OUR personal FINANCE issue

Roller-coaster markets, a horrible hedge fund year — can anything be done? See inside

Hedging forward? P. 30

Getting back in the investment game P. 18

He’s rocking it on the curling ice P. 6

GAAP to IFRS: who’s managing the risks? P. 38

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November 2009

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Investing in due diligence

Our annual personal financial planning issue focuses on basic processes investors tend to neglect when the markets are up.

The past two years have witnessed an unprecedented blow to pension funds, private investors and individuals alike. The credit crunch, the recession and the loss of confidence triggered by massive frauds have ruined or jeopardized the retirement dreams of countless baby boomers. Our annual personal financial planning issue looks at how to make things better.

But before we go into details about this month’s content, I would like to thank Ian Davidson, vice-president at Assante Capital Management Ltd., for his contribution as Technical editor for Personal financial planning for the past 15 years and for making it one of the most popular sections in the magazine. To replace Davidson, I am pleased to welcome Garnet Anderson, CA, CFA, vice-president and portfolio manager with Tacita Capital Inc. Anderson was key in determining the content of this year’s special issue and wrote one of the feature stories.

Regarding the market meltdown, one of the issues investors should be concerned with is due diligence. Over the past 10 years, hedge funds evolved from a niche offering to one of the most popular investment products. But their failure to deliver superior returns in 2008 showed that a key decision tool, operational due diligence, was ignored during the funds’ successful run. In “Hedging forward” (p. 30), Christopher J. Addy explains why operational due diligence is making a comeback and offers a 10-point framework he feels will impact the industry.

At press time, the worst of the debacle seemed to be over as markets rebounded from their March 2009 low. “But where does that leave us?” asks Anderson in “Getting back in the game” (p. 18). “In the hole,” is his answer. But he suggests we go to the past to look at the future as he puts forward 10 investment fundamentals. I would suggest reading the sidebar “Communicating with clients” (p. 28), by Strategic Imperatives” Dan Richards. It looks at how advisors should respond to clients’ concerns.

Our Regular sections opens with a transition to IFRS article (p. 38); two standards pieces (p. 43 and p. 51); a tax article (p. 46) and a technology piece (p. 49).

Netwatch columnist Jim Carroll had quite an experience when his cottage went into withdrawal. Read about it in “Disaster-proofing your data” (p. 12).

Our annual personal financial planning issue focuses on basic processes investors tend to neglect when the markets are up.
As investors try to pick up the pieces in the aftermath of the market madness, they want answers to investing questions. This means advisers must now help clients rethink their investment philosophy and reevaluate their strategies.

BY GARNET ANDERSON

Given that 2008 was considered the annus horribilis for the hedge fund industry, operational risk is now a prime concern for hedge fund investors. And what can we expect in the short-term future? Here is a 10-point outline for a new consensus.

BY CHRISTOPHER J. ADDY
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Breaking news, tax updates, job postings, archives, more articles: you’ll find them all at www.CAmagazine.com
INFORMATION PLEASE

I read Annie Beaudin’s article “Changes ahead” (August) with interest, but noted a major omission. “One of the requirements of CAS 265 is the communication of all internal control deficiencies noted during the audit” (p.41). In fact, the CAS specifies which deficiencies identified during the audit the auditor is required to communicate to management and those charged with governance. Under paragraph 9 of the CAS, the auditor is required to communicate in writing significant deficiencies in internal control identified during the audit to those charged with governance on a timely basis.

According to paragraphs 10 and A22, the auditor must communicate to management significant deficiencies in internal control that have been referred to those charged with governance, and other deficiencies in internal control identified during the audit that, in the auditor’s professional judgment, are of sufficient importance to merit management’s attention, taking into account the likelihood and potential magnitude of misstatements that may arise in the financial statements as a result of those deficiencies. The author did not address the matter of professional judgment.

In preparing for the transition to CASs, auditors should be able to rely on the information published in CAmagazine.

Jacques Grenier, CA
Québec City

Technical editor’s reply:
The purpose of “Changes ahead” was to briefly describe the most significant differences between the Canadian auditing standards (CAS) and current generally accepted auditing standards, including the standard on communicating deficiencies in internal control (CAS 265). The article mentions one of the requirements of CAS 265, which is to communicate all internal control deficiencies noted during the audit. This requirement can also be found in The CICA’s Guide to ISAs in Canada.

In his letter, Jacques Grenier provides some relevant, albeit more detailed, explanations on the application of this standard, which was not the objective of the article. Its purpose was only to provide an overview of the major differences.

Yves Nadeau, CA.

FRAUD PREVENTION

In “The fraudster next door” (Value added, September), James Hunter, KPMG’s national leader of forensic practice, says that to prevent and detect fraud, a company should focus on three things. The No. 1 method, he suggests, is to have an effective whistleblowing hotline. The other two things are a code of business conduct and a system for prescreening new hires.

Perhaps I have been removed from the audit business for too long, but I would still hang my hat on a robust system of internal control to prevent and detect fraud in my business. The three methods suggested by Hunter have their place but more as a complementary way to the core internal control system.

Chris Eivers, CA
Brantford, Ont.

OUT OF THE OFFICE

As a CA who teaches the skills of connecting (networking), I was delighted to read in Yan Barcelo’s “Ten ways to add value” (August) that access to networks was one of the 10 ways accountants add value to SMEs. As part of our workshops, we ask participants to complete an online anonymous survey to rate their networking skills, attitudes and networks in work and life in addition to sharing their networking challenges. I am always amazed to see how many accountants are uncomfortable in a networking situation and hence do not make the effort to build a network of depth, breadth and reach. They go to a professional development course and sit with people they know. They go to a conference and at the break get on their BlackBerrys instead of talking with the people around them.

We find most people are uncomfortable because they think networking is about selling. We have a philosophy called Positive Networking that focuses on discovering what you can do for someone else. It is about having a natural curiosity about people, asking them questions to determine how you might be able to add value to their lives. At a recent workshop for CAs, I read them Barcelo’s comments
Mailbox

Judy Thomson, CA
Vancouver

Mailbox to remind them that by building their own network, they are helping their clients. I am hoping this new viewpoint will get them out of their offices and into the community.

Judy Thomson, CA
Vancouver

A CÔTE BOOSTER

Marcel Côté’s monthly columns are a must-read. I read them before any other articles in the magazine. CAmagazine, which is excellent, is worth subscribing to for his columns alone.

If you think about his article “Rethinking executive compensation” (September), if his ideas were adopted, it could fundamentally change the stock market.

Côté’s articles are timely and farsighted. Please ensure that his columns are always included in the magazine; he is a boost.

Sheldon Recht, CA
Israel

GRAY MATTER

Each time I receive your magazine, I am a little disappointed to see that its dull and uninspired graphic design hasn’t changed after all these years.

You seem to recycle images and have been using the same beige-and-gray graphic style for at least a decade. Wouldn’t it be a good time to invest in the magazine’s image so it appeals to the next generation of CAs?

Daniel Vézina, CA
Montreal

Editor’s reply:
We value comments from our readers. That said, the current design was launched in April 2007. Since then, the magazine has won six gold and 10 silver medals and 10 honourable mentions at the 2008 and 2009 Canadian Business Press Kenneth R. Wilson Awards. Fifteen of the 26 prizes were awarded for visuals. In addition, independent research shows that readers are very satisfied and proud of the visual presentation of their publication.

CAmagazine welcomes letters to the Editor. Please write to us at 277 Wellington Street West, Toronto, Ontario M5V 3H2 e-mail address: letters.editor@cica.ca Letters may be edited for space and clarity

it takes one to know one

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camagazine November 2009 5
You can't fault Nolan Thiessen for thinking ahead to the Vancouver Winter Olympics in February, when he could be competing as a member of the Canadian Olympic curling team. In fact, the 29-year-old allows himself to take the daydream a step further. “I've pictured what it might be like to be standing on the podium, receiving a medal, with the cheers of the home crowd,” says the Edmonton-based manager at Ernst & Young. “I'm sure it would be an indescribable feeling.”

He's already part way to donning the maple leaf. Next month he'll throw stones as part of Team Koe, competing against seven other teams at the Olympic qualifying tournament, dubbed the Roar of the Rings, in Edmonton. With numerous former national and world champions in the field, some pundits are calling it the toughest bonspiel ever.

For Thiessen, competing in the Olympics has been a long-term goal. Growing up in Manitoba, a curling stone's throw away from the rink, he started playing at age 11. He didn't get serious until his late teens when he started to move up the competitive ranks, including an appearance at the Canadian Junior Curling Championships.

Since joining Team Koe in 2006, Thiessen's schedule has been a grind. He plays more than 100 games from September to April, often travelling across the country and internationally. And that's not counting near-daily practices and off-rink, off-season training. Having a supportive employer — tournaments take him out of the office midweek and through the weekends — is a major plus. “The partners are great — they totally understand why I'm doing this and why it's important,” he says.

He feels the job itself helps his game, and that a CA's attention to detail lends itself to curling. “We know how to prioritize, to figure out what needs to get done and how best to get it done. It's the kind of strategic thinking that I can bring to the ice.”

You go, curl

Faithful readers might remember we profiled another Olympic curling hopeful, Stefanie Lawton, in this spot four years ago, prior to the Winter Games in Turin, Italy. While Lawton didn’t make it to Italy (her team placed third at the Canadian Olympic trials in 2005) the 29-year-old CA has a second chance to become an Olympian — competing at the Roar of the Rings in December for the opportunity to represent Canada at the Vancouver Winter Games.

Currently on leave from Meyers Norris Penny in Saskatoon, Lawton says she'll practice and play as hard as she can leading up to the trials. As for the strange coincidence that two CAs (see left) are competing for Olympic spots in curling this year, she couldn’t be more pleased. “I think that's incredible,” she says. “It just goes to show that CAs work hard — and that hard work pays off.”

Olympic curling hopeful Nolan Thiessen brings strategic thinking to the ice when competing

Résumé

2001 competes in Canadian Junior Curling Championships
2007 joins Veres Picton & Co., Edmonton
2007 obtains CA designation (Alta.)
2008 wins curling’s Canada Cup with Team Koe
2009 qualifies for Canadian Olympic curling trials
Volunteering for the CICA continues to be a positive and rewarding experience, according to a volunteer survey conducted earlier this year. More than nine in 10 (96%) CAs who volunteer with the CICA are satisfied with the experience — a high level of satisfaction consistent with the results of volunteer surveys done every second year for the past 10 years. In addition, virtually all (96%) said they would likely volunteer again.

So what makes volunteering at the CICA so enjoyable? The benefits to the volunteers themselves. In fact, when volunteers were asked what the most positive aspect of the volunteer experience was for them, meeting and sharing experiences with peers (54%) topped the list. Other positive aspects cited include giving back/contributing to the profession (26%) and developing a better understanding of the issues (8%). Here’s how one respondent summed up the CICA volunteer experience: “It offers a chance to grow and develop, to learn about the good practices of others and to develop a greater appreciation of the variety of issues and challenges faced by the profession.”

For more information on volunteering for the CICA, go to www.cica.ca. Click on CICA under the About the Profession tab and select “Getting involved with CICA.”

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

**Findings**

**What was the most positive aspect of your volunteer experience?**

<table>
<thead>
<tr>
<th>Positive Aspect</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Meeting and sharing experiences with peers</td>
<td>54%</td>
</tr>
<tr>
<td>Contributing to significant issues / giving back profession</td>
<td>26%</td>
</tr>
<tr>
<td>Support of CICA staff</td>
<td>19%</td>
</tr>
<tr>
<td>Better understanding / perspective of issues</td>
<td>8%</td>
</tr>
<tr>
<td>Information provided / learning</td>
<td>6%</td>
</tr>
<tr>
<td>Intellectually stimulating</td>
<td>6%</td>
</tr>
<tr>
<td>Ability to effect change / accomplish things</td>
<td>5%</td>
</tr>
<tr>
<td>Ability to influence policy</td>
<td>4%</td>
</tr>
<tr>
<td>Chance to learn of changes firsthand</td>
<td>4%</td>
</tr>
</tbody>
</table>

**Sources:** CICA, 2009

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**ASK AN EXPERT**

**I’M 57. SHOULD I BORROW TO INVEST IN STOCKS TO MAKE UP FOR MARKET LOSSES?**

Absolutely not. If we learned anything from the past year, it’s that people nearing retirement should reduce their exposure to equities. In fact, I advise getting out of equities altogether. Focus on the factors you still have control over that can add years to your retirement funding:

**Split pension income.** You can minimize your taxes through effective income splitting, and that includes income from the Canada Pension Plan. New pension income-splitting rules also allow RRSP annuity income after age 65 and RRIF income to be split with a spouse or common-law partner.

**Elect CPP early.** You can choose to receive CPP as early as age 60, as long as you are not working by the end of the month before, and during the month of, the pension’s commencement. (This can be done by taking a two-month leave from your job.) The benefit of receiving CPP early is that you won’t have to make any more CPP contributions, which will increase your after-tax cash inflow even if you are in the highest tax bracket.

**Extend your retirement date.** Staying in the workforce for even one extra year can have a huge impact on the number of years your retirement nest egg will last, because you are bringing in money instead of draining it while your investments benefit from another year of growth. Alternatively, you might be able to earn a few thousand dollars a year from a rental property or a hobby, which can reduce the amount of money needed during retirement.

David Trahair, CA, is the author of *Enough Bull: How to Retire Well Without the Stock Market, Mutual Funds or even an Investment Advisor*.
Homes owned by Julius Melnitzer, who in 1992 was sentenced on 43 fraud charges relating to a $27-million Ponzi scheme. Melnitzer, a London, Ont., lawyer, was disbarred, served two years in jail and is now a legal commentator who writes on white-collar fraud.

Years after Melnitzer was jailed that another London, Ont., Ponzi schemer was convicted of bilking investors out of $19 million.

6 Years it took for 191 Canadian victims of a Ponzi scheme to get most of their money back from accounts frozen by the BC Securities Commission in 2003. It is rare for victims of a Ponzi scam to see any funds returned.

30 to 50 Estimated percentage return on funds to participants in a faith-based investment scheme operating through Canadian and US Christian evangelical churches. In 2007, the former leader of the New Life Church in Kelowna, BC, and a US associate agreed to pay $500,000 in restitution to victims who lost $1.3 million in the Ponzi shakedown.

Age of Vancouver investment executive Brian Bassett when he was sentenced to two years of jail for fraud earlier this year. Bassett took more than $2 million from a group consisting largely of fellow stockbrokers to provide his children with flying lessons and other extravagances.

Investors allegedly defrauded of at least $40 million by Toronto fund manager Weizhen Tang in a Ponzi scheme. Tang, the self-described “Chinese Warren Buffett,” was charged in March by the Ontario Securities Commission.

Charles Ponzi, whose name is synonymous with frauds that pay early investors with funds secured from later arrivals, began his criminal career in Canada. No wonder Ponzi schemes are so popular here.

HARI VARSHNEY, FCA
PRESIDENT
VARSHNEY CAPITAL CORP.

COMPANY PROFILE: Based in Vancouver, Varshney Capital Corp. knows how to spot a good idea — and then put its money behind it. The merchant banking, venture capital and corporate advisory services firm specializes in public venture capital for companies ready to go public. The company has raised tens of millions of dollars for venture capital projects in real estate, resource exploration, alternative energy and technology.

HOT FACTOR: This family-run business is known as much for its generous philanthropy as it is for its business sense. For the past 13 years, it has held the Varshney Capital Corp. Charity Golf Classic in July, with proceeds going to several children’s charities. President Hari Varshney is also a well-known benefactor of the University of British Columbia; a $1-million donation to its Sauder School of Business resulted in the creation of the Hari B. Varshney Business Career Centre. To recognize the Indian immigrant’s many contributions to Canada, he was recently voted as one of Canadian Immigrant magazine’s Top 25 Canadian Immigrants of 2009, after a nationwide online vote.

COOL PROJECTS: Varshney Capital recently hit pay dirt — literally. It is backing Canada Zinc Metals Corp., which has discovered one of the largest undeveloped zinc deposits in the world in northern BC. Varshney has put in $38 million, becoming the controlling shareholder. The find is worth billions, as zinc is used as a coating on iron and steel to protect against corrosion. More than 11 million tons of zinc are consumed annually worldwide.

IN HIS OWN WORDS: “By providing risk capital for new ideas and discoveries like the zinc mine, which is the main part that I love, we have been instrumental in providing jobs to thousands of people through our ventures and creating shareholder wealth — it’s a great feeling.” Margaret Jetelina
Accountant’s role keeps expanding
No longer just the numbers experts, accountants in industry are continuing to develop their positions beyond financial functions. According to a survey by international staffing firm Robert Half Management Resources, more than one-third (36%) of the average senior-level accountant’s time is now focused on performing less traditional accounting responsibilities, such as offering strategic advice or providing input on IT projects. That figure is expected to go up to an average of 40% in five years time, according to the 1,400 US CFOs polled, with more than one-quarter (26%) of respondents predicting that senior accountants will spend as much as 50% of their time on non-finance functions.

“In today’s economy, the increased focus on cost savings and liquidity has accentuated the importance of the finance function, and senior-level accounting and finance managers are being asked to step into leadership roles,” says Paul McDonald, executive director of Robert Half Management Resources. “Accountants will always be required to maintain stringent oversight of financial reporting, but in the coming years, an increasing amount of their time will be devoted to providing strategic insight that helps support company initiatives.”

The evolving professional
Amount of time CFOs expect senior-level accountants to devote to less traditional accounting functions in five years

<table>
<thead>
<tr>
<th>% time spent</th>
<th>% CFOs who agree</th>
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<tr>
<td>10 or less</td>
<td>15</td>
</tr>
<tr>
<td>11-20</td>
<td>11</td>
</tr>
<tr>
<td>21-30</td>
<td>16</td>
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<td>31-50</td>
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<tr>
<td>51-75</td>
<td>12</td>
</tr>
<tr>
<td>76-100</td>
<td>8</td>
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<tr>
<td>Don’t know/refused</td>
<td>1</td>
</tr>
<tr>
<td>Mean</td>
<td>40%</td>
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</table>

*Percentages do not total 100% due to rounding

Source: Robert Half Management Resources

Execs sad, suspicious
Employers may experience an executive exodus when the economy rebounds, according to a poll by international recruiter Korn/Ferry. Nearly half (47%) of working executives surveyed in 70 countries are either somewhat or very dissatisfied with their current position.

The lacklustre job market has not only left executives unhappy with their jobs, but a third of respondents also indicate a lack of trust for corporate leadership. A surprising 31% do not trust their boss, while 36% do not trust their CEO.

“The global recession has left fewer employees to do more work, often for less pay,” says Ana Dutra, president and CEO of Korn/Ferry Leadership and Talent Consulting. “Companies must take proactive steps to keep key employees engaged if they want to retain them for the long term.”

TAX TREND TURNAROUND?
Average personal income tax rates for the world’s highest earners have declined for a seventh year in a row — to 28.9% in 2009 from 29.2% in 2008 — a KPMG study finds. A reversal to the trend may be on the way, with countries such as Ireland and the UK already proposing rate increases for its top earners in 2010.

SHOW ME THE MILES
Nine in 10 Canadians (93.6%) belong to at least one consumer rewards program that offers points, miles, gift certificates, discounts, rebates or other benefits. Canuck’s participation in such loyalty programs is up 9% since 2007, according to research by Colloquy, a service provider for the global loyalty-marketing industry.

TRAINING DRAIN
Spending on staff training may be slowly eroding away, suggests a Conference Board of Canada survey. The 218 Canadian organizations polled spent an average of $787 per employee (or 1.5% of their total payroll) on training, learning and development in 2008 — a 40% drop over the past decade and a half.
Older workers deferring retirement

Faced with fallout from the financial crisis, workers who were counting the days to retirement are having second thoughts.

Despite the sharp rebound in recent months, the S&P/TSX Composite Index was about 11,000 points at the time of writing — still 25% below its peak in 2008. This translates into hundreds of millions of dollars in losses for investors.

A critical factor influencing when workers retire is financial readiness. With deep investment losses from the financial crisis, retirement could become unaffordable. Estimates based on detailed wealth data suggest most Canadian families without a defined benefit pension have more than 60% of their financial assets invested in equities; therefore, a 25% stock market slump implies a sharp decline of more than 15% in retirement savings. Many older baby boomers may not have time to recoup their losses. Unless they can significantly increase their savings, their only choice is to delay retirement.

A Watson Wyatt survey shows a significant number of US workers are adjusting their planned retirement age in response to large losses in their retirement savings. In particular, more than half of those aged 50 or older indicated they will work at least three years longer than previously expected. Decline in the value of their 401(k) accounts is cited as the most important reason for postponing retirement. The survey also shows that workers who participate in a defined contribution-only plan are more likely to delay retirement than those with a defined benefit plan.

As more workers defer retirement, some could “retire” on the job, as they struggle to remain productive and engaged. These older employees, unable to exit as planned, could pose a significant challenge for companies trying to streamline and restructure their operations. In anticipation of an eventual economic recovery, one might expect to see a wave of older workers retiring, creating significant workforce transition issues for employers in the medium term. To effectively manage workers’ exits from the workforce, companies will need to take a comprehensive approach to their retirement programs.

For an expanded article, please visit camagazine.com/retirementdelay.

Terence Yuen is a senior research economist and Dan Morrison is a senior consulting actuary at Watson Wyatt Worldwide

Public sector needs survival plan

Canada’s public sector is better suited than many of its foreign counterparts to make the changes necessary to survive beyond the downturn, according to a KPMG International survey.

The Wolf is at the Door is based on a survey of government decision-makers in six countries — Australia, Canada, Germany, the Netherlands, the UK and the US. It notes that the downturn and aging populations are likely to put increasing demands on the public sector, while leaving it with fewer resources to meet them.

Canada, it says, has one or two years to draw up plans to deal with the difficult times ahead. Other governments, particularly those in the UK and the US, face greater challenges; they have borrowed heavily to bail out banks and manufacturers.

“We have never witnessed a time like this when so many countries have shared similar long-term challenges,” says Craig Fossay, a partner in KPMG’s government sector practice. “Governments in Canada need to implement cost saving initiatives and performance measurement programs that will enable them to make tough decisions to create the healthy economy we want and need in the future.”

Only 20% of global respondents indicate they are making radical changes to their organizations and are planning to change their business or service delivery models. However, 77% are planning to increase their productivity levels to offer the same services at a lower cost, and 43% are planning to change (but not necessarily reduce) their services.

Public sector organizations face certain statutory requirements. Once the public gets used to receiving a particular government service, it is very difficult to just stop providing it.

“It makes sense not to do something yourself that somebody else can do for a third of the cost,” says Fossay. “For example, some governments have public-private partnerships and have outsourced routine transactional activities.”

This is a summary. For an expanded article in which Fossay looks at the survey findings, please visit www.camagazine.com/publicsectorsurvivalplan.
Ballparks are for baseballs, not market information.

Working with an AIC expert reassures your clients that you are working in their best interests. With an independent appraisal, your clients can be sure they are getting the most accurate and expert advice regarding the real value of a property. Put an AIC expert on your team and get accurate, reliable advice and market information. Our real property experts are at the forefront of the market and can advise your clients on everything from choosing the right risk management strategies to ensuring that they are IFRS compliant.

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Well, I never thought I’d experience a tornado, but I can now check that one off my list. Back in August my family and I were busy installing a new kitchen in our ski chalet north of Toronto. We’d been monitoring the weather forecasts and knew there was a tornado warning for our area. My sons used online weather sites to track the radar, and we could see a thunder cell coming directly toward our community.

Moments later, there was a big flash of lightning. The power went out, the skies went dark and then from our front window we saw the tornado go by about half a kilometre northwest of us. It was later confirmed by Environment Canada to be a category F2; it did significant damage to our ski club and the nearby homes. Fortunately, no one was hurt.

We began to debate whether what we had seen was actually a funnel cloud and how big it was. My sons often laugh at my “fish story” from years past, and how the fish that I caught keeps getting larger; we started joking that over time, the scope of what we had just witnessed would surely increase.

Yet we had no verification of what we had seen since we now had absolutely no access to information. Without power, we had no Internet connection. My iPhone was suddenly a connectionless little device, likely due to the widespread power outage. We realized our state of emergency planning was quite poor; we started joking that over time, the scope of what we had just witnessed would surely increase.

Yet we had no verification of what we had seen since we now had absolutely no access to information. Without power, we had no Internet connection. My iPhone was suddenly a connectionless little device, likely due to the widespread power outage. We realized our state of emergency planning was quite poor; we didn’t even have a radio handy. A half-hour later, I used the car radio to get the news and confirmed what we had seen. We soon visited the damaged area and realized how lucky we were.

It was a busy night as we discussed the situation in the dark with our neighbours. I found myself roaming up and down the street with my phone, desperately seeking data. No luck.

My eldest son must have gotten tired of me complaining about the lack of information, because the next morning he came out of his room with a small generator he had used for a science project. He plugged it into the cable modem and network hub and, voilà, we had a full range of information. (I think my wife was disappointed that I went after the information with our precious power resources rather than firing up some coffee.)

The experience underlined for me the overwhelming reliance we now place on technology and connectivity. How reliant are we becoming? I still marvel at an article I read (“Hello, Real World,” Globe and Mail, November 22, 2008) that tells the story of then 24-year-old Robert McGroarty, who lost his job in Toronto’s banking district as a result of the global financial meltdown. His work-issued BlackBerry was quickly taken away and — here’s the part I find fascinating — he had no idea how to contact his friends because their numbers were all automatically programmed in. The only phone numbers he knew were his parents’. His solution? He turned to Facebook as his primary means of correspondence.

Is this where we are headed in terms of our reliance on the devices and data that have become such a significant part of our daily lives? Maybe, and that’s the reason why I’ve become a digital pack rat. I’ve got three or four hard drives in our bank vault full of copies of business files, digital family photos and other digital heirlooms.

Do you have such a strategy? Do you know how to get some type of connectivity when the usual means of access go offline? Or what to do when the hard drive containing all your precious memories from the past 10 years disappears? It might be some food for thought.

Jim Carroll, FCA, is a well-known speaker, author and columnist. Reach him at jcarroll@jimcarroll.com or log on to his website at www.jimcarroll.com.

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AcSB on track for adding IFRS to Handbook

Beginning in 2011, international financial reporting standards (IFRS) will replace the standards currently in the CICA Handbook — Accounting, as Canadian GAAP for publicly accountable enterprises.

While PAEs are busy preparing for this change, the Accounting Standards Board (AcSB) has been taking the necessary steps to ensure that IFRS is available for use in Canada when needed.

Because of the many references in Canadian legislation to Canadian GAAP and the Handbook, the AcSB cannot simply tell Canadians to report in accordance with IFRS. Instead, the board must incorporate IFRS into the Handbook. First, it must expose IFRS for public comment in Canada, as is normal due process for proposed Handbook changes.

The AcSB began the process of exposing IFRS in spring 2008. Rather than expose the standards individually, it grouped them in a series of omnibus IFRS exposure drafts. The first two exposure drafts were issued in April 2008 and March 2009. Each exposed the IFRSs included in the most recent bound volume of IFRSs from the International Accounting Standards Board (IASB), and asked if there is any reason why a particular standard would not work in Canada. It addressed other issues, including the definition of a PAE, and presented a draft of new introductory material for the Handbook once it contains IFRS. Based on the comments received, the AcSB continues with its plans to incorporate IFRS into the Handbook by the end of 2009. The third and final omnibus exposure draft, Adopting IFRSs in Canada, III, was issued early this fall. Comments are requested by November 15, 2009.

Once the IFRSs now in force have been added to the Handbook, they will require updating to reflect changes made by the IASB. This will be done on a real-time basis by exposing the IASB’s proposals individually as they are published. The AcSB has already issued separate exposure drafts of some recent IASB proposals because of the nature or importance of their subject matter.

Keep informed by subscribing to website updates or by viewing Exposure Drafts at www.acsbcanada.org.

CICA launches improved knotia.ca website

On September 21, 2009, CICA introduced version 3.0 of its knotia.ca website, offering an enhanced online research experience for users of its more than 100 accounting and tax titles.

“We listened to subscribers’ feedback on speed, features and search requirements,” says Brian Loney, director of publishing, member services. “I think they’ll be pleased with this latest version of knotia, which builds on an already robust platform.”

Loney credits longstanding technology provider Ernst & Young Electronic Publishing Services Inc. (EYEP) for developing cutting-edge solutions. “Our 20-year relationship with EYEP has helped us stay ahead of the curve and bring innovation to our publishing operations.”
Many of the improvements to the website come from optimizing the underlying web architecture, says Margaret Hoffman, vice-president of operations for EYEP. “Users consistently told us they wanted faster searching, so our development team got to work reducing average document download size from 200 kilobytes to six kilobytes, minimizing JavaScript server requests by 35%, and compressing these transmissions by 37%.”

All in all, Hoffman says, users will find the site significantly faster, especially with web 2.0-optimized browsers, such as Internet Explorer 7 and Firefox 3.0. While improved speed is the No. 1 request, Hoffman says users also ask for a more seamless interface. “So in addition to beefing up the search engine, we’ve paid attention to how users work and made it easier to search, save and share documents.”

More than 75,000 CICA members access their CICA Handbook on knotia.ca, and many will get their first taste of the improvements when they receive the October 2009 e-mail update. “We’re constantly striving to improve the member experience,” says Loney. “In these economic times, it’s important to provide value. Having everything in one place makes it easy to find the information you need quickly. That means you can focus more time and energy on your business.” For more information go to www.knotia.ca/Information/Revolution.cfm.

CA conferences prove popular and informative

Two conferences staged by Canada’s CAs in September featured strong agendas that attracted prominent media attention. Both gatherings were held in Toronto.

The first event was the 11th annual Investigative and Forensic Accounting Conference. The CICA established the Alliance for Excellence in Investigative and Forensic Accounting (IFA Alliance) in 1998 to implement a specialist certification program for CAs practising in investigative and forensic accounting. The conference was a presentation of the IFA Alliance.

“The goal of the conference was to provide a mix of things and that was accomplished,” says Ted Baskerville, chair, IFA Alliance. “The sessions were topical with something for everyone.”

One highlight was a presentation by the Honourable Justice Stephen Goudge on the Expert Witness — A View from the Bench. Justice Goudge recently served as commissioner of the inquiry into pediatric forensic pathology in Ontario.

“The expert must understand his or her role, because that role is changing,” says Baskerville, who has given expert evidence at least 60 times around the world in criminal courts, civil courts, arbitration tribunals and government inquiries.

The coming changes are aimed at ensuring an expert witness is impartial and objective in the judgment of the courts.

Other topics covered at the two-day conference included how data is stolen and the criminal use of gemstones. The keynote address was given by well-known Canadian lawyer Edward Greenspan. His views on evident new vigour in prosecuting white-collar crime and a new severity in its sentencing drew coverage from The Globe and Mail and Toronto Star.

The second gathering was the 12th annual Financial Reporting and Accounting Conference. The two-day event is one of the most respected and attended conferences of its kind in Canada. The conference offered sessions to help participants better understand the changing landscape in terms of financial reporting and accounting.

Two keynote presentations were featured. The first was by Don Drummond, senior vice-president and chief economist, TD Bank Financial Group, titled Report Card on the Recession. “This is one of the first opportunities I’ve had to give a presentation that is not all doom and gloom,” Drummond told the audience.

The second keynote address was by David Garofalo, senior vice-president of finance and CFO of Agnico-Eagle Mines and 2009 CFO of the Year. His presentation was titled Creating Opportunities in an Uncertain Economy. Garofalo noted that the credit market is opening up but added it is quite selective.

Canada’s transition to international financial reporting standards (IFRS) was the focus of many sessions at the conference. “With the majority of conference delegates working for or serving public companies it makes sense to dedicate a large amount of time to IFRS, especially with the 2011 changeover date quickly approaching,” says Gord Beal, project leader for the CICA’s IFRS transition strategy. “Canada’s move to a global accounting language requires companies to be taking action now if they are to achieve a seamless transition.”

Both conferences were well-attended, attracting participants from within and outside the CA profession.

The Investigative and Forensic Accounting Conference and the Financial Reporting and Accounting Conference were well-attended and attracted media attention.

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**RECENTLY ISSUED PRONOUNCEMENTS**

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**EIC Abstracts**

| Application of Section 3465 to Mutual Fund Trusts, Real Estate Investment Trusts, Royalty Trusts and Income Trusts, EIC-107 (revised) | July 8, 2009 |

**CICA Handbook – Assurance (Part I)**

| Preface to the CICA Handbook – Assurance | |
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| ED Financial Instruments | December 11, 2009 |

**Legend**

ED – Exposure Draft  EDI – ED issued by the IASB  rED – Re-exposure Draft
DS – Draft SORP  ITC – Invitation to Comment  SOP – Statement of Principles

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

* Stated date reflects the comment deadline set by the International Accounting Standards Board (IASB).

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As investors try to pick up the pieces, there is an opportunity for CAs to help clients reevaluate their strategy and investment philosophy.

Getting back in THE GAME

By Garnet Anderson

Markets have been like a roller-coaster, with the spills outnumbering the thrills by a punishing margin. Overlay aging demographics and crimped incomes, and it is easy to understand why so many Canadians are anxious. As clients turn to professionals for advice, chartered accountants need to be prepared with context to respond to clients' concerns.

How did we get here? There is little value in rehashing the triggers to the massive decline suffered in the world markets, but suffice to say, there was a host of interrelated causes: persistent trade imbalances; US government home-ownership policy; loose central bankers; under-resourced and impotent regulators; overleveraged and undermanaged banks; lax credit agencies; herd-mentality investors and spend-
thrift consumers. The players may change, but history is replete with episodes of this bubble-like behaviour. In every cycle, fear and rational expectations give way to greed, envy and overconfidence as the economy expands. And then some unpredictable event pops the bubble and fear takes root and the rout is on.

At the time of writing, it appears that the Great Depression II has been downgraded to "just" the Great Recession. Bank failures have subsided, equity indices have bounded higher and corporate bond spreads have narrowed from ungodly levels. The market, historically leading the economic recovery by about three months (see table “S&P 500 lead/lag vs. US economy” below), is strongly suggesting that an economic resurgence is on the horizon.

Still, world trade, capacity utilization, government balance sheets and employment levels have suffered significantly. And while it is the popular view that equity indices hit their lows in March 2009, it’s not a guarantee. If that possibility seems outlandish (the MSCI World Equity Price index in local currencies was, after all, 56.3% off its July 13, 2007, high on March 9, 2009; for its part, the S&P/TSX index’s peak-to-trough damage amounted to 50.6%), consider the ugly 20-year plight of the Japanese equity market, which is still off its 1989 high by more than 70%.

Where does that leave us? In the hole! The math is basic, but it continues to confound investors. It takes a return of 100% to recover from a 50% market drop. In other words, portfolios will take time to recover. Not a problem for a 30-something investor, but a potentially serious issue for someone living off of his or her savings and facing the risk of depleting his or her capital base.

What have we learned? Remember the words of poet and philosopher George Santayana: “Those who cannot remember the past are condemned to repeat it.” So as investors try to pick up the pieces, the following investment fundamentals may help them chart their new and wiser courses.

1. Portfolio diversification remains critical. Unfortunately, geographic diversification in equities provides only so much protection as correlations increase in times of distress. Go back to first principles and consider an appropriate allocation to cash, fixed

<table>
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<td>Oct. 1949</td>
<td>4</td>
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Average recession lead time 8
Average recovery lead time 3

Source: NBER; month-end measurement

It takes a return of 100% to recover from a 50% drop.
In other words, portfolios will take time to recover.
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income, equities and real estate. Then consider geography, style, currency, sector, method of security selection and vehicle type.

2. Investing is part science and part art. Modern portfolio theory, capital asset pricing model, efficient market hypothesis and stochastic (VAR) modelling are all conceptually brilliant and useful, but not perfect given the unpredictability of the real world. The folks who conceived, built and managed adjustable-rate mortgages, collateralized debt obligations, special-purpose vehicles and credit default swaps are obviously bright, but not bright enough to have covered all angles. Investment professionals need to be well schooled in the limitations and risks of the various theories and investment types. If something is too complex to grasp, then avoidance is probably the best policy.

3. Risk calibration is important. Investors now know what risk really feels like. Interestingly, the last market blow-off was in 2000, and while it was different this time, one would have thought that the lesson about being prudent would still have been relatively fresh during the last bull run. Understanding an investor's
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risk tolerance (emotional attitude to risk) and capacity (ability to financially cope with losses) is a cornerstone of an investment strategy that a client can live with through thick and thin. A single emotion-based investment decision can undo years of careful planning and execution.

4. Strategic asset mix remains relevant. Numerous studies have concluded that an investor’s asset mix is of utmost importance. Yet, some pundits now contend that strategic asset allocation, where asset class targets are set and then rebalanced to, did little to protect investors in the meltdown. This would be rash as both individual and institutional investors need the discipline of a strategic plan to control portfolio risk and the emotions that beset us all. While intuitively appealing, alternatives such as market timing and portfolio insurance have such challenges as precision, repeatability, transaction costs and taxes.

5. Tactical changes are expected by many investors. Standing in the corner and getting beaten by a plunging market without taking action is difficult for investors to accept. Predesigned and agreed-upon asset mix ranges should be set to provide the adviser or portfolio manager with the flexibility to buffer the portfolio through changes without providing too much licence to abandon the core strategy. It is a delicate balance; the investor must understand the degree of flexibility permitted and realize that the adviser will never be perfect in implementing these “tweaks.”

6. Being Canadian has its benefits. Given our commodity-influenced economy, the Canadian dollar runs higher in good times but retreats when the global economy slows. The result is a built-in portfolio shock absorber for US and international investments. The issue is that many investors will forget this downside support, and grous about currency losses when the Canadian dollar is rising and want their currency exposures hedged. Given the current exchange rate levels and the difficulty in forecasting currency changes, now is a good time to set a longer-term currency hedging strategy. The focus should be on minimizing investor regret by using a partial hedging strategy.

7. Stocks for the long run. Most individuals, endowments and pensions need to incorporate equities into their portfolios to meet long-term obligations. Given their incremental risk, it makes
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sense that stocks generate higher returns than cash or bonds. The table “Annualized total returns” on page 24, however, emphasizes that it can take years before an investor can be sure stocks will generate a positive nominal return. It also shows that bonds (intermediate term US government) can outperform stocks over substantial time frames — most investors need both.

8. Due diligence is worth its weight in gold. It takes experience and resources, but searching for better or different investment products is critical to improving the client experience. Flare-ups such as the frauds perpetrated by the hedge fund Portus and Bernard Madoff only serve to heighten the importance of establishing a review process. Initial due diligence has to morph into ongoing monitoring so that weak links can be constantly identified. Investors have to ask themselves whether their managers perform as expected, given that the sell-off was far and wide.
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9. Tax loss harvesting. A silver lining in the massive sell-off was the opportunity to tax loss harvest and generate cash flow for some, or create future tax deferred growth room for others. Successful harvesting often requires you to sell, temporarily replace the market exposure and then reintroduce the original security when permitted by the Income Tax Act.

10. Financial planning. Surveys show that clients know their world has changed. For example, Phoenix Life Insurance’s July 2009 edition of High-Net-Worth Market Insights indicated 49% of pre-retiree respondents expect they will have to defer their retirement date. The 2009 EBRI Retirement Confidence Survey indicated that 72% of working Americans now expect to work

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**Communicating with clients**

By Dan Richards

There has been a broad range of aftereffects from last year’s collapse of global stock markets. As a result consumers are rethinking their spending and retirement plans; regulators around the world are reviewing the policies for oversight of financial industry practices; and governments have had to step in to keep financial institutions solvent and to stimulate their economies. Similarly, investment industry professionals and academics are reexamining the fundamentals of how portfolios have been built and the measures in place to control risk.

In discussions with almost 500 investors during roundtable focus groups and one-on-one interviews about the recent market downturn, a number of themes kept recurring regarding what investors want from their financial advisers.

Some of the things investors seek from their financial advisers remain constant. Investors still look for advisers who listen, demonstrate they care, put their clients’ needs first and provide advice tailored to each investor’s needs along with the ability to recommend solutions from the widest range of offerings.

At the same time, a fundamental shift has occurred in other things that investors look for from their financial advisers. Four new imperatives have emerged.

**DEMONSTRATE EMPATHY**

Almost no investor has emerged from the market events of last fall unscathed — even with the market’s recovery since March, some still feel devastated by the impact on their portfolio and retirement plans. In many cases, the first priority for financial advisers is to establish a bond of empathy and to tap into client feelings — often, clients are unable to listen to their adviser until they first feel listened to.

If an adviser hasn’t had an in-depth conversation about how a client feels, one of the better ways to start a meeting is to say, “Many investors have lost sleep because of the market events last fall. Tell me, how have you been affected by the market over the past while?”

Sit back and listen — encouraging clients to elaborate with phrases such as “Tell me more about that.”

Sometimes, clients feel better if their adviser talks about how he or she feels. One adviser tells clients, “This has been the most incredibly difficult period in the markets that anyone can remember. I’m truly sorry that I was unable to anticipate the decline and protect you from the downturn — unfortunately, almost no one saw this coming, including some of the smartest and most experienced people in the investment world.”

**PROVIDE GUIDANCE AND DIRECTION WITH BALANCED OPTIMISM**

The second imperative is to provide guidance going forward. While almost no one is happy with what’s happened to their portfolios, as a general rule investors aren’t blaming their advisers for this — they see everyone they know in the same boat.

What is causing dissatisfaction among many investors is a sense that their adviser is overly passive and not providing direction on what they should be doing going forward. Today, investors are looking for guidance on how to move forward — and if they don’t get
Investors suffered material setbacks over the past few years. How lasting the ensuing rebound is remains to be seen.

For pay in retirement. While no one wants to reset his or her expected retirement date, spending rate or gifting plans, many need to. Instead of letting clients live in a fear-laden fog, a revised financial plan will give them the context to march ahead and tackle the required adjustments. This is particularly relevant for those in or close to retirement. The chart on page 26 shows that retirement success can partly be attributed to luck. It charts the 25-year outcomes of an inflation-indexed withdrawal rate of 4% overlaid on a simple portfolio (60% S&P 500 total return, 35% intermediate-term US government bond total return and 5% cash return) for someone retiring at the beginning of each decade since 1930. Identical spending and investment strategies lead to varying outcomes: Ms. 1980 Retiree’s $100 turned into $552 after 25 years of funding her monthly withdrawals, while Mr. 1960 Retiree had just $40 left.

Timing is only part of it. Clients often don’t appreciate how little of their portfolio they can spend annually if they want a high probability that their capital is not depleted. The following version (chart on page 28) simply boosts the initial spending rate to 5% of the $100 of capital with the result being that in four of six exhibit periods, the capital was totally depleted.

In summary, individual and institutional investors suffered material setbacks over the past few years. How lasting and vigorous the ensuing rebound is remains to be seen. Regardless, such an episode is a great time to evaluate your investment philosophy, portfolio implementation techniques and value proposition to clients. Major pension plans have already started to incorporate lessons learned into their strategies, and Canadian investors deserve the same thoughtful review and introspection.

Garnet Anderson, CA, CFA, is vice-president and portfolio manager with Tacita Capital Inc. in Toronto. He is the new technical editor for personal financial planning. He can be reached at ganderson@tacitacapital.com

INCORPORATE FRESH PERSPECTIVES

A common complaint among investors is that their portfolios are unchanged since the market meltdown began last fall — a common comment is, “If my portfolio made sense then, given everything that’s changed, I don’t see how it can be right now.”

In cases where investors are in mutual funds or managed money, of course, their portfolios have been actively managed — and it’s incumbent on the adviser to help clients understand how their investments have changed.

In other instances, it might make sense to introduce a new element into client portfolios, such as investment-grade corporate bonds. Clearly, any recommendation has to be appropriate and you never want a change for the sake of change — but failing to recommend appropriate changes runs the risk that clients will see their adviser as taking them for granted.

That doesn’t mean you can’t recommend a stay-the-course strategy — just understand that you have to work harder to support that recommendation, demonstrating all the alternatives that were considered and the options examined before concluding that no change is merited.

RAMP UP COMMUNICATION

The events of last fall have heightened demand for the frequency of contact — whatever the level of contact clients wanted a year ago, it’s almost certainly higher today. And it’s not just demand for quantity that has increased — investors are looking for more substantive commentary on prospects for the market and for their portfolio. Many advisers can’t meet this demand simply by increasing the number of meetings and phone calls. Supplement the traditional personal contact with new communication vehicles — e-mailing articles, conference calls and group sandwich lunches in a boardroom, to name just three.

Investment managers have been forced to reexamine their practices and adopt new approaches. In a similar vein, to be effective, investment advisers need to rethink their approach to client communication, bearing these four imperatives in mind.

Dan Richards is president of Strategic Imperatives in Toronto. He can be reached at Richards@getkeepclients.com
Hedge funds have moved into the mainstream of institutional investing. Just 10 years ago, they were still largely the “secret club of the super-rich” but now, pension funds, sovereign wealth funds and large endowments embrace the absolute return and diversification benefits available from hedge funds. Retail investors are also exposed to them as never before: your corporate pension very likely has hedge fund exposure, and, more generally, the movements of both stock and bond markets are now heavily influenced by hedge fund investment decisions and capital flows.

Undeniably, however, 2008 was the annus horribilis of the hedge fund industry. Evidently, the funds failed in their central premise to generate absolute returns

Hedging FORWARD

The disasters of 2008 made operational risk a prime concern for hedge fund investors. What can we expect in the short-term future? Here is a 10-point outline for a new consensus

By Christopher J. Addy

Illustration by JUD GUITTEAU
While market conditions were unprecedented, events nonetheless highlighted structural weaknesses in many hedge funds, notably the trend to place ever more illiquid assets into what is still an open-ended investment vehicle irrespective of market direction. According to the Credit Suisse/Tremont index, the average hedge fund returned -19% in 2008. While this compared very favourably with the -38.5% drop in the S&P 500, 2008 destroyed the myth that hedge funds had somehow discovered the secret of alchemy and could always deliver positive performance.

Two further factors combined to rein in the industry during 2008. Toward the end of the year, funds worldwide took advantage of the fine print on their prospectuses to impose gates and suspend redemptions. While market conditions following the collapse of Lehman Brothers were unprecedented, events nonetheless highlighted structural weaknesses in many hedge funds, notably the trend to place ever more illiquid assets into what is still an open-ended investment vehicle. By the end of 2008, many funds simply declared themselves unable to give investors their money back, at least in the short term.

The other factor, of course, was the colossal fraud perpetrated by Bernard Madoff. To be precise, Madoff did not offer a hedge fund; rather, he was an institutional money manager offering clients private, managed accounts. However, his hedged strategy, and the large number of hedge fund investors involved, profoundly shook the confidence of investors worldwide.

It is against this background that the discipline of operational due diligence for hedge funds has come into renewed focus. The idea of completing a review of the accounting controls and business operations of a hedge fund manager is not new — it has been around for more than a decade. However, due diligence practices across the industry have been very mixed. While some investors have conducted thorough operational reviews for some time, others have continued to consider only performance.
In practice, a number of issues combine to make hedge funds unduly exposed to operational risk. At their heart, hedge funds are a paradox: while they may trade large volumes of extremely complex securities, most hedge funds have fewer than 50 staff. As a result, investors cannot rely on the depth of resources — or deep pockets — that can be taken for granted at a major asset-management institution. Moreover, many hedge fund managers, while skilled traders, may not be effective business managers (many fund managers launch their own firms to escape the bureaucracy of a large investment bank). Finally, there remains a complete lack of standard business practices in the hedge fund industry. Operational practices vary widely from fund to fund, particularly in critical areas such as valuation and administrator oversight.

Given the painful experiences of 2008, operational risk is now a central concern for all hedge fund investors. Many new topics are on the table, including transparency, fee structures, managed accounts and outsourcing. It will likely take some time for a new consensus to emerge and, in practice, the industry will likely continue to offer a range of alternatives rather than a standard solution.

As the dust settles, however, we can outline a 10-point framework that will impact the world of Hedge Funds 2.0.

10. Operational due diligence is about more than operations
Many investors have traditionally viewed operational due diligence only as a defence against fraud and other catastrophic loss. Due diligence procedures have, therefore, tended to focus narrowly on accounting controls and procedures if being conducted by an accountant — or legal terms and conditions when conducted by a lawyer.

While any due diligence review will consider the risk of a blow up, effective due diligence provides a much broader insight into the overall quality of each manager’s business, including each firm’s culture and operational philosophy. Indeed, business risk due diligence is probably a more helpful description than a more limited operational due diligence framework.

Managers who fail to make an appropriate investment in people, systems and other infrastructure will unavoidably fail to deliver optimal performance. The purpose of operational due diligence, therefore, is as much to assess the risk of a drag on performance due to a poorly run business as it is to identify outright fraud.

9. Due diligence requires judgment, not a scorecard
Judgment is critical in the due diligence process. There is an enormous variety of hedge fund operating models across different strategies and jurisdictions, meaning that the typical hedge fund structure is far from one size fits all. While some due diligence practitioners use a rigid, predefined list of criteria to determine an overall score, effective due diligence must combine a consistent process with subjective opinion.

In our experience, yellow flags and warning signs are as likely to be subjective impressions as they are objective facts. Perhaps a manager is a little too aggressive in passing through research or spurious back office costs to the fund; perhaps the firm's compliance procedures spend more time on justifying exceptions than on enforcing rules; perhaps the manager has gone above and beyond to ensure that the fund's offering documents allow flexibility “in the sole discretion of the investment manager.” Individually, these issues may not be overly significant, but collectively they can be important signals to help investors understand how managers view their business and their relationship with investors.

8. Due diligence is just as important on the biggest and the best funds
The Madoff fraud was astonishing, not only in terms of the sums involved but also because of the number of years over which it was sustained. Madoff was, unfortunately, able to take advantage of a perfect confluence of circumstances — he conducted his crime in an industry that not only had enormous sums of money, but was also prepared to accept that certain managers didn’t have to explain what they were doing.

The lesson for investors is obvious: irrespective of the manager in question, it is empirically necessary to complete robust, detailed due diligence. It will no longer be possible for any investor to have a list B of certain managers who, because of
Events of recent months have demonstrated how quickly
the operational rules can change and create new challenges.
tunity to earn incentive fees if they are under their high-water marks. How these managers will run their business to navigate the coming 12 to 24 months is just as important as their investment thesis.

Even when times are more stable, on-going due diligence is essential. Every hedge fund faces a constant challenge to keep up with new trading technology, adapt for new instrument types, and match the ongoing evolution of industry best practices.

Funds also update their offering documents, change service providers and experience turnover in key roles such as the CFO and COO. Each of these events must be evaluated on a timely basis.

6. Investing is a partnership: good managers accept advice

Operational due diligence is an important touch point in the relationship between manager and investor. Many managers appreciate comments and perspective from a seasoned due diligence team; while managers may know their own organization in minute detail, they have much less knowledge of the practices adopted by their peers and competitors.

The attitude of the manager during the due diligence process can also give valuable insights. At one extreme, some managers may view due diligence as a mundane necessity, adopting a bored attitude when answering investor questions. At the other, we consistently find that the more capable the CFO, the more quickly he or she will ask for feedback and suggestions about how controls and procedures could be improved. A commitment to continuously improve the hedge fund organization sends a strongly positive signal regarding culture and business philosophy.

5. Remember that the administrator, directors, auditor and law firm are paid by the investor, but hired and fired by the investment manager

External service providers perform important functions to support a hedge fund and, in theory, safeguard investors. However, service provider relationships are often imperfect due to the unavoidable tension between the interests of the investment manager — who is the day-to-day client and has the power to hire and fire the service provider — and those of third-party investors. For investors, service providers must be independent and above all, work to protect their interests rather than those of the manager.

In the legal area, the redemption crisis of late 2008 has created a strong backlash against the efforts of hedge fund lawyers to insert ever tighter disclaimers, exclusions and waivers into fund offering documents — despite all the legal bills being charged to the fund and paid by investors. Going forward, we expect investors to be far more active in negotiating changes to the fund prospectus to derive more balanced terms.

A related issue is corporate governance. There is now an increasing awareness that billion-dollar hedge funds need meaningful, independent boards able to consider the interests of investors as well as the manager. Unfortunately, most hedge fund boards today are comprised of the manager plus representatives from offshore corporate secretarial firms who often act as directors for tens, if not hundreds, of other hedge funds. Going forward, investors will push for more involved and investor-focused board members.

Perhaps the most important service provider, however, is the fund administrator. We are strong proponents of the need for effective administration, which, in our view, is investors’ best defense against fraud and malfeasance. However, investors should be conscious that not all fund administration is created equal. For example, some administrators take accounting information from the custodian/prime broker and then complete an entirely circular reconciliation back to the same custodian, without any effort to obtain trade information from the fund manager. The lack of a thorough, three-way reconciliation (manager to administrator to prime broker) significantly reduces the value of third-party oversight.

The biggest issue in the administration industry is, however, valuation. Many investors continue to assume that an administrator hired to calculate a fund’s net asset value must also independently value the portfolio. Unfortunately, this is not the case: the administration industry typically seeks to disclaim legal responsibility for pricing and, ever more, limit its role to one of price verification, where that verification can be selective.
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and in accordance with widely varying tolerances. As such, today’s investors face a confused and unpredictable array of administrator pricing, which varies from strong to entirely ineffective. In particular, for hard-to-value securities — which are self-evidently those instruments where fraud is most likely and third-party pricing oversight most important — we see an alarming increase in the number of hedge fund administrators who are prepared to accept manager valuation marks without any form of independent verification. Careful due diligence is required and investors should emphatically not assume that top-tier administrators will always provide top-tier servicing.

4. Beware of conflicts of interest
Conflicts of interest are also a lingering issue within the hedge fund industry. Fee breaks, retrocessions, side letter agreements and other behind-the-scenes deals all merit careful attention. There can be conflicts allocating trades between hedge funds and other investment products in larger investment houses that also offer traditional funds. Service provider conflicts can also be present: some funds own their own administrator, and the situation where a prime broker also owns its own administration is also not conflict-free. As always, investors should examine and consider each potential area for conflict and decide if it represents a material due diligence issue.

3. Be prepared to ask tough questions — even when you are making money
Madoff reminds us that every Ponzi scheme exploits a fatal flaw in investors’ psychology: there always seems to be less tolerance for hard-to-value securities — which are self-evidently those instruments where fraud is most likely and third-party pricing oversight most important — we see an alarming increase in the number of hedge fund administrators who are prepared to accept manager valuation marks without any form of independent verification. Careful due diligence is required and investors should emphatically not assume that top-tier administrators will always provide top-tier servicing.

2. If it looks too good to be true, it probably is
While some investors are more skilled than others and some managers have better resources and infrastructure, no one has discovered the secret of alchemy. Despite investors’ enduring optimism, it is simply not possible to design an investment strategy that, over time and under all investment environments, will always generate consistent, positive returns. Investors should be conscious that a high proportion of hedge funds that did turn out to be frauds offered some combination of unreasonably high returns, unreasonably low volatility, or a minimum guaranteed return.

1. Be prepared to say no
Our final comment is perhaps the most obvious but, all too frequently, can be one of the most difficult. Very few investors can truly remove emotion and the human element from investment decision-making. Sometimes the effort expended in researching a new fund can create almost unstoppable momentum to get the fund approved and into the portfolio. There can also be strong peer pressure to take scarce capacity in well-regarded funds: after all, the argument goes, if everyone else has already invested, the fund must be safe.

The role of investment teams and advisers is to identify funds that will generate good risk-adjusted returns, to focus on what the reward will be if all goes according to plan. The role of operational risk due diligence, however, is to worry about what can potentially go wrong. This creates an unavoidable trade-off: what happens if a fund has strong performance but is operationally weak?

Given these issues, the real lesson of Madoff is that investors do need to be prepared to say no, and recognize that not every investment will meet their investment criteria once the risk/reward profile includes operational factors. In our view, a consistent and comprehensive due diligence process allows better investment decisions: investors will be better informed to reject those funds that do have deficient operational controls, and have more confidence to invest with those firms that genuinely do have a top-tier business infrastructure.

Christopher J. Addy is president and CEO of Entreprise Castle Hall Alternatives Inc., a specialist provider of operational due diligence services to global hedge fund investors with offices in Montreal and Halifax.
Who’s managing risks?

A smooth journey from Canadian GAAP to international financial reporting standards requires a risk-intelligent approach.

As markets inch toward economic recovery, Canada’s publicly accountable enterprises (PAEs) face an added bump in the road: mandatory conversion to international financial reporting standards (IFRS). Although the switch won’t officially flip from Canadian GAAP to IFRS until 2011, PAEs will need to issue comparative IFRS statements for 2010 — which means that organizations with a December 31 year-end will essentially need to be IFRS-ready as of January 1, 2010. So, for some organizations, we’re no longer counting down to IFRS in terms of months; we’re talking weeks.

When you couple these ever-tightening timelines with the fact that virtually every Canadian company is looking for ways to reduce costs, organizations may be tempted to scale back their plans or delay bringing in external help as long as possible. But such choices could prove risky — and costly. To avoid costly surprises, organizations should make risk management an inherent part of the conversion project from day one (although it’s never too late to adopt a risk-intelligent approach to IFRS conversion). Failure to do so can result in project delays, missed deadlines, increased costs and other negative impacts on processes, personnel or systems.

Identifying risk hot spots

To navigate the risks throughout IFRS conversion, PAEs need to map impacts across the organization. IFRS conversion will require management to explore the implications of changing not only financial and tax reporting but also processes as diverse as human resources and compensation, budgeting and forecasting, internal control certification, contracts and financing agreements. So the key...
to a smooth journey will be understanding precisely what processes, people and systems will be affected, and identifying who needs to be involved in flagging and tracking risks on the road ahead.

There’s no question that an enterprise’s finance team needs to be at the core of IFRS conversion activities. After all, finance will be the driving force behind translating the organization’s elections from Canadian GAAP to IFRS, and redesigning financial statements. To establish a broad risk viewpoint, however, IFRS conversion requires a strong project management backbone that incorporates the viewpoints of a range of stakeholders affected by the cascading impacts of financial decisions.

Looking beyond financial reporting, at least three other specific stakeholder groups can expect significant impacts from IFRS conversion: internal audit, internal control certification and information technology. This trio needs to be directly involved in the IFRS journey, as it can provide unique insights into particularly challenging aspects of the conversion effort. Keep in mind that while these three groups should anticipate notable impacts from IFRS conversion, other stakeholders will need to be addressed — including tax, training, investor relations, legal, boards and audit committees. With that in mind, let’s walk through questions stakeholders will want to consider.

**Internal audit**
As the objective assurers and proactive monitors of enterprise-wide risks, internal audit needs to consider several aspects of IFRS conversion. For example:

- **Enterprise risk assessment** How will IFRS, including increased judgment and estimates, affect enterprise risk? Are current risk management procedures adequate to manage evolving risks?
- **Project management** Is the IFRS conversion project periodically reviewed to ensure it remains on track, and that risks are constantly reassessed?
- **Data and system conversion** Does the data conversion strategy and plan provide for adequate controls over property, plant and equipment data conversion (data cleansing procedures, mapping of converted data, handling of data exceptions or invalid data procedures, timing of conversion and reconciliations)? Does the entity have a plan to address the dual-reporting of data (IFRS and Canadian GAAP) in 2010?

**Internal control over financial reporting (ICFR)** What new or revised business processes are being designed to compile additional IFRS-compliant data? When will the operating effectiveness of new key controls be tested? Is the organization taking the opportunity to streamline processes beyond what may be strictly required for IFRS compliance?

- **Interpretation of standards** How do the organization’s interpretations of individual standards compare to industry peers?

**Internal control certification**
This group must pay particular attention to policies, procedures and documentation (along with the underlying associated internal controls), ensuring they accommodate the redesigned accounting, reporting, consolidation, reconciliation and disclosure processes. Key questions may include:

- **Scoping and risk assessment** With each IFRS interpretation creating potential changes to the organization’s risk profile, how will risk assessment and ICFR processes be adapted? Who is assessing accounting policies and IFRS elections?
- **Disclosure controls and procedures** Explanations will be required within the quarterly management’s discussion and analysis (MD&A), press releases, financial statement notes and revisions to debt arrangements. What needs to be disclosed and when? What’s being done to ensure disclosures remain consistent from the parent company through to every subsidiary? Do the board and audit committee have the appropriate level of IFRS literacy to review disclosures?
- **Entity level controls** Is the audit committee effectively responding to reporting implications? Does the core accounting or reporting team have adequate knowledge of IFRS to complete conversion activities and operate within an IFRS environment?
- **Business process controls** Do process owners have adequate IFRS training and tools to assess the impact of accounting changes on their controls? Are they equipped to assess the impact of identified deficiencies?
- **Information technology** Have existing IT
or general computer controls been assessed to identify processes that need to be updated or established? Are existing IT controls sufficient to address the dual reporting requirements?

Information technology
As data flows through technology, getting further from its source, the risk of errors increases. Virtually every application and interface in the system architecture can be affected — from the upstream source of data to the farthest downstream end of reporting tools. As IT systems changes are planned, considerations should include:

- **Information quality** IFRS-based accounting decisions will require access to historical data; where will such data be stored? Will this data be easy to locate during and after IFRS conversion?
- **Reporting data warehouses or data marts** How will changes to financial reporting requirements impact information management systems? Can data governance functions and metadata repositories handle new data definitions?
- **Upstream systems** Have upstream systems — including financial sub-ledgers, financial instrument or investment valuation systems, product-specific systems and interfaces that post financial transactions — been analyzed to identify and document which internal and external data sources need to be updated? What data will be missing due to differences in accounting treatment or additional disclosure requirements? Are required enhancements to legacy systems included in the IFRS plan?
- **Downstream systems** What additional information will be needed to support IFRS reporting and disclosure requirements? Are information systems sufficient to provide information on nonfinancial data that may be required — directly or indirectly — to support IFRS analyses?
- **Infrastructure** How will IFRS impact support applications such as rules engines, allocation engines, middleware and operation data stores that affect or transact financial information? Will IFRS changes affect outsourcing arrangements or systems?

Tax
Tax has been the biggest cause for material weaknesses for internal control certification, so changes need to be given high priority. Will you need to revise methodologies for calculating and disclosing income tax and deferred taxes? Because tax data is often housed on a different — and often manual — technology platform, will there be separate tax-related system and process issues to address? IFRS also presents new tax opportunities; who is assessing how to take advantage of them?

Legal
Many contracts and financing agreements will need to be reexamined for possible impact. Will changes to how income and fixed assets are measured require any contracts to be updated or even renegotiated and restructured?

Investor relations
The MD&A will have to reflect any modification of comparative results of operations on conversion, as well as any material changes that may evolve preconversion. Companies must produce coherent analysis for the first quarter of the IFRS conversion year within days of completing the Canadian GAAP-based annual report for the previous year. With the time-sensitive nature of this task, PAEs will need to manage investor expectations. How will you explain the impact or fluctuations of earnings per share and return on capital?

Training
The best-laid adoption plans won’t go far unless the people be-
hind the systems and those responsible for putting processes in motion are IFRS-literate. However, training applied broadly across the organization is ineffective and costly. Who are the key internal stakeholders (including boards and audit committees)? What do they need to know to perform their jobs under IFRS?

**Boards and audit committees**
How will the organization ensure that boards and audit committees are appropriately engaged in IFRS decision-making? What steps will be taken to ensure these groups have the level of IFRS literacy required to fulfill their responsibilities? Will the audit committee expect the internal audit team to review the process? Have the internal control certification implications been considered and worked into the plan?

**The risk register**
While creating a comprehensive project plan requires gathering multiple perspectives, the more people you have driving change within particular areas of the organization, the more potential there is for risk exposure. That’s why it’s vital to define ownership for project management activities — whether it’s an individual, a team or an external provider — and follow a consistent risk assessment process that’s capable of capturing risk interdependencies and interrelationships.

To put this theory into practice, we recommend that organizations create an IFRS risk register: a categorized inventory of risks to act as a constantly evolving reference point for monitoring, prioritizing and scheduling risk management activities throughout the conversion process. From that risk register, the organization can track the consequences of each risk, outlining the possible paths. It doesn’t have to be complex. But to be truly effective, the IFRS risk register should be overseen by a knowledgeable person with the time and authority to take action when required. PAEs may have several items in their risk register (for examples see table on page 40).

**Where will you go from here?**
Many roads will lead you to IFRS, but strong risk management throughout the conversion journey can ultimately make the difference between a well-coordinated adoption and a last-minute scramble to issue the initial set of financial statements prepared under IFRS. While risk management throughout IFRS conversion requires upfront and ongoing investment, in the end, it’s an investment that saves money. Sound risk management practices enable efficient resource allocation, and help to head off such risks as ineffective certification results or even restatements. The next step is yours. Will you follow a risk-intelligent route?

Steen Skorstengaard and Kendra MacDonald are enterprise risk partners with Deloitte Canada

Technical editor: Ron Salole, vice-president, Standards, CICA

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Commitment to excellence

The new quality control system will allow public accounting firms to show their commitment to quality control

On December 15, 2009, a new era of quality in Canadian auditing begins. As of this date, a new quality control standard comes into effect for all audits of financial statements taking place in Canada.

CSQC 1, Quality Control for Firms that Perform Audits and Reviews of Financial Statements and Other Assurance Engagements replaces the existing standard, GSF-QC, or General Standards for Firms Performing Assurance Engagements. The new standard introduces a robust new quality control system that will benefit public accounting firms by allowing them to demonstrate a strong commitment to quality control.

CSQC 1 addresses the policies and procedures firms must put in place to establish and maintain a system of sufficient quality control to help them meet professional, legal and regulatory requirements. It outlines the necessary steps to provide reasonable assurance that assurance reports issued are appropriate given individual circumstances.

Understanding the new standard and how it applies to your firm’s practice will help improve the quality of the work done for your clients. The experience gained in designing, implementing and monitoring quality control systems under GSF-QC can be effectively leveraged to comply with CSQC 1 regarding key activities. These activities include acceptance and continuance of client relationships, recruitment and professional development of staff, engagement performance management and inspection of completed engagements.

Attracting and retaining your client base

Deciding to accept a new client or providing services to existing clients is part of daily business. Attracting and retaining the right clients is about ensuring they fit with your firm. Taking on an engagement where the firm has few capabilities or resources may expose the firm to potentially unacceptable risks of failing to properly perform the engagement, with resulting potential lawsuits or disciplinary actions. Also, from a business viewpoint, accepting or continuing to serve only appropriate clients will positively impact the firm’s ability to attract and serve more clients productively.
There are numerous ways to introduce appropriate rigour into client acceptance and continuance decisions. For example, the firm may use a standardized questionnaire. For firms with two or more partners, the client acceptance/continuance process may include second partner approval using criteria agreed upon by the partners.

Client acceptance or engagement continuance considerations may include:

- partners’ and staff’s knowledge of the industry and experience with the regulatory and reporting requirements;
- the firm’s access to experts who may be required;
- the firm’s ability to meet the engagement reporting deadline;
- reasons the client left the predecessor audit firm;
- qualified reports issued in prior years;
- lawsuits or negative publicity surrounding the client;
- signs of tax evasion or criminal activity; and
- disciplinary actions taken against the client (for example, the Travel Industry Council of Ontario publishes disciplinary actions against travel agencies for violations of its regulations).

Recruitment and professional development of staff
A firm is only as strong as the professionals it employs. To ensure firms have the capacity and competency necessary to meet their clients’ needs, they may want to consider establishing rigorous policies and procedures for staff recruitment and professional development.

Firms may consider developing a standard job interview process and documentation of that process to allow them to better compare candidates. A probationary period could also be established for all new personnel, together with a performance review upon successful completion of the probation period, to minimize the risk of hiring the wrong person.

To ensure that sufficient staff resources are available for peak periods and avoid, for example, excessive workloads that can lead to quality of work issues, firms may consider developing detailed plans setting out expected hours per engagement and related staff assignment schedules. If potential resource shortages are identified, the firm may consider hiring qualified temporary staff or cooperating with another practice with different peak periods to allow both practices to be fully staffed.

Assigning an individual responsibility for approving attendance at professional development courses and reviewing records annually of professional development courses taken by partners and staff will help ensure that they have up-to-date knowledge to properly serve the firm’s clients.

In-house training is often an effective approach. For instance, a firm may assign responsibility for monitoring new developments in accounting, assurance and tax to individual staff members and ask those individuals to present the new requirements and guidance to other members of the firm.

Engagement quality control review
Sometimes known as concurring partner review or second partner review, engagement quality control review provides an objective assessment of the appropriateness of the key judgments and conclusions reached in the issued engagement report.

Engagement quality control review provides an objective assessment of the appropriateness of the key judgments made and conclusions reached in the engagement report that is issued.

An engagement quality control review not only reduces the risk of inappropriate reports being issued, but is also an effective safeguard against certain threats to independence. For example, a familiarity threat may arise when a partner has been providing services to a client for many years. One effective way to safeguard against this kind of threat may be to subject the engagement in question to an engagement quality control review.

Firms may benefit from making their engagement quality control review criteria more robust. For example, a firm may decide that a quality control review should be undertaken in circumstances when one or more of the following conditions exist:

- the client has many passive shareholders;
- significant risks have been identified with the decision to accept or continue the client engagement;
- the client has entered into substantial new and complex transactions, such as derivatives and hedges;
- significant judgments need to be made (for example, there are difficult asset valuation issues); or

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material uncertainty exists as to the client's ability to continue as a going concern.

The engagement quality control reviewer cannot be a member of the engagement team. In the case of smaller firms, an external professional may serve in that capacity or the firm may choose to contract with another firm to provide engagement quality control review services.

Inspection of completed engagements
An inspection of completed engagements, also known as file inspection, must be performed on a cyclical basis. File inspection may yield many benefits, not only related to improving the effectiveness of future work, but also improving efficiency and lowering costs. A file inspection may be an effective tool in identifying areas where engagement teams may need to update their knowledge of new accounting or auditing standards. Considering that new standards such as Canadian auditing standards, international financial reporting standards and GAAP for private enterprises will become effective in the next few years, it is prudent for firms to have a robust file inspection process in place.

CSQC 1 provides a list of factors that may affect how a firm organizes its inspection cycle, including the timing of selection of individual engagements. The following are examples of things a firm should consider in establishing an inspection process:

- a firm may find it prudent to inspect complex and/or high-risk engagements annually and other engagements less frequently;
- if results of external practice inspection programs (for example, by the provincial institutes or the Canadian Public Accountability Board) or internal monitoring have identified significant deficiencies in files completed by a particular engagement team, the firm may find it wise to inspect engagements completed by the particular engagement team more frequently and may select such files without prior notification to the engagement team;
- in the case of a firm with engagements in a variety of industries, or where different types of engagement are performed, a firm may select engagements in a manner that allows it to inspect the full spectrum of industries and types of engagement.

CSQC 1 requires that professionals performing the engagement or the engagement quality control review not be involved in inspecting the completed engagement.

Smaller firms may need to use the services of a suitably qualified external person or another firm to carry out inspections of completed engagements. Such firms may arrange to share resources with other organizations to assist in certain monitoring activities.

Firms are required to have a quality control system compliant with CSQC 1 by December 15, 2009. Implementing this new quality control standard may look like extra work. However, as Thomas Edison said, “Opportunity is missed by most people because it is dressed in overalls and looks like work.” Firms are well advised not to miss this opportunity to establish a robust quality control system.

Chi Ho Ng, CA, CPA(IL), MBA, is a principal in the CICA’s Auditing and Assurance Standards department

Technical editor: Ron Salole, vice-president, Standards, CICA

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<td>69%</td>
</tr>
</tbody>
</table>

Even though it has been more than 20 years since the introduction of the general anti-avoidance rule (GAAR) and the Supreme Court of Canada has decided several GAAR cases, it is still difficult to predict whether the Canada Revenue Agency (CRA) or the courts will apply the rule to a particular series of transactions. No doubt this is due in part to the required examination of legislative intent, something rarely clear-cut. However, some trends can be gleaned from GAAR-related statistics.

GAAR committee statistics

It is well known the CRA has a committee that reviews potential GAAR assessments. This GAAR committee is made up of representatives from various divisions of the CRA, with participation as well from the Department of Finance and the Department of Justice. The committee advises on whether it is appropriate to apply GAAR in particular fact situations and whether the application is consistent with how GAAR has been applied in other cases. Although the committee has no statutory mandate and there is no legal requirement that CRA auditors adopt its advice, it is understood that they almost always do.

The GAAR committee periodically releases statistics as to the number of referrals and the number and percentage of affirmative decisions (i.e., approvals for the application of the GAAR), along with a generic listing of the issues under consideration. The chart above presents the statistics provided by the CRA for the first five years that such statistics are available (there are none for 1994) and the most recent statistics.

According to the CRA, these statistics are gathered on a somewhat ad hoc basis and as such may not be completely reliable. That said, they seem to reflect a couple of trends that are borne out by anecdotal evidence. First, if one looks at the cumulative GAAR referrals, the average increase per
year between 1993 and 2004 was about 50. The average increase between 2004 and 2009 was about 40. This trend is confirmed by CRA officials, who have indicated that the number of referrals continues to decline and as a result the GAAR committee meets less frequently than it used to. Secondly, the cumulative rate of affirmative decisions appears to be increasing. While the overall rate has normally fluctuated between 60% and 65%, it increased to 69% in 2009 from 62% in 2004. This means there has been a very high affirmation rate of new cases presented between 2004 and 2009 — more than 90%. While that figure could be exaggerated, this trend also conforms to CRA information.

The conclusion seems to be that fewer potential GAAR assessments are being referred to the GAAR committee, but that those that get there are more likely to be approved. The explanation for this may not be any change in CRA approach or policy, but rather an improved screening process with fewer cases that do not merit the internal standards of the CRA for application of the GAAR. In other words, if a client's proposed assessment or reassessment makes its way to the GAAR committee, there is reason for serious concern.

The 2009 statistics presented above do not take into account the following special projects:
- RRSF Project: 1363 files (GAAR secondary position);
- Barbados Spousal Trust Project: 76 files (GAAR secondary position); and
- 300 provincial GAAR cases.

Aside from these special projects, the single largest category of referrals to the GAAR committee is surplus stripping, which appears to be a catch-all for any transaction that involves the extraction of accumulated earnings from a corporation in a manner that does not involve the payment of a taxable dividend. Other issues include kiddie tax, Part 1.3 tax, offshore trusts, cross-border leases, Part XIII tax, rental losses, capital and noncapital losses, stop loss rules, charitable donations, capital gains, interest deductibility, debt parking, indirect loans, debt forgiveness, loss creation using stock dividends, tower structures and treaty exemption claims. Recall that the figures by subject matter are cumulative, and do not, therefore, indicate current activity.

The conclusion seems to be that fewer potential GAAR assessments are being referred to the GAAR committee.

Those that get there are more likely to be approved

and circumstances, litigation may be a reasonable alternative for a taxpayer faced with a GAAR assessment.

Second, tax court decisions on the application of the GAAR are rarely appealed, and when they are, they are rarely reversed. At the time of writing, the only fully successful appeal of a GAAR case was the Crown's appeal court victory in MacKay, 2008 DTC 6238. The loss generation transactions at issue in that case were similar to those considered in Mathew, which may be part of the reason the Supreme Court refused the taxpayer's leave application. The Supreme Court also dismissed the appeals in all three GAAR cases it considered; however, it overturned the appeal court's reasoning with respect to interest deductibility in the Lipson case, 2009 DTC 5015.

This deference to the findings of the tax court judge was endorsed by the Supreme Court in paragraph 46 of the Canada Trustco case: "Provided the Tax Court judge has proceeded on a
proper construction of the provisions of the Act and on findings supported by the evidence, appellate tribunals should not interfere, absent a palpable and overriding error.”

GAAR cases are, by their very nature, fact-driven, so this deference to the trial judge seems appropriate. But it also means that any party choosing to appeal a tax court GAAR decision faces an uphill battle.

Recent cases and cases to watch
There have been six GAAR cases decided over the past year or so: Lipson et al v. The Queen, 2009 SCC 1 (reverse attribution and interest deductibility); Remai v. The Queen, 2008 TCC 344 (charitable donation); The Queen v. Landrus, 2009 FCA 113 (terminal loss); Lehigh Cement Limited v. The Queen, 2009 TCC 237 (withholding tax on interest); Copthorne Holdings Ltd. v. The Queen, 2009 FCA 163 (surplus stripping); and Collins & Aikman Products Co. et. al v. The Queen, 2009 TCC 299 (surplus stripping). Of these, Lehigh and Remai are being appealed to the appeal court and perhaps Collins & Aikman as well. It is understood that the taxpayer will be seeking leave to appeal to the Supreme Court in Copthorne.

In addition, there are a number of GAAR cases brewing at the tax court. Appeals have been heard and decisions are pending in Garron Family Trust v. The Queen (offshore freeze) and Paul Antle v. The Queen (Barbados spousal trust). Pleadings have been filed in Global Equity Fund Ltd. v. The Queen (and similar cases) (loss creation transactions); Schiesser v. The Queen (RRSP strip); Aventis Pharma Inc. v. The Queen (offshore banking centre); Marchaux v. The Queen, Michael Edwards v. The Queen (leveraged charitable donations); Cunningham v. The Queen (kiddie tax); and Canadian Tire Corp. Ltd. v. The Queen (offshore reinsurance).

It is fair to say that the CRA does treat GAAR as a provision of last resort and its process for identifying and applying has become more efficient to address abusive tax avoidance. It was not intended to introduce uncertainty in tax planning. With more than 20 years of experience with the GAAR, it is fair to say that the CRA does treat it as a provision of last resort and its process for identifying and applying the GAAR has become more efficient. Once a file makes its way to the GAAR committee, there is a very significant risk that the GAAR will be applied. However, the application of GAAR is an inherently factual exercise and therefore will always be susceptible to some uncertainty and unpredictability. Given court statistics, it appears that a taxpayer who chooses to appeal a GAAR assessment has a greater than 60% chance of success. However, the success rate may decline if the CRA continues to refine its internal processes for determining GAAR-appropriate cases. In any event, almost any decision rendered by the tax court with respect to the application of GAAR is going to be difficult to overturn.

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Going down the paperless road

Document management need not be just for the experts — there is a system for the rest of us.

It’s getting difficult to attend a professional development seminar in accounting these days without encountering one or more sessions on the paperless office. While most practitioners have gone at least part way down the paperless road, many are having difficulty moving beyond the first tentative steps.

Many have experience with scanners; they are mainly used to scan documents, which are then e-mailed to clients or colleagues. When you think about it, all that’s been done is that fax machines (which involved only one step — faxing) have been replaced with a three-step process (scan, attach to e-mail and send). Once in a while, a document is scanned, saved to a PDF file and then lost because no one remembers where it is stored.

Most accounting and tax software prints a report or a return to a PDF file. Word processing files and spreadsheets can either be saved in their native file formats or exported/printed into a PDF file. Again, we have to decide where to store those files so they can be accessed easily.

Most of us have the hardware, software and experience to save the majority of documents in electronic format, whether those documents are created or converted from paper-based forms. The challenge comes in designing a logical, intuitive and consistent storage mechanism for those electronic forms. Not only do they need to be accessed quickly, but the storage mechanism must ensure they are safely stored, properly archived and backed up on a timely basis. Accountants have always feared disasters such as fires or floods that would destroy their paper files — the only record of their labour. They are even more uneasy when work is stored in transient electrons, which are susceptible to erasure, corruption or disappearance.

Elegant document management solutions such as DocIt and CCH Document have been developed for firms that have the volume and size necessary to amortize their significant up-front and installation costs — both in terms of dollars and hours. For those who are unable or unwilling to purchase a ready-made solution, there are a number of ways to manage electronic documents effectively.

One system available to anyone who uses a Windows operating system is the ubiquitous Windows Explorer. For a one-person office manned by someone experienced with Windows products, the directory and subdirectory (now called folders) structure of Windows Explorer offers a logical layout for document management. Unfortunately, the flexibility inherent in Windows Explorer can cause a range of problems when the system is accessed by less-knowledgeable people. Users need to understand how the system is managed in order to know where and in what format to store documents. It is difficult to design fail-safe and automatic procedures to ensure that documents are not lost or accidentally deleted.

Many small and medium-sized accounting firms use a document management system using CaseWare (CW). The main user interface in CW is called the Document Manager, which is an excellent backbone upon which to design a simple document management system.

Planning your document management structure

One issue in designing a document management system is planning how to lay out directories and how and where to store files so they can be easily retrieved. If using CW, a structure is in place to store client files, so why not use the same tool for all document management? Since staff...
may be familiar with CW, there is little learning curve involved with expanding it into a full-blown document management system. In fact, staff often drives the conversion and will suggest new ways to use CW to further reduce reliance on paper and speed up the transfer of files and documents to the document manager. There are a number of ways to deal with file continuity using this sort of system. With documents that will be referenced on an ongoing basis, subfolders can be set up on the CW document manager by year and type. The advantage is that the CW file is totally self-contained, and it can be accessed easily by staff working outside the office. By using the checkout procedures in CW, staff can transfer the file to a laptop. Alternatively, if file size is an issue, the documents can be stored elsewhere and referenced with a link provided on the document manager in CW. (The downside of storing the document elsewhere is the CW file is no longer self-contained. This makes working remotely more challenging as the user will have to find a way to connect to the office network remotely to access those documents.)

Implementing the CW document management system

CW comes with the capability to scan documents directly into its document manager. It’s just a matter of right clicking anywhere on the document manager and selecting new scan. It uses a standard PDF format and even contains its own PDF reader, which is faster than Adobe when opening a PDF file in CW. It takes only seconds to scan in the file, and the only decision left is what to call it.

Files that don’t have to be scanned (such as tax files, spreadsheets, word processing and PDFs created from accounting programs) can be linked with a few keystrokes and become accessible from the document manager by a double click. They can be linked from any location on the network; ideally, they should be saved into the CW file. For example, some may save all tax files as PDF files into the clients’ CW files when preparing their tax returns. Then, when preparing the year-end file in CW, they can simply link to the PDF stored in the CW file.

The facility exists in CW to create Word and Excel spreadsheets directly from within CW. Some firms have all their correspondence created in Word from within CW so it can be automatically placed on the document manager at the same time as the correspondence is created.

If you choose to store all documents in the CW file, backup and archiving is simplified. Once the CW file has been compressed, a relatively small file containing all the relevant documents for the client can be backed up. Since the number of files to back up is reduced, the process itself is simplified, and the practitioner can make as many backups to as many locations as needed. CW files can be backed up daily to a local and a remote external drive, archived to an external drive monthly, and archived to DVD media quarterly. All backups to external drives can be done using a simple Xcopy backup in simple batch file, which is easily scheduled on the server using the scheduled task program. Files can be copied rather than using a more traditional backup format so recent files can be easily called up in the event that today’s CW file is corrupted or deleted while working in it.

Reasonably well-equipped offices already have most of the hardware that is required to operate an electronic document management system

Hardware requirements

Reasonably well-equipped offices already have most of the hardware required to operate an electronic document management system. You will need at least one high-volume scanner for scanning multiple documents such as clients’ tax slips. The cost will depend on anticipated volume, but expect to spend between $1,000 and $2,500. If you don’t plan to scan existing documents and the primary use is to scan tax slips, then maybe all you need is something like the Kodak i220, about $1,100.

Each workstation can be equipped with an all-in-one printer/copier/scanner, about $200. Some firms use one or more network scanners, but many employees like having a unit at their desk and being able to scan the documents as they work on files as opposed to batching them. Test the scanner to ensure it will automatically scan into CW. The mentioned Kodak scanner, for example, is not compatible with versions of CW prior to CW2009.

Workstations can have dual monitors. Even without a document management system, a productive enhancement in any office is providing employees with multiple monitors. There are low-priced dual VGA display adapters, which were less than $50 each but are now difficult to find. An economical alternative is a USB multiple monitor attachment. USB devices have the advantage of being easily moved from one computer to another and can be attached without opening the computer case.

Notes of caution

When planning the implementation of a document management system, impress on users that having a scanner doesn’t mean they have to scan everything. If you don’t need to keep a document in a paper file, you don’t need to keep it in an electronic file. Scanning everything can be an amazing time waster.

Scanner drivers offer the option of various resolution levels. Unless you want to create gigantic files that are time consuming to compress and expand, scan documents in black and white. For the few that do not scan properly in black and white, use gray scale, not the millions of colours’ mode.

Ready to take the leap?

If you are using CW, there is little transition involved if you want to use it as a document manager. Plan the structure carefully and involve all staff early in the process.

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How to stay out of the rough

Understanding and getting started on adopting the new Canadian auditing standards will make the task easier

One day this summer, a group of friends — Lara, Meigan, Caitlin and Jacqui — all CAs, were playing a round of golf. Like many accountants, their minds didn’t wander far from work.

Halfway through the round, Lara, a sole practitioner, hit her ball into the rough: “Well, here I am in the rough again! It seems like you standard-setters are going to make audit practice rougher too. The latest release of the Handbook is twice as long as it normally is.”

“We’re not trying to mess up your golf game or your practice,” said Jacqui, who is with the CICA’s assurance standards department. The July 2009 release of the Assurance Handbook is bigger because it contains two parts, she explained. Part I includes the Canadian auditing Standards (CASs) and Canadian Standards on Quality Control (CSQC3), as well as sections and guidelines from the existing Handbook that don’t relate to audits of financial statements or historical financial information. A few existing guidelines relating to financial statement audits are also included. Part I of the Handbook is effective for years ending on or after December 14, 2010. She went on to explain that Part II of the Handbook includes the existing sections and guidelines and is to be used on engagements that have a year-end before December 14, 2010.

“Don’t worry about the length — it’s only temporary.”

“I heard that CSQC 1 has an earlier effective date,” said Caitlin, who is with a large accounting firm. “Isn’t it effective as at December 15, 2009? My firm has begun updating its system of quality control to be compliant with the new requirements.”

“Sounds like your firm is using the right club from their bag,” Jacqui joked. “You and your firm are absolutely correct. Everyone should be looking into this sooner rather than later to avoid any penalty strokes.”

As they finished the hole, Meigan asked why Part II was included in the Handbook.

“Practitioners may find that they will need to use both parts of the Handbook, depending on the circumstances of the client,” Jacqui replied. “For example, Lara mentioned that while most of her clients have December 31 year-ends, she has a couple of November 30 year-ends. In 2010, she will need to use Part II when auditing her November 30th clients.”

As the round continued, the group discussed the nature of the changes and how they would affect their work.

On the next green, Jacqui noted that Lara had a new putter. Lara said she was trying a new approach because she had been missing so many putts lately. “Speaking of changes, what has really changed in the standards?” she asked, after sinking a 20-foot putt. “You said you’re not making things more difficult for me. How different...”
are the CASs from the existing Handbook sections relating to audits?"

There is quite a bit of change, Jacqui explained, but not as much as you might think. Many existing Canadian auditing sections were based on the equivalent international standard. "The clarification of the auditing standards by the IAASB and their subsequent adoption in Canada as CASs didn’t result in significant changes in these standards," she said. "For example, there were very few changes to standards on fraud, audit risk and audit planning. I know you adopted the new audit risk standards when they were introduced back in 2005, so for you, there are relatively few changes regarding how you assess and respond to risks of material misstatement. It’s like buying a new set of golf clubs. If you bought them a few years ago, you’re already used to them, but if you buy them this year, it’ll take you a bit of time to adjust."

On the other hand, Jacqui continued, some of the auditing standards have changed significantly. "The new audit report looks a lot different from the existing one. Standards related to terms of engagement and group audits also changed quite a bit."

"What’s this about the audit report?" asked Meigan, who is a CA in industry. "How has it changed?"

Caitlin asked for an explanation of the differences. "I have a lot of clients who don’t understand the current report," she said. "How am I going to explain the new report to them?"

"The new audit report is a lot more detailed than the old report," Jacqui said. "In Canada, current GAAS reflects a simple model. General purpose financial statements have to be prepared in accordance with GAAP or US GAAP to get a clean auditor’s report. Special purpose financial statements prepared under regulation or contract can be prepared using a non-GAAP framework, but the auditor’s report must contain an emphasis of matter paragraph stating that such statements don’t follow GAAP. The new auditor’s report will contain more information, which is an improvement over the old report. It explains in more detail the role of management and the auditor, and explains what an audit is. The report will include subtitles, which will help draw the reader’s attention to the different sections of the report."

"The dating of the audit report has also changed," Jacqui continued. "Instead of the old way of dating a report when the audit is substantially completed, auditors will now be required to date the report no earlier than when those responsible for the preparation of the financial statements have approved them. This may result in reports being dated later than is the case now, which means that more work will have to be done to audit subsequent events, unless the time needed for approving the financial statements is shortened."

"Speaking of more work, I do a lot of group audits," Caitlin said. "I’ve looked at the new group audit standard. It appears to be a lot more robust than the existing standards, with a number of new requirements. It looks like there will be a lot more work to do under the new CASs — like playing a different course that is longer and has more difficult greens. Is that right?"

"Well, I haven’t heard it put that way before," Jacqui said. "But you’re right."
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Globalization slowdown

The financial crisis has significantly reduced the pace of globalization. International trade fell 12% in 2009 and won’t rebound to 2007 levels for another three years. On reflection, this slowdown is happening at the right time. Globalization has been running off the rails for a few years now and a break will allow us to take the steps needed to get back on track.

Very few economists will tell you that international trade is not a good thing. It does, however, impose obligations, particularly on exporting countries, as we have seen with the sporadic scandals involving imported foods. And melamine-contaminated dairy products from China are not the only offenders. Canada and the US tried to export genetically modified grain to Europe, where its sale is prohibited. In other related incidents, the safety of nonfood products and the working conditions in production plants have been questioned.

The global integration of production presupposes a concurrent harmonization of manufacturing/production conditions for exports, a goal still far from being reached. Conditions remain lax in a number of countries, particularly in emerging ones. There are also major differences between what is considered legal or illegal from one country to the next, whether we’re talking about genetically modified organisms, generic drugs or computer programs. It will be some time before harmonization, currently often based on bilateral agreements, is achieved worldwide. In the meantime, it may be preferable not to depend solely on international trade to meet our consumer needs.

One of the most troubling aspects of globalization is industry concentration arising from megamergers. For example, three companies, Rio Tinto, BHP Billiton and Vale, now control 75% of the world’s iron ore production — a concentration seldom allowed in domestic markets — making it easy to fix prices. However, few countries have the actual power to prevent such mergers on a global scale, which leads to high concentration levels in areas from produce to basic manufactured products such as steel and aluminum to more sophisticated items such as certain software packages. Only the EU acts as a merger watchdog, albeit from a European perspective. China, a major importer of iron ore, has also taken action in this respect, although it has been relatively uncoordinated because it isn’t equipped to prevent such mergers.

The economic recovery will spark a new wave of international mergers as companies look to enhance their market position. They will be backed by their governments, which are fond of these giants when they set up head offices in their territory. As a relatively small country with an open economy, Canada is at risk in this environment. We should be concerned about these megamergers, making sure they are reviewed before they get the green light.

In the end, however, the behaviour of globalized financial institutions is the greatest cause for concern in terms of the adverse impact of unregulated globalization. A few hours before multinational Lehman Brothers filed for bankruptcy in September 2008, the US parent drained the coffers of its international branches to repatriate liquid assets, leaving empty shells abroad. A number of countries were less than appreciative of this move. More and more, governments will be regulating foreign institutions in their territory. What’s more, as recently witnessed with the quarrel between Swiss bank UBS and the US government, this control will also cover foreign transactions carried out by a country’s residents. In short, in the financial sector, countries are reaffirming their right to regulate the forces of globalization, which is laudable in light of the recent financial crisis.

Let’s hope that the Canadian government — ever naive about such issues — will also take note.

Marcel Côté is founding partner at SECOR Consulting in Montreal
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