



A history of neglect

Investors are at the mercy of pliable auditors, inept regulators and cowardly politicians

If the Spanish philosopher George Santayana had been a Canadian, his oft-quoted aphorism about history might have read: Those who cannot remember the past are condemned to exceed it. Certainly, this is the case when it comes to investor protection. Unlike the U.S., Canada has actually managed to systematically erode the integrity of its capital markets.

For Canadian investors, the rot really began to set in shortly after the 1980-82 recession. As asset values were driven down and fresh capital became scarce, businesses began looking to accounting tricks and evasive financial reporting to cover up unpleasant realities. In this, their auditors were wholly compliant.

Granted, many businesses weren't very good at masking their excesses, given the string of financial failures during the 1980s. A partial list of that decade's flame-outs includes Northland Bank, Canadian Commercial Bank, Principal Group, National Business Systems, Hercules Managements and Victoria Mortgage.

At least in that era, official inquiries were held to shed light on causes, even if little disinfecting took place. The Estey Commission made several important observations about the 1985 Alberta bank failures, including the following: "The auditors failed to bring to bear on their primary task, that of determining whether the financial statements as prepared by management fairly reflected the financial position of the bank." Similarly, the Code Report into the failures of the Principal Group said that: "Accounting policies and practices... were designed to recognize income as soon as possible and to defer losses for as long as possible."

The 1990s provided further evidence of pliable auditors and their natural companions, inept regulators. The list of financial failures grew to include the likes of Confederation Life, Standard Trust, Livent, YBM and Philip Services. Politicians, however, wisely chose to avoid embarrassing inquiries and royal commissions. Politicians also sat on their hands after the Supreme Court voted in 1997 to essentially prevent shareholders from successfully suing auditors for signing grossly misleading annual financial statements. No significant legislation was forthcoming to

overrule the Court's impractical and destructive stance.

This decade, the assault on investors has continued, first with pro forma reporting (think Nortel) and now with grossly deficient income trust reporting. Roughly 22% of the income trusts that are between one and five years old have lost more than one-third of their value since their IPOs. Clearly, these are not acceptable losses. Much of the \$2.1 billion that has been lost is a result of initial overvaluation of trust units, made possible by manipulated financial reporting.

Just last month, the Canadian Securities Administrators issued a review of the quality of disclosure among a cross-section of Canadian income trusts. Of those reviewed, the CSA said 84% needed improvement. That's a staggering figure.

One of the more surreal examples identified by the CSA was Algonquin Power Income Fund, whose cash distributions to unitholders regularly exceeded its cash available for distribution. The company explained, rather dryly, that this was achieved by simply handing back some of the cash it had received from selling units of the fund in the past. There's a word for that kind of arrangement, you know. It starts with a capital P. Meanwhile, many investors likely continued to value the company based on a multiple of its distributions.

So what's being done about this systematic rip-off? Instead of going after

Algonquin, our regulators merely chastised the trust for not quantifying what portion of the distributions to unitholders had actually been funded by a return of their original capital. Heaven help us all if this is the type of reaction we can expect to the pervasive abuse of financial reporting in the income trust market.

History is repeating itself with greater emphasis, thanks to inept regulators, auditors that are far out of their depth and the utter lack of political will to tackle the tough issues. Just how far we sink will depend upon when our regulators and politicians finally wake up to the grim reality facing investors. □

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