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OPINION: Canadian profit statements need a credibility fix

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Canadian investors have been left vulnerable to significant losses resulting from unreliable financial statements permitted by a regulatory system that does more to facilitate corporate profits than safe markets. While most investors are aware of corporate accounting improprieties, such as manipulated profits, Canadian investors have particular reason to doubt the credibility of earnings statements.

Lax regulatory oversight is the primary culprit. Canadian regulators inadvertently enable financial deception through their inaction against vague standards and auditor immunity. Such failings diminish domestic wealth and, when publicized internationally, erode confidence in Canada as a destination for foreign investment.

Auditors, regulators, lawmakers, sell-side research analysts, and financial media all bear responsibility for the lack of reliability in financial statements. Most of these parties have inherent conflicts of interest, and many investors wrongly assume these institutions are responsible for protecting investments.

Several solutions exist, including:

- Forming a national securities enforcement authority separate from provincial commissions;
- Giving a national enforcement regulator full authority over acceptable accounting rules; and
- Introducing legislation that makes auditors accountable to investors in cases of negligence.

Auditors

Twenty years ago, the body representing financial statement auditors in Canada — Chartered Professional Accountants (CPA) Canada — convinced the Supreme Court that they essentially owe no responsibility to investors that use audited financial statements. The CPA's stance was that they should not owe a fiduciary duty of care to an unknown number of investors. Since then, investors can only rarely sue auditors successfully for losses based on misleading annual financial statements.

What then is the point of auditing financial statements if investors cannot trust the numbers? Conversely, why should companies waste investors' money on auditors if the audits do not help investors? Dropping the pretense of investor protection would at least leave investors better informed about where they stand — vulnerable and exposed.

Audit firms are self-regulated, profit-seeking entities whose use by public companies is legally mandated in Canada.

With no other checks on the reliability of financial statements, national lawmakers must intervene to make auditors accountable to investors. Instead, however, Canadian lawmakers and regulators brush off the problem and delegate problems back to the auditors, creating a false sense of investor confidence in Canadian markets.

International Financial Reporting Standards

Since auditors need not consider the interests of investors, they can concentrate entirely on addressing the wants of their corporate clients. Accordingly, Canadian auditors wholeheartedly backed the adoption of International Financial Reporting Standards (IFRS). It was an easy decision; looser rules and regulations make for happier companies.

For many nations, IFRS represented progress. The European Union (EU), for example, used IFRS to harmonize accounting rules among member states. For Canada, however, IFRS significantly muddled financial transparency and reliability. The country already had reasonable accounting rules — the Canadian Generally Accepted Accounting Principles (GAAP) — that were refined over decades to address loopholes and investor concerns.

IFRS allows Canadian executives to choose the value of their own assets, with little or no outside verification, if they desire. The situation would be akin to acquiring a mortgage by telling the bank what you thought your house was worth.

The resulting questionable numbers then become cemented into balance sheets, despite not being based on actual transactions or sales. Given the way accounting works, they produce a picture of higher profits (and asset values), which analysts and investors might misinterpret when determining value.

IFRS is overly focused on placing "current values" on the balance sheet, while providing excessive leeway for executives to craft numbers that make them look best come bonus-time. It has shifted attention away from previously fundamental accounting concepts, such as profits triggered by the realization of third-party transactions and high-confidence assurances of cash collection before reporting revenue. Under GAAP, expenses had to be matched to reported revenues, while "conservatism" had to apply when doubts existed.

The new rules have failed investors by creating fake profits, low-quality earnings, inflated asset values, and misstated cash flows. This has created many concerns for parties tasked with financial compliance and risk assessment. Even basic values used for lending practices have been thrown into question now that corporate executives can bolster reported figures based on little more than enthusiastic assumptions.

To defend their position, Canada's auditing industry deploys marketing based on simplistic platitudes that do not withstand deeper analysis. Auditors will claim, for example, that IFRS allows for financial statement comparability around the world. In reality, IFRS does not improve corporate comparability, even within the same country, or even the same industry. In fact, the same company might not even be comparable to itself, from quarter to quarter, under IFRS.

The major problem is that IFRS rules are deliberately light on substance, supposedly to maximise management's ability to reflect their own company. The thinking from auditors is that management knows their company best, so give them the leeway to tell their story.

Ultimately, this allows auditors to rest on the notion that companies "could" be comparable under IFRS. What is left unsaid is that the management of those different companies would need to share a brain. Like asking two executives to draw a picture of a house, given the same instructions and materials, the end results would differ greatly. But if you gave them more rules, greater clarity, defined measurements, and clear prohibitions, the resulting pictures would be closer in substance to each other. Investors do not want to compare a fast-food chain in India to a biotech firm in Canada. They want actual comparability and greater utility of financial statement figures nearer to home.

Proponents of IFRS have neglected the reality that some executives will exploit regulatory vagueness to their own advantage. While there will be shady practices under any accounting framework, IFRS is worse than any rules-based system, because when it comes time to prosecute someone who veers outside the bounds of fairness, there needs to be something of time-tested substance to pin on them.

For more evidence on the deficiencies of IFRS, much greater detail is noted in our recent book, "Easy Prey Investors: Why Broken Safety Nets Threaten Your Wealth."

Securities regulators

Securities regulators in Canada are conflicted, having the dual mandate of promoting domestic markets, while also protecting investors. The fees needed to run the regulatory framework are collected from the issuing companies, whose money and collective voice drowns out those of individual investor advocates. Amid this conflict, the practice seemingly followed by regulators is to introduce limited rules that clamp down on small-time scams, while largely ignoring accounting and financial reporting issues at larger public companies.

Investors need only look at the poor track record of Canadian securities regulators on everything from the abuse of non-GAAP measures to the enforcement failings on cases like Nortel and Sino-Forest.

It does not help that Canadian securities regulation remains fragmented across 13 provincial and territorial jurisdictions, with no national capital markets authority. Recent efforts to establish a national securities regulator were put on hold last year, due to ongoing resistance from some provinces, led by Quebec and Alberta.

Despite repeated false starts over the last two decades, one could argue that securities regulation in Canada has improved its ability to address some white-collar crime. Unfortunately, Canadian regulators do not seem to believe that fighting financial crime should include serious investigation of IFRS deficiencies or of the widespread deterioration of financial statement reliability. In essence, they have deferred to the creators of IFRS to establish the framework for acceptability.

Canada urgently needs an independent national securities enforcement agency tasked with addressing the issues that have too frequently fallen to U.S. regulators to act first, such as Livent, Hollinger, Nortel and other instances of dual-listed Canadian failures. On a larger scale, Canada must clamp down on pervasive non-GAAP abuses, and take ultimate charge of accounting in Canada, similar to how the U.S. Securities and Exchange Commission (SEC) has the final say on American GAAP.

Lawmakers

Canadian lawmakers have failed by not correcting the major gaps that leave investors open to abuse. It has been two decades since the nation's highest court ruled that investors cannot rely on financial statements (the Hercules Managements case). The biggest failure has been to allow self-regulation by the audit firms.

Canada must stop allowing self-regulatory institutions to exist unchecked. They allowed auditing firms to choose IFRS on behalf of investors, even after disavowing any duty of care to the public. Quite often, when a conflict of interest arises, lawmakers' first and sometimes only response was to ask SROs to judge their own behaviour, making it a clear case of asking the fox to guard the chicken coop.

Sell-side analysts

Equity analysts at investment banks do not write research for the prime benefit of individual investors, and banks have a profit incentive to encourage the sale of new issues. There is no better way to facilitate this than to accept corporate earnings figures at face value, and to promote the same in written research reports. While not every research report from a given firm is unreliable, the investing public lacks the crucial ability to effectively screen out the many conflicted ideas.

A well-known example is Valeant Pharmaceuticals. Research analysts substantiated sky-high target prices for the firm on the basis of the company's non-GAAP performance metric. In the year it collapsed, Valeant reported $8.14 per share in "adjusted EPS" versus an actual loss per share of $0.85. Those compromises in research helped underwriters raise roughly $30 billion of debt for Valeant to fund an extended acquisition spree right up to the point it came crashing down in a haze of accounting and regulatory concerns.

Institutional investors may have access to more of the real picture by paying for special one-on-one analyst access, but much of the official story is obscured by inflated profit figures produced from pliable IFRS rules and non-GAAP adjustments. The lack of independent research providers in Canada, relative to the United States, makes it difficult to find a reasonable balance of opinion.

Re-prioritising enforcement and liability

Lawmakers must make auditors liable to investors harmed by misleading financial statements. No other single measure would do more to clamp down on inflated profits than making those who check the books responsible for the quality and reliability of their work.

Additionally, Canada should establish an enforcement body responsible for deterring and punishing financial reporting abuses. To be effective, the new entity must be completely separate from the existing administrative framework that seems more focussed on easing capital formation.

The new enforcement authority should also have exclusive authority to determine the acceptability of specific IFRS rules, instead of the International Accounting Standards Board (IASB), which seems frequently consumed by European politics, now including Brexit.

A new regulator overseeing IFRS in Canada could also give specific thought to the uniqueness of Canada's resources-heavy capital markets, its past history of financial institution failures, and its penchant for tightly-controlled companies with weak governance.

Until such fixes occur, however, investors, directors, issuers, and compliance personnel need to be aware of the large gaps in regulation and investment safety that exist in Canada and ultimately impact market confidence.

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