COMMENT

Investors must be vigilant if OSC is not

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FirstService Corp. finally admitted just two weeks ago that it had been backdating its stock options for years. This came as no surprise to our long-time clients, as we had started asking the company about these practices starting in September, 2002.

On Jan. 29, First Service disclosed that a special committee concluded the firm did not properly account for its stock-option grants between 1995 and 2007, and took a $3.3-million expense after revising the dates of the grants.

By backdating stock options, many companies have effectively managed to understate their compensation expenses, and overstate their income. Some companies backdated options for both senior executives and board members.

FirstService says the amount of the compensation, and earnings overstatement is "non-material." And the committee completely absolved all senior executives, board members, and employees of any wrongdoing. Its decision seems strange, however, given that the backdating continued for another four years after we brought it to the attention of management back in 2002.

At the time we questioned FirstService about the mispricing of options grants to the CEO, it responded that the options were priced using the market close on the day before the grant. But the numbers didn't add up. Likewise, the company's secondary explanation of foreign exchange impacts didn't work for us either.

As well, FirstService never once mentioned its so-called "practice" of pricing options using the low trade of the month prior to the option grants. And our research indicates some options were priced even lower than the low close of the previous month. In fact, FirstService used a litany of pricing mechanisms throughout the backdating period. The company was obviously pricing other option grants using the close price on the date of the grant, despite its recent claim that it applied its pricing policy "consistently."

Nevertheless, the board of FirstService has evidently closed the books on the matter, and life goes on. My point here, so many years later, is the amount of time that investors were forced to endure to have matters dealt with.

FirstService says it undertook its internal investigation at the behest of its "primary securities regulator." Let's assume it's the OSC, even though the company is also listed on Nasdaq. While the OSC is also investigating **Research In Motion Ltd.**, it has not been revealed who else is under scrutiny. In contrast, dozens of backdating cases are being publicly investigated by the SEC, which guarantees that many more U.S. companies have since taken corrective action on their backdating.

The questions surrounding the backdating of options is reminiscent of a more recent financial reporting boondoggle in Canada—namely the current mess surrounding asset backed commercial paper (ABCP) writedowns. In both instances, regulators just seem to want the situation to quietly go away.

It's hard to appreciate the OSC's approach to regulation, when matters of importance to the market as a whole are settled behind closed doors.

Limiting enforcement to quietly asking companies to restate their financials almost guarantees they'll be back pushing the envelope the next time around. Our regulators always seem to fall for the explanation that companies don't know how to handle new situations, like ABCP, and therefore need more "understanding" and "compassion," to use the OSC's own words.

A few months back, we highlighted how companies were taking advantage of the OSC's weak regulatory stance when it came to reporting on impaired ABCP holdings. Despite clear accounting guidelines that require ABCP to be written down to fair value, a full 20% of companies decided to do nothing at all. Since that time, **Unigold Inc.**, a microcap mining concern, is the only company that the OSC has cajoled into recognizing a writedown and reissuing statements.

The silence on ABCP writedowns continues even though the Montreal Accord has been pushed back a third time and credit markets have continued to deteriorate. Canaccord Capital announced just last week that it nearly doubled the impairment it is recognizing on its ABCP, now 20% of the original value.

Hundreds of millions more in ABCP writedowns should be recognized by the more than 80 Canadian companies that hold ABCP. Nevertheless, silence exists on the regulatory front.

In any event, the impact seems clear. Investors can't just blindly put their faith in management, the board, auditors, and regulators to ensure that solid financial reporting exists in the companies they own. Further action must be taken, including a serious delve into the accounting of every company in your portfolio.

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alrosen@accountabilityresearch.com

Al Rosen is a forensic accountant at Accountability Research Corp., an independent equity research firm.