

FP INVESTING

COMMENT

National securities regulator needed

Would help end current accounting conflicts of interest

AL ROSEN

Canada is the only country in the industrialized world without a national securities regulator. It is also the only nation that allows its financial-statement auditors to set their own self-serving accounting rules. The existence of just one of these situations is an international embarrassment.

But both, taken in combination, spells disaster for investors. Do we really think that we have found the secret recipe to investor protection, while the rest of the world has chosen to worship false idols?

Investor protection continues to fail in Canada because the confluence of factors, more than the individual circumstances, make the situation so insidious. Individual pockets of self-regulation rather than over-arching responsibility have resulted in buck-passing and large gaps in our investor safety net. Therefore, a multi-pronged solution is clearly needed to bring Canada up to world standards.

In last month's column, I estimated that roughly 95% of capital markets fraud is committed through the vehicle of audited financial statements. In short, deliberately weakened accounting standards allow unnecessary management leeway, which results in fabricated financial performance. Corporate executives easily bend the vague rules; the auditors rubber stamp the statements (knowing they can't be effectively prosecuted); regulators defer to the auditors; and investors get screwed.

To address the problem, I suggest a four-step solution: (1) separate the accounting rule-setters and the auditors; (2) separate the auditing rule-setters and the auditors; (3) legislate that auditors owe a duty of care to investors; and (4) form a national securities commission that has the ultimate authority to set accounting rules, and a clear mandate to prosecute misleading financial reporting.

In industrialized countries other than Canada, accounting practitioners are separate from accounting rule-setters. This ensures that accountants cannot set deliberately weak and self-serving accounting rules that their paying clients (corporations) can then turn around and abuse.

In Canada, our accounting rule-setters and rule-followers are part of the same organization, which means that the rule-setters are financed, and therefore easily controlled, by the rule-followers.

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Why do we even have financial statement auditing?

rule-setting bodies need to be established in Canada in order for investors to be made the main priority. Spurious claims of so-called independent supervisory boards buried within the current accounting regime need to be dismissed for what they are: public-relations diversions.

While auditors escape responsibility to investors by downloading accounting choices to corporate executives through overly-vague rules, the real sanctum is provided by the Supreme Court of Canada, which has ruled that auditors cannot be held liable to investors for signing misleading annual financial statements.

Suppose you paid your car insurance religiously for years, and when someone rear-ended you, your insurance company was allowed to walk away with your premiums and not pay you a dime.

So goes the financial statement auditing game in Canada. Why do we even have annual financial statement audits? Good question.

Auditors claim in their very own accounting rules that they are designed for "external communication of economic information about the entity to present and potential debt and equity investors." However, they routinely argue in court they cannot be held responsible to investors when that communication is misleading and results in investor losses.

Obviously, the intent of legislating audits into Canadian companies and securities acts has been tossed aside by our courts, leaving

investors in limbo, while still having to pay handsomely for a worthless service.

The fourth and final step should be to place ultimate accounting rule-setting authority with a national securities commission that will act as an added layer of protection on top of a newly created, truly-independent rule-setting body. Just as important, the commission should be charged with the principal mandate of protecting investors. This would give it an interest to pursue more cases of misleading financial reporting, and hopefully eliminate the false notion such problems do not exist in Canada.

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■ Al Rosen is a forensic accountant at Accountability Research Corp., an independent equity research firm



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Forensic accountant Al Rosen.

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The accounting rule-setters are rendered ineffectual though a deliberate financial hobbling by the accounting rule-followers. This clearly needs to stop.

Likewise, the same conflict exists when it comes to auditing rules. How can investors expect auditors to set tough auditing rules that would conflict with their clients' desire for minimal oversight? In short, they can't.

Two completely new, fully independent, and externally financed accounting and auditing