

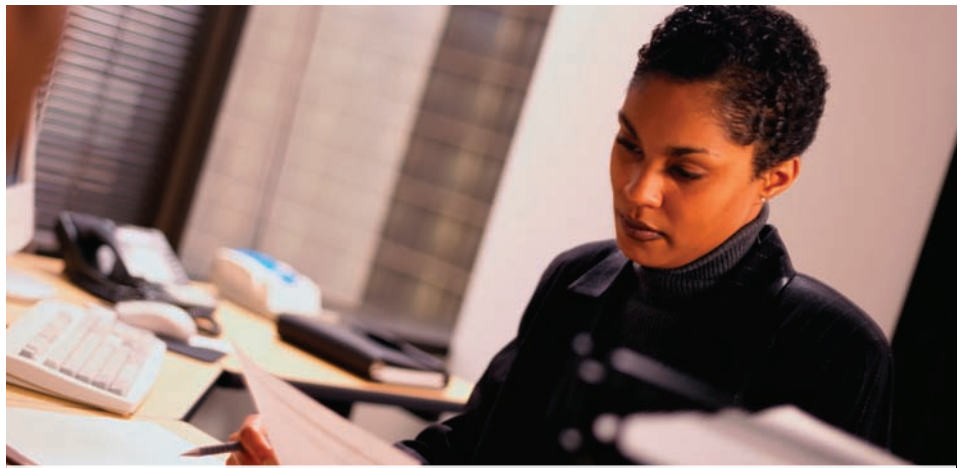
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Previous issues of *Risk Alert* are available on the AASB’s website ([www.aasb.ca](http://www.aasb.ca)). Suggestions for and comments on *Risk Alert* are always appreciated and may be directed to:

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# risk

# ALERT

FOR CHARTERED ACCOUNTANTS PERFORMING AUDIT AND REVIEW ENGAGEMENTS

## Responding to the Special Needs of Regulators or Funding Bodies

Auditors are often requested to provide audit opinions in accordance with the reporting requirements of certain regulators or funding bodies as a by-product of the financial statement audit (“derivative reports”). However, recent changes to auditing and assurance standards now clarify that derivative reports may only be issued in the limited circumstances set out in Assurance and Related Services Guideline AuG-13, *Special Reports on Regulated Financial Institutions*. This Risk Alert explains the dangers of issuing derivative reports and provides suggestions on how auditors can better meet the reporting

needs of regulators or funding bodies by other means.

### What is a derivative report?

The mandate of an auditor of a regulated entity, or an entity that has received funding from a funding body, may include special reporting responsibilities in addition to the responsibility to report on the financial statements to the owners of the entity, the regulator or the funding body. These special reporting responsibilities may be set out in legislation and may require the auditor to report, for example:

- matters that come to his or her attention during the financial statement audit;
- compliance with certain legislative requirements or the requirements of an operating agreement between the entity and the funder; or
- on a schedule of supplementary financial information.

General and subjective terms are often used in legislative requirements or operating agreements to describe the matters on which derivative reports are required. Further, there is rarely a clearly articulated concept of materiality.

Often the wording of the special report is set out in legislation or in guidance materials issued by the regulator or funding body and is not wording that has been developed or reviewed by either the CICA or a provincial Institute/Ordre. In other cases, the report wording may be developed by the auditor, for example, by analogizing from AuG-13 or from US auditing standards. Such report wording may not comply with the standards in the CICA Handbook – Assurance, or may be based on the form of report set out in the Handbook for special reporting engagements.

There is often an expectation on the part of the entity, the regulator or the funding body that the auditor will meet the special reporting requirements without performing audit procedures beyond those required as part of the normal financial statement audit.

Auditing and assurance standards staff have encountered the following examples where derivative reports have been requested:

- The "Year-end Reporting Handbook (YRH) for First Nations, Tribal Councils and First Nation Political Organizations" ("First Nations") issued by Indian and Northern Affairs Canada (INAC) sets out

requirements related to federal government funding of First Nations activities. The YRH requires that auditor attestations accompany various schedules of financial information to be submitted by a First Nation (for example, the schedules listed in YRH Annexes D to G).

One of the reporting options is for the auditor to provide a "derivative report".

- The Canada Mortgage and Housing Corporation (CMHC) has operating agreements with entities such as housing co-operatives, First Nations, non-profit housing sponsors and urban native housing sponsors. Each operating agreement contains requirements for the auditor of the financial statements of the entity to confirm the entity's compliance with certain requirements of that agreement. Further, the guides provided by CMHC to assist in preparing the financial statements and the auditor's reports present the confirmations to be provided by an auditor as a form of audit opinion.

### Problems with derivative reports

- A derivative report does not provide assurance on the accuracy of individual detailed amounts such as those contained in confirmations of compliance or supplementary schedules of financial information. A derivative report is designed to communicate matters that came to an auditor's attention as a result of auditing the entity's financial statements. In completing an audit of financial statements, auditors establish materiality, below which individual items may not be tested. A balance disclosed on the financial statements may be comprised of a number of items that fall below the level of materiality and therefore are not individually tested.

- While the auditor has conducted tests for the purpose of issuing an audit opinion on the financial statements of the entity, he or she has not necessarily conducted audit tests on all the amounts comprising an account or performed sufficient testing during the audit to issue a separate opinion on such verification.
- General and subjective terms are often used in legislative requirements or operating agreements to describe the matters on which derivative reports are required. The auditor requires reasonable and attainable standards against which he or she can evaluate the adequacy of the matters to be reported on — known as "suitable criteria". However, these have often not been developed.

Accordingly, while the regulator or funding body may believe that the auditor's derivative report provides assurance that the subject matter can be relied upon, in fact no assurance can be given by the auditor in that regard based on the financial statement audit. For these reasons, the AASB believes it is inappropriate for auditors to issue derivative reports except within the limited scope of AuG-13. In addition, auditing and assurance standards staff have already communicated the AASB's concerns with derivative reports to both INAC and CMHC.

### How can auditors meet the reporting needs of regulators or funding bodies?

The AASB believes that for regulators or funding bodies to get the assurance they need regarding special reporting requirements, it would be much more effective to ask a funded entity's auditors to report under either Section 5805, *Audit Reports on Financial Information Other than Financial*

*Statements*, or Section 5815, *Audit Reports on Compliance with Agreements, Statutes and Regulations*. Of course, this more detailed audit work would result in increased audit costs. The regulator or funding body would need to assess whether the benefits of a high level of assurance would outweigh the added costs.

Another perhaps less costly option would be for the regulator or funding body to ask a funded entity's auditors to perform a separate engagement under Section 9100, *Reports on the Results of Applying Specified Auditing Procedures to Financial Information Other than Financial Statements*. A Section 9100 approach would entail the auditor being asked to perform specified auditing procedures, which would be agreed with both the entity and the regulator or funding body in advance, that would be targeted at key areas where the regulator or funding body may have concerns.

Regulators or funding bodies may also consider requiring separate engagements that provide a moderate level of assurance, such as are described in Section 8500, *Reviews of Financial Information Other than Financial Statements*, and Section 8600, *Reviews of Compliance with Agreements and Regulations*.

Before accepting an engagement to issue a special report, the auditor would consider whether the engagement would fit within any of the above engagement types. If not, it may not be possible for the auditor to accept the engagement.

Auditors should also be careful not to provide assurance on a subject matter for which management is not willing to accept responsibility. Before accepting a special reporting engagement, the auditor should ensure that management is willing and able to provide an explicit representation with respect to the subject matter upon which the auditor is being asked to report.

### **Conclusion**

Given the problems with derivative reports, now is an appropriate time for auditors to discuss with the entity and the regulator or funding body the different means by which the auditor can meet his or her reporting requirements other than by issuing a derivative report.

Auditors who are unsure about their reporting responsibilities may wish to seek advice from the practice advisors at their provincial Institute/Ordre.

