

COMMENT

Executives don't need to break rules, just bend them

Accounting standards useless if not enforced

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Canada is slowly moving towards adopting International Financial Reporting Standards (IFRS) over the next three to four years. The aim is that by 2011, financial statements will supposedly be comparable between Canada and likes of France, Australia, Korea, and even Russia, to name a few. It sounds like a useful advancement, but it's doubtful whether many investors will even notice given our long history of accounting apathy.

Canadian accounting rules have in fact already changed significantly over the past decade, and many investors have remained blissfully unaware. The definition of income has changed too many times to even count. Nevertheless, some investors continue to take accounting figures at face value, hoping that either their quantitative models are somehow immune to the resulting errors, or that the majority of investors are just as equally unaware.

Canada has not always aimed to adopt IFRS. Just a few years ago, we were still trying to converge our standards with U.S. accounting rules. As recently as this year, in fact, Canada proposed a

rule to place pension deficits on company balance sheets (matching a move made by the U.S. last year). Then rather abruptly, the proposal was dropped altogether — another example of the indecisiveness that investors have endured in Canada.

At times, we have introduced accounting rules that were completely out of step with both U.S. and international standards, only to reverse course after several years of unfortunate financial reporting consequences.

Other times, investors have had to wait in vain for accounting rules that were sorely needed to address Canadian-specific issues like income trusts, but which never came in the end.

Canada has chosen to go the IFRS route for so-called ideological reasons, believing that its current standards are more "principles-based" rather than "rules-based" like in the United States.

One commonly-cited knock against rules-based standards is that people will always find loopholes in the accounting rules, and that still more rules will be needed. Whereas some might describe this simply as progress, critics also charge that rules-based standards did nothing to prevent accounting scandals in the United States such as Enron. Easily forgotten, it seems, is that failures have taken place under IFRS as well. Nevertheless, what's done is done, and Canada has chosen to continue with its principles-based approach to accounting standards.

The major factor needed to make principles work is trust. In other words, broad accounting concepts are laid out for executives to follow, with the hope that their moral senses guide them through all the resultant grey areas and slippery slopes.

Not surprisingly, not everyone proves to be so trustworthy, and disputes naturally arise between executives and investors who routinely have conflicting objectives. Investors of course have little recourse when they claim foul. Executives don't need to break accounting rules to manipulate markets in Canada.

PRINCIPLES-BASED STANDARDS RELIES ON ENFORCEMENT

They simply need to bend accounting principles that are pliable by design.

Thus, a major piece of investor protection necessary in any country that follows principles-based accounting is a securities commission that will punish companies for steering offside when it comes to interpreting vague accounting principles. Unfortunately, we don't have that level of enforcement in Canada.

In an ironic twist, Canada's securities regulators also claim to follow a principles-based approach, the major advantage of which is usually cost savings

(whether in accounting or securities regulation). The push for lower costs always comes from the companies themselves. Corporations are allowed to cut corners when it comes to compliance costs, and the accountants and regulators hope that the downside of such is manageable.

With the accountants and regulators each following the same head-in-the-sand approach, they actually end up mitigating each other's downside. The accountants placate their clients by not setting many rules and keeping accounting costs down. Meanwhile, without concrete accounting rules in place and by not questioning the lack of standards, regulators can't be accused of letting companies violate the would-be rules. They thus satiate corporate cost cutters by not spending money on what would be futile enforcement efforts.

It's quite a convenient quid pro quo arrangement when you think about it. Basically, the securities regulators trust the accountants to trust the executives to not screw over the shareholders who are placing their trust in the regulators in the first place.

Companies may end up saving money on compliance costs by following IFRS, but who knows how much of that will get diverted to executive pockets via ill-conceived bonus structures defined by the same vague accounting rules. Therefore, it just won't matter what accounting standards Canadian companies follow if the regulatory enforcement isn't there for investors to trust the numbers in the end.

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