

Audit evidence: **Strengthening audit quality**

The Canadian Public Accountability Board (CPAB) is seeing increased significant findings in our inspections of Canadian reporting issuers engaged in new or evolving business models and emerging industries. Evolving business models can result in material unusual transactions and/or arrangements that require auditors to exercise increased professional judgement and skepticism.

This communication provides more detail on the nature of significant findings observed on material unusual transactions and sufficiency of audit procedures to support revenue recognized. We illustrate the importance of the application of professional judgement and professional skepticism on individual audits. We also emphasize the need for auditors to be open to the possibility that transactions may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets. Finally, we share our concerns related to compliance with relevant ethical requirements, including independence.

We expect firm leadership to distribute this communication to all audit engagement team members and actively encourage open dialogue among engagement teams as they finalize their current audit engagements.



What our inspections reveal

Our inspections continue to identify instances where engagement teams did not exercise an appropriate level of professional skepticism. Contradictory evidence identified during our inspections was usually information that was or should have been evaluated and included in the engagement file. However, there was insufficient evidence to demonstrate that senior engagement team members considered this information in forming conclusions, or it was dismissed or rationalized away without performing a stand-back evaluation. Our significant findings included:

- Non-cash consideration and fair value measurement.
- Revenue from contracts with customers.
- Ethical requirements, including independence.

We have included scenarios below to assist engagement teams as they perform their risk assessments so that the risk associated with unusual transactions and revenue is identified and appropriate audit responses can be developed. The scenarios are based on actual significant findings, but facts have been modified or excluded to protect reporting issuers' identities.

In each scenario, auditors did not exercise an appropriate level of professional skepticism and often placed too much reliance on representations from management. As a result, they did not investigate contradictory evidence or stand back to consider the economic substance and business rationale for the transactions. Further, the risk assessment, including the identification of fraud risk factors, placed too much emphasis on the year-end balances which had been almost entirely written down.

We also observed in some inspections that auditors identified the increased risk associated with unusual transactions, but they did not consider that the transactions could be fraudulent in nature. Instead, they were willing to accept less persuasive audit evidence and dismissed or rationalized inconsistent information. Auditors did not consider whether a modification to their independent auditor's report was necessary in situations where they were unable to obtain sufficient and appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.



Fraud can have a significant impact on investors and the reputation of the audit. We performed a review of fraud procedures in 2021 to evaluate the work performed by auditors and will publish our observations in 2022, including improvements auditors can make in advance of any changes to the auditing standards.



Non-cash consideration and fair value measurement

We had significant findings in several inspections where insufficient procedures were performed on the fair value of assets acquired and liabilities assumed during the year, and related impairment assessments. We observed a higher prevalence of findings in situations where the transaction consideration was either entirely or primarily paid through issuance of shares. Significant findings related to non-cash consideration and fair value measurement were observed most often in business combinations, asset acquisitions and investments by investment entities.

Scenario one

The reporting issuer acquired controlling interests of several entities during the fiscal year through the issuance of their publicly traded shares. The fair value of the investments was determined based on the closing price of the shares issued. The acquired entities were newly incorporated with no assets or liabilities and reporting issuer management represented them as highly speculative investments in an idea. The investments were made to seek capital appreciation but there were no available resources within the entity acquired to execute the idea. The investments were fully impaired at year end and the fair value of the investments recorded by management at year end was based on the subsequent sale to a third party for a nominal amount. We identified the following concerns over the engagement team's procedures:

- No fraud risk factors were identified in connection with the non-cash consideration or the dilutive impact of these transactions on existing shareholders.
- No evidence was obtained to demonstrate a connection between the acquired entities and the ownership or rights to control the idea.
- No audit procedures were performed to support that the fair value of the assets acquired were equivalent to the fair value of share consideration issued on the date of acquisition.
- The purchase agreement indicated that there were no assets, and this was not identified as contradictory evidence.
- Too much reliance on the subsequent sale for a nominal value without obtaining an understanding of what was initially acquired and what events or conditions led to the impairment.

Scenario two

The reporting issuer, an investment entity, acquired 100 per cent of shares in a newly created entity for share consideration of \$15 million. The new entity held a single investment purchased for \$500 thousand cash consideration only a few weeks earlier. The fair value of the investment was written down to a nominal amount at year end. We identified the following concerns over the engagement team's procedures:

- No fraud risk factors were identified in connection with the non-cash consideration or the dilutive impact of these transactions on existing shareholders.
- The difference between the amount paid for this investment by the reporting issuer and the cost to acquire the investment only weeks earlier was not identified as contradictory evidence, as such, was not investigated.
- Too much emphasis on the nominal value at year end without obtaining an understanding of what events or conditions led to the impairment or consideration of whether the fair value recognized by management on the date of acquisition was overstated.

Scenario three

The reporting issuer acquired an asset through issuing their publicly traded shares. Subsequently, the same asset was sold back to the party it was acquired from in exchange for a note receivable. Management determined the fair value at the acquisition date and year end to be equal to the face value of the note receivable. At the acquisition date, the excess of consideration over the fair value of the asset acquired was expensed. We identified the following concerns over the engagement team's procedures:

- Too much reliance was placed on the fair value of the note receivable to support the fair value of the asset on the acquisition date.
- No audit procedures were performed at the date of the acquisition or the date the asset was sold back to support the fair value of the asset.
- The engagement team did not question the business rationale for the transaction or consider whether there was potential management bias.

Scenario four

The reporting issuer acquired 100 per cent of the outstanding shares of an inactive incorporated entity through the issuance of shares. This was accounted for as an asset acquisition with the total consideration paid expensed to the statement of profit and loss on the basis that the entity did not meet the definition of a business. There were no assets acquired, or liabilities assumed on the date of acquisition. We identified the following concerns over the engagement team's procedures:

- No identification and evaluation of significant agreement terms to support the engagement team's understanding of the business rationale for the transaction.
- No assessment of the significant assumptions made by management's expert to support the accounting treatment of the transactions as an asset acquisition.
- No evaluation of the reasonableness of the key inputs and assumptions used by management's expert in the valuation of the share consideration paid.



Revenue from contracts with customers

We had significant findings in several inspections where there were insufficient procedures performed to address the risk that revenue is materially misstated, whether due to fraud or error. Auditors did not obtain sufficient appropriate evidence over the identification or satisfaction of the performance obligation. Although engagement teams identified a significant risk in connection with many of these transactions, more weight was placed on evidence obtained that supported management's position and contradictory evidence was either dismissed or rationalized.

Scenario one

The reporting issuer operates a business where a significant portion of revenue earned and expenses incurred are transacted in cash. We identified the following concerns over the engagement team's procedures:

- Insufficient evaluation of the design and implementation of controls to address misappropriation and unrecorded cash transactions risks.
- Insufficient testing of cash reconciliations prepared by management to support that revenue transactions occurred and were complete and accurate.
- No evidence was obtained to demonstrate the performance obligation was satisfied (product was delivered or service was provided).

Scenario two

The reporting issuer recognized material revenue with two customers who were also suppliers. There were no shipments made until after year end (bill and hold) and payables and receivables were all settled on a net basis. Both suppliers were also holding inventory on the reporting issuer's behalf. We identified the following concerns over the engagement team's procedures:

- Incomplete evaluation of the fraud risk factors surrounding revenue.
- Insufficient procedures were performed to demonstrate an understanding of the business rationale and economic substance of these transactions, including evaluating key terms within agreements and related impact on revenue recognition.
- Insufficient evaluation of whether the transactions represented contracts with a customer or were in substance, manufacturing agreements or acting as an agent.

Scenario three

The reporting issuer recognized material revenue three to six months prior to year end for a new customer with no shipments prior to year end or payments received (bill and hold). Payment for inventory was not due until after the product was shipped, which was planned to take place over a period of approximately twelve months after revenue was recognized. We identified the following concerns over the engagement team's procedures:

- Insufficient evidence to support the performance obligation had been satisfied to recognize revenue.
- Contradictory evidence that indicated a portion of the inventory purchased may need to be processed further prior to shipment was not sufficiently investigated.



Ethical requirements, including independence

We had significant findings related to threats to independence that were not identified and evaluated from non-audit services provided either as part of the audit engagement or as a separate engagement. We also had significant findings over the sufficiency of audit procedures in the focus area for which the non-audit services were performed. In one example, the engagement team provided significant accounting support to the reporting issuer as part of the audit in areas that were material to the financial statements and related to complex transactions requiring significant judgment on the application of the applicable financial reporting framework.

We identified the following concerns in several files inspected:

- The threat to independence was not identified, as such, there was no evaluation of the significance of the threat or whether safeguards could be put in place to eliminate or reduce the threat to an acceptable level.
- Too much reliance was placed on engagement letter terms that indicated the firm would not perform any management functions and the requirement for management to take responsibility for the services.
- The threat was identified but the engagement team inappropriately concluded it was a breach of internal policies only and not a breach of the Canadian Chartered Professional Accountants Code of Conduct Rule 204.

While independence standards contemplate that the audit process involves extensive dialogue between the engagement team and management of the audit client, the auditor needs to remain alert to non-assurance services that may create a self-interest, self-review or advocacy threat that impacts the firm's independence. It is in the public interest and, therefore, required by the relevant independence and other ethical requirements, that the auditor be independent of the entity subject to the audit. The relevant independence and other ethical requirements describe independence as comprising both independence of mind and independence in appearance. The auditor's independence from the entity safeguards the auditor's ability to form an audit opinion without being affected by influences that might compromise that opinion. Independence enhances the auditor's ability to act with integrity, to be objective and to maintain an attitude of professional skepticism.¹



Looking ahead - system of quality management

The new quality management standards move beyond policies and procedures and require firms to design and implement a risk assessment process to establish quality objectives, identify and assess quality risks and design and implement responses to address the quality risks. The effective dates for the new quality management standards are:

- CSQM 1 is required to be designed and implemented by December 15, 2022.
- CSQM 2, engagement quality reviews and CAS 220, quality management for an audit of financial statements are effective for audits and reviews of financial statements for periods beginning on or after December 15, 2022.

¹ CAS 200, CA19.

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