

COMMENT

Plenty of ways to fudge numbers

Hedge accounting rules too loose to protect investors

AL ROSEN

Imagine if distributable cash had never been used to sell income trusts. We would never have had financial commentators erroneously comparing income trust "yields" to common stock dividend yields or bond yields.

Investors would have never assumed that cash distributions were as stable as dividends, or even bond coupons. Many companies would not have pushed the accounting envelope and imploded, and many would never have converted to income trusts in the first place, despite the tax advantage.

And investors would not have lost as much when the income trust bubble popped. Of course, that's not to say we're done yet.

My intense dislike of using distributable cash to rate the performance of income trusts is hardly a secret. Surprisingly though, many people believe I favour using income as an alternative. This, despite the fact that for most of my 45 years in business, I've demonstrated how easy it is for corporations to manipulate income.

In fact, it's better to think of income and distributable cash as if they are two of the descending rings in Dante's *Inferno*. Distributable cash just happens to be considerably lower than income.

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View trusts with skepticism

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So how can we sensibly view income trusts? Certainly it should be with a skeptical eye. The best fund managers have always examined income trusts the same way they evaluate corporations, looking at them through many prisms and always with healthy suspicion.

Remember, distributable cash is derived from income, or cash from operations, which is itself derived from income. In other words, distributable cash only provides company management with more leeway to produce whatever figures they like.

But reported income is hardly an alternative to such abuses. So as another phase of trust fervour dies down, it's time to press forward and examine one of the ways — and there are many — in which net income can also be used to mislead investors.

One of the more complex areas of accounting is the reporting of financial hedges. I'll use the example of a basic currency hedge to give just a flavour of what investors need to watch for. A currency hedge might be used when long-term U.S. dollar-denominated debt is issued by a Canadian company to help offset a long-term, partially guaranteed services contract that will be paid to the company in U.S. dollars.

For starters, I should mention that hedge accounting is optional for many types of arrangements. Thus, the long-term debt and services contract might or might not be deemed as a hedge by corporate management. If it's considered a hedge, then the long-term debt and services revenue would be recorded at the exchange rate existing on the date the hedge was declared as such. If hedge accounting is not adopted, then the long-term debt and revenue would be recorded at more recent exchange rates.

Suppose that the long-term debt was issued at a rate of \$1.50 Canadian per U.S. dollar in our example, and the rate subsequently drops to \$1.10. If hedge accounting was not used, the company would record its revenue at the lower exchange amount, but would also report less debt on its balance sheet.

It's possible the unrealized gain on the debt might (and I emphasize the word might) offset the lower revenue in the re-

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spective years of the contract.

At this point, there are already numerous problems with comparability both within the company from year to year, and also between the company and its peers. In the hedged case, the revenue and debt amounts are economically inflated since they are translated at an outdated exchange rate.

Suppose the situation was reversed, and that the hedge was originally imposed at \$1.10 Canadian per U.S. dollar, and that more recently the rate had risen to \$1.50. If management decides to no longer consider the transaction to be a hedge, the company can report higher revenue and gross margin figures, even though nothing has changed economically.

It would be easy to bury this kind of manoeuvre in the financial statements so that most investors — and analysts — would not catch it.

It would also be easy for management to accomplish this. I'm afraid the wording of the hedge accounting rules is far too loose to be of much protection for investors.

Management need only provide "reasonable assurance" that the revenue will — or won't, for that matter — offset the debt repayments in order to justify the accounting decision. Might one manager's reasonable assurance also be another's unreasonable assurance? I've seen it happen.

Could the same manager's reasonable assurance swing the other way in response to exchange-rate movements, with the possibility of a bonus for "increased" revenues? Of course.

This example merely scratches the murky surface of hedge accounting, which, in turn, is just one of the income and cash-flow manipulation techniques available to companies.

Management has extensive freedom to choose the accounting it prefers. The result can have a significant impact on revenue, income, cash flows, and, of course, the perceived value of an investment.

So, while I'm glad to see the use of distributable cash on the wane (finally), it's time to refocus our attention on the myriad ways financial statements can be easily misinterpreted unless investors have a good working knowledge of the accounting choices available to corporate management.

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