

PART I OF IV

Accounting takes a step backwards

Canada's adoption of international rules will hurt investors

BY AL AND MARK ROSEN

Canada has embarked on a complex and premature path to overhaul its accounting guidelines and the way in which every public company reports earnings and cash flows to investors.

In just three years — a short time given the disruption that will ensue — Canada is planning to adopt International Financial Reporting Standards (IFRS), a collection of guidelines that in many ways is a step backwards for investment transparency and financial reporting consistency in this country.

The proposed changes are so significant that almost every document that references accounting measures in Canada will have to be rethought and possibly redrafted at significant expense to corporations, investors, and individuals alike. This could include everything from individual contracts to securities regulations.

On top of this, every accounting practitioner in Canada will have to engage in significant retraining. Analysts, brokers, bankers, lawyers and numerous other financial professionals will also require accounting reeducation of some form or another.

In addition to three years of costs leading up to the changeover, investors will also face a five-year epilogue of confusion and deficient transitional financial information. Investors who use any sort of quantitative process or screening technique will be shocked at the loss of transparency that will take place in terms of measuring income, asset, and cash flow trends.

Given the serious drawbacks, one naturally wonders how Canada decided to take this path. On the whole, IFRS is far from being a time-tested benchmark of accounting quality. The standards have only been in significant use since 2005 in Europe and some other parts of the world.

Many argue that Canada is too small to go it alone on the accounting world stage, and that it needs to adopt either IFRS or U.S. accounting standards. Unfortunately, we seem to have completely abandoned the third choice: a middle ground between the two standards that recognizes issues that affect Canada.

It's hard to imagine accounting standard-setters in the rest of the world caring much about financial reporting for income trusts or Canadian non-bank asset backed commercial paper. As well, formulating accounting standards for resource companies, which form the backbone of our economy, could be far down the list of international priorities.

Nevertheless, Canada has abandoned its previous approach in order to chase a theoretical ideal that is unattainable, not to mention too costly to achieve in the proposed time frame.

The carrot being dangled in front of investors is the idea that companies will be comparable across international borders once IFRS standards are adopted. Sure, comparability would be possible if not for different currencies, interest rates, tax regimes, legal frameworks, ethical standards, auditing enforcement, regulatory ideologies, and so forth.

It is tempting to believe that more comparability is better than what we have now. However, that ignores the high costs of transition in the short term. The rush to action is inappropriate given the extensive deficiencies that still exist within IFRS.

Worst is that nobody is worried about the hidden cost of phantom comparability. The SEC recently eliminated the need for foreign issuers to reconcile their IFRS results to U.S. accounting standards. Some in Canada applauded the move, not because it indicates the two standards are comparable, but rather because they think investors are skeptical of the existence of two sets of books. Are we really prepared to move forward on such spurious notions?

Unfortunately, it will be difficult to stop IFRS coming to Canada, given the apathy usually exhibited by legislators and stakeholders in such matters. But that doesn't mean investors need to get run over in the process. Knowledge is the first weapon to understand and deal with the financial confusion that will reign over the next several years should Canada continue down the IFRS path.

The next two parts of this series examine the over-arching shifts in ideology and some of the specific accounting

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Financial statements will be exposed to much greater interpretation

changes that are proposed under IFRS. Financial statements will be exposed to much greater management interpretation and estimation, and result in decreased transparency — the opposite of what is intended. The deficiencies of IFRS are important for understanding international equities and where Canada is headed in the near future.

The final part of this series will examine what steps can be taken to ensure that Canada's accounting standards-setting process is not sold down the river anymore than has already taken place. The current low quality of IFRS standards will mean that the biggest beneficiaries are not investors, but foreign issuers accessing Canadian capital, companies wishing to dilute the integrity of domestic financial reporting, and auditors looking to reduce their legal liabilities and increase their revenue from changeover services. With a solid understanding of the issues, it is possible to defend against those who will inevitably exploit the situation.

Financial Post

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PART II OF IV

New accounting standards leave too much to chance

Vague wording means loopholes won't be closed

BY AL AND MARK ROSEN

Canada's auditors and accounting standard setters are aggressively promoting the adoption of International Financial Reporting Standards (IFRS) as a step forward for investors. The premature nature of the change and its costly drawbacks were detailed in part one of this series yesterday. Now it's time to examine the purported benefits of IFRS and the impact it will have on investors.

The notion of a single international accounting framework is a great concept with many potential benefits. However, it remains a theory that is far from implementation. Simply put, IFRS is too weak in its current form for investors to accept on par with current Canadian standards. Nonetheless, we are on course to implement IFRS in just three years.

In remarks made in Canada just two months ago, former SEC chairman Arthur Levitt said moving to IFRS in its current form "could bring significant risk for investors and capital market participants; increase the likelihood of future scandals such as what we are experiencing now in the subprime market; and increase the price of and decrease the availability of capital."

Those statements are in contrast to the claims of proponents who believe that IFRS will deliver greater comparability and transparency, and decrease the cost of capital. Mr. Levitt's concerns focus significantly on the gaps between IFRS and North American accounting standards, as well as the inconsistent application of IFRS itself across different countries.

Our investigative experience on the implosion of many high-profile Canadian companies over the years leads us to believe the application of IFRS would have worsened many situations by allowing the manipulations to go undetected longer, resulting in greater investor losses.

The root of the problem with IFRS is that it backtracks on many of the advancements made in Canadian accounting over the past 25 years. While this clearly seems like an odd approach, it is masked by the promise that IFRS is somehow better because it steps back from the specific rules that are implemented to close known accounting loopholes.

The main argument for IFRS is that the accounting job can never be finished if it is continually chasing down new loopholes. While this is merely typical of the advancement of any discipline, IFRS purports to have a magic solution to the problem: Stop making detailed rules, and let executives find their own way through all the new gray areas.

IFRS supposedly relies on broad principles to establish a basic framework of acceptable accounting. Within that wide latitude, management is required to exercise significant, ahem, professional judgment to nail down the details. In a perfect world we wouldn't need more rules, but history has shown that in this one we do. There is too much at stake to gamble on the honesty of corporate executives to suddenly take up the cause of righteous financial reporting.

IFRS proponents respond by alleging that fraudsters will conduct their ill deeds regardless of whether they operate under the cover of vague principles or specific rules. This cynicism is shocking and, on deeper reflection, spurious, but nevertheless, we move on.

In addition to the bad apples that will inevitably spoil the honesty party, the amount of estimation and guesswork required of management in numerous areas means that no two companies will be comparable, let alone the thousands promised by IFRS promoters.

Standard-setters in Canada claim that our accounting framework is already focused on principles, thus their aggressive endorsement of IFRS.

In actuality, court cases have shown that Canadian auditors automatically gravitate towards a rules-based mentality. Published materials provide extensive appendices, interpretations, industry tabulations and other comparative guidance that are nothing more than rules. Based on the evidence, Canadian accounting has been significantly rules-based for over 40 years.

The truth is that IFRS principles are not broad and overarching in nature, so

“Countries may follow principles, but the devil is in the details

much as they are bare-bones, to ensure that multiple countries will agree to sign on to some kind of shared framework.

The goal of international comparability under IFRS is really just a mirage. Numerous countries can agree to follow a set of broad principles, but the devil is in the details.

IFRS will fundamentally alter the way in which Canadians value their investments as well as create several new analytical pitfalls. Part three of this series, tomorrow, explains some of the wide-ranging effects IFRS will have on the reported income, assets and cash flows of nearly every public company in Canada.

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PART III OF IV

IFRS accounting will make analysis tricky

Revenue, asset
values will have
new meanings

BY AL AND MARK ROSEN

Canada is moving quickly towards adopting International Financial Reporting Standards (IFRS). The first two parts of this series focused on the costly drawbacks and purported benefits of the move. This time, we examine some specific impacts IFRS will have on the way in which Canadians value their investments.

IFRS is based on so-called broad principles that form a basic accounting framework. However, to get most countries to agree to the structure, IFRS was built using a lowest-common-denominator approach. In other words, the least-strenuous accounting requirement in each particular area was often selected to ensure acceptance. Consequently, much is left open to interpretation and executives must make considerable assumptions to fill in the holes.

Countries can, and will, build on top of the diluted proposals to make them more strenuous, and even individual companies will seek higher ground. However, that destroys the claim to fame of IFRS: that it allows financial comparability across borders. While there is already some management leeway within North American accounting rules, the lack of consistency will skyrocket under IFRS.

One staggering aspect of IFRS allows companies to fair value their long-lived assets on adoption of the new standards. That choice alone means there will be no comparability between companies in terms of basic investing measures like debt to equity ratios or return on assets. Investors will also be upset to learn that they might only be given two years of financial statements. Historical trend lines will become use-

less for enterprises that decide to revalue their assets.

The IFRS guidance describing the estimation of those fair values only adds to the lack of comparability that will plague investors. The problems stretch into other areas too. The considerable latitude given to executives affects the recognition, amount and timing of asset impairment charges, which are critical to establishing profitability.

On another front, IFRS standards on related-party transactions are shockingly deficient, and at least a dozen years behind current Canadian requirements. IFRS ignores the measurement aspects and therefore thoroughly misses the boat. As it stands now, inadequate related party measurement is already an epidemic under Canadian rules.

Revenue recognition under IFRS is also deficient compared to current Canadian standards (which themselves require improvement).

We have already been told of cases where revenue under IFRS is higher than what is allowed under Canadian regulations. Had IFRS rules been in place during the years for which Nortel

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has repeatedly restated its revenue, a bad situation would have been even worse for investors.

Turning to other accounting fiascos in Canada’s past, it’s clear we have had considerable trouble with reporting in the financial services sector. While improvements have been made to Canadian accounting, much of that gain will be lost under IFRS. Given our intimate post-mortem knowledge of many of those situations, it’s easy to foresee certain problems resurfacing at significant cost to investors.

After the failures of two Canadian banks more than 20 years ago, our accounting rules were changed. We plugged loopholes that allowed uncollectible mortgages to remain on balance sheets at seemingly unimpaired values, and interest revenue to be recorded on bad loans. Without such clear requirements to report default and late payment rates and collateral values, troubled companies can appear healthy for years. This is precisely the sort of illusion that IFRS will invite again to Canada.

Similar problems will occur for investors analyzing real-estate companies. Under IFRS, neither the requirements for cash flow reporting nor asset impairments are particularly robust.

Financial statement note disclosure requirements are deficient in many areas, since much of the fine-tuning made over last two decades is being given up for the sake of phantom comparability. Similarly, IFRS is essentially silent on areas affecting Canada, such as resource-based companies.

IFRS is laying waste to broad concepts of North American accounting. These include using historical cost for reporting assets, matching revenues and expenses, and general conservatism when it comes to reporting expenses and impairments.

The sheer breadth and technicality of issues raised by IFRS requires that this series be kept at a high level. More detail is available on the specific issues that impact investors (including those currently holding international equities).

Given the deficiencies, high costs, and phantom benefits of IFRS, it’s natural to wonder why Canada’s auditors decided to adopt these rules. That question is the focus of the fourth and final installment of this series tomorrow.

Financial Post

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PART IV OF IV

One-size-fits-all of IFRS is inappropriate for Canadians

BY AL AND MARK ROSEN

The first three instalments of this series examined the vast deficiencies, high costs, and phantom benefits of Canada's premature move toward adopting International Financial Reporting Standards (IFRS). This final article focuses on how the decision was made and what steps can be taken to rectify the situation.

Not too long ago, Canada was more interested in aligning its accounting rules with its largest trading partner, the United States, for obvious reasons. Then there was a rather abrupt shift toward IFRS, with significant and wide-ranging impacts on literally every investor in Canada. As such, you might assume the change was legislated by our federal and provincial parliaments after an exhaustive cost-benefit process that consulted stakeholders from coast to coast. What we got instead was a peremptory and self-interested decision by a special interest group.

The accounting standardsetters in Canada, who are financially controlled by the auditors, have decided to effectively resign their duties. They have ceded control of our accounting destiny to an understaffed foreign body that lacks independent funding and is influenced by political interests abroad.

It's hard to ignore the potential motivation of our standardsetters in seeking the general dilution of financial reporting quality provided by IFRS. Auditors control the finances and thus the quality of Canadian accounting standards. By endorsing the weak IFRS framework, they improve on an already significant advantage by further reducing the likelihood they can be sued for performing substandard audits.

Because IFRS places much more emphasis on management estimates and assumptions — and much less on the specifics of accounting rules — auditors will find it easier to avoid accountability. As if that wasn't motivation enough, the fees they stand to reap from providing changeover services will make Sarbanes-Oxley expenses look paltry by comparison.

The fallout from the decision to pursue IFRS is overwhelming. Every document that references accounting measures in Canada will have to be seriously rethought and possibly redrafted at significant expense. Every accounting practitioner in Canada will have to engage in significant retraining. Analysts, brokers, bankers, lawyers and numerous other financial professionals will require accounting re-education of some form or another.

Furthermore, after three years of endless expense leading up to the changeover, investors will also be treated to a five-year epilogue of confusion and deficient transitional financial information. Investors will be shocked at the loss of transparency they will face in analyzing income, asset and cash-flow trends.

Simply put, IFRS will forfeit what strength has been built into Canadian accounting over the past two decades. The proposed standards also ignore major issues that are of critical importance to Canadian markets, such as the unique reporting requirements of resource and extraction companies.

All this for promised improvements that will ultimately prove unattainable. The supposed benefit of international financial comparability under IFRS simply will not happen. In an effort to create a groundswell of consensus among countries, too much leeway was baked into the process. Upon the application of IFRS, the varying abilities, ideologies and experience of individual executives will destroy any semblance of cohesion alleged to exist in the standards.

It is highly questionable whether our auditors even possess the decision-making power to switch to IFRS. Nonetheless, they have made their intentions clear. It is now up to our securities regulators and politicians to recognize that our accounting standard-setters have thrown in the towel.

What Canada needs — and quickly — is a new, ideologically and financially independent accounting body (as well as a separate independent auditing entity). Only after removing the debilitating conflicts of interest inherent in our current auditor-

controlled system can we adequately choose a proper course of action.

Accounting standard-setters in the United States are proceeding with great caution in examining the cost-benefit tradeoff between adopting IFRS and staying with current North American standards. Perhaps that's no surprise given that they are independently funded, unlike here. By comparison, the rush to judgment in Canada is simply inexplicable.

IFRS was a worthy effort to elevate countries at the bottom of the accounting standards pile. However, dragging down countries like Canada that have better-than-average standards is just intolerable.

It is also important to recognize that the Canadian economy has unique drivers. The appropriateness of the one-size-fits-all IFRS option must be considered against many factors, including our weak securities regulation.

IFRS is at least a decade away from reaching investor credibility, given what we

“ Investors will be shocked at the loss of transparency

have become accustomed to in Canada. As it stands now, the low quality of IFRS standards means the biggest beneficiaries won't be investors. Rather, the winners are foreign issuers accessing Canadian capital, companies wishing to dilute the integrity of their domestic financial reporting, and auditors looking to reduce their legal liabilities and increase their revenue from providing changeover services.

Unfortunately, time is now the enemy. The move to adopt IFRS has momentum, and if the apathy exhibited by legislators and stakeholders in past accounting matters is any indicator, the standards may well be adopted. If Canada continues down the IFRS path, investors are going to need a great deal of knowledge to cope with the resulting financial confusion. They just should not make the mistake of consulting those who drew us into this predicament in the first place.

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