

Manager missteps

• Wrongful dismissals

• IT storage



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# Management

OCTOBER 2009 \$5.50

**Corporate divestiture  
transactions**

**Maximizing potential  
employees**

**Introducing this  
year's FCMA's**

Bob Strachan, CMA, FCMA,  
chair, CMA Canada National  
Board of Directors

## **Strengthening partnerships, sustaining quality growth**

Board chair Bob Strachan prepares to take  
on new challenges with CMA Canada

# From Bay Street to Wall Street



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# Dispelling the myths

Implementing and managing a co-operative education (co-op) or internship program at your organization isn't just about hiring people to pick up the workload during challenging economic times. A co-op/internship program is a great way to find and secure top talent. Students are highly capable of contributing all kinds of business value. And, when well-managed, the amount of time co-ops/interns contribute yields far more productivity.

As Frank Potter, CMA, explains in his article "Maximizing potential employees," co-op/internship programs may look good on paper, but are often abandoned because the training and orientation becomes too much of a burden for many organizations. He draws examples from his own experience working with co-ops and interns at the Ministry of Alberta Finance and Enterprise. Their approach is to hire interns for eight-month periods but on four-month offsets so that the "senior intern" provides most of the orientation and training effort in assimilating the "junior intern." Although the type of program they use is designed in a government setting, the author provides suggestions on how the program could be adapted to most organizations.

This year, Mental Illness Awareness Week (MIAW) — an annual national public education campaign coordinated by the Canadian Alliance on Mental Illness and Mental Health (CAMIMH) runs from Oct. 4 to 10. The campaign is designed to help open the eyes of Canadians to the reality of mental illness. Mental illness affects the great and small alike despite the stigmas that still too often surrounds it.

Earlier this year, Canadians mourned the loss of Dave Batters, former Saskatchewan member of Parliament who struggled with severe anxiety and depression. History shows that other politicians have carried the same burden — Abraham Lincoln, Winston Churchill and former premier of Ontario, John Robarts. In the end, Batters lost the fight against his illness. Sadly, each year, nearly 4,000 Canadians make this same choice.

According to the Canadian Mental Health Association, mental illness affects all Canadian at some time through a family member, friend or colleague. Twenty per cent of Canadians will personally experience a mental illness in their lifetime. Mental illness affects people of all ages, educational and income levels and cultures.

John Stokdijk, CMA, chief financial officer, Mental Health Commission of Canada, joins *CMA Management* this month for a personal account on this topic. His article "Hiring the mentally ill," discusses a significant emerging issue which will impact many more employers in the coming years. The bright side is that there are tools for employers to help their employees cope with the many challenges they may face.



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Insertion orders and advertising materials are to be sent to: Crystal Himes  
chimes@dvetail.com Dovetail Communications Inc., 30 East Beaver Creek  
Road Ste. 202, Richmond Hill, ON L4B 1J2, Fax: (905) 886-6640

## Circulation and Administration

For general inquiries, change of address notices, etc. please call:  
Liliane Kenyon (877) 262-6622  
lkenyon@cma-canada.org

**Subscriptions** Member: \$15.00 (plus GST)  
Non-members: \$15.00 (plus GST)  
U.S. and overseas: \$40.00 (U.S. funds only)

## Undeliverable Mail

Canada Post: send undeliverable copies to:  
CMA Management  
1 Robert Speck Parkway, Suite 1400, Mississauga, ON L4Z 3M3  
email: info@cma-canada.org  
Telephone: (905) 949-4200  
PM 40064728  
PAP Registration No. 9858

CMA Management is a member of the Canadian Circulations Audit Board/Business Publications Audits International (CCAB/BPA)  
Indexed in Canadian Periodical Index ISSN 1490-4225.  
Issue Date: October 2009

CMA Management is published monthly, except December-January and June-July, August-September (combined issues), by CMA Canada. If you no longer wish to receive this publication, please contact CMA Canada.

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We acknowledge the assistance of the Government of Canada through the Publications Assistance Program toward our mailing costs.

Printed in Canada by Web Offset Publications Ltd., Pickering, ON.

Canada



# CMA Management

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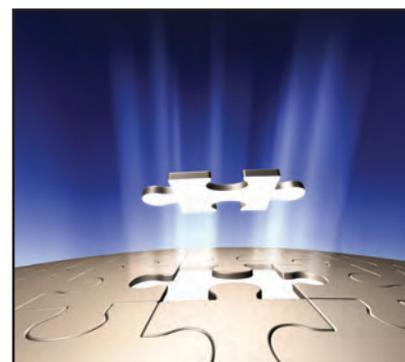
For companies that are looking for a way to reduce their hiring risk, access low cost or seasonal staffing, and complete long-drawn-out projects, a co-operative education student (co-op) or internship candidate (intern) might be the right choice for your organization.

By Frank Neil Potter, CMA

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- Hiring the mentally ill, By John Stokdijk, CMA
- Canadian public sector prepared for challenges ahead
- Business community celebrates first annual CMA Ontario Creative Leadership Awards
- CMA Canada Research Foundation
- 2009 National Recognition Award

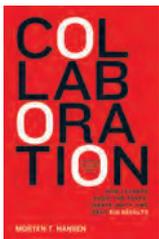
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- IFRS: Looking beyond the technical aspects
- Data quality: Garbage in, garbage out



# Delivering results

## Collaboration

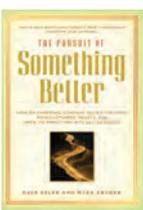


Collaboration is a skill as much as an art. It can be learned, it can be taught, and it can be instilled in an organization's DNA. Based on 15 years of research, *Collaboration*, by Morten T. Hansen, is the guide for mastering the discipline of effective collaboration. In his counterintuitive book, Hansen concludes that there is such a thing as too much collaboration and that bad collaboration is far worse and often more common than good collaboration.

Hansen says the challenge is not to cultivate more collaboration but to promote the right kind that leads to great results. He suggests the following: unification — when leaders want to motivate people to collaborate, they can craft compelling common goals, articulate a strong sense of cross-company teamwork, and talk the talk of collaboration to send strong signals that bring people together; t-shaped management — in an environment where people already collaborate, managers often need to step in to direct the right people to work together on the right projects. By cultivating t-shaped management, leaders can reward both independent results and cross-unit contributions; nimble networking — when performed incorrectly, networking can actually destroy results. He also identifies six rules of disciplined networking that can transform bloated networks into powerful tools that deliver results.

Morten T. Hansen. Harvard Business Press.

## The Pursuit of Something Better



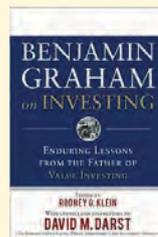
*The Pursuit of Something Better* is a story of the transformation of U.S. Cellular from an ordinary company in danger of extinction into an organization that is admired by employees and customers alike, and a proven winner by every measure. Even more remarkable is how this transformation took place — the company focused on values and heart; inspirational and

empowering leadership; motivation by values, not fear; ethics and integrity and an insistence on always doing the right thing.

*The Pursuit of Something Better* will provide business leaders, HR professionals, managers and corporate development specialists with a roadmap for how to: put the customer and quality of customer experience first and achieve business success; inspire employee dedication and loyalty and see bottom line results; put ethics and integrity at the forefront of all corporate decisions; and institute positive corporate culture change.

Dave Esler and Myra Kruger. Esler Kruger Associates, Inc.

## Benjamin Graham on Investing



Known as the “father of value investing,” Benjamin Graham remains one of the world's most acclaimed financial thinkers. Graham's work has influenced many of today's most successful investors, including Warren Buffett, Michael F. Price, and John Neff. *Benjamin Graham on Investing* is

a selection of his early articles that appeared in *The Magazine of Wall Street* over 10 years (1917-1927) and show how his thinking evolved and matured during the years predating the Great Depression. David Darst, a respected expert on asset allocation, provides insightful analyses connecting Graham's articles to events occurring today.

“Investors of every age can learn from and practically apply Graham's ways of framing key questions, big and small, his emphasis on the potential for error and the need for internal cross-checking and consistency and his steadfast awareness of the potential for the market's short-term verdict to stray from underlying reality,” Darst writes.

This is the first time these early writings are available exclusively in a single volume.

Rodney G. Klein and David M. Darst. McGraw-Hill.



## “How do I know that a potential hire is going to fit our culture?”

Unfortunately, you can't know for sure. But there are ways to greatly increase your chances of finding the right fit. One is to work with a recruiter who truly understands the importance of corporate culture.

So how do you find that mythical recruiter? Those people who have actually demonstrated that they get it? Not just for their clients, but for themselves?

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Very simply, we know how important it is to get the right fit. How important it is to find, not just the candidate who delivers all the appropriate skill sets and experience, but one who will fit in with and make a real contribution to your business.

We've done it for ourselves, and we do it for our clients every day. If you'd like to find out how we can do it for you, just give us a call at (416) 340-1500.

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# News and views

New and noteworthy information you can use

## IFAC G20 Accountancy Summit issues renewed mandate for adoption of global standards



Governments and regulators need to step up initiatives to promote convergence to global accountancy and auditing standards — and they need to do so quickly — according to over 60 leaders of the accountancy profession who attended the International Federation of Accountants' (IFAC) G20 Accountancy Summit on July 23 and 24 in London. The summit was organized to achieve consensus by the profession on a series of recommendations to be made to the G20 leaders on issues related to the financial crisis.

Participants unanimously agreed that the public interest would best be served by a single set of high-quality, principles-based financial reporting and auditing standards for listed and public interest entities.

"It is critical that national standard-setting bodies establish roadmaps to move toward adoption of IFRS and international standards on auditing," Robert Bunting, president, IFAC, said. The group stressed the importance of having balanced views in the standard-setting process and ensuring that there is no undue influence from any one stakeholder group. They also emphasized the need for the International Accounting Standards Board to have a robust governance structure that

will ensure its effectiveness and independence.

In addition, summit participants called upon governments to follow the same high standards of financial reporting as their private sector counterparts and to adopt international public sector accounting standards.

"The group expressed strong concerns about the liabilities and contingencies being assumed by governments in many countries as a result of the financial crisis," explained Ian Ball, CFO, IFAC. "IFAC will continue to emphasize to the G20 the need for governments to provide clear and transparent reporting to their taxpayers and to capital markets."

Other key recommendations from the group included the following:

- The needs of small and medium enterprises (SMEs) should be considered in the development of standards, as well as in any re-regulation. "SMEs are the economic engine of global growth and we need to ensure that they are not faced with any unnecessary or unintended compliance or other burdens," Bunting said.
- The G20 should continue to make strengthening corporate governance a priority. Focus should be placed on examining the role of independent directors, CFOs, and audit committees, as well as improving the linkage of remuneration schemes with performance.
- There is a need for a more robust financial reporting model that includes, among other things, reporting on sustainability and environmental issues.

### Management

#### Editorial Think Tank

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**Ramesh Swamy, CMA**  
Senior manager, Deloitte Financial  
Advisory Services  
Los Angeles, Calif.

## Hiring the mentally ill

By John Stokdijk, CMA

Would you knowingly hire someone with a mental illness?

The Mental Health Commission of Canada, launched by the Government of Canada in 2007, faced this question in its early days of organizational life. The Commission is “a non-profit organization created to focus national attention on mental health issues and to work to improve the health and social outcomes of people living with mental illness.” My colleagues on the senior management team and I quickly agreed that it was important for the credibility of the Commission to “walk the talk.”

Of course all potential employees must demonstrate that they have the skills, knowledge and experience to successfully perform the tasks which will be assigned to them. Organizations cannot afford to accept employee performance that does not meet expectations. But is there any other valid reason why someone with a mental illness should be excluded from consideration?

The Commission believes the answer is an emphatic “no” and that all too often those with a mental illness are inappropriately discriminated against. To counter the myths and misconceptions that abound about the mentally ill, the Commission is embarking on a multi-year anti-stigmatization, anti-discrimination campaign.

When I hired my administrative assistant, I selected a candidate with bipolar disorder who had been out of the workforce for 12 years. However, people do recover from mental illness. Given an opportunity, skills can quickly return as they did in this case. Most of the time, my administrative assistant performs at a level that exceeds expectations. But this story is about more than my staff. It is also about me.

For the first time in my career, during my first interview with former Senator Michael Kirby, now chair of the Mental Health Commission of Canada, and his team, I felt comfortable disclosing that I have experienced significant mental health problems. During my teen years, I suffered from serious bouts of depression which continued throughout my adult life. Twice I have needed professional help because I was no longer able to function effectively in the workplace. Nevertheless, I was hired as the chief financial officer of the Commission and am greatly energized by our organization’s motto “Out of the Shadows Forever.”

Where is the leading edge of change in the workplace today? In recent decades, much improvement has been seen in how women are accepted and how motherhood is supported. Visible minorities are now part of the workforce everywhere. Employers have learned to make accommodations for the physically disabled. But people living with mental health problems or mental illnesses remain largely invisible.

A new dimension in occupational health and safety is

emerging in Canada — the idea that employers have a duty to provide a psychologically safe workplace. Earlier this year the Commission released a discussion paper, *Stress at Work, Mental Injury and the Law in Canada* by Martin Shain S.J.D., which will undoubtedly generate much discussion. The report describes a rapidly changing legal landscape and the implications for management. Organizations may be faced with an expanding duty to provide “a psychologically-safe workplace ... that permits no harm to employee mental health in negligent, reckless or intentional ways.”

Stress in the workplace can sometimes reach unbearable levels and can lead to depression. Yet it can be difficult to successfully assert a short-term or long-term disability claim in such circumstances. Too often, employers still expect employees to “suck it up and get on with it.” Is it really acceptable that employees have no option but to quit a job when they find themselves in these circumstances? Should the employer not bear some responsibility for mitigating workplace stress?

Interestingly, employees with mental health problems or mental illness may have some advantage over other employees when it comes to coping with stress. Many of these employees have learned the hard way the importance of maintaining work-life balance and maintaining good physical health through proper eating, sleeping and exercising. In addition, many, like my administrative assistant and myself, are not reluctant to reach out for professional help when necessary.

Employers may believe that they have fulfilled their obligations to employees by providing workplace wellness programs and employee assistance programs. Such programs have certainly made a significant contribution. However, the negative aspects of some organizational cultures too often still subtly overpower positive programs and policies. The need for organizational success and the need for containment of employee benefit costs are powerful forces which constrain the degree of employee support that is possible. But the direction of change must be to do more.

The concept of comprehensive support for employees with mental health problems or mental illness has the potential to contribute to organizational success while reducing the costs for society as a whole. Mental Illness Awareness Week runs Oct. 4-10, 2009. If done properly, hiring someone with a mental illness can be a win-win situation for the organization, the employee and the country.

John Stokdijk, CMA, is CFO of the Mental Health Commission of Canada, headquartered in Calgary. His blog, which includes his powerful personal story, can be found at <http://johnstokdijk.blogspot.com>.

## Canadian public sector prepared for challenges ahead

Canada's public sector is better suited than many of its foreign counterparts to make the changes necessary to survive and thrive in the current economic downturn, according to a KPMG International survey entitled *The Wolf is at the Door*.

The survey demonstrates that governments around the world are facing challenges of how they will provide key services to their citizens. The economic downturn and aging populations are all factors having profound effects on the public sector. These factors are likely to put more demands on the public sector than it is presently seeing, but provide it with fewer resources with which to meet these demands.

The survey suggests that Canada has one or two years to draw up plans to change its business models to ensure its ability to continue providing key services during the difficult times ahead without compromising on the quality of those services.

Other countries, particularly the U.K. and the United States, face greater challenges; these governments have borrowed heavily to bail out banks and manufacturers, and to finance fiscal stimuli.

KPMG International surveyed 124 government decision makers in six countries: Australia, Canada, Germany, the Netherlands, the U.K., and the United States.

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

Other key findings of the survey are:

- Eighty-one per cent of Canadian respondents are unlikely to change their strategy in the next year as a result of the downturn.
- Sixty per cent of global respondents are making long-term changes to try to put their organization in a good position for the next decade.
- Fifty-two per cent of Canadian respondents are making long-term changes to try to put their organization in a good position for the next decade.
- A quarter of global respondents are planning to change the eligibility criteria for the services they offer.
- Only five percent of Canadian respondents are planning to change their eligibility criteria.

"The economic downturn has to be seen as an opportunity for the public sector to reflect on traditional ways of thinking and acting," said Astrid Göbel, of KPMG in Germany. "There are many examples of challenges like this generating new ideas and solutions."

How are public sector organizations planning to cope with this reality? Only 20 per cent of global respondents indicate they are making radical changes to their organizations and are planning to change their business or service delivery models.

Public sector organizations are complex and face certain statutory requirements to provide services. While private sector companies have the option to stop manufacturing products that are no longer profitable, governments don't always have that option. Once the public gets used to receiving a particular government service, it is very difficult to just stop providing it.

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## Business community celebrates first annual CMA Ontario Creative Leadership Awards

Four CMAs in Ontario demonstrated how they use big ideas, intuition, imagination and innovation to take on today's business challenges.

At the inaugural CMA Ontario Creative Leadership Award gala hosted in June 2009, members of the business community gathered to celebrate the impact of creative vision and execution by CMAs in organizations across Ontario. Nominated by peers and colleagues, and chosen by a panel of leaders in various fields, the CMA Ontario Creative Leadership Awards recognized achievement in four key areas: big ideas, envisioning a holistic business idea or strategy that was not previously conceived; intuition, generating successful ideas and solutions from a divergent thinking perspective; imagination, exemplifying leadership in harnessing the energy and possibility of creative activity in a workplace; and innovation,

success in generating a creative idea and applying in order to create a novel and viable product or service.

Nominators were encouraged to include information in their application package to show how the nominee made a significant and valuable contribution to one of the four categories. At the awards gala, the recipients were profiled in a video and presented with a trophy to commemorate their achievement.

"I am impressed by the level of creativity demonstrated by the award recipients, and am proud to see the success that can be achieved when CMAs have the courage to break from convention and confront business challenges creatively," Merv Hillier, MBA, FCMA, president and CEO, CMA Ontario, says. "The importance of creativity and innovation in business leadership today cannot be overstated."

### 2009 recipients

#### Big Ideas

**Victoria Davies, CMA**

CFO, Knightsbridge Human Capital Solutions



Victoria Davies knew a bold move was required to achieve Knightsbridge's corporate vision of \$100 million in revenues by the end 2010. Her "big idea" proved to be successful. It allowed Knightsbridge to be a global player, leverage new technology and place the company on the right path to achieve its \$100 million target.

#### Intuition

**Susan Richards, CMA**

Vice-president of Finance and CFO, Chipworks



Susan Richards created a significant and sustainable cash source and profit generator for Chipworks, an Ottawa-based tech firm, by re-framing the issue of declining cash flow from an R&D perspective. Susan repositioned Chipworks' research work product to fit within the definition of "experimental development," which qualified it for additional tax credits through the Scientific Research & Experimental Development program (SR&ED).

#### Imagination

**Noel John Fernandes, CMA**

Management Consultant



Noel John Fernandes received the Imagination Award for his work as director of finance and administration, residential development with Fairmont Raffles Hotels International. By leveraging the power of his teams' multi-functional expertise, Noel used his "imagination" to develop a multi-national due diligence process to successfully facilitate Fairmont's appropriation and management of Private Residence Club properties around the world.

#### Innovation

**Jeffery Zajac, CMA**

President, Solus One



Jeffery Zajac is the president of Solus One, a call center solution provider with offices in Ontario and Mexico. After tapping into the creativity of his team, Zajac innovated Solus One's product line to create remarkable growth out of the economic downturn, developing products for the Canadian political, small-to-medium enterprise, and international markets.

## Q and A with Anne-Marie Gammon, CMA, FCMA, chair, CMA Canada Research Foundation



The CMA Canada Research Foundation (the Foundation) is the leading global resource for new and emerging practices in strategic management accounting. Governed by a seven member board of trustees — five CMAs and two non-members — the Foundation generates research products and services such as Management Accounting Guidelines (MAG<sup>®</sup>s), Management Accounting Practices (MAP<sup>®</sup>s) and infocast events that provide practical tools for building the competencies of business professionals and for enhancing the success of organizations. They are available at [www.cma-canada.org/foundation](http://www.cma-canada.org/foundation) under Business Resources.

**CMA Management:** *What is the objective of the Research Foundation?*

**Anne-Marie Gammon:** The vision of the Research Foundation is: “*To be recognized as the world leader in advancing the field of Strategic Management Accounting.*” This supports

### CMA Canada names DECIMAL recipient of 2009 National Recognition Award

CMA Canada is pleased to announce that DECIMAL has been named this year’s recipient of CMA Canada’s National Recognition Award for its contribution to the awareness and influence of the CMA<sup>®</sup> designation. This award is given annually to a group, company or institution that has made a significant contribution to the overall development of CMA Canada’s growth and to the discipline of management accounting.

DECIMAL, a consultancy firm that designs specialized corporate performance management solutions, is dedicated to supporting the next generation of CMAs and developing the CMA profession. It has a staff of 34 employees which includes no less than seven CMAs and eight candidates involved in the process leading to this highly coveted designation.

During the past year, DECIMAL demonstrated its outstanding contribution to the influence of the CMA profession through its exemplary participation in all recruiting activities organized by the Ordre des comptables en management accrédités du Québec and student committees across the province.

The partnership between DECIMAL and CMA Canada has helped make the firm a leader in the global marketplace and contributed greatly to the advancement of the management accounting profession. We congratulate them for their outstanding work and commitment!

CMA Canada’s vision of CMA as the designation of choice and its mission of driving value creation by developing professionals and resources to lead the advancement and integration of strategy, accounting and management.

The Research Foundation has a clearly defined mandate of governing the research activities conducted by CMA Canada and is accountable to the CMA Canada National Board of Directors. Specifically, the purpose\* of the Research Foundation is to:

1. Expand the conceptual boundaries of management accounting by encompassing new developments and practices that may influence the professional accountant in business; and
2. Develop relevant knowledge management materials that will either create or add value for CMAs and other business professionals.

**CMA Management:** *What are some of the benefits of the Research Foundation and what does it offer to CMAs?*

**AMG:** The Research Foundation is the leading global resource for new and emerging practices in strategic management accounting. Some of the benefits of the Foundation include the generation of leading-edge research for CMAs, other strategic management professionals, the business community, other accounting professionals, the academic community, and prospective members in educational institutions.

It is vital for a CMA’s integrity and ongoing professional development to have contemporary research that can be applied to his/her job and to other organizations that he/she may be involved in. The day-to-day dynamics of strategy, accounting and management in the business world demand CMAs have access to appropriate tools that can be developed and/or further enhanced by dedicated research. Our employers and community leaders expect this from a professional accountant. We have to keep sharpening the tools we work with as well as acquire new ones.

**CMA Management:** *What are some of the current initiatives the Research Foundation is working on?*

**AMG:** Some of the current initiatives the Research Foundation is working on include:

1. A fundraising program to attract dedicated sources of funding to support the operational activities of the Research Foundation and to fund ongoing research.
2. The identification and prioritization of future research initiatives as well as to monitor progress on current research activities. For instance, the Foundation is supporting the development of five more contemporary MAGs and updating eight existing MAPs.

3. The recommendation and subsequent development of an emerging issues paper.
4. The assessment of e-news and other more frequent and contemporary ways of communicating research developments to CMAs and other stakeholders.
5. A means to solicit input from the CMA membership on research that interests them such as focus groups.

**CMA Management:** *Why should CMAs take more advantage of the resources that are being offering to them?*

**AMG:** The CMA is part of a professional body. When I think of the hallmarks of a great profession, the words that come to mind are relevance, competence, expertise, enduring, specialist, legitimate and transformational. CMAs need to take more advantage of the resources that are being offered to them to continue to support their growth and relevance as strategic management accounting professionals. The profession needs to change and adapt as the world around it continues to change. Taking advantage of resources, being informed and making

that personal investment will directly benefit the individual CMA and the professional body as a whole.

**CMA Management:** *What do you want CMAs to know about the Research Foundation*

**AMG:** First, I would like CMAs and other stakeholders to know that the Research Foundation exists. Dedicated and knowledgeable staff at CMA Canada and the Foundation's board of trustees work to fulfill the Foundation's vision. Secondly, research is an integral part of CMA Canada's strategy; but it is not research for the sake of doing research. The nature of the research conducted falls within the framework of the CMA Competency Map so it has to meet the tests of practicality, applicability and relevance. Third, there is a cost to having the Research Foundation and the Foundation needs to rely on a reliable source of funding to support operational and research activities.

\*Research Foundation Terms of Reference.

# 30 Management Strategies for a Tough Economy



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# Missteps managers often make in an uncertain economy

The way companies treat their employees during tough times plays a key role in how well the business is able to weather the storm and emerge ready to take advantage of improving conditions.

By **Connie Stamper, CMA**

When the stakes are high, some managers feel they have little time to spend outside of accomplishing their own personal objectives. The truth is, it's more critical than ever during difficult times for managers to maintain a high profile and communicate openly, honestly and often with employees. Keep staff informed about anything that may directly affect the status of the company. While frequent e-mail updates can help, don't let them replace face-to-face conversation with your team. Make a point to touch base regularly with everyone as a group and individually.

Frequent and clear communication from management helps keep rumours from taking root and sowing anxiety throughout the workforce. Just make sure communication with your staff is a two-way street: solicit feedback from every team member, including those who are not as vocal as other workers. Remember, for every employee who approaches you with questions or comments, there are several others who will be inclined to keep their concerns to themselves. Some workers would rather keep quiet than be seen as "rocking the boat" by questioning decisions or requesting more detailed information from management. Let everyone on your staff know their feedback and suggestions are always important to you – and the company.

## **Failing to acknowledge staff contributions**

Now is no time to lighten up on efforts to demonstrate to employees how much their commitment is appreciated. They are likely expected to accept and adapt quickly to many changes that have come with little or no warning. While all professionals on your team deserve a "thank you" for their hard work, employees who go the extra mile to embrace change and continue to approach their jobs with obvious enthusiasm should be particularly acknowledged.



Putting the spotlight on a team member who exceeds your expectations not only encourages that one worker to keep performing at a high level, but can increase morale, productivity and work quality throughout your entire staff. Be sure that the praise you give is timely and specific, however, so your workers know you are taking note of their individual contributions. You don't want to appear to be doling out "blanket" praise in an insincere manner.

## **Relaxing efforts to support employees**

Employees are any organization's most important assets. But many firms working with a leaner staff due to layoffs and tighter budgets must ask much more of their employees. This includes top performers, who are often the least likely to complain or ask for help. Let all your employees know it is acceptable to ask for assistance with projects. Proactively addressing a situation where a team member is feeling overloaded helps ensure that deadlines won't be missed, work quality won't slip and a good employee won't succumb to burnout.

Help staff prioritize. Even if the recession has you operating in a

crisis mode, avoid labeling every project, deadline and conference as “urgent.” For example, your tendency to call meetings may deserve some rethinking. Twenty-seven per cent of workers polled in a survey by Robert Half said meetings are their biggest time waster at work. Don’t take away precious productivity time from your employees when they are already being pressured to do more. Limit meetings to those absolutely necessary for achieving a specific goal and keeping your department running optimally.

When you know heavy workloads and intense deadlines will converge and the challenge must be met head-on, consider bringing in temporary resources to support your core team. You’ll likely find that providing extra support during an exceptionally high-stress work period can bolster employee morale while also helping you keep your department’s overtime costs in check.

### Cutting out incentives

Even if budget constraints prevent you from providing financial perks such as raises or bonuses to deserving employees, it doesn’t mean you can’t reward them in other ways. Low- and no-cost incentives can go a long way toward making a professional feel valued.

Simple, inexpensive gestures, such as a pair of movie tickets, a gift card for the local coffee shop, a thank-you card, or an afternoon off are just some ways to demonstrate your appreciation and motivate employees to continue performing at their best. Incentives such as compressed workweeks and occasional telecommuting can show professionals who are putting in extra hours for the company that management remains sensitive to their ongoing need for work/life balance.

### Not giving staff the chance to shine

Some people tend to perform best during challenging times. Take this opportunity to develop the raw talent in your team by empowering “leaders in the rough” to make decisions and solve problems. Provide guidance on how to resolve dilemmas, and offer feedback on the way staff handled an important issue: let them know what they did well and what they could have done better.

If you encourage employees to think about things they could do to help achieve business goals, you may be pleased to discover how resourceful they are. They are working in the trenches each day and often have insightful ideas about which issues should be addressed promptly and areas where more support is needed.

When appropriate, consider involving select staff members in generating new business. Explain ways they might focus on growing relationships with the company’s existing clients as well as identifying and pursuing new prospects.

In a down economy, managers face the challenge of creating an atmosphere of stability and optimism for their staff; and in the process, often make mistakes. Admittedly, it’s a tall order, but taking the time to engage in meaningful communication with your employees, giving them well-deserved praise and encouragement, and providing additional support as needed can help you keep your team, and your business, on track. ■

Connie Stamper, CMA, is a branch manager at Robert Half Canada. For additional tips or to request a copy of *The 30 Most Common Mistakes Managers Make in an Uncertain Economy*, visit [www.rhi.com/30mistakes](http://www.rhi.com/30mistakes).



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# Employers struggle with wrongful dismissals

Organizations need to consider the legal implications before cutting labour costs.

By **Stuart E. Rudner**

Many organizations, including professional firms, face a need to reduce costs. Unfortunately, it is not unusual for organizations to see the potential savings that cutting labour costs will generate, but fail to consider the legal risks. The result can be an expensive, time-consuming legal nightmare. Below are examples of some common mistakes. If you are advising a client, or dealing with your own organization's labour issues, it is critical that consideration be given to the legal implications of any proposed actions.

## **Failure to provide sufficient notice**

If you are going to let some people go, you have to provide the requisite notice or pay in lieu thereof. At the very least, you must provide the notice required by the applicable employment standards legislation. However, unless a binding employment agreement clearly limits the employer's obligations in the event of dismissal, the common law requirement of "reasonable notice" will apply. What is "reasonable" will depend upon the specific circumstances of each case, including the employee's age, length of service and position within the organization. Contrary to popular belief, there is no "rule of thumb" of one month per year of service. In fact, short-term employees often receive disproportionately lengthy notice periods.\*



## **Failure to meet all obligations during the notice period**

A common mistake is to misunderstand the employer's obligations during the notice period. By default, all forms of remuneration should continue after they have been notified and until employment formally ends. It is not enough just to pay base salary – commissions, bonuses, and all employment-related benefits must continue. Some forms of benefits, such as long-term disability, can be tricky since many insurers will not continue to cover an individual who is no longer actively employed. However, failing to continue benefits can expose an employer to substantial liability, so employers should ensure they address this issue.

### Failure to consider all the options

There are many ways to let an employee go. For example, employers are entitled to provide working notice of dismissal. Instead of offering a “package” in which the employer receives nothing in exchange for the severance payments, organizations can insist that an employee continue to work during the notice period. Obviously, however, there will be situations where this is not practical. Other options include salary and benefit continuance (with or without “clawback” provisions in the event the individual finds new employment), lump-sum payments, or combinations thereof.

**Because employment standards legislation in most jurisdictions refers to temporary layoffs, many people mistakenly assume that they are entitled to lay employees off.**

### Constructive dismissal

Some organizations have proposed to cut costs by unilaterally reducing wages or hours of work, imposing unpaid leaves, or otherwise changing working conditions. Few of the employers that I spoke with considered taking a binding contract and unilaterally changing a key term. Many were shocked when advised that they may not have the right to do so. This can be a creative approach to a difficult issue, but it must be adopted cautiously. A constructive dismissal can occur when an employer unilaterally makes a substantial change to a fundamental term of the employment.

### Unlawful layoffs

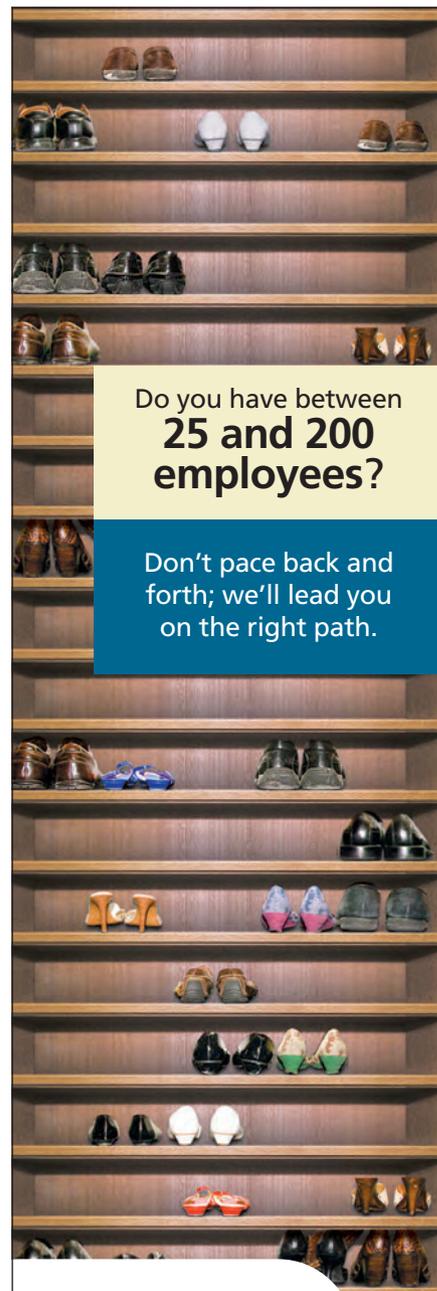
Misunderstandings about the right to lay workers off temporarily are common amongst organizations. Because employment standards legislation in most jurisdictions refers to temporary layoffs, many people mistakenly assume that they are entitled to lay employees off. However, the legislation does not confer the right to lay workers off; it merely sets limits on such layoffs in circumstances where the right already exists. In order to be legally entitled to lay off an employee, there must be either an express term to that effect in an employment agreement, or an implied term based upon the nature of the position or industry. Laying off an individual without the right to do so is a common mistake that often results in a claim for constructive dismissal. ■

### The Bottom line

Efforts to reduce labour costs inevitably carry some risk. Any decisions should be made based upon a full understanding of the financial and legal consequences.

Stuart E. Rudner is a partner in Miller Thomson LLP's Labour and Employment Law Group. He speaks and writes extensively on employment law topics.

\*This is one reason why I always counsel employers to use employment agreements that limit their obligations in the event of dismissal.



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# Maximizing potential



For companies that are looking for a way to reduce their hiring risk, access low cost or seasonal staffing, and complete long-drawn-out projects, a co-operative education student (co-op) or internship candidate (intern) might be the right choice for your organization.

# employees

By Frank Neil Potter, CMA



Although definitions vary, a co-op is a registered member of a post-secondary academic program in which work experience is integrated into academic learning. An intern is an individual who has completed his/her post-secondary studies (diploma, degree, advance degree) and is enrolled in a six to 24 month employer sponsored program that focuses on developing professional skills such as accounting. The choice of which one to use is a function of organizational preference, academic institution relationships and the nature of the work. In either case, a nine-step model can help your company develop and deliver an optimal co-op or intern program.

## 1. Infrastructure

Infrastructure is the base to support a co-op/intern program and it should focus on four critical elements: organization support, over-lapping placement, process documentation and community liaison. The most critical infrastructure requirement is strong and ongoing senior management and organizational support for the program. Develop and constantly review the co-op/intern's job description and a learning plan. Ensure senior management supports the principle of over-lapping placement. This is the key to an efficient co-op/intern program. This is accomplished by having at least two co-op/interns who will start and leave on an over-lapping interval. For example, if you are hiring co-op students, only hire them for two consecutive semesters (e.g. each co-op will work for an eight month engagement composed of two, four-month semesters) and then plan to hire a new co-op every four months. This will give your organization a senior and a junior individual co-op/intern at all times. Develop process documentation so that the senior co-op/intern has content to train the junior. Assign accountability for this documentation to the co-op/interns.

Maintain a college/university and community recruitment presence and relationship. Ask department heads of schools in fields applicable to your organization to encourage students/graduates to apply for your program. Be sure to maintain an ongoing link on your organization's website to your program. These strategies will attract the best candidates to apply to your program.



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## 2. Selection

When hiring permanent employees, the focus is on how to retain the individual. With co-op/interns, the focus is on how to migrate the individual to future positions within your organization. Given the level of mentorship investment by your organization, it is critical that you attract and hire top candidates. Plan to pay your co-op/intern 60 to 90 per cent of an entry level position depending on the level of academic completion, the individual and local labour conditions or union agreements.

## 3. On-boarding (or initiation)

The first month of a program is the period of lowest productivity and this is when the tone for the experience is set. This is also when your previously hired intern transitions from the junior role to the senior role. The senior should be able to complete about 80 to 90 per cent of the junior's on-boarding activities. Because your permanent staff is not completing these activities, consider developing a certification process. For example, use a combination of documentation and an intern-question database to test their knowledge and absorption of the material. This database and materials can be used to orientate new full-time employees.

## 4. Work

What assignments are given to your co-op/interns is a function of their education level and abilities. Begin with well documented transactional activities; a handy rule is that a task cannot be assigned without pre-existing documentation for the activity – although documenting that activity is a legitimate assignment. Documentation of business processes is a good activity for the first few months assuming the co-op/intern has sufficient language and education skills. Ensure that you have writing guides, a place for the documentation and a permanent staff member to review the end product.

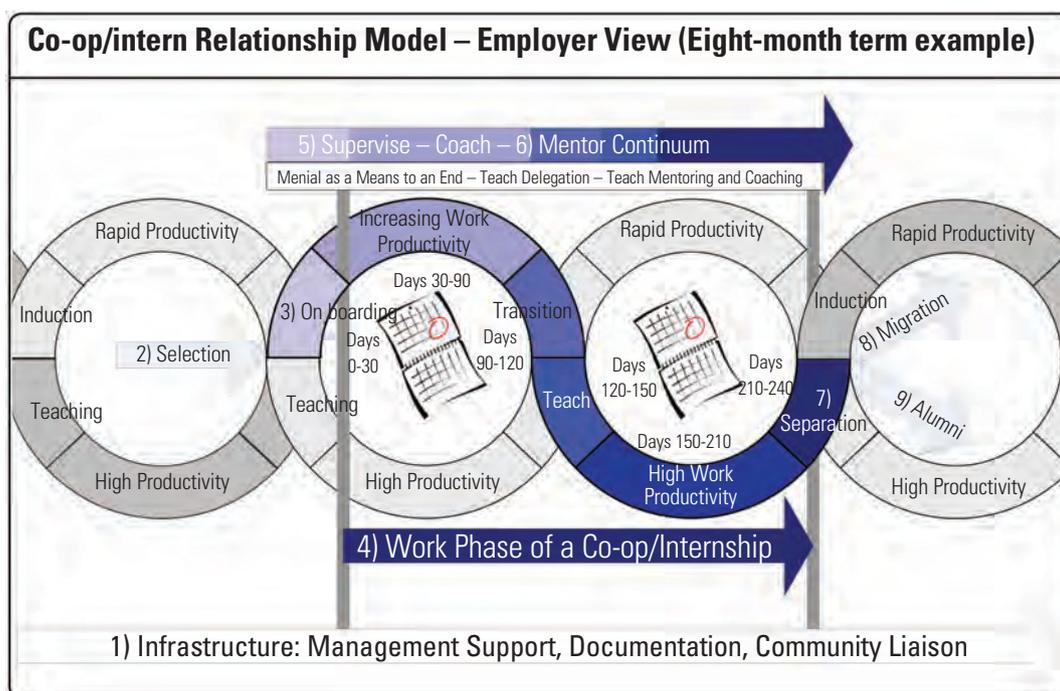
As a rule, keep administrative/menial work to about 20 per cent of the entire experience. As the co-op/intern gains confidence, the complexity of the work can increase to include analytical, ad hoc or special projects. Ad hoc projects should be run using good project management principles and work assigned to an individual should be discrete enough that they can be accomplished within their tenure. Have enough auxiliary tasks assigned to the co-op/interns so that they do not have downtime. Work with your local university or college co-operative education offices to tailor work term reports to focus on your organization issues or problems.

## 5. Supervising-coaching

It's often suggested that organizations select the best and most passionate supervisors to work with co-op/interns. The problem with this suggestion is that good, passionate supervisors tend to be in high demand. Help your supervisor manage their co-op/interns with the following techniques.

- Menial as a means to an end. Use well documented initial administrative or transactional tasks as a way to ease co-op/interns into organizations. Initially, 80 to 90 per cent of their time may be "menial" tapering off to 0 per cent at the end of the experience for an average of 20 per cent discussed above.
- Teach delegation. The senior/junior model is an ideal way to teach delegation and supervision to your co-op/interns who are most likely future managers. Monitor these relationships carefully and step in as required.
- Teach mentoring and coaching. Give your permanent staff the opportunity to practice mentorship and coaching. Remember that co-op/interns are a supplement and not a replacement for permanent staff. As well, task accountability can be delegated to the co-op/intern, but responsibility remains with the permanent employee.

As the supervisor, stay constantly in touch with the co-



op/interns to see how they are beyond the immediate tasks at hand. This can be done informally or via more formal weekly sessions.

## 6. Mentoring

The relationship between yourself and an individual co-op/intern should evolve from a supervisor to a coach and finally to a mentor. As work is completed, be sure to consistently debrief and refocus the co-op/intern on how the experience fits with their career plans and where on their resume they can reference it. To paraphrase the proverb, "It Takes an Organization to Mentor an Intern," encourage the individual to network through social and work-related committees and interview senior staff about their work experiences and career history. You can also establish a buddy system where your co-op/intern is matched with a mentor — a permanent employee similar in age and work position.

## 7. Separation

The separation phase will lead directly to one of two next steps, either migration to a position within the organization or an alumni association for the graduate. (See section nine below.) Just like with permanent employees, conduct an exit interview to understand what went well with the program and where to improve. Have the departing senior intern critique and recommend changes and improvements to the program. For co-operative education students, consider whether the individual can migrate to a part-time or seasonal role until graduation.

## 8. Migration

Migration is when a co-op or intern program adds its greatest organizational value. Companies that move well trained and vetted individuals into positions that require more responsibility within the organization experience recruitment savings, immediate productivity in the new position and a reduction in hiring risk. During the selection process, you should be upfront and honest about job prospects post separation – make good on any promises about job offers. For example, in the current program at Alberta Finance and Enterprise, it's the department's goal to migrate at least 50 per cent of its interns to somewhere within the Alberta government.

## 9. Alumni

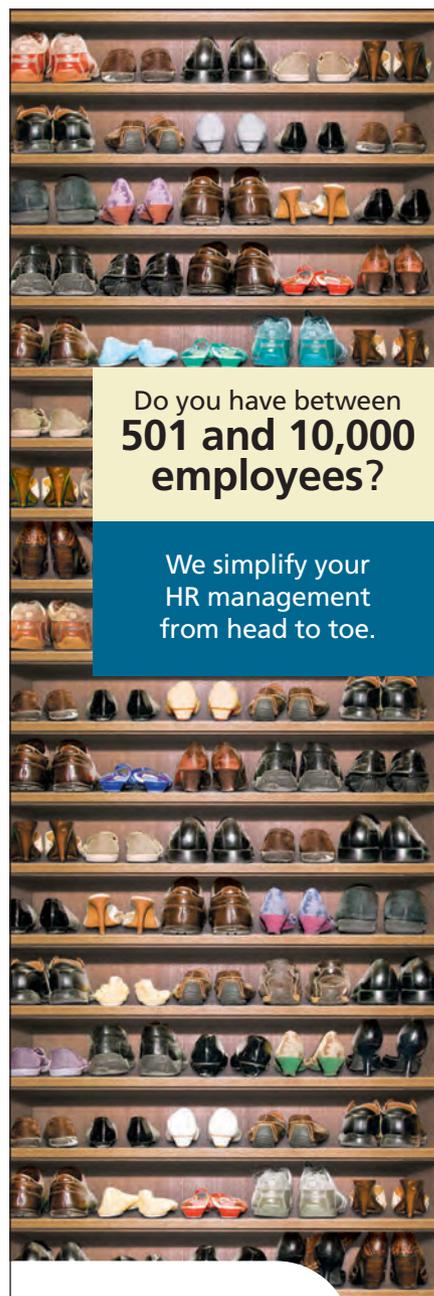
If you cannot find a permanent position for your co-op/intern after their tenure, try to at least stay in touch as he/she may become an employee in the future. Not-for-profit organizations should view their alumni as future members of boards, foundation donors or community advocates with a special connection to your organization. If you are a supervisor working for a for-profit company, you should remember that your current co-op/intern might someday be a customer making buying decisions about your products.

### Co-ops, interns, the looming talent wars and suggested reading

For a modest investment of direct costs, management time and goodwill, organizations can develop a direct pipeline of quality recruits. Starting a best practice co-op/intern program may be difficult in a period of downsizing and staff layoffs. Such a program can help organizations win the talent war by developing future leaders and improving the retention of staff. If this is of interest to your organization, the following free resources are suggested reading:

1. International City/County Management Association, Internship Toolkit, available: [www.icma.org](http://www.icma.org).
2. Alberta Public Service Internship Program, Intern Supervisors Handbook (May 2008), available: <http://www.chr.alberta.ca/Employees/?file=corporate/gain/overview>. ■

Frank Neil Potter, ([frankpotter@gov.ab.ca](mailto:frankpotter@gov.ab.ca)), CMA, MBA, is the director of financial planning and budgets, Alberta Finance and Enterprise.



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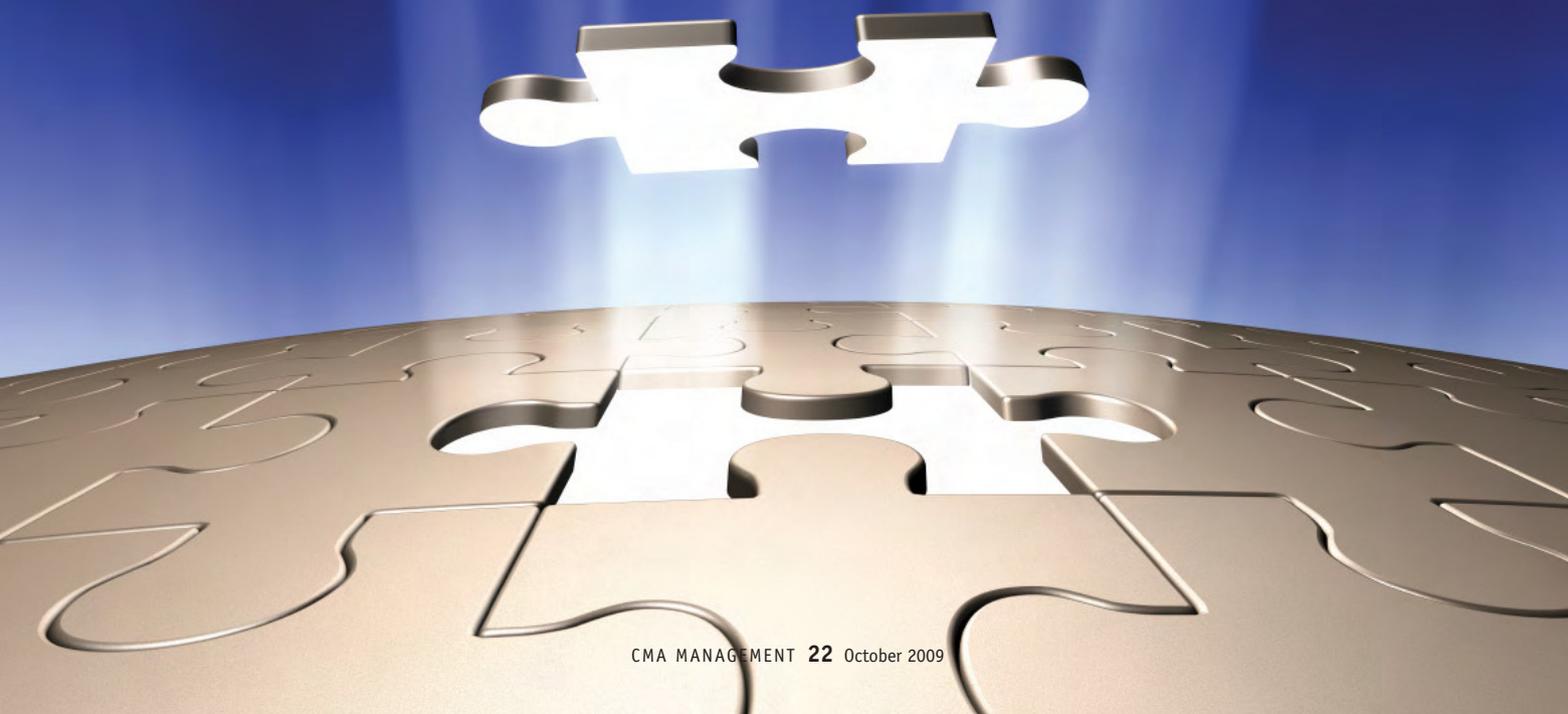
# A STRUCTURED APPROACH TO CORPORATE DIVESTITURE TRANSACTIONS

**CORPORATE DIVESTITURES ARE COMMON TRANSACTIONS INVOLVING ORGANIZATIONS OF ALL SIZES. IT PRESENTS A PRACTICAL, SYSTEMATIC METHODOLOGY FOR PLANNING, PREPARING AND EXECUTING A SALE TRANSACTION WHEN IT IS THE CHOSEN OPTION.**

**BY WILLIAM J. GOLE**

**I**n both prosperous and difficult economic times, corporations, often with little fanfare and driven by either strategic or tactical considerations, divest non-core assets with surprising regularity. In practice, corporate divestitures occur quite frequently, accounting for fully one-third of all merger and acquisition (M&A) transactions in the last decade<sup>1</sup>. This level of divestiture activity has routinely generated a significant transfer of shareholder value between buyers and sellers, averaging well over \$60<sup>2</sup> billion per year over this period.

Corporate divestitures are M&A transactions in which an entity sells off a discrete segment or part of its business (a business unit), such as a subsidiary, division, or product line, as distinguished from the sale of an entire business enterprise. Because these transactions involve the sale of only part of a business, corporate divestitures have characteristics that differentiate them from other types of transactions, thus presenting unique challenges to sellers.



Among other things, the need to separate out or “disentangle” a business being sold from its parent company requires skills, resources, and processes that differ from those involved in the sale of an entire enterprise. Divestitures also entail substantial communication and management challenges not present in an acquisition setting, since the announcement of the prospective sale generally occurs months before the identity of the buyer is known. After the announcement, if the employees of the business being sold are not kept informed and motivated, an environment of paralyzing uncertainty can result, substantially eroding the property’s value. During this period, external stakeholders join the audience of interested parties, and would also view an extended period with no news from the selling corporation as portending a problem.

Layered onto these issues is the potential for divestitures to be afforded “orphan” treatment by the selling organization. In contrast to acquisitions, which almost automatically generate enthusiasm and support, divestitures are often viewed as dead-end transactions that have little pay-off for their participants. In addition, divestitures have a tendency to fall off the radar of the executive management of the seller as it understandably focuses on building and running the businesses that will be retained. These factors create an environment in which divestiture transactions are often starved of important resources.

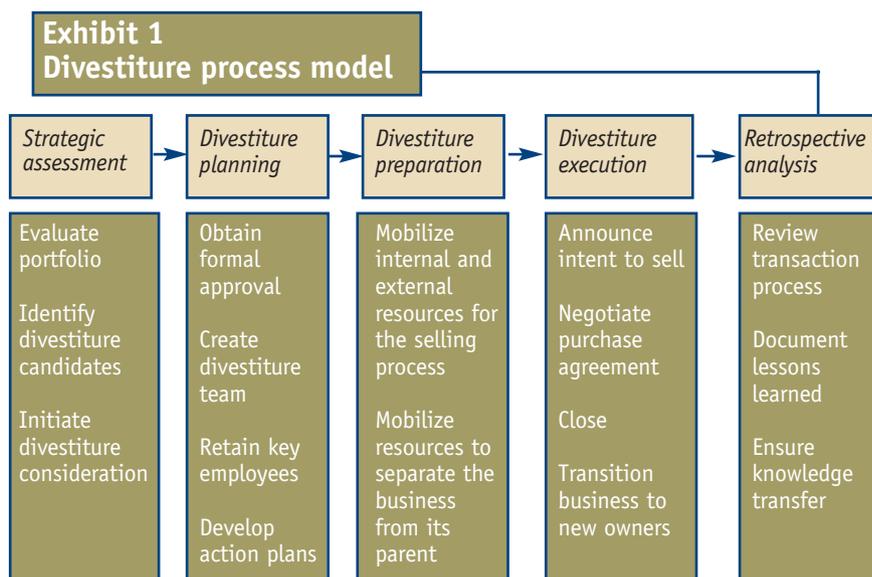
The operational challenges, the public nature of the divestiture, and the potential for under-resourcing combine to magnify the risks associated with these types of transactions — namely, the risk of either a sale at a price that is substantially less than the true value of the property being sold or of a failed transaction. An organization that effectively plans for the operational and transactional aspects of the divestiture, that communicates effectively, and that supports the efforts of those managing the transactions is likely to optimize the value of the transaction for the enterprise and its shareholders.

### Corporate divestiture transactions

A fundamental characteristic of good practice relative to divestitures is a structured and disciplined process orientation. While this does not guarantee success, it provides an important condition for a favorable outcome. Exhibit 1 offers an overview of a divestiture process model that embodies these characteristics.

increasing shareholder value.

**Transaction planning.** This next phase of the process starts with management making the business case for divesting specific properties. Once corporate approval has been secured, the seller would implement practice measures that are designed to ensure the proper staging and management of the transaction. These measures



The model outlines a structured process that starts with the strategic assessment of the organization’s business portfolio, followed by the planning, preparation and execution phases of the transaction. It ends with an evaluation of the transaction that is intended to ensure that any lessons learned are duly noted, documented, and incorporated into the organization’s institutional memory.

**Strategic assessment.** Divestiture transactions typically originate with the assessment of the organization’s business portfolio as part of its strategic planning process, when elements of the portfolio are evaluated in the context of the organization’s strategic and financial objectives. Candidates for divestiture will emerge when an organization decides to exit non-strategic or shrinking markets, to monetize undervalued assets, or to generate cash for higher value uses — all with the ultimate objective of

include: developing organization and personnel retention plans, assigning a divestiture team leader, creating the divestiture team, and developing formal, detailed divestiture and communication plans.

**Transaction preparation.** This stage of the process focuses on getting the business unit being divested ready for sale. It has two distinct components: preparing for the selling process, and preparing for separating the business being sold from its parent (often referred to as disentanglement).

The former entails the engagement of external resources and the creation of selling materials to be distributed or presented to potential buyers (e.g., an offering document or prospectus that describes the business in considerable detail and a management presentation that mirrors that content) and the staging of steps that will be implemented during the selling process (e.g., identification and initial

engagement of potential buyers and preparation of a data room).

The latter component includes formally assigning the internal resources necessary to support the disentanglement effort and initiating the actual process of separating the business being sold from the seller's organization. This effort typically entails the creation of a disentanglement team tasked with identifying cross-company interdependencies and with creating a plan for their resolution.

**Transaction execution.** The execution phase of the process spans activities from the announcement of the intent to sell through pre-closing agreement on contract terms and compliance with any applicable laws and regulations. Accordingly, it covers the management of the selling process, specifically, announcing the prospective sale, soliciting offers from potential buyers, managing the due diligence process, negotiating final legal documents, and ensuring compliance with legal/regulatory requirements.

**Retrospective analysis.** After the transaction is closed and the business has been transferred to new ownership, the seller should perform an analysis of the transaction and record all relevant information for access by those in the organization tasked with responsibility for future divestitures. This would entail identifying lessons learned — both positive and negative — and documenting those findings to ensure incorporation of these lessons into the seller's institutional memory.

### Critical success factors

Corporate divestitures are protracted, complex, and demanding transactions. In addition, they have the potential to be conducted in a resource-starved environment. The combination of a demanding transaction and the tendency of organizations to limit resources heighten the need for a structured and efficient process, such as the one outlined above. That process requires a strong focus on high quality analysis, thorough planning, detailed

preparation, and disciplined execution, as well as adherence to principles that enable the effective execution of the transaction. A well-structured process is a necessary, but not sufficient, ingredient of an effectively and efficiently conducted transaction. In addition, the organization conducting the transaction must also apply the following principles to add rigor to that process.

**Empowered leadership.** Early in the divestiture process, an individual should be assigned a leadership role and tasked with managing the transaction. That individual will have responsibility for directing a core team of senior executives, and for coordinating internal and external support when needed. It is critical to the success of the transaction that this team or project leader has the qualities necessary to manage the transaction, and is empowered by senior executive management, typically the CEO of the selling entity. The team leader's span of authority must be broad, mutually understood by the CEO and the team leader, and effectively communicated to all relevant parties.

Empowerment also implies timely access to the CEO. A predetermined mechanism for communication between the team leader and the CEO is necessary to assure seamless management of the transaction when issues arise that exceed the decision-making authority of the team leader. In addition, the team leader must also be empowered to draw on the resources necessary to effectively manage the divestiture process.

**Team cohesiveness and ownership in the transaction.** The project leader will head a small team of managers — typically, senior executives in the human resources, finance and accounting, and legal functions, as well as the most senior executives of the business being divested — all of whom will have responsibility for the ongoing management of the transaction. The organization must be committed to their participation in the transaction, e.g., executive management must

recognize and accept that a substantial portion of the time of these team members will be dedicated to the divestiture effort. In addition, these individuals must approach their roles with a team mentality, a keen sense of ownership of the transaction, and a realization that “credit” will only result from a successful transaction. Key elements of team cohesiveness in the context of the transaction are: proactive information sharing, a holistic approach to the project, and a cross-functional managerial approach.

Divestitures are complex transactions, comprised of multiple steps, involving a large number of individuals over an extended period of time. This creates an environment of constant change. Sharing relevant information completely and quickly is critical to keeping the transaction on track. Those running the transaction must also resist the temptation to take a narrow, functional view of their responsibilities. Given the functional bounds within which they are used to operating, this will require a different mindset. It means shedding their silo mentality and adopting a comprehensive or holistic approach to the transaction. In this regard, they must take ownership in the entire transaction, not a piece or an aspect of it. An outgrowth of this approach is the need to engage in aggressive cross-functional resource management (e.g., the management of those involved across the organization, as well as the contract professionals and consultants who are providing advice and expertise).

### Clearly defined roles, tasks, timelines and deliverables.

Divestiture transactions entail numerous and diverse activities, frequently involving sub-groups of the larger team, which generally occur over a number of months. Effective management of a process of this magnitude requires a high degree of discipline. That discipline can only be exercised by clearly defining (and redefining, when necessary) and unambiguously communicating what

has to be done, by whom, and when, and by regularly holding those responsible accountable for delivering on their commitments.

**Frequent and regular communication.** Frequent communication among team members is critical to the management process. Although communication may take many forms, such as e-mail, formal and informal meetings, conference calls, and individual telephone conversations, arguably the key communication component should be regular status meetings run by the team leader or sub-group project leaders, as frequently as weekly. This is also where communication intersects with defining roles, tasks, and deliverables. These meetings should be structured around formal project management documents that identify assignments, the responsible individuals, deliverables, and their deadlines.

Equally important is the communication associated with protecting the asset being divested. The announcement of the prospective sale can be expected to have a disruptive impact on the business unit being sold. Left unattended, disruption can lead to employee defection and business erosion. Effective communication can minimize employee distraction and its impact on the business. Therefore, it is critically important for parent company management to maintain frequent and

regular two-way communication with this employee base. After the initial announcement is made, mechanisms, such as regular meeting and a dedicated website, should be established to provide these employees with news and developments relative to the sale, as well as to enable them to get timely answers to their inquiries.

Corporate divestitures are very challenging yet commonplace transactions. Their successful execution requires a high level of structure in the form of detailed planning and preparation and disciplined execution. It is also imperative that this structured and disciplined approach is buttressed by the application of enabling principles such as empowered leadership, accountability, and effective communication and documentation to ensure its effective implementation. ■

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The preceding article is based on a Management Accounting Guideline (MAG®), published by The Society of Management Accountants and The Chartered Institute of Management Accountants.

<sup>1</sup> *Mergerstat Review 2007*. (Santa Monica, CA; Factset Mergerstat, LLC; 2007), 8.

<sup>2</sup> All monetary amounts in the *Guideline* are presented in U.S. dollars.

**Role of financial managers.** The financial professionals of the selling organization (e.g., the CFO or his or her designee and seller's finance and accounting managers) play a critically important part in corporate divestiture transactions. Although executed for strategic purposes, divestitures are essentially financial transactions. As such, the seller should draw on the skills and expertise of its financial management team. Within the context of a divestiture, these capabilities take the form of project leadership, resource coordination, analytical input, and broad operational participation.

**Project leadership.** The senior financial manager on the divestiture team may, in some cases, be the overall divestiture team leader. Even if this is not the case, that individual generally plays an essentially co-equal role, along with the organization's senior business development executive and legal counsel, in shepherding the transaction from beginning to end. In this capacity he or she will help shape documents critical to the efficient and successful execution of the sale, such as the corporate approval document, key employee retention plans, the transaction's offering document or prospectus, and management presentations to be made to potential buyers.

**Resource coordination.** Finance and accounting managers usually coordinate the involvement of key external and internal resources, such as accounting firms, tax specialists,

financial advisors (e.g., business brokers or investment bankers), and operational managers within the seller organization. Because financial and legal/regulatory considerations frequently intersect throughout the process they will also be responsible for coordinating regulatory compliance and balanced and informed positions on key documents, such as confidentiality agreements, letters of intent, and the final purchase agreement, with legal counsel.

**Analytical input.** The financial team provides detailed analysis relating to such things as the tax and accounting effects of the potential structures of the transaction (e.g., asset versus stock sales), quantifying disentanglement costs, and development of pro-forma financial statements to present the business being sold as a standalone entity, a particularly critical and complex step in the preparation process.

**Operational participation.** Financial professionals are major contributors to operational aspects of divestiture transactions. They must be actively involved in the disentangling process, particularly as it relates to the quantification of the impact of decisions made. And, they are active in the staging and management of due diligence, especially in data room preparation which is a very labor intensive activity involving a large volume of financial data.

# Employee share ownership plans (ESOP): **Are they right for your company?**

While the benefits of a properly designed ESOP can be significant, there are potential risks and issues that should be carefully considered before they are introduced.

By Howard E. Johnson, FCMA



**M**any business owners and executives may implement an ESOP within their company to attract, retain and motivate employees.

In essence, an ESOP is an arrangement whereby certain employees of a company can become shareholders if they meet the specified criteria. Qualifying employees are either granted shares or an option to buy shares in a company at a specified price. The acquired shares usually are held until the employee leaves the company or a specified liquidity event occurs, such as a sale of the company to a strategic buyer or an initial public offering.

There is a considerable amount of flexibility in how an ESOP is designed. Some of the basic considerations are summarized in Exhibit 1.

magnitude of an employee's participation in the ESOP program often varies based on factors such as job title and compensation, so that senior management employees are rewarded more than individuals who occupy administrative and junior positions. This approach allows for the benefits of the ESOP to be widespread, but requires a larger pool of shares be made available, thereby diluting the interests of existing owners. A company-wide ESOP can also be more costly and time consuming to administer.

Another key consideration when designing the ESOP program is to determine the size of the ESOP pool. For example, what proportion of ownership are the existing shareholders prepared to give up in favour of ESOP participants? The obvious trade-off is that a greater degree of ownership

employees must acquire the shares at their prevailing fair market value. Requiring employees to acquire shares can be difficult for those individuals with limited financial resources — even if attractive payment terms are offered. Options are attractive because the price paid for the shares (as determined pursuant to strike price of the option) usually takes place concurrently with a liquidity event, so the employee is not out-of-pocket. However, if the value of the shares declines, then the options may be “under water” and provide little incentive. Having employees actually own shares can help to solidify retention, since they will have made a monetary commitment. Some ESOPs are designed to include both an element of physical shares and options in order to balance the pros and cons of each alternative.

Establishing the characteristics of the ESOP shares is another key decision. In some cases, the shares issued pursuant to an ESOP have different rights and privileges than those held by the existing shareholders. For example, ESOP shares may be non-voting or having limited voting rights. While this can help to ensure that the existing owners retain voting control in the organization, it can make employees feel as though they are receiving lesser economic value. Where the ESOP shares do have voting rights, it is also important to consider whether and how ESOP participants will be represented on the company's board of directors. A properly structured shareholders agreement that sets out the rights, privileges and obligations of all shareholders within a company is a critical component of any ESOP.

Finally, the provisions and restrictions governing the liquidity of the ESOP shares must be clearly established. In most cases, the shares received pursuant to an ESOP cannot be freely traded, and employees must wait for a “liquidity event” in order to get paid for their shares. Where the liquidity event involves a sale of the company to a strategic buyer or an initial public offering, then payment for the ESOP shares is a non-issue, since external financing is available. However, liquidity

### Exhibit 1 ESOP considerations

Criteria for participation

Size of the ESOP pool

Shares vs. options

Characteristics of the ESOP shares

Liquidity provisions and restrictions

The first issue to be addressed when designing an ESOP is to determine the criteria for participation. In this regard, there are two basic schools of thought. The first option is to restrict ESOP participation to a handful of key employees. This can be a way of recognizing and incentivizing select individuals who are viewed as critical to the long-term success of the organization, and making those individuals feel distinguished within the company. However, it can also lead to the feeling of two classes of employees within a company — those that are ESOP eligible and those who are not. The other basic alternative is to extend the ESOP to all employees that meet certain basic criteria, such as having been employed with the company for a specified period of time. In this case, the

participation creates added incentive, but existing shareholders experience greater ownership dilution. Business owners and executives should also remember that an ESOP pool will grow over time, as new shares are issued each year. Therefore, if shares representing four per cent of the company are issued pursuant to an ESOP each year, then the existing owners will have diluted their interest by 20 per cent within a five-year period. At that point, it may be difficult to modify the ESOP to slow down the rate of dilution, as employees will have established expectations.

It is also necessary to consider whether the ESOP will take the form of shares or options that can be exercised for shares. In conjunction with this decision is whether shares offered will be given to employees, or whether

events are more problematic when the company must finance the purchase of its own ESOP shares, such as when an employee leaves the company (most privately held companies do not want former employees holding shares). In this regard, many ESOPs are designed such that, in the event of a voluntary departure from the company, the redemption price is subject to a discount from what their value may otherwise be. This serves as a type of penalty to an employee who leaves the company and wants to cash in.

### Major benefits, risks and issues of an ESOP

The major benefits, risks and issues relating to ESOPs are summarized in Exhibit 2.

- Attract financing. Many commercial lenders and private equity firms perceive that there is less risk in dealing with a company that has a well designed ESOP, since it can help ensure that key employees are committed to the company. This is particularly the case where employees must pay for shares on their issuance (rather than receiving options) since equity injections will help to strengthen the company's balance sheet; and
- Income tax efficiency. Properly structured, employees participating in an ESOP will only be taxed on the disposition of their shares at capital gains rates. In addition, there can be an opportunity to utilize the lifetime capital gains exemption, which

- Potential erosion of the company's cash reserves. As noted above, where employees leave the company, the shares that they received pursuant to the ESOP usually are redeemed. Even where the redemption price is subject to a discount, the company must still finance the redemption with other internal resources. As an alternative to a redemption discount (or in addition to one), some companies pay for redeemed shares over a period of several years (normally without interest) in order to alleviate financing issues;
- The possible demotivating impact where share values have declined. Many companies have experienced this phenomenon in recent years with the downturn in economic conditions. Employees who acquired shares pursuant to an ESOP may feel that they were forced to overpay. Where options were granted in lieu of shares, the strike price of those options may be so far "under water" that they provide little economic incentive; and
- Possible friction among employees where not everyone participates in the ESOP. As noted above, this can create the feeling of two classes of employees within an organization.

<b>Exhibit 2</b>	
<b>Benefits</b>	<b>Risks and issues</b>
Attract, retain and motivate employees	Incremental costs
Reduce cash compensation	Governance requirements
Alignment of interests	Cash required for share redemption
Obtaining financing	Impact of a decline in share value
Income tax efficiency	Possible friction among employees

#### Major benefits

- Attract, retain and motivate key employees. This makes ESOPs particularly attractive in industries where specialized skills or knowledge are essential (such as high technology).
- Reduce cash compensation paid to employees, which can be critical for smaller and rapidly growing companies that need to preserve cash in order to finance expansion initiatives.
- Align the interests of employees with those of the business owners. A properly structured ESOP can encourage employees to think like entrepreneurs and find new ways to grow the company and reduce costs. In particular, an ESOP can help to alleviate employee concerns about a liquidity event that involves a sale of the company to a strategic buyer, since the employees stand to benefit financially.

means that up to \$750,000 of income per employee may be received tax free.

#### Major risks and issues

- Incremental costs. ESOPs involve up-front legal, administrative and accounting costs relating to developing and implementing the plan. Once the ESOP is established, there are additional ongoing costs in terms of financial reporting and valuation.
- Additional governance requirements. Participants in an ESOP have certain rights as current or prospective shareholders within an organization. There may be a need for a formal board of directors where ESOP participants have representation. This may have an impact on the company's strategy and key decisions. Further, an ESOP will reduce the flexibility that business owners have in terms of making discretionary payments such as bonuses to themselves and family members.

#### The next steps

Business owners and executives who are considering an ESOP are well-advised to do their homework and get sound and objective professional advice. They must be satisfied that the prospective benefits will outweigh the costs involved. Further, as much as the legal and administration costs of an ESOP can be significant, the potential consequences to a company from a poorly designed ESOP can be far worse. It is much easier to implement an ESOP than to try to modify or cancel it afterwards. Hence the need to invest the time, effort and cost to ensure that an ESOP is designed properly from the start, and that the long-term implications of an ESOP are carefully considered. ■

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# Strengthening partnerships, sustaining quality growth

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Bob Strachan, CMA, FCMA, sees the current market conditions as an opportunity to show the business community why CMA is the designation of choice.

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By Andrea Civichino

**T**he world is increasingly a global economy and with that comes the need for a strong and enabled management accounting profession. Bob Strachan, CMA, FCMA, the new chair of the CMA Canada National Board of Directors, says the business community needs to recognize the relevance of CMAs in the current marketplace.

“When times are tough, when the economy changes, there’s a dire need for the product CMAs deliver; strategic financial management,” he says.

“When the economy is doing more with less, reinventing itself to deliver different goods and services, realigning business entities, or is in a state of flux in the global economy, there is a distinct need for CMA Canada to be even stronger and more direct in branding our designation as the one that adds more value for the strategic delivery of a business organization.”

Strachan sees the current economic conditions as an opportunity for CMA Canada to maintain its profile as the designation of choice.

His support for the CMA designation dates back to 1994 when he started volunteering with the British Columbia (B.C.) Victoria Chapter. Beginning as a student member, he quickly experienced the governance cycle right from the bottom through to the top by serving roles on various committees and task forces at both the provincial and national levels. Strachan’s exposure to working collaboratively with other CMA provincial offices increased while he served as the chair of the CMA B.C.’s Board of Directors from 2001-2003.

Strachan, a resident of Victoria, B.C., received his CMA in 1995 and was awarded the Fellow of the Society of Management Accountants of Canada (FCMA) in 2004. He is the most recently accredited CMA to ever become board chair.

“When I was in my late 30s, I decided that I wanted to develop better skills at leading the financial management of an



organization,” he says. “I had some experience earlier on in my career in public practice and financial statement preparation, but found a need to participate in more operational, management and strategic decision making.”

While going through the CMA accreditation process, Strachan says he learned how to optimize on organizational behaviour and collaborate with a variety of stakeholders in developing and attaining common goals and objectives.

“Our goals can only be realized when we work closely with others who have a shared common vision,” he says. “Working my way through the CMA Canada governance experience from provincial partner level to chair of the CMA National Board of Directors has helped me develop skills in realizing the value-added contribution of every stakeholder along the



Photo: DESTRUBÉ PHOTOGRAPHY

“It’s only through the successful delivery and increased awareness of our brand that we can and will continue to sustain quality growth.”

way,” he says. “In every instance of participating in a CMA Canada event or meeting I continue to work with motivated volunteers, highly skilled and knowledgeable people, and a common thread of making a contribution back to our community. It is this professional ethic that has captured my passion.”

Although volunteering has been etched into his daily

routine for many years, Strachan’s volunteer efforts are not exclusive to CMA. He supports and lends his skills to various organizations and causes. He’s held positions with the Vancouver Island Rugby Union, United Way Victoria, Accounting Policy Advisory Committee (APAC) with the Ministry of Finance, Province of B.C. and currently sits as director of the board of Leadership Victoria.

#### **A new chapter unfolds**

As chair of CMA Canada’s National Board of Directors, his first order of business will be to work with newly appointed president and CEO, Joy Thomas, to ensure a seamless transition into her role. This includes the continuance of a strong and healthy partnership amongst senior staff of the

partnership; CMA Canada, the provincial and territorial partners and the Order.

"I'm excited about the new leadership we will see under Joy's direction," Strachan says. "I was the chair of the CMA Canada President and CEO Selection Task Force that resulted in Joy's appointment. I've been involved with the CMA community for a number of years and observed Joy's participation initially with CMA Nova Scotia then as president and CEO of CMA Alberta. I've been impressed with her passion, her dedication and her ability to engage others in thinking outside the box."

**"Earning the CMA designation has given me the opportunity to develop a wide array of skills that have helped me build a successful career."**

Although she's already a few months into her new position, Strachan will continue to support her as she becomes more familiar with the governance and management culture of CMA Canada.

Secondly, Strachan wants to adopt a new CMA Canada Partnership Strategic Plan and oversee its execution. This means working with all stakeholders in developing a cohesive CMA community who are focused on achieving common goals and objectives. "We need to continue to develop new and stronger external relationships with all stakeholders of our profession including domestic and international, business and educational, and members and students," he says. "It's only through the successful delivery and increased awareness of our brand that we can and will continue to sustain quality growth."

"Thirdly, working on the development of our strategic global management accounting alliance; this includes working with the CMA Canada Research Foundation to develop new ideas and generate revenue and increasing CMA Canada's visibility as a leading accounting voice. The world doesn't revolve only around the other accounting designations. We are a strong entity. We have a niche of knowledge and we have to be proud and loud in championing our designation," he says. "We are actively working with our international partners to develop strategies on issues of common interest; such as the development of the global management accounting alliances, IFRS or the supply chain of new candidates to the profession. CMA Canada unto itself is the third largest accounting body in terms of number of members in Canada. Internationally we are even smaller. International partnerships provide us with mass and synergy to the point that we have a global voice."

Strachan also sees the importance of working closely with other like organizations of significance in the international community to support the relevance of the management accounting profession. The exchange of information on standards, and the development of research material on

emerging issues such as IFRS all are vital to our own sustainability. The demand for material from CMA Canada MAG®s and MAP®s will continue to put CMA Canada in a position of significance in the global community.

### **Life as a CMA**

As Strachan moves into the role of chair of the board, previously held by Michael Tinkler, CMA, FCMA, he's looking forward to applying 23 years' experience with Capital Region District (CRD) – a regional government whose services transcend the boundaries of 13 municipalities and three electoral areas on Southern Vancouver Island.

"Being employed by the District allows me to work with a number of motivated staff who are committed to delivering goods and services that benefit the area's local communities. We're 'making a difference together.' "

Before his tenure with CRD, Strachan worked with the Greater Victoria Hospital Society as an accountant involved in the integration of four hospitals' revenue operations under a newly consolidated model and with the Province of B.C. as an accountant preparing the province's Public Accounts and financial statements.

Before becoming the manager of accounting services at the CRD, Strachan held management positions in the areas of treasury and risk management. Currently, his primary responsibilities include oversight for accounting services of a very large and diverse organization. The District has in excess of 200 individual services, each with separate budget and funding. The scope of his responsibilities include accounting, revenue, cash and banking, taxation, financial reporting, grants management and the integrity of the related enterprise financial system components.

"What is particularly interesting about this position is that there is such diversity in the types of businesses we are engaged in," he says. "The CRD delivers water to residents of the region, has a wastewater (sewer) collection infrastructure, regional parks, environmental services including landfill operations and recycling, a number of recreation centers, transit services, building inspection, animal control, bylaw enforcement and regional housing to name a few."

Strachan says his CMA training has helped him develop a host of skills to deal with the diversity and scope of management and operations of the District. On a daily basis, Strachan touches on the three pillars of the CMA profession: accounting, management and strategy.

"Earning the CMA designation has given me the opportunity to develop a wide array of skills that have helped me build a successful career. I've learned to be better at using financial data to make strategic and management decisions, work strategically to gain best operational advantage, work more collaboratively with stakeholders and effectively lead change management from idea generation through business process development." ■

*Andrea Civichino is the editor-in-chief of CMA Management.*



# Is your portfolio on the path to recovery?

Although it may be difficult to predict when the markets will fully recover, there are many options to consider as part of your investment strategy.

By Michael Low, CMA

Long before arriving at their destination, parents taking their children on long car trips are very familiar with the question “are we there yet?” It’s a question many investors are asking right now, as they wonder when a full market recovery will be attained.

But unlike restless children who ask the question far too early and too often on a road trip, successful long-term investors are patient. These investors know it’s difficult to predict when a recovery may arrive or how the market will move until then. Yet, at the same time, they also appreciate the importance of preparing their portfolios for recovery, even though a great deal of economic uncertainty remains.

**Although past results cannot guarantee future outcomes, historically the stock market has rebounded six months before the economy emerges from a recession.**

In other words, you don’t necessarily have to wait for clear indications of recovery before adding equities. Although past results cannot guarantee future outcomes, historically the stock market has rebounded six months before the





## money management

economy emerges from a recession.

With that in mind, here are some ideas you might want to think about as part of your investment strategy during these challenging times:

1. Reduce the impact of low short-term interest rates. The Bank of Canada (BOC) lowered short-term rates to 0.25 per cent in April and has announced plans to keep those rates low until June 2010. If you have more than you need in cash accounts, short-term guaranteed investment certificates (GICs) and money market funds, you may have too much in low-interest rate investments. You might want to consider bonds and dividend-paying stocks as they may be appropriate investments to help increase your expected income today and over time — though keep in mind dividends may be increased, decreased or eliminated at any point without notice.

**Equities have historically provided investors with the highest returns, and they experienced the largest losses over the past year.**

2. Compare your goals to your current situation. Do you need to invest more to achieve your long-term financial goals? This is a time when you might be able to spend less and invest more while prices are still low. By investing more at lower prices, you may be able to increase your long-term returns.
3. Upgrade the quality and diversification of your portfolio. While it cannot guarantee a profit or protect against loss, diversification has been an effective strategy for many investors. If you own more than a few investments, you may think your portfolio is diversified. However, diversification means

owning the right investments in the right amounts, and this requires skill and knowledge. As general guidelines:

- Ensure no individual investment (not including mutual funds) represents more than five per cent of your total portfolio.
  - If individual stocks constitute the majority of your equity portfolio, make sure you own at least 25, spread across all the major industries.
  - Strive to own at least 10 individual bonds in a diversified portfolio that's laddered based on different maturity dates.
  - If you don't have a goal of owning enough individual stocks and bonds, mutual funds may be a better approach, but try to avoid any single fund being more than 25 per cent of your total portfolio.
4. Consider adding equities. Equities have historically provided investors with the highest returns, and they experienced the largest losses over the past year. As a result, you may need to add equity mutual funds and individual stocks to your portfolio. Even with the rebound we've seen since March, you might find they are attractively valued.

Above all, remember that if you own a well-diversified portfolio of quality investments, patience is critical. Speak with your financial advisor to determine what you might want to do to get your portfolio recovery ready. ■

Michael Low, CMA, CFP, ([michael.low@edwardjones.com](mailto:michael.low@edwardjones.com)), is a financial advisor with Edward Jones in Toronto.

*The opinions contained in this article are those of the author and are not necessarily those of CMA Management.*

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# What every manager should know about IT storage

Non-technical managers don't need to be storage experts to understand the basic issues.

By Jacob Stoller

Information assets figure significantly in the valuation of most companies. This means that much of a company's net worth — customer lists, procedure manuals, proprietary processes, or software code — is likely to reside on a company's IT storage systems.

Storage decisions can impact issues such as business continuity, employee productivity, accuracy of transactional and customer information, and of course, security. Non-technical managers don't need to be storage experts to connect the dots, but should understand the basic issues. Here's a quick primer:

1. **Growth:** Storage capacity grows every year as companies accumulate more and more information from e-mail, file shares, wireless devices, websites, and other sources. Companies need strategies for controlling this growth and planning around a variety of potential growth barriers. For example, there may be physical space limitations, or capacity limitations on the network. Also, many storage systems have expansion limits where reaching a maximum could necessitate a major acquisition.  
Growing pains can be mitigated by reducing unnecessary storage of data, but this discussion has to involve the business. "There's a disjoint in a lot of organizations between the IT folks and the business folks that haven't come together and said 'we need to define our policy around how long we keep



our data, and where it needs to be maintained," Jeffrey Wiggins, business development, IBM Canada, says. "If they haven't put a policy in place to actually cull the data and archive it or delete it, then most companies are keeping it forever."

2. **Green IT:** Storage represents a significant and growing portion of IT's environmental footprint. "If we put on our environmental hats for a minute," Wiggins says, "the amount of storage, because it's growing so fast, is driving up the power and cooling of the data centre. The more efficient, better utilization of a storage environment is really going to help."
3. **Access:** It's easy to store data — the real issue is whether people can get at it when and where they need it. Requirements vary — active customer files might have to be accessed multiple times a day in time-sensitive circumstances, while information such as obsolete



part numbers might stay dormant for months or years.

**Management tools, in spite of their importance, are often not a priority.**

“You need to store the data on a device that’s appropriate for its current value to the business,” says Nolan Evans, consulting solution architect for Mississauga, Ont.-based storage integrator FlexITy Solutions, “and that’s where you get into the concept of tiered storage. You can pay a whole lot of money for very high performance – disk

subsystems that will be able to keep up with any high-end database – but you’re not going to want to store all of your employee e-mails on it.”

4. Networking: Data has to be transported in and out of storage systems, often at high volumes and speeds. High performance fibre channel storage area networks (SANs) can handle the job, but they’re expensive. Companies, therefore, try to tier their networking the same way they tier storage capacity, reserving the high performance component of their network for the most business-critical traffic.

New developments are making it easier to manage traffic with varying priorities. “We call it data centre networking,” Wiggins says. “It’s really the convergence of the SAN network and the Ethernet network (e.g., the standard network infrastructure used in offices) to provide a unified medium for all the storage. There’s going to be a lot more unified infrastructure.”

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5. **Redundancy:** All devices fail eventually — the key is making sure that failure doesn't impact the business. Redundancy allows businesses to avoid interruptions by maintaining duplicate copies of data. As with tiered storage and networking, the degree of redundancy, and the accompanying cost, is determined by how important the data is to the business.

Another use of redundancy is to guard against a single point of failure. "That's almost a given," Evans says. "You can't have any storage environment where any one thing breaks and the whole thing goes down."

6. **Backup and recovery:** Offsite storage of backup data is a special type of redundancy designed to protect against the inaccessibility or physical destruction of an entire facility due to a disaster such as a flood, fire, or pandemic. Data has to not only be redundantly stored, but maintained so that it can be quickly deployed at an alternate location. "Storage and disaster recovery are very tightly tied together," says Evans, "because that's the core of your infrastructure."
7. **Mobility:** Storage is no longer confined to glassed-in facilities — corporate data resides on home computers, laptops, mobile phones, PDAs, and even GPS devices. "The sheer number of devices that can collect data and feed it back to a centralized IT environment has grown at a phenomenal rate," Wiggins says. The issue is not just about devices — the stewardship of data is now literally in the hands of employees, and storage strategies need to address the complex issues that this brings to the table.
8. **Security:** Data is the target of most security threats, and storage systems are the vaults that protect it. Security, however, is much more than buying a system that keeps the bad guys out — secure data depends on managing how people use it, when and where it can be accessed, and by whom. In

other words, security has a lot to do with employees, customers, and business partners.

The growth of mobile environments has made security a lot tougher. A growing number of companies are turning to encryption — technology that allows data to be stored in scrambled format that cannot be unlocked with a special piece of software code, or key. Encryption technology is not difficult to deploy, but managing the keys in a secure fashion is a demanding chore.

9. **Management:** As the above indicates, there's a lot to monitor and regulate in a storage environment. Furthermore, many storage environments have grown in an unruly fashion, leaving companies with complex multi-vendor arrays of equipment. Storage management can be simplified using special software tools that allow the entire environment to be viewed under a single pane of glass.

A popular trend in storage management is virtualization — the management of diverse devices as a single capacity pool. This allows not only the operation, but the growth of storage to be managed rationally.

Management tools, in spite of their importance, are often not a priority. "This is often one of the things that is left to the end, or thought of as a 'nice to have,'" says Evans. A typical consequence is inefficient use of expensive resources. "A company may wind up with an enormous storage environment that is only 30 per cent utilized," says Evans, "because there's all this stale data out there that's not really being monitored."

10. **Outsourcing:** Given these challenges, many companies decide to leave storage to somebody else. Outsourcing options include online backup, remote management of storage systems, and various hosting options. The issue here for businesses is convenience versus control.

One of the keys is ensuring a workable separation of infrastructure. "To outsource just the storage component is tricky because it depends on your applications and how they're structured," Evans says. "Having the storage and the processing co-located is the optimal way to go."

### The bottom line

Data is a valuable and critical asset that can, if mismanaged, be lost, corrupted, stolen, or rendered inaccessible. Business stakeholders need to engage with IT to ensure that stored data is appropriately protected and readily available to authorized users, and that the costs of ensuring this are reasonable. ■

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# Reduce the risk of transfer pricing adjustments

In order to stay under the radar of the Canada Revenue Agency (CRA), it can be helpful for management teams to know what high-risk activities may flag its attention, as well as what strategies will minimize opportunities for potential transfer price adjustments and hefty penalties.

By Charles Osoro and Hendrik Swaneveld

Ever since the federal government updated Canada's transfer pricing legislation in the 1997 federal budget, audit activity by the CRA has steadily increased.

Today, more than 460 CRA international tax auditors conduct over 2,000 transfer pricing audits each year. Companies of virtually any size that conduct cross-border business with related parties may find their transactions under review. Even the recession has not slowed this area of tax enforcement; the CRA is increasingly employing court actions and exchange of information arrangements with other countries to investigate suspected transfer pricing transgressions.

When Canada updated its transfer pricing legislation to harmonize with the *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* developed by the Organisation for Economic Co-operation and Development (OECD) 12 years ago, this ushered in an era of essentially new requirements for organizations having cross-border related-party transactions.

First, these transactions had to meet the arm's length principle, which stipulates that related parties must price their transactions in a manner that parallels similar transactions between unrelated parties. Should the CRA determine that a transaction does not meet the arm's length principle, it has the power to change the transaction, either by adjusting the amount or recharacterizing the nature of the transaction in order to meet arm's length terms and conditions.

The second requirement is "contemporaneous documentation," which must explain the business



context in which transactions take place and support the basis of the transfer prices. Standards and requirements for documentation are set out in Canada's Income Tax Act and OECD guidelines.

When an enterprise does not demonstrate that it has made "reasonable efforts" to determine and use arm's length transfer prices or it does not have the appropriate documentation to substantiate cross-border related-party transactions, the CRA can apply penalties of 10 per cent on the total adjustment it makes to a transaction, plus interest.

When identifying prospects to audit for potential transfer pricing



discrepancies, the CRA targets certain industries, organizations, transactions and activities. Highly regulated industries such as financial services and health care, and highly profitable industries, such as pharmaceutical, for example, are regularly scrutinized.

Certain types of transactions are also in the CRA's sights because of their high potential tax exposure. These include transactions involving intangibles, especially moving intangibles offshore; financial transactions such as intercompany financing involving guarantee fees; business restructuring; royalties (especially for "unregistered intangibles" such as technical know-how and trade secrets), and intercompany services such as management and other centralized services.

### Certain types of transactions are also in the CRA's sights because of their high potential tax exposure.

Along with targeting these industries, organizations and transactions, the following activities can also flag the attention of the CRA.

- "No" is the response to question six on the slips of Form T106: Information Return of Non-Arm's Length Transactions with Non-Residents. The CRA screens these forms to identify audit targets, relying particularly on question six, which asks whether the taxpayer has contemporaneous documentation pursuant to subsection 247(4) on hand.
- Transfer pricing methodology has been changed; this would also be reported on Form T106.
- The enterprise is undergoing another CRA audit, such as income tax or GST; this will likely precipitate a request for transfer pricing documentation.
- The enterprise has a higher portion of its business involving cross-border related-party transactions; the higher the value of the transactions, the more likely an organization will be audited.
- Intercompany agreements do not exist or have been used contrary to legislation.
- The entities involved in a transaction have been mischaracterized. This might happen, for example, if a company has two dominant business activities, such as manufacturing and distribution, involved in cross-

border related-party transactions, but characterizes all activities as manufacturing when determining transfer prices.

- Transactions have been tested with profit level indicators that are not typically used for that particular business activity. The return on sales ratio, for example, is commonly used to test distribution activities, while service and manufacturing operations are tested with the return on total cost ratio.
- Large year-end journal entries are not well documented.
- Operating results are unreasonable; the CRA will often investigate chronic losses and/or low profitability.
- Cross-border operations have been restructured. This might include situations such as the transfer, sale or lease of tangible or intangible assets to non-resident



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related entities, or plant closures in one location and openings of others in new locations set up through non-resident related entities.

- Payments of withholding taxes do not reconcile with amounts disclosed in Form T106 or transfer pricing documentation.
- An organization has transactions with low-tax jurisdictions.

### Strategies to reduce risk of transfer pricing adjustments and penalties

Despite the increasing number of international tax auditors, as well as the growing list of audit risk factors, it is both possible and practical for companies to reduce their risk of transfer pricing adjustments and penalties. While the process of determining appropriate transfer prices is highly subjective, when an organization can demonstrate that it has made reasonable efforts to arrive at and document an arm's length transfer price, even if the CRA disagrees with that price, it is less likely to impose penalties.

Although the legislation does not define reasonable efforts in terms of the level of documentation required. An organization would be deemed to have made reasonable efforts to determine and use arm's length prices in its transactions if it prepares adequate contemporaneous documentation to support its transfer pricing policies.

The contemporaneous documentation requirements are specified in subsection 247 (4) of the Income Tax Act. Developing appropriate transfer pricing policies and preparing supporting documentation involves:

- Identifying the material transactions requiring a transfer pricing policy—usually those transactions reported on Form T106.
- Describing the facts and circumstances regarding the transactions.
- Characterizing the entities involved in the transactions according to the functions performed, property used or contributed and risks assumed in relation to those transactions.
- Describing the data and methods considered and the analysis performed to determine the appropriate transfer pricing methodologies; this includes identifying arm's length comparable companies to determine the appropriate pricing for similar transactions.
- Describing any other assumptions, strategies and policies that affected the transfer prices.

Following this process not only reduces a company's risk of transfer pricing adjustment, but also helps identify opportunities to reduce taxes and implement tax saving planning.

The Income Tax Act also requires an annual update of any significant changes to transactions in subsequent years. Management should annually review transfer pricing policies and any supporting documentation in conjunction with the relevant transactions to identify any material changes that would necessitate updating the documentation.

### For large companies that anticipate contentious issues, an advance pricing arrangement can be a valuable precaution.

A diagnostic audit can be helpful when an organization has complex transactions and management is concerned that transfer pricing discrepancies may arise. This is essentially a rehearsal of an international tax audit whereby a transfer pricing specialist reviews the transfer pricing issues and documents the CRA would typically request, thus revealing potential areas of exposure.

For large companies that anticipate contentious issues, an advance pricing arrangement can be a valuable precaution. This is a formal agreement between the government and a taxpayer that confirms, in advance, the appropriate transfer prices for cross-border related-party transactions.

Filing an accurate and complete Form T106 within the prescribed timeline is an essential first step. But, should the CRA subsequently request transfer pricing documentation, management should review the documentation to ensure it is complete, and then submit it within the three-month request deadline, without undue delay. CRA auditors do not have the discretion to provide any extensions to documentation requests.

By employing proactive strategies like these for cross-border related-party transactions, organizations can stay on the right side of the CRA — and significantly reduce their risk of punitive transfer price adjustments and penalties. ■

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# Running for the border

Before a Canadian company heads south, there are numerous tax issues, structural considerations and financing questions to consider.

By Arthur Azana and Dan Cassidy

With only a friendly border between Canada and the United States and more than 300 million potential customers, it's tempting for a Canadian company to consider doing business with its southern neighbor.

Easy transportation, wealthy buyers and a recently revised tax treaty between the two countries make this proposition even more intriguing. Knowing the ins and outs of each of these issues and getting the right expert advice could make the difference between a successful foray into the United States and an embarrassing, if not financially fatal, mistake.

## Know when a Canadian company will become subject to expensive U.S. taxes

Over the past two years, Canada and the United States have worked to ratify changes to the Canada — United States Tax Convention, a treaty that governs when Canadian businesses become subject to U.S. federal income taxes. The treaty's new rules in this regard generally take effect in 2010. As in the past, Canadian companies are subject to U.S. income taxes once they have created a "permanent establishment" in the United States. A permanent establishment is generally defined as a fixed place of business, although there are specific inclusions and exclusions from this general rule. For example, Canadian businesses can establish a permanent establishment merely by having employees in the U.S. who regularly approve contracts on behalf of the Canadian



company. (This can generally be managed by having final approval for contracts that specifically take place in Canada.) Also, under the treaty's new rules, Canadian businesses that provide services in the U.S. for more than 183 days in any 12-month period may be considered to have a permanent establishment in the U.S.

Individual states are not party to the income tax treaty with Canada. Therefore, the permanent establishment provisions do not apply. In their place are the state nexus rules. These rules vary from state to state. These rules determine when a company will become subject to taxation in a particular state. In general, a Canadian company will become subject to state income taxation if it has employees performing services in the state, owns tangible property located in the state, or owns intangible property that is being used in the state. This often results in a situation in which the Canadian company is exempt from federal tax by virtue of the treaty, but is still subject to state income taxes. Common examples include cases where the Canadian company



holds inventory in public warehouses or has employees that provide services in the U.S. for less than 183 days.

Even if a Canadian company does business in the U.S. without a permanent establishment, it is required to file a tax return with the U.S. Internal Revenue Service (IRS) to show that it is claiming a treaty exemption.

#### **Get advice in the beginning and choose the appropriate structure**

Many businesses interested in doing work in the U.S. make the mistake of waiting until they have established their business there before getting advice. This could cost them significantly in the long run. It's imperative to choose the right structure from the beginning. Should the business be structured as a branch or subsidiary? If the wrong structure is chosen it often is too costly to restructure. As the type of structure is contemplated, the business should consider several factors, both current and future, and both general and specific to either the U.S. or Canadian operations. What is the impact of the structure on current taxation, particularly where there may be start-up losses? What are the plans for repatriation of profits? What is the exit strategy for the U.S. operations, Canadian operations, or both?

There are several entity choices — including a branch, Limited Liability Corporation (LLC), Partnership, or C Corporation (a C Corporation is a corporation that is subject to corporate level tax, as opposed to partnerships and LLCs whose tax liability generally flows through to its owners). In general, Canadian companies most frequently will choose to set up a U.S. C Corporation for business reasons. However, if a company expects significant start up losses and wants to take deductions for those losses immediately in Canada, a branch or limited partnership could make more sense. Unfortunately, Canadian rules do not allow for a

U.S. branch or limited partnership to convert to a U.S. corporation on a “rollover” or tax-deferred basis in the future. Consequently, it's extremely important to choose the right structure from the beginning. Canadian companies should consider what structure they want in the long run and be very realistic about the business' future.

### **Transfer pricing rules are one of the most challenging issues companies doing business internationally must address.**

A common trap for Canadian companies is to use U.S. LLCs for their U.S. operations. U.S. LLCs are generally treated as flow-through vehicles in the U.S. (which makes them attractive for U.S. shareholders), but they are treated as ordinary corporations for Canadian income tax purposes. U.S. LLCs have historically been problematic for Canadian shareholders, in practical terms because of the U.S. filing requirements imposed on the Canadian shareholders, and in taxation terms because of the potential for excess taxation given the differing treatment between Canada and the U.S. Under the hybrid rules of the new treaty, U.S. LLCs are even more problematic because payments from U.S. LLCs to Canadian shareholders may no longer receive treaty protection. Tax rates for repatriating income through interest, dividend, and royalty payments into Canada may be greater under the new treaty than under the old one. In general, the only time to consider an LLC is if a Canadian business is in a joint venture with a U.S. partner. U.S. partners stand to save significant taxes by using an LLC. However, this poses problems and a significant tax burden for the Canadian partner. The additional tax burden should be explicitly considered by the Canadian partner before entering into the joint venture.

Choosing to open a Canadian branch in the U.S. is rarely done because the risks and liabilities of the U.S. branch may impact the Canadian business. Using a C Corporation allows the business to separate what happens in the U.S. corporation from its Canadian counterpart. A separate U.S. corporate entity also gives the business more flexibility to create charges and sales to manage the profit between the entities. Finally, while a branch has to follow certain allocation rules, two corporations can contract with each other to get a different result.



### Capitalization options — debt vs. equity

Once the structure is determined, the next step is to determine how to capitalize the company. When everything is considered, many businesses will choose equity over debt. This isn't always apparent. In general, businesses can get a slightly better result by using debt as opposed to equity (by repatriating profits by way of deductible interest, rather than after-tax dividends). But this comes with significant risk. And for debt to work, the U.S. corporation must be adequately capitalized, the debt instrument must be interest bearing, and the debt must be on commercially reasonable terms — otherwise, the IRS may treat it as equity anyway. If all these criteria are met, the overall effective income tax rate on the interest income paid to Canada is typically lower than the overall effective income tax rate on U.S. taxable income repatriated to Canada. However, if the U.S. entity isn't profitable, don't expect to get any benefit from an interest deduction. Even if the business is profitable in the U.S., if it is in the lower tax bracket, the tax savings won't be as great. In addition, U.S. earnings stripping rules may prevent the business from utilizing all of its interest deductions.

### Beware transfer pricing rules

Transfer pricing rules are one of the most challenging issues companies doing business internationally must address. These rules are designed to protect the tax base of countries like the U.S. and Canada, and essentially require that any transactions between related companies take place at an arm's length price. That is, the amount charged in a given transaction has to be equivalent to what two independent parties would charge each other in the same circumstances. For example, if a U.S. company is a distributor for a Canadian manufacturer, the Canadian company may sell the goods to the U.S. company for resale by the U.S. company, or the U.S. company may sell

the Canadian company's goods and earn a commission. In either case, the sale price of the goods or the sales commission paid must be the same as that for an arm's length party under similar contractual terms.

### Many companies attract scrutiny when they fail to account for intangibles such as intellectual property or trademarks.

A common trap is failing to pay for home office expenses such as accounting, general management, marketing, engineering, branding, etc. Many companies attract scrutiny when they fail to account for intangibles such as intellectual property or trademarks. The U.S. company must pay the Canadian company for the use of such intangibles.

In all cases, the entities must comply with strict documentation requirements to support their transfer prices, and penalties may apply if such documentation is not maintained.

### Nexus — revisited

Canadian companies should also be aware that many U.S. states, cities and other locales have their own income taxes, gross receipt taxes, and sales and use taxes. Income and sales taxes vary from state to state and in some cases come close to 10 per cent. Nexus rules apply for other taxes besides income taxes. It's possible for a Canadian company that doesn't have a permanent establishment in the U.S. and that doesn't have income tax nexus in the state it is operating in to have sales tax nexus. And unlike Canada's GST, not all state sales taxes are automatically passed on to consumers and many aren't easily tracked. Canadian companies must learn about the intricacies of the U.S. sales tax system and understand how to apply the taxes to goods and services sold in a way that they can be recouped.

No doubt, there are challenges and hoops to jump through when doing business in the U.S. But this vast land just across the border is full of opportunities. For the Canadian company that intends on taking advantage of those opportunities, early planning and expert execution could lead to significant business successes with high profit potential. ■

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