

Office of the Auditor General of Canada

**Report on a Review of the
Annual Audit Practice**

Practice Reviews Conducted in the 2011–12 Fiscal Year

January 2012

Practice Review and Internal Audit

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Introduction

1. The Office of the Auditor General conducts independent audits that provide objective information, advice, and assurance to Parliament, territorial legislatures, and Canadians. The Office has several product lines, including performance audits, annual audits, and special examinations.
2. Annual audits include audits of the summary financial statements of the Government of Canada and the three northern territories, and of the financial statements of Crown corporations and other entities. They are performed in accordance with Canadian generally accepted auditing standards. The objective of annual audits is to provide an opinion on whether financial statements are presented fairly in accordance with Canadian generally accepted accounting principles. Where required, the auditor also provides an opinion on whether the transactions examined comply, in all significant respects, with the legislative authorities that are relevant to a financial audit.
3. The Practice Review and Internal Audit team conducted practice reviews of seven selected annual audits that were reported in 2011. This work was done in accordance with the monitoring section of The Canadian Institute of Chartered Accountants (CICA) Handbook—"Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance Engagements (CSQC-1)." It was also done in accordance with the Office's 2011–12 Practice Review and Internal Audit Plan (paragraph 7), which was recommended by the Audit Committee and approved by the Auditor General. The plan is based on systematic monitoring of the work of all audit principals in the Office, on a cyclical basis.
4. To meet CICA standards, the Office establishes policies and procedures for its work. These are outlined in an audit manual, various other audit tools, and a quality management system (QMS)¹ for each product line—which ensures that quality is built into the audit process. These guide auditors through a set of required steps to ensure that the audits are conducted according to professional standards and Office policies. There is a product leader at the assistant auditor general level for the annual audit product line, whose primary function is to provide leadership and oversight for the product line and to contribute to the quality of the individual audits.
5. This report summarizes the major observations related to the practice reviews of the selected annual audits.

¹ The Office's system of quality control was updated as part of the Renewal of Audit Methodology (RAM) project, which is applicable to all product lines. Because this update has been applicable only since November 2011, the old QMS would still be applicable to the annual audits under review, with year ends between July 2010 and July 2011.

Overview

Objective

6. The objective of practice reviews is to provide the Auditor General with assurance that

- annual audits comply with professional standards, Office policies, and applicable legislative and regulatory requirements; and
- audit reports are supported and appropriate.

Scope and methodology

7. We planned to conduct eight practice reviews of annual audits in the 2011–12 fiscal year. We conducted seven² practice reviews, including five of annual audits and two of audit components of the Government of Canada's summary financial statements. The reviews were conducted on audit files for financial statements with year ends between July 2010 and July 2011. The five annual audits included three of Crown corporations, one of an international organization, and one of the Public Accounts of Canada.

8. Our reviews included an examination of electronic (TeamMate) and paper audit files. We examined audit files related to the planning, examination, and reporting of the audits. We also interviewed audit team members, engagement quality control reviewers (EQCRs), and other internal specialists, as appropriate.

Quality management system elements and process controls reviewed

9. We focused our work on the selected elements and key process controls of the Quality Management System for Annual Audits (Appendix A) that we considered key or high risk.

10. We also looked at how the EQCRs carried out their responsibilities. EQCRs are management-level employees of the Office who are appointed to provide an objective evaluation, before the auditor's report is issued, of the significant judgments that the audit team made and the conclusions that it reached when it was formulating the audit opinion. The EQCRs are an important element of the Office's QMS, and they are involved in selected individual

² Of eight practice reviews planned, seven were completed during the 2011–12 fiscal year. We were unable to start the practice review on one of the files because the annual audit was not substantially completed in time for the preparation of the summary report. It is scheduled to be completed in 2012–13, and the results will be included in the summary report for that fiscal year.

audits—from the initial planning decisions to the closing of the audit file. Appendix B describes the key process controls reviewed for each selected element of the Quality Management System for Annual Audits.

Rating system

11. We applied one of the following ratings to each selected QMS element of the individual annual audits under review:

- **Compliant.** Office policy requirements and applicable auditing standards were met.
- **Compliant but needs improvement.** Improvements are necessary in some areas to fully comply with Office policies and professional auditing standards.
- **Non-compliant.** Major deficiencies exist; there is non-compliance with Office policies or professional auditing standards.

12. After completing each practice review, we concluded on whether the audit opinion was supported and appropriate.

13. This report highlights the procedures performed, the observations and recommendations made, and management responses.

Results of the Reviews

14. Overall, we found that, in the seven files reviewed, the audit opinions were supported and appropriate.

Compliance with the quality management system and process controls

15. Two of the seven audit files were fully compliant with the elements reviewed. The remaining five needed improvement in how certain elements of the quality management system (QMS) were applied. None of the files needed improvement in three or more QMS areas, compared with 18 percent in the 2010–11 fiscal year.

16. The 2008–09 summary practice review report identified a number of instances of the QMS not being applied consistently and rigorously. As a result, the Office made it a priority to update and strengthen the design and implementation of the QMS. In our opinion, the many actions taken since that time (for example, information sessions, checklists, TeamMate updates, and

training) have contributed to the improvements we observed in this year's practice reviews.

Good practices

17. During our reviews of the audit files, we observed the following good practices, at the planning stage:

- The audit team compared the previous year's audit risks to the current year's and analyzed the results. This activity helped the team to develop an appropriate audit strategy and to show improvements made by the entity.
- The audit team added a column in the "preliminary audit approach by cycle/component" to link significant risks to the annual audit report to Audit Committee. This practice allows the team to remember important risks when it presents that report.

Notable improvements

18. In the files we reviewed this year, one area showed significant improvement over previous years: Integration of the information technology (IT) work in the annual audit engagement files.

19. Of the seven files we reviewed, all had properly integrated IT work in the audit planning, execution, and reporting phases.

Opportunities for improvement in three areas

20. Based on the findings most commonly identified in the individual practice reviews, there are three notable areas for improvement:

- consistency among the annual audit risk assessment, audit strategy, assertion alignment, and audit work performed;
- timely management review; and
- completion of independence forms.

Consistency in the annual audit risk assessment, audit strategy, assertion alignment, and audit work performed

21. Five of seven files that we reviewed had issues at various levels under this observation. The audit team performed risk procedures designed to identify risks of material misstatement that are relevant to the audit. In designing the audit procedures to respond to these risks, audit teams should determine the source of

likely material misstatements in account balance, class of transactions, or disclosure in order to identify those financial statement assertions that are relevant. The audit teams must link each significant risk to a relevant assertion, when they complete the Audit Risk Assessment.

22. In three of the seven files that we reviewed, we observed that the audit teams had trouble identifying and properly documenting the relevant assertions. In these three files, the audit teams did not properly link and document all relevant assertions for significant financial statement cycles or components that were affected by the assessed risks. Nor did they properly document

- risks per assertion, in the audit strategy, which meant it was difficult to determine whether enough audit work was carried out to address identified risks; or
- changes in the risk assessments.

23. In addition, as we had reported in previous years, audit teams have difficulty completing “summaries of comfort” (SOCs)—an audit tool used to link the risk of material misstatement with relevant audit assertions, audit work performed, and assurance gained. In three of the files that we reviewed, several SOC were incomplete and did not align with the audit work performed. For example:

- The audit procedures described in the SOC did not align with the audit work performed in the detailed file sections, so it was difficult to align the work performed with the audit strategy.
- There were incorrect or missing links between the assertion risks and audit steps and the SOC.
- When the work performed did not match the planned level of assurance for the related financial statement assertions, the SOC did not include enough justification or the required approvals for the changes in the audit approach.

24. Three of the audit files we reviewed had multi-location or regional impact implications. For two of the three files, audit teams had not assessed the multi-location implications on the assertion risks and, ultimately, on the audit strategy.

Timely senior management review

25. We found that, in two files, the audit programs had not been approved or reviewed before the examination phase.

26. We also observed that, in three of the files, senior management (the Director or Principal) had not performed timely review of the audit work at various phases of the audit.

Completion of independence forms

27. We noted that, in three of the seven files that we reviewed, independence forms were missing or incomplete. In some instances, reports were not completed, and there was no rationale on file for why people had not completed their forms. In another file, there were “blanket” reports that did not relate to specific audit engagements. It is Office policy for everyone working on an audit to submit an independence form.

Other observations noted in our review

Controls-reliant approach: Identifying and testing controls

28. The Office is committed to taking a controls-reliant approach to an audit, whenever it is appropriate and practicable. We observed that, over last year, audit teams have significantly improved the way they apply the controls-testing methodology and guidance. In three of the seven audit files that we reviewed, the audit teams performed tests of controls in certain significant cycles. There was only one instance where there was no justification on file to support why it is inefficient to test IT-related controls: the audit team chose to move away from IT reliance and to use a substantive approach without indicating why it was inefficient to test automated controls.

29. We noted that, in the three files that tested controls, the audit teams had difficulty identifying the key controls, which may have led them to perform more audit work than necessary to get the required assurance.

Authorities: Group and component audits

30. Because the Office of the Auditor General is a legislative office, there is an expectation that the work related to compliance with applicable authorities is integrated into the overall audit strategy.

31. When we reviewed the Public Accounts audit, and two of its component files, we noted that the evaluation of the component auditor team’s work on authorities needed improvement. While component teams were asked to report on authorities, many of them did not make specific reference to authorities in testing results. In one instance, because the component team planned to test only high-value transactions, and there were none, no authorities work was performed. This fact was not communicated to the group auditor, and there was no evidence on file that this fact was addressed.

32. Although we were satisfied that the work on authorities was performed, the group auditor should ensure that component auditors are given specific instructions regarding authorities work for what they should report on.

File finalization

33. There was one instance of a team not finalizing a file according to Office guidelines. In another case, the audit team finalized the electronic file according to Office guidelines, but did not finalize the paper file in a timely manner.

Considerations for the Professional Practices Group

34. During our practice reviews of annual audits, we noted areas where audit teams would appreciate methodological clarification in some areas.

35. One suggestion was that guidance be prepared on the extent of testing required to assess the completeness and accuracy of reports (data reliability) that the audit team uses for entities, when the audit team does not test the IT General Controls (which include the application of specific controls). Effective for audits with fiscal periods ending after November 2011, new methodology now provides guidance for assessing data reliability.

36. Auditors also informed us that it is difficult to use TeamMate to document the review and approval of audit programs, when modifications are made to the programs during the audit. This is a technical issue related to TeamMate, which has a limited capacity to support a documentation trail of changes made and their review and approval.

37. Some audit teams are applying a narrow definition of a “group audit,” and hence are not considering the CAS 600 requirements that relate to audits of entities with multiple locations. The Professional Practices Group should consider whether methodology guidance could be improved to encourage auditors to apply CAS 600 to audits of multi-location entities, and not only when there are subsidiaries and investees or groups.

Conclusion

38. For each of the five annual audits that we reviewed, the auditor’s report was supported and appropriate.

39. While the level of compliance with Office policies and professional audit standards is high, we observed that there is a need for improvement in three areas:

- better alignment of audit planning documents,
- timely review by senior managers, and
- documentation that due consideration was given to audit team independence.

Management's response: *Agreed. Over the past couple of years, practice reviews and the international peer reviews have also identified a need for the Office of the Auditor General (OAG) to improve the alignment of our audit planning. OAG management agreed that this need would be addressed as part of our Renewal of Audit Methodology (RAM) project. We are currently in the process of redesigning our audit planning methodology, including our audit tools and templates, with the clear objective of improving this area of our audit work.*

We expect that this improved planning methodology and process will be provided to our auditors later this fall.

Timely reviews by audit managers are an ongoing expectation and responsibility of our audit directors, audit principals, and assistant auditors general. The need for improvement in this regard has also been identified in past practice reviews and our international peer review. Ensuring timely reviews is not related to the need for improved methodology or processes; rather, it is a "change management" issue that relates to the need for improved accountability. We will take steps to re-emphasize the importance of audit file reviews being completed on a timely basis for all our audits. In addition, we will ensure that managers are held accountable for their product management performance in this area.

As part of Phase 1 of our annual audit RAM project, the Office introduced new independence forms in November 2011. All individuals who work and charge time to our audits are required to complete these independence forms. This is a clear expectation of our audit methodology, which we expect to be complied with. For this reason, we will take steps to re-emphasize the importance of ensuring that independence forms are fully and accurately completed on a timely basis for all our audits.

Appendix A—Quality Management System Elements for Annual Audits³



³ The elements in italics are explained in detail in Appendix B. This system is applicable to audits under the review period, with year ends between July 2010 and July 2011. A new system of quality control has been applicable since November 2011.

Appendix B—System of Quality Management Elements and Process Controls Reviewed

Our review covers the following Quality Management System elements:

Conduct of the audit. We reviewed whether the audit was planned, executed, and reported in accordance with Canadian generally accepted auditing standards, applicable legislation, and Office policies and procedures. We considered whether the Office meets its reporting responsibilities by having in place appropriate audit methodology, recommended procedures, and practice aids that support efficient audit approaches, producing sufficient audit evidence at the appropriate time.

As part of the conduct of the audit, we also reviewed **audit file finalization**. We determined whether audit files were closed within 60 days of the Auditor's Report being given final clearance by the signatory and the financial statements being approved by the Board of Directors of the entity, or its equivalent, as required by Office policy.

Consultation. We reviewed whether consultation was sought from authoritative sources and specialists with appropriate competence, judgment, and authority to ensure that due care was taken, particularly when dealing with complex, unusual, or unfamiliar issues. We also reviewed whether the consultations were adequately documented, and whether the audit team took appropriate and timely action in response to the advice received from the specialists and other parties consulted.

We reviewed whether the quality reviewer carried out, in a timely manner, an objective evaluation of

- the significant judgments made by the team,
- the conclusions reached in supporting the auditor's report, and
- other significant matters that have come to the attention of the quality reviewer during his or her review.

We reviewed whether the work of the quality reviewer was adequately documented, and whether the audit team took appropriate and timely action in response to the advice received from the quality reviewer.

Resourcing. We reviewed whether the adequacy, availability, proficiency, competence, and resources of the audit team were appropriately assessed and documented.

Independence. We reviewed whether the independence of all individuals performing audit work, including specialists, had been properly assessed and documented.

Leadership and supervision. We reviewed evidence of whether individuals working on the audit received an appropriate level of leadership and direction and whether adequate supervision of all individuals, including specialists, was provided to ensure that audits were carried out properly.