

COMMENT

Delighted auditors pass the cookie jar

Huge scope for
manipulation
under lax new
standards

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The global shift toward adopting International Financial Reporting Standards is in full swing, much to the delight of corporate auditors around the world. Unfortunately, investors are being left out in the cold because they don't pay the auditors, and, frankly, the auditors want nothing to do with them.

So ignored are investor needs that even frank commentary from the auditors detailing the weaknesses of IFRS inevitably concludes that switching standards was somehow a *fait accompli*. While possible, that still does not address why Canada has rushed so blindly and prematurely into the fray.

The United States is currently requesting feedback on the idea of switching all public companies to IFRS by 2016. That would be five years later than the date Canada has already cemented for the change. Canada has further decided to eschew adopting any improvements made to IFRS over the next few years. This means that Canada will initially adopt standards that have only been tested in the market for three years, whereas the United States will be looking at using standards that have been proven and strengthened for more than a decade.

In short, vast improvements will have to be made to IFRS before the United States requires companies to adopt the standards (that's assuming they even go that route). Overall, it's a puzzling choice that has been made on behalf of Canadians, and we've talked to many institutional investors who ask how it happened this way. In that regard, it's interesting to see that one of the big four auditing firms has weighed in on the issue.

PricewaterhouseCoopers believes that IFRS was rushed into Canada because the Accounting Standards Board had gone into hibernation long before the public was sufficiently consulted on the process. Basically, the decision

had been made internally before the constituents had been heard. At that point, it became a decision of whether or not to delay IFRS and to restart active standards-setting in order to prevent our accounting from, as PwC puts it, "smelling as bad as the leftover salmon behind the lettuce at the back of the fridge." Instead, the Accounting Standards Board took the easier, less embarrassing and more profitable route, leaving investors all the worse off.

Investors would have benefited greatly from a delay in IFRS because it would have allowed them to see how corporate management in other countries adjust to their broad new powers to control reported income and cash flow figures. Under IFRS, executives have much greater leeway to play with those numbers, which are still paramount to investor interests, despite being given short shrift by accountants.

Take the example of accounting cookie jars, which are basically reserves that can be added to or subtracted from at whim. The effect is that those pluses and minuses directly impact reported income, and tend not to be transparent for investors. Thus income can be manipulated up and down by management with ease. While some cookie jars exist in Canadian accounting already, they have multiplied significantly under IFRS.

Management is actually allowed to write up the value of capital and intangible assets under IFRS. Previously, these items were recorded at historical cost, and written down to reflect any impairments in value. The concept of writing up the value of non-financial assets is completely new and will inevitably impact how companies are analyzed and valued.

In fact, management does not even need to have the in-

tent to manipulate earnings in order to cause frustration for investors. The volatility alone of honest managers trying to grapple with the new rules will cause comparability among companies to plummet.

Consider **Lihir Gold Ltd.** (LGL/ASX), an exploration company with a US\$4-billion market cap. In 2004, the company reversed a writedown that it had previously taken on the value of its mine properties. Essentially, the company adopted a more positive outlook for the long-term price of gold. The impact, even to this day, is to boost shareholders' equity by more than 50% under IFRS compared with

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what it would be under Canadian or U.S. accounting rules.

Such previously unheard-of adjustments will become routine once IFRS is more widely adopted, and are bound to wreak havoc on investment screening processes, not to mention the valuation of companies in general — and that's just the tip of the iceberg. If you thought accounting was boring, just wait until you see the impact it has on your portfolio in no time at all.

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