AUDITING CONCEPTS AND PRACTICES AS SEEN FROM A CANADIAN STANDPOINT

by R. D. Thomas

The clear expression of ideas, as Mr. Burggraaff points out in his introduction to this series of articles on ,,Accounting Crossing National Borders", is extremely difficult to achieve even on relatively exact subjects - which auditing certainly is not. The solution to this problem becomes even more elusive in trying to communicate ideas and concepts between countries because some of the basic concepts used in one country may be unheard of in another or, what is more subtle and difficult, similar terminology may be used but with significantly different meanings. To attempt to describe adequately the auditing concepts in one country, much less several, in a short article is an imposing task in itself since auditing concepts are constantly evolving and may at any given moment be the subject of strongly-held differences of opinion. I therefore propose to limit these brief comments to the auditing of financial statements for uses external to an enterprise as it is carried on in Canada at the present time (i.e. I will not attempt to deal with any differences in approach that may exist in internal auditing or government auditing nor with any approaches other than those used in Canada).

Auditors' Responsibilities

The responsibilities undertaken by, or imposed on, auditors vary greatly from country to country because of historic, legal, financial and other environmental differences. One simple example: the method of financing corporate activities has a great influence on the method of appointment of auditors, the scope of the audit, the purpose and wording of the audit report, and the uses to which financial statements, on which auditors express their opinion, are put.

In Canada companies have traditionally raised their initial capital by the issue of shares, and therefore the first law[1]) dealing with audited financial statements required that the auditor be appointed by the shareholders and that his report on the annual accounts be addressed to them; this concept has had important effects on auditing practice in Canada ever since.[2]) However, companies also have other sources of financing (bank loans, the issue of bonds, and the use of their credit with their suppliers) and so, when Canadian auditors express an opinion on a company's financial statements, they are keenly aware that an enterprise's financial fortunes have significance

[1]) There are separate corporate (and related) laws in each province and for federally-incorporated enterprises.

[2]) For example: legal requirements of minimum financial disclosure have mainly been directed to information needed by shareholders; there is now a trend for company law to require that the Board of Directors have an audit committee of which the majority of members are not part of the company's management; and there are usually statutory references regarding the auditors' attendance at the annual general meeting of shareholders.

to many groups beyond its owners. Statute and case[3]) law have also increasingly recognized that audited accounts are important to such groups as employees, creditors, competitors and governments.

It would be imprudent, probably dangerous, for me to attempt to generalize on auditors' responsibility for fraud. This is a complex subject and, in Canada at least, one of the most misunderstood areas of auditors' responsibilities. It is an amalgam of statute and case law combined with professional pronouncements on auditing standards and established practices by auditors. A thoughtful statement on this subject was given by J. R. M. Wilson, FCA, a past President of the Canadian Institute of Chartered Accountants (CICA), in an address in Toronto 28 January 1966:[4])

> „In the discharge of his responsibilities, the auditor must see that an adequate audit program is developed which should detect errors and that a properly trained staff carry out the program. But, as a learned English judge said many years ago, auditors must not be made liable for not tracking out ingenious and carefully laid schemes of fraud when there is nothing to arouse their suspicion and when those frauds are perpetrated by tried servants of the company and are undetected for years by the directors. So to hold would make the position of an auditor intolerable." And let me assure you, no audit program or no audit technique has yet been devised to detect some of the frauds which can be perpetrated by senior officials of a company. For all that, an auditor's responsibility is not a light one, and I think all members of my profession take it very seriously indeed. However, while we have a responsibility, and therefore sometimes maybe a liability, it is not by any means an unlimited liability. Sometimes it turns out that statements which were issued were incorrect. This can arise because information known to certain officials was withheld or because subsequent unexpected and unforeseeable events made estimates of realizable value wrong. Occasionally, there may have been an attempt to deceive the auditors - more frequently no one could have reasonably assumed that what did happen would happen. So please don't assume when somebody tells you that last year's financial statements were not correct that obviously this means that you should sue the auditors."

Auditing Standards

While audits and auditors had early recognition in statutes, auditing practices have also been influenced by two other factors: professional pronouncements and the knowledge that auditors' opinions on financial statements are a key ingredient to the integrity of our private enterprise system.

The wide distribution of, and attention given to, audited financial statements contained in company annual reports have been basic features of Canadian financial reporting for many decades. Through its research activi-

[3]) For example: Hedley Byrne & Co. v. Heller & Partners Ltd. (1963) established a legal precedent on the responsibility of auditors to third parties.

[4]) Reprinted *Journal of Accountancy*, May 1966 („Statements in Quotes: Responsibilities of Auditor and Company Directors").

ties, the Canadian accounting profession has developed a widely-followed and highly-respected series of Accounting and Auditing Recommendations. These standards are published in the *CICA Handbook*[5]), (hereafter referred to as „the *Handbook*"), a looseleaf manual containing the Accounting and Auditing Recommendations of our Accounting Research Committee and Auditing Standards Committee respectively. While professional accounting bodies in many countries have devoted a good deal of attention to the development of sound accounting practices, rather fewer of them have developed and promulgated professional standards in auditing and financial reporting with the result that, in some countries, government intervention in setting reporting standards is greater than in Canada.

The re-Exposure Draft[6]) of proposed Auditing Recommendations on Auditing Standards (set out in Appendix A) is a good summary of basic auditing standards.

The biennial survey of financial reports, published by the CICA in *Financial Reporting in Canada,* clearly shows the wide following of *Handbook* Recommendations. An indication of this high degree of acceptability is the following Policy Statement issued in December 1972 by the national Securities Administrators in Canada (representing all Canadian securities regulating authorities):

> „Where the term „generally accepted accounting principles" is used, either in Securities Legislation, Regulations, and Companies Legislation and Regulations, the Securities Administrators will regard pronouncements by the Accounting and Auditing Research Committee of the Canadian Institute of Chartered Accountants to the extent set out in the research recommendations in the „CICA Handbook" as „generally accepted accounting principles"."[7])

The effect of this Policy Statement is that all companies with securities offered to the public in Canada are required to follow *Handbook* Recommendations in their published accounts.

Test Audit Basis

Both the practice of auditing and the pronouncements on auditing standards in Canada are based on a test audit approach using procedures which have reached highly-sophisticated levels. A basic element in a test audit is the system of internal control in effect. The auditors' review and tests of this

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[5]) At the present time there are approximately 37,500 subscribers to the *Handbook* a substantial portion of whom are officials in business and government.

[6]) Exposure Drafts of proposed *Handbook* Recommendations are an important part in the development of the profession's pronouncements. Comments on Exposure Drafts invariably result in changes (sometimes so significant as to require a re-Exposure Draft) before the responsible Committee approves material for inclusion in the *Handbook*.

[7]) This Policy Statement was issued before the Accounting and Auditing Research Committee was split into the present two separate Committees, the Accounting Research Committee and the Auditing Standards Committee. The authority in the Policy Statement has been applied to these two new Committees even though the Policy Statement itself has not been amended to reflect the change.

system indicates the degree to which they can rely on it.[8])

Reporting

In issuing a report, Canadian auditors have stringent standards laid down for them by the Auditing Standards Committee. One of the purpose of these standards is to make it absolutely clear when auditors are expressing their opinion without reservation or qualification, when they are expressing a reservation in their opinion, when they are giving an adverse opinion, or when they are denying an opinion. For example, when auditors are reporting on financial statements of an incorporated company and are able to express an unqualified opinion, Section 5500.10 of the *Handbook* suggests the following form for the auditor's report:

AUDITORS' REPORT

To the Shareholders of ....

We have examined the balance sheet of ....

as at ...., 19 ... and the statements of income, retained earnings and source and application of funds for the year then ended. Our examination included a general review of the accounting procedures and such tests of accounting records and other supporting evidence as we considered necessary in the circumstances.

In our opinion these financial statements present fairly the financial position of the company as at ...., 19 ... and the results of its operations and the source and application of its funds for the year then ended, in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

(signed) ....

CHARTERED ACCOUNTANTS

City [9])

Date

If auditors have a reservation in expressing their opinion, it is usually as a result of:

a. auditing deficiencies, including:

i. inability to obtain essential information, and

ii. limitations in the scope of the examination;

b. accounting deficiences, including:

[8]) See, for example:

R. J. Anderson, FCA and R. M. Skinner, FCA, *Analytical Auditing* (Toronto, Sir Isaac Pitman, 1966) 160 pp.

Internal Control and Procedural Audit Tests, (Toronto, Canadian Institute of Chartered Accountants, 1968) 38 pp.

Statistical Sampling in an Audit Context, (Toronto, Canadian Institute of Chartered Accountants, 1972), 43 pp.

Computer Audit Guidelines, (Toronto, Canadian Institute of Chartered Accountants, 1975), 180 pp.

[9]) The Accounting section of the *Handbook* has recently been amended to refer to „the statement of changes in financial position" rather than the „statement of source and application of funds"; the Auditing section of the *Handbook* has yet to be amended to reflect this change.

i. failure to disclose essential information, and
ii. failure to adhere to generally accepted accounting principles;
c. inconsistencies in the application of generally accepted accounting principles;
d. disagreement on valuation;
e. other matters which may have an effect on the fairness of the financial statements.[10])

If a reservation in the auditor's opinion is necessary, the following *Handbook* Recommendations indicate how it should be reported:

„The auditors should give a clear explanation of the circumstances which prevent them from expressing an opinion without qualification." (para. 5500.33)

„Where circumstances require the auditors to qualify their opinion, the opinion paragraph should be modified by wording which clearly conveys the qualification. The words „except for" should be used in expressing a qualification other than in the circumstances set out in paragraphs 5500.36 and 5500.50. Phrases such as „with the foregoing explanation" are not considered sufficiently clear or forceful and should not be used." (para. 5500.34)

„The words „subject to" should only be used in expressing a qualification where the outcome of the matter giving rise to the qualification is uncertain, and is primarily dependent on future developments or future decisions by parties other than management, directors or owners." (para. 5500.36)

There are also the following modifications of auditors' opinions available if the circumstances require their use.

Adverse opinions are opinions in which the auditors state that one or more of the financial statements, or the financial statements taken as a whole, do not provide a fair presentation. Such opinions represent the most serious type of reservation which can be expressed by the auditors. They are normally appropriate in situations where the auditors have obtained sufficient information to determine the extent to which the financial statements are misleading, and accordingly, do not ordinarily result from auditing deficiencies. When auditors have formed the opinion that one or more of the financial statements, or the financial statements taken as a whole, do not provide a fair presentation, it is their duty to express an adverse opinion.

Denials of opinion occur when auditing deficiencies are so material that the auditors have no basis for an opinion as to whether the financial statements are presented fairly or where accounting deficiencies are so significant and of such a nature that the auditors cannot express their qualifications so as to show clearly how, and to what extent, the statements may be misleading. A denial of opinion is not an appropriate substitute for an adverse opinion.

Where financial statements showing financial position, results of operations or changes in financial position have been audited, and an adverse

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10) *Handbook* 5500.29.

opinion or denial of opinion is given, auditors sometimes include in their report an unqualified opinion on certain specific items in the financial statements. Such opinions are called *piecemeal opinions.*

Appendix B illustrates a „decisqon tree" for auditors in deciding which form of opinion is appropriate.

Objectivity and Independence

Because of the requirement that auditors be appointed by a company's shareholders and because of the wide public interest in financial statements as evidenced by the widespread distribution of corporate annual reports and the attention given to operating results in the financial press, Canadian auditors lay great stress on objectivity. An important element in this objectivity is their independence from ownership interests in a client's business. Thus, objectivity is basic to the proposed general standard set out in Appendix A and this is reflected in the Uniform Code of Ethics. This Code, which is presently in use in most Canadian provinces, states, *inter alia:*

> „No member or firm of which he is a partner, acting as a public accountant, shall express an opinion on the financial statements of any organization if the member, his partners, or his or their immediate families, have any direct or indirect financial interest in the organization or such other interest as could influence the independence of the member or firm."

Another aspect of the independence of auditors is their independence from the management of a client. This has many manifestations in audit procedures: for example, it has long been established in Canada that auditors should attend a client's physical stocktaking as part of their independent verification of quantities and stocktaking procedures where inventories are financially significant in the client's business. Again, while it is customary for auditors to obtain representations from the client's senior officials on the important aspects of the financial statements on which the auditors are giving their opinion, management representations are not accepted in an unquestioning way; auditors independently verify all material elements in the financial statements.

While I have confined my paper to some of the basic auditing concepts as they are seen from a Canadian point of view, valuable insight into some of the differences in both accounting and auditing between Canada, the United Kingdom and the United States can be found in the Studies published by the Accountants International Study Group formed by accounting bodies in the three nations.[11])

Just as the concepts discussed in this paper have evolved in response to the

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11) The following AISG Studies are particularly relevant to auditing:
Accounting and Auditing Approaches to Inventories in Three Nations - 1968
The Independent Auditor's Reporting Standards in Three Nations - 1969
Using the Work and Report of Another Auditor - 1969
Materiality in Accounting - 1974
International Financial Reporting - 1975

particular circumstances in Canada, the growth of multi-national businesses and international financial markets will undoubtedly be strong influences toward the development of international accounting and auditing standards. Close co-operation among professional accounting bodies throughout the world, coupled with the work of the International Accounting Standards Committee, should provide the means for this evolution to be orderly. By drawing on the experience of all accountants, this evolution should also be in the best interests of the public that, as accountants, we serve.