

Regulators stuck serving two masters

Agencies funded
by industry unlikely
to stick up for investors

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I have received several comments lately that the introduction of a national securities regulator will take a big bite out of the current financial reporting abuses plaguing investors. While it's nice to have dreams, I'm afraid I just don't see it as very likely.

If and when Canada cobbles together a national securities commission, it will definitely be well worth the effort. However, it could be far from the panacea some people are predicting.

The primary benefit of a national securities commission will be to reduce registration and compliance costs. That's the easy part, and can be attained through a simple amalgamation, and elimination of redundant services. Even better is that the virtues of cutting the red tape are being espoused by the people who have enough pull to make changes happen — corporate issuers.

Unfortunately, there aren't nearly as many people championing the reduction of financial reporting abuses in this country. In short, money talks; and it's easier for some people to make very good money in the short run by ignoring (and even promoting) financial reporting abuses, instead of working to eliminate them.

If a simple amalgamation of regulators had even a chance of reducing financial reporting abuses, there would already be a hint of such activity at the provincial level. The problem is that the provincial commissions are stuck serving two masters with conflicting interests. On the one side, there are the fee-generating corporate issuers, with their well-paid underwriters, lawyers, accountants, lobbyists and consultants. On the other side is you, the investor. Care to guess who's winning the contest?

For a crackdown to occur, much more than a simple amalgamation of provin-

cial regulators needs to take place. A national securities regulator needs to be completely accountable, independent, investor-minded, and not funded by corporate issuers in any way.

The funding issue is key. A few years back, the Ontario Securities Commission moved from being funded by the provincial Ministry of Finance to being self-funded. The argument for the switch was that the commission would be able to funnel all of the fees it collected into providing a beefed-up level of service. Many people thought that would mean increased market scrutiny and prosecutions of scam artists. Those people were wrong.

Instead of hiring new staff to prosecute the plethora of market abuses, the commission decided to give the money back to the issuers through rebates and fee reductions. The moral is that as long as corporate issuers provide the funding for securities regulation, there will always be pressure to spend the least amount possible.

In addition to being funded by taxpayers, a national regulator needs to wear its investor hat, and take the stance that the buck stops with them. The need for accountability and investor-mindedness has never been greater than now.

As just one example, the lack of guidelines provided so far for distributable cash reporting by the income trusts constitutes a severe breakdown in regulation.

Some senior people at the OSC have recently promised to re-examine the distributable cash problem. To put it mildly, they have their work cut out for them because the very essence of regulation is at stake.

One of the main problems with distributable cash reporting is that companies can pump up their unregulated figures by simply low-balling their maintenance capex needs. Maintenance capex is the amount that management estimates was spent on maintaining capital assets during the period.

The figure is not audited or checked by any outside party. Maintenance capex is used to replace depreciation (an audited figure) in the calculation of distributable cash. Depreciation is the amount by which management estimates the capital assets eroded during the period. Please note the

similarity between the two definitions.

On average, maintenance capex is a much smaller number than depreciation, which means that distributable cash is much higher. Some people believe that the accounting rules are "wrong" and require too much depreciation to be recorded. This argument alone should pique the interest of the securities regulators. That is, if the audited depreciation figure is supposedly "wrong" for so many trusts, then what else is wrong?

However, the regulators know better. They recognize that depreciation is also a management estimate, and that the accounting rules do not specifically require any minimum amount to be recorded. Therefore, the problem is this: management has made two different estimates of the same number — the amount by which capital assets deteriorated during the period.

The only difference is that one figure is regulated and the other is not. I shouldn't need to tell you which one corporate management hopes investors latch on to when it comes to valuing the trusts.

To clear up the problem, securities regulators should require trusts to explain both qualitatively and quantitatively in line-by-line detail why their distributable cash figure differs from their regulated net income.

Further, if the trusts are going to provide an unregulated distributable cash figure, they should publish why they think it can form the basis for a long-term valuation of the company. Simply blaming analysts for supposedly pushing the envelope should not be acceptable.

In sum, an immediate attitude adjustment is needed by the provincial securities commissions of Canada, if there is any hope for an amalgamated national regulator to do right by investors.

Financial Post

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