In a skittish market, accurate information can have a calming effect.

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The perils of your portfolio

A piecemeal approach and investing in US assets could wreak havoc with your hard-earned capital

Conventional wisdom has it that diversification is the wise approach to investing. Consequently many investors split their assets among several managers and brokers, taking a hodgepodge approach with minimal oversight. But how successful is this way of investing? Every November, we devote the issue to personal financial planning, and the lead story this year is by Michael Nairne and Joanne Swystun, investment counselors at Tacita Capital Inc. in Toronto. They say the typical investor has a stable of managers who haven’t been seriously evaluated in years, a couple of recent hotspots recommended by friends and a broker running some stocks and bonds. And often, each manager is unaware of how much capital the others are dealing with or what they are doing with it. In “Fragmentation will bomb,” p. 20, they explain that piecemeal approaches result in aggregate costs that can make wealth creation difficult. These costs, they say, are often hidden from the unsuspecting investor. This very educational story, which gives a breakdown of the costs of fragmented investments, is a must-read for anyone investing in these uncertain times.

The second story in our package is about the dreaded US estate tax. Many Canadians believe the grass is greener south of the border and want to buy property in the US and invest in US securities. But how can they do this while avoiding or reducing estate taxes that can be quite onerous? A Canadian with more than $5 million invested is subject to this tax. In “Haven or hell,” p. 28, Robert Blumenfeld, a Florida attorney, tells readers the various methods to avoid estate tax.

Our columnists are in fine form in this issue: Jim Carroll owes his optimism to Google (Netwatch, p. 12). He tells us how Google alerts help him keep a sense of perspective in a world of doom and gloom news by focusing on topics that are important to him. In Outlook (p. 56), Marcel Côté is sure to spark some controversy with his views on how right-wing ideologues in the US are favouring individual rights over collective rights, which is contributing toward the recession. Côté believes Canada should think twice before adopting the American way.

We have regulars on personal financial planning, taxation, insololvency, fraud and assurance. The fraud regular (p. 45) is particularly interesting. It focuses on people who try to lessen responsibility for wrongdoing by claiming to have a mental illness. Writer and technical editor David Malamed says that being aware that depression can be a factor in fraud can help a forensic accountant in knowing how to communicate with a suspect or witness in a case.

Okey Chigbo, Editor
upfront

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When Toronto CA Andrew Imrie took up the triathlon in 2003, it was mainly to stay in shape. Then he began setting specific goals for his training. And the new focus paid off last year when he won a triathlon in Ottawa. This year Imrie qualified for the Ironman World Championship in Hawaii

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Things always seem to look greener south of the border. But when it comes to investing in US property or securities, Canadians need to first consider the US estate tax. But is there a way to invest in US entities and reduce or eliminate that dreaded tax?
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Breaking news, tax updates, job postings, archives, more articles: you’ll find them all at www.CAmagazine.com
I must congratulate Marcel Côté on his commentary regarding changes to the Senate in “Political nearsightedness” (Outlook, September). Côté’s comments regarding the nonrepresentative nature of the Senate are correct. Given that the ratio of senators to provinces ensures that any tweaking to the way in which senators are “seated” will never result in proportional representation, there is no point to what Stephen Harper is trying to do. Being elected doesn’t mean the results will be better, but it almost certainly means there will be more rancor between the houses and less will get done.

The Senate’s purpose is to provide second, sober analysis of proposed legislation and it is rare that it does more than attempt to modify legislation. Without constitutional amendments any reforms enacted will be subject to constant reinterpretation at the provincial and federal levels. This will create an uncertain situation for senators that will either cause them to “shut up if they know what’s good for them” or pursue their own electoral politics. The idea of second, sober thought will be thrown out the window.

If the current Senate offers no value, abolishing it would be better than trying to change from an appointed Senate to an elected one. I am surprised that Harper is even pursuing this, as the Senate has not hindered his legislative agenda.

Christopher Loucks, CA
Kitchener, Ont.

Côté rightfully points out the irrelevance of the Canadian Senate. He says the “senators have little political legitimacy” and “the Senate is in fact an anachronism.” Its role of providing a second, sober review of proposed legislation is a fantasy. Harper proposes that as a reform its members be elected, but this would not address the core question. Such reform would only prolong an ineffective and costly institution that Canada can ill afford, symbolically or financially. In 2005, the NDP and the Bloc called for the Senate’s abolition. In light of the merits of doing away with the Senate and in honour of the late Jack Layton, I suggest the government get on with resolve to abolish this political relic.

Ken Wightman, CA
Unionville, Ont.

ALL CLEAR NOW

My compliments and a great big thank you to Dwayne Bragonier for demystifying cloud computing with a well-written article (“Still foggy on cloud computing?” September). It was clear and easy to read, with simple, effective analogies.

John Robshaw, CA
Toronto
Why invest the time to get to know our clients?
Because we care to fully understand what you're up
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understanding so we can help you achieve your ambitions.

IT ALL STARTS WITH BUILDING
A GREAT RELATIONSHIP.

Strong relationships with over 50,000 business clients
across Canada have proven our commitment.

BDO. MORE THAN YOU THINK.
Cycling the 90 km of a half-ironman triathlon is hard enough, sandwiched between a 2-km swim and 21-km run. Ontario CA Andrew Imrie, however, made the race even more difficult when he took a wrong turn on his bike and added almost 3 km to the Peterborough Half-Ironman in July. Amazingly, he still won the race by almost five minutes — about the same amount of time he lost on his detour — finishing in four hours and 17 minutes. The irony? Imrie is a Peterborough, Ont., native, to which he attributes the error: “I took the route the course had always followed, not realizing it had changed this year. That’s the last time I take a course for granted.”

The 34-year-old director of corporate reporting at Cineplex Entertainment in Toronto started racing in 2003, mainly as a means to stay in shape. A competitive swimmer in his youth — he also swam varsity for Queen’s University — he began to compete for the top spots after learning how to maximize his training. “It was breaking a mental barrier,” he says. “I asked myself at one point, ‘Why can’t I go faster? If my current limit is x, why can’t it be y?’”

He recalibrated his training, giving it more structure and setting specific goals. Most important, he improved his running to where it’s the strongest of the three sports. “That’s helpful when it’s the last stage of the race,” he says. His new training focus began to pay off last year, winning the National Capital Triathlon in Ottawa, where he defended his title in July.

He attributes much of his current success — in August he qualified for the Ironman World Championship in Hawaii, scheduled to take place just after press time in October — to his CA skill set. He points to links between managing work projects to managing his training. “I’m a numbers guy, so I spend a lot of time poring over the data on my training,” he says. John Shoesmith
Keeping clients is top concern

Retaining quality clients is the top issue facing CA practices, according to a CICA survey conducted on behalf of the International Innovation Network. Among the 664 owners (partners/sole practitioners) of Canadian CA firms polled, nearly nine in 10 (87%) rate client retention as critical or very important.

Keeping up with changes in accounting and auditing standards is the No. 2 issue on the list, with 80% rating it critical or very important, up 5% from the previous survey conducted in 2007. Staying on top of professional development requirements (80%) and adapting to changes in rules of professional practice (75%) were third and fourth on the list, respectively.

Although 10% fewer respondents rate balancing work and personal issues as critical compared with 2007, it remains critical or very important for 74%, placing sixth on the list. Related to this is balancing work through the year (65%), which ranked eighth. Practice owners say they continue to find tax-season peak periods particularly challenging.

Hiring and retaining qualified staff ranks ninth (64%), although 30% rate it as critical. While this is down 7% from 2007, it is still the third most likely item to be rated as critical.

Practice owners from smaller and rural practices say they continue to have difficulty finding and retaining qualified staff.

John Tabone is CICA’s manager of member value and research services.
Canadian companies recommending their employees join social networking sites such as LinkedIn, according to a June survey.

Years since Ernst & Young created a Facebook page to recruit students — the first company ever to do so. Today, E&Y’s career page has more than 69,000 followers.

Percentage of Canadian accountants using networking site LinkedIn for business, according to a May survey; 18% of respondents said they were members of Facebook.

Percentage of Canadian companies that today forbid employees from using social media sites at work. In 2009, the figure was 58%.

Percentage of English-speaking accountants using social media in Canada in a professional capacity, according to a 2011 survey. One-third of French-speaking Canadian accountants claim to use social media, while the figure is 57% in the United States.

Percentage of Canadian companies employing social media to promote visibility that have no “formal or measurable objectives” for those marketing practices.

Videos produced by Deloitte staff in 2007 to describe the firm’s culture and values. A Deloitte Film Festival is held and the best films are uploaded to YouTube to promote the company among potential hires.

Tweets sent from August 2010 to August 2011 by the US Financial Accounting Standards Board to keep accountants up to date on reporting, compliance and other issues.

Going Concern

KAREN GAVAN, FCA
PRESIDENT & CEO, THE ECONOMICAL INSURANCE GROUP

COMPANY PROFILE: Founded in 1871, the Waterloo, Ont.-based group is currently Canada’s eighth largest property and casualty (P&C) insurer, managing $4.5 billion in assets and $1.3 billion in policyholder equity. It consists of eight member firms with 2,600 employees and deals with 900 independent brokers.

COOL PROJECTS: The group is about to become the first Canadian P&C insurer to demutualize under new rules. Industry members have discussed options with the federal regulator. Many expect the final process will be similar to the one that governed major life insurer demutualization in the 1990s. With the change, insurers will become shareholder-owned rather than policyholder-owned entities. They will be able to tap into wider capital markets more easily to finance internal infrastructure and resource investments as well as to facilitate growth and the acquisition of strategic partners. That will lead to a more resilient P&C sector.

HOT FACTOR: The group’s online quote, sales and insurance portfolio management tool, Insurance on Demand, won an Insurance Canada Technology Award as well as the US-based 2011 Insurance Accounting and Systems Association Technology Innovation Award. It was the first Canadian company to receive the prize. Earlier this year Economical was named a top-100 learning-focused company at Elearning Media Group’s Learning 100 Awards, and Training magazine ranked the firm second in its annual list of the top-125 global companies that excel in human capital development.

IN HER OWN WORDS: “The industry is still recovering from the 2008 crisis resulting from losses in our investment portfolios and from auto insurance frauds. Of the seven insurers ahead of us, five are stockholder owned. The board decided that better access to capital from demutualization would position us to become a dominant player.”

Ken Mark

Steve Brearton

With 15 million Canadians claiming to be active Facebook users, can businesses ignore social media? Accounting firms have often been early adopters.
CCH Scan is a paperless software solution loaded with intelligent features and options that boost T1 volumes and increase efficiency. By using CCH Scan, Gordon B. Lee Chartered Accountants reduced tax preparation time by 10 to 20 minutes per return, saving hundreds of hours of manpower.

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CCH Scan can classify 140 plus types of slips. Advanced AutoFlow technology automatically imports all common T-slips and RRSP documents into Personal Taxprep.

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Easily, with CCH Scan.

“What I like the most about CCH Scan is the time and cost savings plus the accuracy of the final tax return.”

Gordon B. Lee
Gordon B. Lee Chartered Accountants
Show me the money, Canadian workers say

Employees in Canada consider base pay the most important part of their employment deal by a wide margin, according to a 2011 report by consulting firm Mercer. Yet only 53% of the 2,000 workers polled say they are satisfied with their base pay.

In addition, just 52% of respondents believe that pay in their organization is as good as or better than the pay offered by other organizations in their geographic area.

Canadian workers’ dissatisfaction with pay is contributing to a decline in employee engagement, indicates the report, with a total of 58% “checked out” on some level and one-third seriously considering leaving their employer. Other markers of engagement are also down (see chart below).

“Employers with modest budgets for salary and promotional increases may be left with few tools to recognize and retain key people,” says Iain Morris, human capital business leader for Mercer in Canada.

<table>
<thead>
<tr>
<th>Employee engagement in Canada</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010</td>
</tr>
<tr>
<td>My work gives me a feeling of personal accomplishment</td>
</tr>
<tr>
<td>I feel a strong sense of commitment to my organization</td>
</tr>
<tr>
<td>I am proud to work for my organization</td>
</tr>
<tr>
<td>Overall satisfaction with my job</td>
</tr>
<tr>
<td>Overall satisfaction with my organization</td>
</tr>
</tbody>
</table>

Source: Mercer, 2011

'Til retirement do us part?

Married couples are having a communications breakdown when it comes to planning the when, where and how of retirement, according to a US study by Fidelity Investments.

Nearly two-thirds (62%) of couples polled who are approaching retirement don’t agree on their expected retirement ages, while one-third (33%) either don’t agree or don’t know where they plan to retire. Furthermore, nearly half (47%) the couples don’t agree on whether they will continue to work in retirement.

“Far too many [couples] don’t take the time, or have the comfort level, to jointly discuss their plans for the future,” says Kathleen Murphy, president of personal investing at Fidelity.

Indeed, three-quarters (73%) of couples cannot even agree on whether or not they have completed a detailed retirement income plan, the study finds.

NEW ROLES FOR CFOs

Canadian financial executives continue to take on responsibilities outside traditional accounting and finance, according to a survey by Robert Half Management Resources. About one in five CFOs polled said they have become more involved in IT (21%) and human resources (18%) in the past three years.

STAR EMPLOYEES MOVE ON

Despite a generally slow job market, 75% of North American companies lost top talent in the past year, finds a survey by human resources firm Right Management. This is a significant increase from the 54% of respondents who reported losing talent the previous year in a similar survey.

NO MORE CAREER FOR LIFE

Nearly half of working Canadians expect to switch careers within the next five years, according to a survey by staffing firm Kelly Services. The main reasons cited by the 4,000 Canadians polled were improved work-life balance (24%), changing personal interests (24%) and higher income (23%).
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The Better Way to Pay.
I owe my optimism to Google

I am a heavy user of the Google Alerts system; it constantly scans the web for articles about future trends, innovations and many other topics that are central to my business and beliefs.

It’s a perfect tool for keeping up to date on what is going on in the world, since it can focus on topics that are important to you. It can also be the antidote to the sense of gloom that can develop if you rely on the 24-hour news cycle of radio and television. Stories of ongoing stock-market volatility, political gridlock in the US and a never-ending European debt crisis imply there isn’t much left to enjoy in the future — that it’s all downhill from here.

That’s why when Google Alerts pulls up a little nugget such as The Washington Post article “Tech company to build science ghost town in NM; backer says project will be economic boost” (Sept. 6, 2011), you get some reassurance that everything is going to be A-OK.

Apparently, the plan is for a Washington-based company to build New Mexico’s “newest ghost town to test everything from renewable energy innovations to intelligent traffic systems, next-generation wireless networks and smart-grid cyber security systems.” This could be the perfect laboratory-type environment to help shape our world through the next several decades. For years, I’ve been suggesting that we are entering a world where everything around us is linking together and that this is going to lead to fascinating new developments.

Put this New Mexico town in perspective in relation to an article that appeared in the Globe and Mail a couple of weeks earlier (“Google gets behind the wheel,” Aug. 25, 2011). The piece outlined how Google was actively testing a series of vehicles in the San Francisco Bay area that would auto-pilot themselves through city streets, using Google Maps and a series of internal and external sensors on the car.

Fast-forward a decade or two — or maybe less — and you can see a world in which we’ve solved some of our energy, infrastructure, transit and city-crowding problems through some extremely intelligent infrastructure. Science fiction? I don’t think so.

Everyone has an option as to how he or she wants to prepare him- or herself for the future: as a pessimist, convinced the frequent twists and turns in the global economy indicate economic gloom is our future, or as an optimist, who knows there are a tremendous number of innovative people dedicated to discovering the next big thing, and working to solve some of the major problems our global society faces.

This ghost town in New Mexico could turn into one of the most important innovation engines of our time. I have no doubt that at some point we will have highways and city streets full of cars that effortlessly guide themselves along. We’ll have extremely smart buildings that will regularly interact with the presence and activities of their inhabitants to manage their energy usage, helping to reduce our use of energy worldwide. We’ll see the emergence of fascinating, hyperconnected healthcare technologies that will allow an increasing number of baby boomers to live out their senior years in the comfort and safety of a connected community rather than traditional seniors homes.

The future is out there — and it’s yours if you choose to watch it and track it.

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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Benchmarking survey 2011

In December 2010, we launched our first-ever business process benchmarking survey (see www.camagazine.com/benchmarking-survey10). The idea was to give organizations a chance to compare their performance with that of other organizations to expose possible problems and targets for improvement. Given the lack of benchmarking data in Canada, we were sure we could all benefit.

Unfortunately, the survey did not draw enough respondents to provide statistical reliability. But we learned a lot in the process and have made improvements that we hope will encourage you to participate, if you have not already done so.

First, a few lessons we learned — or relearned.

1. There will always be people who try to beat the system. We had a number of respondents who entered bogus data just to see the results. We have fixed this problem by scanning for bogus data and eliminating the results they generate.

2. For any given metric, the results can change dramatically according to the size of the organization and other factors. For example, a large, complex organization might take months to complete the budgeting process, while a small company might take just days or weeks. That is why the benchmarking survey tool allows you to compare your organization’s metrics by industry, company size, complexity and region.

3. Accounting and ERP systems don’t contain some of the data that could be used in the benchmarks. In these cases, you have to decide whether it makes sense to look for the information, depending on the value of knowing the metric.

4. Before starting the survey, it helps to know what data you will need. The system will allow you to download the list of metrics in advance.

Now for the changes and improvements we have made since last December.

• Simplifying. The first version contained 63 metrics across 15 business processes — too daunting to handle for many organizations, even though you could skip over many of the metrics. We now offer a “light” version with 13 of the most important metrics. You can always switch to the advanced version later.

• Expanding the respondent base. The business process benchmark tool will be opened up to other organizations to increase the number of respondents.

• Introducing new metrics. We have added manufacturing to the business processes and have included metrics for efficiency (standard labour hours/actual labour hours x 100), timeliness (percentage of production completed on time), quality (percentage of products returned and scrap percentage) and cost (production downtime/total available production time x 100).

The results can change dramatically according to the size of the organization and other factors.

• Adding accounting/ERP systems to the mix. In addition to comparing your organization by industry, company size, complexity and region, you can see how you compare with other organizations that have the same accounting/ERP system as yours.

Despite our best efforts, organizations might have their own reasons for choosing not to participate, with concerns about confidentiality being chief among them. We will release information only in the aggregate and not publish any individual responses. We have also steered clear of financial metrics for revenue and costs.

For an expanded version of this article, please visit www.camagazine.com/benchmarkingsurvey11. For the survey, visit www.180benchmarks.com. Please complete it by January 15. As always, suggestions for improvement are welcome.

Michael Burns, MBA, CA • IT, is president of 180 Systems (www.180systems.com), which provides independent consulting services, including business process review, system selection and business case development. Contact 416-485-2200; mburns@180systems.com
Specialty Meat Producer uses ERP to Pack Confidence

Proveal Inc., located in Milton, Ontario, is a specialty meat processing and packaging company. Opened in 1992 by Willem Vergeer and his wife, Mariska Vergeer, Proveal currently employs some 20 workers in a 14000-sq. ft. processing plant, and markets its product lines to national retail and food service customers in Canada and the United States.

In 1999, Proveal went shopping for an Enterprise Resource Planning (ERP) solution. “We needed an integrated system that would give us optimum information for minimal effort,” says Vergeer. “In the food industry, the margins are very tight, and you need to know your costs. In addition, you have to ensure complete food security, as specified by HACCP, the industry-required food safety program.”

Proveal’s search for an ERP eventually led the company to SYSPRO. “It had everything we needed,” says Vergeer, “I’m not really an IT person, but I was amazed at all the things SYSPRO could do.”

The implementation of SYSPRO was an important strategic component for Proveal’s growth and development. “SYSPRO’s interaction between incoming goods and outgoing finished products has enormous operational value,” says Vergeer. “Being able to control our product and our cost with full traceability from every BOM detail has allowed us to position ourselves strategically as a niche manufacturer.”

As Proveal realized the power of its new ERP, the software itself became a fundamental selling tool. “SYSPRO is the ‘added ingredient’ that helps establish the quality of the entire company,” says Vergeer. “If we have visitors, we show them the plant, the product, and the way that everything is integrated under SYSPRO.”

National retail and food service operations, explains Vergeer, need to have one-hundred percent faith in the quality of their suppliers’ products. “Our clients have all been very impressed with the accuracy and detail that SYSPRO provides. Our consistency and full product control gives them confidence in their relationship with us. In addition, we have received very positive comments after every mandatory third-party audit.”

Over the years, SYSPRO’s modules have grown with, and even anticipated Proveal’s needs. “We rely heavily on full product traceability,” says Vergeer, “as well as detailed BOM cost controls, product movement analysis, sales analysis, forecast analysis, historical planning control and SYSPRO’s many other features. They make it possible for us to run a tightly controlled processing facility in a very competitive business environment.”

In today’s marketplace, says Vergeer, rapid access to information can be critical. “Every day of the week our customers are asking us for information. In addition, industry-required food safety programs, like HACCP, all demand information at a moment’s notice. SYSPRO has proven over and over that it delivers full control, confidence, and peace of mind – all at the touch of the button.”

In 2010, says Vergeer, by way of example, when the Canadian government listed bisphenol A (used in the manufacture of plastics) as a toxic substance, one of Proveal’s biggest customers asked the company if bisphenol A was present in their packaging materials. “If you keep your SYSPRO system updated,” says Vergeer, “it’s extremely efficient.” In this instance, Proveal had the answer within two hours, and the customer was reassured.

“We’re proud to be SYSPRO users,” concludes Vergeer. “Furthermore, we can state with confidence to our colleagues in the industry that SYSPRO ERP is an excellent ingredient for the success of an organization in the food sector.”
To better inform the overall consultation process, the national CA and CMA organizations commissioned an independent survey to gather opinions of the business community about a potential CA-CMA merger. Survey respondents included business owners and executives, 95% of whom have responsibility for selecting their company’s external professional accounting firm and/or for hiring people for midlevel and senior financial positions.

Once provided with a brief summary of the key points of the proposed CA-CMA merger, a majority of those sur-

### Survey results

**OPINIONS OF CANADIAN BUSINESS LEADERS ABOUT CA-CMA MERGER**

<table>
<thead>
<tr>
<th>Statement</th>
<th>Agree</th>
<th>Disagree</th>
</tr>
</thead>
<tbody>
<tr>
<td>A merger of the CMA and CA designations would be positive for Canadian business</td>
<td>57%</td>
<td>13%</td>
</tr>
<tr>
<td>A combined qualification process that takes the best of the CA and CMA programs would result in better quality professionals for Canadian businesses</td>
<td>69%</td>
<td>8%</td>
</tr>
<tr>
<td>A merger of the CMA and CA designations would be positive for the Canadian public</td>
<td>54%</td>
<td>13%</td>
</tr>
<tr>
<td>The differences between the CA and CMA designations are blurring</td>
<td>58%</td>
<td>17%</td>
</tr>
<tr>
<td>The CMA and CA designations have very unique skill sets and it would be challenging for businesses to find the specialized skill sets they need if these two designations were combined</td>
<td>39%</td>
<td>28%</td>
</tr>
<tr>
<td>It would be beneficial to have a designation (chartered professional accountant) that is aligned with both CPA and CA — the two most widely recognized accounting designations globally</td>
<td>72%</td>
<td>9%</td>
</tr>
<tr>
<td>A consistent code of conduct would be beneficial to Canadian businesses</td>
<td>85%</td>
<td>3%</td>
</tr>
<tr>
<td>Creating a single qualification process and designation for professional accountants will make hiring easier in the future</td>
<td>64%</td>
<td>13%</td>
</tr>
<tr>
<td>If the CPA designation included post-qualification specialties (similar to those found in medicine and law) this would allow businesses to continue to find the specialized skill sets they need if the CMA and CA were combined</td>
<td>68%</td>
<td>9%</td>
</tr>
<tr>
<td>Creating a single qualification process and designation for professional accountants will reduce confusion over which accountant is best</td>
<td>67%</td>
<td>17%</td>
</tr>
<tr>
<td>The Canadian CPA would create confusion with the US CPA designation</td>
<td>38%</td>
<td>28%</td>
</tr>
</tbody>
</table>

Notes: “Agree” column represents a combined total of “strongly agree” and “somewhat agree” responses; “disagree” column represents a combined total of “strongly disagree” and “somewhat disagree” responses; remaining responses included “neither agree nor disagree” and “don’t know”
The Dictionnaire — updated and revised

The 2011 edition of Dictionnaire de la comptabilité et de la gestion financière is a unique English-French dictionary of accounting and financial management terms.

A first-rate tool for accounting professionals, financial managers, translators and anyone striving for the right word in accountancy-related fields in English or French, the Dictionnaire is a valuable resource for those who want to understand the terms they encounter in their work or in their readings. Available as a fully searchable Internet-based version on CICA’s knotia website, on CD-ROM or in print, this practical guide will help users find precise and nuanced answers to all their questions concerning accounting and financial management terminology.

The 2011 edition contains more than 840 new entries, and nearly 40% of the main entries have been modified to reflect and integrate the terminology used in international financial reporting standards and in auditing standards (ISA and CAS). In all, it offers 8,661 entries covering more than 16,400 English terms with corresponding French terms and/or definitions.

Four organizations from three countries collaborated on the Dictionnaire — the Canadian Institute of Chartered Accountants, France’s Conseil supérieur de l’Ordre des Experts-Comptables and Compagnie Nationale des Commissaires aux Comptes de France, and Belgium’s Institut des Réviseurs d’Entreprises. Main author Louis Ménard, FCA, MBA, is a professor at the École des sciences de la gestion of Université du Québec à Montréal.

For more information, visit www.castore.ca and search for “dictionnaire.”

Transfer pricing — time to take notice

The increased scrutiny with respect to transfer pricing by the Canada Revenue Agency is raising alarm bells with leaders of multinational entities across Canada, causing them to look at ways to protect themselves through proper documentation and methodologies.

According to recent information from the director of the international tax division at the CRA, the number of reassessments from transfer-pricing-related issues has jumped to approximately 1,200 in 2010 and resulted in more than $1.4 billion of additional tax being assessed. Assuming the assessments were evenly distributed, each entity would have owed about $1.2 million of additional tax.

To assist CAs and other professionals in this marketplace, the Canadian Institute of Chartered Accountants (CICA) is developing an In-depth Transfer Pricing Course. This course will complement the CICA’s existing in-depth offerings and provide members with a more complete and robust stable of tax and trade training products that meet the demands of today’s professionals.

The CICA’s In-depth Transfer Pricing Course will provide a benchmark for fundamental transfer-pricing knowledge to members and nonmembers in both public practice and industry, as well as professionals in the CRA and other government settings who focus in this area. To learn more about the CICA’s new In-depth Transfer Pricing Course and expected offering dates as they become available, please visit www.cpd.cica.ca/transferpricing.
**Standards digest**  Want to be kept informed? Log on to [www.cica.ca/stds-subscribe](http://www.cica.ca/stds-subscribe)

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**Documents for Comment**  IASB Re-exposure Drafts Regarding Leases and Revenue Recognition

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Legend

- CP – Task Force Consultation Paper
- ED – Exposure Draft
- DII – IASB Draft Interpretation
- EDI – ED based on IFRS/ISA
- IP – Issues Paper
- ITC – Invitation to Comment

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With today’s low rates and lukewarm valuations, ignoring the perils of a piecemeal approach means investors could be losing precious returns

By Michael Nairne + Joanne Swystun

Frag·men·ta·tion
WILL BOMB

The fast pace of life today makes time and attention scarce resources. This is particularly true for busy professionals and businesspeople grappling with an uncertain economy. As such, it is understandable that many people take a fragmented and passive approach to investing, splitting their investable assets among a hodgepodge of managers and brokers in a series of ad hoc decisions followed by only cursory oversight.

A typical investor’s stable of managers is comprised of some old standbys who haven’t been seriously evaluated in years, a couple of recent hotshots recommended by friends, and a broker running some stocks and bonds. And often, each manager is unaware of how much capital the
others are dealing with or what they are doing with it.

Such a piecemeal approach often results in a host of costs that in aggregate can materially impair wealth creation and, in the extreme, inflict lasting harm. And, like the proverbial iceberg lurking under the surface, these costs are hidden from the unsuspecting investor, so the damage can persist and compound for years.

Toting up the costs of fragmentation

The forgone free lunch One of the most remarkable discoveries in modern finance is that diversification can improve the expected return of a portfolio without increasing its risk. What is extraordinary is that this higher return is absolutely free. All it requires is a thoughtful, integrated approach to portfolio construction. When a portfolio is assembled in a haphazard manner, many investors forgo much of the proverbial free lunch available from proper diversification.

To illustrate, compare two portfolios. One is fragmented among a grab bag of managers hired on an ad hoc basis and the other reflects an integrated approach to a unified investment plan. Assume that, as at January 1, 2001, the first portfolio is comprised of 30% Canadian bonds and 70% equities. To roughly approximate mutual fund asset mixes at that time, 40% of the equity portion is allocated to Canada, with the remaining 60% split equally between US and international developed countries.

The asset mix of the fragmented portfolio is depicted in the pie chart above right.

While at first blush having a group of managers may appear diversified, in aggregate a jumble of managers is most likely to emulate broad market indices. On this basis, over the 10 years ended December 2010, a period that includes two severe bear markets, the fragmented portfolio earned a 3.6% compound annual return.

Contrast this with the integrated portfolio depicted in the pie chart below. This robustly diversified portfolio incorporates a broader range of assets and a greater diversity of equities. It still has 30% allocated to bonds but instead of being allocated solely to investment-grade bonds, a small piece is allotted to Canadian high-yield bonds. Equities are reduced to 55% from 70% of the portfolio to make way for a 15% allocation to real assets, including Canadian real estate investment trusts, energy stocks and gold. The equity component is much more diversified, with allocations to value and small-cap stocks as well as emerging markets.

This integrated portfolio earned a 6.8% annual return, leagues ahead of the 3.6% return of the fragmented one. As illustrated in the chart on page 24, $1 invested in the integrated portfolio grew by 93¢ to $1.93, more than double the 42¢ growth generated by the fragmented portfolio.

Yet, there was no difference in the volatility of these two portfolios. (The standard deviations of the fragmented and inte-
grated portfolios were 9.25% and 9.24%, respectively.) Although they have similar patterns of movement over time, the integrated portfolio pulled far ahead in wealth creation.

**Failure to rebalance** A portfolio must be balanced at regular intervals to maintain risk levels compatible with the investor’s goals and tolerances. A failure to rebalance can result in unwarranted losses and over the long run forgone gains. Rebalancing imposes a discipline of selling high and buying low, as some of the better-performing assets must be sold and replaced by more poorly performing assets.

As markets oscillate over time, rebalancing has the potential to increase returns. For example, over the past four decades (January 1971 to December 2010), a portfolio made up of one-third Canadian, one-third US and one-third international stocks that was rebalanced annually had a return that was 0.4% per year higher than a non-rebalanced portfolio. And more important, this was achieved with slightly less overall volatility. Over 40 years, this rebalancing gain compounded to 15% greater wealth — a handsome reward for proper oversight.

When capital is scattered among a number of managers, it’s easy to lose track of the portfolio’s exposure to risky assets. This is particularly true during bull markets when escalating stock values can lure investors into complacency. Over time, this unmanaged drift can result in excessive equity allocations that leave an investor perilously exposed to loss.

This happened often during the run-up of stock prices from 2003 to 2008. As Canadian stocks more than doubled, many investors reveling in their returns failed to rebalance their portfolios by selling equities to buy bonds in order to keep risk levels compatible with their goals and tolerances. The global credit crisis hit them like a tsunami. As stocks worldwide plummeted by more than 50%, many investors awakened too late to the excessive riskiness of their portfolios.

**Balance-sheet blindness** Proper portfolio planning should extend beyond the investable assets to encompass the investor’s entire balance sheet and, in particular, the nature of any business risks. When the selection of managers and their mandates ignores broader balance-sheet realities, risk levels and hence potential losses can easily escalate. In good times, it’s easy to forget that the value of private businesses can be as volatile as public companies, a fact obscured by the absence of mark-to-market pricing for private company shares. In tough economic conditions, however, when businesses are under financial stress or even fail, it becomes only too apparent that these assets share many of the same risks as publicly traded stocks.

The savage downturn in the Canadian manufacturing sector over the past several years is a case in point. Integrated planning that considered cyclical, private-business interests as higher risk equity assets typically resulted in more conservative strategies for the investment holdings elsewhere on the balance sheet.
Hence, as the value of private-business equity plummeted in 2008, assets such as federal and provincial bonds rose, helping to offset damage to the overall balance sheet and also acting as a source of liquidity.

Fragmented planning on the other hand can leave individuals in the dark while amplifying the risks they face. In one instance, a part owner of a small marketing firm placed a hefty part of her portfolio with a high-octane small-cap manager. Just as the recent downturn hammered her firm, her small-cap investment fell by more than 60% — a distressing double whammy. In another case, an owner of a business that was dependent on sales to the US was angered to find that the soaring loonie not only undercut his business but also wreaked havoc with his US stock portfolio.

Cognitive costs Behavioural-finance experts have identified a litany of cognitive biases that can distort investor decision-making and lead to unnecessary costs.

First, investors frequently exhibit what is called “narrow framing” — the inclination to view facts in a narrow context, failing to consider the whole picture. When managers are selected on an ad hoc basis, it’s easy to hire managers who have overlapping investment mandates. For example, over the past several years, stronger Canadian stock-market performance has led to many investors overallocating to Canadian equity managers, leaving global equity managers underrepresented in their portfolios and forgoing the opportunity for superior diversification.

Investors also display loss aversion and the disposition effect. Loss aversion is the tendency to feel more pain from losses than pleasure from gains. This contributes to the disposition effect — the tendency to hang on to losing funds, preferring to wait to get even rather than suffer a loss. When managers are hired in a fragmented manner and not objectively benchmarked against appropriate indices, losing managers may be retained simply to avoid the pain of a permanent loss.

Investors also evince the endowment effect — or the tendency to value what they have more than what they don’t have. Over time, investors can develop an attachment to a particular stock or manager even in the face of chronic subpar performance.

Herd behaviour, the tendency to follow the crowd, interacts with cognitive biases, particularly loss aversion, to create a pattern in which many investors end up buying high and selling low as the market moves through its inevitable cyclicalit.

The propensity to buy high and sell low means investors, as a group, earn returns well below those of their fund investments. Investment research provider Morningstar found that from 2000 to 2009, US mutual-fund investors earned returns 1.5% a year less than the funds themselves earned. Over the entire decade, emotionally driven investing cost investors 14% in forgone investment wealth.

A fragmented approach with only casual oversight allows these cognitive biases full rein, hijacking potential returns. Without a unifying investment strategy and process, emotions can more easily dominate, leading to ill-timed decisions, excessive trading costs and adverse performance results.

Needless taxes and penalties Fragmented investing almost inevitably leads to unnecessary tax bills. In many cases a registered retirement savings plan (RRSP) is assigned to one manager or broker while other managers are handling the nonregistered investments. In the absence of strict guidelines, this typically leads to the RRSP being at least partially invested in Canadian equities. Meanwhile, the managers of the taxable accounts are busy investing a portion of the investor’s capital in bonds, the interest on which is more highly taxed than Canadian dividend income or capital gains. The investor is left as the unwitting beneficiary of a negative tax arbitrage. As simple as this mistake is, it is extraordinarily common. One US study found that the average household misallocates one-third of its taxable bonds to taxable accounts.

Unnecessary taxes can also arise when investments are not appropriately distributed across the various household accounts. When a low-bracket spouse has nonregistered money, a fragmented approach can easily miss the opportunity to reduce taxes by allocating Canadian preferred and common stocks to that account to better capitalize on the enhanced dividend tax credit.

Similarly, dividends on US stocks placed within a tax-free savings account (TFSA) as opposed to an RRSP are subject to normal withholding tax since a TFSA is not a pension trust under the Canada-US income tax treaty, as is an RRSP. And, of course, the foreign tax credit for the withholding tax is not available in a TFSA as it is for unregistered accounts.

When investments are handled by numerous managers, it’s
possible for foreign stocks, bonds and exchange-traded funds to creep up to $100,000-plus in costs without the investor being aware. In such a case, if a T1135 Foreign Income Verification Statement is not filed on time, the investor could face a fine of $25 a day to a maximum of $2,500. And that’s for each year of failing to file. Furthermore, the $100,000 limit applies to any time during the year, so monitoring this aspect effectively requires a monthly statement compilation.

Wealthier individuals using multiple managers can also unknowingly be exposed to US estate taxes. Speaking generally, under current law, if the value of a Canadian resident’s worldwide assets exceeds US$5 million and he or she owns US situs assets, which include stocks and bonds of US companies, US real estate and US business assets, there can be US estate taxes on death. A family coping with an untimely death hardly needs the added unhappy news that the managers who independently loaded up on US stocks left the estate with a serious tax liability.

Advantages of scale Big is beautiful in the world of portfolio management. Larger bond positions can be bought at better prices than smaller purchases. Similarly, trading commissions are spread more thinly over larger transaction sizes. Scale in the fund world means graduating from retail-unit classes to high-net-worth or institutional classes where fees are lower. Most portfolio managers and custodians offer tiered fee schedules where each successive tranche is charged at a lower rate. Some go so far as to consolidate multiple-family-member portfolios to help the family qualify for a lower average fee. By reining in the number of investment-service providers, material savings are often realized.

While the indirect costs of fragmentation can prove damaging, paying excessive direct costs is certainly a luxury most investors cannot afford.

Method to the madness
The only sure way to avoid the pitfalls of fragmentation is to implement an integrated investment strategy. This process has five key elements.

A written investment plan Called an investment policy statement (IPS), this written document sets out the strategic game plan for a family’s investments. Like all good plans, an IPS starts with a statement of the investor’s objectives. It should also define the investor’s risk profile and identify an appropriate asset mix that is compatible with both the defined goals and risk parameters. A comprehensive IPS will also spell out rebalancing guidelines, manager-selection criteria and performance benchmarks, and the frequency of reports and policy reviews.

Experienced, do-it-yourself investors might try their hand at designing their own plan. For most individuals, the better option is the growing number of portfolio managers who will create a proper IPS as part of their service or develop one on a consulting basis.
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Allocate your investments tax effectively  Proper investment tax planning should catalogue the entire gamut of existing and potential asset locations within the investor’s household and the related tax reduction or deferral opportunities. These include traditional vehicles such as RRSPs, registered education savings plans and TFSAs, as well as the opportunities presented by a low-tax-bracket spouse or child. The recommended asset mix should be allocated appropriately across the household accounts, including any holding companies or family trusts, to minimize the present value of potential taxes.

Although the Canada Revenue Agency and the courts have eliminated some income-splitting techniques over the years, there are still ways to shift capital within the household. Spousal loans, family trusts and gifting strategies are examples. Accountants, in particular, can advise in this area.

Carefully select and assess managers  In an integrated approach, managers are assigned specific asset class and investment strategy mandates to form a cohesive portfolio-management team as set out in the IPS. Manager selection for these mandates can be undertaken by the investor directly or with the assistance of professionals. There are a growing number of independent portfolio-management firms that can assist in manager selection. The explosion in exchange-traded funds has dramatically increased low-cost and tax-effective index options and increasingly these are forming the core of an integrated portfolio. Individual management performance then needs to be assessed on a regular basis.

Consolidate reporting  One of the critical weaknesses of a fragmented approach is the absence of a regular consolidated picture of the family’s investments. Whether it is compiled by the investor, an accounting firm, or a custodian or portfolio manager, it is a crucial step in understanding the performance status of the entire portfolio.

Monitor and rebalance  A portfolio is a dynamic creature that needs to be monitored and rebalanced as necessary; even an integrated portfolio is no place for cruise control. Accountants can play a vital role in monitoring changes to tax and pension laws as well as the investor’s tax situation and overall financial situation. Revisions to the plan should be implemented sooner rather than later, since time is money in the investment world.

Investors who ignore the perils of fragmentation can leave precious investment returns on the table. In today’s world of depressingly low interest rates and lukewarm stock valuations, investors can ill afford a piecemeal approach.

Michael Nairne and Joanne Swystun are principals of Tacita Capital Inc., a family office and investment counselling firm that provides integrated wealth advisory and portfolio management services in Toronto.
Things might look greener south of the border. But when it comes to investing, beware the dreaded US estate tax. But with a little good advice, you might just get around it.

It seems everyone wants what other people have. Americans want to buy property in Mexico because the beaches are perceived to be better, the ocean bluer and the seas saltier. They want to invest in Mexico because their impression is that the yields are higher and the risks lower. Similarly, Canadians want to buy property in the United States because the weather is warmer, and they want to invest in US securities because they think investments there are better, higher yielding and safer.

Whether perception meets reality is akin to the phrase “beauty is in the eye of the beholder.” In any event, Canadians continue to buy property in the US and invest in US securities and entities. Perception aside, we need...
A second class of nontaxable entities, called “portfolio debt instruments,” are a special class created solely for the nonresident alien investor. They fall into the “died and went to heaven” category, as they are not subject to US income tax, estate or gift tax.

Direct investments
To encourage investment in the US, US bank accounts owned by foreigners are not subject to estate tax at the death of the account’s owner. However, there are two caveats to be observed here. First, if the bank account is effectively connected with a trade or business in the US, it becomes subject to taxation. Second, the account must be with a US bank. Many people put their funds in a money-market account with a brokerage house. To the uninformed, there is no distinction between the money held in a brokerage house and the money on deposit with a bank. Unfortunately, the IRS sees such accounts differently. Money-market funds are viewed as shares of stock in the brokerage house, $1 per share, and are taxable in the estate of a nonresident.

A second class of nontaxable entities is called “portfolio debt instruments.” These securities are a special class created solely for the nonresident alien investor. They fall into the “died and went to heaven” category from a foreign investor’s perspective. They are not subject to US income tax, estate tax or gift tax. However, before getting into such investments, investors would be wise to consult with their account executive or broker.

Other investments, other solutions
Before getting into the techniques available to avoid or postpone US estate tax liability, there is one more important caveat: if you already own assets in the US, be they shares of US stock or a house in Palm Beach, Fla., in your name, and you try to transfer these assets into a foreign entity that is not in your name but which you control, the IRS will tax these assets in your estate if it learns of such a transaction. An example of this might be a condominium in St. Petersburg, Fla., which you purchased in your own name several years ago. You later decide you want to create a situation in which this asset is not subject to US estate tax so you form a corporation in Canada of which you are the sole or controlling owner. You transfer the title to the condominium to that corporation. In the Internal Revenue Code, there are three sections called the string sections. Here you purportedly give something away or transfer it but maintain control over its use or enjoyment. In the eyes of the IRS, you haven’t given it away because you can still use it to control its enjoyment in the hands of other people. So how do you avoid the string trap? There are two things you can do: sell the assets you own in the US and purchase replacement assets with funds coming directly from the newly created Canadian entity, or sell the US assets to the Canadian entity, but you must remember to pay fair market value for these items. A below-market sale can create the difficulty cited above.

There are a number of methods to consider to avoid the dreaded estate tax.

The foreign trust solution. Many foreigners who own US assets create foreign trusts, for example in Barbados or the British Virgin Islands. Many US tax planners have a preferred list of foreign havens whose laws are best suited for structuring such an entity. But to set up such a trust, there are costs involved, including initial setup costs, which may be several thousand dollars; annual service costs; and some type of cost relating to filing income tax returns. At the end of the day, however, if it is structured properly, the US property — be it securities or real property — owned by the trust will not be subject to the 35% bite of the US estate tax. However, the trust may be subject to US income tax based on the entities held by the trust.
The partnership. This could be a minefield for the unwary because of the unsettled status of partnerships. Let us say you and two Canadian friends decide to buy a building in the US. To shelter it from US estate tax, the three of you create a Canadian partnership that purchases the building. But what happens if one of the partners dies? Is the building within the partnership taxable by the IRS? There is a split of authority here. Many US investment counselors follow the ruling in a case called Blodgett v. Silberman, 277 US 1 (1928). It holds that the situs of any intangible is the domicile of the decedent. Since a partnership is an intangible, the partnership itself and all its components will be nontaxable by the IRS at the death of one of the partners. Known as mobilia sequuntur personam for those who enjoy working with the Latin phrase, this principle, which is the key to this case, holds that if a person who is legally domiciled in one jurisdiction dies with property in a second jurisdiction, that property is legally treated as though it were in the first jurisdiction.

But it is not all that simple. Unfortunately the IRS does not see it this way. It looks upon a partnership as a transparency. Like Alice in Wonderland, the IRS looks through the looking glass at the components of the partnership and taxes those that would be subject to taxation if the partnership did not exist. (Personal disclosure: having worked at the IRS as a senior attorney for 32 years, my thought on the matter is that partnerships are to be avoided. There are other avenues available to reach similar results so why incur the wrath and taxation of the IRS.)

The corporation. Perhaps the easiest way to own assets in the US is through a Canadian corporation (or for that matter, a corporation formed in any country but the US). The purchase methodology for bringing assets into this corporation is important. As opined earlier, you cannot include US assets that you already own in your own name into such a corporation. In addition, when this corporation purchases assets in the US, your money should go directly into the corporate bank accounts that will be the source of acquisition seed money for purchases of US assets. If you, the owner of a Canadian corporation, write cheques directly to a title company or a brokerage house, the IRS may attack the corporation as a sham. But setting up such a corporation is relatively easy to do properly, although it may take an extra step or two. Considering that few of us like to subject our assets to a 35% tax that can easily be avoided, you should be very circumspect about how you proceed. A foreign corporation, even one that owns US assets, is not subject to US estate tax. Therefore, via this corporation, you could own unlimited US assets that would still not be subject to estate tax at the time of your death.

The qualified domestic trust. This is a tax-deferral technique that can only be utilized by married people. Assume that Henry and Wendy are Canadians who are married to each other and own US$20 million worth of assets in the US. Upon the death of either Henry or Wendy, the US$20 million passes to the survivor. Clearly this is well in excess of the $5-million threshold available...
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under the US-Canada tax treaty, and Henry and Wendy have not put these assets into a Canadian corporation. Should Henry die unexpectedly, what would happen? Here the Internal Revenue Code, which generally disallows assets passing to a surviving spouse who is not a US citizen to qualify for the marital deduction, makes an exception. If the surviving spouse is willing to create a qualified domestic trust and place the assets into such a trust, the tax is not avoided but is deferred until the survivor either dies or takes assets from the trust, either at one time or over a period of years. As assets are extracted from this trust (or the spouse dies), the deferred tax comes due on April 15 after the year in which the extraction or second death occurs. Although this does not avoid the US estate tax, it is akin to obtaining an interest-free loan for the life of a qualified domestic trust. Who else would loan you several million dollars for several years without charging interest? Isn’t the IRS great? Just a word of warning: to qualify this trust for the marital deferral, the trustee on trusts exceeding US$2 million must be a US bank. Additionally, to prevent a Canadian capital rollover, there must be at least three trustees, two of whom must be Canadian citizens.

The nonrecourse loan. Under US tax law, any debts or expenses such as mortgages must be prorated in the ratio of US assets divided by worldwide assets multiplied by any debts or expenses taken as deductions on the tax return. An example might be a Canadian who has an estate worth $4 million, inclusive of a $2 million mortgage on a $3 million US situs property. Therefore the full amount of the mortgage would not be deductible, only the prorated portion. An exception to this is if the mortgage is nonrecourse paper. In order to be nonrecourse, the prerequisite is that only the property can be held responsible for the mortgage, and if the value of the property does not cover the mortgage, the owner of the property cannot be held responsible for the excess debt. Therefore, if the $2 million mortgage were a nonrecourse mortgage, the $2 million would be directly deductible against the US assets to determine the taxable estate. (However, I have never seen a successful nonrecourse mortgage situation.) But US banks are loath to loan money to a foreigner predicated only on a property in the US. Foreign banks are also generally loath to loan money on real property located in a foreign country. Additionally, if the nonrecourse loan is from a close relative, the IRS will probably call it a sham and require apportionment.

These are the primary ways to invest in the US and successfully address the 35% crunch of the US estate tax. However, some of these techniques may create problems north of the border and local advice may be required.

Robert Blumenfeld is a Florida attorney who was a senior attorney with the IRS international tax group in Washington, DC. He can be reached at rblumenf@aol.com
Realistic retirement

When planning for your golden years and sustainable retirement income, there is fantasy and then there’s reality.

Take a look at your recent portfolio statement. Does the growth of your retirement assets follow the forecast in your original retirement plan? If you are a bit worried about your retirement finances, you are not alone.

One of the challenges of distribution planning is to make an accurate estimate of sustainable withdrawals such that market risk, longevity risk and inflation risks are covered for life. Once you know how much you will need during retirement, you can then calculate the size of your assets that will provide this cash flow. These assets must be large enough to finance not only the distributions, but also provide a sufficient cushion to overcome the effects of these risk factors for the rest of your life.

Projecting portfolio growth

Notice the term “portfolio growth,” not portfolio shrinkage. In reality, there is portfolio shrinkage, the fees you pay and the losses you experience. If you are holding average mutual funds, you pay about 20% to 30% of the portfolio value at age 65, as fees over the entire ensuing retirement period. This amount can be reduced significantly, to about 7% to 10%, by using low-cost diversified exchange-traded funds. At low withdrawal rates, portfolio costs can have as much impact on longevity as optimizing your asset allocation or chasing the best managers.

There are three practical ways of modeling the portfolio outcome: forecasting, simulations and aftcasting.

The straight-line forecasting method uses formulas suitable for calculation of time value of money. With that, you need to make certain economic assumptions about future growth and future inflation. There are shortcomings of such methods, especially during retirement when ongoing portfolio withdrawals are made.

Simulation, a modeling method especially popular among academics, uses Monte Carlo simulators, which generate thousands of forecast scenarios based on certain future economic assumptions with some fluctuations around them. The size and frequency of these fluctuations are usually determined by applying some form of Gaussian “normal” distribution formulas (a.k.a. bell curves).

The inherent problem with these simulators is that...
they can simulate the volatility of returns reasonably well but fail miserably when it comes to simulating the sequence of returns. In real life, a secular trend might be bullish and last 20 years (1920-1929, 1949-1962, 1982-1999). Or it might be sideways, which can last just as long (1900-1920, 1938-1948, 1964-1982). Simulators based on Gaussian mind-set are incapable of accounting for trend discontinuities that can have a great impact on wealth creation and preservation. Even when rare “fat tail” factors are incorporated into planning software, important multiperiod trends aren’t captured.

Going one step further, each secular trend is made up of several cyclical trends that are generally caused by business cycles. The cyclical trends create specific sequences of events; that is patterns of directions in inflation, interest rates, bond yields and equities with a specific array of intercorrelations and phase gaps.

When randomized, there is a one in 16 chance of modeling this typical sequence of events in the correct order. In other words, if you run 16,000 simulations at random, only 1,000 of these will likely have the correct sequencing of each component. The remaining 15,000 runs do not fit the historical sequencing reality and thus render the entire simulation useless.

As opposed to straight-line forecasting or Monte Carlo simulations, aftcasting uses the inflation rates, equity returns and proxy bond returns as they occurred in history. While future rates and market cycles have yet to play out, this approach is preferred because it addresses the sequence of returns issue and lays out the outcomes exactly as they would have occurred in the past.

**Planning criteria**

Next, parameters for the retirement plan should be defined. There are three significant financial risk factors in retirement.

**Longevity risk**: when designing a retirement plan, the age of death should be selected so that the probability of survival does not exceed 10%. The mortality tables indicate that if the current age is between 60 and 74, then the survival rate is below 10% at age 97. If your current age is between 75 and 81, then it is 98.

**Market risk**: quantifies the probability of portfolio depletion. This number should not exceed 10% at the age of death used for the plan. Otherwise, irreversible calamities can happen. If the market risk is more than 10%, even slightly, the market history shows you would need an exponentially higher level of genius or luck to recover from a routine market correction.

**Inflation risk**: refers to the ability of maintaining the purchasing power. (My limit is 10%, i.e. the income stream must stay above 90% of the requested withdrawal amount after adjusting for inflation throughout the retirement period. While this isn’t an issue in the example following because the withdrawals are fully indexed to inflation until the portfolio depletes, this can be important in the case of guaranteed income vehicles such as any variable annuities, variable pay annuities, or index-linked annuities that do not provide full inflation protection.)

A retirement plan must meet all three criteria to be considered a well-designed plan. As an example, take Bob Smith, 65, who has $500,000 in his portfolio. His asset mix is 50% TSX index and 50% fixed income. He is retiring and wants $25,000 pretax each year from his portfolio. His age of death is planned for 95.

**Straight-line forecast example**

Assume that we can get the same type of returns as the Canada Pension Plan Investment Board hopes for — 4% over and above inflation. The historical inflation has been 3.3% since 1900, so we assume a 7.3% average annual growth rate for Bob’s portfolio.

The chart on page 34 displays the forecast, which looks fantas-
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tic. Bob’s $500,000 investment grows gradually to $700,000 by age 85, because his initial withdrawal rate of 5% ($25,000 of $500,000) is below his portfolio growth. But, because of annual indexation of withdrawals by 3.3%, his withdrawals start exceeding the portfolio growth around age 85. From that point, his capital declines. But he doesn’t have to worry because by age 95, he is projected to have about $600,000 (pretax) assets to pass on to his children.

Look at your financial plan. See what age of death, average return and inflation rate were used. Look at the chart that shows your plan’s forecast. Retrieve your statements and calculate your portfolio’s internal rate of return (IRR) since inception. Does your actual IRR exceed the assumed portfolio growth rate stated in your original financial plan? If yes, keep going. Otherwise, ignore all excuses and reconsider your assumptions in a realistic way.

**Aftcast example**

An aftcast of Bob’s retirement assets is more interesting. On the chart on page 35, the shaded aftcast area represents numerous thin lines. There is one line starting at the left vertical axis for each year since 1919 (Canadian historical equity market data is not available prior to 1919). Each aftcast line displays 40 years of Canadian portfolio history for each starting year before 1972. After 1971, each aftcast line ends in year 2010. There are 2,915 data points that reflect the actual market history, interest rate and inflation, exactly in its historical sequencing.

There are also heavy black, green, blue and red lines. The black line is the forecast done earlier, using 7.3% portfolio growth and 3.3% inflation. The green line is the lucky outcome, which is the top 10% (top decile) of all historical outcomes. Note the forecast line is at about the same level as the lucky line at age 95, meaning there’s a 90% probability that our fantastic forecast won’t happen.

The blue line is the median where half the portfolios did worse and half did better. The red line is the unlucky outcome; the bottom 10% (bottom decile) of all historical outcomes. The aftcast tells us that the probability of running out of money by age 95 is 52% (i.e. 52% of the gray shaded area falls to zero before the age of 95). This is a material breach of the 10% criteria.

It is probable that future extremes will be more severe than historical extremes. Review the total asset value every five years. If it has declined by more than 15% (excluding withdrawals and any additions) since the last review, recalculate the sustainable withdrawal amount. Also, when unexpected or unplanned withdrawals occur, recalculate the sustainable withdrawal amount.

Enjoy your retirement!

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Restructuring guidance

The OECD’s new guidelines help taxpayers and authorities deal with business restructuring, but questions still remain.

To deal with the effects of the economic downturn, international expansion or centralization, many businesses are, or are considering, restructuring their operations, including reorganizing their supply chains or rationalizing their operations. Generally, business restructurings are material transactions that raise transfer-pricing issues, in addition to those taxpayers face under domestic tax legislation. Tax authorities, including the Canada Revenue Agency (CRA), are focusing attention on the area of business restructurings. As a result, restructuring has become a relatively new and highly contentious area of transfer pricing in Canada.

In July 2010, the Organization for Economic Co-operation and Development (OECD) issued revisions to its Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. The revisions included a new chapter, Chapter IX — Transfer Pricing Aspects of Business Restructurings. These changes are the first major amendments to the guidelines since 1998. While the revised guidelines provide much-needed guidance on the transfer-pricing implications related to business restructurings, uncertainty still exists.

In Canada, the CRA has issued little guidance on business restructurings. However, it has long stated its adherence to the guidelines. In addition, the CRA was actively involved in developing the revised guidelines. As such, the guidelines will likely have a strong influence on how the CRA audits business restructuring transactions in Canada.

Business restructurings

A business restructuring is defined in the guidelines as “the cross-border redeployment by a multinational enterprise of functions, assets and/or risks.” Examples include:
- conversion of full-fledged distributors into limited-risk distributors or commissionaires;
• conversion of full-fledged manufacturers into contract manufacturers or toll manufacturers; and
• transfers of intangible property rights to a central entity within the group.

Chapter IX of the guidelines contains four parts, each addressing certain transfer-pricing issues arising from business restructurings.

Special considerations for risks
Transfer prices are significantly influenced by which parties bear risks and by the significance of those risks. Therefore, risks are of critical importance in the context of business restructurings. The guidelines provide guidance on the circumstances in which a tax authority may challenge the contractual allocation of risk resulting from a business restructuring.

The guidelines indicate that it is not necessary to have comparable transactions between arm's-length parties to support the contractual allocation of risks between parties not dealing at arm's-length, but in the absence of comparables, it will be necessary to demonstrate that the allocation is arm's-length. The guidance focuses on two criteria that can be used to test whether a contractual allocation of risk is arm's-length: control of the risk and financial capacity.

In order to control a risk, a party must have the capacity to make decisions about assuming the risk, and whether and how to manage that risk. It must also have the financial capacity to bear the consequences of that risk.

According to the guidelines the choice of transfer-pricing method should be consistent with the risk profile of the business, or stated another way, the transfer-pricing method does not determine, but rather is based upon, the risk profile of the business.

Arm's-length compensation for the restructuring transaction
One of the key points in the guidelines is that a reduction in profit potential for an entity following a restructuring does not, by itself, demonstrate that compensation would be paid to the restructured entity in an arm's-length situation. However, where there is a transfer of something of value, such as rights or other assets, or the termination or renegotiation of existing arrangements, compensation may be paid in an arm's-length situation.

The guidelines introduce the concept of “options realistically available” in order to evaluate whether compensation is required in a business restructuring. Independent enterprises would only enter into a transaction if it does not make them worse off than their next best alternative. The analysis therefore must take into account the perspectives of both parties to the restructuring. The guidelines don’t provide detailed guidance on how this approach is to be implemented.

Remuneration of post-restructuring intercompany transactions
The guidelines indicate that the arm's-length principle should not apply any differently to post-restructuring activities than it would to transactions that were structured as such from the beginning. The guidance also emphasizes the importance of a before and after analysis of the functions, assets and risks (functional analysis) of all the parties involved in the restructuring.

Recognition of the actual transactions undertaken
Chapter IX provides further commentary on the circumstances in which tax authorities may disregard the transactions established by the taxpayers. It reiterates statements made elsewhere in the guidelines that the nonrecognition of actual transactions should be limited to exceptional cases, which is intended to mean rare or unusual. Tax administrations may disregard transactions in cases where the economic substance of the transaction differs from its form or the transaction or arrangements differ from those that would have been adopted by independent enterprises in comparable circumstances.

Key implications for Canadian multinationals
From a Canadian perspective, the CRA has historically focused on the concepts of the control and financial capacity to bear the consequences of risks and has been using the recharacterization provisions of paragraph 247(2)(b) of the Income Tax Act to challenge business restructuring transactions, in particular transfers of intangible property rights to related foreign parties. The CRA has also been challenging post-restructuring arrangements and reviewing whether compensation should be paid to Canadian entities that are party to a business restructuring, including some cases of Canadian plant closures.

From the guidance, certain basic principles can be identified that all multinationals should consider in the context of a business restructuring.

Sound commercial reasons
Likely the most important aspect of a business restructuring from a tax perspective is that there must be sound commercial reasons, or a business rationale, underlying the restructuring.

Establishing the business purpose may be straightforward in situations such as a supply-chain restructuring aimed at improving efficiencies and/or reducing costs, but may be more difficult for other transactions that might otherwise be motivated primarily by tax reasons. Key issues to be considered include the reasons for the restructuring and the cost/benefit analysis performed (on a pretax basis) prior to the implementation of the restructuring.

Importantly, the guidance notes that, based on the arm's-length principle, it’s not sufficient that the restructuring is executed for sound commercial reasons for the organization as a whole; the arrangement must be arm’s-length at the individual legal entity level as well. This may not always be obvi-
ous. For example, if on a global basis, a decision has been made to transition all manufacturing activities, including those in Canada, to a lower-cost jurisdiction, what is the business purpose for this change to the Canadian entity viewed on its own? Consideration would have to be given to the existing contractual arrangements, the Canadian entity's profit potential before and after the restructuring, the options realistically available to the Canadian entity, as well as any compensation for the restructuring itself. Having said that, the guidelines do imply that if the restructuring is commercially rational for the entire group, transfer pricing related to compensation payments would generally be available to make the arrangement arm's-length for individual group members. This seems to imply that a business restructuring could always make sense — at the right price.

**Economic substance**

Once a business purpose for the restructuring has been established, it is critical to determine the economic substance of the transaction and to demonstrate that it is consistent with the form of the arrangements and with what would be expected between arm's-length parties. The conduct of the parties will be paramount.

Consideration will need to be given to the risks of the parties both before and after the restructuring. The party that purports to have control of the risk must have the capability to do so. This includes having employees or directors with sufficient knowledge, expertise and authority to manage the risks. For example, if intangible property rights are transferred to a related foreign entity, company A, as part of a restructuring, it would be expected that company A has the capability to make decisions related to the strategy, development, maintenance and exploitation of the intangible property. Day-to-day monitoring of a risk can be outsourced to another party, but company A must be able to control the risks.

The party controlling the risk must also have the financial capacity to bear that risk. If not, it is doubtful whether a risk would be assigned to a party in an arm’s-length situation. Consider the example where company B bears customer product liability risk and enters into an arrangement with company C pursuant to which the latter will reimburse any liability claims suffered by company B. If company C does not have the financial capacity to assume this risk, such an arrangement may not be effective from company B’s perspective and likely would not be entered into in an arm’s-length situation.

In the context of a business restructuring, it will also be important to demonstrate what has changed as a result. What functions are now being performed by other entities in the group? How has the burden of potential risks changed? What assets, both tangible and intangible, have been transferred as a result? If a business restructuring is alleged to have occurred, but there has been no change in the functions and risks of the relevant parties, the tax authorities will have reason to question the legitimacy of the restructuring and the implications that flow from it and may seek to disregard the transactions entirely.

**Compensation**

Arm's-length compensation, both as a result of and following the restructuring, will need to be determined. The guidelines clearly state that compensation is not required for a mere decrease in the expectation of an entity’s future profit as a result of a business restructuring. What should be determined is whether there has been a transfer of something of value or a termination or renegotiation of an existing arrangement that would be compensated at arm’s-length.

One of the important factors will be to consider the “options realistically available” to the parties. As noted above, generally, independent parties would not enter into a transaction unless it left them better off than their next best alternative. Existing contractual arrangements between the parties should be reviewed. For example, prerestructuring activities may be governed by a contract that provides that either party may terminate the arrangement upon notice. The contract may also contemplate what, if any, compensation should be paid upon a termination. In some cases, a restructured entity may have no other option than to accept the conditions of the restructuring.

One of the concerns with the introduction of the concept of

**The party that purports to have control of the risk must have the capability to do so. This includes having directors with expertise to manage the risks**

The “options realistically available” is how many options taxpayers must consider to support their conclusion. Certainly, it could be relatively easy for tax authorities reviewing transactions years later to suggest various alternatives based on the benefit of hindsight. The guidelines anticipate this and suggest that the intention is not to create a requirement for taxpayers to document all possible hypothetical options.

**Documentation**

Like many other aspects of transfer pricing, documentation of a business restructuring is critical. If a business restructuring is driven by the business, then for the finance or tax department of a multinational, one of the most important aspects will be to ensure that proper documentation of the various elements of the restructuring is prepared and maintained. People in business operations should be involved in developing such documentation. Important components of the documentation should include:

- the commercial reasons for and anticipated benefits of the restructuring from the perspective of all parties involved. A sound business purpose is the first line of defence against a tax authority’s attempts to disregard or recharacterize transactions;
- the analysis of the functions, assets and risks of the parties before and after the restructuring, restructuring transactions and actual changes that took place upon the restructuring;
- the determination of the value of any tangible and intangible assets being transferred as part of the restructuring and,
conversely, the reasons and supporting analyses why no such transfers were considered to have taken place;
• the analysis and rationale of the profits of the parties both before and after the restructuring and the determination of the value of any compensatory payments as a result, including an analysis of the options realistically available to all parties that take part in the restructuring; and
• the determination of arm’s-length transfer prices for the activities of the parties postrestructuring, taking into account any changes in the functions and risks as a result of the restructuring.

Conclusion
With changes to its guidelines, the OECD has stepped up to provide additional guidance to taxpayers and tax authorities on how to deal with various aspects of business restructurings from a tax and transfer-pricing perspective. A number of questions, however, remain. Some of the concepts involved are complex and will be refined with experience. Canadian businesses that have recently undertaken, or are contemplating undertaking, a business restructuring should consult the guidelines to ensure they have considered the issues that may result and that they have the appropriate documentation to defend themselves in the event of an audit by the CRA or other tax authorities.

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Thanks to a number of factors, the pace of restructuring in Canada is not likely to be brisk for the next few years.

The restructuring landscape

Thanks to a number of factors, the pace of restructuring in Canada is not likely to be brisk for the next few years.

If you read newspaper headlines or watch TV news, you may be barraged by stories about the economic troubles in Europe, the US and generally worldwide. You might think these problems would translate into a significant amount of work for restructuring specialists. However, this is not the case. Most restructuring specialists are not working 12-hour days; they are working on lowering their golf handicaps.

The Insolvency Institute of Canada recently held a conference on where and when the next round of Canadian restructurings will happen. As a starting point to what is happening in the restructuring industry today, filings under the Companies’ Creditors Arrangement Act (CCAA) were considered.

Over the past decade, the CCAA has been the restructuring vehicle of choice. A CCAA filing initiates a debtor-in-possession (DIP) process; thus, it does not expose third parties, such as lenders, to statutory obligations such as environmental and successor employer claims. The lender does not take possession nor operate the business. The CCAA has also proven to provide more flexibility than other restructuring statutes, in larger cases.

The graph below represents CCAA filings in Canada for the period 2004 to 2010.

The sharp increase in CCAA filings in 2007 and 2008 was no doubt a result of the global economic meltdown. It appears that CCAA filings peaked in 2009 with 65 filings whereas there were only 32 in 2010. Will this downward trend continue?

Perhaps restructurings have moved away from the CCAA to other statutes.

The number of business bankruptcies and proposal filings under the Bankruptcy and Insolvency Act (BIA) were also reviewed at the conference. They have declined...
steadily in the past years as indicated by the graph on page 44.

The decline in filings seems to be countrywide, with a slight decline, as a percentage, in the West, and an increase in Quebec. Ontario and the Atlantic provinces, as a percentage of filings, remained roughly the same. Put another way, Quebec, in absolute terms, had roughly the same number of filings while the rest of the country decreased.

In a PricewaterhouseCoopers presentation at the Insolvency Institute's conference, it was pointed out that on a regional basis, real estate and construction sectors were a big source of work for restructuring specialists in the West, in Ontario it was the automotive sector, and in Quebec and BC it was the forestry industry. By now, the feeling was that most candidates in these industries have been identified and restructured.

What about size? Since Canwest Global Communications Corp., there have been a limited number of major restructurings in Canada. Almost all filings have been in the midmarket sector, which makes sense given that Canada is largely a midmarket economy. The question is whether there has been a hollowing-out of Canadian industry whereby in the future a significant restructuring may not be initiated in Canada but at a foreign corporate head office.

With enactment of Part IV of the CCAA, it is now easier to have a nonplenary filing (the recognition by Canada of a court order from a foreign jurisdiction whereby that court's orders are enforced) in Canada. Couple this ease of obtaining foreign recognition orders with the recent controversial Ontario Court of Appeal decision in the Indalex Ltd. case (the Ontario Court of Appeal gave certain pension-deficiency claims a priority claim over a previously court-approved DIP loan obtained in conjunction with a CCAA filing) and it is easy to sense that it will be hard to justify a plenary filing in Canada if there is an opportunity to do one, say, in the US.

It also seems that while Toronto used to be the Delaware of Canada, in that most large CCAA filings were initiated in Toronto, this has changed with major filings in Montreal (Abitibi and Quebecor) and in Calgary (Calpine and Trident). So it seems that four locales can now be the recipient of major Canadian filings, once Vancouver is added to the mix. In 2010 these four cities represented approximately 73% of all CCAA filings. So certainly filings in Toronto will be down.

What is happening on the lending side? Major trends, according to the BMO Capital Markets’ conference presentation, include:

- asset values have largely recovered from the depths of 2008-2009, allowing for new lending opportunities;
- there is unprecedented debt-market liquidity in the North American market. On an annualized basis, 2011 is shaping up for issuance of more high-yield debt than ever before;
- interest rates are low, stimulating refinancing activity, thus

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helping to deal with the US “maturity wall” expected in 2014 though 2017;
• “covenant-light” loans are back with current covenant packages similar to those in 2006-2007; and
• asset-based lending is very much in vogue and on the rise.

So where does this leave the Canadian restructuring landscape? Some broad conclusions were drawn at the conference.
• As long as interest rates are low and companies do not have negative cash flow, lenders will adopt, amend and extend strategies with troubled borrowers. This strategy can work only until interest rates go up. Interest rates are not likely to significantly rise in the foreseeable future given the state of the Canadian and world economies. As well, the impact of an interest rate increase on the Canadian dollar will be taken into consideration by the Bank of Canada. The strength of the Canadian dollar can make businesses big winners or big losers; distributors/importers love it, but manufacturers/exporters hate it.
• Input costs (energy and raw materials) will play a big role in determining whether manufacturers can flourish or even survive. If costs continue to go up at recent rates, then one can anticipate a fallout in the manufacturing sector, especially of companies that are on the margin. The question is how much of Canada’s manufacturing base can survive or will Canada become polarized into a service and commodity-based economy?
• There is a trend to informal work-outs as compared to formal filings. This is largely driven by the cost and time of a CCAA filing. These factors loom especially large in midmarket situations. Nontraditional lenders also are a factor here as companies have a longer time frame to execute a turnaround using a nontraditional lender.
• With the powers and protections now afforded to a “national” receiver (Secs. 14.06 and 243 provisions of the BIA), there may be a shift away from CCAA filings to more receiverships. These sections protect a receiver from becoming responsible for pre-filing employee claims. This concern became an issue as a result of the TCT Logistics case (GMAC Commercial Credit Corp. of Canada v. T.C.T. Logistics Inc., 2004 CANLII 11415, where the Ontario Court of Appeal granted leave to a union to proceed to the Ontario Labour Relations Board as to whether or not a court-appointed receiver is a successor employer). With changes to legislation to address this issue, lenders are no longer beholden to directors to cooperate by filing for CCAA. In a receivership, lenders do not necessarily have to bear the cost of directors’ charges and retention bonuses and promise to pay all government payables and the cost of a CCAA filing.
• It is likely Canada will see the rise of more foreign-recognition orders as opposed to plenary proceedings being commenced in Canada. That is, the main restructuring action will be conducted outside Canada. Until the risk to lenders that lend into distressed situations is resolved by the Supreme Court of Canada as a result of the Indalex decision, given the choice, companies will not want to file in Canada.

So what is the future pace of restructurings? It’s not likely to be brisk for the next couple of years until the current lending activity motivates startups and increased interest rates and input costs separate the successful companies from those just hanging on.

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Mental-health check

The “black dog” of depression is often cited as a trigger and mitigating factor for an accused fraudster’s behaviour

Canada's reputation for being soft on white-collar criminals was again brought into question this year when BC Provincial Court Judge Carol Baird Ellan allowed a convicted fraudster to spend up to a year aboard her sailboat in Malta prior to being sentenced.

Why the largesse? The judge said she did it to help 57-year-old Clarice Vidalin recover from her depression and, in doing so, perhaps find a way to repay her victim.

In March, Vidalin pled guilty to having defrauded her former boss, Molly Lori Young, of approximately $110,000. Vidalin had worked for Young's husband, a noted West Vancouver shopping centre developer, until he died several years ago. Following his passing, Young kept Vidalin on the payroll as a personal secretary and property administrator of her family home.

According to The Province, Young was often away so

she gave Vidalin, whom she trusted implicitly, power of attorney over her bank account in order to pay Young’s household bills. In 2007, when Vidalin’s job ended, Young discovered that $7,000 had been transferred from her bank account to a credit card she didn’t own. Understandably, that raised suspicions.

A forensic audit was soon conducted and 13 more transfers, totaling more than $64,000, were discovered to have been made to credit cards issued to Vidalin over an 18-month period. An investigation also revealed that Vidalin had been paying herself in excess of her negotiated salary of $4,000 a month.

Crown counsel Mark Rankin told the court it was “doubtful” Young would ever get the money back. Vidalin no longer had a job, having been fired from her most recent one after her employer was informed of her criminal case.

Vidalin's lawyer, Mark Rowan, told Judge Ellan his client had battled depression all her life. Her illness, he said, caused her to “spend money compulsively. She spent to make herself feel better.” She took the money from Young, he said, to pay for bills incurred during the lowest point in her life.

Rowan explained that Vidalin wanted to live on her $21,000 boat in Europe for up to a year because she was too depressed to work and couldn’t afford to continue living in the Vancouver area.

Needless to say, the judge's decision to permit her request elicited a range of reactions. One focused on the concern that Vidalin, although a Canadian citizen, would not return for sentencing. Another contentious issue was the image of a convicted fraudster having what one BC journalist described as a “Mediterranean vacation” prior to sentencing.

Her lawyer, however, countered that if she had contested the charges, a year’s delay before a trial commenced would not have been unusual. But the Crown noted that the postconviction adjournment period was considerably long. Interestingly, Young, through her counsel, communicated that she was not unhappy with the arrangement.

A seemingly key factor in the ruling was...
the contention by Vidalin’s lawyer that she had “mental-health issues.” The reporting on the trial made no mention of experts being called to verify this claim.

Depression, of course, is a serious and rampant illness. The World Health Organization estimates about 121 million people worldwide suffer from depression. The WHO projects that by 2020 it will be the second leading contributor to what it calls the global burden of disease.

Although prevalent and on the increase, depression can be difficult to diagnose. The online journal The Clinical Advisor reported in 2009 that it had examined 157 primary studies in 11 countries to determine the ability of clinicians to diagnose a mental disorder. “We found that depression was identified accurately in about half the cases,” the journal concluded. If genuine depression was that hard to identify, could false claims of depression also be hard to assess?

Although there are no statistics on how many people fake an illness, it’s commonly accepted that it does occur. On a base level, a person accused of a wrongful act might claim an illness to lessen his or her responsibility for his or her actions. And there are people who can convince themselves that they do indeed suffer from an ailment. Known as factitious disorders (from the Latin word for “artificial”), they are “mental disorders in which a person acts as if he or she has a physical or mental illness when, in fact, he or she has consciously created his or her symptoms,” reports the prestigious Cleveland Clinic. It goes on to note that factitious disorders are included in the Diagnostic and Statistical Manual of Mental Disorders, Fourth Edition (DSM-IV), which is the standard reference book for recognized mental illnesses in the US.

Another, less scientific way of looking at it comes from the Seinfeld character George Costanza. He claimed that it’s not a lie if you believe it to be true.

Being aware that depression, both legitimate and faked, can be a factor in a fraud case can be helpful for a forensic accountant. Obviously, a CA is not expected to be an expert on real or imagined mental disorders. However, being aware of the symptoms of depression might help identify a possible perpetrator and/or assist a forensic accountant in knowing how to communicate with a suspect or witness during an interview.

A connection between depression and fraud occurs often enough to warrant a fraud investigator’s interest in the topic. It seems depression is brought forth in an increasing number of fraud cases as a trigger and mitigating factor, to some extent, for an accused’s behaviour.

Perhaps the most famous Canadian case of (alleged) depression-triggered fraud emerged about seven years ago. A bank manager in Edmonton, Nick Lysyk, created and approved 64 false loans between December 1996 and August 2002 when he was caught, totaling $16,33 million. Lysyk, who was 55 in 2004, used the money to buy 17 homes, 40 vehicles, expensive furniture, clothes, vacations and meals, among other luxuries. He also doled out millions of dollars to 14 prostitutes, his ex-wife and some family members. His fraudulent spree was triggered, he testified in court, when he came upon his recently estranged wife with her boyfriend. It worsened when he subsequently learned she had been involved in an affair with the man for several years during their marriage.

A balding and paunchy man with low self-esteem, Lysyk, soon after seeing his ex-wife, visited a massage parlour in search of a prostitute. The escort he encountered, Lillian Green, turned out to be a customer from his bank. They began what became a four-year relationship, although Green continued to have a boyfriend while they dated. During their four years together, Lysyk began his false-loan scam and gave Green almost $3.5 million of the stolen funds. Another escort, Melanie Dmytrow, received approximately $773,000 and the husband of another escort Lysyk was “dating” pocketed more than $125,000.

Described in court as being “overly compliant,” Lysyk was characterized as someone unable to say no to the many people who asked him for money during his six-year scam period. For example, Lysyk provided his daughter and her husband with $700,000 to pay for, among other purchases, a luxury car. “They came right to the bank with a new Jaguar demonstrator. I personally felt pressure,” he said. He even gave his former wife, who had betrayed him, more than $1 million.

In the late summer of 2004, Lysyk pled guilty to fraud. During a nine-day sentencing hearing, noted forensic psychologist and expert witness Marc Nesca, who by the time of the trial had conducted about 2,000 assessments of individuals accused or convicted of crimes, testified that in his opinion Lysyk suffered from clinical depression. Nesca said the condition, combined with evidence that Lysyk had been threatened by some male friends of the numerous escorts he frequented, helped explain why a man with no history of wrongdoing suddenly committed extensive fraud. The Crown, on the other hand, said it was simply a case of greed and perceived opportunity.

In a 2004 interview, Nesca said he understood why people react with disbelief when they hear that depression is being offered as a mitigating circumstance for a person’s extreme behaviour, such as stealing $16 million. However, he said clinical depression can be so severe it can completely wash out a person’s criminal responsibility.

Despite his views on the effects of depression, Nesca didn’t think mental health experts should have an increased role in the legal system. “I think we botch things up a lot,” he said. Nonetheless, he did advocate taking depression into account when determining an appropriate sentence.

It’s unknown whether that occurred in Lysyk’s case. He was given seven years and four months in jail, although he was
released 13 months later on day parole. Now on full parole, his sentence expires in January 2012.

This past summer, convicted fraudster Joselito Arganda, who claimed depression led him to participate in a cheque-fraud and counterfeit-money scheme in Winnipeg, convinced the Manitoba Court of Appeal to shave one day off his 24-month sentence so he could contest a deportation order to his native Philippines. Under Canadian law, a noncitizen convicted of a crime of two years or more can be deported without any right to appeal. If the sentence is less than two years, the order can be challenged.

*The Winnipeg Free Press* reported that Arganda, 41, was one of 11 people who devised a scheme to use forged cheques to buy merchandise at Winnipeg stores and resell the goods for cash. Arganda also pled guilty to possessing counterfeit money, stolen identification and stolen credit-card data.

“I made a mistake because I was depressed at that time and there was a divorce,” he told the court. Again, there was no indication if his claim was supported by any expert testimony.

In another interesting case some years ago, depression played a role in what at first appeared to be a fraudulent scheme perpetrated by the comptroller of a retail company. The company had been acquired by a venture capital fund. During the due diligence process, it discovered about $2 million worth of inventory was missing. Forensic accountants quickly determined the comptroller had made false entries in the company’s financial statements. This raised immediate concerns that a serious inventory problem had been covered up by the vendor.

An interview was arranged with the comptroller. He nervously confessed to having cooked the books for several years. This began after the firm’s CFO had left. “They decided not to replace him,” he said, “and just dumped most of his work on to my plate. I could barely cope with what I had to do.”

His situation became virtually unbearable when his wife was diagnosed with a terminal illness. “I became overwhelmed and depressed,” he said, noting he was afraid of telling anyone he couldn’t cope for fear he would lose his job and, more importantly, his family health benefits. At that point he began a three-year process in which he booked false entries to make it appear as if he was handling the inventory properly.

Following a thorough investigation, the forensic accountants reported that the comptroller had not benefited financially in any way as a result of his actions. He was placed on disability leave and the fund negotiated a new purchase price based on accurate inventory numbers.

Nesca concurred that fraud investigators should be cautious about jumping to conclusions about a suspect’s state of mental health. He did say, however, that certain symptoms tend to be recognizable. “In some patients there is a general slowing of behaviour and posture changes such as shoulders hunched and hips flexed. Eye contact is generally lower. Grooming tends to be off. There’s typically an increased need for sleep. And sometimes employees can start to come in late as a result.”

Knowing about depression, he added, can also be beneficial to a forensic accountant who has checked a suspect’s background only to find no evidence to suggest any previous wrongdoing. “It’s very, very rare,” he said, “where a criminal goes undetected his whole life. There are almost always indicators that this person harbours an unconventional value system.” In the absence of any evidence of previous wrongdoing, don’t eliminate a suspect before considering that depression might have triggered aberrant and out-of-character behaviour, he pointed out.

Winston Churchill called his depression the “black dog.” In legitimate cases, it has a deep and painful bite that nonsufferers can only imagine. Except it leaves no teeth marks, unless you know what to look for.

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The right approach

Internal audits are an essential strategic tool in delivering on an organization’s mission, but how it’s done is up to you.

The role of the internal auditor has evolved considerably in the past few years, yet stereotypes of internal auditors still abound in many enterprises. Internal auditors have worked hard to clarify their role and promote the profession, but there is still much to be done. Few people are truly familiar with the function of internal auditors. When they visit an enterprise, they are often greeted with comments such as “you again,” “you and your policies slow us down,” or “here comes the accounting police.” How can internal auditors provide added value to an organization if no one understands their role or, even worse, if they are feared?

Internal auditor’s role and responsibilities

An internal auditor’s role is very different from that of an external auditor. In addition to providing assurance on financial information, internal auditors assess business processes, procedures, methodologies and compliance with current legislation. They ensure appropriate control mechanisms exist. Internal auditors are also attentive to their clients in order to support them in ongoing improvements. They also provide clients with tools to meet their objectives and implement their corporate strategies.

Senior management is increasingly aware that internal audit has a key role in an organization’s ability to deliver on its mission.

Another aspect of the internal auditor’s role is assessing the processes set out in the annual enterprise risk management plan. While evaluating internal controls, internal auditors adjust their involvement based on risk and see to the improvement of business processes and operational effectiveness. They carry out best-practice reviews when necessary to propose new management practices and methods to benefit the company.

Although management and employees are experts in their field, it is the internal auditor’s task to impartially examine the workings of a department and its contribution to the enterprise’s objectives.

Age of hypergovernance

In recent years, financial scandals have made headlines, giving rise to hypergovernance. Senior executives are closely scrutinized and live in fear of the next audit, be it internal, external, tax compliance or statutory audits. Such audits can take place one after the other or concurrently. Executives understandably worry about the impact of an audit on the reputation and longevity of their company. But they often forget the results can be advantageous for their enterprise.

The recommendations of qualified professionals are
based on their diversified experience, which can lead senior executives to question their methods of doing things. Business processes are often carried out routinely, with no improvements made, which can result in expensive or useless controls or, conversely, a flagrant lack of control. This observation applies to all the enterprise’s processes, including internal audit.

Quality assurance and improvement program
According to the Institute of Internal Auditors (IIA), “The chief audit executive must develop and maintain a quality assurance and improvement program that covers all aspects of internal audit and continuously monitors its effectiveness. The program must include periodic internal and external quality assessments and ongoing internal monitoring.”

The goal of the IIA is to help validate and strengthen internal audit activities, enhance effectiveness, efficiency and successful practice implementation. When internal audit activities are carried out in keeping with good practice, they inevitably provide added value to the enterprise. Internal auditors, with their comprehensive vision, understanding of issues and knowledge of risks and controls, often find ways to improve processes, or at least provide managers and senior executives with elements to consider.

The IIA’s proposed quality assurance and improvement program includes the independent quality assurance reviews analyzed below and regular or periodic internal review processes. In all cases, the program covers all internal audit activities and their contribution to the organization. Among the elements assessed are the structure of internal audit, its independence from the organization, documentation quality, the application of best practices, quality reviews, the satisfaction of auditees and clients of the department, added value for the enterprise, staff competence and audit committee and management satisfaction. Quality assurance and improvement help optimize internal audit operations so mandates can be carried out with greater effectiveness and efficiency.

Internal audit already uses this approach to assess the enterprise’s other business functions. It therefore needs to apply it to its own ways of doing things, in order to design a continuous improvement approach that will allow it to remain proactive in the enterprise. Even if a quality assurance and improvement program is in place, only 59% of enterprises with internal audit activities conduct an independent quality assurance review every five years as required by IIA standards.

Most managers who do not meet this requirement do not consider it a priority for their enterprise. Furthermore, internal audit has existed in certain organizations for less than five years, which means they are not yet subject to a quality assurance review in accordance with IIA standards. Finally, some organizations consider the process to be too costly. In none of these cases can the enterprises state that their internal audit conforms with IIA standards.

As part of the quality assurance review process, like its clients, internal audit must submit to an assessment. Internal auditors have no trouble issuing opinions on their clients’ methods, but it is much less natural for them to view their own actions with a critical eye.

Types of independent quality assurance review
The IIA proposes two types of independent quality assurance review: an independent external assessment and a self-assessment with independent validation. The former is preferred by the IIA, but either is permitted, as long as it is performed at least every five years.

According to the IIA, 81% of enterprises that conduct quality assessments do so every five years, and 18% do so even more frequently. Barely 1% of enterprises let more than five years go by between quality assessments. For each of the two types of review, the external assessment can be conducted by a specialized independent firm or by a team made up of internal auditors from three or more organizations, which is also known as a peer review.

Independent external assessment
The IIA favours review by way of an independent external assess-

Obtaining the opinion from an outside expert allows for a more objective, critical view of the function as a whole than when the opinion comes from an internal source

ment, taking the view that this type of review generates the most confidence and added value. With it, an independent internal audit specialist is required to verify all the department’s activities and attest their conformance with IIA standards. The advantage lies in the degree of independence and confidence in the results.

Obtaining an opinion from an outside expert allows for a more objective, critical view of the function as a whole than when the opinion comes from an internal source. The review includes interviews with the board, senior management, internal audit clients, the external auditor, the head of audit and staff. Internal auditors can thus gain insight into their department’s performance. Moreover, parties involved generally feel more comfortable confiding in a person who is independent of their organization.

During the quality review, a survey assessing conformance with IIA standards is generally distributed throughout the organization to compile information that will be used to draw a portrait of internal audit. Trends can also be identified, which will then be used to define solutions.

All the procedures involved in the independent quality assurance assessment also generate visibility for internal audit and demonstrate that it is subject to audits and standards just like the organization’s other departments. This exercise enables auditees to help improve processes.

If the conclusion of the assessment is positive, it can bolster internal audit’s credibility in the eyes of the audit committee, the board of directors, management and the external auditor. In
fact, according to a recent IIA study, 65% of the results of these reviews are forwarded to senior management, 73% to the audit committee, 19% to the board of directors and 37% to external auditors. Results are not communicated in only 15% of cases. It is still recommended to show transparency when results are less positive. The results can justify additional budget requests to strengthen the internal audit function and encourage the organization’s growth.

Given that the assessment is carried out by outside professionals, internal audit continues to operate and can carry on with its annual plan. With internal reviews as presented below, the mandate monopolizes significant resources.

Self-assessment with independent validation
In this age of hypergovernance and economic troubles, it is not surprising that one enterprise out of four chooses self-assessment with external validation. This method is less costly and provides a high degree of confidence due to an independent validation of the process and comparison with current best practices.

The review is conducted by internal audit, but each stage must be assessed by the independent validator. This validator must also conduct a certain number of interviews and is given the responses to the aforementioned survey, which is key to the independence of the exercise.

This method also has the advantage of being controlled by the head of internal audit. Considering that this exercise is carried out by professionals who master their business processes and methodology, the quality review can be completed more quickly. It can also be a training opportunity when less experienced employees participate in the exercise.

Specialized firm or peer review
In addition to being able to choose between the above two methods, enterprises can decide to entrust the work to a specialized independent firm or a peer review team.

The peer review team must include internal auditors from three or more different organizations in order to pass the IIA’s independence test. These organizations generally operate within the same industry or the same region, or they are part of a professional group or association. Every professional assigned to carry out the assignment must have the level of knowledge required to ensure that the review or validation is conducted properly. As a rule, the person in charge of the team is a current or former head of internal audit, while the other members of the team hold or have held senior internal audit positions. They are familiar with the industry of the enterprise that is being reviewed.

Peer reviews have the advantage of generally being less costly and the added value gained from in-depth knowledge of the industry can be significant.

However, it also has its limitations, especially when an enterprise has highly confidential practices, when there is a small pool of enterprises combining the required qualities or when the peer review team includes enterprises with varying organizational maturity. Moreover, administering and coordinating the team’s work can be challenging and time consuming. The choice between an independent specialized firm or a peer review team will depend on the enterprise’s situation.

Conclusion
Regardless of the method selected, reviewing the quality of the internal audit function is an essential activity that contributes to its added value, in addition to being essential to the enterprise’s credibility. It enables internal audit to improve its internal processes and perform its engagements more effectively and efficiently. Better procedures will be of help when implementing the annual audit plan. The exercise also helps bolster the image of internal audit within the enterprise and promotes the role of internal auditors.

The role of internal auditors has evolved considerably in the past few years, and their responsibilities have grown steadily. Not surprisingly then, the profession is increasingly recognized by boards as an essential strategic tool in delivering on the organization’s mission. Increasing employee confidence and management support are enabling internal audit to carry out audit assignments more effectively.

The IIA prefers the independent external quality review method, but self-assessment with independent validation is also an option worth considering, as it provides a new perspective and comparison with best practices. Now it is up to you to choose the approach that is right for you.

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The US crisis

According to the US Constitution, the government was created to represent the interests of its citizens and to protect their individual rights, including the right to life, liberty and the pursuit of happiness. The promotion of collective rights is secondary to these individual rights. A book by US historian Gordon S. Wood reminds us that government structures in place today reflect that fundamental principle.

The formula has proven successful. Americans have built a country that is the envy of the world and the world’s most powerful economy. Over time, the original model has also become “socialized” thanks to Franklin Roosevelt’s far-reaching social programs and Lyndon Johnson’s Great Society.

However, the US model is experiencing a major crisis. Everything seems to have fallen apart, economically speaking. With an unemployment rate of 9%-plus, the US has recorded one of the worst performances among OECD countries.

Compounding unemployment woes, a budget crisis has reared its ugly head, with Washington facing a structural deficit of colossal proportions representing 11% of the GDP. Revenue only covers two-thirds of the government’s spending. Even Greece is doing better.

The US is also dealing with its greatest social crisis in 80 years. Of all OECD countries, it probably has the most tenuous social safety net. The unemployed and low-income earners receive substantially less public assistance than those in most OECD nations and three in 10 Americans qualify for food assistance.

The crisis stems from a political system ill-equipped to deal with the structural problems plaguing the economy. Republicans want to eliminate the deficit by slashing social spending. They oppose any federal tax hikes and stimulus measures funded through increased government spending. Democrats are determined to protect social programs and raise taxes for the wealthy. Since both parties have the right to filibuster in Congress, nothing gets settled. Washington came close to defaulting on its financial obligations twice in recent months.

The impasse can be attributed to an increasingly polarized US political class, largely dominated by right-wing ideologists. This polarization is caused by many factors and encouraged by the US system of government, where the Congress is independent of the president and is governed by its own rules, representatives are elected every two years and party financing is barely regulated, etc.

Tax hikes in particular are creating a deep divide in US society. Americans are among the least taxed in the world — tax revenue in the US accounts for 27% of the GDP, compared with the OECD average of 35%. Conservative opposition prevents any significant tax increases, limiting the White House’s options to jump-start the economy, which would in turn attenuate the deficit. The right is pushing for cuts in government spending, putting the country’s already fragile social safety net at risk and further depressing demand. In such an environment, how can the US meet the social justice standards considered to be inalienable rights in most OECD countries?

Given this stalemate, the US deficit is likely to reach 100% of the GDP this year. And economic recovery will be slow, while high unemployment will persist. As a result, the US dollar’s weak performance against other currencies is expected to continue.

The issue in the US is mainly political. The country lacks the government structures required to emerge from the crisis, and the entire nation is paying the price.

Canada must learn from the US troubles. To survive, a nation must ensure that collective interests take precedence over individual interests and that this priority is reflected in its political structures. We should think twice before adopting the American way of government.

Marcel Côté is founding partner at SECOR Consulting in Montreal
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