

# CA

magazine

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with earnouts 43

January/February 2011

www.camagazine.com

A blue umbrella on a black pole, with a black silhouette of a factory at the base of the pole. The umbrella is open and tilted to the right. The background is a textured, light-colored surface.

# WHY BANKRUPTCY

as we know it may soon be **history**

When dealing with troubled firms, insolvency experts are no longer just liquidating, they are reviving. **Why?** P. 16

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# Contributing factors

Over the years the subspecialty of insolvency has seen its profile grow. Why's that?

By June 30 last year, 145,233 Canadians had filed for bankruptcy or a consumer proposal in the 12 months that had gone by. The recession probably had much to do with this figure, but bankruptcy figures have been climbing since the 1960s. While last year's figures represent an increase of 33.7%, bankruptcy numbers grew from less than 1,000 in the 1960s to 2,700 in 1971 and 19,000 in 1980. This has meant an increased profile for the insolvency subspecialty of the accounting profession. Writer John Lorinc examines its history and the factors contributing to its exponential growth in this month's cover feature, "Insolvency then and now" (p. 16).

"The insolvency sector is one of those classic counter-cyclical industries," Lorinc writes. "Bad times for the rest of us are good times for the firms called in to sort out the problems that accumulate during and after recessions." The profession, one insolvency expert tells us, is in a state of flux: continuing economic uncertainty is making it difficult for the professionals in the subspecialty to find solutions for companies and individuals in trouble.

What are the personality traits and characteristics of a top-shelf CA? Writer Lorie Murdoch set out to find out, asking experts, managers and CAs who have excelled in the profession. Her findings are detailed in "CA 'it' factor," p. 24. It seems a high UFE score and left-brain thinking are very important, though much more than that is required. You have to be hard working, see the positive side of things, have a broad range of experience, not get discouraged when things don't go well and not complain. To top all that, you need to have a strong ethical compass. It's a fascinating read.

Marcel Côté writes about an issue on everybody's mind — the growing burden of the public debt the boomer generation is leaving future generations. Should the next generation be worried? He thinks not (p. 52). In this issue we have regulars on taxation, fraud, business valuation and transition to IFRS, which reminds us that while the deadline for the transition is here, there is still work to be done.

I'd like to take this opportunity to thank Trent Henry, chairman and CEO of Ernst & Young in Canada, for his contribution to CAmagazine. Henry was the technical editor of Taxation for many years. In his stead, I'd like to welcome Jay Hutchison, tax managing partner, Canada, at Ernst & Young.

By the way, CAmagazine is 100 this year. We'll have a special issue to celebrate in June.



Okey Chigbo, Editor-in-chief (interim)

PAUL ORENSTEIN

## upfront

### 4 PEOPLE

No one can accuse Louise Senécal of not having an eye for detail. The Montreal-area accountant is an expert lace maker, is the president of a Quebec lace-making association and is the first Canadian president of an international organization she refers to as the “United Nations of lace”

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Few accounting subspecialties have changed as radically as insolvency. Today practitioners do more than monitor receiverships or liquidations. The scope of their practice is more broad based and business oriented as they aim to revive insolvent companies rather than preside over the corporate equivalent of estate sales

BY JOHN LORINC

### 24 CA “it” factor

So what makes a good CA? Do they excel in math and sports, are they organized and outgoing? Industry experts debunk the stereotypes and present a picture of the typical young CA by dissecting the characteristics and traits that are needed to succeed in the profession

BY LORIE MURDOCH

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A modest proposal: everyone would like to see tax disputes resolved quickly, but in Canada there are a few impediments to settling such cases **By Fred O'Riordan**

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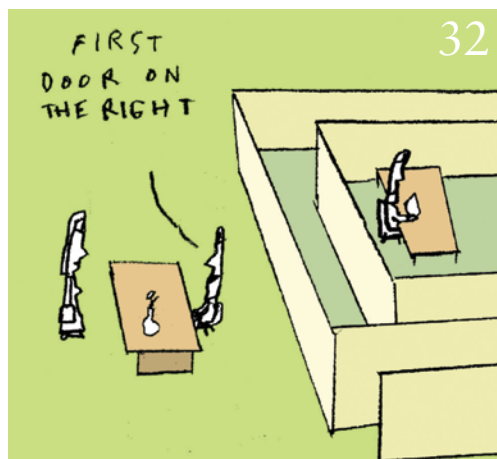
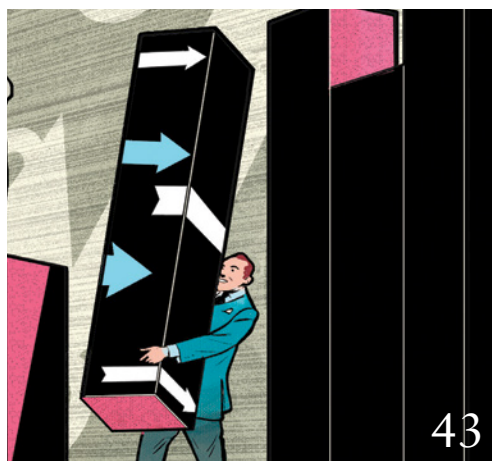
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Finishing touches: the IFRS deadline is finally here, and while there has been a great deal of preparation, it's not over yet **By Jeff Buckstein**

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Bridging the gaps: while earnouts can bridge valuation differences and solve a problem, they can also create other problems

**By Fred D. Tannenbaum**



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Breaking news, tax updates, job postings, archives, more articles: you'll find them all at [www.CAmagazine.com](http://www.CAmagazine.com)



## Accounting and old lace



**A master of the painstaking craft of lace making, Quebec CA Louise Senécal shows off some of her handiwork**

Whether at work or at play, Louise Senécal has an eye for detail. For the past 13 years, the 51-year-old CA has been practising the art of bobbin lace making, an ancient craft that is surprisingly akin to accounting. “Lacework is mathematical; it requires calculation and precision,” she explains.

That’s no problem for Senécal, who has honed these skills since obtaining her CA designation in 1985. She ran her own Montreal-area accounting firm for 20 years before working as a general auditor/counsellor at the Office of the Auditor General of Quebec and is now director of budget and financial strategy, financial services, at Université du Québec à Montréal.

Senécal fell in love with bobbin lace making on a 1996 trip to Bruges, Belgium. She had just bought a house on Montreal’s south shore, where she still lives, and wanted to decorate her windows with lace curtains. She quickly realized, however, that lace making requires more than a simple flick of the wrist. This delicate weaving technique involves working mostly with cotton, linen or silk thread as well as a lace pillow known as a square. “It’s wonderful creating something from nothing, but it’s also very time consuming,” says Senécal, who has made more than 100 pieces, including doilies, handkerchiefs, collars and cuffs. It takes an hour to produce just one square-inch of lace and at least two years to make a lace tablecloth, she says.

Senécal also volunteers with lace-making organizations, including as president of the Association des dentellières du Québec, a position she has held for most of the past decade. In July 2010, she became the first Canadian president of the International Bobbin and Needle Lace Organisation (“It’s the United Nations of lace,” she jokes) at the group’s annual congress in Kobe, Japan.

Once her terms of office come to an end, Senécal plans to return to doing more of her favourite pastime. “I’m not lacking any lace-making projects. My bookshelf is full of books on everything related to lace making,” she says with a twinkle in her eye. Marie-Josée Boucher

### If you wouldn’t say it, don’t send it

Still not convinced that e-mail is anything but private? Consider the predicament of 17 male staff at PricewaterhouseCoopers in Dublin, who found themselves in the hot seat in November after circulating an e-mail that rated 13 of the firm’s new female recruits on their looks. The message, which contained the recipients’ names and e-mail addresses, went viral, caught the attention of the media and is now — and forever — a click away.

How can you avoid a similar fate? “If you wouldn’t say it at work or at the gym or in the middle of a dinner party, don’t do it online,” says Barry Libert, author of *Social Nation: How to Harness the Power of Social Media to Attract Customers, Motivate Employees, and Grow Your Business*. “Repeat after me: there is no such thing as ‘behind someone’s back’ in the world of social media. It’s all out there, virtually forever, so don’t fool yourself,” he says.

#### Résumé

- 1985** obtains CA designation (Que.)
- 1986** opens own firm, Saint-Basile-le-Grand, Que.
- 1999** becomes president, Association des dentellières du Québec
- 2009** joins Université du Québec à Montréal
- 2010** appointed president, International Bobbin and Needle Lace Organisation

MAUDE CHAUVIN/L'EXPRESS

## CA EXECS STILL DELIVER

In an annual review of the positions of chair, CEO, president, CFO, COO and corporate secretary at companies in the *Globe and Mail's Report on Business 1000* magazine, the CICA again determined how many top spots are held by CAs. As in previous years, the 2010 study shows that CAs not only hold many of these top positions but also bring significant returns to their companies.

In fact, top 1,000 companies that had a CA as their top officer (generally CEO or president) performed better on several key financial measures including return on equity, return on capital and return on assets (see chart). It is unlikely this is by chance, given this finding has been consistent every year since the study was first conducted in 1998.

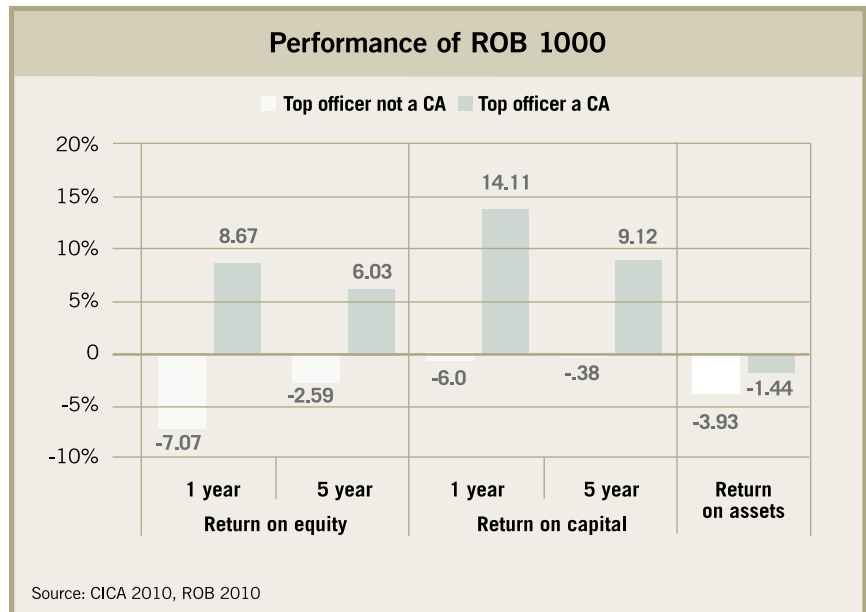
Given the advantages CAs bring to companies, it is no surprise they continue to hold a large number of top positions. CFO is the position CAs are most likely to hold; 57.4% of CFOs in the 2010 ROB 1000 are CAs. This compares to 57.9% last year, 58.7% in 2008, 59.6% in 2007 and 57.9% in 2006.

Other positions frequently held by CAs include chair (11.3%);

CEO (11.1%); president (11.5%); secretary (14.6%) and COO (6.4%).

The study also found that 61.9% of the ROB 1000 companies had at least one CA in one of its top six positions and 21.1% of all the top six positions are held by CAs.

John Tabone is CICA's manager of member value and research services



### ASK AN EXPERT

#### I GET NERVOUS IN JOB INTERVIEWS. WHAT SHOULD I DO IF I SAY THE WRONG THING??

**Employers expect job applicants will have a few pre-interview jitters. The secret is to use this energy to project enthusiasm for the position rather than letting your nerves undermine your confidence. If you do make a mistake during a job interview, here are a few tips on how to recover:**

**Let it go.** By dwelling on it, you draw more attention to your mistake. Instead, focus on putting your best foot forward during the remainder of the meeting.

**Pause.** Collect yourself and remember that everyone makes mistakes. Your ability to recover may just impress the employer.

**Listen.** The types of questions the interviewer asks can give you insight into what he or she is looking for in the ideal candidate. Pay attention to these clues so that you can demonstrate that you are that person.

**Don't jump to conclusions.** You may think a mistake cost you the job, but the hiring manager may not feel that way. You are likely your own harshest critic.

**Follow up.** Send a thank-you note to the hiring manager after the interview. Aside from being a nice gesture, it's another opportunity to clarify your responses and make your case to be hired.

Max Messmer is author of *Job Hunting for Dummies* and chairman of Accountemps ([www.accountemps.com](http://www.accountemps.com))

# #NUMBERS Game

**5.8** Billions of US dollars paid by General Motors in April 2010 to discharge loans from the US and Canadian governments. GM paid the bailout fund five years early.

**19.5** Points below prime paid in interest by Chrysler Corp. on a two-year US\$1.2-billion loan in 1981 that saved the company from bankruptcy. The auto giant made a final US\$813,487,500 payment on the 1% per annum loan in August 1983.

**23** Years after projected settlement that debt from Montreal's 1976 Olympic Games was retired. The Province of Quebec made the final \$22-million payment of the \$1.5-billion shortfall in 2006.

**50** Number of payments made by the British government to Canada to settle a \$1.25-billion loan dating back to the Second

**Paid in full** In October, Germany made its final reparation payment from the First World War — 92 years after the conflict. Other famous last payments:



World War. The \$22.7-million final payment was made in 2006.

**190** Millions of US dollars in dividends paid by Bank of America to the US Treasury during the period it repaid US\$45 billion in Troubled Asset Relief Program funds. The bank made a final payment of US\$19.29 billion in December 2009.

**200** Number of balloons reading "Ciao IMF" released into the air in La Plata, Argentina, following the country's last US\$9.5-billion payment to settle International Monetary Fund loans in 2006.

**1971** Year in which West Germany paid the final installment to the US to settle a US\$1-billion debt that helped the nation recover in the post-Second World War period. Steve Brearton

## Going Concern



**ROBERT BIRON, CA•IT**  
**PRESIDENT & CEO**  
**NORTHUMBERLAND**  
**HILLS HOSPITAL**

**COMPANY PROFILE:** Located in Cobourg, Ont., Northumberland Hills

Hospital (NHH) opened in 2003 with a 137-bed capacity and an operating budget of \$60 million. With 600 employees and about 500 volunteers, NHH boasts one of the highest retention rates among Ontario hospitals. The state-of-the-art facility has a robust suite of diagnostic services given its size. While it belongs to the third of Ontario hospitals running a deficit, an aggressive budget strategy is expected to put NHH in a balanced position by March.

**HOT FACTOR:** In spring 2010 the hospital received a glowing report (scoring 97%) from Accreditation Canada, the independent body tasked with evaluating

quality control across healthcare facilities. NHH was assessed against 1,411 standards, measuring everything from infection control to medication management, and got kudos for its strong teamwork, attention to patient safety and community engagement.

**COOL PROJECTS:** NHH is working with other providers to deliver health services such as outpatient diabetes education in the community rather than in a hospital setting. This year, the NHH spearheaded a citizen's advisory panel to engage community members regarding decisions about hospital services and how to position NHH in the context of the greater healthcare system.

**IN HIS OWN WORDS:** "We're transforming the organization and we're connecting with our community in a comprehensive way. We are committed to being transparent, inclusive and proactive in our decision-making process as it relates to our delivery of services."

Rosalind Stefanac





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## CCH Portal

“Sending an email message is like sending a postcard.”

*Privacy Commissioner of Canada*



Sending confidential information through email is not secure. Which is why experts like the Privacy Commissioner of Canada recommend that you do not email highly sensitive financial documents such as tax returns and T183s.

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### How to get ahead in business

Want to climb the corporate ladder? Exercise your ethics. Of 1,400 US chief financial officers surveyed by staffing service Robert Half Management Resources, one-third (33%) said that, other than technical or functional expertise, integrity is what they look for most when grooming future leaders. Interpersonal and communication skills also ranked high, cited by 28% of respondents.

“History has shown time and time again the importance of ethics in business — even a single lapse in judgment by one employee can significantly affect a company’s reputation and its bottom line,” says Paul McDonald, senior executive director of Robert Half Management Resources. “Leaders who are principled and forthright inspire this same behaviour in their teams, creating a culture in which integrity is a core value.”

Communication skills are also a must-have as executives take on greater responsibility, McDonald adds. “Especially during difficult periods, managers must be able to promote open, two-way communication with their teams,” he says. “Executives in companies that have moved successfully through the downturn understand the importance of listening intently to feedback from employees and are always on the lookout for this skill in potential leaders.”

#### Desirable traits in future leaders, according to CFOs

Integrity	33%
Interpersonal/communication skills	28%
Initiative	15%
Ability to motivate others	12%
Business savvy	10%
Other/don’t know	2%

Source: Robert Half Management Resources, 2010



### Where job seekers lie

Nearly one in five Canadians (19%) would exaggerate their current or previous work responsibilities to get a job, according to a poll by payroll service provider ADP Canada.

How else would job seekers fudge facts to land that coveted position? Here’s a breakdown of the most common offenses the survey found.

- Paycheque pretenders (27%): would exaggerate current or previous compensation.
- Time-will-tells (17%): would lie about having skills such as speaking German or operating a forklift, gaps that would eventually become evident.
- Eager embellishers (15%): would gloss over details such as the duration of a job or gaps of time between jobs.
- Phonies in disguise (12%): would falsify credentials key to the field or position.

### SICK PRACTICE

Next time you call in sick you might get a house call, but not from your doctor. In a survey for US recruiter CareerBuilder, 29% of employers said they have checked up on an employee who called in sick and, of those, 15% went as far as driving by the worker’s house or apartment.

### BOTTOM LINE REPORTING

More than two-thirds of Fortune Global 500 companies publish some form of sustainability or corporate responsibility report, according to research by Ernst & Young. And it’s not just about optics: the reports are increasingly being used to help companies cut costs and improve efficiencies.

### PENSION POSITION

Canada’s pension system ranks fifth among 14 countries for adequacy, sustainability and integrity, in an annual global index produced by consulting and investment firm Mercer. The Netherlands topped the index for the second consecutive year; the UK was 6th and the US 10th.

*“One of the most important consequences of using SYSPRO is that our inventory control has tightened considerably, without having to add additional people or increase anybody’s workload.”*

*Blair Stunder, General Manager, Arctic Manufacturing*

## Arctic Manufacturing

Established in 1974, Arctic Manufacturing is a private company situated in Prince George, British Columbia. With 25 employees, working out of a single, 35,000-sq.ft. facility, Arctic fabricates a variety of stock and custom-designed commercial trailers for heavy transportation. “It’s class 8 equipment,” says Blair Stunder, the company’s General Manager, “mostly for log transportation.”

The bulk of Arctic’s product is made for companies in British Columbia, Alberta, and Northern Saskatchewan. Over the past few years, outside market forces have been unkind to Western Canada’s forest workers, and the current housing crisis in the States has decreased demand for forest products dramatically. “The market’s not what it should be,” admits Stunder, “but everyone’s in the same boat. On the positive side, the Chinese market for timber is starting to open up.”

Like most companies in the global marketplace, Arctic relies on efficient business processes to maintain its competitive edge in difficult times. Having an appropriate enterprise resource planning (ERP) system can help a business integrate its key operations, and synchronize, plan and optimize its available resources. An ERP also offers a wealth of real-time information that can greatly enhance the insight of company decision makers.

For the past 16 years, Arctic has been run on SYSPRO enterprise resource planning (ERP) software. “In the ‘70s,” says Stunder, “we did the books by hand. In the ‘80s we switched to computers, and worked with a custom software vendor. In 1993, we realized that our business had outgrown the capabilities of our software. When you start getting into manufacturing, supply chains, bill of materials, etc., the field of appropriate software narrows considerably. We looked at other systems, but at the time there weren’t many ERPs that had everything we needed. SYSPRO was clearly the best choice, and to make it even better, their support was in the same time zone.”

Working with a SYSPRO VAR, Arctic’s ERP implementation went smoothly. “We went live during our busiest season,” says Stunder. “There were a few long days and evenings, but no major hitches. In retrospect, we spent time making modifications that might not have been necessary. Next time around I would probably go with SYSPRO’s default company set-up. With all the flexibility built into SYSPRO, it pretty much fits our business needs right out of the box.”

These days, Arctic uses most of SYSPRO’s inventory, manufacturing, tracking, reporting, analysis and accounting modules.

“One of the most important consequences of using SYSPRO,” says Stunder, “is that our inventory control has tightened considerably, without having to add additional people or increase anybody’s workload. Whenever you can increase your access to data without adding to staff or work levels, it’s a good thing. In general, with SYSPRO, we’re getting more accomplished, with fewer people, than has ever been possible before.”

Tapping in to SYSPRO’s flexibility, Arctic uses the Work in Progress (WIP) module for overall expense tracking. “Because of the ability of the WIP database to track labour, as well as stocked and non-stocked parts for job costs,” says Stunder, “we can set up a piece of equipment in the WIP and track its maintenance throughout the year. Similarly, at the end of the each month we can look at our building maintenance and cleaning costs, and it gives us an almost live look at our real expenses.”

Not only has SYSPRO helped to keep Arctic competitive, it’s done so within a framework of simplicity. “Many of our employees have worked with other ERPs,” says Stunder, “and are impressed with SYSPRO’s ease of data retrieval. Our employees also appreciate how simple it is to customize the interface. At the warehouse level, the user has manipulated the screen set so he sees strictly what’s important for his job. In the accounting office it’s completely different. It’s great to see employees customize the user interface to optimize their workflow.”

Stunder also credits SYSPRO with improving the company’s relationships with suppliers and customers. “Over the last few years we’ve switched to e-mailing our Purchase Orders in MS Word format. Not only has that cut down on long-distance phone calls, it’s greatly reduced the number of order entry errors.”

In the future, Arctic is considering the implementation of bar codes and scanners. “There’s also a great deal of data entry on the manufacturing side,” says Stunder. “Scanning job tickets would streamline things considerably. As an additional benefit, the printed barcode labels would allow for much better tracking.”

For Arctic, SYSPRO has given 16 years of sterling service. “We’ve had no problems to speak of,” says Stunder. “SYSPRO is a stable, reliable, low-maintenance ERP system, and it does what it’s supposed to do six days a week, every week of the year.”

For information on Arctic Manufacturing please visit: [www.arcticmfg.com](http://www.arcticmfg.com)

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# Netwatch

BY JIM CARROLL

YOUR GUIDE TO BUSINESS & ACCOUNTING ON THE INTERNET

## Don't wait to innovate

**W**hen Apple reported results last fall that blew past analyst expectations, there was a lot of talk about how this innovation juggernaut continues to redefine the technology market. Yet much of the discussion overlooked a significant factor: 60% of Apple's revenue came from products that didn't exist three years prior to the earnings release, according to an analysis of Apple's revenue by mobile app developer Asymco.

Think about that in the context of your operations. What if you had to replenish your product or service line every two or three years? It could become the new normal in many industries.

One of the most profound changes to come about during the past decade has been the collapse of product life cycles. Think about the graph in your marketing textbook from years or decades ago when you first learned about the concept of product life cycles. Remember how it showed a product coming to market: sales increase, reach market maturity and eventually begin to drop off. That's been the model of product life cycles as taught in business schools for the past 100 years or so.

The rule of thumb was that companies would innovate and introduce a new product. If it succeeded, the company would experience growth. At some point, sales would peak. The product would then become obsolete or overtaken by competitors and sales would decline. That might involve a time period of 10, 15 or even 25 years.

What a quaint model. Too bad it bears no resemblance to today's reality. The product life-cycle model today is being turned on its ear by instant obsolescence. In some industries, that product obsolescence now occurs during the growth stage; in the high-tech industry, the decline phase caused by instant obsolescence can occur during the introduction of a product or even before a product makes it to the marketplace.

For example, last year Lenovo pulled the plug on an iPad-like product even before it was released because it was obvious that its limited feature set had already made it irrelevant and obsolete in a very fast-paced market. The

product simply had no chance of competing against the iPad. It was killed before it was even produced.

If you want to master innovation, you need to think about how your own product life cycle is changing. Look at the numbers: it took two years for Apple to sell two million iPhones; it took just two months for it to sell two million iPads. And, as my 17-year-old son pointed out when we were chatting about this at the dinner table, it took but a few weeks to sell a million iPhone 4s.

Clearly Apple is on a very significant innovation roll here, but there are lessons to be learned for other organizations. If product life cycles are collapsing in your industry, do you have the capability and wherewithal to generate revenue where revenue hasn't existed before? Are you prepared to bust into new business models so you can enter markets where you haven't participated before? Do you know how to add service and other revenue streams to commodity product lines so that you can generate additional revenue from previously stale product lines?

For years, I've been preaching to my clients that their ability to survive and thrive in the future is going to come from their ability to generate new sources of revenue and adapt — I covered the issue about a year ago in a column on the concept of chameleon revenue (Netwatch, December 2009). Apple's numbers indicate that the trend might be picking up steam.

Jim Carroll, FCA, is a well-known speaker, author and columnist. Reach him at [jcarroll@jimcarroll.com](mailto:jcarroll@jimcarroll.com) or log on to his website at [www.jimcarroll.com](http://www.jimcarroll.com)

### PRODUCT PROGRESS

#### Asymco

[www.asymco.com/2010/10/19/60-percent-of-apples-sales-are-from-products-that-did-not-exist-three-years-ago](http://www.asymco.com/2010/10/19/60-percent-of-apples-sales-are-from-products-that-did-not-exist-three-years-ago)

#### Typical product life-cycle graph

[www.quickmba.com/marketing/product/lifecycle](http://www.quickmba.com/marketing/product/lifecycle)

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# Work in process

BY MICHAEL BURNS

USING TECHNOLOGY TO IMPROVE THE WAY YOU DO BUSINESS

## How to negotiate software contracts

**A** major acquisition such as an ERP system should be considered a lifetime investment.

It's not just a software purchase; it's a contract that includes maintenance fees, which will exceed the cost of the software in four to five years. A good dose of due diligence is in order — not only in testing the software and assessing the vendor, but also in reading the contract.

**1. Pick the right time to negotiate:** Start reviewing the contract when you are close to making your decision and the remaining vendors are doing everything they can to win your business. Don't wait until the very end, because by then you will have given up most of your negotiating power. And remember, you're not just negotiating prices but also all other fees and terms in the contract. Vendors are often flexible with purchase prices but less so with maintenance fees. Ideally, those fees should be based on the discounted price rather than the list price and they should be capped to prevent unlimited escalation.

**2. Give and take:** Everything is negotiable until you sign the contract. This is not a standard form used by millions of customers to buy a small item. You have an obligation to your shareholders or board to obtain favourable terms. But accept compromise for the less important ones.

**3. Define your scope:** Vendors will often provide a statement of work containing general terms such as "consolidation" and call that scope. But scope should be more specific and include functionality such as inter-company eliminations or foreign currency translation. Scope needs to be defined tightly, or the vendor will keep issuing change orders saying your requests are outside the agreed-upon scope. Ideally, you will have given all the vendors a thorough list of requirements and received

written responses detailing how well their systems meet them. Include the winning vendor's responses in the contract as part of scope.

**4. Nail down the implementation costs:** Vendors will want to charge you based on time and materials — and who can blame them when they are making a trip into the unknown? Consider paying them to agree to a certain implementation cost before you sign the contract. Make sure all costs are covered, including training or travel. The goal is to have no surprises that you will need to explain to your boss.

**5. Define the terms used:** The software contract will contain terms such as design documentation, which could

### Start reviewing your contract when you are close to making a decision — don't wait till the very end

mean something very different to you than it does to the vendor. Make sure you understand exactly what you're getting with your purchase.

**6. Define roles and responsibilities:** There should be a clear delineation of responsibilities between the implementer and your organization. For example, you need to decide if the vendor is responsible for developing extra reports that don't come out of the box.

**7. Include a project plan:** It's hard to fault vendors for not wanting to commit to a specific project plan and schedule when some of the responsibilities they must take on and some of the tasks they must complete depend on factors beyond their control, such as your staff members' skill sets or the time they have available to devote to the project. Nevertheless, you have a right to make sure your vendor meets its obligations on time. As noted in item 4, you could pay the vendor to prepare a schedule before the project is signed based on an understanding of your resources and availability.

**8. Don't overspend on licences:** The vendor might offer a deal for acquiring extra licences upfront. Since you pay maintenance fees on those licences, make sure you can actually make use of them.

**9. Provide incentives to complete the work:** The contract should include a holdback for a portion of the fees (especially for customizations) until your system is working as per the contract's scope. Why pay the full cost until it is working properly?

**10. Get a clear service level agreement:** A service level agreement should include service commitments by the vendor providing for credits or refunds against maintenance fees for missed response/resolution times. There will inevitably be problems but the question is how long it takes to resolve them. Some could be classified as critical in that the entire system is down until they are fixed.

Vendors and implementers will typically do everything they can to make their clients happy and keep them that way. It all

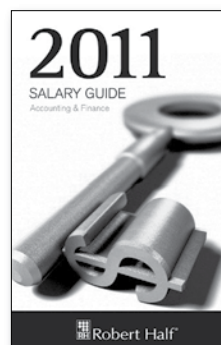
has to do with safeguarding their reputations; in other words, it is much better to have a happy client who can be used as a reference in the future than one who is going around spreading horror stories.

Since there is fine print in every contract, you should seek legal counsel. Lawyers will delay the process somewhat but their help in developing a good contract will stand you in good stead if any problems should happen to arise later on. In the event of a dispute, I recommend arbitration rather than a lengthy and costly court battle, where every argument is met with a counter-argument from the other side. Get past the dispute so you can focus on your business.

Michael Burns, MBA, CA•IT, is president of 180 Systems ([www.180systems.com](http://www.180systems.com)), which provides independent consulting services, including business process review, system selection and business case development. Contact 416-485-2200; [mburns@180systems.com](mailto:mburns@180systems.com)



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## CICA's cash management toolkit helps small and medium businesses

**A** new publication by CICA in conjunction with CIBC, launched recently at a Toronto Board of Trade seminar, provides valuable cash management advice for small and medium-sized enterprises (SMEs).

The Cash Management Toolkit for Small and Medium Businesses by Jeffrey D. Sherman, MBA, CA, is designed to help business owners understand the various components and concepts of cash management. A rich and comprehensive guide, the toolkit is an excellent resource that can be used by businesses in any industry at any life stage.

The toolkit provides an in-depth case study and a number of checklists to assist business owners. It also provides detailed advice on such issues as budgets, projections and forecasts; fraud and risk management; credit and collections, payment terms; optimizing inventory; obtaining and investing cash; handling debt; and working with banking partners.

"Given that SMEs make up almost 98% of Canada's companies and employ five million people, cash management capability in this key sector is an issue that impacts the entire business community," says Paul Gallucci, vice-president, sales and member services, Toronto Board of Trade. "CICA's content-rich



Jeffrey D. Sherman, author of Cash Management Toolkit for Small and Medium Businesses, speaks at the launch of the publication

and informative seminar was topical, timely and extremely well received by our members. The board is proud to have an excellent relationship with the CICA."

The cash management toolkit is available in English and French. Visit [www.CAstore.ca/cashmgmt](http://www.CAstore.ca/cashmgmt) for more information.

## Securities regulators cite CICA publications in environmental disclosures guidance

**Four CICA environmental** reporting publications were specifically referenced in a recent staff notice from the Canadian Securities Administrators (CSA) aimed at helping issuers assess which information must be disclosed on environmental matters — such as risks related to weather patterns or environmental legislation.

"The CICA has been active in this field for many years and our depth of knowledge is recognized and valued," said Chris Hicks, principal, guidance and support, with the CICA. "This CSA publication reflects the increasing importance of environmental matters in financial reporting, the changing regulatory landscape, and increasing investor interest in environmental matters."

CSA Staff Notice 51-333 provides a comprehensive discussion of information required to be reported, including an appendix that provides examples of possible disclosures.

The four CICA publications referenced by the CSA include:

- Environmental, Social and Governance (ESG) Issues in Institutional Investor Decision Making (August 2010)
- Climate Change Briefing — Questions for Directors to Ask (July 2009)
- Building a Better MD&A: Climate Change Disclosures (November 2008)
- Executive Briefing — Climate Change and Related Disclosures (March 2008)

These can be found online at [www.cica.ca/climate](http://www.cica.ca/climate). The additional guidance from the CSA was discussed at the Environmental, Social and Governance Conference hosted by the CICA in December 2010. A key focus of the conference was the financial reporting implications of environmental issues, including climate change.



## RECENTLY ISSUED PRONOUNCEMENTS

<b>CICA Handbook – Accounting</b>	<b>Date issued†</b>
Amendments to Preface and Introductions to Parts I, II and IV	December 2010
2011 Edition of International Financial Reporting Standards (Part I)	November 2010
The Conceptual Framework for Financial Reporting (Part I)	January 2011
Amendments to IFRS 7 regarding Disclosures — Transfers of Financial Assets (Part I)	January 2011
Amendments regarding First-time Adoption (Parts II & III)	February 2011
Accounting Standards for Not-for-Profit Organizations (Part III)	December 2010
<b>CICA Handbook – Assurance</b>	
2011 Edition (Part I)	December 2010
Limited Scope Revisions to Certain Standards for Assurance Engagements	December 2010
Legislative Requirements to Report on the Consistent Application of Accounting Principles in the Applicable Financial Reporting Framework, AuG-10 (rev.)	December 2010
Dating the Review Engagement Report on Financial Statements, AuG-47	December 2010
<b>CICA Public Sector Accounting Handbook</b>	
Accounting Standards that Apply Only to Government Not-for-Profit Organizations, Sections PS 4200 to PS 4270	December 2010

## RECENTLY ISSUED DOCUMENTS FOR COMMENT (to January 31, 2011)

<b>Accounting</b>	<b>Comment deadline</b>
ITC Effective Dates and Transition Methods	January 10, 2011
ITC Three-yearly Public Consultation	March 15, 2011
<b>Auditing and Assurance</b>	
ITC Compilation Engagements	February 1, 2011
ITC IAASB Proposals Relating to International Auditing Practice Statements	January 21, 2011
<b>Public Sector</b>	
ED Financial Instruments and Foreign Currency: Translation Financial Statement Presentation	January 17, 2011

## WATCH FOR

### CICA Public Sector

#### Accounting Handbook

Section PS 3410, Government Transfers

#### Documents for Comment

IASB proposals regarding Financial Instruments — Impairments, Asset and Liability Offsetting and Hedge Accounting

### Legend

ED – Exposure Draft

EDI – ED based on IFRS/ISA

DPI – IASB Discussion Paper

DII – IASB Draft Interpretation

ITC – Invitation to Comment

† Refer to each Handbook pronouncement for the effective date and transitional provisions.

*The information published above reflects best estimates at press time. Please visit our website for the most recent information.*



A classic counter-cyclical industry, Canada's insolvency sector has undergone a dramatic shift from monitors to revivers of troubled companies

# Insolvency by John Lorinc

## THEN and NOW

AS INVESTMENT PROPOSITIONS GO, IT WAS AN AMBITIOUS and visionary plan. In the early-2000s, when hospitality entrepreneur Ken Fowler began planning Red Leaves on Ontario's Lake Rosseau, he dreamt of a sprawling vacation community similar to Intrawest's ski resorts in Whistler, BC, or Collingwood, Ont.'s Blue Mountain, except on the shores of a serene northern lake. The \$750-million scheme included a luxury condo hotel, hundreds of fractional ownership cottages, a hub of shops and a marina. **Illustration by GÉRARD DUBOIS**

After slow initial sales of the hotel condo units, the wrenching 2008 credit crunch laid waste to the financial viability of the hotel scheme. Fowler found himself caught up in a chain reaction, as the global credit crunch forced his lenders to retrench.

In May 2009, about five months after the hotel opened, the project lenders called their loans and installed Alvarez & Marsal Canada as receiver. Richard Morawetz, A&M's Canadian managing director, had a mandate to sell off hundreds of unsold condo units while operating the hotel. It was, in Morawetz's words, a "high-profile engagement." With hundreds of wealthy cottagers watching the unfolding drama with morbid fascination, A&M Canada could scarcely have landed a more visible case.

The insolvency sector is one of those classic counter-cyclical industries. Bad times for the rest of us are good times for the firms called in to sort out the problems that accumulate during and after recessions: debt-addled consumers, overleveraged companies and unpredictable shifts in demand. But the biting 2009 recession revealed that Canada's insolvency industry has undergone a dramatic change of its own — one driven not just by the ebb and flow of the broader economy but also short- and long-term shifts in insolvency regulation, as well as an intriguing evolution in the attitudes of lenders.

The profession, according to Kevin Brennan, chair of the Canadian Association of Insolvency and Restructuring Professionals (CAIRP) and Vancouver-based partner at Ernst & Young, is in a state of flux. He says lingering economic uncertainty is making it difficult for insolvency and restructuring professionals (CIRPs) to determine the path to recovery for struggling companies and debt-ridden individuals. Furthermore, legislative changes enacted in July 2008 and September 2009 have forced CIRPs to adapt their practices. Meanwhile, the Office of the Superintendent of Bankruptcy (OSB) continues to tinker with the new rules and has pledged to make potentially controversial changes in trustee licensing standards (among them, issuing separate corporate and consumer licences and allowing credit counsellors to administer consumer proposals under the Bankruptcy and Insolvency Act). The OSB has promised to issue the new licensing framework this spring, says Brennan. "The issuance of a new directive that deviates from the current framework could have a substantial impact on CIRPs and the profession overall."

Apart from keeping abreast of regulatory shifts, many practitioners working currently do much more than monitoring, receiverships or liquidations. The scope of practice has become more broad based and business oriented as restructuring professionals aim to revive insolvent companies — with operational fixes, balance-sheet re-engineering, refinancings, etc. — rather than preside over the corporate equivalent of estate sales. As veteran receiver Pierre Laporte, Deloitte's reorganization services leader for the Americas, observes, "It's been quite a while since I liquidated a company." A remarkable line, coming a year after one of the worst downturns in a century.

## Fraud on the rise

Former Edmonton Oilers owner Peter Pocklington, the man every Canadian remembers for trading Wayne Gretzky to Los Angeles, has rarely strayed far from controversy. His most recent journey before the kleiglits was narrowly avoiding a bankruptcy fraud charge in the US that could have brought a 10-year jail term. In May 2010, he entered into a plea bargain in which he admitted he had lied to a court that he had almost \$20 million in debt and only \$2,900 in assets when he declared bankruptcy in 2008.

His is not the only case. Canadian insolvency and restructuring professionals say they have seen a sharp increase in bankruptcy fraud cases, especially Ponzi schemes based in Montreal, Toronto and Calgary that prey on investors looking for higher returns in volatile markets.

From his base in Owen Sound, Ont., BDO's Bill Courage has also witnessed a surge in fraud cases — some involving once viable companies that gave their bankers "fictitious" information about assets and inventories as they struggled to get cash. In other instances, Courage says, the receivers quickly discover that the company is nothing but doctored financial statements.

JL

In the accounting world, few subspecialties have changed as radically as insolvency practice — a shift driven by changing social mores, legislative reform, global capital flows and new ideas about over-leveraged companies.

As of the early 1960s, fewer than 1,000 Canadians declared personal bankruptcy each year, and consequently there were few trustees appointed by the courts to oversee those proceedings. The credit-card industry was still young and long-held moral views about insolvency continued to hold sway. But the personal insolvency rolls began to grow almost exponentially — more than 2,700 in 1971 and more than 19,000 in 1980 — and with it grew the insolvency industry.

"Bankruptcy used to be regarded as something strictly for the businessman," one CA said in 1981. "Now it is seen more and more as salvation for anyone who gets in too deep." At the time, the rules dictated that anyone 18 years old or older, who owes \$1,000 can get rid of his or her creditors by going bankrupt.

Until the mid-1970s, moreover, most trustees and receivers worked as sole practitioners. But that changed when a few firms such as Clarkson Gordon set up insolvency practices. Clarkson Gordon became a training ground for young accountants looking to specialize in receivership; the other large firms soon followed suit. At the time, recalls RSM Richter senior partner Peter Farkas, the vast majority of the commercial insolvency work involved bank-driven receiverships that almost always led to liquidations. "You went in on Friday afternoon, literally, and took possession of the company," says Farkas, noting that receivers spent most of their time dispensing with inventory and capital assets. "There was very little effort made to sell a busi-

ness as a going concern.” The whole process took a few weeks.

In the aftermath of the recession of the early 1990s, with both business and personal bankruptcies soaring, trustees noticed that bankrupts no longer seem ashamed of their problems, but they just wanted to find a way to get the bill collectors and repo men off their backs. “When I started in this business 25 years ago, bankruptcy had a moral stigma,” one Quebec trustee said in a 1995 interview with *The Globe and Mail*. “Today, people couldn’t care less. They are just trying to keep their head above water.” At the time, the increased traffic also translated into a boom for CIRPs, as some metropolitan regions, such as Edmonton, saw the number of trustees in bankruptcy and insolvency consultants double to deal with demand. Indeed, the membership of CAIRP grew by almost 50% between 1990 and 2010, to 882 from 603.

During this latest economic downturn, there’s certainly been no shortage of work on either side of the insolvency world.

The number of Canadians making individual filings soared to more than 150,000 for the year ended June 2010. Craig Munro, Ernst & Young’s senior vice-president of transaction advisory services, points out that the number of MasterCard and Visa accounts doubled between 1997 and 2007, to 64 million, while the annual dollar volume on all that plastic tripled, to \$275 billion.

In 2010 however, the number of bankruptcies dropped, but the volume of proposals — negotiated debt restructuring agreements between creditors and debtors — shot up by 32%, a trend Nova

Scotia trustee Darryl Haley regards as entirely positive. “Trustees have certainly exposed debtors to the concept of proposals,” says Haley, who has been practicing insolvency since the 1970s. “It behooves us all to continue in this fashion.”

The shift isn’t just due to an outbreak of good will. Ottawa, through the OSB, made several key changes that have altered the trajectory of personal insolvency. Since 1993, individuals have been allowed to make “consumer proposals,” essentially offering to settle with their creditors for a reduced payment; the number of proposals has risen dramatically in recent years. Then, under 2007 legislation, Ottawa boosted the debt limit to \$250,000 from \$75,000, a level Haley describes as “grossly outdated.” (The \$75,000 limit was in place since 1993.)

But the new rules are also designed to encourage more financial responsibility, so debtors now stay in bankruptcy for far longer — up to 36 months, with penalties for surplus income and second-time bankrupts. “There’s more of a consequence,” says Brennan. “It’s not just nine months, easy in and out.”

Another regulatory change has altered the practice: the OSB now requires two counselling sessions for bankrupts, a change that has meant that trustees such as Haley and his colleagues — he runs a seven-person practice in Bridgewater, NS — have had to train to dispense this kind of advice. “I personally would say it provides more job satisfaction,” he says. “The relief people feel when they leave that meeting is very apparent.”

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**“In the past we would liquidate the business because of a poor capital structure, poor liquidity and no profitability. There were no real options. Banks weren’t as patient as they are today. There’s more willingness to change covenants or credit agreements to help companies through hard times”**

The trends in consumer insolvencies mirror those on the commercial side.

Former CAIRP president Gary Colter, who started insolvency work in 1972 and recently completed a stint as chief restructuring officer for CanWest Publishing, notes that the commercial insolvency dynamic — traditionally driven by secured creditors — shifted in the 1980s and early 1990s, when legislative changes allowed debtor companies owing more than \$5 million to seek creditor protection for up to six months or longer by initiating court supervised restructurings overseen by a monitor and, in many cases, existing management. (Under rules passed in 2009, monitors have to be bankruptcy trustees.)

After the first heavy wave of high-profile corporate filings in 2009 — “unique for its sheer intensity,” as A&M’s managing director Doug McIntosh puts it — volume ebbed somewhat in the second half of 2010. David Planques, PricewaterhouseCoopers’ national practice leader for corporate advisory and restructuring, says that in 2009 firms were engrossed in very high-profile filings, such as AbitibiBowater, Smurfit and Quebecor. As for 2010, it was an average year, says Planques. And 2011 will be at least as busy as 2010 with mid-market files, he adds.

Most firms continue to see a steady stream of regional and sector specific activity — oil and gas servicing in Alberta, commercial and recreational real estate in British Columbia, and agriculture in the Prairies. Owen Sound, Ont., CA Bill Courage, BDO Canada Ltd.’s national insolvency practice leader, points out that some cases he has seen — e.g., tourist operators — are directly tied to the decline in consumer spending. (In some sectors — forestry, auto-parts and manufacturing — sectorwide restructurings predated the 2008 implosion in global credit markets.)

The upshot is that a lot of the ongoing work is geared to small or midsized companies, because the headline-grabbing insolvencies — AbitibiBowater, Stelco, CanWest, Megabrand — have been sorted out. “A lot of the stuff we’re doing is not the stuff you read about in the newspapers,” says E&Y’s Munro, adding that his firm was more involved with advisory work that isn’t public. “It’s more midmarket companies.”

The most notable feature of the past two years, however, has been the increased sense of collaboration between creditors and corporate debtors, and an understanding that protracted insolvency processes didn’t help anyone. “You saw a real prevalence of prepack restructurings,” says McIntosh, referring to the practice — used in some of the most high-profile US corporate insolvencies — of creditors and debtors hammering out agreements prior to formal bankruptcy filings.

Many CIRPs also say Canadian banks, traditionally

the villains in recessionary periods, have exercised much more restraint with troubled firms. “To the extent that the company was relying on bank lending, banks were reluctant to pull the plug because there wasn’t much market for those assets,” says Toronto trustee and CA John Page. Planques agrees: “If there’s a core viable business, I do see lenders rallying around to try to save it.”

There are diverse reasons behind the banks’ newfound forbearance. Canada’s financial institutions, of course, sailed through the downturn, largely unaffected by the devastating fallout from the collapse of asset-backed securities and other exotic financial instruments. And Ottawa’s stimulus policies and the Bank of Canada’s historically low interest rates helped prop up demand in the economy.

But Laporte observes that many businesses have improved their financial management practices since the 1991-1992 recession, meaning that many companies that had to file in 2009 or early 2010 had positive EBITDA but were saddled with cumbersome overhangs of debt; there were fewer basket cases. “In the past, we would liquidate the business because of a poor capital structure, poor liquidity and no profitability,” says Laporte, who advised former Imasco chair Purdy Crawford’s noteholders committee during the 2007 negotiations to untangle the asset-backed commercial paper mess. “There were no real options. Banks at the time weren’t as patient as they are today. There’s more willingness to change covenants or credit agreements to help companies through hard times.” In many cases, Laporte notes, bondholders have agreed to convert their interest to equity when the company is basically viable.

But the banks also know they are no longer the only credit game in town. Until the 1970s and 1980s, the charter banks were the source of most commercial loans. “In those days, 98% of the files were bank-initiated,” says Farkas. “Now, it’s totally the other way around.” Companies and their restructuring advisers can obtain financing and refinancing from alternative or secondary sources; with more competition on credit markets, the banks

<b>As a group, Canada’s trustees are aging and fewer are accountants</b>		
	<b>1999</b>	<b>2009</b>
Average trustee age	48.4	51.6
With accounting qualifications	78%	67.6%
No. administering insolvency estates*	784	740
*opened or closed at least one estate		

have become easier to deal with. Troubled firms, for their part, are also more likely to come forward to ask for concessions. “Debtors are more proactive, coming to the bank with a plan,” says Farkas.

During this downturn, it’s also become increasingly clear to many insolvency practitioners and lenders that the least constructive solution is selling the equipment and inventory and locking the doors. “People understand that you can get greater value by selling the business as a going concern rather than shutting it down,” says Bobby Kofman, co-president of RSM Richter Inc., the firm’s insolvency group. The strategy in recent years, he says, has been to find temporary sources of financing and renegotiate agreements with creditors so the company can operate on a break-even basis, an approach made possible by the Companies Creditors Arrangements Act (CCAA) and other mechanisms. “Then there’s no pressure to liquidate.” The practice, adds Farkas, “is more distressed mergers and acquisitions than bankruptcy. The majority of our cases are sold as businesses. Twenty years ago, that wouldn’t have happened.”

The 1992 reforms to the CCAA gave large companies more flexibility to “de-leverage” and convert debt to equity. Public policy and the courts, in fact, continue to play a significant role in this reshaping of the insolvency landscape, especially in the wake of highly controversial CCAA filings that left retired employees dependent on company pension plans without incomes or benefits.

The most notorious, of course, was Nortel Networks, which filed for protection in January 2009 with a pension deficit exceeding \$2.5 billion. With the media filled with stories of bereft retirees, a group of former employees hired lawyers and persuaded a judge to allow them to participate in the process. In early 2010, the Ontario government offered the pensioners access to payouts from a provincial fund that underwrites private pension plans, the only one of its kind in Canada. But as of late 2010, some disabled Nortel employees were pinning their hopes on property sales and legislative changes to make sure they continue receiving disability payments rather than watch them snapped up by creditors in the bankruptcy process.

Ottawa’s Wage Earner Protection Program Act (WEPPA) — passed in 2008 after a three-year review of federal insolvency policy — has also altered the dynamics of some traditional court-monitored proceedings. WEPPA creates a super-priority for unpaid employees wages up to about

\$3,000. Under the law, says Brennan, if there are no recoverable assets, employees can apply to the federal government for funds to cover outstanding wages.

For practitioners, says Page, WEPPA has created more paperwork because there’s a reporting obligation, while lenders or their advisers must determine ahead of a filing whether there’s enough cash on hand to cover WEPPA obligations and insolvency practitioner fees before calling in loans.

But if regulatory changes have significantly altered the formal disposition process in Canada, there’s yet another factor shaking up the way many filings play out, and that is the increased presence of US capital in the Canadian market. One of the signal



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differences between the 2009-2010 downturn and previous recessions is that foreign lenders, hedge funds and other institutions now hold much more Canadian corporate debt.

During this downturn, the presence of foreign bank debt has turned out to be a channel through which international fiscal and monetary policy reaches deep inside Canadian insolvency proceedings. Morawetz observes that he has dealt with troubled European banks that have been forced to take a “more disciplined approach” to ongoing cash requirements because they received government bailouts. With such lenders on a short leash, he says, “it adds a layer of complexity because it can take longer to get refinancings approved.”

The presence of the offshore debt has also led to very intricate capital structures consisting of a mish-mash of senior and subordinated debt, public debt and loans insured through the derivatives market. “When I first got into the game, we didn’t have hedge funds,” says Colter. Now, he says, “the debt moves around and you don’t know where it is.”

These changes can trigger exceptionally complicated negotia-

### High-profile bankruptcies:

#### 1990s:

Campeau Corp.	(1990)
Olympia & York	(1992)
Consumers Distributing	(1996)
Eaton’s	(1999)

#### 2000s:

Bre-X	(2002)
Stelco	(2004)
Nortel	(2009)
AbitibiBowater	(2009)

tions among creditors, says KPMG Inc. president Nick Brearton, who leads the firm’s national insolvency practice. “If one lender has insurance and others don’t, how does that affect the dynamic?” he observes. “You need to be able to recognize the dynamics and develop restructuring plans that take into account the divergent interests of the stakeholders.”

Increasing globalization has affected the Canadian insolvency sector not just through crossborder capital flows but also with complicated international filings, such as Aero Inventory plc, a British company that provided on-site parts to the commercial airline industry until it collapsed in 2009. The case, currently under investigation by British authorities, extends into multiple jurisdictions, including Canada, Hong Kong, the UK, Australia and Switzerland. “Increasingly, there are more of these international engagements,” says Brearton, noting that such cases require large accounting firms and their legal advisers to coordinate far-flung insolvency procedures. “We have to provide one-stop, seamless solutions and there needs to be consistency.”

But Colter, who is retired from KPMG but runs a restructuring consultancy, points out that for all the changes, a handful of core principles still apply: “In order to save a company, you have to have cash flow, liquidity, a viable business, competent management, supportive and reasonable creditors, supportive and cooperative unions and you need to have a viable restructuring plan.”

In Canada, the most obvious sign of the increasingly globalized nature of commercial insolvency is the conspicuous presence of A&M and FTI Consulting, both US boutique firms that set up

Canadian offices just in time for the worst recession since the 1930s. FTI, which handled cases such as CanWest and Skyservice, was established by former PricewaterhouseCoopers partners.

A&M, a fixture of the US restructuring sector, established a Canadian arm in 2006; it was staffed by a handful of KPMG partners, including CAs Morawetz and McIntosh. With the downturn in full swing, these boutique firms secured numerous high-profile engagements, especially files involving US lenders.

The boutiques owe their existence to the Sarbanes-Oxley conflict regulations that mandated greater audit independence for public companies. “It became a large challenge to have a viable practice,” says Morawetz. Adds McIntosh: “The impact of Sarbanes-Oxley [on the restructuring sector] has been profound.” Four years later, A&M Canada has 25 employees, a Vancouver office and a corporate finance group.

The boutiques adopted an entrepreneurial approach, offering services such as chief restructuring officers and operational fixes, as well as more traditional insolvency functions. They have also been aggressive about raising new or interim sources of capital for troubled firms. “That’s why you’ve seen a quantum shift in the market,” says McIntosh.

These firms have taken a bite out of Big Four insolvency practices. “They’re serious competition because of the US connections,” says Laporte. “But hey, it’s part of doing business. I don’t like it, but we have no control over it.”

Second-tier firms such as BDO have experienced less erosion in their insolvency practices because they serviced smaller firms with fewer conflicts, says Courage. But the Big Four have responded by

borrowing a few ideas from the boutiques. Some have become more active in digging up new sources of capital; PwC recently hired someone to do nothing but find new sources of debt. Brearton adds that KPMG now looks to link its restructuring advisories practice to other services, such as corporate finance, tax, valuation and exit strategy consulting. “You’re now going with your entire suite of services.”

The question currently looming over the entire insolvency industry is what happens next, now that the most intense bulge of restructuring work appears to be over. While the threat of a double-dip recession continues to hang over the economy, most insolvency practitioners say there has been a slowing in 2010 — evidence that the credit shakeout in corporate Canada may be drawing to a close.

Most will focus on finding restructuring assignments in sectors that are or will be experiencing dramatic changes, as happened in auto parts and forestry in Canada before the credit crisis. And they’ll also have to ramp up their sales efforts. RSM says it has worked hard to diversify its referral sources in recent years to ensure a flow of engagements. As Kofman points out, “There are always industries that are going through change.”

Morawetz and McIntosh don’t sound worried. “We continue to be busy,” says McIntosh, adding that the firm’s share continues to grow. “The market has slowed but the attractiveness of the platform is holding us in good stead.”

John Lorinc is a freelance writer based in Toronto





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Are there particular **personality types** who excel as accountants and what are the common characteristics of a successful professional?

# CA “IT” FACTOR

By Lorie Murdoch

**On a hot and humid August afternoon,**

19-year-old Colin Jetha is pouring cement in a Hamilton driveway. He is labouring away his summer to help pay for his first year at Brock University in St. Catharines, Ont., where he is registered in the Accounting Co-Op Program. It will take him four-and-a-half years, including placements, to get his bachelor of accounting. He is intrigued by the idea of becoming a chartered accountant to obtain financial freedom. “I want to learn more about money so I can handle it to my advantage,” he says,

adding that he plans to specialize in tax.

Driven, hardworking and determined to become a CA in order to learn about money and how to handle it, does Jetha have what it takes to make a name for himself and succeed in the profession?

A high UFE score and left-brain thinking are vital to rise above ordinary money manager, bring success to clients and be in demand, but it takes more than that. Experts say a combination of education, soft skills and innate traits separate the ped-

illustration by JEAN-MANUEL DUVIVIER





**Based on 15 years' experience as a recruiter, Marc Belaiche says super CAs are typically hard working, see the positive side of things, have a broad range of experience, don't get discouraged when things don't go well and don't complain. "It's no longer about just doing debits and credits"**

estrians from the marathoners. Take the mathematical, financial and business acumen accrued through years of school and training, add superior listening and communication skills, mix in natural aptitudes such as strategic thinking, networking and adaptability and you've got the super CA formula. A positive attitude, a keenness to keep up with the latest developments and lots of energy will launch the ambitious into the stratosphere.

By all definitions, it would seem Cindy Kottoor qualifies as a super CA. At 37, she runs her own consulting, training and quality assurance company, Neverest Inc., in Toronto, specializing in accounting, audit and risk management. She travels across Canada and the US on speaking engagements and training stints. And when she's not working, she cooks, skis, golfs and does volunteer work. On vacation she can be found mountain climbing in Switzerland, which she and her husband did in September, or sailing in the Bahamas, swimming with the sharks in Borneo or scuba diving in the Indian Ocean.

Before founding Neverest, the University of Waterloo grad honed her skills in public practice, private industry and consulting after five years at Deloitte & Touche in Toronto where she wrote the UFE in 1997.

As a vice-president at US-based training and consulting firm AuditWatch Inc., from 2000 to 2003, her interest was sparked by the constant changes in the profession and the need for prac-

tioners to keep up with them. In 2007, she launched her business, which helps CAs stay afloat in the ever-changing sea of rules and regulations.

Last year, she wrote articles for the CICA as well as courses, including a two-day Canadian auditing standards course (CAS), that were delivered across the country through the provincial institutes. This year, along with speaking engagements, Kottoor plans to do more work with public accounting firms, helping them do audits more effectively and efficiently in the new CAS environment.

Her client base now extends to Ontario, Quebec, Alberta and Saskatchewan and she plans to expand it to other provinces. "We are continually growing our team of instructors and consultants as we work hard to meet client demand," she says. "We are always on the lookout for super CAs."

As president of online job bank and staffing company TorontoJobs.ca, Marc Belaiche, CA, is also always on the lookout for the best in the business. Based on his 15 years' experience as a recruiter, in his opinion super CAs are typically hard working, see the positive side of events and people, have a broad range of experience, don't get discouraged when things don't go well, and don't complain — they work on solving problems. "It's no longer about just doing debits and credits," he says. Today's CAs have to be technically savvy so their work can be done efficiently and accurately by using computers, networks and spreadsheets to their full advantage. They have to be confident, work well both independently or in teams, be good listeners as well as excellent communicators.

The super CA, Belaiche says, has the ability to drill into details while not missing the big picture, whichever is needed for the best result. "The best CAs I know make sure they understand a problem, research it and look at the options. They have an aptitude to see different scenarios and come up with alternatives and, ultimately, find solutions," he says. They explore options, get input from stakeholders, brainstorm, look at alternatives and analyze the various solutions available. They don't go with the first one that comes to mind. "They take the time to make sure the solution is the best for the company, even if there are parts that may have negative consequences for stakeholders and themselves," he says.

A bird's-eye view and an open mind will bode well for a young CA too.

"Confidence, good communication skills and strategic thinking — that is, looking outside the box and always tying work into the big picture — are aspects of the magic formula of a super CA," says Monica Murray, CA, the founder of Higher Resources Inc., a Vancouver-based boutique search firm that places financial

### **The super CA formula**

- **Strong communication skills**
- **Proactive**
- **A desire to stay current on emerging trends and commitment to professional development**
- **Strong ethical compass**
- **Courage to lead — provides clear direction, inspires and motivates others**
- **Dedication**
- **Becoming an expert in his or her field**
- **Ability to see the big picture; perspective**
- **Commands respect from colleagues and clients**
- **Solutions finder**
- **Sense of humour**
- **Good judgment**

professionals. For outstanding success, her advice to young CAs is to combine those qualities with action: speak up, take initiative, be quick to respond instead of waiting for someone else to do the job and adapt to different workplace situations and clients.

Diane Messier, who received her FCA in February 2009, has seen all types of personalities in her role as vice-president, education and recruitment for Ordre des comptables agréés du Québec and believes there is room for all to shine because of the profession's diversity. "The audacious will prefer to take controlled risks, the conservative will be less tolerant of the uncertain and the passionate will manage the art of working with creative people. Everyone can achieve success in the context of where they evolve," she says.

That success may come faster, though, with confidence, determination and perseverance; and, for those on the way up, making

allies and listening to others to solve conflicts or manage difficult situations will fast-track careers.

Messier agrees with Belaiche about the importance of gathering as much information as possible in order to come up with the best solution, but she warns against wallowing around too long before coming to conclusions. "After a good evaluation of the stakes, decide. In fact, the decision-making process is top rank and demonstrates leadership," she says. And in that process is the ever-present issue of integrity. "That is a fundamental value of the profession and our existence," she says.

The integrity and exploring solution combo is summed up in two words by Michele Wood-Tweel: ethical compass. That is a priority for all CAs; adaptability, commitment, passion, pride, and an intrinsic sense of value will enhance the status.

"Number one is having a strong ethical compass," says Wood-

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Tweel, CEO and executive director of the Institute of Chartered Accountants of Nova Scotia. “An internal, intuitive sense of doing the right thing for the right reason. A solution that’s easiest to implement and communicate may not always be the best one in the long run,” she says.

While everyone faces decisions every day at work, at home and in the community, it seems super CAs have a way of grappling with tough decisions and intuitively know the right thing to do. As positive thinkers, they see opportunity in challenging situations and don’t get weighed down — they fix them. “They’re firing on all cylinders on that front,” says Wood-Tweel.

Murray recalls a young CA who fits that profile perfectly. When the recent economic downturn hit his company, rather than roll with the punches, he got down to work and created value for the company with a business plan to position the company for advancement when things turned around. “He was getting his ducks in a row so they could execute the new business model and not have to play catch-up,” Murray says. “His perspective makes him different and he definitely impressed me with his maturity and acumen.”

Providing value to an organization can, indeed, garner success. “A super CA is someone with the ability to take the skills inherent in achieving the designation, and then combine them with their personal strengths to differentiate themselves. This can be done in many ways but the key is to want to provide value that goes above and beyond the designation,” says Ruben Jeffery, partner and assurance people leader at Ernst & Young, in Edmonton. “Essentially, these people take bold ownership of their career goals and make the most of professional and personal opportunities.”

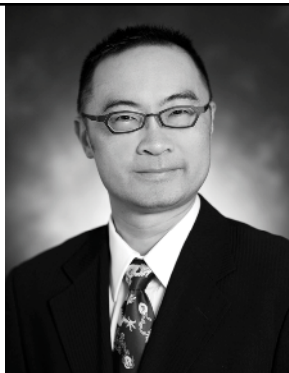
Another big difference that puts such CAs a cut above is being able to keep going when others run out of steam, and being in tune with when to recharge. “Super CAs can recharge their batteries so they can go at things for a long period of time,” says Wood-Tweel. And they do it quickly, because there is not always time to jet off to Napa Valley. There are a variety of ways to rekindle the verve: exercising, spending time with family, finding the funny side of things or meditating. You have to figure out what works for you, she says, adding that camaraderie at work and a half-hour lunch break is a battery booster for her, getting her through thick and thin.

“I walk away to get a change of scenery. Short periods of time can affect people and help them recharge.” And she laments that breaks are a bygone tradition in today’s highly scheduled world, as they were an opportunity for people to talk and get other perspectives on issues.

And while Jetha wants to learn more about money to use it to his advantage, it’s not the paycheck that gets successful CAs up in the morning; it’s the work. “Yes, they are well compensated,” Wood-Tweel says, “but it’s the work that got them to the big paycheck.”

Their great pride in their profession and community are also what motivates

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## McCarthy Tétrault LLP welcomes Chia-yi Chua

McCarthy Tétrault LLP welcomes Chia-yi Chua as a partner in the firm’s Tax Group, where he will practice tax litigation and dispute resolution. Mr. Chua’s skills in helping clients understand, strategize, and resolve or litigate tax issues arising from complex transactions and transfer pricing arrangements will be invaluable. Mr. Chua has acted for companies in the financial services, telecommunications, resources, retail and transportation sectors, and has litigated before the Tax Court of Canada, Federal Court of Appeal, Ontario Court of Appeal, and Ontario Superior Court of Justice. Mr. Chua can also help clients understand tax issues from the government’s perspective, having practiced with the Ontario Ministry of Revenue/Finance.

Mr. Chua serves on the Board of Editors of the publication *Tax Litigation*, and regularly addresses the Tax Executives Institute. He is also a regular speaker at conferences for auditors and appeals officers, as well as the tax and finance departments of North American corporations.

Mr. Chua is recommended in *Chambers Global: The World’s Leading Lawyers for Business 2010*, as one of Canada’s leading tax litigation lawyers. He was singled out by *World Tax*, an international guide to tax firms, as a leader in tax litigation and controversy resolution. He was also recognized by *Canadian Immigrant* as one of Canada’s top 25 immigrants in 2009.

McCarthy Tétrault provides a broad range of legal services, advising on large and complex assignments for Canadian and international interests. The firm has substantial presence in Canada’s major commercial centers and in London, UK.

them at the workplace and outside. Robert Half International's Mike Gooley is proof of that. The CA and vice-president volunteers with Meals on Wheels and a number of organizations in his community.

"It gives me great pride to give back," he says from his Bay Street office in Toronto where he is responsible for managing operations across the finance, accounting, executive search and financial services division of the recruiting company. "Chartered accountants are often committed to their communities and other charitable causes. I believe it is one of the characteristics that distinguishes individuals in our peer group and sets them apart as super CAs."

While Gooley sees education as the framework for a career in business, he believes soft skills play an equal part in getting ahead. "People management is an essential trait for any financial professional looking to advance on the career ladder. The role that soft skills play — leadership, negotiation, communication and interpersonal — is of equal importance," he says, and adds those particular proficiencies led to his successful nine-plus-year career at Robert Half.

At Robert Half, ideal attributes may depend upon what an employer needs. "It also differs on the role," Gooley says. "For example, a controller needs stronger leadership skills and interpersonal skills than a senior accountant." While strong accounting skills are essential, it's an individual's strengths and interests that help dictate the perfect match between employer and employee.

### View from the other side

Aspiring CA Colin Jetha believes being sociable contributes to good relationships with clients. "Generally, people remember a happy, outgoing personality over a quiet one," he says. "And confidence is a must. I'd say my strongest personality traits are that I am outgoing and confident. I am also a good problem solver. I think this makes a good combination and a great first impression." He thinks math, logic, and the ability to analyze and reason are the hard-skill foundation for making a name for yourself.

"We've been told by our clients that we are not typical chartered accountants," says John Chisholm at SB Partners LLP in Burlington, Ont., referring to the firm of 52, including nine partners, that services Ontario business owners from Mississauga to the Niagara Region. Chisholm, CEO and partner, believes his team's priority of being proactive has helped gain the firm its atypical reputation. "Clients want CAs to show recommendations and present opportunities," he says.

Taking initiative has also helped set SB Partners apart. "For many years, we have implemented a number of proactive pro-



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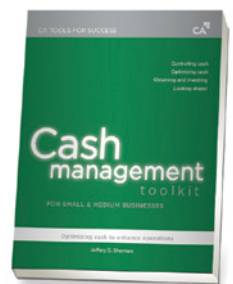
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grams for our small business clients,” says Joe Schlett, partner and chair. For example the firm offers clients complimentary seminars and educational events that go beyond basic topics of accounting and taxation.

One of the biggest challenges facing CAs is communicating ideas; that is, getting them across in a way a client can understand. “It’s a skill to be able to do this,” says Chisholm. “You don’t want to belittle their intelligence, but you have to watch for the eyes to glaze over. It has to be at the right level for them.”

In addition, Chisholm thinks a sense of humour is definitely crucial to the mix. “It helps when you’re in stressful situations and working to deadline,” he says. “It helps keep things in perspective.” He says it’s not as if [CAs] are doctors with a patient’s life in their hands — even though at times they approach a situation in that manner — but he has used humour to relieve pressure in a stressful meeting with a client or to help staff relax after a grueling meeting. “We take our profession seriously, which is fine, but humour lets us be human.”

Many who excel in the profession have an efficacious air, says senior manager Lisa Schoenberger. She describes this as an “it” factor. “They’re charismatic, willing to take chances and are constantly looking for opportunities to further their careers,” says the mentor and student adviser. “They are confident in themselves and their skill set.” These CAs command attention with their presence and instill confidence in colleagues, team members, clients and the community.

They are also not afraid to express their sense of style, Schoenberger says. “This is important because it can say a lot about who you are.”

When interviewing job seekers for Toronto’s Shimmerman Penn LLP, which includes a team of CAs to provide a wide range of services, Maj-Lis Vettoretti prefers the more verbose candidates. “I look for a certain energy that comes from the flow of the conversation,” says the CA and partner. “There needs to be a fair bit of talking on their part rather than short answers to my questions.” She listens for a variety of strengths: technical, communication and relationship-building skills; a willingness to learn and the ability to stay on top of ever-changing professional standards. She also looks for someone who has a sense of where he or she is headed on the career path and who demonstrates that he or she is a team player and self-starter.

“Super CAs need to be able to think outside the box, apply their knowledge to specific client situations and come up with creative, effective solutions,” she says. “Then they must be able to communicate ideas in a clear client-friendly manner, listen to ensure their needs are being met and anticipate future needs.”

How to become one of these shining

stars? Kottoor’s advice for Jetha and his CA aspiring classmates at Brock may be a start. “Take courses to develop the soft skills such as public speaking and active listening,” she says. “Strong writing skills are a must.” She suggests finding a mentor or two. Another key to success: networking. “The people you meet at school and through your employment can be great resources as you progress through your career,” she says. “Take the time to build relationships and always nurture those contacts.”

From personal experience, while Belaiche believes there are pros and cons to working at a larger firm, it may be better for students to prepare for super success at small and medium-size firms. “I didn’t really learn a lot at KPMG’s downtown Toronto office because I saw such microscopic parts of the clients,” he says. “When I moved to its smaller office, it was great dealing with the owners of the companies. Nothing can replace that hands-on work on smaller audits and reviews. You get the breadth of exposure to all areas of a company with someone who really wants you to help them.”

School is just the beginning. “Super CAs are not content with simply achieving the designation,” says Jeffery. “They recognize that it is only the first step toward achieving career success. A super CA realizes there is a lifetime of learning ahead, and they don’t stop once they have ‘CA’ listed in their job title.”

Lorie Murdoch is a freelance writer based in Hamilton

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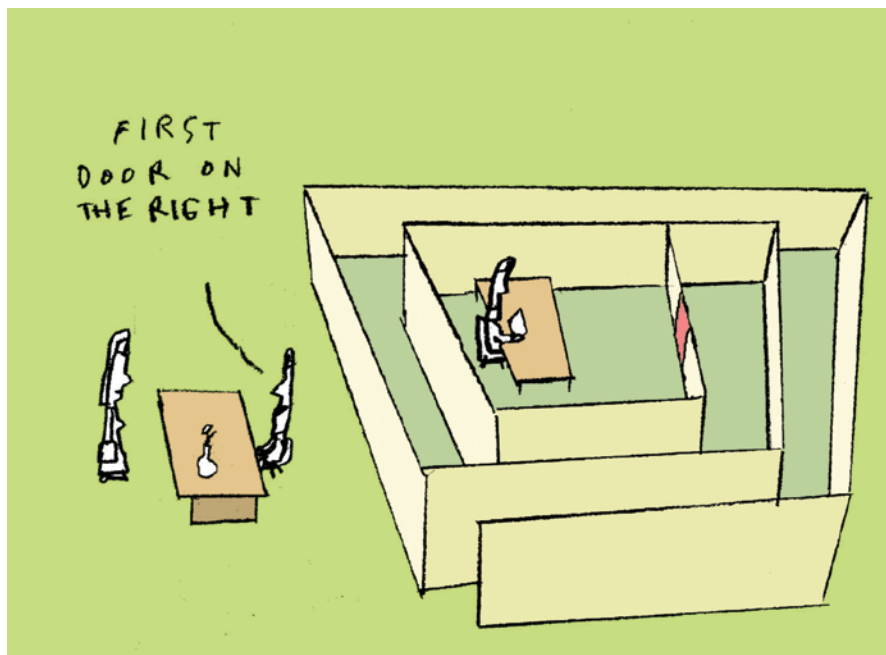


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## A modest proposal

Everyone would like to see tax disputes resolved quickly, but in Canada there are a few impediments to settling such cases



**E**arly resolution of tax disputes benefits all concerned parties by minimizing uncertainty and the time and financial cost that would otherwise be expended. For this reason, as a good management practice the Canada Revenue Agency (CRA) generally encourages consideration of settlement proposals at each stage of the assessment, objection and appeals process and as early as possible. However, there are some serious impediments to settling cases in Canada.

The settlement policy of the appeals branch is outlined on the CRA’s external website. It states that, in general, settlements are most appropriate for factual disputes rather than interpretive issues. Factual disputes usually arise over differences of opinion concerning the nature of an expenditure, the timing of an event or the quantum of an item, such as the fair market value of property or the value of benefits.

To be acceptable to the CRA, settlements must be reached on a principled basis, meaning they have to be well founded in law and consistent with its assessing poli-

cies and technical interpretation bulletins. The CRA doesn’t enter into arbitrary or compromise settlements because the federal tax statutes it administers, including the Income Tax Act and the Excise Tax Act, require the Minister to assess in a manner that is in accordance with the law. These statutes do not have a provision allowing for the exercise of ministerial discretion in the assessment and collection of tax.

Canadian courts have also upheld the view that “[T]he Minister has a statutory duty to assess the amount of tax payable on the facts as he finds them in accordance with the law as he understands it. It follows that he cannot assess for some amount designed to implement a compromise settlement.” The courts have gone even further to state that an “agreement whereby the Minister would agree to assess income tax otherwise than in accordance with the law would . . . be an illegal agreement.”

By contrast, US and UK taxing statutes allow the Internal Revenue Service and Her Majesty’s Revenue and Customs such discretion. The IRS and HMRC frequently exercise their authority to implement compromise settlements with taxpayers, both in individual cases and on a

MIKE CONSTABLE

large scale, as for example in a case of broad amnesty initiatives. A “hazards of litigation” approach may also be taken in settlement negotiations to determine the quantum of a given settlement based on the perceived chances of success in proceeding to court.

Even in Canada, some provincial tax legislation allows for ministerial discretion in determining tax liability and taking collection action. This includes the Ontario Corporations Tax Act, which since 2009 has been administered by the CRA on behalf of the Government of Ontario.

The limitation in the CRA’s ability to settle federal tax disputes is not without proponents, who argue that it ensures uniform application and overall fairness in the administration of tax law by treating taxpayers in similar tax circumstances equitably — in other words, whether they voluntarily comply or they are reassessed, the same amount of tax is ultimately due. Those who are reassessed, and consequently pay the tax later, are also subject to appropriate interest and possible penalty charges.

Furthermore, the performance of the existing notice of objection and appeal process has arguably been efficient and effective. The CRA’s appeals branch traditionally receives between 60,000 and 70,000 notices of objection from taxpayers each year and disposes of similar volumes. About 92% of cases are decided administratively at the objections stage in appeals. Of the 8% that remain outstanding beyond that point, about one-third are settled, one-third are withdrawn by the taxpayer before trial and only one-third (or about 3% of the original objections) actually end up being heard at the Tax Court of Canada.

This situation has started to change in recent years, however. According to a recent article in the *Globe and Mail*, since 2003, the CRA has audited and reassessed more than 170,000 taxpayers who made donations to “gifting tax shelters” being mass marketed by promoters who promised they would be entitled to donation receipts and tax refunds in excess of the original cash donation. Virtually all the inflated donation claims have been disallowed beyond the value of the original donation. A high proportion of those reassessed subsequently filed objections with appeals.

In the past, appeals successfully managed to process large volumes of objections on the same issue that could have a national impact (e.g., the issue of pay equity awards). The formula for success has been that field offices refer the objections to headquarters so they can be managed centrally; a limited number of objections are confirmed and the rest are held in abeyance; a case is selected for litigation by mutual consent with the representative of a group of taxpayers in similar circumstances concerning the same issues; and the others in the group are bound to the outcome at court.

This traditional approach has not worked in the present circumstances because promoters have significant litigation resources and taxpayers have been unwilling to be bound by adverse court decisions (all have been won by the Crown). Substantial resources have had to be diverted from other work by appeals to manage this increased casework. This in turn has impacted its ability to maintain service standards for other objections.

Another recent change has been a steady increase in the cost of

tax litigation to both the CRA and the Department of Justice as the number and complexity of court cases has been increasing. There are indications that these costs may continue to rise. For example, transfer-pricing cases have traditionally been resolved through the mutual agreement procedure in bilateral tax treaties designed to eliminate double taxation, without recourse to available domestic dispute resolution through appeals and the Tax Court of Canada.

A number of cases are now instead working through appeals, the tax court and beyond (e.g., the *GlaxoSmithKline v. The Queen*, 2008 and *GE Capital Canada v. The Queen*, 2009 cases). The sitting time for these cases can be long, with much reliance by both sides on expensive expert witness testimony. In spite of this expense, at the end of the day these cases do not always add much value from a jurisprudential perspective since they tend to turn on the facts rather than on interpretive issues and points of law.

Finally, partly in response to these other developments, the Tax Court of Canada has given notice of proposed rule changes that emphasize the need to ensure full use of post-objection avenues for settlement of cases, including the use of pre-hearing conferences.

These recent developments point to the growing need for reform by removing impediments and improving access to settle-

## **Another change has been a steady increase in the cost of tax litigation to both the CRA and Justice as the number and complexity of court cases has been increasing**

ment procedures. The feasible set of cases qualifying for settlement needs to be expanded so that costs are reduced and court time is devoted to those difficult cases that most benefit from litigation, including those where points of law need clarification.

The most obvious solution would be to modify the underlying tax legislation by passage of an amendment allowing ministerial discretion over the assessment and collection of tax. This was proposed as far back as 1997 in a report to the Minister of Finance and variations have been proposed more recently.

For whatever reasons, this recommendation has never been acted upon. Absent this ultimate solution, is there a more modest administrative reform that could readily be implemented and that would immediately improve settlement prospects? Yes there is, and it lies in an area where ministerial discretion already exists.

Subsection 220(3.1) of the Income Tax Act gives the Minister of National Revenue broad authority to waive or cancel all or any portion of penalty or interest that would otherwise be payable under the act, subject only to a 10-year statutory limitation period. These provisions are referred to as the “taxpayer relief” provisions (formerly known as the “fairness provisions”). (Similarly, Sec. 2281 of the Excise Tax Act gives the Minister the discretion to waive or cancel penalties and interest payable under Sec. 280 of the act.)


CRA administrative policy sets out the circumstances where relief from penalty and interest may be warranted. These include extraordinary circumstances such as natural disasters or serious illness; actions of the CRA; and inability to pay or financial hardship. Notwithstanding such restrictions, it also acknowledges



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that “the Minister may also grant relief if a taxpayer’s circumstances do not fall within the situations stated.”

Currently, official CRA policy is to not make any determination of penalty and interest amounts in the context of settlement negotiations. “A request to cancel penalty and interest ... for an assessment under objection or appeal may be reviewed and an informal decision may be communicated to the taxpayer. However, a final decision about the taxpayer’s request for relief will be held until the objection or appeal is resolved or until all rights of appeal have expired.” Similarly, “the ability of the CRA to waive or cancel penalties is not to be used by taxpayers as a way to arbitrarily reduce or settle their tax debt.”

This policy stance is a significant barrier to resolution of tax disputes through settlement, particularly for those long-standing disputes where the accumulated interest owing may equal or exceed the amount of tax. Although the CRA rightly draws a distinction between the tax and interest amounts at issue, most taxpayers do not. To them, the relevant question in resolving a tax dispute is much simpler — what is the total amount payable and how can it be minimized? Not knowing that quantum with any certainty until after the settlement has been signed is a serious shortcoming (particularly since penalties and interest are not deductible), whereas knowing it would facilitate the process.

No legal impediments prevent the CRA from amending its current policy to allow determination of penalty and interest as part

of settlement discussions. It would only require closer integration and coordination of decision-making between the taxpayer relief and the objection/settlement processes. For disputes where settlement discussions are underway, taxpayer relief decisions would have to be rendered earlier than they are currently in order to have the results available for consideration. Where settlement discussions are not initiated, the relief request could wait until the objection or appeal is resolved, as is currently the case.

In addition to improving the likelihood of settlement, there could also be some economies realized in the operation of taxpayer relief. For example, to the extent that relief decisions are taken earlier and are accepted by taxpayers as part of a settlement, there may be less take-up of subsequent redress rights, including second-level administrative reviews and applications for judicial review of decisions to the Federal Court to determine whether ministerial discretion was properly exercised. (The CRA could also implement safeguards if it felt the need to protect the perceived integrity of the taxpayer relief and settlement processes — for example, by establishing explicit criteria that restrict certain types of disputes from taxpayer relief and settlement consideration.)

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## Card tricks

Drug traffickers, terrorists and other criminals have found a simple and ingenious way to launder their dirty money

**R**onnie had too much cash under his bed. Literally. A small-time drug dealer, he had been storing the considerable profit from his illegal activities in a compartment he had built under the bedframe. About six-inches deep, spanning the length and width of his queen-sized bed, it was jammed with dollar bills, mostly 20s, 10s and fives. (Ronnie is a fictitious character and the scenario is a composite of cases.)

An MBA graduate, who discovered he loathed the corporate office environment, Ronnie came up with the idea of delivering marijuana directly to customers after listening to several middle-class friends complain about how hard it was to obtain the drug without putting themselves into dangerous situations, such as trying to buy on the street.

Ronnie sold only to people he knew well or who were referred to him by someone he trusted. He obtained his product from two cousins who grew pot on farmland in an isolated area. He bought a small van that looked like a delivery vehicle and wore a nondescript uniform, includ-

ing a shoulder sack that made him look like someone dropping off a courier package.

People appreciated the convenience of having their drugs brought to their home or workplace. Within a year of launching his business he had built up a client list that kept him driving throughout the city up to 10 hours a day, five days a week. The cash quickly accumulated and he realized he needed to find a way to launder it.

Ronnie knew he could deposit up to \$10,000 in cash into his bank account without it being reported to the Financial Transactions and Reports Analysis Centre of Canada (FINTRAC). Set up in 2000, the independent government agency was established to detect and prevent money laundering and terrorist financing. But Ronnie also sensed that a canny bank employee could figure out that a customer who regularly deposited large amounts of cash might be up to no-good. He couldn't, and wouldn't, take that risk.

Then he had a eureka moment. A newspaper article about the boom in prepaid debit and loyalty cards, also known as stored value cards (SVC), suggested a safe solution. The cards, he read, could be purchased from banks, cheque-cashing companies, Western Union, casinos and other sources without any identification and without any paper trail back to him. The article spoke directly to him: "They are also being used by drug dealers, terrorists and others who need to launder dirty money," it pointed out, citing a dark side to the otherwise convenient and popular cards.

Ronnie visited outlets throughout his city and the surrounding areas that sold prepaid debit cards. Using cash, he loaded them with various amounts, usually less than \$3,000, occasionally more. Without much effort he could launder \$50,000 in a two-day period, if so inclined. He then used the cards to pay for most of his day-to-day transactions. For large-scale purchases, he would build the balance on one card until he had enough for whatever he wanted to buy. He also used the cards to pay for the pot. Although it took some effort, the process gave Ronnie a peace of mind that he considered well worth the time involved.

The drug dealer was not the only person on the wrong side of the law to find prepaid cards an attractive way to launder money. "Criminals like them because they potentially offer a high degree of anonymity, are easy to transport and have some similar qualities to electronic wire transfers," says Mario Possamai, a certified anti-money laundering



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specialist and Toronto-based anti-money-laundering compliance and fraud consultant. “The more people legitimately use SVCs, the easier it is for money launderers to hide their illicit activities among them. It’s reminiscent of Mao Tse-Tung’s famous quote about guerrilla warfare: ‘The guerrilla must move among the people as a fish swims in the sea.’”

The sea that is the prepaid card industry is a vast expanse. No one is certain of how large it is, although industry assessments make it clear the number is huge and growing. In a March 2008 report, FINTRAC estimated that the prepaid card market would grow to almost US\$300 billion in the US by the end of 2010 and Visa International estimated it will grow to US\$2 trillion worldwide by 2010. Eighty-two per cent of Canada’s largest retailers offered prepaid cards, including gift cards, to clients in 2005, up from 53% in 2003. Network-branded prepaid cards, such as Visa or MasterCard, are currently the fastest growing card-based financial product. Since that report was produced the numbers have kept rising.

The appeal of prepaid cards to criminals is that they are not considered monetary units (cash, share certificates, travellers cheques, money orders, etc.) and, therefore, not subject to anti-money-laundering reporting legislation. Often no identification, and therefore no paper trail, is required when buying the cards.

Currently it is legal for individuals to enter Canada or the US with countless cards in their possession no matter how much money is stored in each card’s magnetic stripe. Needless to say, drug traffickers and those involved in financing terrorist activities have found this loophole appealing.

Testifying before a US Congressional hearing last March, FBI chief Robert Mueller said: “Recent money laundering investigations have revealed a trend on the part of criminals to use stored-value devices such as prepaid gift cards and reloadable debit cards in order to move criminal proceeds. This has created a shadow banking system.” The Federal Financial Institutions Examination Council Bank Secrecy Act/Anti-Money Laundering InfoBase, a US federal banking agency, had also made this point in 2007, noting that “drug dealers have been known to load currency onto prepaid cards and send the cards to their drug suppliers [as payment] outside the country.”

Prepaid cards, especially gift cards, can also be fenced for up to 80% of their value, according to FINTRAC. Popular sites such as eBay, Craigslist and various card-exchange sites have made “e-fencing” an incredibly easy way to launder dirty money for about a 20% cost, much less than what traditional, human fences would charge. FINTRAC cites one ring of thieves who were caught in Florida in 2007 after buying US\$24,000 worth of gift cards from one Wal-Mart and US\$18,000 from another Wal-Mart.

FINTRAC also reports that British experts allege that prepaid cards have been used to move terrorist funds around the world and finance terrorist attacks.

The popularity of prepaid cards among both retailers and consumers is easy to understand. Retailers who sell the credit cards — in reality the cards don’t provide credit; they store an amount of money the purchaser has already paid to the seller but give the appearance of being a credit card, especially those that are affiliated

with Visa and MasterCard — obtain a fee, either per card or on an annual basis. There is no risk of the card users failing to pay. The prepaid debit cards also engender fees to the user with no risk to the provider. Many of the cards can be applied for online.

For consumers who are overburdened with debt, unable to obtain a traditional credit card or want to ensure they don’t amass credit debts they can’t manage, the cards provide the appearance of having credit or can be used to self-regulate their spending habits.

The prepaid credit and debit cards are known as open-loop cards, meaning they can be used virtually anywhere and for any type of purchase. Closed-loop cards are those issued by one business (or, say, a specific shopping mall) and can only be used in locations sanctioned by the issuer. Typically, these are prepaid phone cards or gift cards. Retailers find the latter extremely attractive because recipients of the cards often use them to pay for items that are more expensive than the value on the card. Most open- and closed-loop cards are reloadable, another enticing characteristic to retailers.

The 2008 FINTRAC report notes examples of closed-loop cards. “Hudson’s Bay in Canada offers prepaid gift cards that are reloadable in any amount. The Wal-Mart Canada website also says they offer reloadable prepaid cards for use in their stores. Casinos in Quebec offer electronic Texas Hold’em cards. Money is

## **The appeal of prepaid cards to criminals is that they are not considered monetary units and therefore are not subject to anti-money-laundering reporting legislation**

added to the card at the cashier’s cage and winnings are automatically added to the card. To cash out, individuals have to go to the cashier’s cage. Closed-loop casino cards also exist in South Africa, the United States and Europe.”

In some instances, banks fund prepaid cards without the consumer being aware of their involvement. “One example is the MiCash/The Home Depot Card, which is being marketed to Latinos in Tampa, Fla., and Washington, DC, as a reloadable debit card that can also be used as an ATM card, or as a phone card, and can be sent to a relative in another country,” wrote Steve Cocheo, executive editor of the *ABA Banking Journal*. “The cards are issued in pairs, and include PIN and password. This jointly branded card is actually issued for the two companies by MetaBank, a US\$494.6-million assets savings bank headquartered in Storm Lake, Iowa. Meta Financial Group, Inc., the parent company, issues prepaid cards in more than 500 programs as a business line under its Meta Payment Systems operation.”

Although law enforcement organizations are well aware criminals are using prepaid cards, legislation has yet to be developed to deal with the problem effectively. In a March 2010 Reuters article it was pointed out that US senators Joseph Lieberman and Susan Collins had “authored an amendment to close the stored-value card loophole” in 2009. Lieberman was the chairman of the Senate Committee on Homeland Security and Governmental Affairs and Collins was one of its members.

The amendment “became part of an act on credit-card account-



ability and disclosure President Barack Obama signed into law on May 22 last year,” Reuters reported. “[It] stipulated that the Treasury Department work out regulations on the sale, issuance, redemption and international transportation of stored value cards within 270 days. The deadline lapsed on February 16 [2010]. It’s not clear whether the delay is due to bureaucratic inertia, overwork in a Treasury Department busy with a deep financial crisis, or, as money laundering expert Charles Intriago put it, ‘a manifestation of the unhealthy power of big money, financial institutions and their lobbyists.’”

It seems inevitable, however, that some degree of legislative change will occur, and likely soon. Possamai looks to the US Financial Crimes Enforcement Network (FinCEN), also part of the Treasury Department, to lead the way. In July 2010, FinCEN released a proposed rule that would revise the Bank Secrecy Act requirements currently applicable to money-services businesses with regard to stored value products and services. Intended to address regulatory gaps that have resulted from the proliferation of prepaid innovations over the past 10 years and their increasing use as an accepted payment method, the proposed rules would, among numerous specific measures, place “registration requirements on providers of prepaid access and suspicious activity reporting, customer information recordkeeping, and new transactional record keeping requirements on both providers and sellers of prepaid access.” At the same time, FinCEN’s new rules would exempt certain categories of prepaid access products and services posing lower risks of money laundering and terrorist financing from certain requirements. Another proposal would be to revise the Bank Secrecy Act to call stored-value cards “prepaid access” cards. At the time of writing the proposed changes, which had been sent out for comment, had not been implemented.

Currently no such legislation is being considered in Canada, according to a FINTRAC spokesperson. If the US goes ahead with new rules, Canada will likely follow suit at some point, says Possamai. “Over time, this will likely have a ripple effect and lead to other countries having similar regulatory regimes — in the way that crossborder currency controls were first introduced in the US and then spread to other jurisdictions, including Canada. However, this won’t necessarily eliminate the money-laundering potential of SVCs, just as tighter controls over crossborder movements of cash have not eliminated its use in the illicit economy. As long as SVCs have qualities that make them attractive to criminals, they will find innovative new ways to use them to further their illicit schemes.”

Although the current state of affairs regarding prepaid cards favours criminals who want to misuse them, there are limits

imposed on their usage, both by countries and individual issuers. The Australian Institute for Criminology notes, for example, “the Travelex Cash Passport card in Australia has a maximum card balance value [at any one time] of A\$10,000; a maximum amount that can be loaded onto the card during any 12-month period of A\$45,000; a 24-hour ATM withdrawal limit of A\$6,000; and up to two cards able to be issued per Cash Passport fund.” Western Union in Canada limits the daily loadable amount to \$950 per card. The Bank of Montreal prepaid Travel MasterCard allows a maximum of \$10,000 on the card at any time.

For someone such as Ronnie, any anti-money-laundering legislation regarding prepaid cards changes will likely not affect him or her. He or she can keep buying them, in even smaller amounts, without attracting suspicion. But for large-scale drug criminals or terrorist financiers, new rules could have an impact. They will look for new ways to circumvent them, and most probably will, but that’s how the money-laundering war is fought, one initiative at a time. Money laundering will never be stopped. But slowing it down or making it harder to do is a victory of sorts and one that has to be seen as the right thing to do by all involved, including law enforcement and through compliance to new rules, retailers.

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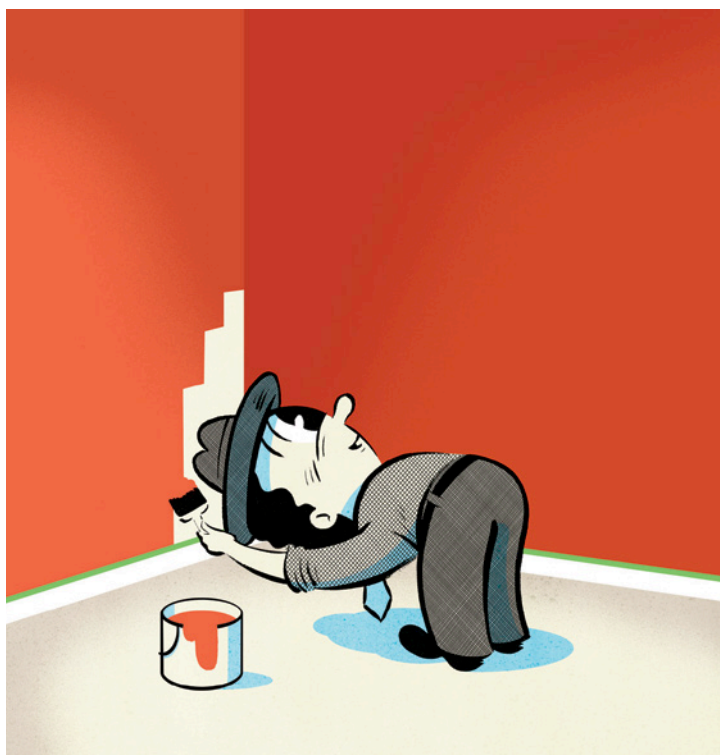


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## Finishing touches

The IFRS deadline is finally here, and while there has been a great deal of preparation, it's not over yet



**T**he long-awaited dawn of international financial reporting standards (IFRS) in Canada has finally arrived. IFRS became Canadian generally accepted accounting principles for most public companies on January 1. But experts advise adopters not to become complacent in the early days of this new era in financial reporting.

The changeover has involved a significant amount of preparatory work. “But adopters should not consider the project complete until they have sustainable processes in place and have communicated with the investment community,” says Gordon Beal, Toronto-based project leader for the CICA’s IFRS transition.

“When investors look at their first-quarter 2011 financial reports, they’re going to want to know, in terms of any differences between this period and last year’s, how much of

that has arisen because of actual business issues, and how much has arisen because of changes in accounting language between IFRS and old Canadian GAAP,” says Chris Hicks, a principal in CICA’s guidance and support group and publisher of *The IFRS Changeover: A Guide for Users of Financial Reports*.

“That’s why it’s important that the preparer community communicate to investors the impact of the changeover,” Hicks says, adding that failure to do so increases the level of uncertainty about an entity’s financial reporting, something investors do not appreciate.

There are a number of key external stakeholder groups, including investors, industry analysts, auditors, regulators, bankers and creditors, that need to be kept apprised of IFRS developments. Time is of the essence. Most firms reporting on a calendar-year basis will, for instance, need to prepare their first-quarter results under IFRS as of March 31, 2011, providing stakeholders with their first complete

picture of reporting under the new regime. These first-quarter reports will be published just a few weeks after the annual 2010 reports that were prepared under old GAAP.

“The way we will report the business will be quite different under IFRS; therefore it’s important [stakeholders] understand those differences in order to understand our results,” says Eric Bouchard, director of financial reporting for Bombardier Inc. in Montreal, whose investor relations efforts began early on during its IFRS adoption process.

Stakeholders need to understand that the measurement and financial presentation of various assets, liabilities, revenues, expenses and cash flows might be impacted by IFRS.

For instance, says Hicks, “there could be circumstances where an entity needs to consolidate something under IFRS they didn’t consolidate under old GAAP, or there might be changes in a revenue recognition policy under IFRS, or changes in the way that an entity looks at the impairment of assets under IFRS.”

The extent of the impact of the changeover will vary from company to company. Says Hicks: “Say you have a real estate investment trust that has, under old GAAP, recorded its investment properties at cost. Under IFRS it has the option of recording them at fair value. If it takes up that option then you’re going to see a very different picture in the Statement of Financial Position — likely with a big increase in the value of properties and a corresponding change to equity.”

Certain reporting changes could have unintended consequences if investors and other stakeholders do not understand them and therefore misinterpret the information. If, for example, the value of assets are written down by significant amounts as a result of the changeover to IFRS, it could, instead of a change of accounting method, be construed as a decline in financial performance and reduce the firm’s stock price.

“Even though there may not be a change in the financial environment of the enterprise, some investors may respond to the change in measurement, rather than the underlying environment,” says Peter Chant, partner in the national office of Deloitte & Touche LLP in Toronto.

Chant draws an analogy to Canada’s metric conversion in 1975. Switching from the Fahrenheit scale to Centigrade involved a relocation of scale, including resetting the freezing point from 32 degrees Fahrenheit to zero Celsius, with the result being that different numbers under the old and new scales meant the same thing — similar to what is occurring as a result of the IFRS transition.

“To prepare investors, it is wise to signal potential changes before financial statements are released, so they understand whether this reflects something that is going to have a substantial impact on the business or is just a different method of measuring and recording that doesn’t ultimately represent a change in the underlying cash flows,” Chant says.

Investors and stakeholders such as industry analysts also have a responsibility to educate themselves about the changeover, taking the initiative to learn about potential reporting changes arising from IFRS and understanding what questions they need to ask in order to be able to pinpoint the root cause of such changes.

Otherwise, investors might have a tendency to conclude “this corporation’s performance has deteriorated, when in fact it hasn’t gone down in economic terms,” says Chant. “It’s just been portrayed differently on the financial statements.”

Misinformation can be very costly to investors as well as the companies they invest in. “Investors who are unaware of the impact driven by business operations versus accounting choices could allow this misinterpretation to skew their investment decisions and therefore miss out on trading opportunities,” says Anthony Scilipoti, executive vice-president of Veritas Investment Research Corp. in Toronto, and a member of Canada’s Accounting Standards Board.

So, where should investors look for information about the changeover?

Information concerning IFRS developments needs to be dis-

closed in the management’s discussion and analysis (MD&A) that accompanies a publicly accountable enterprise’s financial statements. This requirement, mandated by the Canadian Securities Administrators (CSA), demanded increasingly detailed information in the period leading up to the changeover. In 2010, the MD&A should disclose matters such as significant differences in accounting policy between IFRS and old GAAP including when available, the quantified impact on financial reporting. When the impact of the changeover is not yet reliably quantified, the CSA suggests companies report the direction for the impact of changes. In addition, the MD&A should discuss any material business issues created by the company’s adoption of IFRS.

“It’s very important that no matter what happens, we don’t have any covenant issues,” says Bouchard. “Even though we don’t have numbers yet, we want to be sure they’re ready, so there won’t be any issues.”

The first-quarter IFRS financial statements will help users understand the impact of the changeover by providing several reconciliations of comparative period information from IFRS to old GAAP. For calendar-year companies, the reconciliations will include equity at January 1, 2010, December 31, 2010 and March 31,

## **It is not just investors, potential investors and industry analysts who scrutinize financial results and are likely to notice IFRS-related changes**

2010, comprehensive income for the year ended December 31, 2010 and the quarter ended March 31, 2010, and any material adjustments to cash flow.

While the first-quarter 2011 financial statements will provide information about the quantitative aspects of the changeover, they will likely not provide explanations for the change or the impact on reporting on an ongoing basis. Hopefully, companies will provide this sort of information in their 2011 MD&A, including discussions of any key performance indicators whose trends have been distorted as a result of the changeover. As well, both IFRS adopters and stakeholders should also seek more informal communication venues, such as webinars, phone calls and personal meetings, to supplement and solidify an ongoing dialogue.

It’s not just investors, potential investors and industry analysts who scrutinize financial results and are likely to notice IFRS-related changes. Financial statements can also be critically important for other parties. Take bankers, for instance. A firm’s lending arrangements might be tied to covenants that specify certain financial ratios need to be maintained. These could be placed at risk by restated numbers; therefore bankers need to be kept apprised of situations where ratios could potentially be affected by the IFRS changeover.

The Canadian Investor Relations Institute (CIRI) has been encouraging its members working in companies transitioning to IFRS to get involved with the adoption exercise. This puts them in a better position to “go out and start talking to the street about IFRS and the changes that are happening in their company or

industry to help get them through that learning curve," says Tom Enright, president of CIRI.

"Lots of decisions have been made along the way by a company transitioning to IFRS," he says. "The investor relations person needs to understand what alternatives were available during the IFRS transition and why his or her firm made the decisions it did and then be able to explain all that to the street." Sustainability is another priority area for adopters. Beal emphasizes that IFRS adopters who have implemented stop-gap measures in order to meet transition deadlines need to replace such measures with

more sustainable long-term plans as soon as possible in order to avoid potentially negative consequences down the road.

One of the risks associated with instituting stop-gap measures is that investor relations professionals may not be adequately involved. "The accountants and other finance people of the organization are in a good position to advise investor relations professionals on where the need for additional communication will likely arise," says Beal. "Just creating the financial statements and letting whoever is communicating to the markets deal with it afterwards is definitely the wrong way to go."

Firms trying to put things together as quickly as possible during their IFRS transition process might also be prone to excessive use of spreadsheets to make manual adjustments, which increases the risk of error. Additional audit procedures would also then be required to minimize the risk of releasing incorrect information, thereby necessitating greater time and expense.

Furthermore, any time there's the risk of manual errors occurring, there's the possibility of restatement down the road. "No company is going to want to have to go back and explain to the market that an error was made. It really comes back to the reliability and credibility of information that's being released to the markets," says Beal, who believes it is better for IFRS adopters to incorporate changes directly into their accounting systems' automated processes.

Adopters with noncalendar year-ends have the advantage of time, but Beal cautions against underestimating the amount of time these adopters need to make a smooth transition. "I advise them to take advantage of the added time to benefit from lessons learned by those companies that are already disclosing their IFRS information."

The transition to IFRS has been a complex project requiring significant effort by all stakeholders. Hicks says once implemented, however, it should result in better comparability of financial reporting in an international environment with the anticipation that it will lead to increased international analyst coverage in the relatively small Canadian market.

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## Bridging the gaps

While earnouts can bridge valuation differences and solve a problem, they can also create other problems

In the context of a sale of a business, earnouts are price-adjustment arrangements or contingent purchase-price provisions based on future economic events. They have become a popular feature of midmarket private merger and acquisition transactions for two reasons: economic and capital markets uncertainty and the related divergent perceptions between buyers and sellers of a business's fundamental value and earnings power; and to secure the focus of key individuals post-sale or account for specific events that do not lend themselves to fair lump-sum quantification.

Earnouts, however, raise significant complexity. While their theoretical rationale is laudatory, their practical implementation and resulting post-closing complexities frequently create dysfunctional behaviour, uncertainty, tension and dispute. The solution is often worse than the problem. And there are key structural elements of earnouts and common areas of controversy that should be addressed.

### Rationale

Solving valuation gaps is the most frequent motivation of the parties to a sale. The buyer may only be willing to meet the seller's price if after the closing the seller's business performs at or above the level promised or hoped for.

The second principal motivation is the buyer's desire to keep the seller focused, energized and active in the business post-closing, and earnouts often provide significant financial motivation to do so.

The seller, on the other hand, may be more willing to accept a lower nominal purchase price at closing if it is confident that the business can attain significantly greater post-closing performance goals or if it sees no other practical choice to extract a higher payment from the buyer. For the seller, staying in control of the business's management is often crucial to the acceptance of an earnout — why else accept the holistic risk without the control?

While the parties may share similar goals for the earnout, their views on the allocation between the up-front

cash payment at closing and the deferred earnout payment can differ dramatically. Buyers typically prefer longer and larger earnouts for cash preservation reasons, validation of the purchase and risk reduction. Not surprisingly, sellers normally prefer a substantial portion of the price up front and smaller earnouts over shorter time periods.

Generally, an earnout of more than 25% of the purchase price or one longer than three years is too complex to implement and/or presents too much risk to the vendor. If the vendor's ongoing interest is larger or the relationship anticipated for longer, it ceases to be an earnout but more



of a partnership — those animals are not the same. If it is a partnership in spirit, call it such and organize accordingly.

Ironically, the best earnout results are when there's a true partnership spirit between buyer and seller — a genuine alignment of interests post-sale during the earnout period. But an earnout arrangement "ain't a partnership." It is an incentive to a seller, a former owner, under the governance of the new owner and all the potentially conflicting objectives that that entails.

The following deals illustrate intended and unintended consequences of allocation between up-front and post-closing payments:

- eBay Inc. purchased Skype Technologies SA a few years ago with 40% of the aggregate consideration subject to an earnout. Due to a variety of factors such as disappointing financial performance together with culture clashes between the two organizations (which were not well integrated after closing), only a little more than 30% of the earnout was ultimately realized;
- Google Inc.'s purchase of dMarc Broadcasting Inc. represents an illustration of a happier buyer paying an earnout that turned out to be 92% of the total purchase price; and
- the sale of the Juicy Couture fashion line to Liz Claiborne contained an uncapped earnout. This resulted in a surprising windfall of US\$75 million to the sellers before the exasperated buyer sought a negotiation and termination of the earnout.

Where the buyer's synergistic contribution is so large or potentially large, the earnout concept may be too favourable to the seller — however, if the parties believe that one plus one equals two, why not share some of that when it is realized, regardless of who is the more important contributor. After all, it takes two to make synergies. This is true in respect of cost and revenue synergies.

### Metrics for calculating earnouts

The appropriate metric for calculating the earnout is key from the standpoint of valuation and alignment of the parties' interests. Many different determining metric approaches abound. The best are those that are

tailored to the specific objectives and simple to compute. However, there can often be a genuine conflict between these two objectives.

The logic and pitfalls related to common metrics include: **Revenue** This is typically used in early stage, pre-positive EBITDA transactions, and where profit is predominantly a function of revenue such as high fixed-cost businesses or ones where expense levels are at fixed percent levels. In these cases, profit is a predictable function of revenue. This is a simple and clean earnout basis.

Both parties need to be comfortable with the quality of the revenue and revenue-recognition policies. There needs to be a common understanding as to revenue-recognition policies — does the seller recognize revenue when a product is shipped or only when the product is accepted by the buyer? If the business uses percentage of completion accounting, do both parties interpret and apply that policy in the same manner?

**EBITDA** This metric typically refers to the quantum of EBITDA or the increase of EBITDA over target. It is arguably the most comprehensive measure of performance and the most important value driver. An EBITDA-based earnout might work as follows: if the seller feels the multiple should have been six times EBITDA of \$10 million, and the buyer feels it should have been a five-times multiple, a common compromise would be to pay the \$50-million purchase price at closing and give the seller the chance to earn the extra \$10 million based on the attainment of, say, average EBITDA of \$10 million over the two years post-closing EBITDA.

The major objection to an EBITDA earnout-based metric is the potential for the controlling board or management to manipulate

EBITDA in its favour and contrary to the interest of the business in the long run. For example, if the seller spent 5% of sales on advertising or employed only 10 salespeople, a buyer may feel entitled to make larger investments in those items for a long-run benefit, at the cost of short-run profit, and does not want this initiative frustrated in pursuit of higher EBITDA. But, burdening the EBITDA with such long-run investments may not be fair to the seller.

Capping selling, general and administrative expenses at a percentage level for the purpose of the earnout calculation can put both parties at ease. A buyer knows it can incur expenses as it sees fit, the seller knows such excess spending won't affect the earnout.

**EBIT and gross margin** The closer to revenue the earnout basis, the simpler it is — though possibly less tailored to the specific objectives. If one were to use EBIT annual capex would of course be captured, and if one were to move up to gross margin there would be no concern about selling, general and administrative expenses and influence of same. One size does not fit all.

**Occurrence of specific event** Often the most focused earnouts are driven by the execution, maintenance or renewal of key relationships or contracts within the earnout period — the reciprocal is of course these are often the key drivers of the earnings power of

## The best earnout results are when there is a true partnership spirit between buyer and seller — an alignment of interests post-sale during the earnout period

the seller's business on which the purchase price is predicated.

While simply stated, the details can be exasperating to negotiate. For example, if a key contract is not renewed, the seller may blame the buyer for not providing the requisite comfort to the customer. Defining predetermined conditions on whether a contract renewal occurred, such as having a certain term or attaining a certain profit margin, may reduce potential disagreements. In a service business or where there is key man risk, often the earnout paid out annually for the earnout period is based on retention of incumbent client revenue. In this case incumbent client revenue needs clear definition — which clients and what revenue?

### Computing the earnout

Regardless of which metric is used for determining the earnout, precise and careful drafting is the key.

With the ongoing transition to IFRS and the continuance of crossborder transactions, it is imperative that the computation of earnouts be based on a mutually agreed-upon accounting standard. While the calculation of an earnout may be based on GAAP or IFRS, computational ingenuity as well as honest differences of opinion often arise. Parties should carefully consider the potential effects of the following in order to minimize subjectivity and abuse of discretion conferred under GAAP or IFRS:

- The treatment of extraordinary, unusual or nonrecurring items, such as sale- or integration-related costs in the context of the earnout. While the terms are sometimes used interchangeably in valuations (on which the original purchase price may have been

based), not all the terms are defined or used synonymously under GAAP, which can have more specific criteria.

- Accounting policies that can affect the timing and amount of revenue or a particular expense, such as revenue recognition, inventory valuation, capitalizing versus expensing significant expenditures or leasehold improvements, and bad debt provisions.

In addition to differences in accounting policies, the allocation of the buyer's overhead costs to the seller's P&L that may not have a direct impact on the seller's earnings power can be a source of contention in the earnout's computation.

Other earnout-related disputes or complications include:

- *IFRS 3R* requires valuation of contingent consideration at acquisition and on each subsequent reporting date. This requires development of base case cash flow and reasonable what-if scenarios to test range and probability of realization of the earnout. It is essential the valuator be alert to inconsistencies between the probability adjusted fair value of the earnout and other asset valuations.

- *Income taxes* can be complex and material to how an earnout is structured. The most common area of controversy is whether or not the earnout payments will be deductible to the payer, and will they be capital gains or normal income to the recipient. It's essential to resolve this early in the structuring with appropriate tax expertise in connection with the transaction.

- *Form of payment presents* both parties with opportunities. Cash is the most common earnout payment mechanism. At least in this case, risk to the parties, particularly the seller, pertains only to the earnout and not the consideration.

Use of stock as purchase consideration is a subject unto itself and not unique to earnouts. The passage of time and impact of external events create additional risk. Parties sometimes use collars on stock prices if the shares are publicly traded. If the buyer is private, the parties would need to devise an agreeable valuation methodology or process to value the buyer's stock.

Buyers should also consider anti-dilution protection for future stock issuances at lower prices, whereas sellers receiving such stock should negotiate the normal protections of any equity holder. These rights would include pre-emptive rights, exit rights, protective provisions, board or observer representation, information rights, registration rights and tag- and drag-along provisions.

- *Security for payment* can be troublesome for the seller who may actually earn the earnout but discover its earnout is subordinate to senior debt or loans that may prohibit such obligations from being satisfied while the senior debt is outstanding. Alternative scenarios include lack of funding available from the buyer due to working capital constraints, taxes, insufficient free cash flow or capital commitments. Sellers often insist on third-party guarantees and other collateral to assure the integrity of the earnout payment.

- *Dispute resolution* provisions are critical to minimizing cost and time as well as preventing extraneous issues from polarizing the parties or needlessly harming the business. Typically, a buyer will prepare, or have its independent business valuator (or accountant) prepare, and present to the seller a computation of the earnout at the time it is due and payable. The seller will have an oppor-

tunity to accept or raise objections. If the parties cannot resolve any dispute, an independent business valuator or other party or parties may be mutually retained to serve as the ultimate arbiter.

Nuances abound. Can the valuator offer a figure not proposed by a party? Must the valuator choose only one of the parties' figures (the baseball approach) or can the valuator meet the parties between those figures? Can the valuator use a different methodology than that which the parties employed?

The costs and expenses of the independent valuator are typically split between the parties to ensure the accountant is not unduly beholden to the paying party. Separately from the agreed-to amount of the earnout, the timing of payment of the disputed portion of the earnout is often contentious. Middle-ground approaches include requiring the buyer to pay some portion of the undisputed sum to the seller and sum portion to an independent escrow.

- *Events for acceleration of the earnout* may include the buyer's business being sold prior to the ending point for determining the earnout or the seller being dismissed unjustifiably or constructively. The parties might also agree to a partial acceleration and buyout of the earnout in the case of a sale. This formula might recognize the remaining earnout potential (i.e., if there is only half the earnout

## But an earnout arrangement “ain’t a partnership.” It’s an incentive to a seller under the governance of the new owner and all the conflicting objectives that that entails

remaining to be potentially earned, only that portion would be potentially subject to acceleration) then provide that some portion will be deemed earned and some deemed not earned or, alternatively, annualize the appropriate earnout metric then measure whether the earnout has been met based on that annualized figure. The parties should also discuss some form of escrow of the earnout in these circumstances to ensure payment.

- *Events for buyer withholding payment* is the converse of a seller accelerating payment of the earnout due to a possible breach in a representation or warranty under the purchase agreement, or other rights of set-off where the seller owes the buyer funds for specific transgressions. Middle-ground compromises often involve requiring the buyer to deliver the earnout payment to an independent escrow pending resolution of the buyer's claim for offset.

### Conclusion

Earnouts can bridge valuation concerns about post-sale commitment between parties. But, while earnouts can solve a problem, they can cook up another for future confrontation. If the parties feel they need an earnout, they must carefully think through and address the issues raised to ensure the earnout isn't a bridge too far.

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## Are future generations short-changed?

It is often said that baby boomers leave the next generations at a disadvantage by passing on massive government debt. The argument is heard all the more since the economic crisis plunged government finances back into structural deficits.

Should younger generations be worried? Should government raise income taxes today (boomers are the ones with the money) to reduce the public debt that future generations stand to inherit? Many think so. Are they right?

According to the most widely accepted estimate, Canada's public debt represents 75% of the GDP for all levels of government combined, excluding Crown corporations. In the coming years, deficits could drive this percentage to more than 90% of the GDP. That is still lower than the debt-to-GDP ratio in 1995, when the federal debt level alone was close to 70% of the GDP. In the US, the national debt stood at more than 120% of the GDP at the end of the Second World War.

The level of public debt should be examined from the perspective of the public investments done by governments in parallel. Unfortunately, a large portion of these public investments are treated as current expenditures, especially in social areas, such as education. Capitalizing such investments would not only drastically lower government deficits, but would also show that associated with the public debt is a high level of investments in infrastructure and human capital, assets that are passed on to future generations.

An advanced economy needs \$3 to \$4 of capital for each GDP dollar it produces. With a GDP of \$1.5 trillion in 2011, Canada's economy will require capital stock of \$5 trillion to \$7 trillion. A significant portion of this capital stock, about \$3 trillion to \$4 trillion, is found in the private sector and includes housing, factories and other productive assets. The remaining \$2 trillion to \$3 trillion is public capital generated by government investments over the years. The value of this public capital is higher than that of our national debt, taking all levels of governments into

account, and which does not exceed \$1.5 trillion. In short, these publicly owned assets that coming generations will receive in the form of roads, parks, ports and universities are worth more than the legacy of public debt.

But these generations will inherit a great deal more, starting with education. Governments spend 6% of GDP on education annually, a major investment that benefits the next generations. Other social investments also enhance Canadians' quality of life. Future generations will live in a well-functioning society with widely shared values.

Canada benefits from a high level of social capital, thanks mostly to the solidarity-oriented public policies developed over the years. In other words, our social capital didn't magically appear; it reflects the commitment of past

### Social capital reflects the commitment of past generations and their investment in the common good

generations and their investment in the common good, factors not captured in economic statistics. It is our social capital that sets us apart as a country where life is good.

Social capital is the principal legacy we will bequeath to future generations. It is the cornerstone of a Canadian society endowed with solid institutions and relatively little social tension.

In the US from 2001 to 2008, George W. Bush created a major structural budget deficit, with tax cuts that drove up consumer spending. But his low tax policy penalized future generations, leaving them with a huge debt. Indeed, young Americans can rightly denounce these tax cuts, as they will have to finance their consequences.

Canada's situation is different. Our public debt results from investments in education and in physical and social infrastructures. In Canada, the next generations will inherit significant wealth that will exceed our national debt. So, the argument that government debt is an unacceptable burden on future generations doesn't hold water.

Marcel Côté is founding partner at SECOR Consulting in Montreal

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