



# The Corporation of The City of London

**Audit Planning Report**

**For the year ended December 31, 2017**

*KPMG LLP*

Licensed Public Accountants

Prepared as of January 29, 2018 for presentation on February 7, 2018

[kpmg.ca/audit](http://kpmg.ca/audit)



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At KPMG, we are **passionate** about earning your **trust**. We take deep **personal accountability**, individually and as a team, to deliver **exceptional service and value** in all our dealings with you.

At the end of the day, we measure our success from the **only perspective that matters – yours**.

# Executive summary

## Audit and business risk

Our audit is risk-focused. In planning our audit we have taken into account key areas of focus for financial reporting.

See pages 5-7.

## KPMG team

The KPMG team will be led by Katie denBok and Deanna Baldwin. Subject matter experts will be involved to ensure our approach is appropriate and robust.

## Effective communication

We are committed to transparent and thorough reporting of issues to the City Treasurer and Chief Financial Officer, Director of Financial Services, senior management and the Audit Committee.

## Audit Materiality

Materiality for the consolidated financial statements has been determined based on total expenses. We have determined materiality to be \$15,300,000 for the year ending December 31, 2017.

See page 4.

## Independence

We are independent and have extensive quality control and conflict checking processes in place. We provide complete transparency on all services and follow Audit Committee approved protocols.

## Current developments

Please refer to Appendix 7 for relevant accounting and/or auditing changes relevant to the Corporation of the City of London (the “City”).

This Audit Planning Report should not be used for any other purpose or by anyone other than the Board of Directors. KPMG shall have no responsibility or liability for loss or damages or claims, if any, to or by any third party as this Audit Planning Report has not been prepared for, and is not intended for, and should not be used by, any third party or for any other purpose.

# Materiality

The determination of materiality requires professional judgment and is based on a combination of quantitative and qualitative assessments including the nature of account balances and financial statement disclosures.

The first step is the determination of the amounts used for planning purposes as follows:

Materiality determination	Comments	Amount
Metrics	Relevant metrics included total revenues, total expenses and net assets	
Benchmark	Based on an estimate of total expenses for the year. This benchmark is consistent with the prior year.	\$1,020,041,000
Materiality	Determined to plan and perform the audit and to evaluate the effects of identified misstatements on the audit and of any uncorrected misstatements on the financial statements. The corresponding amount for the prior year's audit was \$15,100,000.	\$15,300,000
% of Benchmark	The corresponding percentage for the prior year's audit was 1.5%	1.5%
Performance materiality	Used 75% of materiality, and used primarily to determine the nature, timing and extent of audit procedures. The corresponding amount for the prior year's audit was \$11,325,000.	\$11,475,000
Audit Misstatement Posting Threshold (AMPT)	Threshold used to accumulate misstatements identified during the audit. The corresponding amount for the previous year's audit was \$755,000.	\$765,000 \$3,825,000 for reclassification

Professional standards require us to re-assess materiality at the completion of our audit based on period-end results or new information in order to confirm whether the amount determined for planning purposes remains appropriate. Our assessment of misstatements, if any, in amounts or disclosures at the completion of our audit will include the consideration of both quantitative and qualitative factors.

# Audit approach

Inherent risk is the susceptibility of an assertion related to a significant account or disclosure to a misstatement which could be material, individually or when aggregated with other misstatements, assuming that there are no related controls.

Our assessment of inherent risk is based on various factors, including the size of the balance, its inherent complexity, the level of uncertainty in measurements, as well as significant external market factors or those particular to the internal environment of the entity.

Significant financial reporting risks	Why	Our audit approach
Completeness of accruals	The financial statements include certain accruals, such as legal and landfill liabilities and liabilities for contaminated sites, which involve a significant amount of management judgment and assumptions in developing.	<ul style="list-style-type: none"> <li>• We will obtain an understanding of management’s process and calculations for each of these areas and assess the adequacy of management’s process for identifying critical accounting estimates</li> <li>• We will obtain corroborative evidence to support management’s assumptions and review subsequent payments where possible.</li> <li>• We will send legal letters to internal and external legal counsel, review Council minutes, severance agreements etc. to identify any potential unrecorded liabilities.</li> </ul>
Other areas of focus	Why	Our audit approach
Capital projects and acquisitions	The City of London has a large balance of tangible capital assets and is continually spending on capital projects. There is judgment involved in determining the useful lives of capital and when its amortization period should begin.	<ul style="list-style-type: none"> <li>• KPMG will perform substantive testing over capital additions and disposals, including the determination of when capital expenditures are transferred from assets under construction and amortization begins.</li> <li>• KPMG will review management’s determination of the useful lives of capital assets and the related amortization rates. KPMG will also recalculate amortization expense.</li> </ul>
Payroll and employee future benefits	The City of London provides defined retirement and other future benefits for some groups of its retirees and employees. As at December 31, 2016, the City of London had a liability for employee future benefits of \$149 million.	<ul style="list-style-type: none"> <li>• KPMG will test the reasonableness of assumptions provided by management to the actuaries that are used in developing the valuation and calculating the liability.</li> <li>• KPMG will also specifically test the inputs provided by management to the actuary to ensure accuracy.</li> <li>• KPMG will take a combined approach to testing payroll expense, which will include both substantive and control testing.</li> </ul>

Other areas of focus	Why	Our audit approach
Taxation, user charges and transfer payments revenue	For the year ending December 31, 2016, these revenue streams amounted to more than \$1.0 billion for the City of London.	<ul style="list-style-type: none"> <li data-bbox="869 347 1858 402">• KPMG will perform substantive procedures over these revenue streams, including substantive analytical procedures over taxation revenue and vouching of significant transfer payments.</li> </ul>

# Audit approach

Professional standards presume the risk of fraudulent revenue recognition and the risk of management override of controls exist in all companies. The risk of fraudulent revenue recognition can be rebutted, but the risk of management override of control cannot, since management is typically in a unique position to perpetrate fraud because of its ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively.

Professional requirements	Why	Our audit approach
<p>Fraud risk from revenue recognition</p>	<p>This is a presumed fraud risk. There are generally pressures or incentives on management to commit fraudulent financial reporting through inappropriate revenue recognition when performance is measured in terms of year-over-year revenue growth or profit.</p>	<ul style="list-style-type: none"> <li>• We have rebutted this fraud risk as it is not applicable to the Corporation of the City of London where performance is not measured based on earnings.</li> </ul>
<p>Fraud risk from management override of controls</p>	<p>This is a presumed fraud risk. We have not identified any specific additional risks of management override relating to this audit.</p>	<ul style="list-style-type: none"> <li>• As the risk is not rebuttable, our audit methodology incorporates the required procedures in professional standards to address this risk. These procedures include testing of journal entries and other adjustments, performing a retrospective review of estimates and evaluating the business rationale of significant unusual transactions.</li> </ul>

# Other matters

Other areas of focus	Our audit approach
PS2200 Related Party Transactions	<p>PSAB issued Section PS2200 Related Party Transactions which defines related parties and provides disclosure requirements. A related party is defined as a party that has the ability to exercise control or shared control over the entity. This definition also includes key management personnel and close family members. This standard is effective for fiscal periods beginning on or after April 1, 2017. Although there is no impact on the current-year audit, Management will be implementing a process to ensure that all related party relationships have been identified, including those with key management, members of Council or Boards of the City and its Boards and Commissions.</p>
Ontario Works	<p>In November 2014, the Province of Ontario moved to a new IT system for Ontario Works ("OW"). During the initial stages of the transition, the City was not able to obtain reliable financial reporting from the Province in order to determine the classification of OW expenditures.</p> <p>As of April 1, 2016 and going forward, the City has been able to obtain the necessary information from the Province; however, reconciliations for the period from November 2014 to March 2016 are still outstanding. As such, the City of London has set up an accrual for this period. It is expected that the Province will work toward reconciling this remaining period.</p> <p>Management developed a method to estimate classification and KPMG audited this process and reviewed significant estimates in the prior year. KPMG will audit the accrual amount as at December 31, 2017.</p>
Debt Issuances	<p>Debentures totalling \$41 million were issued in March 2017. KPMG will review the accounting for this transaction in detail during the audit.</p>
Boards & Commissions	<p>The Hyde Park BIA is a new entity that was incorporated in fiscal 2017. In consideration of the limited activity in 2017, Management has decided that an audit will not be performed in the current year. A 15 month audited financial statement will be prepared for the period ended December 31, 2018. The Hyde Park BIA is not considered significant to the consolidated financial statements of the City of London.</p>



# Data & analytics in the audit

We will be integrating Data & Analytics (D&A) procedures into our planned audit approach. Use of innovative D&A allows us to analyze greater quantities of data, dig deeper and deliver more value from our audit.

We believe that D&A will improve both the quality and effectiveness of our audit by allowing us to analyze large volumes of financial information quickly, enhancing our understanding of your business as well as enabling us to design procedures that better target risks.

Area(s) of focus	Planned D&A routines
Journal entry testing	Utilize computer-assisted audit techniques (CAATs) to analyze journal entries and apply certain criteria to identify potential high-risk journal entries for further testing as a response to the fraud risk from Management override of controls.
Tangible capital assets - WIP	Utilize CAATs to compare the WIP detail in fiscal 2017 to the WIP detail in fiscal 2016, testing any projects that did not incur costs in fiscal 2017 and still remain in WIP. This routine will obtain audit evidence over the completeness of tangible capital assets and amortization expense.
Tangible capital assets – Disposals	Utilize CAATs to compare the disposal listing to the asset detail, testing assets that were recorded in both listings. This routine will obtain audit evidence over existence of tangible capital assets.
Holdback accrual	Utilize CAATs to compare the tangible capital asset WIP listing to the holdbacks accrual listing, testing any significant WIP project that did not have a corresponding holdback accrual. This routine will obtain audit evidence over the completeness of holdback accruals.

Detailed results and summary insights gained from D&A will be shared with management and presented in our Audit Findings Report.

# How we deliver audit quality



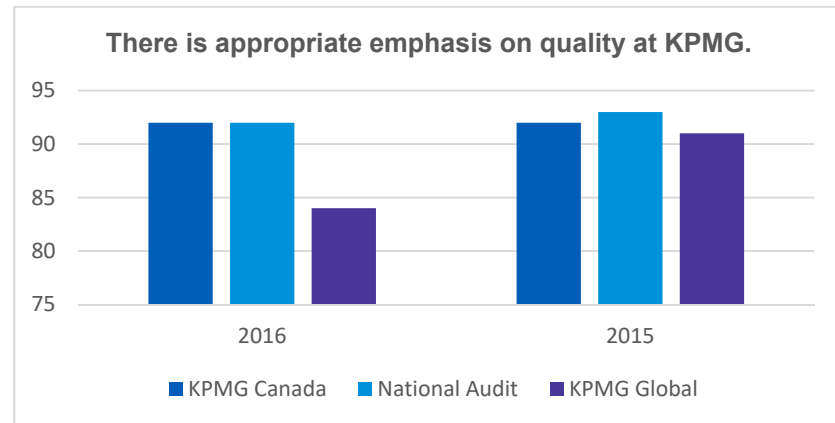
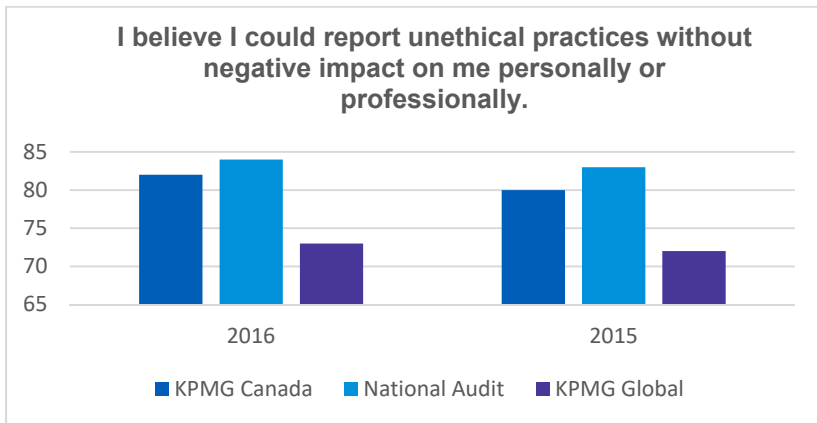
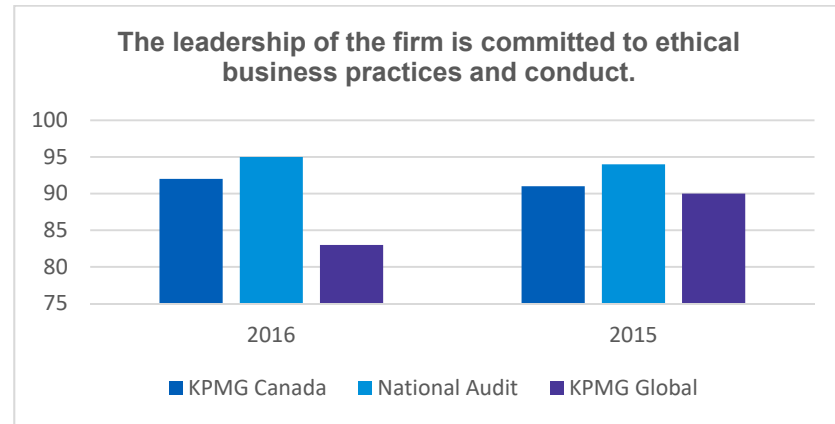
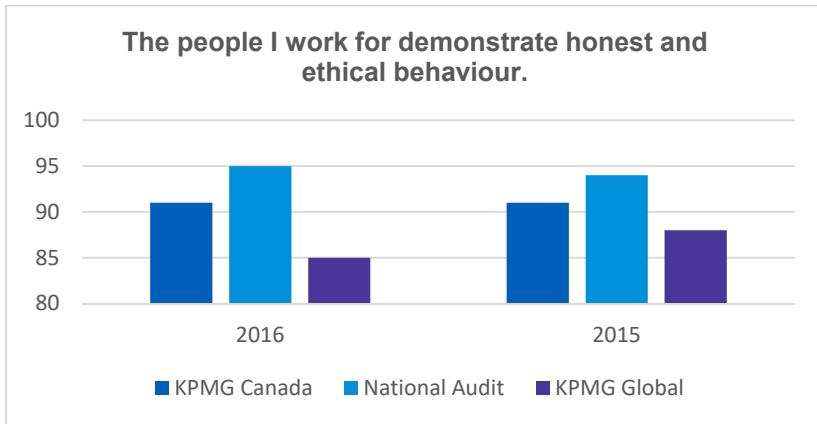
# Highly talented and experienced team

Team member	Background / experience	Discussion of role
<p>Katie denBok  <b>Lead Audit Engagement Partner</b>  <a href="mailto:kdenbok@kpmg.ca">kdenbok@kpmg.ca</a>                      519-660-2115</p>	<p>Katie has over 12 years of public auditing, accounting and reporting experience and has been involved with the audit of not-for-profit and public sector organizations, and a number of local private company clients. She proficiently assists clients with process improvement, accounting and financial reporting matters.</p>	<ul style="list-style-type: none"> <li>• Katie will lead our audit for the City of London and be responsible for the quality and timeliness of everything we do.</li> <li>• She will often be onsite with the team and will always be available and accessible to you.</li> </ul>
<p>Ian Jeffreys  <b>Relationship Partner</b>  <a href="mailto:ijeffreys@kpmg.ca">ijeffreys@kpmg.ca</a>                      519-660-2137</p>	<p>During his 22 years with KPMG, Ian has provided audit and other professional services to clients large and small, operating in both the public and private sectors. He has a significant amount of experience in many industry segments including not-for-profit, municipal, power and utilities, health care, distribution and manufacturing.</p>	<ul style="list-style-type: none"> <li>• Ian will lead our audit for London Hydro and London Transit Commission and be responsible for the quality and timeliness of these audits.</li> <li>• He will often be onsite with the audit team and will always be available and accessible to you.</li> </ul>
<p>Diane Wood  <b>Tax Partner</b>  <a href="mailto:dianejwood@kpmg.ca">dianejwood@kpmg.ca</a>                      519-660-2123</p>	<p>Diane is a member of the Financial Planners Standards Council and the Society of Trust and Estate Practitioners. Her principal activities are in not-for-profit taxation planning and compliance, personal income tax planning and compliance, estate planning, international executive taxation and providing financial planning and taxation assistance to individuals facing early retirement or severance packages.</p>	<ul style="list-style-type: none"> <li>• Diane will assist with any tax related matters that arise.</li> </ul>
<p>Deanna Baldwin  <b>Audit Manager</b>  <a href="mailto:deannabaldwin@kpmg.ca">deannabaldwin@kpmg.ca</a>                      519-660-2156</p>	<p>Deanna has over 8 years of public auditing, accounting and reporting experience and has been involved with the audit of not-for-profit and public sector organizations, as well as a number of local private and public company clients. She proficiently assists clients with process improvement, accounting and financial reporting matters.</p>	<ul style="list-style-type: none"> <li>• Deanna will work very closely with Katie and Ian on all aspects of our audit for the City of London.</li> <li>• She will be on site and directly oversee and manage our audit field team and work closely with your management team.</li> </ul>
<p>Eric Mallory  <b>Audit Senior Manager</b>  <a href="mailto:emallory@kpmg.ca">emallory@kpmg.ca</a>                      519-660-2163</p>	<p>During his 10 years with KPMG, Eric has provided audit and other professional services to clients large and small, operating in both the public and private sectors. He has a significant amount of experience in many industry segments including power and utilities, not-for-profit, health care, transportation, and manufacturing.</p>	<ul style="list-style-type: none"> <li>• Eric will work very closely with Ian on all aspects of our audit for London Hydro and London Transit Commission.</li> <li>• He will be on site and directly oversee and manage the audit field team for these entities, as well as work closely with the management team.</li> </ul>

# Our tone at the top

KPMG's commitment to quality starts with leadership and with the tone at the top that drives the pursuit of audit quality at a global level and in every KPMG member firm and audit engagement. The KPMG network includes more than 162,000 professionals around the world of which 2,500+ are audit professionals in Canada.

Our annual Global People Survey provides our people a chance to communicate how they feel about working at KPMG.



# Value for fees

## The value of our audit services

We recognize that the primary objective of our engagement is the completion of an audit of the consolidated financial statements in accordance with professional standards. We also believe that our role as external auditor of the City of London and the access to information and people in conjunction with our audit procedures, place us in a position to provide other forms of value. We know that you expect this of us.

We want to ensure we understand your expectations. To facilitate a discussion (either in the upcoming meeting or in separate discussions), we have outlined some of the attributes of our team and our processes that we believe enhance the value of our audit service. We recognize that certain of these items are necessary components of a rigorous audit. We welcome your feedback.

- Extensive industry experience on our audit team – as outlined in our team summary, the senior members of our team have extensive experience in audits of municipal and public sector organizations. This experience ensures that we are well positioned to identify and discuss observations and insights that are important to you;
- Current development update sessions – we organize and deliver tailored information on current developments in financial reporting and other matters that are likely to be significant to the City of London and your team. This information assists the City of London in proactively responding to and addressing financial reporting and regulatory changes;
- Involvement of KPMG specialists – Our audit team is supported by specialists in income and other taxes, information risk management, valuations and derivatives. We expect each of the specialists to provide insights and observations resulting from their audit support processes.

# Value for fees

In determining the fees for our services, we have considered the nature, extent and timing of our planned audit procedures as described above. Our fee analysis has been reviewed with and agreed upon by management.

Our fees are estimated as follows:

	Current period (budget)	Prior period (actual)
Audit of the annual consolidated financial statements	\$89,000	\$87,300

## Matters that could impact our fee

The proposed fee outlined above are based on the assumptions described in the engagement letter dated September 15, 2016. There have been no changes in the terms and conditions of our engagement since the date of our last letter.

The critical assumptions, and factors that cause a change in our fees, include:

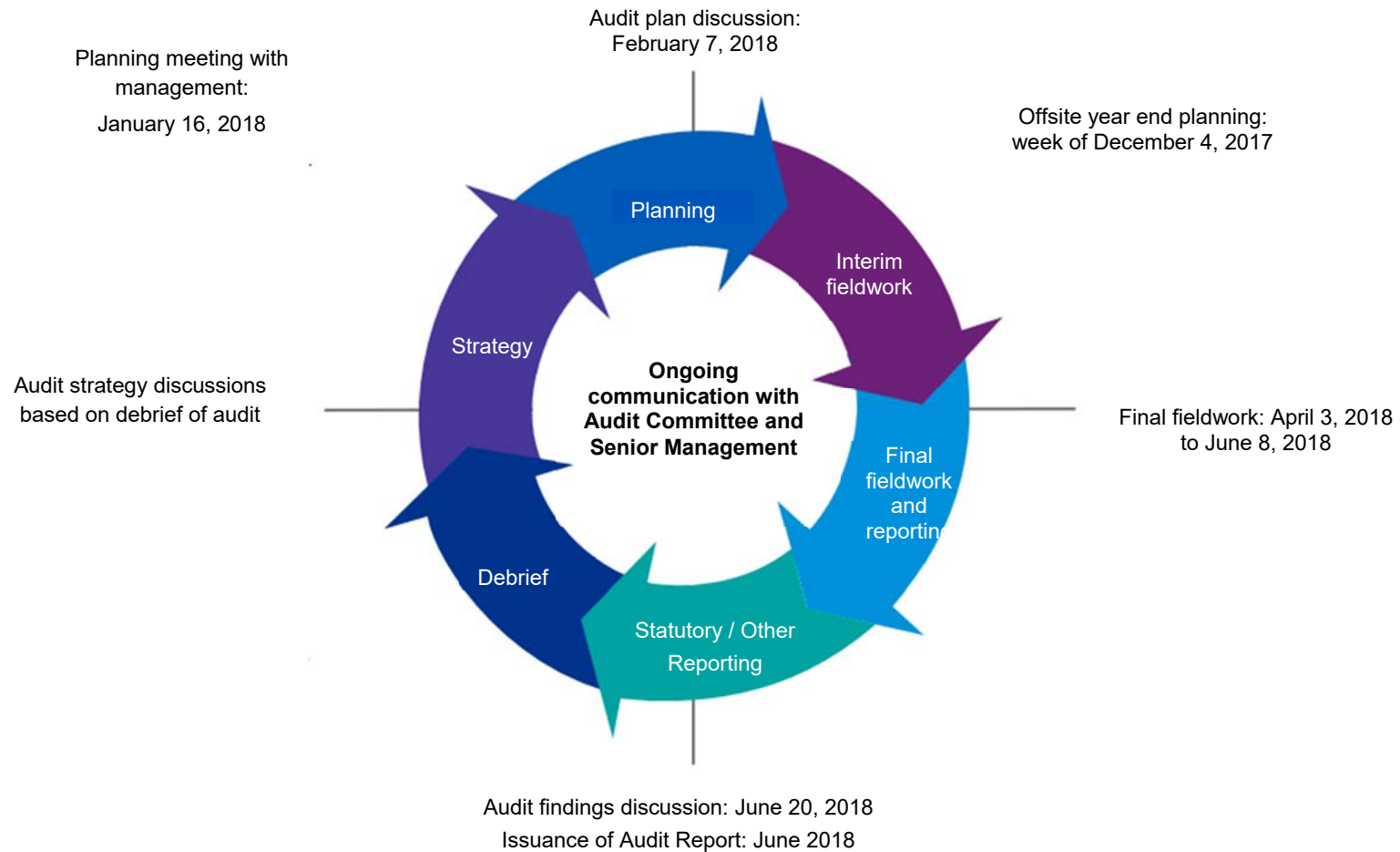
- Changes in professional standards or requirements arising as a result of changes in professional standards or the interpretation thereof

# Audit cycle and timetable

Our key activities during the year are designed to achieve our one principal objective:

- To provide a robust audit, efficiently delivered by a high quality team focused on key issues.

Our timeline is in line with prior year.



# Appendices

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**Appendix 1: Audit quality and risk management**

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**Appendix 2: KPMG's audit approach and methodology**

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**Appendix 3: Required communications**

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**Appendix 4: Data & analytics in audit**

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**Appendix 5: Lean in Audit™**

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**Appendix 6: KPMG's Cyber Security Protocol**

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**Appendix 7: Current developments**

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# Appendix 1: Audit quality and risk management

KPMG maintains a system of quality control designed to reflect our drive and determination to deliver independent, unbiased advice and opinions, and also meet the requirements of Canadian professional standards.

Quality control is fundamental to our business and is the responsibility of every partner and employee. The following diagram summarises the six key elements of our quality control systems.

Visit our [Audit Quality Resources](#) page for more information including access to our audit quality report, [Audit quality: Our hands-on process](#).

- Other controls include:
  - Before the firm issues its audit report, Engagement Quality Control Reviewer reviews the appropriateness of key elements of publicly listed client audits.
  - Technical department and specialist resources provide real-time support to audit teams in the field.
- We conduct regular reviews of engagements and partners. Review teams are independent and the work of every audit partner is reviewed at least once every three years.
- We have policies and guidance to ensure that work performed by engagement personnel meets applicable professional standards, regulatory requirements and the firm's standards of quality.



- All KPMG partners and staff are required to act with integrity and objectivity and comply with applicable laws, regulations and professional standards at all times.
- We do not offer services that would impair our independence.
- The processes we employ to help retain and develop people include:
  - Assignment based on skills and experience;
  - Rotation of partners;
  - Performance evaluation;
  - Development and training; and
  - Appropriate supervision and coaching.
- We have policies and procedures for deciding whether to accept or continue a client relationship or to perform a specific engagement for that client.
- Existing audit relationships are reviewed annually and evaluated to identify instances where we should discontinue our professional association with the client.

# Appendix 2: KPMG's audit approach and methodology

## Technology-enabled audit workflow (eAudit)

### Engagement Setup

- Tailor the eAudit workflow to your circumstances
- Access global knowledge specific to your industry
- Team selection and timetable

### Completion

- Tailor the eAudit workflow to your circumstances
- Update risk assessment
- Perform completion procedures and overall evaluation of results and financial statements
- Form and issue audit opinion on financial statements
- Obtain written representation from management
- Required Audit Committee communications
- Debrief audit process



### Risk Assessment

- Tailor the eAudit workflow to your circumstances
- Understand your business and financial processes
- Identify significant risks
- Plan the use of KPMG specialists and others including auditor's external experts, management experts, internal auditors, service organizations auditors and component auditors
- Determine audit approach
- Evaluate design and implementation of internal controls (as required or considered necessary)

### Testing

- Tailor the eAudit workflow to your circumstances
- Perform tests of operating effectiveness of internal controls (as required or considered necessary)
- Perform substantive tests

# Appendix 3: Required communications

In accordance with professional standards, there are a number of communications that are required during the course of our audit. These include:

- **Engagement letter** – the objectives of the audit, our responsibilities in carrying out our audit, as well as management’s responsibilities, are set out in the engagement letter and any subsequent amendment letters
- **Audit planning report** – as attached
- **Required inquiries** – professional standards require that during the planning of our audit we obtain your views on risk of fraud and other matters. We make similar inquiries to management as part of our planning process; responses to these will assist us in planning our overall audit strategy and audit approach accordingly
- **Management representation letter** – we will obtain from management certain representations at the completion of the annual audit. In accordance with professional standards, copies of the representation letter will be provided to the Audit Committee
- **Audit findings report** – at the completion of our audit, we will provide a report to the Audit Committee
- **Annual independence letter** – at the completion of our audit, we will provide a letter to the Audit Committee

# Appendix 4: Data & analytics in audit

## Turning data into value

KPMG continues to make significant investments in our Data & Analytics (D&A) capabilities to help enhance audit quality and provide actionable insight to our clients by unlocking the rich information that businesses hold.

When D&A is applied to the audit, it enables us to test complete data populations and understand the business reasons behind outliers and anomalies.

Advancements in D&A tools allow us to analyze data at more granular levels, focusing on higher risk areas of the audit and developing insights you can then leverage to improve compliance, potentially uncover fraud, manage risk and more.

## KPMG is enhancing the audit

The combination of our proven industry experience, technical know-how and external data allows us to focus our audit on the key business risks, while providing relevant insights of value to you.

For the audit

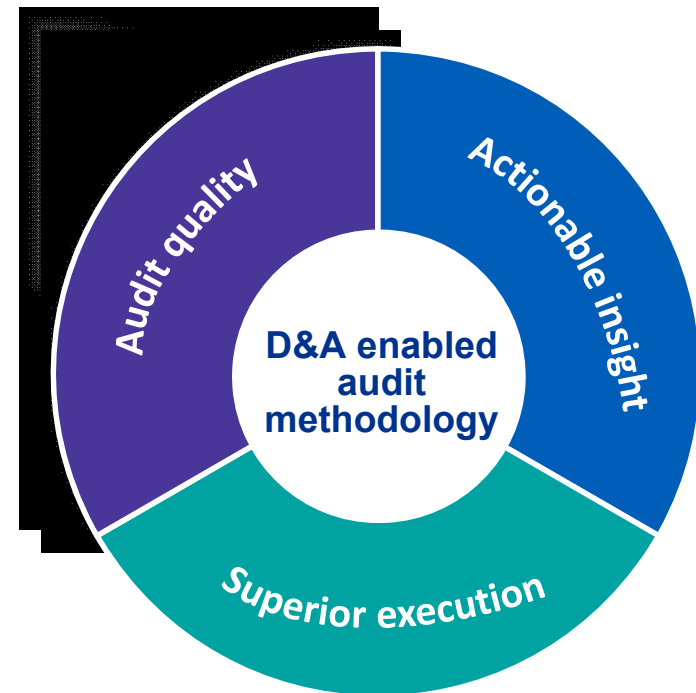
### Audit quality

- Automated testing of 100% of the population
- Focuses manual audit effort on key exceptions and identified risk areas

For your business

### Actionable insight

- Helping you see your business from a different perspective
- How effectively is your organization using your systems?



# Appendix 5: Lean in Audit™

## An innovative approach leading to enhanced value and quality

Our new innovative audit approach, Lean in Audit, further improves audit value and productivity to help deliver real insight to you. Lean in Audit is process-oriented, directly engaging organizational stakeholders and employing hands-on tools, such as walkthroughs and flowcharts of actual financial processes.

By embedding Lean techniques into our core audit delivery process, our teams are able to enhance their understanding of the business processes and control environment within your organization – allowing us to provide actionable quality and productivity improvement observations.

Any insights gathered through the course of the audit will be available to both engagement teams and yourselves. For example, we may identify control gaps and potential process improvement areas, while companies have the opportunity to apply such insights to streamline processes, inform business decisions, improve compliance, lower costs, increase productivity, strengthen customer service and satisfaction and drive overall performance.

## How it works

Lean in Audit employs three key Lean techniques:

### 1. Lean training

- Provide basic Lean training and equip our teams with a new Lean mindset to improve quality, value and productivity.

### 2. Interactive workshops

- Perform interactive workshops to conduct walkthroughs of selected financial processes providing end to end transparency and understanding of process and control quality and effectiveness.

### 3. Insight reporting

- Quick and pragmatic insight report including your team's immediate quick win actions and prioritized opportunities to realize benefit.

# Appendix 6: KPMG's Cyber Security Protocol

This summary is intended to provide management and Audit Committee members with some insight into KPMG's strategies and procedures regarding our cyber defence.

## KPMG Global

KPMG Global provides managed security services for member firms which includes 24x7 monitoring and alerting services to identify potential attacks on our environment. We use a series of centrally managed firewalls among our network of member firms to identify and address potential attacks to member firms and to prevent attacks from spreading between member firms. This approach was in place during the Wanna Cry outbreak and was a critical element in our successful defence against that incident.

KPMG Global has also implemented enhanced email protection to address malware and attacks through email and we have implemented automated vulnerability detection services. This service scans equipment that is exposed to the Internet and identifies known vulnerabilities on a real-time basis. "Good housekeeping" is a central tenet of our approach and we continue to focus on known vulnerabilities and patching.

KPMG Global believes the cloud represents a secure environment when appropriately configured and monitored as a platform to deliver services. Our approach to secure the cloud includes deploying full-time, dedicated security and privacy resources, integrating the cloud platform into our managed security services to promote "good housekeeping," and deploying a continuous monitoring plan for each of the cloud platforms that we deploy to member firms and to our clients.

KPMG Global has invested heavily in enhancing the security of our environment, evidenced by the introduction of our Global Security Operations Centre, managed services and other enhancements to our cyber defence.

## KPMG Canada Approach

- KPMG Canada does not currently use Office 365 or Cloud based email.
- Cloud environments provide robust security when properly configured, with proper password management.
- The Canadian firm's email servers are hosted in Canada and controlled and managed by KPMG Canada.
- In compliance with our global security controls, we enforce strong passwords that need to be renewed at regular intervals.
- We also maintain a specific IT security platform for the maintenance and management of privileged accounts.
- KPMG's Information Security Program is built on a comprehensive framework of policies, standards, and processes based on ISO 27001:2013.
- KPMG's security requirements are set out in Global Information Security Policies and Standards (GISP).
- The Canadian firm undergoes an internal audit every year to ensure compliance to key security controls in the GISP.
- Every three years, the Canadian firm goes through a Compliance Review conducted by a team from non-Canadian member firms.

# Appendix 7: Current developments

*Current Developments*, created by the KPMG Public Sector and Not-for-Profit Practice, summarizes regulatory and governance matters impacting charities and not-for-profit organizations today, or expected to impact over the next few years. We provide this information to help not-for-profit organizations understand upcoming changes and challenges they may face in their industry. We attach this summary to every audit plan and audit findings report that we provide to our public sector and not-for-profit clients. Some of these developments may not impact your organization directly but we believe it is important for audit committee members of charities and not-for-profit organizations to understand what is happening in the sector.

## **Annual Accounting, Tax and Risk Update for Not-for-Profit Organizations**

KPMG held its Annual Accounting, Tax & Risk Update for Not-for-Profit Organizations in mid-November 2017 at the Goodwill building in downtown London. The seminar covered current accounting, tax, technology and risk issues, including those discussed below, in greater detail to provide not-for-profit organizations and charities with guidance on new standards, regulations and best practices.

In prior years, this event has consistently attracted over 50 executives, financial officers and Board members from the London and area not-for-profit and charity community.

Audit Committee members are also invited to attend this session. If you wish to have your name included on the invite list, please e-mail Vicki Ng at [ywng@kpmg.ca](mailto:ywng@kpmg.ca)

## **Tax-Exempt Status of Not-for-Profit Organizations**

Over the past few years, the income tax-exempt status of not-for-profit organizations and the activities that should be eligible for this exemption have been the subject of significant political and public debate.

This debate intensified with the CRA's Non-Profit Organization Risk Identification Project (the "NPORIP") looking at entities claiming the exemption from income tax under Paragraph 149(1)(l) of the Income Tax Act of Canada, and the release of their report in 2014. The report emphasized three main risk areas which in the eyes of CRA would disqualify a not-for-profit organization from claiming the income tax exemption:

- having individual activities not related to their not-for-profit objectives; or earning non-incident profits from individual activities
- using income to provide personal benefits to members
- maintaining excessive accumulated reserves, surpluses or net assets

In 2014, the Government announced its intention to hold public consultations with not-for-profit organizations on these issues, led by the Department of Finance. It was anticipated that this public consultation process would ultimately result in changes to the Income Tax Act and other legislation and regulations governing the activities of not-for-profit organizations, most likely in the 2017 Federal Budget.

The election of a new Government in fall 2015 appears to have delayed progress on this issue. While the official mandate letter of the new Minister of Finance includes providing clarity on the activities of not-for-profit organizations and charities, the Department of Finance has provided no indication as to when, or if, it expects to begin public consultations with the not-for-profit community on the issues surrounding the tax-exempt status of not-for-profit organizations. However, in fall 2016, the Government did announce the formation of Consultation Panels on two related issues in the charity/NPO sector: Political Activities of Registered Charities; and Social Enterprise/Social Impact Financing. As such, the general expectation is that any significant changes in income tax legislation impacting the operations of not-for-profit organizations, will not be introduced until Budget 2018 at the earliest.

In the interim, CRA has not performed specific audits of the income tax-exemption status of not-for-profit organizations to our knowledge. However, CRA continues to perform regular HST and payroll compliance audits of not-for-profit organizations and charities. As part of these audits, CRA has included questions relating to the accumulated surplus/net assets/reserves of the audited organization, and is seeking documented evidence of purpose, future plans and governance oversight related to these balances.

KPMG encourages the Boards and management of not-for-profit organizations, and of charities, to continue to prepare their organizations for the anticipated changes to tax legislation and regulations. Organizations should review and consider their not-for-profit or charitable objectives, strategic plans, risk assessments, financial results and operational practices in the context of the aforementioned risk areas identified by CRA. In particular, organizations should develop a written, approved Board policy relating to their net assets, accumulated surpluses and/or reserves explicitly documenting the reasons for maintaining these balances, how the amounts were calculated and quantified, and how the amounts will ultimately be used. Boards should also demonstrate and document their oversight of this policy on an annual basis.

KPMG continues to monitor this situation closely and will continue to update you and all of our audit clients.

## **The COSO Framework: Demonstrating Sound Management Practices and Internal Controls**

Charities and not-for-profit organizations are facing increasing pressures and challenges from various internal and external stakeholders, who are demanding greater transparency and accountability. Chief among these is a heightened level of scrutiny and higher expectations on charities and NPOs to demonstrate sound stewardship, accountability, and achievement of results. This includes being able to demonstrate that resources are managed in a cost-effective manner and that funding received is used to maximize the achievement of the organization's mandate.

A charity's or not-for-profit organization's ability to clearly demonstrate sound management and use of funding and the achievement of objectives are of direct interest to donors, funders, partners, stakeholders and beneficiaries, and increasingly to the Canadian general public. This, combined with a general increase in competition for scarce resources, can compound the challenges experienced by charities and not-for-profit organizations.

In this environment, your organization will be asked to demonstrate that it is using and managing funds in an economical and efficient way and that it maintains a solid control environment supporting management decisions made by the organization. National charities and not-for-profit organizations are beginning to formally adopt the "COSO



Framework” of management practices and internal controls to respond to their stakeholder demands. The COSO Framework is an internationally recognized framework for the assessment of management practices and internal controls in all types of entities.

The main reason that the COSO Framework is gaining acceptance in the charity and not-for-profit sector is that it considers internal controls from the perspective of achieving organizational objectives categorized into three areas:

- Effectiveness and efficiency of operations
- Reliability of financial reporting
- Compliance with applicable laws and regulations

In the current environment of transparency and accountability, charities and not-for-profit organizations must not only achieve, but also explicitly demonstrate, their performance in these three areas. COSO provides a methodology to develop and maintain an effective system of internal control that reduces, to an acceptable level, the risk of not achieving these objectives.

The COSO Framework identifies five core components (Control Environment, Risk Assessment, Control Activities, Information & Communication, and Monitoring Activities) and seventeen key principles within these five components that are required for an effective system of internal control. The Framework is fully scalable to an organization’s size, structure, funding sources, or mandate.

The Framework provides a recognized baseline against which existing management practices can be documented and assessed to confirm existing sound practices and identify areas for improvement to strengthen an organization’s internal control structure and prioritize efforts and resources to the areas of most significance. As a recognized management control framework, an assessment of internal controls against COSO will also serve to provide both internal and external stakeholders with additional confidence in the stewardship, accountability and overall control environment of the organization.

## **Fraud Risk in Charities and Not-for-Profit Organizations**

You only have to read the local and national news to understand the significant, adverse impact that a fraudulent or illegal act can have on an entity’s financial position, on-going operations and public reputation. For charities and not-for-profit organizations, a fraudulent or illegal act can be absolutely devastating not only because of their reliance on public financial support but also their need to maintain public confidence and trust in their activities. With social media, and the 24-hour continuous news cycle, the financial, operational and reputational risk of a fraud on a charity or not-for-profit organization has never been higher.

Therefore, fraud risk management is now a very important element of an organization's overall governance and risk management. To protect against the risk of fraud, Boards and management need to have a heightened awareness of fraud including an understanding of the profile of a fraudster and what may drive otherwise good people to do bad things. As a result, Boards and management of charities and not-for-profit organizations are beginning to incorporate fraud awareness in their training programs to increase their personal individual fraud awareness, and to develop a greater understanding of the key organizational elements of a robust anti -fraud program, designed to address the core objectives of prevention, detection and response.

## Cyber Security - It's more than just Technology

Organizations are subject to increasing amounts of legislative and public pressures to show they are managing and protecting their information appropriately. Simultaneously, the threats from cyber criminals and hackers are growing in scale and sophistication. Organizations are also increasingly vulnerable as a result of technological advances and changing working practices including remote access, cloud computing, mobile technology and services on demand. The financial and reputational costs of not being prepared against a cyber-attack could be significant.

Cyber Security is not solely about Information Technology; it is fundamentally an operational and governance issue. Not-for-profit organizations should develop an operations-wide understanding of their threats, safeguards, and responses. Preparing this summary diagnostic will require the involvement of individuals in all areas of the organization, including those involved in hiring, procurement, customer relations and management. Key elements to consider include:

- Assessing the likelihood and intensity of a cyber-attack, based on the value of your information and your public profile
- Assessing your vulnerabilities to a cyber-attack
- Preparing your people, processes, infrastructure and technology to resist a cyber-attack, and to minimize its impact
- Detecting a cyber-attack and initiating your response
- Containing and investigating the cyber-attack
- Recovering from a cyber-attack and resuming business operations
- Reporting on and improving security

Not-for-profit organizations are at particular risk due to the information they maintain, including research data, member or student data, and health information. The reputational risk of this information not being adequately protected can often outweigh the financial consequences of a breach.

Not-for-profit organizations need to review their operations and consider cyber risks, then assess the organization's cyber maturity in addressing those risks. Structured models for completing this exercise exist for organizations of all sizes, as no one is immune to the risk of a cyber-attack.

KPMG in Canada, in collaboration with Imagine Canada, presented a webinar called "Cyber Security: The new threat for Not-for-Profit Organizations". We encourage you to view this webinar on Imagine Canada's website at: <http://sectorsource.ca/resource/video/cyber-security-not-profit-organizations-presented-kpmg>

## Commodity Tax Considerations

The GST/HST is constantly evolving. The kinds and pace of the changes affecting your organization will depend on your status and activities, and may result from new legislative and regulatory rules, court cases, and changes in the CRA's administrative policies. In addition, major organization changes, such as reorganizations, cessation of activities, major capital projects, new relationships (e.g., shared service arrangements), and new revenue generating activities may have significant GST/HST implications.

The Canada Revenue Agency (CRA) continues to increase its focus on public service bodies (e.g., municipalities, universities, colleges, hospitals, schools, associations, charities, non-profits etc.) for purposes of conducting GST/HST audits. These audits may be undertaken by GST/HST audit teams dedicated to the public sector or by auditors attached to the CRA's GST/HST Refund Integrity Unit. Many organizations have undergone audits over the past couple of years. Based on our work with audited organization, we offer the following general observations on the impact of the CRA's ongoing focus on the public sector:

- The CRA has been focusing on documentation, cost sharing and buying group arrangements, grants and sponsorships, as well as the allocation of inputs between taxable and exempt activities for input tax credit purposes (e.g. the filing of a Section 211 election and claiming of input tax credits on the use of real property).
- The CRA has not consistently been applying audit offsets (e.g., allowing unclaimed input tax credits or rebates) that would help minimize the impact of any assessments.
- Proposed assessments based on sampling and alternative valuation or allocation methodologies conducted by CRA auditors should be reviewed as fair and reasonable alternatives may be available that could significantly reduce an GST/HST assessment.
- The CRA is required to communicate the amount and basis for a proposed adjustment to the registrant, and should allow the registrant a reasonable amount of time to review and respond to the assessment (i.e., generally 30-days). It is entirely appropriate to carefully review and question a proposed assessment. Our experience is that proposed assessments can often be significantly reduced at the audit stage. If a Notice of Assessment is issued, you will have 90 days to file a Notice of Objection with the CRA.
- It is important that you have a plan in place for a GST/HST audit, including having a fixed point of contact for the auditor. Planning and managing the audit is as important as having the appropriate policies and procedures.
- Organizations that have undergone significant changes in operations are more likely to be selected for an audit. Many of these organizations are completing compliance reviews by indirect tax professionals in advance of a potential GST/HST audit to verify that the GST/HST is being appropriately handled.

Our experience with GST/HST auditors has varied from audit to audit. However, in each case, the taxpayer has the burden of proof. The best approach is to be prepared in advance of receiving that audit notification from CRA.

## **Income Tax Considerations**

The funding landscape for charities and not-for-profit organizations has changed dramatically over the last number of years. Gone are the days when government or public funding agencies had the ability to fully support public purpose organizations that were established legally as either Registered Charities (Charities) or Not-for-Profit Organizations (NPO's) for tax purposes. This includes not only specific public purpose organizations, but those organizations that are recognized as Public Institutions for tax purposes, such as Universities and Hospitals.

In order to fill the funding gap that has been created by reduced public financial support, many of these organizations have looked to non-traditional means of operating and capital funding to make up the shortfall. In many cases this involves the use of certain of the assets and resources that are available to the organizations to raise funds that has the look and feel of operating a business. Charities and NPOs have very specific (and different) guidelines that are spelled out in various pieces of governing legislation, including but not limited to, on a Federal basis the Income Tax Act and the Excise Tax Act. The expansion of the activities to raise funds by these organizations has in some cases begun to stretch

the limits of what was contemplated by either a standalone Charity or NPO. As a result, certain unique planning structures have been utilized in an attempt to protect the allowable activities of either a Charity or NPO, yet manage on a tax efficient basis certain potentially non-allowable activities that are being operated by the organization.

This change in landscape has also attracted the attention of the Canada Revenue Agency which has established audit teams focused on auditing specifically within the charity and not-for-profit sectors. This includes auditing for GST/HST, payroll taxes as well as Income Tax to determine if compliance within the various pieces of legislation is being adhered to. Many Charities and Not-for-Profit Organizations have completed comprehensive tax reviews designed to assess whether the ongoing operations of the organization are organized to maximize tax savings opportunities and minimize compliance risk, while continue to support the goals and objectives of the organization.

## Charity Tax Returns

The Federal Court of Appeal (FCA) recently upheld CRA's proposals to revoke the status of two registered charities. The decisions in *Jaamiah Al Uloom Al Islamiyyah Ontario v. Minister of National Revenue* (2016 FCA 49) and *Opportunities for the Disabled Foundation v. Minister of National Revenue* (2016 FCA 94), both written by Justice Michael Ryer, may lead to troubling results for registered charities who make errors when filing their information returns.

In *Opportunities*, the FCA concluded that the CRA can issue a notice of intention to revoke a registered charity's status, in certain circumstances, if there are inaccuracies in the charity's T3010 Registered Charity Information Return. In *Jaamiah*, the CRA argued that it may issue a notice of intention to revoke a registered charity's status where the charity has not prepared T4 and T4A statements of remuneration paid. Although the FCA upheld the notice to revoke on other grounds, this case gives insight into the CRA's possible position on what constitutes grounds for revocation. Both cases are available to read online.

### Legislative background

The CRA may issue a notice of intention to revoke a registered charity's status under subsection 168(1) of the Act if a registered charity:

- Applies to the CRA in writing for revocation of its registration (paragraph 168(1)(a))
- Ceases to comply with the requirements of the Act for its registration (paragraph 168(1)(b))
- In the case of a registered charity or registered Canadian amateur athletic association, fails to file an information return as and when required (paragraph 168(1)(c))
- Issues a receipt for a gift that does not comply with the rules (paragraph 168(1)(d))
- Fails to comply with or contravenes any of sections 230 to 231.5 (paragraph 168(1)(e)), or
- In the case of a registered Canadian amateur athletic association, accepts a gift the granting of which was expressly or implicitly conditional on the association making a gift to another person, club, society or association (paragraph 168(1)(f)).

With respect to the condition in paragraph 168(1)(e) for failing to comply with sections 230 to 231.5, subsection 230(2) of the Act requires that a registered charity keep records and books of account containing:

- Information in such form as will enable the CRA to determine whether there are any grounds for revoking its registration under the Act
- A duplicate of each receipt containing prescribed information for a donation received by it, and
- Other information in such form as will enable the CRA to verify the donations to it for which a deduction or tax credit is available under the Act.

## KPMG's observations

The FCA's decision in *Opportunities* is troubling since it states that inaccuracies in a T3010 return can, in certain circumstances, justify revoking a charity's status under paragraph 168(1)(c). This may result in situations where a disagreement between a charity and the CRA auditor about a filing position could lead to revocation (as a filing position that is different than the auditor's position could result in numerous "inaccuracies").

The CRA position that an incomplete T3010 return was grounds for revocation is interesting given that subsection 188.2(2.1) (added by the 2012 federal budget) provides that a charity that files an incomplete T3010 return can have its receipting privileges suspended. Since *Opportunities* dealt with a T3010 return filed for a 2010 taxation year, it is unclear whether a case with similar facts, post 2012 federal budget, would have yielded a temporary suspension of receipting privileges instead of a revocation.

The troubling aspect of *Jaamiah* was not the decision of the FCA itself, but rather the insight into the CRA's asserted grounds for revocation. Many practitioners understood that the revocation provision in paragraph 168(1)(c) would only apply where a charity failed to file a T3010 return. The CRA's grounds for revocation here, however, included the "failure to file an information return as and when required" by not preparing and issuing proper T4 and T4A statements.

The Act has separate penalties relating to T4 and T4A filings that are applicable to employers (including charities). These filings arguably have nothing to do with a charity's compliance with the requirements in subsection 168(1) and should therefore not be grounds for revocation. Unfortunately, the FCA did not offer any guidance in this regard, with the result that charities may face increasing risks with respect to general compliance requirements that are not specific to charities.

As a result of these decisions, charities and their advisors should be very cautious when preparing their T3010 and other information returns.

## Public Sector Accounting Board: Accounting Standards for Government Not-for-Profit Organizations

The Public Sector Accounting Board of Canada is responsible for setting the accounting standards that your organization is required to apply in preparing the general purpose financial statements. **The following new or revised accounting standards approved by the Board may have an impact on your financial statements over the next two years as described below.** We encourage Management to review these standards and determine whether the impact, if any, on your organization's financial statements.

In addition, we provide a summary of the status of the Board's deliberations on the future of accounting standards for government not-for-profit organizations. KPMG will continue to update you as these deliberations progress.

### Summary of New and Revised Accounting Standards

#### Assets

PSAB issued Section PS3210 Assets which provides a definition of assets. Assets are defined as follows:

- Assets embody future economic benefits that involve a capacity, singly or in combination with other assets, to provide goods and services, to provide future cash inflows, or to reduce cash outflows.
- The public sector entity can control the economic resource and access to the future economic benefits.
- The transaction or event giving rise to the public sector entity's control has already occurred.

The standard also includes disclosure requirements related to economic resources that are not recorded as assets to provide the user with better information about the types of resources available to the public section entity. This standard is effective for fiscal periods beginning on or after April 1, 2017.

### **Contingent Assets**

PSAB issued Section PS3320 Contingent Assets which defines and establishes disclosure standards for contingent assets. Contingent assets have two basis characteristics:

- An existing condition or situation that is unresolved at the financial statement date.
- An expected future event that will resolve the uncertainty as to whether an asset exists.

The standard also has specific disclosure requirements for contingent assets when the occurrence of the confirming event is likely. This standard is effective for fiscal periods beginning on or after April 1, 2017.

### **Contractual Rights**

PSAB issued Section PS3380 Contractual Rights which defines contractual rights to future assets and revenue and establishes disclosure requirements. Information about a public sector entity's contractual rights should be disclosed in notes or schedules to the financial statements and should include descriptions about their nature and extent and the expected timing. The standard also indicates that the exercise of professional judgment would be required when determining contractual rights that would be disclosed.

Factors to consider include, but are not limited to:

- (a) contractual rights to revenue that are abnormal in relation to the financial position or usual business operations; and
- (b) contractual rights that will govern the level of certain type of revenue for a considerable period into the future.

This standard is effective for fiscal periods beginning on or after April 1, 2017.

### **Related Party Transactions**

PSAB issued Section PS2200 Related Party Transactions which defines related party and provides disclosures requirements. Related parties could be either an entity or an individual. Related parties exist when one party has the ability to control or has shared control over another party. Individuals that are key management personnel or close family members may also be related parties.

Disclosure is only required when the transactions or events between related parties occur at a value different from what would have been recorded if they were not related and the transactions could have a material financial impact on the financial statements. Material financial impact would be based on an assessment of the terms and conditions underlying the transaction, the financial materiality of the transaction, the relevance of the information and the need for the information to enable the users to understand the financial statements.

This standard also specifies the information required to be disclosed including the type of transactions, amounts classified by financial statement category, the basis of measurement, and the amounts of any outstanding items, any contractual obligations and any contingent liabilities. The standard also requires disclosure of related party transactions that have occurred where no amounts has been recognized.

This standard is effective for fiscal periods beginning on or after April 1, 2017. In conjunction with the approval of this standard, PSAB approved the withdrawal of Section PS 4260, Disclosure of Related Party Transactions by Not-for-Profit Organizations, effective for fiscal periods beginning on or after April 1, 2018. Government not-for-profit organizations currently applying Section PS 4260, will therefore only be required to adopt the new standard in their fiscal period beginning on or after April 1, 2018.

### **Inter-entity Transactions**

PSAB issued Section PS3420 Inter-entity Transactions that specifies how to account for transactions between public sector entities within the government reporting entity. This standard relates to the measurement of related party transactions for both the provider and the recipient and includes a decision tree to support the standard. Transactions are recorded a carrying amounts with the exception of the following:

- Transactions in the normal course of business are recorded at exchange amount
- Transactions with fair value consideration are recorded at exchange amount
- Transfer of an asset or liability at nominal or no consideration is recorded by the provider at carrying amount and the recipient has the choice of either carrying amount or fair value.
- Cost allocations are reported using the exchange amount and revenues and expenses are reported on a gross basis.
- Unallocated costs for the provision of goods or services may be recorded by the provider at cost, fair value or another amount dictated by policy, accountability structure or budget practice

This standard is effective for fiscal periods beginning on or after April 1, 2017. In conjunction with the approval of this standard, PSAB approved the withdrawal of *Section PS 4260, Disclosure of Related Party Transactions by Not-for-Profit Organizations*, effective for fiscal periods beginning on or after April 1, 2018. Government not-for-profit organizations currently applying Section PS 4260 will therefore only be required to adopt the new standard in their fiscal period beginning on or after April 1, 2018.

### **Deliberations on the Future of Accounting Standards for Not-for-Profit Organizations**

In April 2013, the Accounting Standards Board (“AcSB”) and the Public Sector Accounting Board (“PSAB”) jointly issued a Statement of Principles (“SOP”) that proposed to revise Part III of the CPA Canada Handbook and the CPA Public Sector Accounting Handbook to streamline and improve the existing standards for financial reporting by not-for-profit organizations and Government not-for-profit organizations. The SOP garnered much interest from the Not-for-Profit community and, based on the feedback the Boards received, the proposals did not proceed further through the accounting standards development process. In March 2015, citing different financial reporting challenges, user needs and differing priorities faced by PSAB and the AcSB, the Boards announced that they would independently pursue improvements to not-for-profit accounting standards, but collaborate on common issues.

Based on the responses from the SOP, the Public Sector Accounting Board decided that making substantive changes to the Accounting Standards for Government Not-for-Profit Organizations was not a priority at this time. The Board’s long-term strategy is to better align the accounting standards used by not-for-profit organizations (as provided in the Section 4200 series in the Accounting Handbook) with those used by other government entities, where practical.

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