The VIEW *from* BURGUNDY

OCTOBER 1999

THE HAM IN THE SANDWICH

On the occasion of an address to the Financial Reporting Conference of the Canadian Institute of Chartered Accountants, our firm delivered an assessment of the position of the auditor in the late 1990s and concluded that it was acutely uncomfortable and filled with the potential for conflicts or perceived conflicts. It reads rather quaintly now that Sarbanes Oxley bulldozed managements into much more stringent (and expensive) actions than this modest series of proposals would have foreseen. Separation of audit from consulting practices followed the Enron scandal immediately. Vastly increased responsibilities for the Audit Committee also followed.

We feel that we were a useful part of this debate, and even a little ahead of our time.

Richard Rooney, 2007

Richard Rooney, CA, the President of Burgundy, gave the following speech to the Financial Reporting and Accounting Conference of the Canadian Institute of Chartered Accountants, on September 28, 1999. Mr. Rooney has been nominated to the Canadian Accounting Standards Board, where he may have the opportunity to put his money where his mouth is.

The Ham in the Sandwich

Ladies and gentlemen, you have been drawn here under false pretences. Your program agenda made reference to our firm's February publication, and implied that I would be referring to it extensively. My speech today did arise out of that publication, but it is focused on one specific area. My remarks about auditors and accountants in the February publication were rather brief and general. What I want to do today is give you a shareholder's view of the accounting profession as it appears in 1999. For those of you who can still hear the names "Bre-X" and "Livent" without nausea, and are interested in our opinions, all of our publications are available free of charge on our website at www.burgundyasset.com.

A reasonable description of my job would be "professional shareholder." What I attempt to do on an ongoing basis is value the equity of companies relative to competitors and relative to competing investments. It is a job that can be as simple or as complicated as you wish it to be. At my firm, we tend to try to keep things simple, bearing in mind the dictum that simple things are rarely easy. We look for companies that deliver high returns on shareholders' capital consistently, which are well financed and run by trustworthy and competent people. We try to find a number of these investments and then hold them for the long term.

One document is the foundation for all of our work. That document is, of course, a company's financial statement. As in most advanced capitalist economies, we can generally rely on the propriety of these statements, due to the protections afforded us by the system of external auditors and securities commissions, which has evolved over the last 70 years or so.

The accounting profession is our first line of defence against fraud and error in these statements. If it

doesn't do its job, then I can't do mine. The second line of defence, the Securities Commission, is supposed to backstop the system if the auditors and accountants don't do their jobs. But it is really only expected to deal with rare and exceptional cases where the auditing and accounting professions have failed to ensure that the financial reports are presented fairly. The underlying assumption of the whole system is that the first line of defence is working.

So I was disturbed by the remarks of Arthur Levitt, the SEC chairman, in September of last year, and those of David Brown, the OSC chairman, in June and September of this year. These gentlemen paint a very grim picture indeed of the state of financial reporting and auditing in North America.

I've been giving the subject a lot of thought lately, and I've come to four conclusions. First, that the negotiating position of the external auditor has become dangerously weak, and must be reinforced through some changes in Canadian corporate governance. Second, that some of the wounds to the profession's credibility are self-inflicted. Accounting firms must end the perception of conflict of interest between audit and ancillary services offered to audit clients. Third, that managements' lack of accountability for their stock options has given them a powerful incentive to cook the books, so changes must be made in the way employee stock options are granted and accounted for. And fourth, that Canadian accounting standards must either become more rules based, or compensate for their elasticity by offering shareholders better-structured financial statements and improved disclosure.

Corporate Governance and The Auditor – Pollyanna or Frank Magazine?

I'd like to start by reading you two paragraphs. The first will outline how Canadian corporate governance is supposed to work. It is the Pollyanna view, if you like. The second is the way the system might be viewed by a jaded and cynical person who dislikes the system intensely. It's the Frank Magazine view.

Here's Pollyanna:

Every year at its annual meeting, a public company's shareholders elect a slate of directors who appoint the management of the company. The shareholders also appoint the independent auditors who will attest to the fairness of the financial statements prepared by management. The auditors will ensure that the financial statements are prepared in accordance with GAAP (Generally Accepted Accounting Principles), whose standards and principles are determined by the accounting profession after due process and codified in the *CICA Handbook*. Production of the financial statements will involve a process of negotiation between the auditors and the management on a wide variety of issues. Unresolved or contentious issues between the auditors and management can be raised in front of the Audit Committee of the Board of Directors who, as the shareholders' representatives, will make whatever determinations are necessary to protect shareholders' interests.

And here's Frank Magazine:

Every year at the annual meeting, the senior managers of a public company nominate a group of their friends to the Board of Directors. Providing they have not caused too much inconvenience, the auditors will be reappointed by the management as well. If the auditors have been difficult, they can be pacified by promises or threats about current or future consulting work. Management will do its level best to manipulate the financial statements to provide themselves with the best opportunity to make money from their stock option plans, whether that involves smoothing earnings to show a deceptively reliable progression, taking big bath write-downs to shore up future profit reserves, or making some "immaterial" errors on the interim report. The near-absence of firm rules in the *CICA Handbook* makes this exercise pretty easy. In the event of a fundamental disagreement over GAAP between management and auditors, the Audit

Committee will listen to both sides of the question and then side with management, because the Audit Committee members have stock options, too.

Now the fact is that sometimes the Pollyanna version is pretty close to the truth, and sometimes Frank Magazine has the right version. Usually, the truth is somewhere in the middle. But I think it's clear that the Frank Magazine version is not where we want to be. And the position of the auditor and professional accountant in that reality is completely untenable.

Canada has plenty of Boards of Directors that have been appointed by management. And on such Boards, the Audit Committee can be a mere cipher. In cases like that, the auditors really serve at the discretion of the management of the company, not of the shareholders. So the negotiation process that is supposed to take place doesn't. And the auditors are left with the stark choice: sign off, or resign. It is not surprising that the latter choice is so seldom taken.

Conflict of Interest – Auditors or Consultants?

This imbalance of power would make the audit firm's position quite difficult even in the absence of other factors. But one of those factors muddies the water considerably: the provision of ancillary services to audit clients, especially general management consulting. Now I am aware that the consulting arms of the big accounting firms did not arise out of some satanic plot to undermine the legitimacy of the audit function. They arose, incrementally and naturally, out of a desire to help our audit clients. But what's that old saying? The road to hell is paved with good intentions.

Auditing and consulting are very different jobs. Auditing is a painstaking progress through the financial data towards the issuance of an opinion on the financial statements. And consulting? Well, one of my professors at the University of Toronto, John Crispo, used to say that a consultant was someone who is brought in to solve a problem and stays around to become part of it. A really good consulting project never ends. Auditing is a shareholder-focused activity; consulting is a management-focused activity. Think about it: What consultant could ever take a position that is fundamentally opposed to that of senior management? Yet an auditor must be prepared to do that at any time. If you are auditing and consulting to the same public company, it is tough to look independent. And that perception of auditor independence is vital to me as a shareholder. If the auditors are not on my side, it's a cold world out there.

Gilding the Lily – Options and Earnings Management

As if this institutional weakness and perception of conflict of interest was not enough, the managements with which auditing and accounting firms must deal are now sometimes less reasonable and less reliable as stewards of the shareholders' interests than ever before. Gilding the lily has been a natural temptation since the dawn of financial reporting. But never has the lily-gilding industry been as huge and as difficult to control as today. The main reason for this imperative to cook the books is the metastasization of the employee stock option plan. And this has been a case where the process has been aided and abetted by the accounting profession.

I'm sure that you have seen the numbers coming out of the U.S. on options grants. Managers of the 350 largest U.S. corporations realized over $1 billion in options gains in the single year 1997. Gains from vested, but unexercised options were over $7 billion at the end of that year. Over $45 billion worth of options had been issued in the five calendar years ending 1997. These companies had reserved 13.2% of their total shares outstanding for employee stock options at that time. And things have become much worse since then. This is looting on a scale unprecedented since the days of the robber barons. And because of the accounting rules, it is made to appear a victimless crime.

There is no expense charged to income for options gains. Yet, as Warren Buffett asks, if options are not compensation, what are they? And if they are compensation, why are they not accounted for? Since options have no direct effect on net income under current accounting treatments, managements can reward themselves opulently for profit achievements that do not take into account the full costs of their own compensation. It is the most intellectually dishonest accounting treatment I have ever seen.

We wrote an article in our firm's publication in August of 1998 on the subject of employee stock options. We dealt with the behavioural aspects of these plans in some detail. One issue we did not address was the role of stock options as an incentive to aggressively manage earnings. I'll make up for that now.

My thesis is simple: option holders will always make the decision most likely to positively affect the stock price right now. And the most direct influence on the stock price is the quarterly earnings report. So it follows that earnings must be managed if options gains are to be maximized. We have seen what happens to the stock prices of companies that disappoint expectations, even by a modest amount. Exceeding expectations is almost always good for the stock price. And mammoths like Dupont and GE have a major interest in showing stable, predictable earnings, with a very low standard deviation around a long-term growth rate. Their nosebleed Price-Earnings multiples depend on it. All this adds up to an irresistible temptation to manage earnings aggressively. I believe that the systematic earnings management of major U.S. corporations has given the investing public a totally unrealistic conception of the sustainability and stability of corporate earnings. This, in turn, has led to equity prices being bid up to totally unrealistic levels, with consequences that are not yet known, though somewhat predictable.

So this is the basic message: earnings management is the symptom of a major disease in the capital markets. That disease is employee stock options. Because employee stock options are inadequately disclosed and accounted for, this form of employee compensation lacks the self-correcting nature of salaries and bonuses, which impact the net income figure on which managements are usually assessed. The absence of this self-correcting mechanism leaves management with an irresistible incentive to manage earnings, overstating or understating earnings as required. The rewards for successful earnings management over a period of years can be enormous, as investors award very high multiples to companies that show reliable earnings growth. This is not a trivial issue! It is at the root of many of our problems with aggressive and inconsistent accounting treatments. And options grants are not yet out of control in Canada, as they clearly are in the U.S. Action now could help to keep us off the earnings management merry-go-round that they have been on in America for the last five years.

Stock options also tend to subvert Boards of Directors. Directors with options have their interests aligned with other holders of options, not with shareholders. And the other option holders are the managers of the enterprise. So options are a dangerous threat to director independence, especially for Audit Committee members.

The Gaps in GAAP

A situation where the auditor's negotiating position is weak, where the auditors are perceived to have conflicts of interest, and where management is working to its own wealth-creating agenda at the expense of the shareholders is not very healthy. But now let's add the last ingredient to the recipe: gross inconsistencies in accounting treatments caused by the latitudinarian approach of Canadian standards-setting.

Let me give you an example. It's not a terrible or outrageous example, just the kind of thing we run into all the time. Two weeks ago, in our morning investment meeting, we were looking at public mutual

fund companies. Now, when a broker or financial planner sells a mutual fund, the mutual fund company pays him a commission. The money is paid out immediately and is deductible for tax purposes. The companies tend to capitalize the expense as a deferred sales charge, and amortize it over varying periods of time. One company, which we will call Investors Group, expenses 50% of the sales charge immediately, and the other 50% over 18 months. Another company, which we will call Trimark, capitalizes the whole thing, and expenses it over three years. Mackenzie and Dundee capitalize and expense over seven years. Dundee and Investors have the same auditor, despite being at opposite ends of the spectrum in amortization periods. Now I can't figure out why three such variant treatments are used for the same problem. It's not as if the Investors Group funds have higher turnover among unitholders than the others; on the contrary, it is about half as high. In the U.S., they'd probably have a rule for this, and the result would be comparable income statements for these four companies. In Canada, my analysts tell me that you just don't look at earnings for these companies. That is a terrible indictment of Canadian financial reporting, and one we are hearing more and more often.

Any experienced analyst will agree that there are usually no right or wrong answers in accounting, only different ways of painting the picture. But one of the most powerful tools of the shareholder in analyzing companies is comparison, and huge variations in accounting treatments like the previous examples only serve to reduce the usefulness of the net income figure by reducing comparability. To have comparability, we must have a degree of consistency.

The inconsistencies in application of GAAP are beginning to seriously annoy the regulators, and with reason. If you have read Mr. David Brown's speech to the ICAO Business Leaders Luncheon in June of this year, you will remember that he went into this problem in detail. In one case, he found the same accounting firm advocating contradictory treatments for the same transaction, for different clients. This kind of incident is gravely disquieting to me as a shareholder. And as a shareholder, I welcome the toughness and activism of the securities commissions.

Conclusion

Let me return to the four diagnoses I made at the outset of the speech.

My first contention is that the position of the external auditor versus management has become dangerously weak, and must be reinforced by changes to Canadian corporate governance.

Steps must be taken to redress the balance of power between management and auditors. All too often, our Frank Magazine version of corporate governance actually applies. So what are the possible remedies? Well, if you talk to any academic, they will tell you that a good way to empower yourself is to get tenure. What if auditors were appointed for periods of five, seven or ten years, rather than the traditional one year? It would certainly transfer power from managers to auditors, if the auditors' incumbency was longer than that of the average CEO.

Another way would be to require shareholder approval of firing as well as appointment of auditors. That would make a change of auditors an automatic agenda item at annual meetings. That way, the departing auditor could answer questions from shareholders, and would not just go gently into that good night. Auditors and regulators should think about mechanisms like these that involve shareholders in the process, rather than treating them as bystanders.

My second contention is that accounting firms must overcome the perception of conflict of interest between audit and ancillary services offered to audit clients.

I believe that the independence of the auditor is a vital part of the system. Some related services offered

to audit clients give rise to a perception of conflict of interest. The immediate fix for this problem is disclosure; all dealings between a company and its audit firm should be disclosed in a related party transaction note, regardless of materiality. Warren Buffett says that the supreme test of the propriety of an action is if you are willing to see it reported in detail on the front page of your hometown newspaper. Let's apply that test to our profession. Longer term, I feel that auditing and consulting should be entirely separate entities.

My third conclusion is that changes should be made in the way options are granted and accounted for. Contrary to popular belief, employee stock options do not align managers' interests with shareholders. They also act as an incentive to manage earnings.

When employees exercise a stock option, they are appropriating money that has been foregone by the shareholders of the company. There should be recognition of this cost in the financial statements of Canadian public companies. Canadian managements do not yet have as massive a stake in the options system as their U.S. counterparts, so action is still possible.

Members of the Audit Committee of the Board of Directors should not be permitted to participate in employee stock options plans. Ideally, all non-employee directors should be ineligible for such plans. Stock options grants align directors' interests too directly with management, rather than with the shareholders to whom they owe their primary allegiance.

My fourth and final conclusion is that Canadian accounting standards must either become more rules-based, or compensate for their elasticity with better statement structure and improved disclosure.

If the profession wishes to make the net income calculation meaningful, then it must be prepared to make rules and enforce consistency. If it is not prepared to make rules, then it appears likely that the regulators are prepared to do so. So it is the self-regulation of the profession that is at stake in this area. Ladies and gentlemen, we need some breakthroughs in the area of standards and disclosure. Canada is not well regarded in international circles as a place to invest. And it's pretty clear to me who is going to take the blame for that.

Fortunately, I believe that there is a solution at hand that would at the same time leave the Canadian system of standard-setting philosophically unchanged, while taking Canada to the forefront of financial reporting and offering a new level of service to financial statement users. I am referring to adoption of the direct method of reporting for cash flows from operations as outlined in Financial Accounting Standard 95 (see Exhibit One on following page).

The objective and easily comprehensible nature of this statement would be a huge boon to users of financial statements. Use of this statement structure might have prevented or at least mitigated some of Canada's recent embarrassing and expensive disasters. Livent, Loewen Group and YBM Magnex come to mind. The arguments against the use of this statement are not convincing, and those in favour are overwhelming. The status quo is the worst of both worlds – we get U.S.-style statements without the rules that often make them more consistent and comparable.

You will have noticed that my view of the world has been conditioned by my experiences as a shareholder. I see regulators and shareholders as people with very similar interests in the area of financial reporting. I see management as having its own agenda, often complementary to, but sometimes directly opposed to, both of these groups. And I see accountants as the ham in the sandwich – their better instincts inclined to the side of the shareholders and regulators, but their economic interests perhaps more aligned with management. That ambiguity currently threatens the credibility of the profession, and steps must be taken to address it.

We Chartered Accountants are the heirs of a proud legacy and guardians of a public trust. Unless we set our standards very high, the legacy will be dishonoured and the trust will be reposed elsewhere.

EXHIBIT ONE
An Example of the Direct Method (FAS 95)
Consolidated Statements of Cash Flows
Years Ended December 31

	1998 (thousands $)	1997 (thousands $)
Cash Flows From Operating Activities		
Cash receipts from clients	**186,064**	135,059
Cash paid to suppliers and employees	**(166,694)**	(131,071)
Distribution from equity investments	**96**	222
Interest received	**2,930**	1,721
Interest paid	**(3,221)**	(2,110)
Income taxes paid	**(7,217)**	(3,634)
CASH FLOW FROM OPERATING ACTIVITIES	**11,958**	187
Cash Flow From Investing Activities		
Business acquisitions, net of cash acquired	**(6,718)**	(11,827)
Net proceeds on disposition of capital assets	**85**	-
Purchase of capital assets	**(4,579)**	(2,162)
Proceeds on disposition of capital assets	**762**	85
CASH FLOW FROM INVESTING ACTIVITIES	**(10,450)**	(13,904)
Cash Flows From Financing Activities		
Repayment of long-term debt	**(2,998)**	(650)
Proceeds from long-term borrowings	**-**	6,294
Repurchase of shares for cancellation	**(459)**	-
Current tax benefit of financing costs	**396**	449
Proceeds from issue of share capital	**11**	14,174
CASH FLOW FROM FINANCING ACTIVITIES	**(3,050)**	20,267
Net increase (decrease) in cash and cash equivalents	**(1,542)**	6,550
Cash and cash equivalents, beginning of the year	**7,613**	1,063
Cash and cash equivalents, end of the year	**6,071**	7,613
Cash and cash equivalents consists of:		
Cash	**6,071**	16,645
Bank indebtedness	**-**	(9,032)
	6,071	7,613

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