

# GUIDE to Canadian Independence Standard

(2009 Update)

**This version updates the *Guide to New Canadian Independence Standard* released in 2003.**

The Guide has been updated for wording modifications that have been made to the Independence Rule since it was introduced in 2003, and provides additional guidance in a number of areas that are subject to frequent calls to practice advisors.

A few topics have been added to the Guide:

- Compilation engagements;
- Communication requirements; and
- Impact of adoption of International Standards on Auditing as Canadian Auditing Standards

## Disclaimer

This *Guide to Canadian Independence Standard* ("Guide") has been prepared to assist members and firms in understanding and applying the independence standard. **It is neither a definitive analysis of the standard nor a substitute for a careful reading of Rule 204 "Independence" and the accompanying Council Interpretation.** Members must read the standard to determine how it will apply to their own specific circumstances. In doing so, discussion with a professional colleague or a representative of a provincial institute may be of assistance and is encouraged.

## Use of Guide in Quebec

In Quebec, references to Rule 204 and related Council Interpretation are not applicable as the independence rules are included in the *Code of Ethics of Chartered Accountants* adopted under the *Professional Code* (R.S.Q., c-26, s.87), specifically in Division II.1, sections 36.3 to 36.11. However, these materials may still provide useful guidance in the interpretation of certain aspects of Quebec rules as the rules in other provinces are similar to those in Quebec.

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## 1.0 INTRODUCTION

It is a fundamental principle of the practice of Chartered Accountancy that a member who provides assurance services shall do so with unimpaired professional judgment and objectivity, and shall be seen to be doing so by a reasonable observer. This principle is the foundation for public confidence in the reports of assurance providers.

The confidence that professional judgment has been exercised depends on the unbiased and objective state of mind of the reporting accountant, **both in fact and appearance. Independence is the condition of mind and circumstance that would reasonably be expected to result in the application by a member of unbiased judgment and objective consideration in arriving at opinions or decisions in support of the member's report.**

Rule of Professional Conduct 204 *Independence (Rule 204 or independence standard)*, or in Quebec, the *Code of Ethics of Chartered Accountants* adopted under the *Professional Code* (R.S.Q., c-26, s.87), specifically in Division II.1, sections 36.3 to 36.11 (the *Code*), outlines the requirements for independence that apply to all members and firms when they conduct an assurance engagement or a specified auditing procedures engagement (together referred to throughout this Guide as assurance engagements).

The independence standard addresses professional engagements ranging from a sole practitioner's or national firm's review of the financial statements of a small owner-managed business to an audit of a large multi-national corporation. Note that although this standard introduces additional requirements for auditors of reporting issuers, there may be further requirements imposed by various governing bodies and regulators, such as the Canadian Public Accountability Board or the Securities Commissions. Information on their requirements should be obtained by contacting these bodies.

The independence standard provides a systematic, principles-based framework for analyzing independence for each assurance engagement. This framework has positive requirements for members and firms to:

- a) Consider independence in fact and appearance before and throughout each assurance engagement;
- b) Consider whether there are any circumstances and activities which members must avoid when performing assurance engagements. These are referred to as “prohibitions”, and they preclude the undertaking or completion of the proposed engagement; and
- c) Apply a threats and safeguards approach to identify any “threats” to independence that are clearly not insignificant, and where such threats are identified consider whether there are “safeguards” that exist that may be applied to eliminate the threat or reduce it to an acceptable level. This may require eliminating the activity, relationship, influence or interest creating the threat(s), and where safeguards are found to be inadequate, declining

or discontinuing the engagement. The decision to continue or accept the engagement should be documented.

Although there is no requirement to be independent in order to perform a compilation engagement, there is a requirement to disclose in the Notice to Reader any activity, interest or relationship which impairs the member's or firm's independence.

Each of these concepts is discussed in more detail later in this Guide.

**This Guide is intended to help members and firms understand and apply the independence rules. It is not intended to be a substitute for a careful reading of the rules and related Council Interpretations in the context of a particular situation.** Most provinces, except Quebec, have Council Interpretations that provide a significant amount of guidance, including examples, to assist members and firms in applying the framework. (Note that in Quebec the independence rules are all contained in the Code; there is no equivalent to the Council Interpretations that are adopted in other provinces.) These forms of guidance are not intended to be comprehensive or all-inclusive.

## 2.0 OVERVIEW OF INDEPENDENCE STANDARD

Rule 204.1 requires a member or firm who performs an assurance engagement to be independent of the client. When independence is required, the member or firm must comply with any prohibitions that exist. Where no prohibitions exist, the member or firm shall then identify and address any threats to independence that are not clearly insignificant, and where such threat(s) cannot be reduced to an acceptable level, refuse to accept or continue the engagement.

### **Prohibitions**

Determine if there are circumstances and activities that must be avoided ("prohibitions") and that preclude performing the engagement because adequate safeguards do not exist that could eliminate the threat or reduce it to an acceptable level. Examples of prohibitions are:

- financial interests in client
- loans and guarantees to or from client
- close business relationships with client
- family and personal relationships with client
- recent employment with client in position of significant influence
- serving as officer, director or company secretary of client
- making management decisions or performing management functions for client

There are additional prohibitions applicable to the audits of reporting issuers (see Section 3.0 *Prohibitions*.)

In situations where a prohibition has been identified, the engagement should not be accepted, or must be discontinued if it has already been accepted. (In the latter situation it would be prudent to clearly document the situation and decision.)

### **Threats and Safeguards**

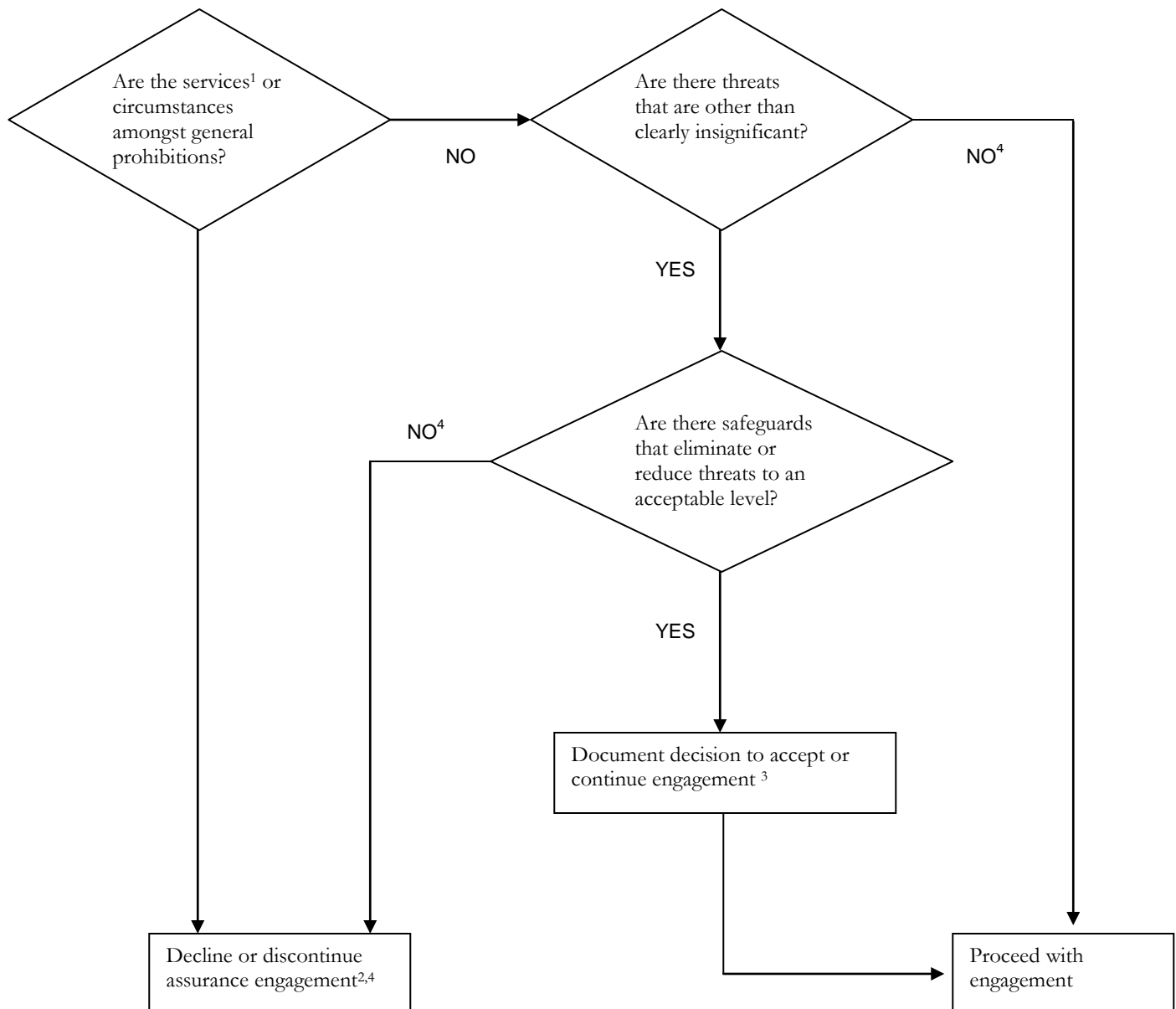
1. Identify and evaluate threats to independence. Threats are categorized as:
  - self-interest
  - advocacy
  - intimidation
  - self-review
  - familiarity
2. For each threat that is not clearly insignificant, determine if there are safeguards that can be applied to eliminate the threat or reduce it to an acceptable level. Possible safeguards include:
  - safeguards within the entity
  - safeguards within the firm

Wherever threats that are other than clearly insignificant cannot be reduced to an acceptable level, the member shall:

- eliminate the activity, relationship, influence or interest creating the threats; or refuse to accept or continue the engagement.
3. For each engagement where threats are identified that are other than clearly insignificant, document a decision whether to accept or continue with a particular engagement, including:
- a description of the nature of the engagement
  - the threat identified and the evaluation of the significance of the threat
  - where applicable, a description of the safeguard applied to eliminate the threat or reduce it to an acceptable level and an explanation of how the safeguard eliminates the threat or reduces it to an acceptable level.

The flowchart on the following page illustrates the steps that must be taken.

**OVERVIEW OF INDEPENDENCE STANDARD FOR ASSURANCE ENGAGEMENT  
— FLOWCHART**



**Notes**

- 1 These services are discussed in Section 3.0 Prohibitions. Note that there are additional prohibitions to be considered for reporting issuers.
- 2 Consider whether a compilation engagement will meet client's needs, and whether it is appropriate in the circumstances to downgrade to a compilation. If so, disclose in the Notice to Reader the nature and extent of lack of independence. (Discussed in more detail in Section 7.)
- 3 Documentation should include the nature of engagement and safeguards to eliminate threats or reduce to an acceptable level.
- 4 Documentation of the assessment would be prudent.

## 3.0 PROHIBITIONS

Rule 204.4 describes circumstances and activities which members and firms must avoid when performing an assurance engagement, because adequate safeguards do not exist that would, in the view of a reasonable observer, eliminate a threat or reduce it to an acceptable level. Accordingly, the member or firm will not be independent of the client as required for an assurance engagement, and therefore will be prohibited from performing the assurance engagement. The requirements to avoid these circumstances and activities are referred to as “prohibitions”.

Some prohibitions apply to **all assurance engagements** while others only apply to **audits of reporting issuers**. The prohibitions applicable to audits of reporting issuers were developed having regard to the current expectations of securities regulators and investor groups.

Note that certain of these prohibitions still apply to firms when partners who have **retired from active practice** retain a close association with the firm, and either continue or begin to provide service to clients of the firm (independently or behalf of the firm). These retired partners are considered to be members of the firm for the purposes of Rules 204.1 to 204.6. (See paragraph 33 of the Council Interpretation for more details.)

### 3.1 Prohibitions Applicable to All Assurance Engagements for All Clients

1. Members of the engagement team (and immediate family members) may not have a financial interest, as defined in Rule 204, in an assurance client or its related entities. This is extended to network firms (also defined) in the case of audit clients. Non-engagement team members of the firm (and immediate family) are prohibited from owning more than 0.1% of an audit or review client.
2. The firm and members of the engagement team may not have a loan, or a loan guarantee, to or from an assurance client or a related entity. There are limited exceptions for loans that are made in the ordinary course of a bank (or similar financial institution) client’s business.
3. The firm and members of the engagement team may not have a close business relationship with an assurance client, **unless** the relationship is limited to an immaterial financial interest that is clearly insignificant to the client, the firm and the member.
4. Members of the engagement team may not have an immediate family member in a position with the client during the period covered by the engagement where that person would be able to influence the subject matter of the assurance engagement.

5. Members of the engagement team must not be an officer or director of the client, or an employee of the client in a position to influence the subject matter of the assurance engagement, during the period covered by the engagement. As well, other members of the firm may not be officers or directors of an assurance client.
6. Members and firms are prohibited from performing management functions (as described in Rule 204.4(22) and paragraphs 130 to 132 of the Council Interpretation) for an assurance client.
7. Members and firms must obtain client management approval for the making of journal entries, accounting classifications, etc. The creation of source documents such as cheques, invoices, etc. is prohibited. (See paragraphs 134 to 143 of the Council Interpretation for more details.)
8. Members and firms may not provide legal services that involve dispute resolution of matters that are material to the financial statements of audit and review clients.
9. Members and firms may not provide corporate finance services such as dealing in, promoting, or buying/selling an assurance client's securities, acting on behalf of the client in making investment decisions or executing investment transactions, or taking custody of assets.
10. A member or firm may not provide an assurance service to a client for a fee that is significantly lower than market ("low ball") unless the member can demonstrate that all professional standards have been met in performing the service.
11. Members and students on the engagement team and the firm may not accept other than clearly insignificant gifts or hospitality from an assurance client.

### **3.2 Additional Prohibitions Applicable to Audits of Reporting Issuers Only**

Members in Quebec should refer to Article 36.3 and the transitional provisions as there are some differences in wording that affect the guidance provided below.

Public companies, which include mutual funds, are referred to in the independence standard as "**reporting issuers**". A reporting issuer is defined in the standard to be an entity that is deemed to be a reporting issuer under applicable Canadian provincial or territorial securities legislation, other than an entity that has market capitalization and book value of total assets that are both less than \$10 million.

An entity that meets the definition will be considered to be a reporting issuer until:

- its securities cease to be quoted or listed, or
- its market capitalization and total assets have fallen below the \$10 million threshold for two years. If either remains above the \$10 million threshold, it will be considered a reporting issuer.

1. A firm may not perform an audit engagement for a reporting issuer if a member of the firm's audit team accepts employment with the client in a financial reporting oversight role within a period of one year after the date at which the financial statements were filed with the securities regulator or exchange.
2. Audit partners must take leave of the audit team in accordance with the rotation requirements described in Rule 204.4 (20). (Note that some rotation requirements differ in Quebec.)
3. The client audit committee must pre-approve all services provided by the firm to the client.
4. Audit partners may not be directly compensated by the firm for selling non-assurance services to their audit clients.
5. Members and firms may not provide:
  - Bookkeeping and accounting services, including the preparation of the financial statements;
  - Financial information systems design and implementation unless it is reasonable to conclude that the results of the services will not be subject to audit procedures;
  - Actuarial services unless it is reasonable to conclude that the results of the services will not be subject to audit procedures;
  - Valuation services unless it is reasonable to conclude that the results of the services will not be subject to audit procedures;
  - Internal audit services unless it is reasonable to conclude that the results of the services will not be subject to audit procedures.

There is a rebuttable presumption that the results of financial information systems services, actuarial services, valuation services, and internal audit services will be subject to audit procedures.

6. Members and firms may not provide the following services, even if not subject to audit:
  - Expert services including litigation support for the purpose of advocating a client's position;
  - Legal services;
  - Management functions;
  - Human resources services.

## 4.0 THREATS TO INDEPENDENCE

Threats to independence must be considered before and during an assurance engagement. It is not possible in this Guide or the Rules of Professional Conduct to cover every circumstance; it is up to the member to evaluate the various relationships and circumstances in terms of what a reasonable observer would consider to be acceptable. There are five categories of threat to independence.

A **Self-Interest Threat** occurs when a firm or a person on the engagement team could benefit from a financial interest in, or other self-interest conflict with, an assurance client. Circumstances that may create a self-interest threat include having a direct financial interest or material indirect financial interest in the assurance client.

A **Self-Review Threat** occurs when any product or judgment from a previous engagement needs to be evaluated in reaching conclusions in the particular assurance engagement. Circumstances that may create a self-review threat include a person on the engagement team being, or having recently been, an employee of the assurance client in a position to exert direct and significant influence over the subject matter of the engagement.

An **Advocacy Threat** occurs when a firm, or a person on the engagement team, promotes an assurance client's position or opinion to the point that objectivity may be, or may be perceived to be, impaired. This would occur if the judgment of a person on the engagement team were to be subordinated to that of the client. Circumstances that may create an advocacy threat include the dealing in, or being a promoter of, shares or other securities of the assurance client.

A **Familiarity Threat** occurs when, by virtue of a close relationship with an assurance client, its directors, officers, or employees, a firm or member of the engagement team becomes too sympathetic to the client's interests. This could be a close business, personal, or family relationship. Some examples include a person on the engagement team having an immediate or close family member who is a director or officer of the assurance client; or a former partner takes on a role with the client where he is able to exert significant influence over the subject matter of the assurance engagement.

An **Intimidation Threat** occurs when a person on the engagement team may be deterred from acting objectively and exercising professional skepticism by threats, actual or perceived, from the directors, officers or employees of an assurance client. Circumstances that may create an intimidation threat include the threat of being replaced due to a disagreement with the application of an accounting principle.

Paragraphs 40 to 44 of the Council Interpretation provide more examples of threats in each of the five categories that must be considered when analyzing independence.

In identifying threats to independence, care must be taken as threats are not always direct or overt and, in many cases, they can be quite subtle. Consideration must always be given to the public perception of a threat. The public perception is that of the “**reasonable observer — a hypothetical individual who has knowledge of the facts, which the member knew or ought to have known, and applies judgment with integrity and due care.**” Often it is the reasonable observer’s perception of a threat that is most important and presents the most complexity in determining whether one is independent.

Section 5.0 discusses the identification and application of safeguards to eliminate a threat to independence that is clearly not insignificant or to reduce it to an acceptable level. In certain circumstances, there may be no safeguard available; for example, as described in Section 5.2, some firm-wide safeguards may not be available to smaller firms and sole practitioners.

## 5.0 SAFEGUARDS

### 5.1 General

In circumstances where the member and firm are required to be independent, and threats to independence have been identified that are other than clearly insignificant, the members and firms must determine whether safeguards are available to eliminate a threat to independence or reduce it to an acceptable level, and if so, apply them. The term “safeguards” in this context is inclusive of measures that are preventative in nature. There are three categories:

**Safeguards created by the profession, legislation or regulation**, which are essentially preventative or environmental measures, include:

- a) Education, training and practical experience requirements for entry into the profession;
- b) Continuing education programs;
- c) Professional standards;
- d) External practice inspection;
- e) Disciplinary processes;
- f) Members’ practice advisory services;
- g) Participation by members of the public in oversight and governance of the profession; and
- h) Legislation governing the independence requirements of the firm and its members.

A member must carefully consider whether these safeguards are sufficient by themselves to reduce a threat that is not clearly insignificant to an acceptable level, and whether, therefore, additional safeguards are required.

**Safeguards within the assurance client** include:

- a) Employees of the client who are competent to make management decisions;
- b) Client policies and procedures that emphasize the client’s commitment to fair financial reporting;
- c) Internal procedures that ensure objective choices in commissioning non-assurance engagements; and
- d) An audit committee, comprised of qualified individuals, that provides appropriate oversight and communications regarding a firm’s services.

**Safeguards within the firm’s own systems and procedures** include:

- a) Firm-wide policies and procedures, which promote a high degree of awareness and compliance with the requirements for independence; and
- b) Engagement-specific safeguards, which include, for example, third party consultations, rotation of senior personnel, discussions with audit committees, etc.

Certain regulatory measures, such as practice inspection, are preventative because they remain in the background of a member’s thinking. Safeguards can be implemented at the firm level or be engagement-specific as appropriate in those circumstances, such as removing

a particular member from the engagement team. Paragraphs 50 and 51 of the Council Interpretation contain several examples of firm-wide and engagement-specific safeguards which members and firms must consider when they encounter threats in respect of a particular engagement for which independence is required.

In accordance with the requirements of 204.3, documentation of safeguards should include a description, for each threat that is clearly other than insignificant that is identified, of which safeguard(s) have been identified and applied, and of how in the member or firm's professional judgment the safeguard(s) eliminates or reduces the threat to an acceptable level.

## **5.2 Sole Practitioners and Small Firms**

Resource and other constraints may mean that many of the firm-wide and other safeguards are not available to sole practitioners and smaller firms. This is addressed in paragraph 52 of the Council Interpretation as follows:

*The size and structure of the firm and the nature of the assurance client and the engagement will affect the type and degree of the threats to independence and, consequently, the types of safeguards appropriate to eliminate such threats or reduce them to an acceptable level. For example, it is understood that not all the safeguards noted in paragraphs 47 to 51 will be available to the sole practitioner or small firm or within smaller clients such as owner-managed entities. Smaller clients often rely on members to provide a broad range of accounting and business services. Independence will not be impaired provided such services are not specifically prohibited by Rule 204.4 and provided safeguards are applied to reduce any threat to an acceptable level. In many circumstances, explaining the result of the service and obtaining client approval and acceptance for the result of the service will be an appropriate safeguard for such smaller entities. Similarly, such clients often have a long-standing relationship with an individual who is a sole practitioner or partner from a firm. Independence will not be impaired provided safeguards are applied to reduce any familiarity threat to an acceptable level. In most circumstances, periodic external practice inspection and, where appropriate, consultation will reduce any threat to independence to an acceptable level.*

As noted above, there are certain measures such as external practice inspection that are preventative safeguards in the sense that they remain in the background of a member's thinking. Similarly a member/practice advisor may serve as resource for members to consult on a particular situation regarding the application of the independence rules. These measures may not, however, be sufficient by themselves for a particular threat, and other safeguards may need to be applied to reduce the threat to an acceptable level.

Keep in mind that the need to identify, evaluate and document independence prohibitions, threats, and applicable safeguards does not vary, irrespective of the size and structure of the firm and/or the nature of the client.

## 6.0 COMMON THREATS AND SAFEGUARDS

The Council Interpretation to Rule 204.1 to 204.6 provides detailed guidance on the application of the framework, and contains examples that describe threats created and safeguards that may be appropriate to eliminate them or reduce them to an acceptable level.

The following examples demonstrate the application of the framework to the provision of bookkeeping services and valuation services in circumstances where assurance services are also being provided. Additional services, such as advocacy, are covered in Section 10.0 *Frequently Asked Questions*.

### 6.1 Bookkeeping Services

A practitioner has an engagement to review the financial statements of an owner-managed entity. The client's bookkeeper maintains the disbursements and receipts journal but does not understand accrual accounting. Consequently, the client relies on the practitioner to provide bookkeeping assistance and prepare the financial statements. Does the provision of this assistance impair the practitioner's independence?

#### **Does Rule 204 prohibit the activity?**

Rule 204.4(23) states that a member shall not prepare or change a journal entry or change an account code of a transaction or prepare or change another accounting record without obtaining management approval. (See further discussion on this topic in paragraphs 134 to 144 to the Council Interpretation).

The practitioner should sit down with the client to explain the purpose of each journal entry made. Alternatively, the practitioner could obtain approval through the management representation letter. It is recommended that the management letter specify the journal entries being approved, and that separate management approval should be obtained for any journal entries not covered specifically by the management representation letter.

Having ensured compliance with any specific rule, the practitioner must also consider whether there is still a threat to independence. Applying the framework, the practitioner would answer the following questions:

#### **Does the provision of the bookkeeping services create a self-interest, self-review, advocacy, familiarity or intimidation threat?**

The practitioner should consider whether there is a self-interest threat, for instance, whether the provision of the bookkeeping services influences his ability to keep the review engagement.

There is a self-review threat because the practitioner is preparing the journal entries and therefore will be in a position of reviewing his or her own work. The client should prepare source documents, such as purchase orders, time cards and invoices (see paragraph 137 to the Council Interpretation). Trial balances and account reconciliations do not constitute

source documents, so it should not be problematic to create these documents as part of the services provided to clients.

**How significant is the threat? Is it other than clearly insignificant?**

If the journal entries are **simple in nature**, for example, to record a simple (mechanical) depreciation calculation, or to post accounts receivable and accounts payable amounts from a subledger, the threat would be clearly insignificant. None of these entries require the application of complex accounting standards, or involve taking on the role of management, such as in making judgments on how to interpret terms of contracts. Consequently, no safeguards would be necessary.

If the client had a transaction during the year for which the **accounting was complex**, involved significant judgment, and the practitioner had not encountered this type of transaction before and was therefore unfamiliar with the accounting, the self-review threat created would not be at an acceptable level. The practitioner would have to apply safeguards to eliminate the threat or reduce it to an acceptable level. One way to achieve this would be to consult with another professional accountant to confirm the accounting treatment proposed. If based on this discussion the practitioner is satisfied that the accounting treatment adopted is appropriate, the self-review threat will have been reduced to an acceptable level.

**For reviews and other assurance engagements**, if the self-review threat cannot be reduced to an acceptable level, the practitioner shall refuse to continue the engagement.

**What types of similar services are not considered threats under normal circumstances?**

There are certain types of activities conducted as part of the financial statement audit and review process, such as providing input on the appropriateness of accounting principles, financial statement disclosures, or providing assistance in solving **basic** reconciliation problems, that do not normally constitute independence problems. Dialogue between management of the client and members of the engagement team along these lines, and provision of various forms of technical assistance, is a normal part of the process of promoting the fair presentation of the financial statements. (For more examples, refer to paragraph 138 of the Council Interpretation to Rule 204.1 to 204.6). The self-review threat generally arises when the member has more active involvement in the preparation of financial information, including providing more input to management's decisions when there is a lack of management experience and understanding, and subsequently provides assurance thereon.

**How about reporting issuers?**

There is a prohibition on the provision of accounting or bookkeeping services to clients that are reporting issuers (per 204.4(24)), unless it is reasonable to conclude that the results of these services should not be subject to audit during the audit of such financial statements — there is a rebuttable presumption that these services will be subject to audit.

## **6.2 Valuation Services**

A practitioner is asked by an audit client, which is a private company, to perform a valuation service. This could encompass the business as a whole, an intangible asset or tangible asset or liability. Does the provision of the valuation service impair the practitioner's independence?

**Does Rule 204.4 prohibit the activity?**

Rule 204.4(25) does not contain any specific prohibitions related to valuation services for a private company, or any non-reporting issuer. There are specific prohibitions for reporting issuers, as described below. (For further discussion, refer to paragraphs 145 to 151 to the Council Interpretation).

**Does the provision of the valuation service create a self-interest, self-review, advocacy, familiarity or intimidation threat?**

The specific circumstances should be reviewed to assess whether any of these threats exist; for instance, if the valuation affects the financial statements, a self-review threat will be created because the practitioner will be in a position of auditing his or her own work.

**How significant is the threat? Is it other than clearly insignificant?**

In determining the significance of the threat the practitioner would consider the following (see paragraph 146 of the Council Interpretation for a more comprehensive list of factors):

- Whether the valuation is material to the financial statements;
- Whether the valuation involves significant judgment — for example, it may be dependent on future events that are uncertain; and
- Whether the client will be involved with the service and the assumptions to be applied. The extent of the client's knowledge, experience, and ability to evaluate the issues and assumptions, and approve significant judgments, also factor into this assessment.

**Possible safeguards to be applied**

If the practitioner concludes that the threat is other than clearly insignificant, safeguards should be applied to eliminate the threat or reduce it to an acceptable level. Such safeguards might include:

- Involving another professional accountant who was not a member of the engagement team to review the work performed;
- Confirming with the client its understanding and approval of the underlying assumptions and methodology used in the valuation\*;
- Obtaining the client's acknowledgement of the responsibility for the results of the valuation work performed by the practitioner\*; and
- Ensuring that the person who performs the valuation work does not participate on the engagement team\*.

\* These may not be considered to be sufficient safeguards by themselves.

**How about reporting issuers?**

There is a prohibition on the provision of valuation services to clients that are reporting issuers (per 204.4(25)), unless it is reasonable to conclude that the results of these services will not be subject to audit during the audit of such financial statements — there is a rebuttable presumption that these services will be subject to audit.

## 7.0 IMPACT OF INDEPENDENCE RULES ON COMPILATION ENGAGEMENTS

Independence is not required for compilation engagements; however, compilations do require an assessment of independence. Rule 204.1 to 204.7 and the related Council Interpretation provide a framework for members and firms to determine whether they are and appear to be independent with respect to a particular assurance engagement. Rule 204.8 requires that members and firms providing professional services disclose any activity, interest, or relationship, in respect of this service which would be seen by a reasonable observer to impair the member's or firm's independence. This disclosure is required in the member's or firm's written report (such as a Notice to Reader) or other written communication accompanying financial statements or financial or other information. The disclosure should indicate the nature of the activity or relationship and the nature and extent of the interest.

The assessment of independence should be documented in the engagement file. A checklist is a useful tool to use to document consideration of independence issues.

One area where there is confusion in respect of the application of the independence standard is in the preparation of accounting records or journal entries in connection with a compilation engagement. Paragraph 4 of the Council Interpretation to Rule 204.8 indicates that "the preparation of accounting records or journal entries in connection with a compilation engagement is not an activity that requires disclosure in the Notice to Reader unless such preparation involves complex transactions as contemplated by paragraph 143 of the Council Interpretation to Rule 204.1 to 204.6." Where the nature of the transactions are such that management does not understand and cannot review the entries, perhaps because the calculations were complicated or else involved interpretations of complicated contracts or legislation, the member or firm is effectively taking on a management role, which creates a lack of independence and requires disclosure. (Note that in situations where the client understands these 'complex' journal entries, there is no independence issue). In Quebec (see the note below), disclosure is required of the preparation of journal entries or accounting records, unless the journal entries involve mechanical calculations and simple postings (such as posting subledgers to the general ledger).

A number of situations are provided below that discuss whether there is an independence issue, and, if so, whether disclosure is required of the relationship and interest in the Notice to Reader. The references to various rules in the following examples are directed at assurance engagements, because, as noted above, applying the framework for evaluating prohibitions and threats for assurance engagements is useful in helping to identify whether there are circumstances that require disclosure in a Notice to Reader. Sample wording of the additional disclosure, if required, is provided; this disclosure would be included as the last paragraph in the Notice to Reader communication. Note that there is no need to make a specific conclusion regarding independence; this may instead lead the reader to conclude that there was an independence requirement, where there was not. In each situation, the member

should also document on the file the assessment of whether there were any independence issues to be disclosed.

**Note:** In Quebec, the independence rule in respect of a compilation engagement is effectively a transparency rule. Any matter that would constitute an independence issue in an assurance or specified auditing procedures engagement must be disclosed in the Notice to Reader. The application of safeguards is irrelevant. In **all** of the situations described below, disclosure would be required.

**Situation 1 — Prohibited Financial Interest in the Client**

The member, firm, partner or professional staff in the office, or any of their immediate family (spouse or dependent), have a direct financial interest or a material indirect financial interest in the client.

*Discussion*

If a member of the **engagement** team, their immediate family members (spouse or dependent), the partners in the **same office** or their immediate family members have a financial interest in the client, disclosure will be required. In addition, disclosure would be required if any partner or professional employee of **the firm** owns more than 0.1% of the securities of the client or controls the client. See the financial interest prohibitions for assurance engagements provided in Rule 204.4 (paragraphs 1 through 8) for types of financial interest that would impair independence and require disclosure in the Notice to Reader.

*Example of additional disclosure:*

A partner in this accounting firm owns xx% of the Class A shares and xx% of the Class B shares of Client Limited.

**Situation 2 — Threat to Independence — Financial Interest in the Client**

A close family member (such as a parent, non-dependent child or sibling) of the member, firm, partner or professional staff in the office has a financial interest in the client.

*Discussion*

This differs from Situation 1, as this refers to a close, not immediate, family member with a financial interest that is known. Per Rule 204.4(8), a member is prohibited from participating on the engagement of an assurance client if a close family member owns more than 0.1% of the equity securities or controls the client.

In respect of a compilation engagement, ensuring that the partner or staff member whose family owned shares was not on the engagement team and had no influence on the compilation engagement could remove perception of an independence impairment, and the Notice to Reader would not require additional disclosure under Rule 204.8. If the partner or staff member whose family owned shares was on the engagement team, Rule 204.8 requires disclosure of the relationship and interest in the Notice to Reader.

*Example of additional disclosure:*

The father of a manager of this accounting firm, who worked on this engagement, owns 37% of the common shares of Client Limited.

### **Situation 3 — Threat to Independence — Close Business Relationships**

The firm or a member of the engagement team has a close business relationship with a client, or with a significant shareholder or senior management of the client.

#### *Discussion*

In the context of an assurance engagement, the business relationship creates a self-interest or familiarity threat (or both) to independence that, if not reduced to an acceptable level through the application of safeguards, would cause the member to be prohibited from performing an assurance engagement. Rule 204.4(13) prohibits a member from participating on the engagement team where a close business relationship exists, unless that relationship is limited to a financial interest that is immaterial and the relationship is clearly insignificant to the member and the client or its management. A safeguard that could be applied would be to remove the person who had the relationship from the engagement team and ensure that person had no influence on the engagement.

Putting this situation in the context of a compilation engagement, if the member participates on the compilation engagement or can otherwise influence the engagement, Rule 204.8 requires disclosure of the relationship and interest in the Notice to Reader.

#### *Example of additional disclosure:*

Two partners of this accounting firm and a director of Client Limited each own a 1/3 interest in a commercial real estate property venture.

### **Situation 4 — Threat to Independence — Employment with client**

A former staff member, or an immediate family member of a partner or professional staff, is the controller, CFO or director of a client.

#### *Discussion*

In terms of an assurance engagement, the closeness of the relationship between the members of the firm and the person at the client, and the role of the person at the client, determine whether there are prohibitions to be complied with or threats that are other than clearly insignificant. As outlined by Rule 204.4(14), members or students shall not participate on engagement teams of assurance clients if the member's or student's immediate family is (or was during the period of the engagement) a director or officer of the client or in a position to exercise direct and significant influence over the subject matter of the engagement. A possible safeguard for the former staff member would include ensuring people on the engagement team had no prior relationship with such persons at the client or if a relationship existed. For the second situation, the person with the immediate family member at the client would have to be removed from the engagement team.

In the context of a compilation engagement, unless there was the ability to structure the engagement team as described by the safeguard scenarios above, there is likely an independence impairment that requires disclosure in the Notice to Reader.

(Note that although there are further restrictions relating to audits of reporting issuers, as described in Rule 204.4(15 and 16), they are not discussed here, as it is unlikely that a member or firm who is independent for the purposes of the audit would have any

independence issues requiring disclosure in a Notice to Reader that is being prepared (as a separate engagement) for the reporting issuer client.)

*Example of additional disclosure:*

One of the directors of Client Limited was, until [date], a partner of this accounting firm.

**Situation 5 — Prohibited — Performance of Management Functions**

Members of a firm execute client instructions to sign cheques while the client is on vacation. Similar situations are when clients rely on a firm's business and accounting advice to the extent that the firm is a *de facto* decision maker.

**Discussion**

The member would be prohibited from performing an assurance engagement (per Rule 204.4(22)) for the client. There are no safeguards for this prohibition.

In the context of a compilation engagement, Rule 204.8 requires disclosure of the nature of this influence in the Notice to Reader.

*Example of additional disclosure:*

A partner of this accounting firm signed cheques drawn on Client Limited's bank account during the year. Additionally, the partner made *de facto* management decisions pertaining to Client Limited's purchase of real property during the year.

**Situation 6 — Threat to Independence — Accounting and Bookkeeping Assistance**

Many clients need members to prepare journal entries or to provide bookkeeping services for them. The nature and number of journal entries can, however, vary widely depending on the situation, from simple mechanical postings to complex entries involving technical matters (such as Section 85 tax rollover transactions) that some clients are not equipped to fully analyze.

**Discussion**

Rule 204.4(23) prohibits the performance of an assurance engagement if the member or firm prepares or changes journal entries, determines or changes account codes or other accounting records without management's approval.

In compilation engagements, the preparation of routine journal entries or the provision of routine bookkeeping services are not activities that require disclosure in the Notice to Reader. It would be prudent, however, for the practitioner to review these types of journal entries with their client and obtain documented approval; the absence of approvals would not, however, be identified as an independence issue — except in Quebec. In Quebec this situation would need to be described, except if the entries were basic mechanical and posting type entries.

**If the transactions are complex** and the client does not understand the work performed, the member may implicitly be taking responsibility for these entries in place of management, unless additional procedures are applied, such as consulting with another professional

accountant (see paragraph 143 of the Council Interpretation to Rule 204.1 to 204.6) about the appropriateness of specific journal entries. If the additional procedures mitigated the potential impairment of independence, then this should be appropriately documented in the member's file; the Notice to Reader would not require additional disclosure (except in Quebec, as noted above).

*Example of additional disclosure:*

This accounting firm prepared journal entries on behalf of management to record the Section 85 tax rollover transaction that occurred at December 31, xxxx. These journal entries have not had any form of additional review or approval.

**Situation 7 — Threat to Independence — Long Term Association with the Client**

Long term relationships with clients are evidence of providing valuable advice over an extended period. Often, such business relationships foster significant friendships and collegiality.

*Discussion*

Such relationships in the context of an assurance engagement could pose a familiarity threat to independence that, if not reduced to an acceptable level through the application of safeguards, would cause the member to be prohibited from performing the assurance engagement. In reviewing whether undue reliance has been placed on either the member or firm or the client, the complexity of the work performed should be considered. The second aspect of this type of threat relates to the closeness of the relationship that has formed between the client's management and the staff. Living in the same community, on its own, is not necessarily an independence threat. Business relationships are expected and not included in this second category. However, if close personal friendships have developed, then removal of the staff or partner from the engagement team, or review of the work by someone with no relationship with the client, would reduce the threat to an acceptable level for an assurance engagement. Closeness is also a matter of appearance. Consider if you holiday together, play golf weekly, are invited frequently to each other's homes. If safeguards were applied, the member's file would indicate the threat to independence that existed and the safeguards that were applied to reduce the threat to an acceptable level.

In the context of a compilation engagement, if 'safeguards' have not been introduced such that a reasonable observer would see an impairment of independence, Rule 204.8 requires disclosure of the relationship in the Notice to Reader.

*Example of additional disclosure:*

This accounting firm has provided professional services to Client Limited and its owners for several years. This professional relationship has given rise to a close personal relationship between the sole proprietor and one of the owners of Client Limited.

## 8.0 COMMUNICATIONS

### 8.1 Requirements to Disclose Relationship, Interest, or Provision of Service within Firm

- Rule 204.5 requires any member or student who has a relationship or interest or who has provided a professional service precluded by Rule 204 to notify in writing a designated partner of this interest, relationship or service.
- If a member or student who has been assigned to an assurance engagement team has any interest, relationship or activity that would preclude them from being on the engagement team, he or she is required to advise in writing a designated partner of the firm of that interest, relationship or activity.
- Firms that perform assurance engagements are required by Rule 204.6 to ensure that members of the firm do not have any relationship or interest, or perform any service, that would preclude them from performing the engagement, as well as ensuring that members of the firm remain free of any such influence.
- Members participating in any aspect of an insolvency practice are also required to remain free of influences, interests or relationships which could impair their professional judgment or objectivity (per Rule 204.7).

### 8.2 Communicating Independence Requirements to Clients

In addition to the requirement of Rule of Professional Conduct 204.1 to assess independence when conducting assurance engagements and specified auditing procedure engagements, the requirement to document the decision to accept or continue in circumstances where a threat has been identified that is other than clearly insignificant per Rule 204.3, and the requirement to communicate matters relating to independence as outlined in paragraphs 48 and 49 of the Council Interpretation to Rule 204.1 to 204.6, there are also requirements per the *CICA Handbook – Assurance* to communicate independence matters to clients. Further details are provided below.

#### Audit Engagements

*For audits of financial statements and other historical financial information for periods ending before December 14, 2010*

The auditor is required to communicate at least annually various matters relating to the auditor's independence in a letter to the audit committee (or to those having oversight responsibility for the financial reporting process if there is no audit committee), as outlined by *CICA Handbook – Assurance* section 5751 “Communications with those having oversight responsibility for the financial reporting process”. The auditor is required to disclose all relationships between the auditor and his or her related business or practice and the entity and its related entities that in the auditor's professional judgment may reasonably be thought to bear on independence. The auditor of an entity with public accountability is also required to disclose to the audit committee the total fees charged for audit and for non-audit services provided by the auditor and his or her related business or practice to the entity and its

related entities during the last year. This disclosure would be in the form agreed to with the audit committee (for example, by type of services or within specific dollar ranges).

The auditor may wish to include in the letter information on how the entity can play a role in establishing its own safeguards to ensure the auditor's independence, and if these safeguards are not strong, how the auditor has implemented compensating safeguards within his or her own firm.

For entities with foreign reporting obligations, the auditor would also consider additional requirements for independence in legislation to which the entity or auditor may be subject, such as securities, incorporating or other governing legislation, and in the relevant standards of professional conduct for auditors in those jurisdictions. Where an entity also has reporting obligations in a foreign jurisdiction that require the auditor to confirm his or her independence in relation to the requirements of that jurisdiction to the audit committee, the auditor may do so in the letter referred to in *CICA Handbook – Assurance* paragraph 5751.28.

*For audits of financial statements and other historical financial information for periods ending on or after December 14, 2010*

CAS 260, “Communication with Those Charged with Governance,” requires, in the case of listed entities, that the auditor communicate with those charged with governance:

- (a) A statement that the engagement team and others in the firm as appropriate, the firm and, when applicable, network firms have complied with relevant ethical requirements regarding independence; and
- (b)
  - (i) All relationships and other matters between the firm, network firms, and the entity that, in the auditor’s professional judgment, may reasonably be thought to bear on independence. This shall include total fees charged during the period covered by the financial statements for audit and non-audit services provided by the firm and network firms to the entity and components controlled by the entity. These fees shall be allocated to categories that are appropriate to assist those charged with governance in assessing the effect of services on the independence of the auditor; and
  - (ii) The related safeguards that have been applied to eliminate identified threats to independence or reduce them to an acceptable level.

## **Review Engagements**

*For reviews of financial statements for periods ending before December 14, 2010*

As outlined by *CICA Handbook – Assurance* “Public Accountant’s Review of Financial Statements,” paragraph 8200.69, in performing a review engagement, the public accountant communicates with those having oversight responsibility for the financial reporting process, such as the audit committee or equivalent. As stipulated in paragraph 8200.69, with respect to the other communication requirements of Section 5751, the public accountant would use professional judgment in determining with whom to communicate, as well as the substance of such communications, except for communicating matters that bear on independence, which would be in a letter in accordance with paragraph 5751.35.

*For reviews of financial statements for periods commencing on or after December 14, 2010*

As outlined by *CICA Handbook – Assurance* “Public Accountant’s Review of Financial Statements,” paragraph 8200.69, in performing a review engagement, the public accountant communicates with those having oversight responsibility for the financial reporting process, such as the audit committee or equivalent.

**Compilation Engagements**

Although independence is not required for compilation engagements, Rule 204.8 requires disclosure, in a compilation report, of circumstances where there is “an impairment of a member’s independence.” Further details are provided in Section 7.0 *Impact of Independence Rules on Compilation Engagements*.

## 9.0 IMPACT OF ADOPTION OF INTERNATIONAL STANDARDS ON AUDITING AS CANADIAN AUDITING STANDARDS

Following extensive consultation with stakeholders across Canada, in 2006 the Auditing and Assurance Standards Board announced its decision to adopt the International Standards on Auditing (ISAs) as Canadian Auditing Standards (CASs). The CASs will become Canadian generally accepted auditing standards and are effective for audits of financial statements and other historical information for periods ending on or after December 14, 2010.

An audit is premised upon an auditor complying with relevant ethical requirements, including those pertaining to independence. Under the ISAs, “relevant ethical requirements” are defined as the ethical requirements that the engagement team and engagement quality control reviewer are subject to, which ordinarily comprise Parts A and B of the International Federation of Accountants (IFAC) *Code of Ethics for Professional Accountants* (Code), together with national requirements that are more restrictive.

In Canada, auditors are subject to rules of professional conduct or codes of ethics issued by the professional accounting bodies in each province that governs their membership.

However, as a member of IFAC, the CICA and Canadian CA profession need to monitor and consider any changes made to the IFAC Code, such as the changes approved in April 2009, which include a number of revisions to auditor independence requirements. It is expected that the revised IFAC Code will be released in July, 2009, to be effective on January 1, 2011. The profession's Public Trust Committee has formed an Independence Task Force to review these revisions to determine whether changes are necessary to the CA profession's rules. The review will involve extensive consultations with stakeholders.

### 9.1 Frequently Asked Questions Relating to Independence Standards When Conducting an Audit Under the CASs

**QUESTION 1**      **What are the relevant independence standards applicable to an audit conducted in accordance with the ISAs?**

**ANSWER**              Relevant independence standards in the ISAs ordinarily comprise the independence standards in Parts A and B of the IFAC Code, together with national requirements that are more restrictive.

**QUESTION 2**      **With the adoption of ISAs as CASs, when I conduct an audit in accordance with Canadian generally accepted auditing standards must I now comply with the IFAC Code instead of the independence standards in the rules of professional conduct?**

**ANSWER**              No. You are still required to comply with the independence standards in the rules of professional conduct of your professional accounting body. You do not have to comply with the IFAC Code to conduct an audit in accordance

with the Canadian generally accepted auditing standards (i.e., CASs).

**QUESTION 3** I conducted my audit in accordance with Canadian generally accepted auditing standards. If my client requests it, can I also report that I have conducted my audit in accordance with the ISAs?

**ANSWER** Maybe. The independence standards in the rules of professional conduct of your professional accounting body may be different from the IFAC Code. Accordingly, you should not represent compliance with the ISAs unless you are satisfied that you have also met the requirements of the IFAC Code. You should also consider whether there are any other differences between the CASs and ISAs that may affect your compliance with the ISAs. Differences between the CASs and ISAs are set out in the Preface to the Handbook.

## 10.0 FREQUENTLY ASKED QUESTIONS

Frequently Asked Questions have been organized according to a number of categories that are listed below. The answers include guidance in the nature of best practices.

Note that not all prohibitions or threats are covered by the situations described below. As noted in the Introduction, **independence is a state of mind, both in fact and in appearance**. Consideration must always be given to the public perception of a threat, which is that of the “**reasonable observer — a hypothetical individual who has knowledge of the facts, which the member knew or ought to have known, and applies judgment with integrity and due care.**” Often it is the reasonable observer’s perception of a threat that is most important and presents the most complexity in determining whether one is independent.

### 10.1 Prohibitions — All Clients

#### FINANCIAL INTERESTS

##### QUESTION 1

**I am the auditor of a credit union in a small community. Am I allowed to keep a chequing or savings account at that credit union?**

##### ANSWER

According to paragraph 87 of the Council Interpretation to Rule 204.4, deposit or brokerage accounts of a firm or member on the engagement team with a bank, broker or similar financial institution would not create a threat to independence provided the deposit or brokerage account was held under normal commercial terms and conditions.

Also, if there is a concentration of services and products with this financial institution, for the firm and personally, such as RRSPs and other investments, mortgages and lines of credit, etc., then the reasonable observer test also needs to be applied.

##### QUESTION 2

**Who is considered to be a professional employee of the firm?**

##### ANSWER

A professional employee is any employee who provides professional services to a client. An administrative assistant (receptionist, financial statement typist, office manager, etc.) is generally not considered to be a professional employee. With respect to Rule 204.4(7), if an employee who is not a professional employee owns more than 0.1 per cent of the shares of a client, the firm is not prohibited from performing an audit or review engagement. However, the firm must still consider whether the employee's interest in the client creates a threat to its independence, and if it does, safeguards must be applied to reduce the threat to an acceptable level.

**CLOSE BUSINESS RELATIONSHIPS WITH CLIENTS**

**QUESTION 3** I practice in a small town where I often socialize with my clients. When will this become a familiarity threat to my independence?

**ANSWER** There is no simple answer to this question as threats to independence are often about perception as well as actual impairment. Socializing with clients is usually not a problem unless the practitioner is seen together with the client so often that the rest of the community may view the member as becoming too close to the client and the relationship as no longer being on just a professional level.

**QUESTION 4** I have known my client for 40 years and have been the partner in charge of his review engagements for 20 years. I dine with my client once or twice a year. Is there an independence issue?

**ANSWER** Such a situation gives rise to a familiarity threat. To comply with the independence rules, the member must apply (and document) safeguards to reduce the risk of familiarity to an acceptable level, such as external consultation on more complex issues to validate the member's judgment. In addition, the member must ensure there is appropriate documentation in the review engagement file of any advice given to the client.

**QUESTION 5** Can I audit my church/golf club/etc.?

**ANSWER** It depends on your involvement with the organization's finances and/or accounting. Membership in a religious organization or social club would not normally impair independence as long as neither the CA nor the CA's immediate or close family members serve on the organization's governing body or exercise any significant influence over its financial and/or accounting policies. (See paragraphs 117 and 118 to the Council Interpretation for more details).

With respect to the golf club, the member or firm would be prohibited from performing the audit if the member of the club could dispose of his membership for gain, or has not forfeited any entitlement to the distribution of assets.

It's important to keep in mind that this prohibition of serving as an officer or director of a client extends to professional employees of the firm and is applicable to all audit and review clients, including not-for-profit organizations (which includes condominium corporations). Serving as an officer or on the Board of Directors of an assurance client is described in more detail in paragraphs 113 to 116 to the Council Interpretation.

**EMPLOYMENT WITH A CLIENT**

**QUESTION 6** Can I accept a position with a client?

**ANSWER** **It depends.** The prohibition is actually on firms. A firm may not perform an audit engagement for a reporting issuer if a member of the firm's audit team accepts employment with the client in a financial reporting oversight role within one year after the date when the financial

statements were filed with the relevant securities regulator or stock exchange.

There are no restrictions to prevent an audit team member from going to work for a client; however, members being offered employment by a reporting issuer client for roles such as CFO, controller, director of financial reporting, or director of internal audit, are advised to discuss the possible consequences with their client. This is to avoid the awkward situation wherein a reporting issuer inadvertently ends its relationship with an audit firm by hiring a staff member from said firm's engagement team.

Although the restriction does not apply when the client is a private enterprise, an actual or perceived threat to independence may still exist in such cases as well; thus it would be prudent for firms and their CA staff members to evaluate the self-interest threat and mitigate any possible concerns by implementing the necessary safeguards.

### LONG ASSOCIATION OF SENIOR PERSONNEL WITH AUDIT CLIENT

#### QUESTION 7 ANSWER

#### Do we have to rotate partners on all assurance engagements?

The rotation requirements are for **reporting issuers only**. There are four categories of audit partner for reporting issuer engagements that are subject to rotation requirements:

- 1) The lead engagement partner (who is the person with overall responsibility for the engagement, i.e. signs the audit report) cannot serve in that capacity for more than five years. After five years they will be subject to a five-year "time-out" period before taking either such role (of either the lead engagement partner or engagement quality control reviewer).
- 2) The quality control reviewer (often called the reviewing or second partner) is subject to the same requirements as the lead engagement partner.
- 3) The lead engagement partner on a subsidiary cannot serve in that capacity for more than seven years, after which he/she would be subject to a two-year "time-out" period.
- 4) A partner other than a specialty or technical partner who provides more than 10 hours of audit services to the reporting issuer must rotate after seven years and be subject to a two-year time out period. (This is not a requirement in Quebec.)

There are additional restrictions for the lead engagement partner and the engagement quality control reviewer outlined in paragraph 20 of Rule 204.4 regarding reporting issuers that are mutual funds.

On all assurance engagements, the senior personnel's long association, if any, should be evaluated to determine if it is significant enough to warrant safeguards, such as rotation of senior personnel. Note moreover that periodic partner or staff rotation brings "fresh eyes" to a file and ensures that staff members obtain a wide variety of experience.

### PERFORMANCE OF MANAGEMENT FUNCTIONS

**QUESTION 8** The owner of an audit client, which is a private company, has asked if I can lend him one of my staff members for three days per week to fill in for his controller who is on maternity leave. The duties my staff member will perform include preparing monthly financial statements for the bank, as well as acting as one of two signing officers on company cheques. My staff member will likely also help negotiate the financing for the purchase of a new large piece of equipment. Will this arrangement affect my independence when it comes time to do the audit?

**ANSWER** Paragraph 132 of the Council Interpretation states that staff may be loaned to an assurance client only if the person loaned is not involved in making management decisions, creating, approving or signing agreements or other documents or exercising discretionary authority to commit the client. (All of these types of activities are management functions, which are prohibitions for which adequate safeguards do not exist). In this particular situation, the staff member has too much involvement in management activities; the audit firm's independence will likely be impaired and the firm would be prohibited from performing the audit if the staff member was loaned to the client.

**QUESTION 9** Our firm provides review engagement services to a client whose major source of income is from providing services in remote locations. Dual signatures are required on all cheques — the controller and the managing shareholder. On infrequent occasions where there is a strict deadline, the managing shareholder is unable to leave the remote location in time to sign cheques. As a client service, a partner of the firm is authorized as a second cheque signer on the rare occasions when the managing shareholder is unavailable. What are the implications of this circumstance under Rule 204?

**ANSWER** The cheque signer in many organizations is also providing an internal control function, where the signing of cheques is a significant approval step in the disbursement process. Cheque signing is therefore usually viewed as an important management function, which is prohibited under Rule 204 where assurance services are also being provided. The preparation of source documents for this client, such as a signed cheque, would also be prohibited, as described in paragraph 137 of the Council Interpretation to Rule 204. In such circumstances, either this service should not be performed by the partner, or the firm should not provide the assurance engagement. If a compilation engagement could serve the client needs, the nature and extent of the apparent impairment of independence would need to be disclosed in an additional paragraph to the Notice to Reader.

### PREPARATION OF JOURNAL ENTRIES, ACCOUNTING RECORDS AND FINANCIAL STATEMENTS

**QUESTION 10** I have many small private company clients who have difficulty with their bookkeeping and I am required to make many adjusting entries as a part of my year-end review in addition to assisting with the drafting of the financial statements and notes. Am I able to do that?

**ANSWER**

Yes, but with some caveats. Members are **not** prohibited from assisting with the preparation of the financial statements of their private company clients. This is further described in Rule 204.4(23) and (24).

Notwithstanding these rules, members may discuss with their clients the implementation of new accounting policies, financial statement disclosures, the appropriateness of controls, and valuation methodologies without threatening their independence. This type of technical assistance is seen as an appropriate way to promote fair financial statement presentation, as long as it is the client who makes the final decisions.

Many firms serve owner-managed clients who require assistance with the preparation of financial statements or journal entries as part of a review or audit. The rules require members to reduce the self-review threat to an acceptable level. One common safeguard is to obtain client approval for adjusting entries and to review, in detail, the finished product with the client's owner-managers. Even though members are always responsible for their own work, their clients' management must retain ownership of the financial statements. (See Question 12 for a situation involving complicated accounting transactions.)

If you do not mitigate the self-review threat, and if you act without the client's knowledge and consent, you are not acting independently; this kind of impairment cannot be dealt with by way of disclosure in the review engagement or audit report. Members should review paragraphs 134 to 143 of the Council Interpretation for additional guidance.

**Compilation engagements clients**

A compilation engagement, by its nature, usually involves the member in the preparation of **routine** accounting records and journal entries. This is not an activity that would require disclosure in the Notice to Reader, except in Quebec, where the preparation of other than basic bookkeeping entries (such as posting balances from subledgers) requires disclosure in the Notice to Reader, irrespective of whether management approval has been obtained. Although not a requirement, it would be prudent for the member to conduct a detailed review of journal entries with management and get management's approval.

**QUESTION 11** I have many small private company clients who only require compilation engagements. At year-end they expect me to assist with the preparation of complex adjusting journal entries, as well as assist with the drafting of the financial statements. Am I able to do that?

**ANSWER** Independence is not required for compilation engagements pursuant to Rule 204.8. The preparation of **complex** accounting entries is, however, an activity that would be disclosed in the Notice to Reader if these entries are such that management cannot be reasonably expected to understand and review them. (The approach in Quebec would be the same.) (See also Questions 10 and 12).

**QUESTION 12** I am a sole practitioner and many of my clients are owner-managed enterprises that rely on me to help record complicated accounting transactions, such as foreign currencies and leases. Can I do that?

**ANSWER** Providing technical assistance to clients is generally viewed as an appropriate method of promoting fair presentation of the financial statements. However, if the member is required to prepare a journal entry to record a material complex transaction, reviewing the journal entry with a client who lacks sufficient accounting knowledge may not be sufficient to reduce the self-review threat to an acceptable level. A safeguard, such as consulting with another CA on the accounting for the complex transaction, could be applied to reduce the self-review threat to an acceptable level. Members are urged to review paragraphs 141 to 143 of the Council Interpretation for additional guidance.

#### **PROVISION OF NON-ASSURANCE SERVICES TO AN ASSURANCE CLIENT**

**QUESTION 13** If you are asked by your audit or review client to be an executor of his/her will and/or a trustee of his/her estate or family trust, is your ability to act affected by the Independence Rules?

**ANSWER** The answer is probably yes — and does not differ whether your client is living or has died. You need to consider that as a trustee or an executor you can influence the financial direction of the trust or estate, irrespective of your level of involvement or the number of trustees/ executors with whom you share this responsibility. This could trigger issues with a number of aspects of the Independence Rule, such as:

- This role is not dissimilar to serving as an officer or director of an entity, since you have the ability to exercise influence over the financial and accounting policies of the trust or estate. Rule 204.4(18) precludes a member or firm from performing “an assurance engagement for an entity if a member of the firm serves as an officer or director for the entity.”
- A trustee or executor can be viewed as having a management function, by having the ability to exercise authority or by being actively involved in decision-making. According to Rule 204.4(22), “a member or firm shall not perform an assurance engagement for an entity if, during the engagement period, a member or firm makes a management decision or performs a management function.”

- According to Rule 204.4(1), a member or student is not allowed to participate on an assurance engagement if the member or firm, or his/her immediate family, holds, as a trustee, a direct or indirect financial interest in the client. Per paragraph 64 of the Council Interpretation to Rule 204.4, this is viewed no differently than holding the interest as the beneficiary.
- There are further restrictions on the ability of the office of the firm to complete an assurance engagement if the member involved is a partner. A member who is a partner of a firm and who holds, or whose immediate family holds, a direct financial interest or a material indirect financial interest in an audit or review client shall not practise in the same office as the lead engagement partner for the client.
- The basic rule of thumb test of how a reasonable observer would view the relationship should also be applied.

Is the nature of the threat such that safeguards could be introduced to reduce the threats to an acceptable level? No, these are specific prohibitions for which there are generally no safeguards available.

Your options are limited, so what role — if any — can you play? One possibility, if you want to continue providing assurance services rather than acting as a trustee, is to take on an advisory role to the trustees that involves no decision-making power. You will need to assess whether you have inadvertently taken on a *de facto* decision-making role. Each situation must be reviewed based on its own merits within the independence rule framework.

**QUESTION 14** **Would the provision of governance consulting services to a client by a firm that is also the auditor of the client impair the independence of the auditor?**

**ANSWER**

Rule 204 does not include any specific prohibitions against the provision of such consulting services by an auditor, and therefore, the situation must be addressed within the threats and safeguards framework.

Whether independence is impaired in fact or in appearance would depend on several factors. Consulting advice on “governance” may involve issues that are very high-level in nature or may involve detailed analysis and advice related to internal control, management reporting systems and structure and responsibilities of Board committees, including audit committees.

Accordingly, there are several threats to independence that may arise from the provision of such advice:

- to the extent that such consulting arrangements could result in the auditor effectively “auditing his or her own work”, there is a self-review threat;

- to the extent that the provision of such services might allow the auditor to develop too close a relationship with management, the Board or the Audit Committee, there is the possibility of a familiarity threat;
- in some cases, the firm may risk assuming the role of advocate for the client. For example, where the firm provides governance consulting advice to a client and assists the client in supporting a submission based on that advice in order to satisfy the requirements set by a regulatory body, it may be seen to be advocating on behalf of the client; and
- to the extent that the consulting contract may be very lucrative for the firm, there exists the possibility of self-interest or intimidation threats.

Although the rules do not specifically contemplate the question of impairment of independence related to the provision of governance consulting services, there is some guidance in the Council Interpretation to Rule 204.1 to 204.6.

- Paragraph 128 provides some guidance as to what safeguards may be put in place to protect against possible impairment that may be caused by the provision of non-assurance services.
- Paragraph 131 also recognizes that engagements to assess and provide recommendations with respect to improvements in internal control procedures would not necessarily impair independence.
- Paragraphs 154 through 160 deal more specifically with this type of consulting engagement. In particular, members should be aware that the magnitude of the auditor's involvement in internal control and related activities may present a threat to independence.

**QUESTION 15**

**Can I provide legal and corporate secretarial services to my assurance clients?**

**ANSWER**

The ability to provide secretarial services is described in paragraphs 114 to 116 of the Council Interpretation. Generally there is a high degree of association with the clients. Depending on the nature of the services, for instance whether they are of a routine administrative nature or involve decision making, there may be independence threats.

The provision of legal services may also create self-review or advocacy threats; guidance to evaluate these threats is provided by paragraphs 177 to 183.

**QUESTION 16** **If I cannot provide legal or secretarial services to my assurance clients through my firm because there are independence issues, can I provide those services through a separate management company that I have an interest in?**

**ANSWER** Not if the separate management company is a network firm. A network firm is defined as “an entity under common control, ownership or management with a firm, or any entity that a reasonable observer who has knowledge of the facts would conclude to be part of a firm nationally or internationally.”

**QUESTION 17** **Given that CAs are often asked to assist business owners with sales of their businesses, when does an independence issue arise and can it be adequately managed with safeguards?**

**ANSWER** If the sale has not been finalized prior to the company’s fiscal year end, the CA will be in a position of reporting on financial statements at least once more. Depending on their level of involvement with the sale, this may create an independence issue. The most relevant guidance is found in the following Council Interpretation to Rule 204.1 to 204.6 regarding corporate finance and similar activities:

186. Rule 204.4(33) provides that, during the engagement period, a member or firm, or a member of the firm, may not provide any of the following services to an assurance client:

- (a) promoting, dealing in or underwriting the client’s securities;
- (b) making investment decisions on behalf of the client or otherwise having discretionary authority over the client’s investments;
- (c) executing a transaction to buy or sell the client’s investments; or
- (d) having custody of assets of the client, including taking temporary possession of securities purchased by the client.

The Rule further restricts a network firm or member of a network firm from providing such services during either the period covered by the financial statements subject to audit or the engagement period, with further restrictions in the case of an audit client that is a reporting issuer.

Although the examples provided do not specifically include a sale of assets, the same causes for concern — advocacy or self-review threats — exist. If the CA is preparing the sale agreement or identifying potential buyers, there are no appropriate safeguards that will reduce the threat to an acceptable level. However, if involvement was limited to other corporate finance activities similar to those outlined in paragraph 187 to the Council Interpretation to Rule 204.1 to Rule 204.6, it may be possible to provide assistance as well as assurance services.

**QUESTION 18** I am about to retire as a partner in a public accounting firm, but would like to be able to provide services to former assurance clients, if requested. What kinds of services can I provide?

**ANSWER**

A retired partner may be considered to be a member of the firm if there continues to be a close association with the firm (see paragraph 33 to the Council Interpretation), and as a result, the retired partner would still be subject to Rule 204.1 to 204.6. When evaluating the nature of the association the retired partner has with the firm, the overriding consideration should be given to how a reasonable observer would view the relationship. Even where there is no continuing close relationship, there may be a familiarity threat if the former partner exerts direct or significant influence over the subject matter of the assurance engagement.

This could affect the ability of the firm to conduct an assurance engagement if the retired partner who has a close association with the firm, for instance, takes on a role on Audit Committees or provides various non-assurance services to an assurance client of the firm. As the former partner would have likely supervised staff, care will also have to be taken in selecting the audit engagement team.

Note also that if your former assurance clients are reporting issuers, Rule 204.4(16) does not allow a member or firm to perform an audit engagement for a reporting issuer if a person who participated in an audit capacity in the audit of the financial statements of the entity accepts employment in a financial reporting oversight role (which would include Board of Director positions) until a period of one year has elapsed from the date that the financial statements were filed with the relevant securities regulator or stock exchange.

**FEES — OVERDUE**

**QUESTION 19** What documentation is required to show that unpaid fees from prior engagements do not pose a significant threat?

**ANSWER**

As outlined by paragraph 191 to the Council Interpretation for Rule 204.1 to 204.6, the member should consider whether the threat posed by unpaid fees is clearly insignificant. If the threat is not clearly insignificant, the member should document the identification of the threat, the safeguards identified and applied, and how the safeguards reduce the threat to an acceptable level.

In situations where the threat to independence posed by unpaid fees is clearly insignificant, it is still prudent to document the reason(s) for the member's conclusion that it is insignificant. Some factors to consider include:

- Percentage of the member's total fees derived from the particular client;
- Client's previous payment pattern;
- Percentage of prior year's total fees that are outstanding when the report is issued; and

- Any unique or non-recurring circumstances that the client is currently facing.

## 10.2 Threats — All Clients

**QUESTION 20** **Can we prepare forecasts for our review clients to assist them with borrowing requirements?**

**ANSWER** Preparing a forecast for a review client may create an advocacy or self-review threat to independence. As is the case when providing bookkeeping services to a client, a member should review the forecast carefully with the client and ensure that the client accepts responsibility for all aspects of the forecast, including the assumptions upon which the forecast is based. Further, when accompanying a client to present the forecast to the bank, the member's involvement must be restricted to explaining the forecast to the banker. The partner should exercise care to ensure that he or she is not perceived to be encouraging the banker to take a particular viewpoint with respect to any ongoing financing to the client. Refer to paragraph 187 of the Council Interpretation for Rule 204.1 to 204.6.

**QUESTION 21** **I perform a review engagement for a company that owns a rental property. I prepare an occupancy cost report, calculate the balance due by each tenant, and have the client approve it. Can I then send a letter to each tenant advising of the balance due and the revised occupancy fee, or does the client have to send this letter?**

**ANSWER** Generally, preparing an occupancy cost report and calculating the balance due by each tenant would not create a threat to independence, provided the client approved these documents. However, sending a letter to the tenants advising them of the balance due and revised occupancy fees could be interpreted as a management function and may jeopardize your independence. To avoid misinterpretation of your role, the client should send these communications to the tenants.

**QUESTION 22** **Our firm is working with CRA on behalf of our audit client in the resolution of a proposed re-assessment of prior years' income taxes. We are in the midst of our audit of the financial statements and the amounts involved in the proposed re-assessment are material to these statements. Is our independence threatened such that we must resign from the audit engagement?**

**ANSWER** There may be an advocacy threat but most often, the answer to this question will be “No, your independence is not threatened such that your firm may not complete the audit engagement.” This issue is addressed in paragraphs 188 and 189 of the Council Interpretation, which notes that taxation services are unique among non-assurance services for several reasons. Detailed tax laws must be consistently applied and CRA has discretion to audit any tax filing. Accordingly such engagements are generally not seen to create any threats to independence that are not adequately offset by available safeguards.

**QUESTION 23** Our private company audit client (a group of related companies) routinely requests the engagement partner to accompany them to the bank to review with the banker the group's financial statements and the covenant calculations related to the bank financing provided to the group. Can we provide this service and maintain our independence?

**ANSWER** There may be an advocacy or self-review threat but the answer to this question will often be “yes”. Provided the discussion with the bank manager is restricted to facts, whereby the partner provides explanations as necessary, it is unlikely that a threat to independence would be created. The partner should exercise care to ensure that he or she is not perceived to be encouraging the banker to take a particular viewpoint with respect to any ongoing financing to the client.

### 10.3 Reporting Issuers

Note: There are differences in wording in Quebec relating to “reporting issuers”; these examples are not relevant; refer instead to Article 36.3 and to the transitional provisions.

**QUESTION 24** How do I determine if my public company clients meet the definition of a “reporting issuer”?

**ANSWER** A “reporting issuer” is defined to be an entity required to report under applicable Canadian provincial or territorial securities legislation that has market capitalization or total assets over \$10 million in respect of a particular fiscal year. Once an entity is considered to be a reporting issuer, it remains so classified unless, and until, it ceases to have its shares or debt quoted, listed or marketed in connection with a recognized stock exchange or the entity has stayed under the threshold for a period of two years. If the reporting issuer does not have listed securities or publicly traded debt, this definition shall be read without reference to market capitalization. (Note that there are differences in wording in Quebec in this situation, so this example is not applicable; refer to Article 36.3.)

The calculation of “market capitalization” for a particular fiscal year is the average market price of all outstanding listed securities and publicly traded debt of the entity measured at the end of each of the first, second and third quarter of the prior fiscal year and the year-end of the second prior fiscal year. “Total assets” refers to the net book value of the total assets of the entity at the end of the third quarter of the prior year.

**EXAMPLE**

ABC Ltd.

Calculation for Year ending December 31, 2xx2

(Calculation performed on January 1, 2xx2)

Total assets on September 30, 2xx1: \$ 9,200,000

Market capitalization based on 1 million outstanding shares in total with average price at end of each quarter noted below:

December 31, 2xx0	\$ 9.75	\$ 9,750,000
March 31, 2XX1	\$10.25	\$10,250,000
June 30, 2XX1	\$10.15	\$10,150,000
September 30, 2XX1	\$ 9.95	<u>\$ 9,950,000</u>
Total		<u>\$40,100,000</u>
Average		<u>\$10,025,000</u>

Conclusion: Client is defined as a "Reporting Issuer" for 2XX2.

**QUESTION 25**

**One of my clients is planning to go public. How do I determine if the client will meet the definition of a "reporting issuer" after it has gone public?**

**ANSWER**

An entity is defined to be a reporting issuer if it has either market capitalization or total assets in excess of \$10,000,000. In the case of an entity that makes a public offering, market capitalization is measured at the closing price on the day of the public offering and total assets refers to the total assets presented on the most recent financial statements that are included in the public offering document.

XYZ Ltd has a December 31 year-end and goes public on August 31, 2xx5. The public offering document contains audited financial statements for the years ended December 31, 2xx2, 2xx3 and 2xx4 and reviewed financial statements for the six-month period ended June 30, 2xx5. XYZ issues 6,500,000 at an offering price of \$1.50 and the closing price on August 31, 2xx5 has risen to \$1.60.

**TOTAL ASSETS ON**

December 31, 2xx2	\$ 6,545,000
December 31, 2xx3	7,863,000
December 31, 2xx4	7,912,000
June 30, 2xx5	7,834,000

**MARKET CAPITALIZATION**

Opening price 6,500,000 shares at \$1.50	\$ 9,750,000
Closing price 6,500,000 shares at \$1.60	\$10,400,000

Conclusion: XYZ Ltd is considered to be a reporting issuer because the market capitalization at the end of the day of the public offering is in excess of \$10,000,000.

When a client contemplates its initial public offering it may not be able to estimate its market capitalization on the offering date with any degree of accuracy. Members and firms should take appropriate steps to ensure compliance if it is possible the \$10 million threshold will be exceeded. If it appears that the market capitalization might exceed \$10 million, the member or firm who had been providing bookkeeping services to the

client should ensure the client understands that such services could no longer be provided.

**QUESTION 26**

**My client originally met the definition of “reporting issuer” based on the market capitalization test but NOT the total asset test. The market capitalization subsequently dropped to less than \$10 million for a period of two years, but the total assets now exceed \$10 million. Would my client still be considered a reporting issuer?**

**ANSWER**

The emphasis of the definition is on the first clause, that is, if the entity meets **either** threshold (market capitalization or total assets exceed \$10 million), it is considered to be a reporting issuer.

**QUESTION 27**

**One of my clients (Company A), which is a private company, is going through a reverse takeover with Company B, which is a public company. I have been the lead engagement partner for this client for many years, and have been asked to continue as the lead partner for the new entity which is public. When does the period for the determination of partner rotation begin?**

**ANSWER**

Paragraph 122 of the Council Interpretation would apply, so that if the lead engagement partner had been in that role for three or more years at the time the client became the reporting issuer (per the reverse takeover), then he or she could continue in that role for two more fiscal years before being replaced as lead engagement partner. (Note that there are differences in wording in Quebec in this situation; refer to the transitional provisions.)

**QUESTION 28**

**Our firm is the auditor of a reporting issuer with assets of \$15 million. In the midst of our audit, we have encountered significant difficulties with the accounting treatment and disclosure related to financial instruments and stock based compensation. The client’s staff requires assistance to deal with these situations adequately. What role can the firm have in resolving the problems without compromising our independence?**

**ANSWER**

Paragraph 138 of the Council Interpretation discusses the circumstance in this question. It says in part, “... the financial statement audit and review process involves extensive dialogue between persons on the engagement team and management of the audit or review client. During this process, management will often request and receive input regarding such matters as accounting principles and financial statement disclosure...” It goes on to say, “The provision of technical assistance of this nature for an audit or review client is an appropriate method of promoting the fair presentation of the financial statements. The provision of such advice, per se, does not generally threaten the member’s or the firm’s independence.” Thus, although the firm **cannot** in this situation prepare the journal entries, accounting records or financial statements, the firm **can** provide advice and technical assistance related to the identified problems. However, there should be clearly documented evidence that decisions

related to the resolution of the circumstances were made by management, **not** the auditors.

**QUESTION 29**

**How much assistance can we provide our assurance clients with their transition to IFRS (or other applicable financial reporting standards)?**

**ANSWER**

It is not uncommon for firms to provide to their assurance clients a range of services within their skills and expertise. However Rule 204.1 requires firms to be independent and free of any influence, interest or relationship which impairs the professional judgment in respect of the engagement. Assisting your assurance client in transitioning to new financial reporting standards, such as IFRS, may create threats, such as self-review or self-interest to independence as discussed in Council Interpretation paragraph 127.

**If your client is a reporting issuer transitioning to IFRS:**

Rule 204.4(22) through (28) sets out management related and non-audit activities that firms may not perform for their reporting issuer assurance clients, such as: making management decisions, preparing accounting records and financial statements, and providing other services, such as internal audit and/or IT services where it is reasonable to conclude that the results of such services will be subject to audit procedures during the audit of the client's financial statements.

Notwithstanding these rules, there are certain forms of assistance that you can provide. As noted in paragraph 138 to the Council Interpretation, management often seeks and receives input from their auditors on technical matters, and such assistance does not generally threaten independence. Examples of technical matters include: “...accounting principles, financial statement disclosure, the appropriateness of controls and the methods used in determining the stated amounts of assets and liabilities. ... Other services ... that do not, under normal circumstances, threaten independence include: ...assisting in the preparation of consolidated financial statements (including... transition to a different reporting framework such as International Accounting Standards).”

However, there is still a self-review threat, and depending on the nature and extent of the assistance, you will need to carefully evaluate the significance of any threat created by providing the assistance. If adequate safeguards cannot be put in place to reduce the threat, you should either not perform the audit, or not provide the additional assistance requested.

The provision of this assistance, as with all professional services provided to a reporting issuer client, will require prior approval by the audit committee (per Rule 204.4(21)), unless the requirements set out in paragraph 125 to the Council Interpretation for Rule 204.1 to 204.6 are met.

## 10.4 Documentation

### QUESTION 30 What documentation do I have to put in my files?

#### ANSWER

It's very important to document in your files that you have considered any potential threats to your independence. Moreover, if there is a threat that is not clearly insignificant, it is vital that you document your assessment of its significance. If the threat is clearly significant, just note your conclusion in your working papers. If safeguards are necessary, it would be prudent for you to discuss the safeguards you're taking to eliminate or reduce the threat to a reasonable level with those managers or directors of your client who are responsible for governance. A good way to document these discussions is in your annual independence letter.

Since independence is about a member's relationship with their client, it encompasses both factual circumstances and the appearance of these facts to a reasonable observer. If challenged, you must be able to defend your position with evidence proving that you've considered the situation and have exercised reasonable professional judgment.

For more details, refer to Rule 204.3 and the documentation requirements of the *CICA Handbook – Assurance* (such as those outlined by Sections 5030 “Quality control procedures for assurance engagements” and 5145 “Documentation”).