CA

THE CHARTERED ACCOUNTANTS ACT, 2010

DISCIPLINE COMMITTEE

SETTLEMENT AGREEMENT
June 2011

IN THE MATTER OF: **Settlement Agreement. John D. Aitken, CA, a member of the Institute, before the Discipline Committee.**

IN THE MATTER OF: CHARGES AGAINST JOHN D. AITKEN, CA, A MEMBER OF THE INSTITUTE, BEFORE THE DISCIPLINE COMMITTEE

SETTLEMENT AGREEMENT

made pursuant to Bylaw 510 (7.1) of the Bylaws of the Institute of Chartered Accountants of Ontario

Introduction

1. The Professional Conduct Committee approved draft charges against John D. Aitken, CA ("Aitken") **Doc 1**.

2. The draft charge pertains to professional work performed by Aitken with respect to the audit of financial statements of "HCU" for the eight months ended October 31, 2005.

3. The documents referred to in this agreement are found in the Document Brief. The applicable *CICA Handbook* sections are found in the Brief of Authorities.

4. The Professional Conduct Committee ("PCC") and Aitken agree with the facts and conclusions set out in this settlement agreement for the purpose of this proceeding only, and further agree that this agreement of facts and conclusions is without prejudice to Aitken in any other proceedings of any kind, including, but without limiting the generality of the foregoing, any civil or other proceedings which may be brought by any other person, corporation, regulatory body or agency.

Background

5. Aitken trained with Thorne Riddell and shortly after obtaining his CA designation in 1978, left public practice briefly. He then became a sole practitioner. Aitken practiced either on his own or as part of smaller partnerships until 1996, when he joined Collins Barrow as a partner. He has been a partner at the Chatham office of Collins Barrow since that time.

6. Collins Barrow is an association. The Chatham office is operated independently although the national office of Collins Barrow provides guidelines for standards and performs reviews of the files prepared by the office. The Chatham office has five partners and about twenty employees, including four CAs, three or four CA students, and six technicians.

7. HCU is a corporation operating in southern Ontario, providing disaster restoration, carpet and upholstery cleaning services and sells carpet cleaning systems.

8. Aitken had performed a review of the annual financial statements for HCU over a period of several years. At the request of HCU's bank, an audit was performed for the eight months ended October 31, 2005.

9. Prior to completing the review engagement for the year ended February 28, 2007 **Doc 2**, HCU discovered that the financial statements were significantly misstated. A prior period adjustment was processed to the February 28, 2007 financial statements **Doc 3** to reduce the 2006 retained earnings from $972,147 to $10,957. The adjustments, which totalled $961,190 are described in Note 3 **DOC 2 page 023** and impact virtually every account on the financial statements. They were not allocated to a specific prior period.

10. It has been alleged that the former spouse of HCU's principal fraudulently misstated the financial statements to improve the financial results, in order to deceive HCU's bank so that it would continue to loan funds to the company.

11. Aitken came to the attention of the PCC as a result of a complaint from HCU, which alleged that the audit of the financial statements for the eight months ended October 31, 2005 should have detected the fraud.

The Audit of Financial Statements of HCU for the Eight Months Ended October 31, 2005

12. The financial statements for HCU for the eight months ended October 31, 2005 are reproduced at **Doc 4**.

13. Aitken issued the Auditor's Report attached to these financial statements and presented it and the financial statements to the shareholders of HCU.

14. Materiality for this audit was set at $13,000 **Doc 5**.

Charge 1(a)(b) – Risk of Material Misstatement Due to Fraud; Professional Skepticism

15. The request for an audit was an unusual occurrence for HCU. The audit opinion was requested for October 31, 2005 by HCU's bank. The request for the opinion at mid-year timing should have lead Aitken to conclude that the bank had concerns about their loan to HCU and the audit should therefore have been assessed at higher risk. Aitken should have conducted the HCU audit with this risk assessment in mind, particularly as the audit summary correctly noted that the "bank is primary user of audited F/S." **Doc 5 page 4**

16. An auditor has a responsibility to consider fraud on every engagement. *CICA Handbook* Section 5135.024 states: "The auditor should maintain an attitude of professional skepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience with the entity about the honesty and integrity of management and those charged with governance." **Tab 1**

17. *CICA Handbook* Section 5135.032 **Tab 2** requires an auditor to perform procedures to obtain information that is used to identify risks of material misstatement due to fraud such as making enquiries of management, considering whether any fraud risk factors are present, considering any unusual or unexpected relationships that have

been identified in performing analytical procedures and considering other information that may be helpful in identifying the risks of material misstatement due to fraud.

18. Although a Fraud Risk Assessment questionnaire for the October 31, 2005 audit was completed by a staff accountant, there is no evidence of review by Aitken. **Doc 6** The checklist completed identifies a series of risk factors and asks is they are present. All 40 questions were answered in the negative, no additional comments were provided, and the checklist was not tailored to this specific client.

19. Although some audit issues were identified, there is no indication that Aitken appreciated that these issues could lead to fraud and that the audit program was tailored accordingly. For example, the audit "Highlights Memo" indicated that HCU "continues to have cash flow problems, i.e. sales decreased, A/R increased, A/P increased, LTD increased however positive working capital." **Doc 7**

20. The audit working paper file shows no evidence of a discussion among audit team members regarding the susceptibility of HCU's financial statements to material misstatement due to fraud contrary to the requirements of *CICA Handbook* Section 5135.026 **Tab 3**

21. *CICA Handbook* Section 5135 requires the auditor to presume a risk of fraud in revenue recognition, and Section 5135.115 specifically requires documentation of the auditor's conclusion on this point. **Tab 4** Aitken's audit working paper file shows no evidence that consideration was given to the risk of material misstatement due to fraud in revenue recognition. The only audit procedures performed on revenue was a comparison of prior year's revenue to October 31, 2005 revenue, and the only comment made in relation to revenue was that "sales fluctuate each year." **Doc 14**

Charge 1(c) – Confirmation of Accounts Receivable

22. The audit procedures for accounts receivable were to perform subsequent receipts testing to ensure proper cut-off and to provide assurance with respect to collectability of opening and closing accounts receivable.

23. All subsequent receipts greater than $1,000 were vouched from the deposit book to the invoice to the accounts receivable listing. This resulted in 45.2% of the accounts

receivable balance of $710,362 being vouched **DOC 10**. Confirmations were not sent.

24. Section 5303.28 of the *CICA Handbook* **Tab 5** requires that the auditor use confirmation as a means of obtaining audit evidence regarding accounts receivable except in circumstances where:

    a. The auditor has assessed the risk of material misstatement associated with the financial statement assertions being audited as low and other substantive audit procedures would provide sufficient appropriate evidence in these circumstances; or
    b. Confirmation would be ineffective in providing reliable audit evidence based on information considered by the auditor in planning the audit.

25. As previously noted, risk for this audit should have been assessed as high. In this case confirmations should have been sent out shortly after October 31, 2005. These confirmations would have provided reliable audit evidence. Aitken was aware of the period end date as the auditors attended the inventory count on October 31, 2005.

Charge 1(d) – Accounts Receivable

26. The accounts receivable listing at October 31, 2005 is 24 pages long and of the total per the listing of $696,911.83, 32.43% or $225,974.07 was in the 120 day column **Doc 9**. Only $2,011.31 was received after the period end, and therefore tested, of the amounts in the 120 day column. There was no assessment documented as to whether or not the remaining accounts actually existed and were collectable.

27. The aging of the accounts receivable at October 31, 2005 was **DOC 10 page 048**:

Days outstanding	*$*[16]	*% of total A/R*
Current	*220,175.43*	*31.59*
31-60	*134,308.54*	*19.27*
60-90	*100,179.99*	*14.37*
90-120	*16,273.80*	*2.34*
Over 120	*225,974.07*	*32.43*
	$696,911.83	

28. There is no evidence of audit work done to test the aging in the working papers but the auditor concluded that it was consistent with the prior period. The auditor prepared an aging summary as part of the ratio analysis for accounts receivable but did not perform additional procedures on the older accounts even though many of them were outstanding for more than a year based on the accounts receivable sub-ledgers for February 28, 2005 and October 31, 2005. **Doc 10**

29. Auditors are required to consider the valuation assertion which would be recorded through the allowance for doubtful accounts. At October the allowance was estimated by HCU to be $4,479.43, which is 0.64% of total accounts receivable, and which was supported by one working paper prepared by HCU. **Doc 11** There is no evidence of audit work related to the client estimate, which proved to be significantly inadequate in light of the subsequent adjustment to accounts receivable to write off $195,291.22 of items from 1996 to 2004 **DOC 3**.

30. *CICA Handbook* Section 5135.075 **Tab 6** requires that an auditor "review accounting estimates for biases that could result in material misstatement due to fraud." Had Aitken performed an assessment of the estimate of the allowance for doubtful accounts and considered the possibility of bias the fraud in the accounts receivable might have been discovered.

Charge 1(e) – Inventories

31. The inventory lead sheet **Doc 12** indicates that the inventory listing could not be reconciled to the general ledger as an inventory listing at October 31, 2005 could not be produced. Accordingly, the March 17, 2006 inventory listing was reviewed and all transactions during October and November 2005 were reviewed to ensure no significant adjustments were made by the client. A sample of items to count was selected from the October 31, 2005 inventory which was available on the client's computer listing and the test counts were agreed to this listing at the time of the inventory count.

32. Although inventory made up 30% of the total assets of HCU on the balance sheet, when the inventory sample was selected 15 items were selected from the inventory

listing and counted, and another 15 items were selected from the floor and compared to the listing **Doc 12**. The basis of the sample size is not documented in the audit working papers. Materiality for this audit was set at $13,000 and the inventory was $533,325.51. Even if a sampling factor equal to materiality had been chosen, a minimum sample size of 41 should have been selected. In light of the risk of this audit, the sample size should have been in excess of 41.

33. There is no evidence in the working papers to indicate testing of the valuation of the inventory items. A sample size of 15 was selected for net realizable value testing **Doc 12**, which was an insufficient sample based on materiality.

34. The work in progress listing **Doc 12 page 52** shows 9 items totaling $62,469.99. Three jobs were in excess of materiality, but the calculation for only one of these three was reviewed. All three of these jobs should have been tested.

Charge 1(f) – Accounts Payable and Accrued Liabilities

35. The approach to auditing the accounts payable listing **Doc 13** was to review the listing for subsequent payments and to perform a search for unrecorded liabilities **Doc 13**. Confirmations were not sent. If an amount was not paid subsequently, no alternative procedures were performed.

36. For example, the accounts payable listing **Doc 13** shows that Dri-Eaz Products Inc. has a balance payable of $61,339.50, of which $33,211.50 is marked as subsequently paid. No audit work was performed on the remaining balance of $28,128 even though it is material and the audit work was done more than four months after period end.

Charge 1(g) – Statement of Income

37. The income cost of sales and expenses were tested by analytical review only. Although an annualized income statement was produced **Doc 14** and explanations for variances were obtained, there is no quantification of the explanations and no detailed testing was performed on these items, which would be required to obtain sufficient and appropriate audit evidence for the Income Statement as required by *CICA Handbook*, Section 5025.53. **Tab 7**

38. The payroll expenses were compared to the amount on the 2005 T4 Summary **Doc 15**, prorated for 10 months. Although the conclusion states that the variance is considered insignificant, it is $14,990.92, which is in excess of materiality. The T4 Summary was prepared from the company's payroll records. The general ledger amounts also originate from the payroll records. Accordingly, the effect of the test is to agree the payroll records to the payroll records, resulting in little assurance being obtained.

Charge 1(h) – Documentation

39. The capital asset section in the working paper file consists of a lead sheet and a continuity schedule. There is no evidence in the working papers that any audit procedures were performed to verify the opening balances which, if incorrect, could impact the period being reported on. **Doc 16**

40. There is a listing of the doubtful accounts **Doc 11** allowed for in the working paper file, but there is no evidence in the working papers of any discussion with the client about the allowance.

41. This documentation, along with the documentation noted as required but missing in the areas of Accounts Receivable, Inventories, Accounts Payable, and Statement of Income above, is required to support the Auditor's Report in accordance with *CICA Handbook* Section 5145.06. **Tab 8**

Failure to Comply with Generally Accepted Standards of Practice of the Profession

42. It is agreed that, with respect to the audit of the financial statements of HCU for the eight months ended October 31, 2005, Aitken failed to perform his professional services in accordance with generally accepted standards of practice of the profession, including the recommendations set out in the *CICA Handbook*, in the manner described above.

Considerations Supporting Settlement

43. In addition to all of the circumstances described above, the Professional Conduct Committee took the following factors into consideration on entering into this Agreement:

    a. Aitken acknowledges the deficiencies in his audit standards of practice as set out above;

    b. Aitken has provided a written undertaking to the Institute not to perform audit engagements in future, nor to act in a quality control or second partner review capacity over audit engagements; and

    c. Aitken has been fully cooperative in the Professional Conduct Committee's investigation into his conduct.

Terms of Settlement

44. Aitken and the Professional Conduct Committee agree to the following Terms of Settlement:

    a) Payment by way of fine in the amount of $10,000;

    b) Aitken will attend on or before December 31, 2012, the following professional development courses offered by the Institute (or their successor courses):

    - *Accounting Refresher (After January 2011 "Accounting Standards for Private Enterprises: A Survey of the Standards);*
    - *Audit and Review Engagements Required Communications;*
    - *Effective Use of Analytical Procedures;*
    - *File Review Methodologies;*
    - *Professional Risk Management: A Practical Perspective,* and;
    - *Review Engagements.*

    c) Payment of costs in the amount of $5,000;

    d) All review engagements carried out by Aitken for a period of 18 months from the date the Settlement Agreement is approved by the Discipline Committee will be reviewed by Paul Cudmore, CA who will act as a supervisor. No review report will be released by Aitken without the prior approval of the supervisor.

e) Aitken will have his review engagement practice reinvestigated by the Professional Conduct Committee following the period of supervision with costs of the reinvestigation, up to $2,000, to be borne by Aitken.

f) Notice of the terms of the settlement agreement is to be published in accordance with the provisions of Bylaw 575(2), including notice to be given to the CICA, the Public Accountants' Council and in *Checkmark* Magazine; and

g) Aitken will be allowed three months from the time the Discipline Committee accepts this Settlement Agreement to pay the fine and costs referred to herein.

45. Aitken also agrees, and hereby undertakes irrevocably, not to accept or perform any audit engagements nor act in a quality control or second partner review capacity over audit engagements in the future.

46. Should the Discipline Committee accept this Settlement Agreement, Aitken agrees to waive his right to a full hearing, judicial review or appeal of the matter subject to the Settlement Agreement. Upon the member fulfilling the requirements of this Settlement Agreement, the draft charges approved by the Professional Conduct Committee and dated February, 2010, shall be forever stayed.

47. If for any reason this Settlement Agreement is not approved by the Discipline Committee, then:

a) This Settlement Agreement and its terms, including all Settlement Negotiations between the Professional Conduct Committee and Aitken leading up to its presentation to the Discipline Committee, shall be without prejudice to the Professional Conduct Committee and Aitken; and

b) The Professional Conduct Committee and Aitken shall be entitled to all available proceedings, remedies and challenges, including proceeding to a hearing on the merits of the allegations set out in the charges, or negotiating a new Settlement Agreement, unaffected by this Settlement Agreement or the Settlement Negotiations.

Disclosure of Settlement Agreement

48. This Settlement Agreement and its terms will be treated as confidential by the Professional Conduct Committee and Aitken, until approved by the Discipline Committee, and forever if for any reason whatsoever this Settlement Agreement is not approved by the Discipline Committee, except with the written consent of the Professional Conduct Committee and Aitken, or, as may be required by law.

49. Any obligations of confidentiality shall terminate upon approval of the Settlement Agreement by the Discipline Committee.

All of which is agreed to for the purpose of this proceeding alone this 1st day of June, 2011.

PAUL F. FARLEY
COUNSEL
PROFESSIONAL CONDUCT COMMITTEE
On behalf of the Professional Conduct Committee

JOHN D. AITKEN, CA
on his own behalf