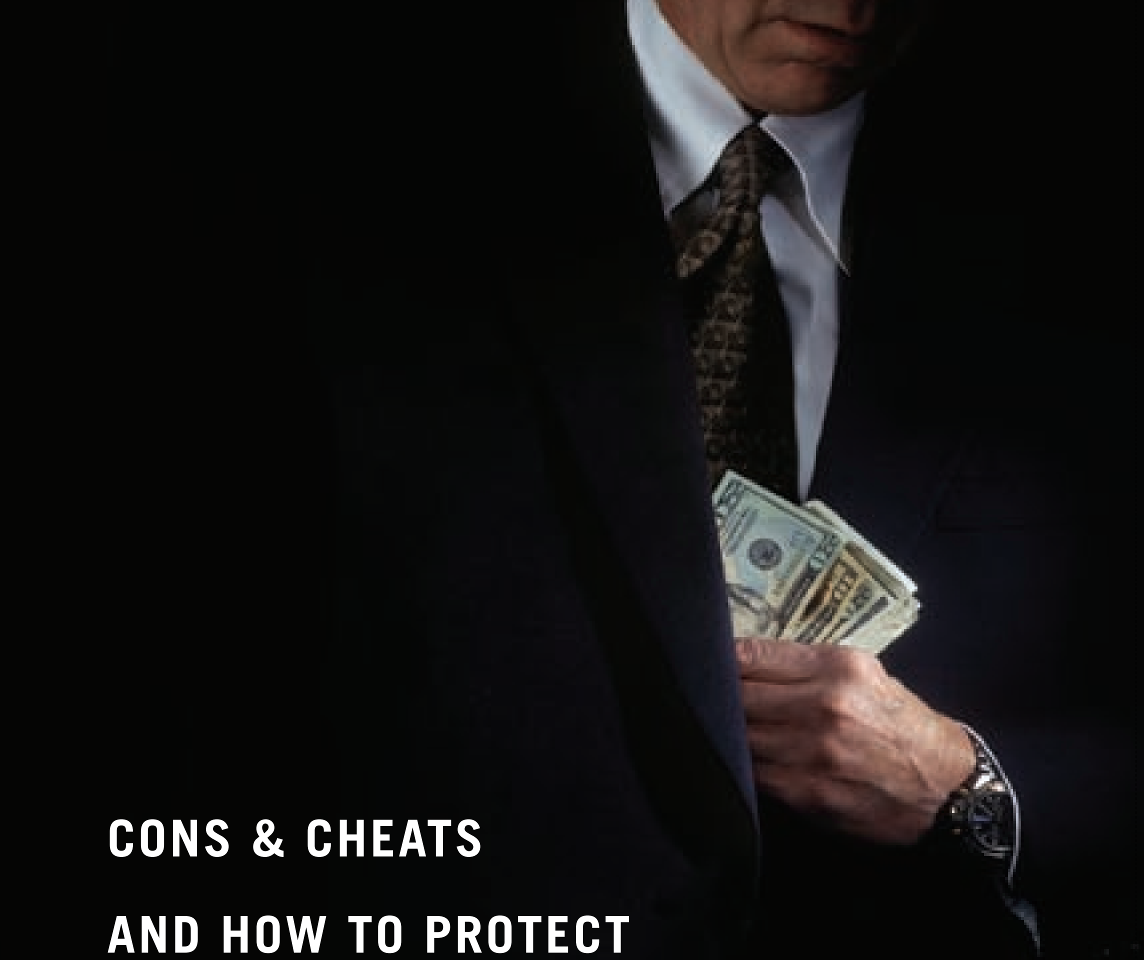

CONS & CHEATS
AND HOW TO PROTECT
YOUR INVESTMENTS FROM THEM

$WINDLER$

AL ROSEN & MARK ROSEN

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CHAPTER ONE

Bogus Gold and Other Tales of Woe

"Those who stand for nothing fall for anything."

ALEXANDER HAMILTON

ELIZABETH MONTGOMERY and Frederick Burgess wanted more money, and they found an easy way to get it. As a refiner and manufacturer of gold, their company, International Nesmont Industrial, sold shares to investors on the Vancouver and NASDAQ exchanges. That in itself didn't attract much money, however. There were lots of gold-mining companies listed on both exchanges. Not all of them made a profit, though.

Profits affect the price of a company's shares. The higher a company's audited profits, the more money an investor will pay for the company's stock. For two years, Montgomery, Nesmont's CFO, and Burgess, its head assayer, made sure that their company reported a substantial profit and that the company's auditors confirmed it. All they needed were a few hunks of brass painted gold.

Over that two-year period, Nesmont reported combined earnings of almost $1 million. The company's auditors, Coopers & Lybrand (now PricewaterhouseCoopers), confirmed the reported earnings. Each year, a junior auditor opened the door of Nesmont's vault and gazed inside at stacks of golden bars. Satisfied that they existed, just as management had said they did, he signed off on the company's reported earnings. Supported by an audited record of earnings, the company's stock price rose to more than $9 a share. The company succeeded in selling 400,000 shares at that price. You might have even bought some of those shares yourself. Many people did. Most of them assumed they could rely on the company's audited reports to obtain a reasonable picture of Nesmont's financial health. They were wrong.

In fact, the company hadn't earned a profit at all. It hadn't even come close. Over the two-year period, Nesmont should have reported losses of $5.7 million.

After two years, warning signs started to appear. Concerned by "certain undisclosed issues," Nesmont's auditors said they would not sign the next year-end audit report. A month later, Nesmont commissioned another audit firm, Deloitte & Touche, to assist in the "resolution of the issues." The company then revealed "certain deficiencies" in its accounting systems. By the time new managers replaced Montgomery and Burgess and discovered the fraud, the stock had fallen to less than $2 a share. By then, Montgomery's mom had managed to unload her shares for almost US$300,000, while the company's remaining shareholders were left with almost nothing.

If Nesmont represented an isolated case of fraud and deception, we would not have written this book. But it doesn't. In our capacity as forensic accountants, we see similar cases every day. (We've listed fifty of them in Appendix A, but we could have listed far more.) Some of them involve deceptive practices so basic a five-year-old could understand them. Brass passed off as gold. Six inches of high-grade copper covering a barrel full of second-grade scrap. Other scams, as we'll see, require more ingenuity. Some scams last for only a year or two. Others can continue undetected for years, if not decades. The longest scam we have witnessed in our work was committed over a span of twenty-four years. But to be successful, all these scams were dependent on a combination of conflicted auditors, inadequate or nonexistent regulation, ill-informed directors, crooked managers, and gullible investors.

Investors need to learn that they can't distinguish the good from the bad simply by looking at the size of the dollars on a balance sheet. Based on the price of its outstanding shares, Nortel once had a value of $374 billion, thanks to misleading financial reporting and accounting misrepresentations. Today, Nortel shares are worthless. Business income trusts (BITs) were once valued at more than $70 billion, based on unwarranted market hype to investors, who believed it all. Today, BITs have lost half their value and all of their cachet. Non-bank asset-backed commercial paper attracted $32 billion from investors, who now wonder how Canada's regulators and lawmakers ever allowed the market to operate.

The total amount that investors have lost to fraud, accounting chicanery, crooked underwriters, dishonest stockbrokers, and financial trickery is incalculable. These losses affect all Canadians, whether they invest in the stock market, purchase units of a mutual fund, or save for retirement through their corporate pension plans.

Even banks get bamboozled. In Manitoba, a rapidly expanding distributor of fishing supplies borrowed money equivalent to about 50% of its audited inventory. The inventory consisted of hundreds of items, from fishing lures to hip waders, imported primarily from Asia. As the company expanded rapidly in sales and inventory, so did its bank loan.

The company had a particularly large customer in the US, to whom it shipped some of its inventory directly from the Asian manufacturers. This made it difficult for auditors to track the location of the inventory. The company, meanwhile, produced hundreds of pages of inventory printouts that carried as many as fifty items on a page. The auditors didn't look closely at the printouts, but did their best to count the inventory on a sample basis and attach costs to each sampled item.

As the company's inventory grew, the bank became very interested in its potential value and saleability. Rather than seeking opinions about the items from fishing specialists, the auditors asked the company's managers if they thought they'd stocked too many items, or if any of the products were obsolete. As the years passed, the auditors appeared to be doing their job, until a new auditor arrived on the scene.

Curious about the amount of inventory stored on site compared to the amounts recorded on the books, the new auditor performed a standard procedure that had not been conducted in the past two years. He added up the numbers. Then he compared the total to the amount reported in the company's financial statements. Simply by doing the arithmetic, he discovered that the company had overstated its inventory by 50%, and had done the same thing for the past two years. This was no honest mistake. The money borrowed from the bank, based on the company's inflated inventory, went into the owners' pockets, some of it through the US customer, who happened to be closely related to the owners. Once the scam was uncovered, the company went bankrupt, and the bank recovered only a portion of its money, all because the auditors had failed to perform some simple math.

If scams like this occurred only once or twice a year, none of us would worry much. Thousands of companies operate in Canada, borrow money, and sell shares to investors. There's bound to be one bad management apple in their midst. But in our experience, deception, treachery, and dishonesty occur far more often. We sometimes see three or four new examples every week.

They occur in all industries and involve companies of all sizes. They go undetected because auditors, regulators, lawmakers, and self-regulated professions in Canada have little incentive to uncover them until after they occur. Under pressure to meet budgets and deadlines, auditors place their trust in a company's management to provide them with reliable information. They often follow a standard, one-size-fits-all audit plan, applying the same routine procedures without changing or adapting to the business from one year to the next. Auditors tend to take the word of a company's managers, and they readily accept their guidance when they check selected samples of inventory, accounts payable, and accounts receivable. To accommodate management's suggestions, they can easily override the audit systems and procedures that are supposed to ensure the selection of random items for testing. Managers know that auditors won't take the time to distinguish gold bars from brass, or add up thousands of numbers on page after page of computer printouts. If they do, the auditors have to justify their increased fees to the company that pays them.

When embarrassing discrepancies appear between a company's audited figures and the true story, auditors quickly paint themselves as the victims. "We were the target of a well-orchestrated fraud," they say. And according to auditors in Canada, it's not their job to look for fraud anyway.

Perhaps that explains why auditors didn't look very hard at the numbers provided by a financial institution in Western Canada that lent more than $2 million to the owners of several properties about five kilometres from downtown Edmonton. When the owners failed to pay any interest on the loan, the institution added the unpaid amount to the loan itself, recorded as an asset on its balance sheet. By the time the financial institution failed, the value of the loan, plus several million in accumulated interest, amounted to more than 110% of the alleged fair-market value of the property.

The lender had approved the loan based on an allegedly independent appraisal of the properties commissioned by the borrower. Along with the dollar value of the properties, the appraiser had included a separate sheet of paper describing a major assumption made in the process of valuing the land. For several years, however, auditors had accepted the appraisal at face value without referring to the other page.

If they had looked at the other page provided by the appraiser, the auditors would have discovered that the value of the properties recorded on the institution's books, and used as collateral against the loan, depended on a fairly improbable event. Downtown Edmonton would have to shift 4.6 kilometres to the west of its current location. If all the buildings in downtown Edmonton had made that short journey, the value of the borrower's property would have increased enormously. But that didn't happen, and the lender eventually took a big hit as it adjusted its numbers. It also put the properties on the market, although potential buyers didn't exactly jump at the chance to acquire a piece of Edmonton's future downtown that was 4.6 kilometres from the one that was already in place. Why buy swampland in Edmonton when you can get it in Florida?

As we've discovered, Canadian investors are on their own when it comes to safeguarding their investments. If auditors seem disinterested in uncovering financial flim-flams, Canada's securities regulators, accountants, lawmakers, and self-regulatory organizations have contributed as well to the complete and utter breakdown of investor protections in Canada. In the never-ending tragedy of investor fleecings, individuals have had to fight one-handed against the misleading, and sometimes truly crooked, actions of corporate executives, brokers, money managers, underwriters, accountants, lawyers, and other financial salesmen.

In the coming years, investors can anticipate even more dubious practices as Canada embarks on an unwise deregulation of financial reporting that will present opportunities to companies to manipulate their profit numbers. Rule changes will allow management to write down inventory, for example, from its cost in one year, and then write it back up to its original cost the next year. Management can then fiddle with their bonuses simply by adopting an optimistic or pessimistic view of inventory costs and values. As companies adjust the value of their inventory as often as every quarter, time-short and experience-challenged junior auditors will have even more trouble catching the manipulations of management. More than ever, auditors will rely on the word of company executives, which will only mean bad news for investors.

The good news is that you can take steps to protect yourself. Just don't expect any help from the individuals and organizations who appear to have your interests at heart. They don't.

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