DAY 2 – DEPTH/ TECHNICAL TEST FOR FINANCIAL REPORTING (or MANAGEMENT) and DEPTH IN ROLE - Assurance

<table>
<thead>
<tr>
<th>AO#2 (FR-COMMON CORE LEVEL) Warranty Provision</th>
<th>PROFILE AT C: The candidate has a reasonable discussion of the warranty provision issue related to the defective tanks—Expected to use HB criteria/framework and apply to relevant case facts</th>
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<tbody>
<tr>
<td>Candidates were asked to review the draft financial statements, discuss any accounting issues, and propose any necessary adjusting entries. Note 8 to the financial statements supplied candidates with information on some lower-quality tanks that were produced by TankCo during a period when replacement workers were used due to a strike by TankCo’s unionized employees. Candidates were told that, during that period, 800 residential tanks were manufactured and shipped, 32 of which had already been replaced at a cost of $400 per tank. Management believed that another 50 tanks might be defective and had committed to its distributors to replace any tanks with manufacturing defects for a period of one year after purchase. No amount had been accrued for these tanks in the financial statements. To demonstrate competence, candidates were expected to discuss whether TankCo should accrue the cost of replacing the tanks using appropriate Handbook criteria and case facts to support their analysis. Candidates also had to calculate the adjustment to be made to the financial statements to correct the situation. With regards to this issue, candidates could have used either the general liability definition or the contingent liability section to support their analysis.</td>
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COMMENTS ON PERFORMANCE FROM MESSAGE TO CANDIDATES in CFE Report: On Day 2, Common, AO#2 (warranty), some candidates were unable to support their analysis using appropriate Handbook criteria. Many of these candidates jumped straight to the conclusion (accrue $20,000) without first applying relevant case facts to the Handbook guidance. SAMPLE RESPONSE: This candidate jumps to conclusion; weak analysis- no HB criteria used in discussion and no application of case facts (beyond referring to the 50 tanks.)

“Cost of Sales”

Tankco has manufactured defective tanks and is expecting them to be returned and replaced. The number of tanks is known to be 50 and at a cost of 400 dollars per tank. Since management has stated to the distributors that they are committed to covering the replacement a obligation now exists. This needs to be recorded in the current year. (Exhibit 1). This obligation exists for one year and then will need to be reversed. The effect is a reduction to income and equity.”

VS SOLUTION: The company shipped 800 residential tanks that were manufactured during the strike. The company has replaced the tanks at no charge and has committed to its distributors to replace any tanks with manufacturing defects for a period of one year after purchase. Management believes that another 50 tanks might be returned from these shipments. Because returns have not been an issue in the past, this would be a new accounting issue for the company to address in
2015. The issue is whether a provision for a warranty on those tanks should be set up in the 2015 fiscal year.

ASPE is silent on provisions, however, this matter could be dealt with in the context of HB 3290 Contingencies. The commitment to replace any defective tanks is an existing condition (the potentially defective tanks have already been constructed), with an uncertainty about the extent of the liability associated with it, making this a contingent liability. The issue will be resolved in coming months as the one-year anniversary expires.

Measurement requires management to assess the likelihood and the amount of the potential loss. The maximum amount of exposure would be that all 800 tanks being returned, less the 32 that have already been returned and replaced. Management has assessed the likelihood of the contingency and believes it is likely that another 50 tanks will be returned. Since the amount both can be estimated and is likely, a loss provision should be accrued in the 2015 financial statements.

At $400 per tank, the contingent loss to be reported would be $20,000. The maximum amount of potential liability should be disclosed in the notes to the financial statements ((800-32) X400= $307,200). Because the company has yet to fulfill this provision by replacing any of the 50 tanks, the provision is not tax deductible. Thus, there is no adjustment required to taxes payable or income tax expense.

Issue #2: To establish a warranty provision

| Cost of sales                         | $20,000 |
| Accounts payable and accruals         | $20,000 |

The incremental provision will weaken our debt to equity covenant calculation.
###PROFILE AT C:
The candidate has a reasonable discussion of the lawsuits issue—expected to use HB criteria and to apply case facts.

Candidates were asked to review the draft financial statements, discuss any accounting issues, and propose any necessary adjusting entries. Note 6 to the financial statements contained information on lawsuits that had been launched against the company. The note explained that it was common for the company to get named as a defendant in lawsuits pertaining to oil spills. TankCo was currently named in 21 lawsuits, a significantly higher number than normal. Candidates were also told that, to protect against exposure to payouts on successful claims, which typically ranged from $255,000 to $410,000 each, the company maintained annual insurance coverage of $5 million, with a $20,000 deductible per claim. When TankCo was named in a lawsuit, the cost of the deductible was accrued. If the lawsuit was subsequently dropped, the amount was reversed. Candidates were also supplied with a continuity schedule of lawsuits outstanding, of which 21 lawsuits were outstanding at year end. To demonstrate competence, candidates were expected to determine whether any additional accrual needed to be made with regards to the lawsuits using appropriate Handbook criteria and case facts to support their analysis. Candidates also had to calculate the adjustment to be made to the financial statements to correct the situation.

###SAMPLE RESPONSE #1:
This candidate either has technical weakness or ignores/misses the case facts provided & the HB guidance, and jumped to the conclusion they wanted to have.

(Those of you that know Susan Wolcott’s work on critical thinking know this as the “Biased jumper”. The discussion is very general/shallow:

“Lawsuits

Lawsuits fall under ASPE 3290 Contigencies. The concern here is that a liability is only recognized if the cost can be measured and it is likely to happen.

Since insurance covers the costs the deductible is always known so it is measurable.

The concern is how likely the lawsuits are to actually happen. If a lawsuit was unlikely to succeed then no accrual needs to be done. This would increase revenue and increase equity. Since no information is given on the likelihood of any single lawsuit succeeding no adjustment has been made. We should speak to the lawyers to find out the likelihood for each of the individual lawsuits actually succeeding.”

###SAMPLE RESPONSE #2: GOOD!

**Lawsuits**

The issue here is whether the lawsuits are recorded correctly as provisions. We must
assess the handbook guidance on this matter. Per ASPE 3290, we must determine if the lawsuits meet the definition of a contingency. A contingency is an existing condition or situation involving uncertainty as to possible gain or loss to an enterprise that will ultimately be resolved when one of more future events occur or fail to occur. Since the lawsuits depend on the future outcome of being found guilty or just being dropped by the plaintiff, the lawsuits do meet the definition of a contingency. The main issue here is whether the insurance coverage is sufficient for the 21 lawsuits on hand at December 31, 2015. The average amount of payout for successful claims is equal to $332,500 (calculated as $255K + $410K divided by 2). Therefore, if we take the total lawsuits at year end of 21 multiplied by the average payout rate, we get a total of $6,982,500, which is $1,982,500 higher than the insurance coverage of $5 million. Therefore, the accrual is not sufficient. In order for a contingency to be recorded both of the following criteria must be met:

"(a) it is likely that a future event will confirm that an asset had been impaired or a liability incurred at the date of the financial statements - MET: It is likely that the lawsuit result will confirm that a liability was incurred at the date of the financial statements. 

(b) the amount of the loss can be reasonably estimated - MET: The amount of the loss can be reasonably estimated. The lawyer has provided a typical range. Therefore, I suggest that the accrual be increased to the lower end of the lawyer estimation multiplied by the 21 outstanding lawsuits at year end. The high end of the estimation multiplied by 21 shall also be disclosed as a note to the financial statements as contingent liability. The lower end of the range would be $255K per
payout x 21 lawsuits = $5,355,000. Therefore since the insurance coverage is only $5M, the difference should be accrued. I propose the following entry:

Dr. Legal expense $355,000
Cr. Contingent Liability (AP) $355,000

**SOLUTION:** TankCo is currently experiencing a significant jump in the number of lawsuits against it, from 4 in 2014 to 19 in 2015. According to HB 3290, paragraph 5, “a contingency is an existing condition or situation involving uncertainty as to possible gain or loss to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm the acquisition of an asset or the reduction of a liability or the loss or impairment of an asset or the incurrence of a liability.” These lawsuits are a possible loss (payout of a minimum of $20,000 deductible, plus any amount that exceeds the insurance coverage) that will be resolved at a future date (either the settlement of the lawsuit or when the lawsuit is dropped). Further HB guidance tells us that

.12 The amount of a contingent loss shall be accrued in the financial statements by a charge to income when both of the following conditions are met:

(a) it is likely that a future event will confirm that an asset had been impaired or a liability incurred at the date of the financial statements; and

(b) the amount of the loss can be reasonably estimated.

It would appear that the lawsuits will result in a likely payout, since very few have been dropped in the past and none on the continuity schedule seem to have been ruled in TankCo’s favour. TankCo also has insurance specifically for this purpose. The actual likelihood of the lawsuits and potential payouts will need to be determined with the assistance of TankCo’s lawyers, but for now I will assume they are all likely. They are also estimable, as we know that, at a minimum, the deductible of $20,000 will have to be paid and that the settlements typically range from $255,000 to $410,000 (so any exposure beyond the $5 million of insurance could be determined). According to HB 3290.13, “when no amount within the range is indicated as a better estimate than any other, the minimum amount in the range would be accrued.”

Therefore, 21 pending claims at $255,000 per claim equals $5,355,000. The company has $5 million of insurance coverage, so the question is whether these two amounts can be offset. According to HB 3290.11, “A likely loss to an enterprise may be reduced or avoided by a counterclaim or a claim against a third party. In such a case, the amount of the likely recovery is an element of the likely loss and, therefore, would be taken into account in determining the amount to be recognized in the income statement. However, if the probability of success in the related action is less than likely, a potential recovery would not be taken into account.” TankCo has a history of lawsuits, and it appears the insurance company has always covered successful
claims; therefore, it is probably safe to assume that the related action is likely, and these two amounts should be treated together.

Assuming the $255,000 is above and beyond the $20,000 deductible, $5,355,000 - $5,000,000 of coverage = $355,000 of additional possible exposure if these claims are all resolved in the coming year. Therefore, this amount needs to be accrued.

The company must also disclose any additional exposure as a contingent liability in the notes to the financial statements. Because these losses are not deductible for tax purposes until the claims are resolved, there is no adjustment to income taxes payable or income tax expense.

Issue #3: To establish a contingent loss on lawsuits.

<table>
<thead>
<tr>
<th>Claim Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contingent loss from lawsuits</td>
<td>$355,000</td>
</tr>
<tr>
<td>Accounts payable and accruals</td>
<td>$355,000</td>
</tr>
</tbody>
</table>

This issue will have a negative impact on the debt-to-equity ratio, which further weakens the lending covenant.
<table>
<thead>
<tr>
<th>AO#11-DEPTH in ROLE Procedures The candidate recommends procedures for the high-risk areas.</th>
<th>Profile at C: The candidate discusses specific audit procedures for several of the significant accounts.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Candidates were asked by the engagement partner to recommend the procedures that should be undertaken on the high-risk financial statement items. In order to demonstrate competence, candidates were expected to provide a reasonable number of procedures that were specific to the accounting issues or audit risks of TankCo.</td>
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**FROM MESSAGE TO CANDIDATES in CFE Report:** On Day 2, Assurance, AO#11 (procedures), some candidates provided procedures that were too vague to determine what exactly they were proposing to do and what risk they were trying to cover. Weak candidates also tended to provide a list of generic procedures that could have applied to any audit. These procedures did not address either the specific accounting issues or other relevant risks described in the case and, as a result, they were of limited value. Candidates are reminded that they need to explain the specific audit risk they are addressing when providing a procedure. This will help them ensure the procedure is both specific and relevant.

**SAMPLE RESPONSE (broken down by procedure):** Procedures not specific enough/generic list and didn’t explain why a particular account was high risk i.e. Cash and prepaids and admin. are not high risk areas. Missing high risk areas like impairment of commercial tank division.

“Procedures

- Cash: Bank recs must be secured alongside bank statements. The engagement member must reconcile the bank reconciliation to the bank statement and the general ledger amount. Verifies Valuation.

- Receivables: Confirmations must be sent out to the client to verify the amounts owed. The engagement member should review a sample of older transaction and verify with management their collectibility. Verifies existence

**VS SOLUTION Issue #1 – Accounts Receivable and Revenue**

The adjusted accounts receivable balance at December 31, 2015, is $2.4 million, which is somewhat comparable to the prior year ($1.9 million at December 31, 2014) because the increase over the prior year relates to a one-time sale. However, the accounts receivable balance is high given the lower sales base of $13.0 million this year versus $15.1 million last year. This lower turnover of accounts receivable suggests that we should focus on the existence and valuation assertions for this account. Because receivables have been posted as security for the line of credit, it is important that we consider the procedures of the special reporting engagement concurrently with the financial statement audit procedures.
To address the existence assertion of accounts receivable, we can send confirmations to the distributors. We can also look at subsequent receipts since year end. The valuation assertion can be tested by looking at the aged listing of receivables and following up on any past due accounts. For the borrowing base calculation, the correct age of the accounts receivable is important. We should sample a few of the receivables listed as under 45 days old in the aged listing and compare each to the date on the invoice to ensure they are dated correctly. We will need to determine whether the decline in accounts receivable turnover relates to weaker financial credit of the distributors or perhaps was caused by the lack of management attention during Lou’s illness.

We will need additional evidence to support the revenue recognition of the bill-and-hold arrangement that allows the company to record revenue for the two commercial tanks held on behalf of the customer. We should inspect evidence supporting the transfer of the risks and rewards of ownership to the customer, especially the fact that the completed tanks have been insured by the customer and evidence that the customer requested the delayed delivery.

**SAMPLE RESPONSE (cont’d):**

- **Inventory:** The engagement member needs to visually inspect the equipment for damage and check with management about who owns all of the tanks. Verifies Valuation and rights and obligations.

- The inventory count needs to be verified and signed off on. This should be compared to the amount in the general ledger to account for any discrepancies.

**[VS SOLUTION: Issue #2 – Inventory and Purchases]**

TankCo carries a material amount of inventory that has also increased year over year from $2.7 million to $3.1 million. Much of this increase pertains to an increase in raw materials on hand (year-over-year increase of $0.2 million), as well as work in progress ($0.2 million in 2015 and none in 2014). Since turnover has declined, there is a risk of overstatement. Inventory has been posted as security for the line of credit, so it is important that we consider the procedures of the special reporting engagement concurrently with the financial statement audit procedures.

The key assertions for inventory will be existence, valuation, and presentation. To address inventory existence, we will use the evidence gathered during the year-end inventory count observation.

**Given the negative gross profit margin experienced in the commercial tank segment, valuation is a particular concern.** To address valuation, we will need to ensure that any inventory on hand pertaining to this segment has a net realizable value greater than cost, including the tank that is 90% complete at December 31, 2015. **To test the NRV of inventory, we should look at subsequent sales.** We should also determine whether fixed overhead has been properly attributed to inventory. As volumes shrink, there may be unused capacity, but that should not factor into the overhead allocation.
To address presentation, we will need to review the inventory listing to ensure that only finished tanks are included in finished goods inventory, since this is the only marginable inventory for the bank’s line of credit.

SAMPLE RESPONSE (cont’d):

- Prepaid Expenses: The engagement member needs to reconcile all prepaids amounts back to their original invoices to ensure that the correct amount is being expensed month to month. Verifies valuation and completeness.

- Property plant and equipment: The engagement member needs to inspect the equipment visually for damage and gain from management original receipts of purchases. Verifies rights and obligations and valuation.

- Development Costs: The engagement member must inquire with management the status of all development costs and whether or not all the criteria are met.

[VS SOLUTION: Issue #3 – Intangibles: Development Costs of Fibreglass Tanks

Given the company’s precarious financial position, we have determined that it would be unable to meet the criteria for capitalization of these costs. However, we should perform procedures to confirm whether each criterion has been met. For example, we should see whether the government certification and the test results have been received since year end. If they have not, does management have any support for the technical feasibility of the project? We should also receive confirmation from the board that they plan to pursue the project. In terms of the necessary financial resources, we should confirm with the bank that it intends to renew the line of credit and not call the term loan.]

SAMPLE RESPONSE (cont’d):

- Long term debt: The engagement member must secure a copy of the long term debt agreement to verify the amount of the books. This verifies valuation and rights and obligations by telling the engagement member that Tankco is actually liable for the debt.

- Accounts Payable: The engagement member must confirm the outstanding balances with the supplier. This verifies valuation.
• The lawsuit account should be reviewed for amounts that are unlikely to succeed. This should be removed to ensure proper valuation.

• Revenue: The engagement member must take a sample of the sales invoices and track them through the general ledger testing completeness. They then need to take a sample from the general ledger and track them back to the invoices testing occurrence.

**VS SOLUTION: Issue #4 – Trade Payables, Accruals, and Provisions**

The payables and accruals account has increased from $0.9 million to $1.5 million, largely due to the provisions associated with the defective tanks and the associated increase in lawsuits. The completeness and valuation assertions pose the largest material risks of misstatement for these accounts.

To address these risks, we should

- discuss the reasons for the increasing volume of lawsuits with the company's legal counsel and request completion of a formal legal letter;
- given the significant rise in lawsuits, review the insurance policy and evaluate the sufficiency of coverage;
- discuss with management how the estimate of 50 additional defective tanks was assessed, and review the communication sent out to the distributors regarding management's commitment to replacing defective tanks;
- review production reports on tanks made during the period of the strike by the temporary workers, and check that the tanks that have been replaced to date were indeed ones made during that period of time;
- review inventory costing schedules to ensure that $400 is indeed the cost of one residential tank unit; and
- examine the number of tanks replaced or changes in the number of lawsuits since year end. There is only a short period of uncertainty left on the warranty provision since the one-year anniversary expires soon.

**SAMPLE RESPONSE (cont’d):**

• Interest expense: The engagement member should recalculate the amount of interest for the year to be paid and compare that to what actually was paid out. This ensures that all transactions have occurred within per the agreement and have been completed within the general ledger.

• Selling, General, Administrative expense: The engagement member needs take a
sample of these expenses and trace them back to their original invoices. This is too ensure that all general expenses are business related. This tests classification.

- Admin should also be reviewed for amounts that need to be moved to Equipment as either an asset or a betterment. This ensures proper classification for the expense and valuation for the asset.”

**Profile at C:** The candidate provides a reasonable discussion of the reporting options for the special report required by the bank and concludes on a valid reporting option.

**Candidates were told by the engagement partner that the bank had invoked the right to a special report on TankCo. As a result, candidates were asked to prepare a separate memo to the partner explaining the reporting options available. In order to demonstrate competence, candidates were expected to discuss at least two valid reporting options and provide a supported conclusion.**

**FROM MESSAGE TO CANDIDATES in CFE Report:** On Day 2, Assurance, AO#13 (reports), candidates struggled to provide valid reports (they needed to be audit-level assurance), as well as to explain the reports. They seemed unfamiliar with the different types of reports and did not have a good grasp of which would meet the users’ needs. Some candidates just spoke to the level of assurance provided or the cost of the different reports, without really getting into the nature of each report itself and why it may or may not be good for the bank.

**SAMPLE RESPONSE:** This candidate created alternatives but suggesting reports that weren’t valid given the case facts (805 and 5815 are the only valid options)- gets to right conclusion, but analysis of “invalid” reports (making stuff up) does not create “DEPTH” of analysis.

**“Special Engagement Report**

The Bank requires a special engagement report that per their agreement offers assurance that all of the provisions laid out are being met. The reporting options are 5815, 8600 or 9100

**5815**

- This provides the highest level of assurance and the auditor a positive opinion on whether or not the covenants are being met.

- This is the most costly and time consuming.

- The requires that the engagement team to have adequate technical training to
review these provisions and is technically competent enough to offer an opinion

- This will have separate engagement report and will require the following
- This report requires us to gain an understanding of the entity and its environment.
- The following should be included in the engagement report per CAS5815

"(a) in the introductory paragraph of his or her own report:

(i) state that compliance with criteria established by provisions of the agreement, statute or regulation identified in the report has been audited;

(ii) identify the provisions of the agreement, statute or regulation;

(iii) describe or refer to disclosure of any significant interpretations of the provisions made by the management of the entity;

(iv) when a report on compliance with criteria established by provisions of the agreement, statute or regulation has been issued in the same circumstances for the preceding period, describe or refer to disclosure of a change in any significant interpretation of the provisions made by the management of the entity;

(v) indicate any other information having particular relevance to the party to whom the report is addressed including the subject of any reservation of opinion on the most recent audited financial statements;

(vi) state that such compliance is the responsibility of the management of the entity; and

(vii) state that it is the auditor's responsibility to express an opinion on this compliance based on the audit;
(b) in the scope paragraph of his or her report state that:

(i) the audit was conducted in accordance with Canadian generally accepted auditing standards;

(ii) those standards require that the audit be planned and performed to obtain reasonable assurance whether the entity complied with criteria established by provisions of the agreement, statute or regulation; and

(iii) such an audit includes:

— examining, on a test basis, evidence supporting compliance;

— evaluating the overall compliance; and

— assessing, where applicable, the accounting principles used and significant estimates made by the management of the entity;

(c) in the opinion paragraph of his or her report express an opinion whether the entity has complied, in all material respects, with criteria established by provisions of the agreement, statute or regulations and
d) disclose the addressee, the name of the auditor (or firm), the date of the report and the place of issue. [JAN. 1, 1992 **(6)]"

The above lays out all of the required information that the bank would require. This would normally be done as a separate engagement letter, though could be ad

**8600: Reviews of compliance with agreements and regulations**

- This offers moderate assurance and is less costly
- Given the fact the bank agreement states the special report must be audited this report is inappropriate per CAS 8600.01 Instead 5815 should be used instead.
9100

- This applies the procedures asked of us by the bank.
- It provides no assurance and is the cheapest option.
- It neither provides an audit opinion like 5815 nor negative assurance like 8600.
- Given the fact that the bank agreement requires an audit opinion this option is inappropriate.

**Conclusion**

5815 is the only report that meets our needs given the fact that the bank requires the special report to be audited. This means that the opinion expressed must offer positive assurance that there are no errors and the provisions are being met.”

**VS SOLUTION:** The Canadian Bank has extended a line of credit with TankCo, with a maximum available amount of $4 million, subject to sufficient security margins:

- 80% of accounts receivables 45 days and under; plus
- 60% of finished goods inventory.

The credit facility has a financial covenant for which the borrower must comply on an annual basis:

- Maximum debt-to-equity ratio of 2:1

It is likely, based on my preliminary accounting analysis, that TankCo is in breach of the covenant as of December 31, 2015. This triggers a 30-day remediation period for TankCo to get the covenant back on side, failure of which gives the bank the right to call all its loans, including both the line of credit and the term loan.

The bank has requested that TankCo provide “a report audited by an independent public accountant calculating the provisions of this agreement.” This statement needs to be clarified with both the client and the bank because it is unclear what this report should look like.

There are two “calculating provisions” over which the bank will want assurance:

1. Whether the company has provided adequate security to support the amount of funds drawn under the line of credit.
2. Whether the company is in compliance with the debt-to-equity covenant.
**Special Report Parameters**

First, we need to determine the nature of our engagement. The options are as follows:

1. **Audited financial statements of TankCo Limited**

   The bank should be able to calculate for itself compliance with the lending agreement using the audited financial statements. This clause appears to be an add-on to compensate for the fact that the agreement only specifies review-level assurance for the company’s financial statements. However, since the client is having the financial statements audited this year, it might sufficiently address the bank’s needs without the need for and cost of a special engagement.

2. **CAS 805, Special Considerations – Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement**

   Using this as guidance, we could provide assurance on the values of the accounts used in the debt-to-equity covenant and the amount of marginable security in the company. There are certain elements, such as receivables older than 45 days, that might not be readily available in standard financial statement disclosure but that would be specifically addressed in this engagement, making the report more useful to the bank.

3. **Section 5815 Special Reports – Audit Reports on Compliance with Agreements, Statutes and Regulations**

   This report would express an opinion on whether TankCo was in compliance with its credit facility.

**Analysis of Major Issues**

The first option is probably the most cost-effective solution. Any missing information in the financial statements can probably be obtained directly from the client. If we go with just the financial statement audit, the materiality used would be that for the financial statements as a whole; therefore, $46,000. That amount might not be low enough to provide the bank with comfort over the inventory and receivable balances used to calculate compliance with the borrowing base. In addition, an appropriate materiality level for the special report may vary depending on how close debt-to-equity covenant is to being breached at December 31, 2015. When the covenant calculation is close to the threshold, then materiality will be lower than if the company is clearly in compliance or default of its covenant. This will vary depending on the extent of the proposed accounting adjustments. Our preliminary analysis suggests that the debt-to-equity covenant will be out of compliance.

If the bank insists on a special report as specified under the agreement, the second option (CAS 805 report) probably provides the bank with the most insight because it will specify the degree to which the debt-to-equity covenant has been violated and the
line of credit overdrawn. In this case, materiality for the engagement should be discussed specifically with the bank to determine what threshold it is comfortable with. The third option may indicate whether the company is complying with the lending agreement but will not assist the bank in determining the full extent of its credit exposure to the company.

Conclude and Advise

Only if the audited financial statements are insufficient to meet the bank’s needs would I recommend that we issue a CAS 805 report. This should be discussed with the bank to confirm that it is suitable for its needs.