

Insurance
Summer 2009 edition

Finding a new strategic position*

Insurance Review: A Canadian perspective



*connectedthinking

PRICEWATERHOUSECOOPERS 

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A new strategic position: Redefining internal audit in an economic downturn

A changing world

Government and business leaders were caught unprepared for the global financial crisis, which has evolved into a worldwide economic deceleration. In the short term these conditions have shattered the confidence of many organizations that reacted to urgent concerns around credit, liquidity, revenue and costs.

More and more organizations are now expecting internal audit to think beyond financial controls and compliance. Management and audit committees expect internal audit to be a significant contributor in addressing the present challenges and providing assurance on how well risks are being managed. However, in order to achieve this objective, many audit departments will need to review their processes and transform themselves first.

How can internal audit refocus to add greater value?

Before audit departments can start finding solutions to improve the effectiveness of their organization, they will need to focus on the following issues within their own processes:

Cost containment focus

The annual audit plan for many departments is based on a risk assessment of the organization's processes. While a risk-based approach should still drive the department's plan, it is important that the department also consider areas where significant cost containment is possible. Wasteful expenditure may be the biggest risk for

many organizations right now, and their survival may depend on identifying ways to contain cost. Internal audit should fine tune its audit plan to focus on cost containment, which may translate to a fewer number of more in-depth audits.

Using the right tools

Auditing a process to identify cost containment potential is different from auditing to assess effectiveness of controls. While both can be achieved within the same audit, internal auditors need to change their approach to provide realistic cost containment recommendations. They will need to audit smarter using better tools and leveraging technology. A good example is the use of Audit Command Language (ACL) or other Computer Assisted Audit Techniques (CAATs) to enhance the depth of audit analysis and efficiency of the audit process overall. For instance, while auditing key cost centers to identify opportunities to reduce costs, it is important that the auditors base their recommendations for cost containment on the data set as a whole, rather than a small sample of transactions. This will help internal auditors to provide recommendations based on empirically-tested evidence rather than just a broad understanding of the process and to create a compelling cost benefit analysis for their recommendations.

Reporting and communication strategy

In addition to enhancing how audit work is performed, there is an opportunity for audit departments to improve upon how they report findings and communicate

the value of audit activities. Audit departments should focus more on incorporating purposeful analysis and quantifying cost savings and value created within the audit report. This will provide enhanced clarity and visibility on the value that internal audit brings to the table. Going a step further, many leading audit departments are using periodic (e.g. quarterly) dashboard reporting to senior management to demonstrate the business value realized through the internal audit program. For many organizations, this will necessitate a reevaluation of the communication and reporting strategy for the department.

Securing the right talent

Implementing change requires the right skill sets. Each audit team should have at least one person with deep process understanding, good financial analysis skills and a strong knowledge of business models and strategy. This is important as teams strive to create value added cost benefit analysis for their recommendations to stakeholders.

Finding value in the audit plan

Once internal audit processes have been reevaluated, audit departments can begin to develop an audit plan to help address emerging risks and provide recommendations to meet the evolving needs and expectations of the organization and key stakeholders. The audit plan should reflect the impact of the economic downturn and incorporate a cost containment view for the organization.

Insurance companies can utilize their internal audit function to monitor the credit ratings and financial performance of reinsurers and other significant counterparties.

Internal audit should consider the following within the audit plan:

Capital adequacy

Compliance with capital adequacy requirements is extremely important for insurers, particularly given the recent pressures on capital arising from the soft market conditions and poor investment performance. Insurers should also set specific solvency benchmarks which should be used as a yardstick to measure performance.

The internal audit team can assist management in setting and reviewing targets relating to solvency margins as well as required capital to ensure that management is inline with the insurance regulator and internal goals, while maximizing their investment surplus of capital. Ongoing monitoring is critical and should involve highlighting potential deviations from set benchmarks and recommending practical solutions to bring the company's capital to an optimum level.

Liquidity and cash management

A significant fallout from the global economic crisis has been the availability of credit. Despite bold measures that many governments are taking, credit remains scarce. New lines of credit are far more expensive in 2009 than they were during early 2008. In this scenario, it is critical to ensure that an insurer's cash management is optimal. A thorough review of the effectiveness of cash forecasting, liquidity and an assessment

of potential illiquid investments could yield significant savings. Similarly, a review of accounts payable processes, treasury processes around banking and the effectiveness of accounts receivable processes often yields cash flow improvements.

Addressing fraud risk

The current economic climate is changing the nature and scale of fraud and integrity risks that organizations face. As a result, many senior executives expect to see more fraud within their organizations over the next few years. The risk of fraud is much higher during a downturn due to two reasons: first, the pressures and incentive to commit fraud is more prevalent as meeting internal targets and budgets is often more difficult during a downturn; and second, with many organizations downsizing people there is a higher potential for compromise in the segregation of duties. There is also greater potential for external fraud risks for the same reasons mentioned above; however, external risks are more difficult to identify and address.

For insurers, fraud risk lies in many areas ranging from policyholders making fraudulent claims, employees who are under financial pressure due to reduced incomes or investment losses and even business partners such as Third Party Administrators who may have cash-flow issues of their own.

While regulators have focused on addressing fraud risks within SOX, it is

now critical that internal audit ascertain the depth of anti-fraud measures that are in place and perform preventive in-depth reviews for areas that have higher exposure.

Capital projects

When the economy recedes capital projects tend to be scaled back. However, as organizations step back from their capital expenditures, internal audit should be evaluating the processes behind this strategy.

Are management decisions based on sound economics, or are they a short-term reaction to the current economic condition and stakeholder pressure? Does the net present value of the project reflect the economic cycle (i.e. do the long-term cash flows from the project reflect a future upturn in the economy, or are they solely based on current prices)? Are organizations putting in adequate processes to enable a smooth restart of the project to leverage past work?

While economic feasibility is important, the present market conditions provide an unprecedented opportunity for low costs. For those organizations that are continuing with their existing projects, this would be a good time to review contract compliance and economics. A thorough review of contracts at this time may yield significant cost savings.

Foreign exchange exposure

Many insurers are exposed to foreign exchange fluctuations. The financial crisis has resulted in extraordinary foreign exchange fluctuations for most currencies, and we will likely see continued fluctuations in the near future as each nation struggles with its fiscal policies and implements strategies to stimulate their economies.



This uncertainty has left many companies with the daunting task of managing their financial risks. Internal audit can add value by reviewing an organization's foreign exchange strategy around hedging and mitigating foreign exchange related risks in this ever changing environment.

Monitoring Credit Ratings

Another impact of the economic downturn has been the number of organizations that have regressed from a solid credit rating to bankruptcy in a matter of weeks. Insurance companies can utilize their internal audit function to monitor the credit ratings and financial performance of reinsurers and other significant counterparties. Where there is a significant change in the financial position of major reinsurers, red flags

should be highlighted to management. Ongoing monitoring of the financial soundness of counterparties can be undertaken by the internal audit teams to ensure that recoverability of receivable balances are not called into question.

Reviewing overall HR Strategy

In the light of the financial crisis, internal auditors should consider whether management has performed a cost benefit analysis specific to the company's overall HR strategy. To eliminate costs, some insurance companies have established shared services centers as well as outsourcing certain functions for example, their policyholder customer relationship function and call centers. Layoffs have occurred as companies try to manage their costs. Insurers need to consider the long-term impact of layoffs,

as the cost of replacing these resources when the economy rebounds could be much higher than the anticipated short-term savings.

Conclusion

Audit committees are looking to internal audit to make a more significant contribution towards the success of the organization's core business strategy. The upside to the current economic crises is that organizations now have an opportunity to realign their processes and make them more cost effective.

Looking forward, audit departments that maintain alignment with the changing risk profile of their organization and the evolving needs and expectations of their key stakeholders will be more successful. During this critical economic time, internal audit can add strategic value and become more relevant than ever before.

To read the full report of *A new strategic position – redefining internal audit in an economic downturn*, please visit www.pwc.com/ca/publications or contact:

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The use of captive insurers and tax havens: Implications of a UK tax court transfer pricing case

On April 22, 2009, UK's first substantive transfer pricing case was made public.¹ The UK Special Commissioners found in favor of Her Majesty's Revenue and Customs (HMRC) that non-arm's length pricing between UK's biggest electrical retailer, DSG Retail Ltd. (DSG) and a captive insurer in the Isle of Man (DISL), resulted in an understatement of UK corporation tax during the period 1996 to 2005.

In addition to its relevance for any groups that make use of captive (re)insurers, the case is relevant for any taxpayer transacting with a tax haven or low taxed country. The case looks in detail at the comparability threshold for comparable data (which would be relevant to taxpayers relying on comparable uncontrolled prices (CUPs) to support their transfer price) and also considers the applicability of the transfer pricing legislation to cases where, prima facie, it might appear it would not apply.

There is potential that this case will become a reference case in other jurisdictions outside the UK where similar arrangements are seen, especially in relation to its findings on the insurance specific aspects of the case. Also, with both sides of the case drawing evidence from a number of expert witnesses (industry experts, actuaries and economists), we expect that transfer pricing cases outside the UK will consider relying on similar testimonies more closely in the future.



The case, combined with recent work by OECD in relation to the taxation of insurance branches, is likely to bring transfer pricing of (re)insurance on the radar of tax authorities with sophisticated transfer pricing regulations.

Facts and issues

DSG's retail outlets offer customers, at the point of sale, the opportunity to purchase extended warranties on electrical goods to cover the cost of repair or replacement within a specified period beyond the manufacturer's standard warranty period. DSG's customers contracted with third parties that passed the risks of extended warranty contracts to DISL. Substantially all of the risks (and profit) on these arrangements were borne (and made) by DISL.

Court findings

Application of Transfer Pricing Legislation

Notwithstanding that there were no direct transactions or contractual arrangements between DSG and DISL and even with the insertion of third parties (as noted above), the Special Commissioners considered DSG to be a party to the overall extended warranty provision with DISL because DSG allowed the extended warranty contracts to be sold in its stores. The Special Commissioner concluded that the relevant transfer pricing legislation applies to the contractual framework amongst the parties.

¹ DSG Retail Ltd vs. HMRC, Special Commissioners TC0001, 30 March 2009.

Selection of appropriate methodology

The case considers the relevance of the OECD Guidelines² to the determination of an arm's length price, and in particular the importance of the hierarchy of transfer pricing methodologies. The taxpayer applied CUPs and the Transactional Net Margin Method (TNMM). The only other method considered by the court was the Profit Split.

Comparable uncontrolled price (CUP)

In general, the CUP approach is the most direct and reliable way to apply the arm's length principle. As stated in the OECD Guidelines, in order to apply the CUP approach, it is necessary to demonstrate that:

- no differences between the transaction being compared or the enterprises undertaking those transactions could materially affect the price in the open market; or
- reasonably accurate adjustments can be made to eliminate the material effects of any such differences.

All of the CUPs that DSG put forward to support the overall levels of commission received in the U.K. were rejected as containing differences—market conditions and product characteristics—that could not reliably be adjusted for. The Special Commissioners drew a clear connection between:

- the overall expected profitability of the warranty cover (as indicated by the loss ratio); and

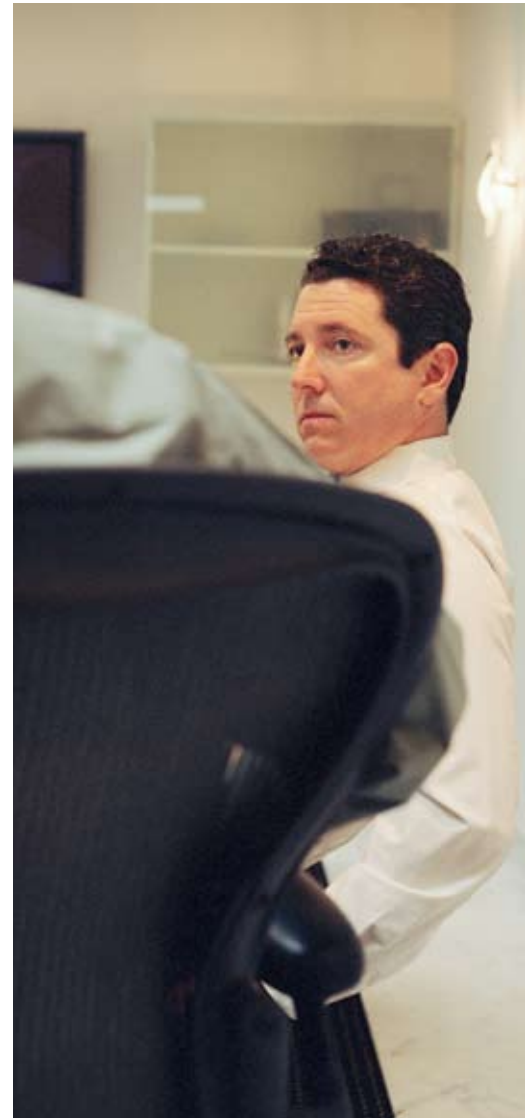
- the amount an insurer would be prepared to offer in commissions in order to access those profits.

Commission rates cited in an Office of Fair Trading report on extended warranties were also rejected on the grounds that it was anonymous and their arm's length nature could not therefore be tested.

Return of capital (ROC)

DSG put forward an alternative approach to benchmarking the arrangements with DISL, namely, a transactional net margin (or comparable profit) approach using the return on capital of Domestic and General Group plc (D&G) as an arm's length benchmark for a market return on capital for DISL. D&G is an insurer that provides domestic appliance breakdown insurance to small retailers and manufacturers.

While the Special Commissioners agreed that the ROC measure was a widely accepted way to determine "normal" levels of profitability (and that it is particularly relevant for insurance business), they did not consider D&G comparable to DISL. D&G's brand, reputation, experience and organizational capabilities are consistent with it being able to earn returns in excess of a routine level. While it may be possible to adjust for difference in capital, the Special Commissioners found there was no method of adjusting for the other cited differences.



² OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators, 1999.

Conclusion

The overall finding on the case was that a profit split approach should be applied to distribute the profits of the extended warranties business between the parties according to each party's contribution to the business. The Special Commissioners considered DSL possessing only routine actuarial know-how and basic adequate capital, both of which DSG could find for itself elsewhere if it chose. Therefore, DSL was entitled to only a routine market return on its economic capital.

All residual profit earned by DSL in excess of this market rate of return was considered to be entirely attributable to DSG's assets and advantages. The parties were instructed to adjourn to consider methods to determine an appropriate measure of economic capital as well as a market rate of return on that capital. On June 25, 2009, DSG released a press statement stating that a private settlement was agreed with HMRC.

Implications

Transfer pricing analysis requires the selection of an appropriate transfer pricing methodology, which in turn almost always entails benchmarking either the transaction price or the profit margins of at least one of the parties. Generally, the party to be benchmarked is the one with the more routine risks and functions. However, difficulties can flow from the assumption that after awarding a benchmarked amount to the "tested party," the residual profit unquestionably reverts to the other party – especially if the residual profit is particularly large (or small). As such, the DSG decision is particularly important for the following reasons:

1. It contributes to increasing scrutiny of financial services transactions.

The case, combined with recent work by OECD in relation to the taxation of insurance branches, is likely to bring transfer pricing of (re)insurance on the radar of tax authorities with sophisticated transfer pricing regulations. In Canada, the Canada Revenue Agency's focus on financial services is evident in the increased audit activity, the recently enhanced disclosure of derivative transactions on its T106 form and two guarantee fee cases currently in the courts.

2. It sets a precedent on circumstances where transfer pricing legislation could apply.

The Special Commissioners found that, under the UK transfer pricing legislation, there was a non-arm's length transaction between DSG and DSL notwithstanding absence of any direct transaction between them. Consideration should therefore be given as to whether taxpayers are aware of all contractual frameworks within their group that can potentially be subject to the transfer pricing rules in the relevant jurisdictions.

3. It sheds light on the validation of transfer pricing methodology.

The case may be used as a point of reference for other tax jurisdictions to challenge arrangements that result in profits outside the taxpayer's home country (particularly those in tax havens) and where the transfer pricing is supported from one-party's perspective. The case endorses the long-held view by some tax authorities that where complex transactions appear to obscure the underlying economic reality then some form of profit split analysis is required.

4. It demonstrates the extent of economic analysis that may be required in the future.

The case demonstrates the high threshold of comparability needed if the intention is to rely on CUPs, especially if there is no satisfactory explanation on the high level profits earned by one of the parties to the transaction. In this case, the approach that if one party has been adequately benchmarked the results of the other must be correct was explicitly rejected in favor of looking directly at DSL's profits; the reason for this was the absence of very good comparables or comparables that could reliably be adjusted.

5. It has implications for benchmarking captives.

For groups with captive insurers that lack significant negotiating power, HMRC is likely to assume that an appropriate measure for determining the arm's length profit of the captive is a routine market return on its economic capital.

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Emerging from the storm: The day after tomorrow for insurance

The insurance industry landscape that emerges from the turmoil of the financial crisis is set to be markedly different from today, enabling some insurers to pull ahead from their competitors and leaving others at risk of being left behind.

The financial crisis has already proved to be a watershed for the insurance industry in many parts of the world. What customers, investors, governments and regulators expect from insurers is changing rapidly and pervasively and the developments we see today are only the beginning. The environment will continue to evolve at a rapid pace over the next two to three years, ruling out any return to the relative stability and certainty that preceded the crisis.

This shake-up will challenge the competitive relevance of some insurers. However, it also offers agile and

farsighted firms a once-in-a-generation opportunity to catapult themselves to the front of what will be a very different racing order within many geographical markets and classes of business – as Rahm Emanuel, White House Chief of Staff, has said: ‘Don’t waste a good crisis.’¹ The companies that will come through strongest are not just looking at how to stabilize their businesses today and even tomorrow, but how the crisis will shape the competitive environment that emerges in the ‘day after tomorrow’ and what they need to do to adapt and succeed.



Surveying the damage: The immediate impact of the financial crisis on the insurance industry

If you asked an insurance executive in 2007 ‘what are the key developments shaping your industry?’ most would have cited at least some of the longer term themes we have listed on the next page. These underlying trends have not gone away and some have been accelerated by the financial crisis. However, as insurers survey the immediate impact of the financial equivalent of a major hurricane, more pressing concerns have come to the fore. The market and economic environment in which insurers operate is subject to considerable uncertainty. Success will depend on close monitoring of developments and the ability to move quickly to capitalize on opportunities as the situation becomes clearer.

Excerpt taken from the report *Emerging from the storm: The day after tomorrow for insurance*. For a complete copy of the report, please contact your local PwC contact or email financial.services@ca.pwc.com.

¹ *Wall Street Journal* web cast, November 21, 2008.

The day after tomorrow report examines how the financial crisis will change the industry landscape and the key considerations this presents for insurers. The report examines what we believe are the main features of this new environment:

one

Organic restructuring:

As insurers withdraw from some of their geographical markets and scale back particular lines of business, the market shares and opportunities for those that remain will sharply increase, leading to a significant reconfiguration in the list of leading players.

two

The end of innocence for retail investors:

What customers demand from savings and investment products and how they want to buy them will take a new direction within many territories; with companies that are slow to catch on becoming increasingly irrelevant.

three

Reawakening of M&A:

The strong underlying rationale for consolidation and restructuring within many markets means that acquisition activity is set to accelerate rapidly once valuation parameters are stabilized and funding becomes more readily available again.

four

Another rethink on reporting:

Without an industry consensus on a genuinely relevant, intelligible and comparable basis of accounting and disclosure, insurers will find it increasingly difficult to compete for capital.

five

Blurring the lines:

The relationship between the public and private sector will change as governments exert a stronger influence over the insurance market as a result of bailouts, regulatory reform and greater control over pensions and health care.

six

Overhaul of rewards:

Insurers will base much more of their performance-related pay on risk-adjusted measures, aligned to their business strategy. They will also face tougher regulation over how compensation is governed.

seven

Mounting uncertainty over tax:

Amid moves to increase tax revenues and tighten the tax rules on offshore business, the stability of the tax regime will be a key consideration in possible relocation, as will choosing where to domicile and where to do business.

eight

Challenging prospects for reinsurers:

While demand for reinsurance is likely to increase within emerging markets, this is unlikely to offset the decline in reinsurance buying in developed markets and may force many reinsurers to rethink how they sustain profitability and growth.

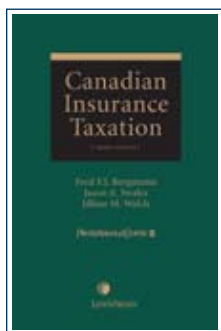
nine

Tilting the regulatory playing field:

Under pressure from governments, supervision will be more intense and regulations will be more subject to national priorities in their interpretation and application.

Recent PricewaterhouseCoopers insurance publications

To view these publications, please visit our website at www.pwc.com and click on Publications.



Now available! Canadian Insurance Taxation, Third Edition

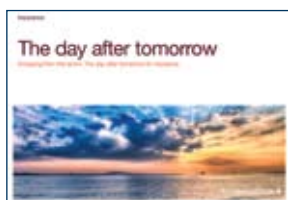
Canadian income tax laws are complex. For insurers, this complexity is compounded by the distinct nature of the insurance industry. The third edition of *Canadian Insurance Taxation* will help insurers identify potential tax problems, make better business decisions and be more effective when discussing these

matters with professional advisors. Copies are now available and can be purchased from www.lexisnexis.ca/bookstore or by calling 1 800 668 6481.



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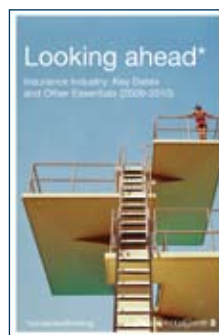
Insurance Digest is dedicated to providing thought-provoking insights into some of the key strategic issues facing the insurance industry.



Insurance The day after tomorrow: Emerging from the storm

Drawing on input from a range of leading insurers, financial market participants and PricewaterhouseCoopers specialists

from around the world, this report examines how the financial crisis is set to reshape the industry as a whole, along with some of the key developments that are likely to affect particular segments and geographical markets.



Insurance Industry Key Dates and Other Essentials (2009–2010)

Insurance Industry: Key Dates and Other Essentials spotlights selected recent tax changes and cases, regulatory dates for Canada, US, UK and annual conferences. Please visit www.pwc.com/ca to view this publication.



Technology forecast Summer 2009 edition

This issue examines the impact of cloud computing trends on IT infrastructure and its role in creating a foundation for business agility. It shows how today's IT environments are dominated by a collection of built to order legacy solutions that were designed to deliver functionality in a silo but not designed for agility and change.



Global Private Banking and Wealth Management Survey 2009 A new era: redefining ways to deliver trusted advice

With contributions from 238 wealth managers across 40 countries, the PricewaterhouseCoopers *Global Private Banking and Wealth Management Survey 2009* reveals the key issues facing the wealth management industry.

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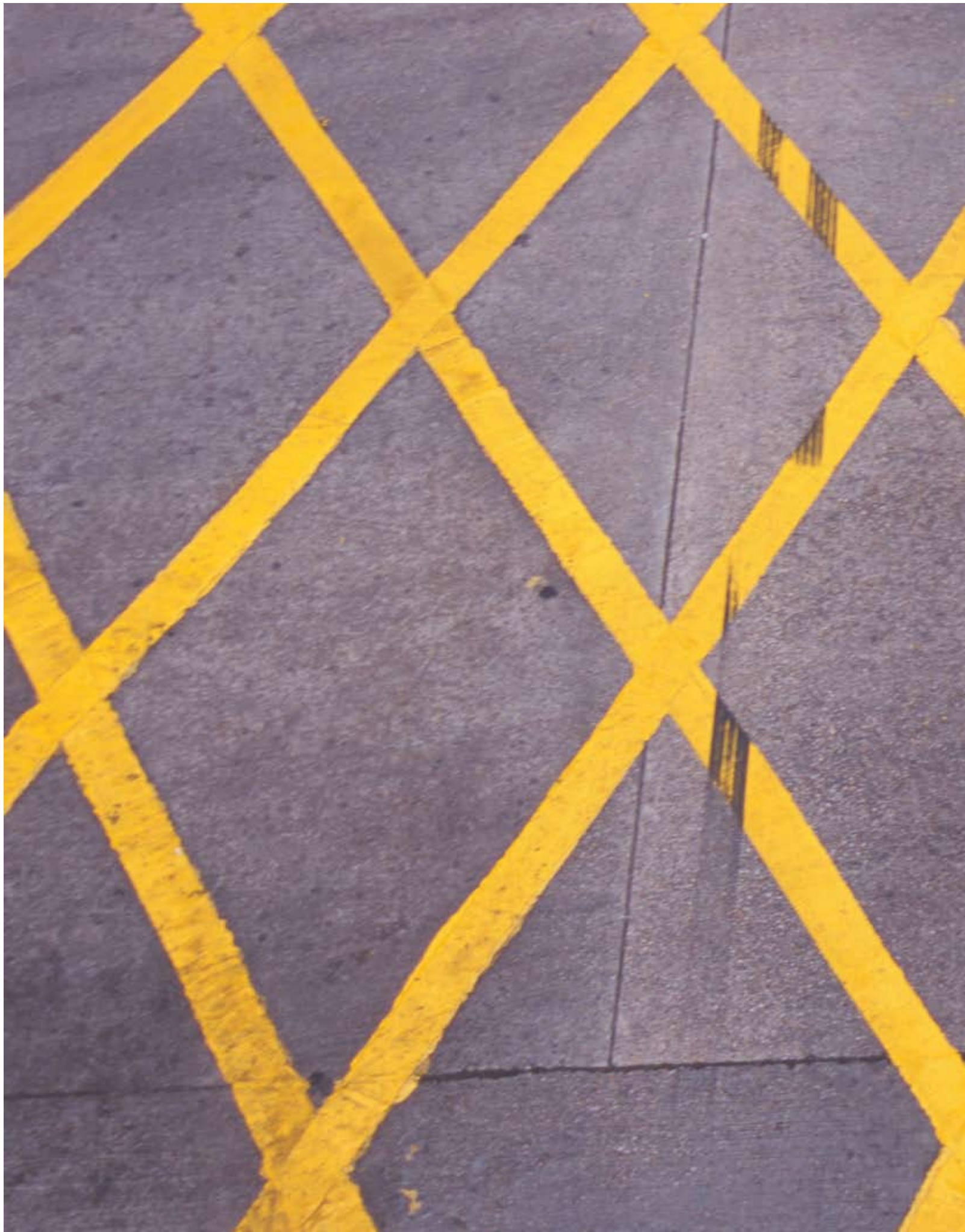
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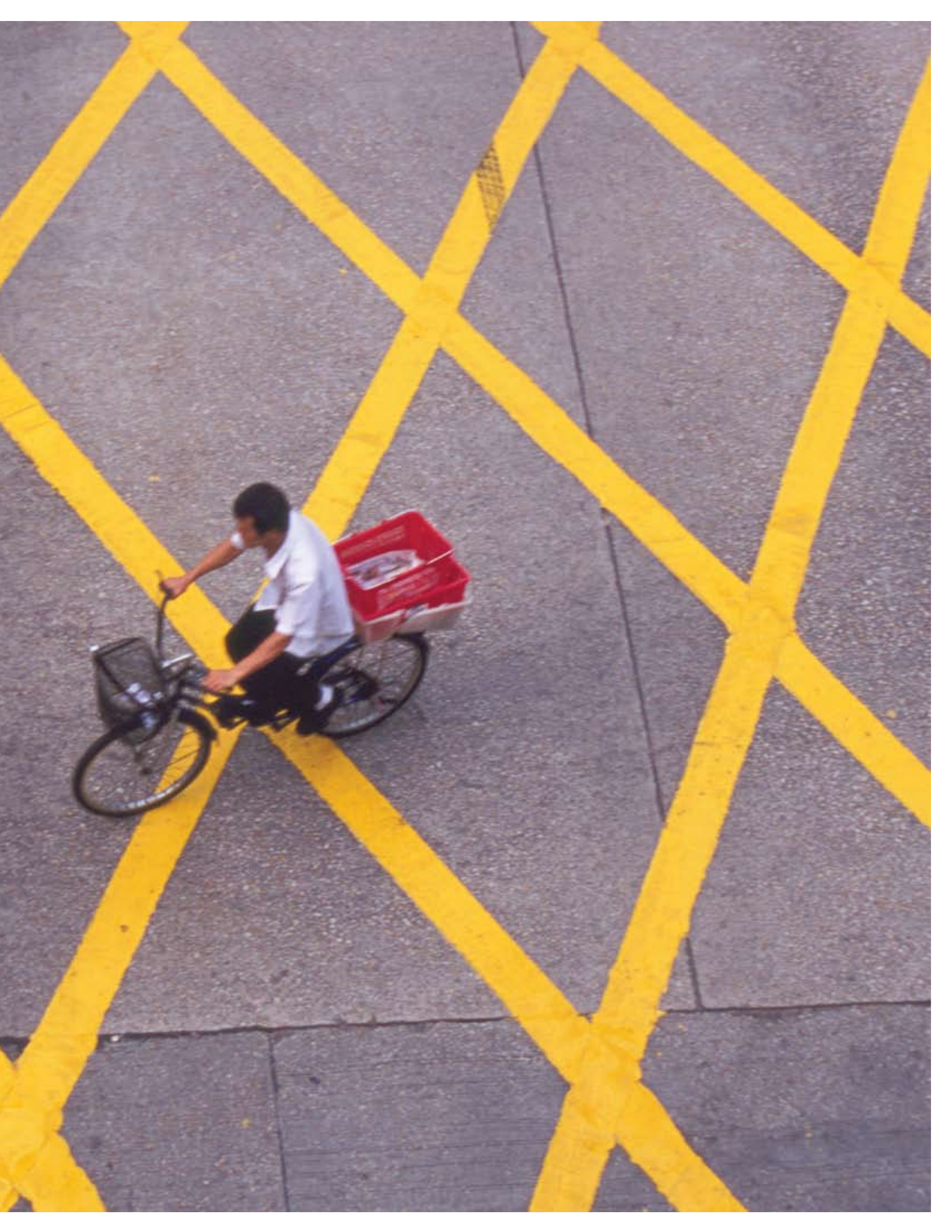
The newsletter can also be viewed on our website at www.pwc.com/ca/insurance.

Our services

Our team of professionals offer value-creating ideas, innovative application of leading-edge technology and deep industry experience to our clients, helping them focus on what they do best. The following provides an overview of our key services and value we bring to our clients:

Your business needs									
Solid financial management and controls		Effective strategy, operations and technology		Sound management of risks and regulations		Well executed transactions		Strong tax planning and compliance	
Our solutions	Assurance <ul style="list-style-type: none"> Annual audit 5970/SAS70 Outsourcing contract review 	Operations and strategy <ul style="list-style-type: none"> Growth strategies Transformation of back and front office and support areas 	Risk management <ul style="list-style-type: none"> Financial, credit, trading and actuarial Model validation Enterprise risk management 	Acquisitions <ul style="list-style-type: none"> Capital sourcing Due diligence Valuations, fairness opinions, PPA 	Income and capital <ul style="list-style-type: none"> Planning/recovery Compliance Structuring Risk management 				
	IFRS <ul style="list-style-type: none"> IFRS policy, diagnostics, conversion and embedding 	Customer <ul style="list-style-type: none"> Customer strategy and experience Customer information and profitability 	Regulatory <ul style="list-style-type: none"> Regulatory compliance and investigations 	Divestiture <ul style="list-style-type: none"> Lead advisor Vendor due diligence Valuations 	Indirect <ul style="list-style-type: none"> Planning/recovery Recovery methods Filings Audit support 				
	Accounting support <ul style="list-style-type: none"> Technical accounting Financial instruments Structuring advice 	Technology and data <ul style="list-style-type: none"> IT effectiveness IT architecture Information security Data integrity 	Forensics <ul style="list-style-type: none"> Forensic technology Forensic investigation Dispute analysis 	Merger Integration <ul style="list-style-type: none"> Planning and reporting Identify and resolve risks Identify, quantify, track value drivers 	Transfer pricing <ul style="list-style-type: none"> Planning Compliance/documentation Transactions Audit defence 				
	Financial management <ul style="list-style-type: none"> Strategic cost management Management information Finance transformation 	Business resilience <ul style="list-style-type: none"> Physical security Business continuity Disaster recovery Crisis management 	Internal audit <ul style="list-style-type: none"> Quality assurance Co-sourcing and outsourcing 	Distressed strategy <ul style="list-style-type: none"> Working capital strategies Distressed M&A Restructuring, CCAA 	International <ul style="list-style-type: none"> Expatriate planning/compliance Policy analysis Reorganization Financing 				
	Controls <ul style="list-style-type: none"> Process and controls assessments SOX compliance IT controls 	Outsourcing <ul style="list-style-type: none"> Shared services Business process outsourcing advisory IT outsourcing advisory Service level agreements 	Sustainability <ul style="list-style-type: none"> Social responsibility Climate change Assurance 	Litigation and disputes <ul style="list-style-type: none"> Loss quantification Litigation support Expert witness Mediation/arbitration 	SR&D <ul style="list-style-type: none"> Project identification Data collection Confirmation and filing/audit support 				







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