

BETWEEN THE LINES

Countdown

An upheaval in Canadian financial reporting is just three years away

by Al Rosen

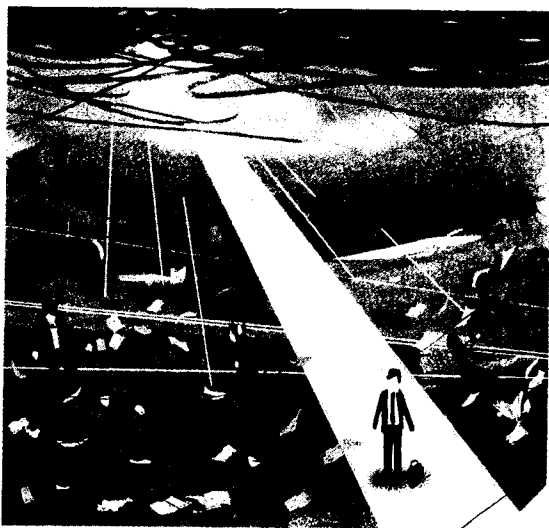


A recent survey revealed that just 42% of Canadian portfolio managers know that Canada is preparing to switch to International Financial Reporting Standards starting in 2011. It's a good bet that even fewer retail investors are aware of the change, despite the significant impact it will have on investment values.

The transition to IFRS represents the biggest upheaval in financial reporting the country has ever seen (some details have been covered in recent print and online articles in *Canadian Business*.) Suffice it to say, investors will need to question the reliability of all their old-hat investment techniques, everything from book values to return-on-equity ratios.

Portfolio managers who use quantitative screening techniques will be hardest hit. Historical trend lines and financial comparability across companies will vanish. Significant time will be wasted investigating false leads, and other opportunities will be missed altogether because of misinterpretations of the new

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accounting rules.

Despite the uproar that IFRS will cause, the implementation date of 2011 is apparently too distant for many to care at this point. By the time 2011 rolls around we'll be too busy phasing out incandescent light bulbs, plastic shopping bags, and analog TV signals to care much about accounting, right?

Wrong. There's more than enough reason to start thinking about IFRS sooner rather than later. The big auditing firms are already tripping over each other to sign up clients to a swath of services aimed at IFRS conversion.

While IFRS is a huge new revenue stream for auditors, the significance of the situation is not being overstated like you might think. Companies will be aiming to have a mirror IFRS system in place by 2010, to ensure that comparable results presented the following year are reasonably reflected. That leaves less than two years for firms to identify, strategize, budget for and implement their IFRS conversion. It will happen sooner than most care to admit.

Investors will need to dedicate similar time and effort to reconsidering their investment strategies. But they can't rely on auditing firms to provide the information necessary to tackle the issues. IFRS white papers from the big firms are focused on their clients (the corporations) and on compliance with a list of IFRS changes. Very little is written with investors in mind.

While it is important to understand specific differences between IFRS and current Canadian rules, that's not going far enough. When Canada switches to IFRS, it will essentially adopt an omnibus bill of changes, the full consequences of which cannot be understood by examining the issues in isolation. The serious problems with IFRS emerge only when the interaction of the various rules are considered.

For instance, the IFRS rule for

testing impairment in long-lived assets is weak. Someone might look at the current rule in Canada, determine it to be just as weak, and imprudently surmise that nothing need be done. The key, however, is to examine the IFRS rule in light of another rule that allows companies to write up the value of their assets upon adoption of the new standards. Therefore, under IFRS, executives can write up the value of the assets to whatever amounts they decide, and keep them at those artificial levels for years while they cash out their stock options.

That situation (just one of many possibilities) is more likely in Canada because of our weak approach to enforcement. Our securities commissions have turned a blind eye to accounting shenanigans, leaving auditors as the only theoretical line

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of defence. Unfortunately, auditors are paid by companies and have argued successfully to the Supreme Court that they owe no duty of care to investors.

With less than three years to go, investors need to identify the numerous IFRS shortcomings, analyze the interaction between them, formulate a strategy to deal with the impacts, and implement an investment solution. Ignoring the issue or procrastinating just might lead your portfolio the way of the plastic bag.

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