

# Audit Adviser

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## If you're involved in transfer pricing your size and industry are irrelevant

If you've been following the major banks' tax avoidance cases thinking they have no implications for any other businesses, think again.

The decisions in those "structured finance" cases are relevant to all taxpayers with cross border transactions – which means just about all multinational businesses.

Transfer pricing, aka the requirement that related party cross border transactions be carried out at arm's length pricing, was at the heart of the bank cases – and it's rated as the number one tax issue facing multinationals. It's easy to see why. While the amount at stake in the BNZ case was significant, it pales in comparison to the sums involved in current overseas transfer pricing disputes, which in most cases becomes a direct cost to organisation's bottom line.

Although New Zealand transfer pricing legislation was not, strictly

speaking, applied in the BNZ case, the principle of arm's length dealings enhanced the judge's view that tax avoidance was present.

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That much is apparent from his statement:

**...none of the transactions, taken either as a whole or in terms of the components, is reasonable or defensible from a commercial or economic point of view. In my view, the six transactions were not determined as part of an arm's length market driven process.**

The judge was not impressed that two experts' evidence, one in support of the BNZ, the other representing the IRD, found that the fixed swap rates used in some of the transactions were outside market rates.

Following an analysis of the pricing of a guarantee procurement fee

(2.95%pa), the judge concluded that the transactions generated the claimed expenses in a contrived or artificial way. A guarantee from the parent of the counterparty would normally have attracted a maximum fee of 0.65% p.a. In other words, the fee generated was 350% above market prices.

The judge also said BNZ contrived to set the fixed rate on the interest rate swap at the highest rate it thought defensible, and in some of the transactions this was significantly outside market parameters. The returns to BNZ and the counterparties alike were substantially higher than what could be expected from a risk free (except for tax risk for the BNZ) investment via a structured finance transaction, negotiated at arm's length.

The finding begs the question: If the transactions had been based on arm's length principles, while still enjoying the structured finance benefits of cross-border transactions, would the Courts still have found tax avoidance. As things stand, the lack of sustainable cross border pricing led to a tainting of the entire transactions, and – inevitably – the Courts' determination of tax avoidance.

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# Governance key concern for Not-for-Profit organisations

A recent nationwide Grant Thornton survey of Not-for-Profit organisations (NFPs) suggests that governance and the pressure on committees are growing concerns. They ranked third behind financing and fundraising, scoring 33% compared with 26% two years ago.

Governance has been the buzzword in both the NFP and commercial sectors in the past few years, with increasing demands on board members, such as additional committee assignments and more frequent meetings.

72% of respondents rated financing as the most significant issue they faced, with 47% identifying fundraising as a key concern. While these also ranked as the major concerns in 2007, they only scored 56% and 30%, respectively.

Retaining, motivating and managing staff, and compliance costs associated with staff, while also scoring highly, are less of a concern than they were in 2007 (when they soared against 2005 levels). No doubt this is a reflection of the tightening job market.

Most NFPs have responded to the economic downturn by looking more closely at their costs and spending only on essentials, along with tighter

monitoring of financial statements and efforts to better understand key business risks.

Despite these responses, NFPs are feeling the pressure, particularly with funding. Many community trusts – a major source of funding – simply have no money to give thanks to the global financial meltdown. Individual donors, who appear to be giving more than ever before, are only partially filling this gap.

The Grant Thornton Not-for-Profit Survey was undertaken by 181 participants covering a wide cross section of organisations and geographic locations. Earlier surveys were completed in 2003, 2005 and 2007.

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# Using audit tools to detect fraud

A recent survey by the Association of Certified Fraud Examiners revealed that organisations lose an estimated seven percent of their annual revenues to occupational fraud and abuse. Local experience indicates that fraud incidents have increased since the start of the Global Financial Crisis (GFC), and fraud levels are expected to continue to rise in the next 12 months .

Increased financial pressure on individuals is not the only factor at work here. Thanks to reduced workforces and looser internal controls, there are now more opportunities for fraud.

Add in increased volumes of electronic data and increasingly complex business systems and processes, and it's easy to see why new fraud schemes are continually emerging.

Traditionally, businesses have used manual procedures to uncover fraud. That's no longer sufficient; they should be used in conjunction with powerful new data interrogation tools that increase not only the precision, but also the effectiveness, of traditional methods.

In essence, these tools allow continuous transaction monitoring by automating data queries that can be run at set periods. Not only can they analyse data without damaging its integrity, they can test up to 100% of transactions from various sources and various file types.

You may have the capabilities within your organisation to adopt these tools. Alternatively, you could engage a professional firm that is not only familiar with them in Computer Assisted Audit Techniques (CAATs), but also versed in fraud risks and controls review.

Here are some examples in fig 1 of fraud incidents and the data interrogation procedures used to uncover them:

**Fig 1: Examples of fraud and data interrogation procedures**

Fraud incident	Data interrogation procedures
<b>Fraudulent sales</b>	<ul style="list-style-type: none"> <li>• search for duplicate sales invoices</li> <li>• match electronic sales records and shipping records</li> <li>• match credit notes to sales invoices</li> <li>• match shipping address to known customer address</li> <li>• match shipping address to employee address</li> <li>• develop statistics, such as sales returns per customer, credit notes per customer, and price exceptions (discounts) per customer</li> </ul>
<b>Fictitious vendors</b>	<ul style="list-style-type: none"> <li>• search for potential duplicate vendor masterfile records by testing duplicates in the vendor names, addresses and contact details</li> <li>• match vendor addresses to employee addresses</li> <li>• match vendor contact numbers to employee contact numbers</li> <li>• match vendor bank details to employee bank details</li> <li>• extract vendors with missing information (ie. ABN, addresses, contact details)</li> </ul>
<b>Fraudulent payments</b>	<ul style="list-style-type: none"> <li>• search for duplicate vendor invoices, duplicate payments</li> <li>• match invoices to purchase order details</li> <li>• match invoices to goods receipt details</li> <li>• extract disbursements payable to cash</li> <li>• match disbursements payable to employees and investigate unusual items</li> <li>• extract gaps and duplicates in cheque numbers</li> <li>• use Benford's law to detect unusual payment patterns</li> </ul>
<b>Corruption/conflict of interest</b>	<ul style="list-style-type: none"> <li>• summarise inventory purchases per supplier per inventory item and investigate concentration of purchases</li> <li>• summarise expense per employee and investigate unusual charges</li> </ul>
<b>Payroll fraud</b>	<ul style="list-style-type: none"> <li>• search for duplicate employees and TFN</li> <li>• search for invalid TFN</li> <li>• search for terminated employees in the payroll register</li> <li>• search for duplicate employee records</li> </ul>
<b>Fraudulent reporting</b>	<ul style="list-style-type: none"> <li>• search for unbalanced journal entries</li> <li>• search for gaps and duplicate journal entries</li> <li>• search for unusual journal entries using Benford's law and search for round dollar entries</li> <li>• search for journal entries created or posted by unauthorised individuals</li> <li>• search for journal entries posted on a weekend</li> </ul>

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## Case study

Last August, a leading Australian electrical appliance and whitegoods company lost nearly \$20 million because of an alleged fraud committed by its payroll manager. The incident was said to be discovered by an accountant who noticed a variation between two company ledgers amounting to \$2 million. Later investigations indicated the alleged fraud was committed by exploiting a weakness in the online transaction software that allowed the user to redirect payments to the employee's account.

Data interrogation tools can identify

situations such as this by reconciling and matching data from various ledgers and various systems. These initial reconciliations can then be automated by developing scripts within the tool that can be run monthly or at desired intervals.

Examiners can also use the online transaction software to extract all transactions where funds were transferred to the employee's account. In addition, the tool can match the bank services billing (BSB) and account number information in the online transaction software to a list of valid

supplier BSB and account numbers in the vendor/supplier master file. A script can also be developed for this test to enable its automation.

Fraud risk management can be a daunting task. Fortunately, data interrogation tools and experts in professional service firms can be a powerful ally against fraud. For a relatively small investment, significant savings can often be achieved.

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# Submissions are in: let's hope some clear direction soon emerges

**The Accounting Standards Review Board (ASRB) and Ministry of Economic Development (MED) are working through more than 70 submissions in response to proposals to change New Zealand's financial reporting framework.**

The number and level of detail provided in many of the submissions highlights the significance of the proposed changes.

On some issues, such as the requirement for large companies to file audited financial statements with the Companies Office, opinion has been sharply divided. The Minister of Commerce, Simon Power announced on 24 February 2010 that there would be no change to the status quo and large

non-issuer companies will not have to file their financial statements with the Register of Companies.

Here are some of the more significant points we made in our 20-page submission to the MED and the ASRB.

## **We agree that it's time for a change**

It has become apparent that IFRS is designed primarily for capital-raising, profit-oriented entities; therefore, it is time to consider a sector-specific approach as set out in the proposals. A Grant Thornton survey of over 100 clients and contacts around the country last August highlighted the need for more emphasis on delivering regulations in a clear and comprehensive manner.

## **Trust accounting – the missing piece**

While the proposals cover a range of entities in great detail, they do not talk at all about the wide-reaching subject of trusts and trust accounting. We note that

trust accounting is currently driven by case law and billions of dollars are tied up in them, so we urged both the MED and the ASRB to address the important financial reporting consequences of not providing any standardised financial reporting guidance for these types of entities.

## **Proposed tiers and thresholds in the not-for-profit sector**

We noted the small number of entities in the proposed Tier 1 for this sector, resulting in a separate 'rule book' for less than 30 entities. We also noted the onerous requirements for not-for-profits with expenditure over \$20,000 to prepare and file general purpose financial statements.

We proposed an alternative, which supports greater application of the cost-benefit principle to these sectors and aligns with the proposed assurance requirements for Tier 3 not-for-profits:

**Fig 2: Not-for-profits cost-benefits**

<b>Current ASRB Proposals:</b>		
	<b>Public sector</b>	<b>NFPs</b>
Tier 1	> \$20 million	> \$10 million
Tier 2	\$2m - \$20m	\$1m - \$10m
Tier 3	< \$2 million	\$20,000 - \$1 million

<b>Alternative suggested by Grant Thornton:</b>		
	<b>Public sector</b>	<b>NFPs</b>
Tier 1	> \$20 million	> \$2 million
Tier 2	\$2m - \$20m	\$100,000
Tier 3	< \$2 million	-\$2 million

**Too many rule books**

A significant increase in financial reporting expertise will be needed to cope with, effectively, eight different sets of GAAP for entities required to prepare general purpose financial statements. This will put significant pressure on New Zealand’s accounting profession, and may lead to reduced independence and choice if some firms choose to specialise in certain sectors.

**Functional equivalence with Australia**

We supported the aims and objectives of functional equivalence with Australia in line with the Single Economic

Market objectives. However, we noted the relative size of the Australian economy and the financial reporting resources available to it and suggested that there may be occasions where it is inappropriate to follow an Australian lead or to work jointly.

**Resourcing the XRB and supporting committees**

We noted in a previous submission to the ASRB the importance of providing more resources to standards setters in New Zealand. We said a significant shift was needed, away from volunteer input, and towards remunerating members of the External Reporting Board (XRB) and its supporting committees. We also suggested that the XRB may need an actuarial subcommittee, given the increasing importance of actuarial assessments in financial reporting, and – in light of recent developments in Copenhagen – also a subcommittee which specifically deals with Sustainability Reporting.

**Economic significance versus privacy – the rights and responsibilities of limited companies**

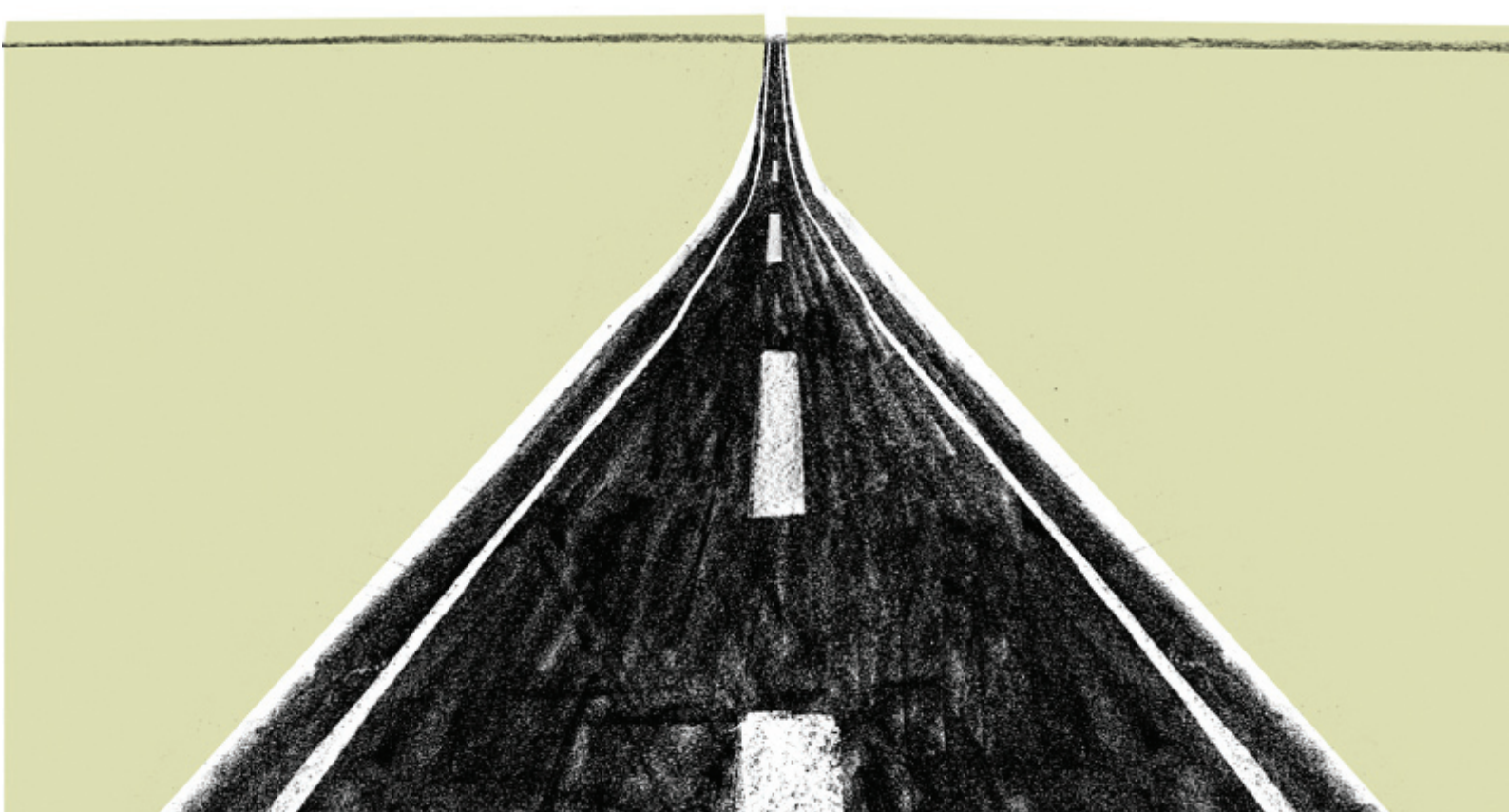
We noted that, for some, a key issue has been the proposed requirement for

large companies to file general purpose financial statements. As seen in the business press, there is concern that this will result in a loss of privacy and the possible compromise of commercially sensitive information. These entities are economically significant and we agree that it is appropriate for them to file general purpose financial statements in line with the proposals, remembering that limited liability is a privilege rather than a right.

**IFRS for SMEs versus differential reporting**

The proposals raised the possibility of requiring Tier 2 companies to prepare general purpose financial statements in accordance with IFRS for SMEs, or the alternative of a differential framework applied to IFRS (possibly developed with Australia). We have stated a preference for the use of IFRS for SMEs but are concerned that this may not align with the Australian decision on the same question. Our understanding is that the Australian Accounting Standards Board is concerned by the measurement and recognition of differences between IFRS for SMEs and full IFRS, and the difficulties that this could cause when consolidating an entity or when an entity

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moves between the two frameworks.

On the positive side, we noted that IFRS for SMEs contains far fewer disclosure requirements than the current NZ Differential Reporting framework, and also allows for greater international recognition and international comparability. We concluded that it makes sense to allow both frameworks until a clear preference for one can be proven.

### Front-running with IPSAS

The proposals suggest the use of International Public Sector Accounting Standards (IPSAS) for public benefit entities. We agreed that this was an appropriate direction but pointed out our concerns about the timing, given that IPSAS is not yet “complete”.

In its current state we would not be comfortable signing off a set of public sector accounts solely on this basis. We noted that while New Zealand has invested heavily in the development of IPSAS and should therefore support its adoption, there are risks involved in being the “first mover” in adopting these new standards. We therefore urged the ASRB to be particularly diligent in reviewing the standards before their adoption and application in New Zealand.

### The future of companies below Tier 2

Companies below Tier 2 will no longer need to prepare general purpose financial statements. We noted, however, that they will still be required to keep proper books and records, and prepare some financial information for tax purposes. Our understanding is that the New Zealand Institute of Chartered Accountants intends to provide ongoing guidance to its members and we indicated that the MED and ASRB also have an important part to play in reminding the directors of “exempt” companies of their responsibilities.

### Changing the balance date – a move away from 31 March

The proposals include the suggestion that filing deadlines be reduced from five months to four. Although we agree with this in principle, we noted the increased

pressure this will place on companies and, more especially accounting firms, with the potential for lower quality service as a result. We proposed that it should be made easier for companies to choose their balance date, and entities should be encouraged to move away from 31 March.

### Electronic media in financial reporting

We note and encourage the increasing use of XBRL and Standard Business Reporting (SBR) in financial reporting functions, and suggest that the XRB, supported by a subcommittee if necessary, should take responsibility for approving the digital tags associated with XBRL and SBR.

### Parent company reporting when group financial statements are prepared

We consider that parent company financial statements add very little decision-making value where group financial statements are provided. We suggest that New Zealand should mirror Australia’s decision on whether or not to continue requiring parent companies to provide financial information. The

recent exposure draft of amendments to the Corporations Act in Australia suggests that the requirement will be removed, and replaced with minimum note disclosures in the group financial statements.

### Overseas-owned companies

We agreed with the proposal that non-large overseas-owned companies should no longer be required to be audited or to prepare general purpose financial statements. Overseas-owned companies should instead be aligned with New Zealand entities, which will reduce their compliance costs and encourage overseas investment in New Zealand.

Whatever decisions are finally made at a statutory and regulatory level are likely to quickly cascade down to reporting entities. We will keep you informed of developments as they emerge.

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## Recent publications

If you would like a quarterly update on all significant IFRS pronouncements and their likely impact on your business, then **IFRS News** on our website is the place the go. In 2010 we intend to bring a more global focus to IFRS reporting issues, briefing you not only on International Accounting Standards Board decisions, but also on how its pronouncements are being interpreted and implemented around the world.



# Want to improve your cashflow? Consider proactive tax management

The recession led most companies to slash unnecessary or excessive expenditure. With little more fat left to trim, then, how will your businesses improve the bottom line in 2010? By striving to lift sales and productivity?



Not so fast. Of course lifting sales and productivity is a good thing. But in tackling expenditure, most New Zealand businesses tend to overlook one of the highest overheads on their books: the costs associated with collecting, administering and paying tax. This is not simply a compliance issue – which, in itself, is significant. Even greater can be the cost of getting it wrong once shortfall penalties and use of money interest have taken their bite. With Inland Revenue actively focusing on increasing the tax take, how comfortable are you with your historic position?

## Payroll tax and GST

Payroll taxes and GST obligations are normally driven by internal processes that have often not been reviewed since inception (“we don’t have the time or resources for that” is a common complaint). But if your original system contains even a minor error, it can compound into a sizeable discrepancy over many transactions.

Now is an ideal time to review your tax obligations and search for increased efficiencies and potential savings. Not only because of the recession, but also because a number of thresholds and exemptions have recently increased. For example:

- You may be able to defer your GST obligations by changing your accounting basis or filing frequency.
- Group GST registration may offer savings (particularly where a holding company exists).
- Fringe benefit exclusions have been reviewed. Are you claiming all that you are entitled to?
- You may be entitled to change from twice monthly PAYE payments to monthly.

Taxation reviews can have a significant positive impact on cash flow by allowing you to defer some obligations. The bonus is that you also gain the comfort of knowing your obligations are being met.

If an error is identified it can be actively managed. While the initial news is not always welcome, the net effect is a lower cost to the business than if the error had been allowed to compound.

## Income tax

Income tax is a different beast again. The only sure thing is that you’re going to have to pay – and that if you underpay you’ll be hit with 8.91% penalty interest, despite the fact that IRD pays a paltry 1.82% interest to you if you’ve overpaid.

Tax payments can create big holes in your cash flow. However,

the introduction of tax pooling intermediaries, who operate “tax pooling” accounts with Inland Revenue, provides a new tool for smoothing out payments.

Businesses deposit tax payments into the tax intermediary accounts until the intermediary instructs Inland Revenue what to do with them. Depositing funds in this way increases your options: you can easily transfer, refund or sell your deposited funds to another business to achieve a higher interest return.

In the event of an underpayment, you can make a request to purchase a historic tax payment via a tax intermediary to reduce interest costs and avoid any penalty interest.

As with all business costs, you should actively manage your tax. With a new year upon us, and a range of powerful tools available, now is a great time to start. We have some great comparative market analysis we would be happy to share with you. You may be surprised at the positive effect it will have on your cash flow and compliance costs.

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# IFRS9: Update on the classification and measurement of financial instruments

Following discussions on the Global Financial Crisis, the G20 developed a list of action points, some of them directed at standard setters. The IASB was specifically asked to improve current accounting standards in relation to financial instruments, not only for users but for preparers as well.

As it was, replacing IAS 39 was already on the IASB's agenda: the G20's demands simply meant bringing those plans forward. To do that, the IASB split the project into three distinct phases. Phase 1 – improvements to the classification and measurement of financial instruments – was completed in time to allow reporters to use it by 31 December 2009.

In November 2009, the IASB published **IFRS 9 Financial Instruments**. Because of unresolved issues on how best to account for financial liabilities, the scope of this standard was restricted only to requirements for classifying and measuring financial assets. Guidance on how to classify and measure them is expected later this year.

The use of IFRS 9 is currently optional. Its mandatory application date is for any annual reporting period beginning on or after 1 January 2013.

## Key features of IFRS 9

- Financial assets are held at either amortised cost or fair value. This determination is based on the business model of the entity and its intention of holding the assets.
- Equity instruments will be held at fair value. An irrevocable election can be made to allow changes in fair value and gains/losses on sale to be taken through other comprehensive income (FVOCI) on initial recognition. Otherwise movements are taken through profit or loss.
- Impairment testing is required only for assets held at amortised cost.
- Embedded derivatives must be separated only if the host contract is not within the scope of IAS 39.
- Reclassification of financial assets between categories is permitted only if the entity's business model changes.

## Next steps

The IASB's tentative project plan for the replacement of IAS 39 falls into three phases:

### Phase 1: Classification and measurement

- The chapters of IFRS 9 dealing with classification and measurement of financial assets have been published.
- Financial liability classification and measurement are currently being considered. Proposals are expected to be released in 2010.

### Phase 2: Impairment

An exposure draft proposing an expected loss model (rather than an incurred loss model) to determine impairment has just been released. It closes for comment in June 2010.

### Phase 3: Hedge accounting

The IASB is continuing deliberations with constituents in this phase in order to reduce the complexity of current hedge accounting rules. An exposure draft is expected in the first quarter of 2010.

A final standard address of all three phases is expected in early 2011.

## What does this mean for my organisation?

We recommend you consider the requirements of IFRS 9 and whether it would be appropriate for you to adopt them for the classification and measurement of financial assets before the mandatory date.

Note, also, that the transition provisions are complex. However, there is a useful optional exemption on retrospective application if IFRS 9 is adopted before 1 January 2012.

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