



THE PRACTITIONER'S VIEW

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NEW FRAUD GUIDANCE ISSUED - AUDITORS OF SMALL BUSINESSES AND NOT-FOR-PROFIT ORGANIZATIONS NEED TO KNOW

One of the most common practice review findings noted last year was poor documentation related to CICA Section 5135, *The Auditor's Responsibility to Consider Fraud*. This standard was first introduced in 2002 for periods ending December 31, 2002; it was significantly revised for periods ending December 31, 2004 and, in June 2005, underwent a third revision effective for periods beginning on or after January 1, 2006.

To ensure your practice is meeting the standard for this critical area, be sure to read the attached article in **Appendix A**, provided by and reprinted with permission from the Institute of Chartered Accountants of Ontario.

Another interesting "fraud" read is an article in the January 2006 issue of CA Practice Advantage regarding employee fraud in restaurants, titled "*Eat, Drink and be Wary*" at www.cic.ca/html/capa/E_12_2005_004.pdf.

RESPONDING TO THE SPECIAL NEEDS OF REGULATORS OR FUNDING BODIES

A special issue of Risk Alert deals with meeting the reporting needs of regulators or funding bodies now that it is clear that derivative reports may only be issued in limited circumstances. If your clients include First Nations or are reporting in accordance with CMHC operating agreements, the March 2006 issue of Risk Alert is a must-read to find out the dangers of issuing derivative reports and alternative means of meeting reporting requirements.

The newsletter can be accessed through the CICA website at http://www.cica.ca/multimedia/Download_Library/Standards/ASB/English/e_RiskAlertMarch06.pdf.

QUALITY ASSURANCE

(The following was adapted from an article that appeared in the March 2006 issue of News & Views, a publication of the Institute of Chartered Accountants of British Columbia)

CICA handbook sections introducing new quality control standards came into effect December 1, 2005. By now practitioners involved in assurance work should have documented their practice quality procedures.

For new practices, or those who may have fallen behind the requirements, CICA has developed a *Quality Assurance Manual (QAM)* aimed specifically at sole practitioners and small firms. The *QAM* is available, at

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reasonable cost, from CICA at www.knotia.ca to help firms develop quality control policies. Practice reviewers will be asking to see documented quality control procedures as well as the staff independence and confidentiality confirmations and the monitoring report (if you have implemented your quality monitoring plan already).

As suggested by many who attended the previous QAM sessions, an update course has been developed and will be offered for fall PD. It will give practitioners an opportunity to revisit the requirements and to review practical implementation issues a year later.

INCOME TAX TIME

(The following was adapted from an article that appeared in the March 2006 issue of News & Views, a publication of the Institute of Chartered Accountants of British Columbia)

Members are reminded that the preparation of financial information such as self-employment and rental income schedules for a personal tax return are compilation engagements. All pages of each schedule prepared and given to the client should have a Notice to Reader on them or refer to a separate Notice to Reader. Many software packages will apply the Notice to Reader as a footer. Where the Notice to Reader is required, please note that your files should include compilation-level documentation in support of significant amounts included in those schedules and the rest of the client's tax return.

T1013 – TIPS FOR COMPLETING

(The following was adapted from an article that appeared in the March 2006 issue of News & Views, a publication of the Institute of Chartered Accountants of British Columbia)

Now that personal tax filing season has begun, practitioners will no doubt be getting a T1013 form – *Authorizing or Cancelling a Representative* signed for their new clients. Below are some common errors that will delay processing of the form:

- Signature and/or date is missing (the form must be signed and dated);
- Proper client has not signed their own T1013 form;
- Client is child and signing person does not state relationship;
- Applicable tax years not indicated;
- Missing/incomplete/incorrect Social Insurance Number;
- Client signs in Part 3 (representative's area) rather than Part 4 (client area);
- Representative ID or Business number is incorrect, invalid or firm has not registered online as a representative; or
- Page 1 or 2 missing – both pages must be submitted to CRA.

Members are encouraged to take note of the above tips provided by CRA to ensure a smoother and less stressful tax season.

DIFFERENTIAL REPORTING – QUESTIONS AND ANSWERS

Test your knowledge of differential reporting – can you answer the following questions:

- Why should clients be allowed to choose the GAAP they want?
- Does shareholders consent need to be obtained annually?
- Can shareholders choose from a list of possible options?
- To whom should shareholders consent be addressed?
- Can shareholders consent be less than unanimous?
- Is the reference to differential reporting in the Assurance Report a qualification?
- Can I still amortize goodwill using differential reporting?
- Why not write off goodwill altogether?
- Are redeemable and retractable preferred shares really different?
- Is differential reporting for income taxes worth it when note disclosures are still required?

If you aren't sure, check for answers in the July 2005 issue of *Focus on PEM*, a newsletter published as part of the Professional Engagement Manual, available through subscription.

SURVIVING A TAX AUDIT

If your client is facing a tax audit or you've wondered how to prepare for the inevitable, be sure to read "Surviving a Tax Audit", written by Peter Budreski, CA. The article, attached as **Appendix B**, provides both reactive and proactive tips for minimizing the impact of a tax audit. It originally appeared in the February 2006 issue of ProConnection, a free monthly eNewsletter published by Intuit Canada, and is reprinted with permission.

FINANCIAL INSTRUMENTS IMPLEMENTATION GUIDANCE – Invitation to Comment

The Financial Instruments Working Group (FIWG) has released the first in a series of draft Implementation Guide documents designed to assist entities with the implementation and application of the financial instruments standards.

The new standards for financial instruments are lengthy and can be complex. However, the effect of the standards on many entities may be minimal. Initial efforts have focused on producing guidance to help you develop a process for determining the extent to which the standards will affect you and for systematically implementing the standards.

The guidance is being published in stages, beginning with more generic issues. Draft documents available for comment at this time are:

- Implementation timeline
- Step 1 – Identification
 - Common assets and liabilities
 - Embedded derivatives

Comments are requested by **April 30, 2006**. The Invitation to Comment and other related information are available at: http://www.acsbcanda.org/index.cfm/ci_id/21832/la_id/1.htm

SUGGESTIONS FOR THE NEXT ISSUE?

Contact **Wenda Bennett, CA** at the Institute wbennett@icans.ns.ca or (902) 425-3291.

ATTENTION AUDITORS OF SMALL BUSINESSES AND NOT-FOR-PROFIT ORGANIZATIONS – NEW FRAUD GUIDANCE ISSUED

By Jane M. Bowen, CA (ICAO)

REVISED MARCH, 2006

The contents of this article reflect the most recent amendments made to CICA Section 5135 to limit the scope of application of this section to only fraud. Material dealing with errors has been moved to other relevant Handbook sections, such as 5141, 5142, and 5751. For more details on the amendment, refer to CICA Handbook - Assurance release no. 22. References to revisions (i.e. updates) in this article have been noted by the applicable content, and the revisions are explained at the end of the article.

CICA Section 5135, *The Auditor's Responsibility to Consider Fraud* has been revised yet again! This revision is derived from International Standard on Auditing 240, *The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements* (ISA 240), issued by the International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC). [Revision 1]

Effective Date: The originally revised Section 5135 applies to audits of financial statements and other financial information relating to periods ending on or after December 15, 2004 (with further revisions effective January 1, 2006). [Revision 2]

What does the standard say?

The revision to this standard contains very specific guidance which will result in substantial changes in the way an audit is planned, executed and documented.

As auditors of small businesses and/or not-for-profit organizations, you may feel that that the possibility of fraud is remote. However, no organization is immune to the possibility of fraud. Section 5135 discusses two types of fraud in an audit:

- **Fraudulent Financial Reporting** – examples include falsification of accounting records or omissions of transactions; and
- **Misappropriation of assets** – examples include theft of assets or fraudulent expenses.

These risks exist in small businesses and not-for-profit organizations. To meet the revised standard, it is important to assess the risk of fraud in the organization. The audit must be completed maintaining an attitude of professional scepticism, which is discussed below as the first step in meeting the standard.

What must I do to meet the standard?

The following eight (8) steps will help put the standard into perspective:

Step 1 Approach the audit with professional scepticism

As the auditor of a small business (SB) or not-for-profit organization (NFPO), you must exercise professional scepticism when considering the possibility that a material misstatement due to fraud could be present. Professional scepticism includes:

- an attitude that includes a questioning mind and a critical assessment of audit evidence;
- recognition that a material misstatement due to fraud could exist; and
- not being satisfied with less-than-persuasive audit evidence. [CICA 5135]

The idea of professional scepticism is not new. However, along with a revision to Section 5090, *Audit of Financial Statements – An Introduction*, one of the significant changes in this latest revision is the fact that the assumption of management's "good faith", honesty and integrity is, in essence, suspended in the planning process with respect to fraud. This means

that you should not, generally, consider a management representation sufficient evidence in itself.

Therefore, as the auditor, you must set aside existing beliefs about management's honesty and exchange ideas on how fraud could occur. The audit team members should keep in mind the incentives, opportunities, and ability to rationalize that usually precede fraud perpetration as discussed in Section 5135.

Step 2 Staff discussions – A meeting is required!

Members of the engagement team must have a preliminary planning meeting to discuss the susceptibility of the financial statements to fraud [Revision 3)]. This should include a discussion among the audit team members to:

- consider how and where the entity's financial statements might be susceptible to material misstatement due to fraud, and
- reinforce the importance of adopting an appropriate mindset of professional scepticism.

The team's discussions should put the engagement team in a better position to design audit tests responsive to the risks of fraud. If there is only one practitioner performing the audit, it may be suitable to have this discussion with a colleague, considering client confidentiality, of course.

Step 3 Obtain information needed to identify the risk of fraud

To obtain information to help you identify the risks of fraud, you must perform enquiry and discussion. It is important that you ask open-ended questions; i.e., questions that cannot be answered with "a yes or no" answer, to facilitate discussion. For example, do not ask "Are you aware of any fraud?" Rather consider questions such as: "Which assets are subject to misappropriation?" It is also important to ask the client to explain what controls they have in place to mitigate any risks.

Therefore, you must gather information necessary to identify risks of material misstatement due to fraud, by:

- enquiring of management and others within the entity about the risks of fraud; and
- considering the results of the analytical procedures performed in planning the audit (see comment below step 8 on analytical procedures).

The process of obtaining information can be completed in many ways. The enquiry and discussion can be separate meetings at the early stages of planning, or could even be performed in conjunction with a discussion of the engagement letter. The engagement letter provides a good opportunity to clarify the role of the audit, the new standards, and the client's understanding and expectations of the audit process so that the client is not surprised by the new procedures.

Alternatively, the information can be obtained by using formal checklists (see the Professional Engagement Manual (PEM) from the CICA for sample checklists on the identification of fraud risk factors and the response thereto). The checklists can be used to organize the discussion and provide documentation of the results. It may be useful to provide the client with an advance copy.

Step 4 Presume there is a Risk of Fraud in Revenue Recognition!

CICA 5135 indicates that there is a presumption that there is ordinarily a risk of fraud in revenue recognition. **There is a specific requirement to document the reasons when you feel that revenue recognition is not deemed a risk.** The risk can be overstatement or understatement. Analytical procedures can be an effective tool in this area.

Step 5 Respond to Assessed Risks

As the auditor, you must assess the identified risks of fraud, after considering controls in place, if any, and respond to the results of this assessment. This response is to be developed in the planning phase of the audit and identifies which procedures would be suitable to respond to the identified risks. Section 5135 provides the following guidance in how to respond:

- Perform further enquiry of management and others within the entity;
- Complete procedures to address the risk of management override which can be pervasive in SBs and NFPO (see below);
- Incorporate an element of **unpredictability** in response to risks, for example, consider completing inventory counts on unannounced dates.

Certain procedures are required to further address the risk of material misstatement due to fraud involving management override of controls. The procedures required include:

- Examining journal entries and other adjustments for evidence of possible material misstatement due to fraud;
- Reviewing accounting estimates for biases that could result in material misstatement due to fraud; and
- Evaluating the business rationale for significant unusual transactions.

Step 6 Evaluate Evidence and Obtain Management Representation

You must evaluate audit evidence and obtain representation from management on the identification of fraud risk factors and any discovered fraud and any impact on your audit procedures and report.

Step 7 Communication

You must communicate information that a fraud exists or may exist to [Revision 4] management on a timely basis (and the audit committee or equivalent if that is a different party). (See CICA Sections 5750 and 5751 for further details.)

Step 8 Document! Document! Document!

The standards require documentation of the above steps. It would be suitable to use forms/checklists and narratives to document the process and findings.

The Power of Analytical Procedures

The use of analytical procedures at the planning, execution and wrap-up phases of the audit is important and as mentioned above, Section 5135 now makes a direct link as follows:

.085 *The auditor should consider whether analytical procedures performed at or near the end of the audit (see ANALYSIS, paragraph 5301.23) when forming an overall conclusion as to whether the financial statements as a whole are consistent with the auditor's understanding of the entity and its environment indicate a previously unrecognized risk of material misstatement due to fraud.* Determining which particular trends and relationships may indicate a risk of material misstatement due to fraud requires professional judgment. Unusual relationships involving year-end revenue and income are particularly relevant. These might include, for example, uncharacteristically large amounts of income being reported in the last few weeks of the reporting period from unusual transactions, or income that is inconsistent with trends in cash flow from operations. [JAN. 2006] (CICA Handbook Accounting – Paragraph 5134.085 [Revision 5])

Conclusion

As the auditor you may also use these new standards to remind SB owners and NFPOs that there are procedures that can help protect them against fraud. For example, the bank statements should be reviewed directly by the manager before anyone else sees it.

In conclusion, it is important that you read Section 5135 in its entirety to ensure compliance with these new standards. It is inevitable that these new standards will require additional time. The effect on the audit fee and staffing requirements should be assessed as soon as possible.

Revisions:

- 1) CICA Section 5135, *The Auditor's Responsibility to Consider Fraud and Error* has been renamed *The Auditor's Responsibility to Consider Fraud*.
- 2) The effective date of the revisions included in release no. 22 is January 1, 2006.
- 3) Deleted the reference to error.
- 4) Scope narrowed to discussion of fraud or potential fraud from misstatements.
- 5) The handbook section has been renumbered from .084 to .085. The wording has been modified slightly to refer to the auditor's understanding of the entity, and the reference to error has been removed.

This article was provided by Jane M. Bowen, CA, who has been involved in the professional development and education of Chartered Accountants for several years. She participates in several programs that prepare finalists for the Uniform Final Examination, and is currently the Coordinator of the Professional Practice portion of the School of Accountancy. Jane lectures in financial accounting at the Schulich School of Business at York University and is also the co-author of the "Guide to Preparing Financial Statements."



SURVIVING A TAX AUDIT

By Peter G. Budreski, CA

Every commercial operation in this country with a business number will, in all likelihood, receive a phone call some day from the Canada Revenue Agency advising them that their business will be audited.

The natural reaction is panic. As a trusted advisor to your client, there is a lot that can be done — pro-active and re-active to minimize the impact of a tax audit.

RE-ACTIVE

On the re-active side, here are some practical considerations you and your clients might want to implement once the auditor has called you.

1. Schedule a time for the auditor to arrive that allows you and your client to be free to deal with them — no sense having an auditor show up at a busy month end or when the financial person is away on vacation.
2. Find out exactly what the auditor is going to audit — is it payroll, GST/HST or a general audit? What time frame is this person going to audit? Knowing these in advance can help your client to prepare for the audit - very important to have all relevant documents on hand so that the auditor does not have to dig. In the case of GST/ HST audits, some auditors have displayed a preference for the HST account to be available to them in spreadsheet format — it makes their job easier.
3. Once the auditor arrives, ensure they have a good place to do their work — comfortable chair and environment, access to phone and other amenities. I was once told of a company who located the tax auditor in a closet in the back of the warehouse with the heat set at an uncomfortable level & the desktop was a piece of plywood on boxes — needless to say almost every transaction had to be traced back to supporting documentation.
4. Appoint a designated person to deal with the auditor on all issues — the auditor should not be asking the accounts payable person about senior management's travel expense accounts. It is very common in a lot of businesses to have clerical staff "gossip" and be suspicious of upper management's travel & entertainment expenses. These are not the staff that should be speaking to the auditor.
5. Make sure that the auditor has easy access to all the records under examination — filed documents should be easy to locate and in a logical order.
6. "Win the war, not the battle" — simply stated, if the auditor proposes an adjustment that is insignificant in relation to the business volumes, have the client pay it and move on.
7. If the client is assessed for a large amount, have your client deal with it promptly and professionally. The amounts being re-assessed should be clearly identified, researched and dealt with before the auditor leaves the client's office, if possible. It is usually much more difficult to have an auditor reverse a position if alternative evidence is brought to their attention two months after the audit.

PRO-ACTIVE

Professionally speaking, I prefer to deal with tax auditors on a pro-active basis. Tax audits can be minimized or even not happen if your clients follow these tips —

1. Ensure your clients file all returns on time and in advance if possible. Late filed GST/HST returns are almost an automatic flag for an audit.

2. Encourage your clients to understand the reason behind GST/HST refunds. Typically a request for refund will trigger an inquiry and maybe an audit. Significant investment in new capital assets is a bona fide reason for a refund, but sloppy or inadequate record keeping will inevitably lead to an audit.
3. Some accounting software can be customized to account for the fact that ½ of the GST/HST on the cost of meals is not claimable against GST/HST collected. All of my clients follow this, with the result being the tax auditor was “amazed” and cut short the visit.
4. Business is business - encourage your clients to keep personal expenses away from the business - quite often a business credit card is used for both personal and business, with a shareholders loan being set-up. The less an auditor sees of personal expenses, the more likely the audit will be shorter.
5. Although many audits are categorized as a GST or Payroll audit, the auditor will inevitably ask the question “Are there any company vehicles available for personal use?” A seasoned payroll auditor once told me that companies with company vehicles were “targets”, whereas those companies that provided compensation to employees using a vehicle for work in the form of a per kilometer rate (documented by a periodic report) tended to be ignored. Unless it is warranted, the company car should be avoided and employees using a vehicle should be compensated via a per kilometer rate.

Last but not least, treat the auditor with decency — he/she is not your best friend, nor are they the enemy — just treat them on a professional basis and with courtesy.

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