



Al Rosen
Between the Lines

Detecting crookery

The first in an occasional series of Street-smart tips for vulnerable Canadian investors

Over the past eight years I have avoided turning this column into an endless series of accounting lessons on how financial statements can be cooked. I fear now that this was to the detriment of investors. I originally believed that the perpetrators of the scams would stop performing certain tricks once they were exposed. Sadly, this was not the case.

The situation really came into perspective when I saw the old "pro forma" financial reporting chicanery at the heart of the 2000-2001 tech meltdown get dusted off and used for many income trust scams.

Unfortunately, Canadian investors have not understood the main reason for the continued unravelling of many trusts. Unmistakable blame should be placed with certain underwriters, accountants, lawyers and regulators who promoted and allowed misleading distributable cash and yield figures that routinely misrepresented the ongoing costs of these businesses.

The lack of willingness of regulators and SROs to clean up these recycled shenanigans once and for all means that it's back to teaching investors how to protect themselves. This column—the first in a small series this year—serves as an introduction for subsequent articles.

Step 1 in protecting your investments involves actually reading quarterly and annual financial reports. By doing this, you will quickly learn that financial statements can be at great odds with what someone has told you about a company. And, of course, after careful analysis you will also find that the financial reports of many companies are frequently incomplete and sometimes quite misleading.

Step 2 involves understanding the type of company you are analyzing. You must recognize that you have a better chance when a company follows U.S. or international accounting rules, and is regulated by the U.S. Securities and Exchange Commission. Canadian regulators are simply too feeble and have a

long history of letting down investors.

Step 3 requires learning the nature of the company, especially its sources of revenue and income, including the countries of origin. Many corporate collapses have involved financial institutions (e.g., Canadian Commercial Bank, Northland Bank, Principal Group, Standard Trust, Confederation Life) and real estate operations (e.g., Bramalea, O&Y Real Estate Investment Trust, Castor Holdings). Monitoring cash inflows is vital, but

financial statements can hide or obscure them. Likewise, the financial statements of resource industries can be of limited use because accounting doesn't focus on valuing the assets in the ground.

Step 4 involves developing a skeptical attitude in general. Canadian regulators rarely prosecute financial reporting misrepresentations. Corporate managers know this better than anyone. They also know the specific tricks available under loose accounting rules that can be used to mislead investors.

Unlike the rest of the industrialized world, Canada has foolishly allowed its auditors to direct and influence the writing of auditing and accounting rules. This has resulted in the current financial reporting process being skewed in the interests

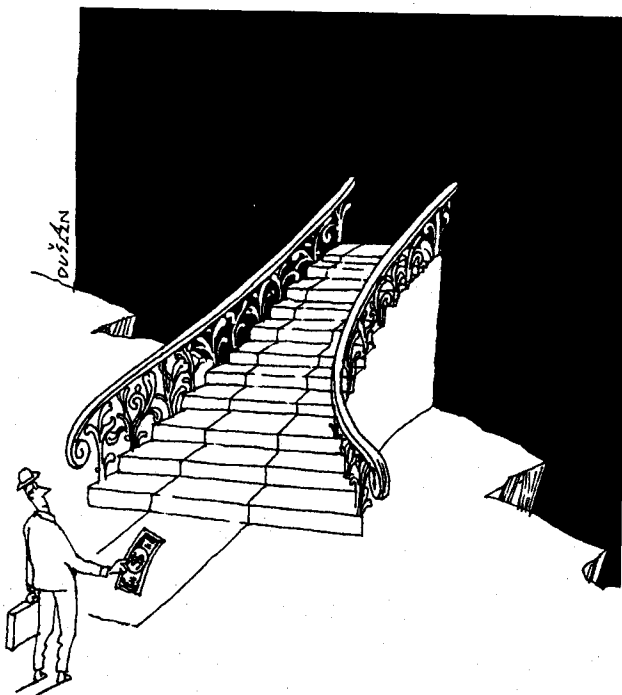
of corporate issuers, instead of addressing the needs of investors.

Even worse, successful Canadian court cases against directors, officers and auditors are negligible. One reason is that the auditor-influenced rules are too weak to secure convictions. The fact that an annual report has been audited and approved by a provincial securities commission must be ignored; virtually all of Canada's major financial failures over the past 25 years had financial statements that passed regulatory oversight.

Step 5 involves recognizing when something is too good to be true. An investment that boasts of tax efficiencies or superior returns must be viewed with a critical eye. Likewise, large gains in reported sales or income should have a good explanation. Any unexplained or windfall results could be a warning sign of financial games being played with your money.



Al Rosen (al.rosen@rosen-associates.com) is a forensic accountant and principal of Rosen & Associates in Toronto.



Step 5:
If something sounds too good to be true, it probably is