# CANADIAN OVERVIEW

## Fourth Quarter

The quarterly Canadian Overview is a newsletter produced by the Canadian member firms of Moore North America.
These articles are meant to inspire conversation and collaboration throughout Canada and beyond.

# Revised CAS 315 - Analysis of Risks Arising from the Use of IT

Written by Shayne Huneault, CPA from Marcil Lavallée

To cope with the recent pandemic, many companies were forced to drastically change their business models and adopt a virtual management approach. Automated bank transfers replaced cheques, face-to-face meetings yielded to Zoom, and a growing number of companies began using and developing integrated software and applications to manage financial transactions remotely.

And although this change offers many opportunities for SMEs, it is nevertheless a major challenge for auditors. To support an audit opinion, it is essential to have a clear understanding of the companies' environment, and the key controls they have in place. For the average CPA, it is much easier to see whether a cheque is legitimate by looking at the signatures it bears than it is to analyze a string of code from an automated bank transfer application. Auditing the use of automated controls can quickly turn into a real headache, especially since most auditors are not IT specialists.

In light of all this, the Auditing and Assurance Standards Board recently amended CAS 315 – *Identifying and Assessing the Risks of Material Misstatement* in the CPA Canada Handbook. The changes to the standard, which will be effective for audits of financial statements for periods beginning on or after December 15, 2021, cover various aspects of audit planning and clarify requirements for assessing the IT environment and risks arising from the use of IT.

### Risks arising from the use of IT – what are the requirements?

Although the previous standard briefly touched on IT risks, the new revised CAS 315 clarifies and heightens the requirements in terms of work and documentation, some of which are listed below:

- The revised CAS now requires auditors to carry out procedures evaluating the relevance and significance of information technology use within the entity. In performing their assessment, auditors must consider, among other things, the automated controls that some applications may have in place and the use of reports automatically generated by these same applications;

- The revised CAS requires auditors to identify computer applications or any other aspect of the IT environment that may present vulnerabilities, in order to assess the risks related to their use for financial data;

- When risks are identified, the revised CAS requires auditors to assess both these risks and the controls in place within the entity that aim to address these risks;

- The revised CAS also requires auditors to determine during the audit whether there are any categories of transactions that, because they are automated, can only be tested using a control approach.

## What impact will this have on your audit files?

The AASB added an important concept to the revised CAS 315: adaptability. The standard mentions that auditors can and should adapt these procedures according to the level of complexity of the entity being audited. In other words, the amount of work involved in assessing IT risks will be limited for small entities with minimal use of such technology. Conversely, assessing the IT environment is going to be an important concern for auditors of large entities that are developing their own systems and those in which automation of operations is becoming increasingly common. In such cases, auditors will have to increase their level of work and the amount of documentation on file when assessing the audited client's IT structure, the identified risks, and the IT controls in place that have to be tested. This may mean adding questionnaires and programs to this effect to the work files, as well as using new analysis tools to evaluate how well automated controls are working.

The development of new technologies and their ever-increasing accessibility for businesses, both small and large, will no doubt reshape our old ways of working. Auditors will find it increasingly important to develop and use tools to properly test various IT controls. For firms to be able to perform high-quality audits, hiring IT specialists is likely to become commonplace. Even though this phenomenon forces auditors to adapt to a new environment, it also introduces new opportunities. The race to develop new automated audit approaches is heating up, and some firms may come away with a major competitive edge.

Author: Shayne Huneault, CPA

Marcil Lavallée

# Renewed CRA Focus: Personal Service Business

Written by Kelly B. Sinn, JD from Mowbrey Gil

Recently the CRA began an “educational outreach project” relating to Personal Services Businesses (“PSB”). In its media releases, the CRA indicated they would be contacting Canadian businesses to request documentation regarding potential PSBs, but that participation would be voluntary. However, the letters that businesses have received from the CRA make no mention of participation being voluntary, and in fact contain references to the CRA’s authority to inspect the business’s records.

We have some doubts that this new CRA initiative is purely educational and believe it may signal a renewed focus by the CRA on the audit of potential PSBs. With that being the case, we wanted to devote this Tax Minute to reminding our clients what circumstances might trigger the PSB provisions and the effects of those provisions are triggered.

**The first question you may be asking is: what is a PSB? In order for a corporation to be designated as a PSB, three conditions must be met:**

1. There must be an individual that performs services for a recipient on behalf of a corporation;
2. That individual, or someone related to them, must hold 10% or more of any class of the corporation’s shares; and,
3. If the individual provided the services directly to the recipient, they would be considered to be an employee of the recipient.

**Even if all three of the above requirements are met, the corporation will not be treated as a PSB if it meets one of two exceptions:**

1. The corporation has more than 5 full-time employees; or,
2. The service recipient is a corporation that is associated with the corporate service provider.

If it is determined that a corporation is a PSB, the tax implications can be dire. Firstly, a PSB's income is taxed at a higher corporate rate: they are not eligible for the general tax rate reduction or small business deduction and they pay an additional 5% surtax. In Alberta this means a total corporate tax rate of 41% and, once the proceeds are paid via dividend to the individual shareholders, an effective tax rate (including corporate and personal tax) of approximately 60% in the case of eligible dividends and 66% in the case of non-eligible dividends, assuming top marginal tax rates apply.

Additionally, expenses the corporation may claim as deductions are severely limited: the corporation may only claim deductions for salary and employment benefits paid to the individual performing the services, legal expenses required to collect amounts owing, and certain expenses that would be claimable by the individual if they were providing the same services personally. These effects combine to strongly disincentivize operating as a PSB and make it prudent to take steps to minimize your exposure in circumstances where the CRA may determine that your corporation is a PSB.

If you have a corporation that is providing services and are concerned that the PSB rules may apply to you, contact the tax team at Mowbrey Gil today.

Author: Kelly B. Sinn, JD

MOWBREY GIL LLP
Chartered Professional Accountants & Business Advisors

# The Importance of Working Capital Definitions in Buy-Side Due Diligence

Written by Greg Shagalovich CPA, CA Senior Manager, Transaction Advisory from Segal GCSE LLP

The process of acquiring a company is a lengthy undertaking which, when completed smoothly, does not significantly impact its normal operations. As many deals are done on a cash-free, debt-free basis, the post-closing balance sheet should reflect the true nature of the working capital of the company which differs from the traditional accounting-centric definition. Therefore, understanding a target company's working capital cycle is a critical component in helping your client to negotiate a fair transaction and to ensure the smooth transition of control.

The type of deal described above typically begins with a letter of intent that has language in it relating to the seller leaving an appropriate amount of working capital in the business to ensure it continues to operate without interruption. As the deal nears completion, setting an accurate working capital target and definition for the purchase agreement is crucial so that undefined liabilities do not become the responsibility of the purchaser.

**As such, deal-related working capital can consist of some or all of the following balances:**

- Accounts receivable, net of allowances for doubtful accounts
- Inventory
- Prepaids
- Non-income taxes receivable
- Accounts payable and accrued liabilities
- Other accruals (i.e., payroll, vacations, etc.)
- Non-income tax payable
- Deferred revenue (if not included in indebtedness within the purchase agreement)

**Determining which of the above components exist can be achieved through careful due diligence. Common steps in doing so consist of:**

- Understanding the target company and whether its working capital is cyclical as well as speaking with management
- Understanding the accounting policies in place and ensuring that proper accrual accounting is followed. This is especially important for interim periods if the target company does not perform regular bookkeeping
- Analyzing the quality of accounts receivable, the salability of inventory, and the relevance of prepaids to ensure good assets are left on the balance sheet
- Observing correct cut-off and accrual procedures at period ends so that unrecorded liabilities don't creep up post-closing

A well-understood and defined working capital target should ultimately leave both the purchaser and vendor on equal footing. The difference between the target working capital and the post-closing working capital (a period defined in the purchase agreement to allow for the books to be cleaned up post-acquisition) ultimately results in a downward or upward adjustment to the purchase price where both sides should feel comfortable about the deal you helped advise them on.

Author: Greg Shagalovich, CPA, CA Senior Manager, Transaction Advisory

SEGAL GCSE

# Making lemonade: Strategies for when the markets are giving you lemons

Written by Nav Pannu, CPA from DMCL

Look, we probably don't have to tell you it's been a hard year to be an investor. Lingering effects of the pandemic, rising inflation, supply chain constraints, war and other external factors have produced significant declines in the markets that could make even the safest of investors sweat.

While it may seem like the only thing you can do in a down market is to hold tight, there are actually a few unique tax planning opportunities that could position you to get ahead. Let's take a look at some of the ways you can use a market downturn to your advantage:

## Tax Loss Selling

Tax loss selling is a common strategy for reducing taxes on capital gains, which involves selling off investments—including stocks, real estate and others—that have declined in value in order to generate capital losses. While it may hurt to see capital losses realized, those losses can be used to offset any capital gains generated during the year, thereby reducing taxes payable for the year.

Additionally, net capital losses realized in a year can be carried back to the three prior tax years (i.e., 2021, 2020 and 2019) to offset any capital gains generated in those years and reduce income taxes already paid (which may result in a refund). Alternatively, these losses can be carried forward indefinitely and applied against future capital gains, allowing for more flexibility in when you wish to reduce your taxes.

It's important to note that capital losses may be denied on the disposition of an investment if they fall under the superficial loss rules, which are as follows:

1. The same or identical property was acquired by you or a spouse during the period beginning 30 days before the disposition and ending 30 days after the disposition; and
2. At the end of the period, you or a spouse owns or had the right to acquire, the same or identical investment.

Note: This includes your RRSP, TFSA, RRIF and properties held in you or your spouse's company.

## Estate (re)freeze for investment corporations

An estate freeze is a strategy where the accrued value of an individual's shares in a corporation are exchanged for "frozen" fixed value preferred shares. This move allows for future growth of the company to attribute to "growth" common shares held by family members.

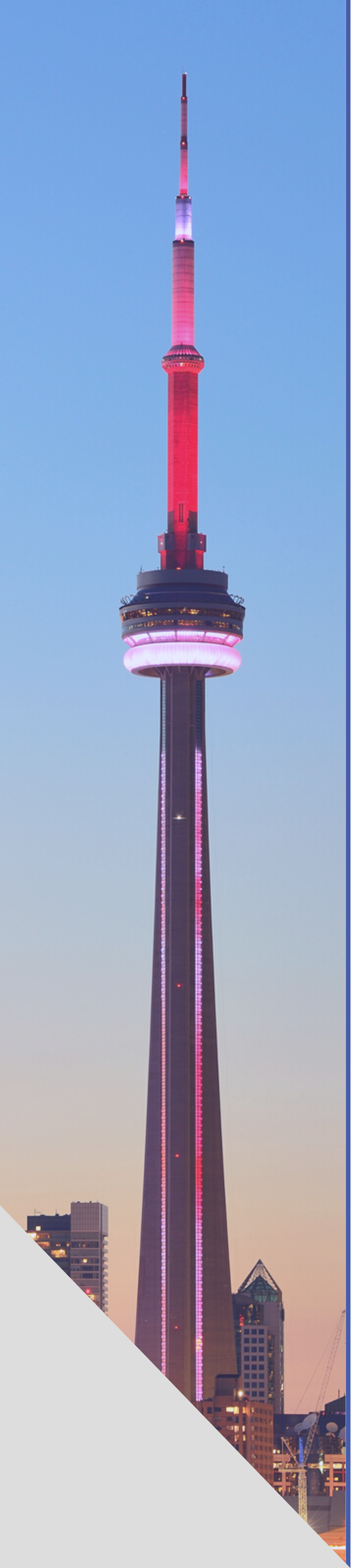
For corporations that have previously implemented an estate freeze, a downturn in the markets may be a good time to review the overall value of your corporate assets. If the value of a corporation's assets has significantly decreased, a re-freeze could yield many benefits.

In a re-freeze, the preferred shares you own with a higher redemption value are exchanged for new preferred shares with a value equal to the current reduced value of the company. If the preferred shares are worth less than their face or redemption value, the common shares' value is nominal.

This can provide several advantages, including:

- Allowing future growth to go to your common share holders (family members or discretionary family trust);
- Reducing the value of your estate and associated taxes owing on death;
- Allowing for dividends to be paid to common shareholders, as corporate bylaws would have otherwise prevented any dividends to be paid when the value of the company is below the value of the preferred shares; and,
- Extending the tax-life of a family trust by introducing a new family trust to hold growth shares of the company (the old family trust shares can be repurchased nominally).

Determining the fair market value of the company's shares is a critical part to executing this plan. Your CPA can help with this process and examine how an estate freeze or re-freeze could work to your benefit.



## Individual Pension Plan (IPP) revaluations

As a refresher: an IPP is an employer-sponsored pension plan that can be setup by and for a single person, in which contributions accumulate and compound while being fully tax sheltered. Contributions made to an IPP are tax deductible for your business in the fiscal year contributions are made (or 120 days after the fiscal yearend).

Generally, an actuary—the person responsible for determining if your plan has sufficient assets at the time of retirement—will provide a valuation report on the same yearend date as your business. This report will assess the IPP financial position to determine the IPP contributions for subsequent years. However, some business owners choose to pursue a revaluation of their IPP with a selected valuation date of when the value of their assets are in a deficit position.

During a market downtown, this revaluation allows for an additional contribution amount equal to the deficit described above, and may also allow for a new annual IPP contribution amount higher than before. The higher contribution amounts will benefit your business if you want to reduce the tax liabilities in a given fiscal year, while also increasing the assets that will be available to you at retirement.

A downturn in the markets can be rattling for any investor, but having the right strategies in place can make all the difference. Talk to your CPA about how you can use this situation to your advantage and they'll be happy to identify the right tax planning opportunities for your unique financial situation.

Author: Nav Pannu, CPA

DMCL
CHARTERED PROFESSIONAL
ACCOUNTANTS

MOORE

Moore North America (Moore NA) is one of five regional members of Moore Global Network Limited (MGNL). Moore NA currently has 35 member firms across North America, including five in Canada. Additional information, including thought leadership and other key collaboration opportunities, available at https://www.moore-na.com