CPA CHARTERED PROFESSIONAL ACCOUNTANTS

GUIDE TO CANADIAN INDEPENDENCE STANDARD

2016 UPDATE

This *Guide to Canadian Independence Standard* ("Guide") has been prepared to assist members, firms, students, candidates, and applicants[1] in understanding and applying the independence standard. This version provides updates for amendments to Rule 204 *Independence* of the CPA Code of Professional Conduct ("CPA Code ") up to and including changes relating to breaches and contingent fees that were presented to provincial CPA bodies for approval in 2016[2].

Disclaimer

This Guide is neither a definitive analysis of the standard nor a substitute for a careful reading of Rule 204 and its accompanying Guidance. 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 CPA body might be helpful and is encouraged.

The CPA Code includes interpretive Guidance that provincial Councils are not bound by, but still follow (except in Quebec where the Guidance has not been adopted by the syndic or Discipline Council of the Order).

1 Provincial CPA bodies use variations of the terms "members, firms, students, candidates, and applicants" in their CPA Code of Professional Conduct, or one term ("registrants") to refer to all. Refer to your provincial body for the appropriate terminology.

2 Members and firms need to follow pre-existing requirements in the CPA Code until these changes have been adopted by their provincial CPA body and are in effect.

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1.0 INTRODUCTION

It is a fundamental principle of the practice of Chartered Professional 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 204 *Independence* ("Rule 204" or the "independence standard") outlines the requirements for independence that apply to all members and firms when they conduct an assurance engagement or a specified auditing procedures engagement. Although an engagement to report on the results of applying specified auditing procedures is not an assurance engagement as contemplated in the *CPA Canada Handbook – Assurance*, for the purposes of Rule 204.4 and this Guide, reference to an assurance engagement also includes a specified auditing procedures engagement.

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.

This Guide is intended to help members and firms understand and apply the independence standard. It is not intended to be a substitute for a careful reading of Rule 204 and its related Guidance in the context of a particular situation. For most provinces, except Quebec, Guidance that provides a significant amount of interpretation and application material, including examples, accompanies the Rule 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 Guidance that is adopted in other provinces.) This Guide is not intended to be comprehensive or all-inclusive.

2.0 OVERVIEW OF INDEPENDENCE STANDARD

Definitions

The CPA Code has a general definitions section that includes terms used in more than one Rule. Some Rules, such as Rule 204, also have some definitions which are specific to that Rule. Some general definitions and definitions specific to Rule 204 are highlighted throughout the Guide.

Framework

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, including activities, interests, and relationships 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, interest or relationship 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.

If a member or student identifies a breach of the independence requirements, whether inadvertent or otherwise, certain requirements and processes must be followed. (New in 2016)

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 in this Guide.

Prohibitions

Some provisions of Rule 204 set out "prohibitions", which are those circumstances that must be avoided. They preclude performing the engagement because adequate safeguards do not exist that could eliminate the threat or reduce it to an acceptable level. In situations where a prohibition has been identified, the engagement should not be accepted, or must be discontinued if it has already been accepted.

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 and listed entities.

See Section 3.0 *Prohibitions* for a discussion of the various types of prohibitions.

Threats and Safeguards

Rule 204 establishes a framework for identifying, evaluating and addressing the significance of any threat to independence, which involves the process outlined below.

1. Identify and evaluate threats to independence. Threats are categorized as:
   - self-interest
   - advocacy
   - intimidation
   - self-review
   - familiarity

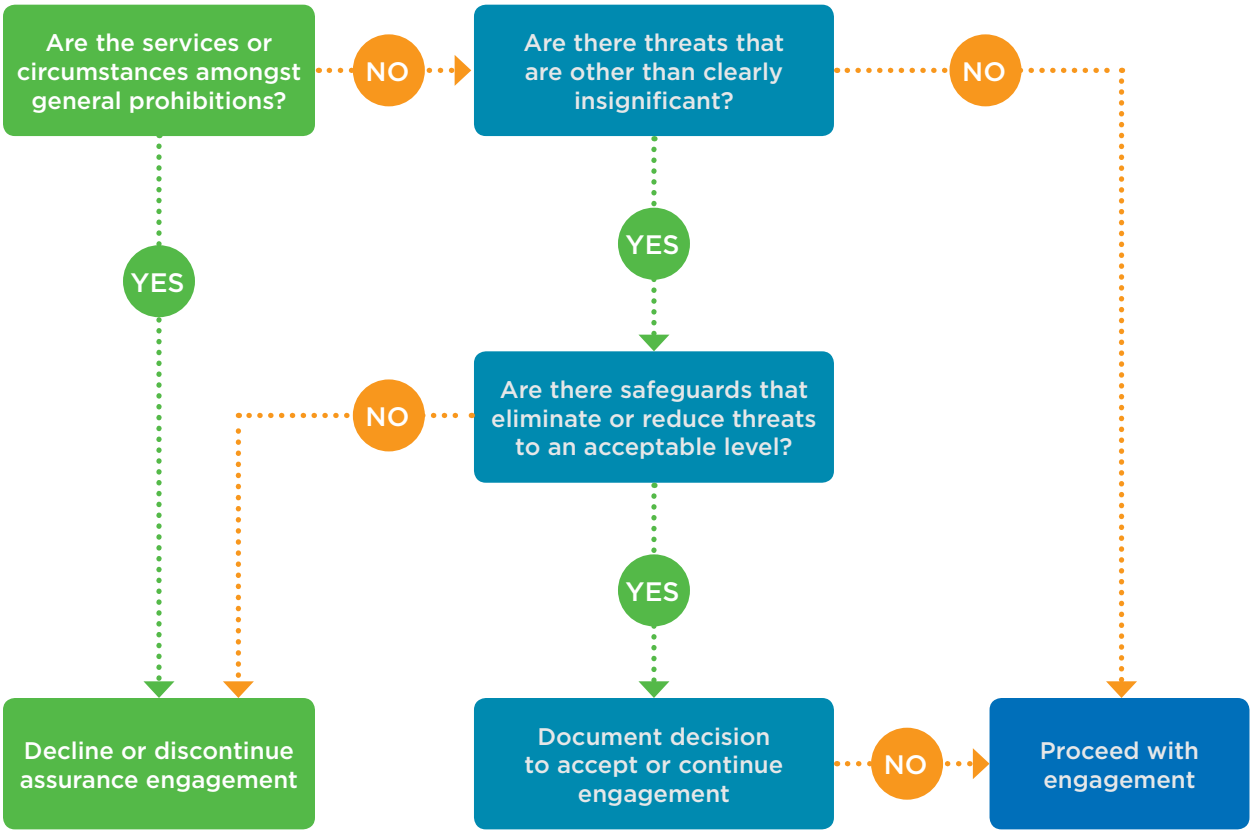
These threats are discussed in Section 4.0 of the Guide.

2. a. 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. Safeguards are discussed in section 5.0 of the Guide.

   b. Wherever threats that are other than clearly insignificant cannot be reduced to an acceptable level, the member or firm should:
      - 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 in accordance with Rule 204.5, 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.

Overview of Independence Standard for Assurance Engagement – Flowchart



Breaches of an Independence rule

There may be occasions when a member, a firm or a network firm is in breach of a provision of the requirements of Rule 204.3 or 204.4, whether inadvertently or otherwise. Requirements and processes to be followed when a breach is identified are outlined in Section 7.0 of the Guide.

3.0 PROHIBITIONS

Rule 204.4 describes circumstances 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 is prohibited from performing the assurance engagement. The requirements to avoid these circumstances are referred to as "prohibitions".

Some prohibitions apply to all assurance engagements while others only apply to audit and review engagements or to audits of reporting issuers or listed entities. It is important to understand that the portions of Rule 204 relating to "all assurance engagements" form the base independence requirements, with an additional layer of requirements that apply to "all audits/reviews" and a final layer that applies to "reporting issuer/listed entity" clients. The prohibitions applicable to audits of reporting issuers or listed entities were developed having regard to the current expectations of securities regulators, investor groups and other stakeholders.

In some circumstances the relationship that the client has with other entities ("related entities") has an impact. The term "related entity" includes different entities depending on whether the engagement is an audit or review engagement or an "other assurance" engagement and whether the client is a "reporting issuer/listed entity" or not. It is also important to note that the term "audit client", when used in paragraphs 204.4(1) to (12) includes related entities of the client. There are specific definitions of "audit client" and "related entity" (and additional Guidance) in Rule 204.

The term "network firm" is also used in relation to audits and reviews, whether the client is a reporting issuer/listed entity or not. It is not normally necessary to specifically identify threats created by circumstances involving network firms with respect to "other assurance" engagements. There is a specific definition of "network firm" (and additional Guidance) in Rule 204.

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 on behalf of the firm). These retired partners are considered to be members of the firm for the purposes of Rule 204. (See "member of a firm – retired partner" in the Guidance to Rule 204 *Definitions* for more details.)

3.1 Prohibitions Applicable to Assurance Engagements Including Audits and Reviews

1. Members and students of the engagement team (and immediate family members) and firms may not have a financial interest, as described in Rule 204.4(1) to (6), in an assurance client or its related entities. This prohibition against holding a financial interest is also extended to network firms in the case of audit and review clients.

   For example, Rule 204.4(1) to (6) includes prohibitions that a direct financial interest or a material indirect financial interest in an audit or review client shall not be held by:

   - The firm or a network firm;
   - A member or student on an engagement team, or any of that individual's immediate family;
   - Any other partner in the office in which an engagement partner practices in connection with the assurance engagement, or any of that other partner's immediate family;

- Any other partner or managerial employee who provides non-assurance services to the assurance client, or any of their immediate family, unless the non-assurance service is clearly insignificant.

2. The firm, a network 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 business with a client that is a bank (or similar financial institution) [Rule 204.4(10) to 12)]

3. Rule 204.4(13) to (19) address relationships between the client and the firm, a network firm, engagement team members and their family:
   - 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 and the business relationship is clearly insignificant to the client, the firm and the member, as applicable. [Rule 204.4(13)]
   - Members of the engagement team may not have an immediate family member in a position with the client (during the period covered by the assurance report or the engagement period) where that person would be able to influence the subject matter of the assurance engagement. [Rule 204.4(14)]
   - Staff of a member or firm or network firm may not be temporarily loaned to an audit or review client or related entity unless the loan is for only a short period of time, is not recurring, does not result in the loaned staff making management decisions or performing management functions and their work is directed and supervised by management of the entity or related entity. [Rule 204.4(17)(b)]
   - Members of the engagement team must not be an officer or director of the client or a related entity, 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 or, in some cases, a network firm, may not be officers or directors of an assurance client. [Rule 204.4(18)]

4. Members and firms (and as specified in some cases, network firms) are prohibited from performing management functions (as described in Rule 204.4(22) and its related Guidance) for an assurance client or a related entity unless the management decision or management function is not related to the subject matter of the assurance engagement that is performed by the member or firm.

   Members or firms are prohibited from performing management functions for audit or review clients, whether or not the management decision or management function is related to the subject matter of the audit or review engagement that is performed by the member or firm.

   Members and firms (and as specified in some cases, network 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 1 to 10 of the Guidance to Rule 204.4(22) to (24) for more details.

5. Members, firms and network firms may not provide valuation services to an audit or review client or a related entity where the valuation involves a significant degree of subjectivity and relates to amounts that are material to the financial statements subject to audit or review by the member or the firm. [Rule 204.4(25)(a)]

6. Members, firms and network firms may not provide internal audit services to an audit or review client or related entity unless certain conditions are met. [Rule 204.4(27)(a)]

7. Members, firms and network firms may not provide information technology system design and implementation services to an audit or review client or related entity if the systems form a significant part of internal control or generate information that is significant to the accounting records or financial statements subject to audit or review, unless certain conditions are met. [Rule 204.4(28)(a)]

8. Members, firms and network firms may not provide litigation support services to audit or review client or related entities if the services relate to amounts that are material to the financial statements subject to audit or review. [Rule 204.4(29)]

9. Members, firms and network firms may not provide legal services to audit or review clients or related entities that involve resolving disputes of matters that are material to the financial statements subject to audit or review. [Rule 204.4(30)]

10. Members, firms and network firms may not provide corporate finance and similar services to audit or review clients or their related entities, including: dealing in, promoting, or buying/selling their securities; acting on their behalf in making investment decisions or executing investment transactions; taking custody of their assets; or advising them on other corporate finance matters as outlined in Rule 204.4(33).

11. A member, firm or network firm may not provide a tax advisory service to an audit or review client or related entity in circumstances where the effectiveness of the advice depends on a particular accounting treatment or presentation, the effect of the advice is material to the financial statements, and the engagement team has reasonable doubt as to the appropriateness of the related accounting treatment or presentation. [Rule 204.4(34)(a)]

    With respect to tax preparation services, paragraph 4 of the Guidance to Rule 204.4(34) highlights that providing tax return preparation services that are subject to audit or other review by tax authorities does not ordinarily create a threat to independence, provided that management takes responsibility for the returns including any significant judgments made.

12. If certain conditions are not met, a member or firm may not be able to perform an audit or review engagement where a member or firm has provided non-assurance services as outlined in Rules 204.4(22) to (34), prior to being engaged to perform an audit or review engagement. [Rule 204.4(35)(a)]

13. 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 or firm can demonstrate that all professional standards have been met in performing the service, and that qualified members of the firm have been assigned to the engagement and will devote the appropriate time to it. [Rule 204.4(36)]

14. A member or firm may not provide an assurance service on a contingent fee basis. Rule 204.4(36.1)(a) and(b) set out the circumstances under which a contingent fee may not be charged for the provision of a non-assurance service to an assurance client. In addition, a firm may not perform an assurance engagement if a network firm that participates in that engagement has provided another engagement on a contingent fee basis and that fee is material to that network firm. [Rule 204.4(36.1)]

15. Key audit partners may not be evaluated or directly compensated for selling non-assurance services to their audit or review clients or related entities. [Rule 204.4(38)]

16. Members and students on the engagement team and the firm may not accept other than clearly insignificant gifts or hospitality from an assurance client. [Rule 204.4(39)]

17. In some cases, an audit or review client might merge with another entity with which a member or firm has a previous or current activity, interest or relationship that, after the merger or acquisition, would not be permitted by Rule 204. In such cases, a member or firm may provide or continue with the audit or review engagement as long as certain conditions are met. The conditions are set out in Rule 204.4(40) and its related Guidance.

18. There are also requirements to be met in respect performing audits under federal, provincial or territorial elections legislation. Rule 204.20 outlines these requirements.

3.2 Additional Prohibitions Applicable to Reporting Issuers or Listed Entities Only

Public companies, which include mutual funds, are referred to in the independence standard as "reporting issuers" or "listed entities". There are specific definitions for these terms (and additional Guidance) in Rule 204 *Definitions*.

1. A person may not participate as a member of the engagement team for the audit of a reporting issuer or listed entity if a member of that person's immediate or close family has (or has had at a relevant time) an accounting role or financial reporting oversight role with the client. [Rule 204.4(15)]

2. A member or firm is prohibited from performing the audit of a reporting issuer or listed entity if an employee of the firm or network firm serves as a director or officer of the reporting issuer or listed entity or a related entity. There is no exception for serving as a company Secretary. [Rule 204.4(19)]

3. A firm may not perform an audit engagement for a reporting issuer or listed entity if a member of the firm's audit team accepts employment 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. If a former Chief Executive Officer (CEO) of the firm takes on a financial reporting oversight role, the firm may not perform an audit engagement for that entity unless one year has elapsed from the date that individual was the CEO. [Rule 204.4(16)]

4. Audit partners must take leave of the audit team for a reporting issuer/listed entity client or of a subsidiary thereof in accordance with the rotation requirements described in Rule 204.4(20).

5. The audit committee of a reporting issuer/listed entity client must pre-approve all professional services provided by the firm to the client. [Rule 204.4(21)]

6. Members, firms and network firms shall not perform an audit engagement for a reporting issuer/listed entity client (or in most cases, a related entity) if providing any of the following services:
   - Bookkeeping and accounting services, including the preparation of the financial statements, except under certain circumstances in emergency situations [Rule 204.4(24)];
   - Valuation services unless it is reasonable to conclude that the results of the services will not be subject to audit procedures [Rule 204.4(25)(b)];
   - Actuarial services unless it is reasonable to conclude that the results of the services will not be subject to audit procedures [Rule 204.4(26)];
   - Internal audit services unless it is reasonable to conclude that the results of the services will not be subject to audit procedures [Rule 204.4(27)(b)];

- Certain financial information systems design and implementation services unless it is reasonable to conclude that the results of the services will not be subject to audit procedures [Rule 204.4(28)(b)]; and
- Tax calculations for the purpose of preparing accounting entries, except under certain circumstances in emergency situations [Rule 204.4(34)(b)].

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

7. Members and firms shall not perform the audit for a reporting issuer/listed entity audit client or related entity if they or members of a network firm provide the following services, even if the results are not subject to audit:
   - Management functions [Rule 204.4(22)(b)];
   - Certain litigation support services for the purpose of advocating a client's position [Rule 204.4(29)(b)];
   - Legal services [Rule 204.4(31)]; and
   - Certain human resources services [Rule 204.4(32)].

8. Where a member, firm or network firm has provided non-assurance services outlined in Rules 204.4(22) to (34) for an audit or review client, prior to the client becoming a reporting issuer or listed entity, the member or firm shall not perform an audit engagement for the client unless certain conditions are met. [Rule 204.4(35)(b)]

9. Specific requirements apply when total revenue from a listed entity or reporting issuer audit client represents more than 15 percent of the firm's total revenue for two consecutive fiscal years, including a prohibition against performing the audit or review engagement in some circumstances. [Rule 204.4(37)]

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 CPA Code to cover every circumstance; it is up to the member to evaluate the various activities, interests and relationships in terms of what a reasonable observer would consider to be acceptable. There are five categories of threats 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 on 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 promotion of the products and/or services 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 30 to 35 of the Guidance to Rules 204.4(1) to (3) 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.

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. Otherwise the member or firm is required to eliminate the activity, interest or relationship that has created the threat(s), or must not accept or shall not continue the engagement. The term "safeguards" in this context is inclusive of measures that are preventative in nature, which are not considered to be sufficient by themselves.

There are three categories:

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

- Education, training and practical experience requirements for entry into the profession;
- Continuing education programs;
- Professional standards;
- External practice inspection;
- Disciplinary processes;
- Members' practice advisory services;
- Participation by members of the public in oversight and governance of the profession; and
- 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 may include:

- Employees of the client who are competent to make management decisions;
- Client policies and procedures that emphasize the client's commitment to fair financial reporting;
- Internal procedures that ensure objective choices in commissioning non-assurance engagements; and
- 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:

- Firm-wide policies and procedures, which promote a high degree of awareness and compliance with the requirements for independence; and
- 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 40 and 41 of the Guidance to Rule 204.1 to 204.3 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 Rule 204.5, 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 42 of the Guidance to Rule 204.1 to 204.3.

As noted in this Guidance, 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 alone are not sufficient for a particular threat, and other safeguards must 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 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 11 *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 or firm shall not perform the audit or review engagement for an entity if they 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 1 to 9 of the Guidance to Rule 204.4(22) to (24)).

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 the provision of the bookkeeping services influences his or her 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 5 of the Guidance to Rule 204.1 to 204.3). 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 is required to 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 6 of the Guidance to Rule 204.1 to 204.3). 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 or listed entities?

There is a prohibition on the provision of accounting or bookkeeping services to clients that are reporting issuers or listed entity [Rule 204.4(24)], 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. There are certain exceptions to this prohibition, in emergency situations, as explained in Rule 204.4(24).

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)(a) prohibits members and firms from providing valuation services to an audit or review engagement client where the valuation involves a significant degree of subjectivity and relates to amounts that are material to the financial statements, unless the valuation is done for tax purposes and certain other conditions apply. (For further discussion, refer to the Guidance to Rule 204.4(25)). There are specific prohibitions for reporting issuers or listed entities, as described below.

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

Even if the prohibition in Rule 204.4(25) does not apply, the specific circumstances must 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 4 of the Guidance to Rule 204.4(25) 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 or there may be a significant degree of subjectivity inherent in the valuation; 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 or listed entities?

There is a prohibition on the provision of valuation services to clients that are reporting issuers or listed entities [Rule 204.4(25)(b)], 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 — however, there is a rebuttable presumption that these services will be subject to audit.

7.0 BREACHES OF AN INDEPENDENCE RULE

Rule 204.6 addresses the situations when a member or firm has breached the provisions of Rule 204.3 and 204.4 and sets out requirements and processes for:

- reporting the issue within the firm,
- ensuring that the nature of the breach is analyzed and evaluated, that appropriate actions are taken, and that the breach is also communicated to network firms as appropriate;
- considering whether safeguards can be applied, and whether the assurance engagement may be continued or whether it should be terminated, and obtaining concurrence from client as appropriate
- considering whether previously issued assurance reports should be withdrawn,
- reporting the matter to responsible parties within the assurance client,
- documenting the analysis and conclusions, and
- reporting the matter to the provincial CPA body/Ordre.

Note that the Rule 204.6(h) provides a requirement for the member or firm to self-report to their provincial CPA body/Ordre in the event that the breach "results in a conclusion to withdraw any previously issued audit opinion, review engagement report or other assurance report".

8.0 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 204.9 and the related Guidance 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 204.10 requires that members and firms providing a professional service that does not require independence 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 Guidance to Rule 204.10 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 11 of the Guidance to Rule 204.4(22) to 204.4(24)." 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).

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 lead the reader to conclude that there was an independence requirement, even though there was not. In each situation, the member should also document in the file the assessment of whether there were any independence issues to be disclosed.

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 firm knows that the firm, a member of the engagement team, or that person's immediate family member (spouse or dependent), or a partner in the same office or that partner's immediate family member has a financial interest in the client, disclosure will be required. See the financial interest prohibitions for assurance engagements provided in Rule 204.4(1) to (6) 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 — 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 204.10 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 3 — 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, candidates or students shall not participate on engagement teams of assurance clients if the member's, candidate'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. 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 and listed entities, 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/listed entity client.)

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

Situation 4 — 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 [Rule 204.4(22)] for the client. There are no safeguards for this prohibition.

In the context of a compilation engagement, Rule 204.10 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 5 — 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)(a) 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 approval of the client's management.

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 be disclosed as an independence issue. In Quebec this situation would need to be described, except if the entries were basic mechanical and posting type entries or if they have been approved by the client.

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 11 of the Guidance to Rule 204.4(22) to (24) about the appropriateness of specific journal entries). If the additional procedures reduced the threat to independence to an acceptable level, 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.

Situation 6 — 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 of this nature 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, could 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 or a reasonable observer would see an impairment of independence, Rule 204.10 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.

9.0 COMMUNICATIONS

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

- Rule 204.7 requires any member, candidate 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, candidate 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 204.8 to ensure that members of the firm (including, in some cases, non-professional staff) 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.

9.2 Other Independence Requirements

- Members participating in any aspect of an insolvency practice are also required to remain free of influences, interests of relationships which could impair their professional judgment or objectivity [Rule 204.9].
- Audits under elections legislation include specific requirements related to the independence of auditors. Rule 204.20 provides additional material, as developed by the profession, in relation to such audits.

9.3 Communicating Independence Requirements to Clients

Rule 204.6 contains various requirements to communicate breaches of independence to clients, and in some cases, to the provincial body. There are also requirements established by the *CPA Canada Handbook – Assurance* to communicate independence matters to clients. Further details are provided below.

Audit Engagements

CAS 260.17, "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.

The auditor's independence is highlighted in the title of the auditor's report, "Independent Auditor's Report" (see CAS 700.21)

Review Engagements

For reviews of financial statements for periods ending before December 14, 2017

As outlined by paragraph 8200.69 of the *CPA Canada Handbook – Assurance*, "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."

For reviews of financial statements for periods ending on or after December 14, 2017

- Paragraph 19 of the Canadian Standard on Review Engagements 2400 *Engagements to review historical financial statements* ("CSRE 2400") states the practitioner's requirements to comply with relevant ethical requirements, including independence.
- Paragraph 40 of CSRE 2400 requires the practitioner to communicate with management or those charged with governance any matters that the practitioner considers to be of sufficient importance to merit their attention.
- Paragraph 94(a) of CSRE 2400 requires the title of the report to clearly indicate that it is the report of an independent practitioner. The sample report suggests, "Independent Practitioner's Review Engagement Report".

Compilation Engagements

Although independence is not required for compilation engagements, Rule 204.10 requires disclosure, in a compilation report, of circumstances where there is "an impairment of a member's independence." Further details are provided in Section 8.0 *Impact of Independence Rules on Compilation Engagements*. Rule 204.10 *Disclosure of Impaired Independence* applies to all services not subject to the requirements of Rules 204.1 to 204.9.

10.0 COMPLIANCE WITH INTERNATIONAL STANDARDS

An audit is premised upon an auditor complying with relevant ethical requirements, including those pertaining to independence. 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.

As a member of the International Federation of Accountants ("IFAC"), the Canadian CPA profession needs to monitor and consider any changes made to the International Ethics Standards Board for *Accountants Code of Ethics for Professional Accountants* (the "IESBA Code"). The independence standards in the rules of professional conduct of a provincial professional accounting body may be different from the IESBA Code. For instance, one of the main differences between Rule 204 and the IESBA Code is with respect to the definitions of "listed entity" and "reporting issuer". In Rule 204, these definitions excludes entities with market capitalization and total assets that are each less than $10,000,000, whereas the definition in the IESBA Code does not have this minimum cap.

Conducting an audit in accordance with Canadian generally accepted auditing standards does not automatically imply that it is in accordance with the ISAs. Differences between the CASs and ISAs are set out in the Preface to the *CPA Canada Handbook – Assurance*.

11.0 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.

Not all prohibitions or threats are covered by the situations described below. As noted in Section 1.0 *Introduction*, independence is a state of mind, both in fact and in appearance. 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.

11.1 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 2 of the Guidance to Rule 204.4 (10) to (12), 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. However, 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, office manager, etc.) is generally not considered to be a professional employee.

QUESTION 3

I am a sole proprietor and I live in a condominium. Can I be the auditor of the condominium corporation in which I own a unit?

ANSWER

Rule 204.1 requires members to remain independent and free of any interest or relationship in respect of the engagement that may impair the professional judgment or objectivity of the member in the view of a reasonable observer. While you do not have a direct financial interest in the condominium corporation (condo corp), your ownership of a unit in the condo corp may be perceived to impair your objectivity.

Condo corps are typically not-for-profit organizations, incorporated without share capital. Although Rule 204.4(1.1) does not specifically refer to condo corps, it can provide guidance, since the members of a condo corp (the unitholders) are similar in some respects to members of a co-operative, credit union, or social club. The Rule states that a member or student shall not participate on the engagement team for an assurance client that is a co-operative, credit union, or social club, if the member, student, or an immediate or close family member holds a financial interest and:

(i) serves on the governing body or as an officer of the organization;

(ii) has the right or responsibility to exercise significant influence over the financial or accounting policies of the organization or any of its associates;

(iii) exercises any right derived from membership to vote at meetings of the organization; and

(iv) can dispose of the financial interest for gain.

Since condominium unit owners can exercise their right to vote at meetings of the condominium corporation and the condominium unit can be disposed of for a gain, this would preclude you from taking part in the audit. This would also apply if an immediate or close family member, the firm, or a network firm (in the case of a practice other than a sole proprietorship) owned the condo unit instead of you.

Close Business Relationships with Clients

QUESTION 4

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 client foots the bill or 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 5

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 6

Can I audit my church/golf club/etc.?

ANSWER

It depends on the organization and your involvement with the organization's finances and/or accounting.

Paragraph 6 of the Guidance to Rule 204.4(18) and (19) provides that membership in a religious organization would not normally impair independence as long as neither the CPA nor the CPA'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.) It's important to keep in mind that this prohibition of serving as an officer or director of a client is applicable to all audit and review clients, including not-for-profit organizations.

Serving as an officer or on the Board of Directors of an assurance client is described in more detail in Rules 204.4 (18) and (19) and the related Guidance.

Rule 204.4(1.1) provides that you and your immediate or close family members can hold membership in a credit union (caisse populaire) or a social club as long as:

(a) The interest held is not more than the minimum amount of financial interest that is a prerequisite of membership,

(b) There are certain restrictions (as set out in Rule 204.4(1.1)(b)) on the distribution of the assets of the organization to its individual members, and

(c) The person holding the interest:

  (i) does not serve as a director or officer,

  (ii) cannot exercise significant influence over the financial or accounting policies,

  (iii) does not exercise any right to vote; and

  (iv) cannot dispose of the of the interest for gain.

Employment with a Client

QUESTION 7

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 or listed entity 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. In addition, if a former CEO of the firm takes on such a role with a reporting issuer/listed entity client, the firm may not perform an audit engagement for that entity, unless one year has elapsed from the date that individual was CEO. [See Rule 204.4(16)]

There are no prohibitions to prevent an audit team member or former CEO of the firm from going to

work for a client; however, members being offered employment by a reporting issuer or listed entity 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 staff members to evaluate the self-interest threat and mitigate any possible concerns by implementing appropriate safeguards.

Members should also keep in mind that disclosure to a designated partner of possible employment with an assurance client might be required by Rule 204.7.

Long Association of Senior Personnel with Audit Client

QUESTION 8

Do we have to rotate partners on all assurance engagements?

ANSWER

The rotation requirements outlined in Rule 204.4(20) are for reporting issuers and listed entities only; this includes mutual funds. There are three categories of audit partner for reporting issuer/listed entity 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 seven years. After seven years they will be subject to a five-year "time-out" period before participating in the audit of the financial statements.

2) The quality control reviewer (often called the reviewing or second partner) is subject to the same requirements as the lead engagement partner.

3) A key audit partner, other than the lead engagement partner or quality control reviewer, must rotate after seven years and be subject to a two-year time out period. Rule 204 includes a definition for "key audit partner".

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 9

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

A member or firm or network firm (as described in Rule 204.4(17)(b)) shall not provide assurance services if staff are temporary loaned to an audit or review client or related entity unless the loan of temporary staff is made for only a short period of time, is not made on a recurring basis, does not result in the person making management decisions or performing management functions, and management of the entity or related entity directs and supervises the work performed by the temporary staff.

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 10

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 204.4(22) 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 5 of the Guidance to Rule 204.4(22) to (24). 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 11

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) and the related Guidance.

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 13 for a situation involving journal entries for complex transactions.)

If you do not apply safeguards to reduce the self-review threat to an acceptable level, 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 1 to 10 of the Guidance to Rule 204.4(22) to (24) 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 if management approval has not 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 12

I have many small private company clients who only require compilation engagements. At year-end they expect me to assist with the preparation of adjusting journal entries for complex transactions, 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 204.1. The preparation of journal entries for complex transactions is, however, an activity that would be disclosed pursuant to Rule 204.10 in the Notice to Reader if these entries are such that management cannot be reasonably expected to understand, review, and approve them. (See also Questions 11 and 13).

QUESTION 13

I am a sole practitioner and many of my clients are owner-managed enterprises that rely on me to help record accounting entries for complex 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 CPA 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 9 to 11 of the Guidance to Rule 204.4(22) to (24) for additional guidance.

Provision of Non-Assurance Services to an Assurance Client

QUESTION 14

If you are asked by the shareholder of an 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, although the independence threat arises once the shareholder passes away. This is due to the fact 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 requirements, 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 4 of the Guidance to Rule 204.4(1) to (3), 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 framework established by the independence requirements.

QUESTION 15

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 as follows:

- Paragraph 47 of the Guidance to Rule 204.1 to 204.3 provides a list of safeguards that may be put in place to protect against possible impairment that may be caused by the provision of non-assurance services.
- Paragraph 1 of the Guidance to Rule 204.4(22) to (24) also recognizes that engagements to assess and provide recommendations with respect to improvements in internal control procedures would not necessarily impair independence.
- Paragraphs 1 to 6 of the Guidance to Rule 204.4(27) 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 16

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

ANSWER

The ability to provide secretarial services is described in Rule 204.4(18) and its related Guidance. Depending on the degree of association created with the client and 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; these services are addressed by Rule 204.4(30) and (31) and the related Guidance.

QUESTION 17

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" or a "related business or practice", which are consider to be a firm for purposes of Rule 204. The definition of a network firm, and related Guidance, is included the Rule 204 *Definitions* section. The definition of a "related business or practice" is found in the general Definitions section of the CPA Code.

In most cases, it is likely that a management company will be either a related business or practice or a network firm.

QUESTION 18

Given that CPAs 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 CPA may be in a position of reporting on financial statements at least once more. Depending on the level of involvement with the sale, this may create an independence issue as the sale may be dependent on what is portrayed in the financial statements. The most relevant guidance is found in Rule 204.4(33) *Provision of corporate finance and similar services to an audit or review client*. The Rule also 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.

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 CPA 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 2 of the Guidance to Rule 204.4(33), it may be possible to provide assistance as well as assurance services.

Rule 204.4(40) *Client mergers and acquisitions* (and related Guidance) states that a "member or firm shall not perform or continue with an audit or review engagement for an entity where, as a result of a merger or acquisition, another entity merges with or becomes a related entity of the audit or review client, and the member or firm has a pervious or current activity, interest or relationship with the other entity that would, after the merger or acquisition, be prohibited pursuant to any provision of Rule 204 in relation to the audit or review engagement" unless various steps are taken as established by the Rule.

QUESTION 19

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 the Guidance to the definition of "member of the firm" in Rule 204 *Definitions*), and as a result, the retired partner would still be subject to Rule 204.1 to 204.10. 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 based on how the retired partner is portrayed to clients, and their roles and responsibilities within the firm. 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 or listed entities, Rule 204.4(16) does not allow a member or firm to perform an audit engagement for a reporting issuer/listed entity 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. In addition, if a former Chief Executive Officer (CEO) of the firm takes on various roles (officer, director, or financial reporting oversight) with a reporting issuer or listed entity audit client, the firm shall not perform an audit engagement for that entity unless one year has elapsed from the date that individual was the CEO.

QUESTION 20

My audit client has asked me to perform valuation services for an estate freeze. Can my firm perform these services in the scenario outlined below?

Scenario

Opco is an incorporated audit client and is wholly owned by Mr. A. The shares held by Mr. A have a cost of $100 and a fair value of $10 million. Mr. A would like to perform an estate freeze whereby he will exchange his common shares for preferred shares. The preferred shares will be redeemable and retractable at an amount equal to the current fair market value of the corporation.

In addition to giving tax advice, a CBV who is an employee (could also assume the CBV is a partner) of the CPA firm will provide a valuation of the shares to be used in the estate freeze. Mr. A will use this valuation to select a redemption value (say $10 million) for the preferred shares from a valuation range. The CPA firm will then send an instruction letter to his lawyer who will draft the necessary legal documentation.

In Opco's books and records, the common shares outstanding before the freeze will be cancelled and new preferred shares will be issued at the same nominal amount. In the financial statements, the amounts reported in share capital will remain nominal (and immaterial) and the notes to the financial statements will reflect that the preferred shares are redeemable and retractable at $10 million.

ANSWER

Rule 204.4(25)(a) *Provision of valuation services to an audit or review client that is not a reporting issuer or listed entity* states that:

> "A member or firm shall not perform an audit or review engagement for an entity if, during either the period covered by the financial statements subject to audit or review or the engagement period, the member, the firm, a network firm or a member of the firm or a network firm, provides a valuation service to the entity or a related entity where the valuation involves a significant degree of subjectivity and relates to amounts that are material to the financial statements subject to audit or review by the member or firm, unless the valuation is performed for tax purposes only and relates to amounts that will affect such financial statements only through accounting entries related to taxation."

In considering whether this scenario would be prohibited, the following factors should be considered:

- What is the degree of subjectivity involved?
- Are the results of the valuation service material to the financial statements?
- Is the valuation performed for tax purposes only?

Degree of subjectivity involved

Paragraph 5 of the Guidance to Rule 204.4(25) states that certain valuations do not involve a significant degree of subjectivity. This is likely the case where the underlying assumptions are

either established by law or regulation, or are widely accepted and when the techniques and methodologies to be used are based on generally accepted standards or prescribed by law or regulation. Assuming that this is not the case in this scenario, one would conclude that there is a significant degree of subjectivity involved.

Amounts that are material to the financial statements

The materiality of the results of the valuation services and the amounts recorded and/or disclosed in the financial statements must be assessed. In this case, although the transaction is recorded at a nominal carrying amount, the notes to the financial statements will reflect that the preferred shares are redeemable and retractable at $10 million. Assuming this amount is material to the financial statements, there are no safeguards that could be applied to reduce this threat to an acceptable level.

Performed for tax purposes only

Since Mr. A's driving motivation for the reorganization is to reduce and/or defer tax and the valuation is an important element of a plan to accomplish this, one could argue that the valuation is being performed for tax purposes only. However, the valuation is related to amounts that will affect the financial statements through accounting entries or balances that are not solely related to taxation. Share capital and/or debt and related note disclosures are all impacted by the valuation. Therefore, it would appear that the tax exemption does not apply in this scenario.

Conclusion

Based on the significant degree of subjectivity involved and the materiality of the results of the valuation services recorded and/or disclosed in financial statements, the firm would be prohibited from performing the valuation service and conducting the audit.

QUESTION 21

My tax client is a property manager and would like to amend its business model to align with investors' long-term intentions. Land inventory (current) would be reclassified in the financial statements as a real estate investment (non-current). Therefore, the accounting and tax treatment of the interest on loans and property taxes would be significant and differ substantially from one model to the next. Upon the sale, the gain could be considered a taxable capital gain by the tax authorities rather than business income. I provide tax planning advice in addition to preparing the corporation's tax returns. Can my firm perform an audit engagement for this client?

ANSWER

Where a member or firm has provided tax planning or other tax advice to a client, Rule 204.4(34)(a) prohibits the member or firm from performing the audit or review engagement for this client or a related entity if:

(a) the effectiveness of the advice depends on a particular accounting treatment or presentation in the financial statements;

(b) the outcome or consequences of the advice has or will have a material effect on the financial statements; and

(c) the engagement team has reasonable doubt as to the appropriateness of the related accounting treatment or presentation under the relevant financial reporting framework.

Paragraph 6 of the Guidance to Rule 204.4(34) states that where the efficacy of implementing such tax planning or other tax advice depends upon a particular accounting treatment or presentation,

there may be pressure to adopt an accounting treatment or presentation that is inconsistent with the relevant financial reporting framework. In this example, the tax advice includes a recommendation that land inventory (current) be reclassified as a real estate investment (non-current) based on a more favorable tax treatment, which is dependent upon the tax authorities' acceptance of the business model. However, the appropriate financial reporting framework might require a different classification. The resulting conflict between the two treatments threatens independence and may result in the member or firm being prohibited from performing the audit engagement. Accordingly, the member or firm must review the materiality of the effect of the tax planning or other tax advice and the appropriateness of the related accounting treatment or presentation with the audit or engagement team as soon as possible prior to completion of the tax planning or other tax advisory service. If it is determined that the proposed accounting treatment or presentation is not appropriate under the relevant financial reporting framework, and it has a material effect on the financial statements, the firm would be prohibited from performing an audit or review engagement for this client.

Fees

QUESTION 22

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

ANSWER

As outlined by paragraph 6 of the Guidance to Rule 204.4(36) and (37), 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;
- Whether payment arrangements have been agreed; and
- Any unique or non-recurring circumstances that the client is currently facing.

QUESTION 23

I have been asked to prepare a Scientific Research and Experimental Development (SR&ED) claim for an audit client. Can I bill this work on a contingent fee basis?

ANSWER

Rule 204.4(36.1)(c) sets out the circumstances under which a contingent fee may not be charged for the provision of a non-assurance service to an audit or review client, and outlines a number of considerations regarding the materiality of the contingent fee to the firm, the member of the audit or review engagement team, or to the financial statements that are subject to audit or review by the member or firm.

Assuming that the restrictions above are not met, a threat to independence may still be created by the contingent fee arrangement. The significance of any threat created will depend on such

factors as outlined in paragraph 3 of the Guidance to this Rule. Guidance is also provided on which safeguards that might reduce the threat to an acceptable level.

11.2 Threats — All Clients

QUESTION 24

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. In addition, a report should be attached to the forecast to clearly communicate the member's involvement in compiling the information. The member 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 2 of the Guidance to Rule 204.4(33).]

QUESTION 25

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 does not constitute the creation of source document, and thus 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 and any potential legal issues, the client should send these communications to the tenants.

QUESTION 26

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.

QUESTION 27

Our firm is discussing with CRA matters related to 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

Providing tax advocacy services where the advice is clearly supported by tax authorities or other precedent, by established practice or has a basis in tax law that is likely to prevail does not ordinarily create a threat to independence that cannot be adequately offset by available safeguards. However, as discussed in paragraphs 7 and 8 of the Guidance to Rule 204.4(34), such services may involve the provision of litigation support services, legal services or both. Assistance during the assessment or objection stage is generally not considered providing litigation support or legal services. However, members and firms should evaluate whether the provision of additional tax advocacy services involves the provision of a service that would be prohibited pursuant to Rules 204.4(29)(a) or (b), (30) or (31).

QUESTION 28

My owner managed audit client has asked me to provide tax planning advice and prepare the corporation's tax returns in addition to the audit. Am I allowed to do this?

ANSWER

Rule 204.4(34)(a) prohibits a member or firm from providing tax planning or other tax advice to an audit or review client, where:

(a) the effectiveness of the advice depends on a particular accounting treatment or presentation in the financial statements;

(b) the outcome or consequences of the advice has or will have a material effect on the financial statements; and

(c) the engagement team has reasonable doubt as to the appropriateness of the related accounting treatment or presentation under the relevant financial reporting framework.

Assuming the prohibition in 204.4(34)(a) does not apply, the provision of tax services may still create a self-review threat where the advice or service affects the audited financial statements. The existence and significance of any threat will depend on factors as outlined in paragraph 2 of the Guidance to Rule 204.4(34), such as:

- the nature of the tax service that is provided;
- the degree of subjectivity involved in determining the appropriate treatment of tax advice in the financial statements;
- the extent to which the outcome of the tax service has or will have a material effect on the financial statements subject to audit or review by the member or firm ;
- the level of tax expertise of the client's employees;
- the extent to which the advice is supported by tax law or regulation, other precedent or established practice; and
- whether the tax treatment is supported by a private ruling or has otherwise been cleared by the tax authority before the preparation of the financial statements.

The significance of any threat should be evaluated and, if it is other than clearly insignificant, safeguards should be applied to reduce it to an acceptable level, as outlined in paragraph 3 of the Guidance to Rule 204.4(34).

Providing tax planning advice where the advice is clearly supported by tax authorities or other precedent, by established practice or has a basis in tax law that is likely to prevail does not ordinarily create a threat to independence, unless the circumstances described in Rule 204.4(34)(a) exist.

In addition, paragraph 4 of the Guidance indicates that tax return preparation services (which are subject to audit or other review by tax authorities) do not ordinarily create a threat to independence, provided that management takes responsibility for the returns including any significant judgments made.

11.3 Reporting Issuers and Listed Entities

QUESTION 29

How do I determine if my public company clients meet the definition of a "reporting issuer" or "listed entity"?

ANSWER

Rule 204 provides specific definitions are provided for "reporting issuer", "listed entity", "market capitalization," and "total assets". These concepts are also discussed in Section 3.2 of the Guide.

An example of the calculation is provided below.

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	$ 9,950,000
Total		$40,100,000
Average		$10,025,000

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

QUESTION 30

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

ANSWER

Rule 204 provides specific definitions are provided for "reporting issuer", "listed entity", "market capitalization," and "total assets". Market capitalization is measured at the closing price on the day of the public offering and total assets are based on the most recent financial statements that are included in the public offering document. These concepts are also discussed in Section 3.2 of the Guide.

An example of the calculation is provided below.

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 or listed entity 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 31

My client originally met the definition of "reporting issuer" or "listed entity" 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 32

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 3 of the Guidance to Rule 204.4(20) would apply, so that if the key audit partner had been in that role for five or more years at the time the client became the reporting issuer or listed entity (per the reverse takeover), then he or she could continue in that role for two more fiscal years before being replaced.

QUESTION 33

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 6 of the Guidance to Rule 204.4(22) to (24) discusses the circumstance in this question. It says in part, "...management will often request and receive input regarding such matters as accounting principles and financial statement disclosure...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. In some situations, the client may need to engage other experts to assist them.

QUESTION 34

How much assistance can we provide our assurance clients with their transition to a new financial reporting framework)?

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 a new financial reporting framework may create threats, such as self-review or self-interest threats to independence as discussed in paragraph 46 of the Guidance to Rule 204.1 to 204.3.

If your client is a reporting issuer/listed entity:

Rule 204.4(22) through (28) sets out management related and non-audit activities that firms may not perform for their reporting issuer/listed entity 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 6 of the Guidance to Rule 204.4(22) to (24), management often seeks and receives input from their auditors on technical matters... Examples of technical matters include: "...accounting principles, financial statement disclosure. ... 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 Financial Reporting Standards)." Rule 204.4(24) also provides relief, under certain circumstances, in emergency situations.

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/ listed entity client, will require prior approval by the audit committee (per Rule 204.4(21)), unless the requirements set out in paragraph 3 of the Guidance to Rule 204.4(21) are met.

QUESTION 35

Our firm has been preparing tax returns for my audit client, which is a reporting issuer. Can we do this?

ANSWER

Rule 204.4(34)(b) states that a firm shall not perform an audit engagement for a reporting issuer or listed entity if, in other than emergency situations, during either the period covered by the financial statements subject to audit or the engagement period, the firm prepares tax calculations of current and future tax liabilities or assets for the reporting issuer or listed entity or a related entity for the purpose of preparing accounting entries that are subject to audit by the firm.

However, there is some relief in certain emergency situations, such as when:

(a) there are no viable alternative resources to those of the firm with the necessary knowledge of the client's or related entity's business to assist in the timely preparation of such tax calculations; and

(b) a restriction on the firm's ability to provide the services would result in significant difficulties for the client or related entity, for example, as might result from a failure to meet regulatory reporting requirements, in the withdrawal of credit lines, or would threaten the going concern status of the client or related entity. Significant difficulties would not be created simply by virtue of the fact that the client or related entity would be required to incur additional costs to engage the services of an alternative service provider.

Members and firms are required by Rule 204.5(c) to document both the rationale supporting the determination that the situation constitutes an emergency and compliance with the provisions of subparagraphs (i) through (iv) of Rule 204.4(34)(b).

Members, firms and network firms should fully assess and consider the circumstances that would constitute an emergency situation. Alternative options must first be considered, such as others who could perform the work or possible extensions of filing deadlines. Emergency situations are very rare, non-recurring and would arise only when clearly beyond the control of the member or firm and the

client or related entity. Caution should be exercised when deciding to undertake services under this exception.

11.4 Documentation

QUESTION 36

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 insignificant, 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. 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. A good way to document these discussions is in your annual independence letter. For more details, refer to Rule 204.5 *Documentation* and the documentation requirements of the *CPA Canada Handbook – Assurance* (such as those outlined by CAS 220 *Quality control for an audit of financial statements* and *CAS 230 Audit Documentation*).

Breaches of the independence provisions also need to be documented along with various matters as outlined in Rule 204.6 *Breach of a provision of Rule 204.3 or 204.4*.