of the financial statements by the board.

Under the previous standards, the auditor had greater leeway to date the report as of an earlier date. This is no longer an option under the new standards. As a result, in many cases, the date of the auditor's report will be a later date than under the previous standards.

Depending on the current policies and procedures in place, the board may need to consider:

- the impact on management's procedures for reporting on subsequent events,
- the coordination of the appropriate approval of the financial statements,
- providing the auditor with sufficient appropriate audit evidence to support the approval of the financial statements and the date thereof, and
- any other effects this may have on the administrative flow for finalization and distribution of financial statements.

Questions for directors to ask:

1. **What is the expected date of the auditor's report for the upcoming audit and what are the implications for the auditor and for management?**
2. **Are there means by which management can improve the efficiency of preparing the final financial statements?**
3. **Are there means of improving the efficiency of the board process for approving the financial statements?**
4. **Are there any other factors which may delay the dating of the auditor's report of which the board should be aware?**

[1] See, for example, section 158 of the Canada Business Corporations Act (CBCA) which requires the directors of the corporation to approve the financial statements.

D. Form and Content of the Auditor's Report

The auditor's report is the key output from the audit. It communicates the auditor's conclusion and the basis for that conclusion. The required format and wording of the auditor's unqualified report under the CASs is different from the previous auditor's standard report (see example auditor's report on the facing page) in a number of ways, including:

- The report uses subheadings to emphasize the purpose of the respective paragraphs in the auditor's report.
- The title of the auditor's report clearly conveys that the report is that of an independent auditor.
- The description of management's responsibility is expanded to indicate that it includes responsibility for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.
- The report contains an expanded description of the auditor's responsibility.
- The auditor's report states that the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

The CASs also allow the auditor to make additional communications in the auditor's report when the auditor believes it is necessary to draw attention to information in the financial statements, for example, a major risk that under the previous standards would have been buried in the notes to the financial statements. This is referred to as an "emphasis of matter" paragraph.

The new standards also allow the auditor to make additional communications in the report regarding the auditor's responsibilities, or the report itself, such as the fact that the organization's financial statements had not been audited in the prior year. This is referred to as an "other matter" paragraph.

Auditors who expect to include one of these paragraphs in the auditor's report are required at the outset of the audit to communicate with the board regarding this expectation and the proposed wording of the paragraph. The board of directors should ensure that they understand the implications of the inclusion of such a paragraph and should be prepared to discuss with the auditor the use and wording of such paragraphs.

Audit reports for not-for-profit organizations which receive donations generally include a qualifying paragraph reflecting the fact that completeness of donations cannot be verified by the audit. This will be unchanged under the new standards.

Questions for directors to ask:

1. **What is the expected form and content of the auditor's report?**
2. **What new features in the expected form of audit report should the board be aware of?**
3. **Is the auditor expecting to include any additional communications in the auditor's report? Why?**
4. **What are the implications of these additional communications in the eyes of our stakeholders?**

Independent Auditor's Report

To the Shareholders of (Company Name)

We have audited the accompanying financial statements of (COMPANY NAME), which comprise the balance sheet as at (DATE), and the statements of income, retained earnings and cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with Canadian accounting standards for private enterprises[2], and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements present fairly, in all material respects, the financial position of (COMPANY NAME) as at (DATE), and the results of its operations and its cash flows for the year then ended in accordance with Canadian accounting standards for private enterprises.[2]

Anytown, Anyprovince	(Signed)
Date	CHARTERED ACCOUNTANT

[2] The description of the financial reporting framework explains which specific accounting standards are being followed. Entities that follow accounting standards for not-for-profit organizations would describe the financial reporting framework as "Canadian accounting standards for not-for-profit organizations."

E. Conclusion and where to find more information

In order to ensure that the upcoming audit proceeds smoothly, boards of directors and audit committees should ensure that they have a good understanding of the changes to the audit as a result of the CASs, and have regular and forthright communication with their auditors.

Visit the CICA website at www.cica.ca/CAS for general information about Canadian Auditing Standards.

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