



Do the math

Worthless audits. Poor oversight. Self-serving rule setters. The odds are stacked against investors

A former chief accountant of the U.S. Securities and Exchange Commission recently told *Forbes* magazine that the discredited American Stock Exchange has become the new "version of the Vancouver Stock Exchange." Even though the VSE was cleaned up years ago, the stench lingers strongly south of the border. Nortel, Bre-X and a growing number of income trust debacles have only added to Canada's reputation for failing investors.

Not that this distracts securities regulators and auditors who put forth a highly disingenuous view of investor protection in Canada.

Unfortunately, playing dumb allows them to push for maintaining the status quo, which they have spent years lobbying for, and manipulating, to serve their own financial interests. The most recent attempt to mislead Canadian investors has come, yet again, from the Institute of Chartered Accountants of Ontario (ICAO). Proclamations about "the safety of investing in [Canadian] capital markets" have little connection to reality and whitewash a vast array of serious investor problems.

The ICAO is downright unseemly in its interpretation of the principal Supreme Court of Canada case involving auditor responsibility to investors, *Hercules Managements v. Ernst & Young*. The ICAO would have you believe that the 1997 Hercules decision leaves auditors in the grip of liability when, in fact, it effectively blocks most or all investor lawsuits against auditors. Any lawyer would tell you the ICAO has deliberately blurred the line between the chances of investors suing auditors and the chances of suing them successfully. The likelihood of financial recovery when investors rely on fake annual financial statements is close to zero.

The ICAO also recently rejected as redundant suggested improvements, such as separating the auditors from the rule setters (a standard protection in every other industrial country), legislating that auditors owe a duty of care to investors (essential, given current legal precedent), and having independent oversight of financial reporting and rule setting (without bastardizing the concept of independence). Who wants checks and balances on self-regulation when you can get by with weak, easily manipulated

financial reporting that gives you the power to be paid handsomely while doing nothing for investors?

Canadian investors must remember three basic facts. One is that almost all of our major financial failures (see "A history of neglect," September 11-24 issue) occurred shortly after fully audited financial statements were released to investors. The audits were completely worthless and, if anything, lent credibility to bogus financial claims.

Second, securities administrators and auditors have remained

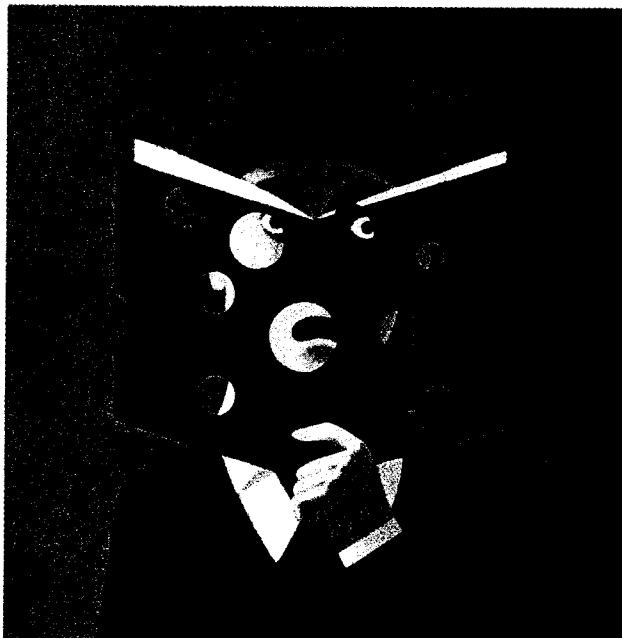
silent while investors have lost billions. Nortel's pro forma reporting, for example, was not addressed until years after the worst of the scam had been perpetrated. The current fiasco in income trust reporting, whereby some firms report whatever distributable cash figures they like, is just the latest rendition. Think about Heating Oil Partners, Specialty Foods, FMF Capital and Spinrite Income Fund, all of which lost more than 90% of their values since their IPOs. The proper word to describe our financial reporting standards isn't "rigorous" but "porous." Indeed, of the roughly 140 business income trusts in the market, the average return over the past 12 months has been -6.6% (versus 7.4% for the TSX composite index). I would wager that the difference in performance is significantly attributable to a wider recognition among investors of the weak financial reporting regime of the trusts.

Third, unlike the rest of the industrialized world, Canada's auditors set accounting and auditing rules that their corporate clients must follow. Such power (and the abuse of same) continues, regardless of specious accounting "oversight" boards. Worse, that power, which has been granted by law to the auditors, has not been repealed by politicians, despite the continued assertions by auditors that they have no legal obligations to investors when they approve bogus financial statements.

Do the math. $1+2+3 =$ devastation for investors.



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