



BETWEEN THE LINES

Kaboom!

Canada is poised to adopt a new accounting standard for public companies. It's a ticking time bomb that should be defused.

by Al Rosen and Mark Rosen



After making several presentations to major law firms on the impacts that International Financial Reporting Standards will have on their clients, some lawyers have asked us who to contact to stop the weak accounting changes from coming to Canada. To us, that's not a surprising response once people take 90 minutes to consider all the negative aspects of IFRS.

A few years back, the European Commission made a surprise announcement that its members should adopt a common accounting language. A nice idea in theory led to a rushed implementation job and poor quality standards from the start. In

fact, a quick search on the Internet can dig up numerous drawbacks surrounding IFRS and the problems encountered so far in the EU and Australia, the only notable users of the rules. Specific complaints have come from the likes of Xerox, France Telecom, SwissHoldings and Commonwealth Bank of Australia to name just a few. As it stands now, IFRS is in its infancy and decades behind the rules currently used in the U.S. and Canada.

Around the time that Canadian accounting standard-setters chose to adopt IFRS by 2011, they had been suffering from schizophrenia for about a decade. They were also severely underfunded and under pressure to please their ultimate masters,

the auditors of Canada. They kept flip-flopping on what their purpose was—whether to harmonize their rules with the U.S. or with Europe. They spuriously chose to adopt IFRS, supposedly because Canada was more “principles-based” in nature (that means there are fewer rules to follow). But as it turned out, the chairman of the board that sets IFRS has since explained that U.S. accounting is also principles-based; it just happens to be more robust.

As a backup explanation, the Canadian standard-setters then argued that fewer rules were better, because rules had not prevented accounting blow-ups in the U.S. That argument is strikingly counterintuitive. One quickly realizes that having fewer rules is not an alternative to having rules; it’s just less of what was supposedly not working in the first place. On a related note, the power to set accounting rules in Canada was originally granted to the auditors by federal and provincial legislation. Our politicians, however, never expected that our auditors would, in turn, hand over control to a foreign standards-setting body that is subject to political interference from abroad, without so much as consulting Parliament first.

Nevertheless, combined with the usual lack of interest in investor needs, the windfall of fees that would be generated from switching the country to IFRS proved too attractive for our auditors to pass up. In an attempt to smoke-screen their good fortune, the beneficiaries of the IFRS make-work project have spouted myths about worldwide comparability of financial statements and the reduced cost of capital that would follow. Unfortunately, such comparability is not possible with different currencies, interest rates, tax regimes, legal frameworks, ethical standards, auditing enforcement, regulatory ideologies and so forth.

In fact, it is highly likely that comparability will be even worse under IFRS, because of the excessive management leeway that is inherent in the new rules.

This is where IFRS theorists take their leave of the real world. They assert that given the right amount of wiggle room, executives from every corner of the earth would be free to honestly reflect the financial position of their business.

Obviously, the concept of honest management is a bit of a laugh given the current financial crisis and the multimillion-dollar compensation packages handed out to executives prior to the failure of Lehman Bros. and the like. Still, executive behaviour need not be outlandish to cause problems. Under IFRS, management will be expected to make a flurry of accounting assumptions within broad acceptable ranges that will directly impact their own bonus. Simply put, human nature will take over.

When confronted with such inevitable scenarios, IFRS proponents default to the academic position that any question regarding management honesty or motivations is a “governance issue” and not something that should impact the pure ideal of accounting principles. This specious argument is usually the tipping point for most lawyers at our presentations, who are well aware that the real world always intrudes on fantasy.

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Faced with their collapsing argument, the IFRS promoters misleadingly claim that the U.S. is about to adopt the new rules. Above all, this tends to be their most pernicious exaggeration. Now, keep in mind that the Canadian accounting standard-setters have already misled the public on numerous issues, including how many countries currently use IFRS. Add in their years of misdirection regarding the hypothetical “rules versus principles” debate. And lastly, digest the revelation that the purported benefit of international accounting comparability actually relies on the unreachable ideals of impeccable management integrity and perfect corporate governance.

That said, just prior to the financial

world going to hell in a handbasket recently, the Securities and Exchange Commission floated the idea of switching the U.S. to IFRS by 2016—provided that vast improvements were made and that political interference from abroad was eliminated. Since then, however, the SEC has been criticized for its financial deregulation initiatives (of which IFRS is one). Not surprisingly, the details on implementation in the U.S., the so-called IFRS road map, is overdue with no word on its current whereabouts.

Part of that road map was supposed to allow industry-leading multinationals to test the IFRS waters next year. But when the CEO of Manulife Financial (the fourth-largest global insurer) says that fair-value accounting, the basis of IFRS, is “absolutely nuts,” the longevity of the proposal comes into question. Indeed, fair-value accounting is already being scrutinized by congressional order in the U.S., and has been modified in the EU in response to the financial crisis.

Given the seriously conflicted decision-making process of Canadian auditors, the high costs to investors and business stewards, the phantom benefits to the market as a whole, and seriously

waning interest in the U.S., the overall appropriateness of IFRS for Canada comes into significant doubt.

Unfortunately, our politicians and securities regulators are not grasping the serious problems inherent in IFRS. And while the lawyers at our presentations are quickly recognizing the issues, they are primarily interested in making money by protecting their clients from the new rules. So, sadly, investors will have to look out for their own interests. Just don’t say you weren’t warned about the IFRS time bomb.

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