

Outlook



BETWEEN THE LINES

The hidden tax

Accounting chicanery takes a bite out of Canadian investors' retirement savings

by Al Rosen



There is a constant call from experts for Canada to lower its personal tax rates, as opposed to making misdirected populist moves like cutting the GST. Presumably, the recent federal budget did not provide any personal tax cuts because of the current uncertain economic climate. More likely, the government decided to more slowly mete out its voter incentives as a way of managing its broader-based support over time.

While there are always feasible, cost-effective options available to help Canadian investors keep more

of their hard-earned money, they don't always get implemented if the direct impact is not readily apparent to a majority of voters. Take regulatory enforcement, for instance. What would cutting down on accounting shenanigans save Canadians every year?

Investors have watched Nortel Networks stock (TSX: NT) drop more than 90% in value, twice, in the past six years on the back of some rather interesting accounting. Fuzzy financial reporting also lubricated the ascent of several dozen income trusts before reality eventually intruded and they declined precipitously in value.

This column has frequently listed numerous Canadian financial failures that were the result of accounting chicanery. While we won't repeat them again here, it's safe to say that investors could have saved untold billions had decent regulatory oversight been in place.

It is sometimes too easy for investors to forget about such losses without considering what they might have turned into had they been avoided. Consider the long-term effect that accounting manipulations and lax enforcement can have on retirement savings.

The accompanying table shows the impact of earning compound returns on an investment portfolio. If \$500 per month is invested for 35 years, a total of \$210,000 is accumulated before any interest is added. Using interest rates of 4%, 6%, 8% and 10%, the table shows that huge differences can exist at retirement time.

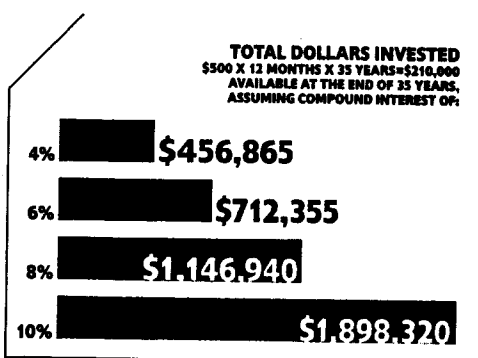
If, for example, your portfolio generated only 8% instead of 10% because of financial shenanigans, the difference at retirement would be roughly \$750,000—a sizable sum by any standard. Naturally, you might question whether financial manipulations can really shave 2% off your portfolio every year. Considering that financial torpedoes seem to come along with unfortunate regularity in Canada, 2% could easily be underestimating the problem. If just 10% of your portfolio is comprised of torpedoes that blow up every five years, then that's more than 2% right there—and that's only considering the headline fiascos that we have seen recently.

The much bigger tax on your savings is actually the collective impact of the smaller losses that never really receive the attention they deserve. There are the self-dealing transactions with management that divert shareholder funds to insiders. There are the countless

ways to manipulate earnings and cash flows in the short term to drive stock prices higher. There are the constant insider trading scams that slowly eat away at investors.

Taking steps to ensure that investors are not unnecessarily taxed 2% of their total investments every year, would far outstrip the benefit of a 2% cut in personal tax rates. However, without the easy-to-understand cause-and-effect relationship, it would not be nearly as popular with voters.

Even so, it's encouraging to see that the federal government has assembled an expert panel on securities regulation in Canada. Hopefully, they will take a serious look at the lack of enforcement on financial reporting and other matters that so deeply impact every Canadian's retirement savings.



Unfortunately, it will take significant effort to push past the usual cheerleaders who will be more than eager to present their opinions. Some enforcement personnel will actually make the argument that Canada is better off on the whole for promoting the safety (real or otherwise) of its capital markets, rather than subjecting them to scrutiny that might trigger investor worries. So here's a tip for the panel: try not to consult too much the parties directly responsible for the current problem.

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