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INVESTMENT EXECUTIVE
CANADA'S NEWSPAPER FOR FINANCIAL ADVISORS ■ JUNE 2010

Investors must increase scrutiny of boards

The new international accounting standards will make comparisons more difficult

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June 2010

While it's true that corporate governance has always been a major concern in Canada because of clubby boardroom atmospheres, the problem has been brought into much sharper focus by unfolding events. The result is that board directors are now investors' last best hope for fair treatment in Canada.

A critical concern — starting now, and for years to come — will be Canada's switchover to a new brand of accounting rules, known as international financial reporting standards. Gauging how boards react to the turmoil will tell investors all they need to know about whether directors are falling short in maintaining their independence and carrying out their expanded duties to investors.

IFRS was adopted in Canada by the Accounting Standards Board, which is financially controlled by the audit firms. The board decided it would no longer financially support separate accounting standards for Canada, so it chose to follow much weaker IFRS over U.S. generally accepted accounting principles. The AcSB initially argued that Canadian GAAP was more ideologically aligned with IFRS, a statement since retracted. Not to be ignored is the fact that the audit firms have received a massive fee windfall for switching corporate clients to IFRS.

IFRS also embeds much more management choice, a characteristic that auditors can use to escape legal liability to investors by essentially downloading oversight responsibilities onto corporate directors.

Meanwhile, our closest trading partner and neighbour, the U.S., has easily grasped the significant deficiencies of IFRS. To quote one U.S. accounting journal: "IFRS adoption will usher in an era of financial statement manipulation that is historically unprecedented. Initially, the Big 4 and the [American Institute of Certified Public Accountants] were touting that IFRS would increase comparability. They seldom tout this today, as it has been convincingly shown that the flexibility and professional judgment embedded in IFRS will make fuzzy numbers a certainty and comparability an impossibility."

Canadian lawmakers and securities regulators are either unaware of the potential negative results for investors in adopting IFRS or simply do not feel any pressure to act. Many parts of the new accounting standards throw Canada backward by decades in terms of appropriate financial disclosure to investors. One example is not requiring financial services companies to disclose separately the amount of cash coming into the firm, a critical factor that can alert investors to potential bankruptcy. IFRS also introduces ideas that are completely foreign to Canadian investors, such as the ability to revalue assets on a quarterly basis, based on management estimates of their worth. One company might use pie-in-the-sky estimates of value, while another might stick to using outdated historical cost figures. Take real estate companies as just one example. The ability to increase and decrease property values on a quarterly basis can have an impact on all kinds of key financial ratios, such as debt/market value.

There are so many choices surrounding similar critical areas within IFRS that companies are almost destined to become completely incomparable in the eyes of investors, thus severely hampering investors' ability to value stocks. Most concerning is that IFRS gives considerable freedom to corporate executives to report the financial figures they want, especially in order to make their own managerial performance look good.

Many wonder why IFRS was adopted in Europe and is spreading elsewhere in the world, given that the standards can be manipulated by management so easily. Europe was essentially forced by the European Commission to adopt a single accounting language to unify the disparate financial reporting on the Continent. The creators of IFRS were given a very tight deadline, which led to some significant holes being left in IFRS. Given those weaknesses, adoption of IFRS for Canada is actually a step backward for investors and directors. Canadian accounting, although far from perfect, includes many more investor-friendly attributes. It was developed over decades — not mere years, like IFRS — and is the product of many costly lessons learned.

As a result, Canadian corporate directors must now become the “real” auditors, acting on behalf of shareholders. In turn, investors have to recognize this fact and step up their scrutiny of a board’s actions.

Investors have to look for tangible signs that a board of directors is carrying out its duties with vigour. This includes having their own budget to hire independent specialists to check the appropriateness of key executive decisions. Investigating management’s choice of accounting rules (from among the numerous alternatives now allowed by IFRS) has now become a major part of the fiduciary responsibilities of directors.

A disturbing sign for investors is evident when auditors also advise the audit committee and board on the acceptability of certain IFRS choices made by management. Directors should be seeking counsel from independent, non-auditing advisors.

Above all, specific answers must be sought on whether the board and audit committee have the ability and financial budget to act, independent of the strong influences of management and the company’s auditors.

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