The VIEW *from* BURGUNDY

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We're Mad as Hell

Frustrated by the deteriorating reputation of the Canadian financial system in the aftermath of several perfectly avoidable scandals, we let loose a Philippic against Canadian investors, auditors, regulators and exchanges in this issue of The View from Burgundy. *Investor behaviour has not changed since then, and may never, but there have been changes in regulation of auditors, there has been a major consolidation of Canadian exchanges, and securities regulators have moved a long way down the path to standardized regulation, always subject to Quebec's desire for autonomy and the West's fear of Ontarian hegemony.*

Richard Rooney, 2007

In the 1976 film Network, Albert Finney gave a riveting performance as a TV anchorman who blew a gasket and began to deliver angry tirades on his nightly news show. His culminating line, if you remember, was, "I'm as mad as hell, and I'm not going to take it anymore!"[1]

We know how he felt.

The last two years have seen a series of embarrassments and disasters in the Canadian capital markets that have turned us into international laughing stocks. Bre-X, YBM Magnex, Philip Services and Livent all have been black eyes for Canada. In this issue of *The View*, we will take a look at each of these situations, and try to extract lessons from them. We believe that it is important that responsible people intervene to stop the drift and the ineptitude that afflict Canadian markets at every level. Canada is no longer comfortably mediocre in this field as we are in so many others; we are a good deal worse than that. We have four main contentions:

1. Canadian investors are not doing their jobs.
2. Canadian auditors are not tough enough in demanding transparent accounting.
3. Canadian regulators cannot do their jobs due to the Canadian market's ridiculous Balkanization.
4. Canadian exchanges are too busy competing with each other to serve the public interest.

Investors Are Not Doing Their Jobs

One of the most pathetic sights in the capital markets are professional investors blaming their own mistakes on brokers and company managements. Elementary precautions could have prevented involvement in situations like Bre-X, YBM Magnex, Philip and Livent. What precautions? Well, when in doubt, do what the winners do:

"Before buying a stock, I like to be able to give a two-minute monologue that covers the reasons I'm interested in it, what has to happen for the company to succeed, and the pitfalls that stand in its path. The two-minute monologue can be muttered under your breath or repeated out loud to colleagues who happen to be standing within earshot. Once you're able to tell the story of a stock to your family, your friends, or the dog… so that even a child could understand it, then you have a proper grasp of the situation."[2]

Let's look at what such a two-minute monologue would have looked like for each of our situations at the height of its popularity. The date in brackets following each monologue is the date at which the monologue would have been written, usually a date close to the peak price of the stock.

1. Bre-X is a gold mining exploration company, listed on the Alberta Stock Exchange and based in Calgary, Alberta. It owns a concession at Busang in Indonesia, which management claims is one of the largest and richest bodies of gold ore in the history of the world. No conclusive assay results are available. The management consists of two mining people – neither of whom has any record of significant achievement in the industry – and a former retail stockbroker. None of the key people have any management experience. In order for the company to succeed, assays must support management contentions, and the top management of Bre-X must be able to run a huge project in a corrupt foreign country. [late 1996]

There is much to be learned about investing from the Bre-X story. Anyone who tells you that Bre-X was a satanically clever, brilliantly orchestrated fraud perpetrated by criminal masterminds was obviously long the stock. It was, in fact, a simple drill-core salting, which, if not the oldest trick in the book, is certainly somewhere in Chapter One. The insiders were a trio of losers with no track record and no management experience. This was the pre-eminent example of greater fool theory that we have ever seen. All businesses are people businesses, and people are the primary asset of any company. Who they are and what they have done are the starting points for any company analysis. A cursory look at the background of the people connected with Bre-X would have been enough to scare off most thinking people.

For financial analysts, there are few lessons to be learned from Bre-X, since the company never had more than $2-3 million in revenues. That means that those who purchased the stock at its peak were paying 2,000 times revenues, a level usually reserved for Internet stocks. There was no financial basis for an investment in Bre-X.

Finally, perhaps a good basic safeguard would be to buy only companies where you are sure the business truly exists.

From its peak value in mid-1996 to its delisting in early 1997, Bre-X represented the erosion of $6 billion of market capitalization. An equivalent investment would have been Power Corp., Canadian National Railway, Potash Corp, Loblaw or BC Tel.

2. YBM Magnex has its headquarters near Philadelphia. The company was originally listed on the Alberta Stock Exchange. Most of its operations are in Hungary. The Hungarian operations are owned through a holding company in the Cayman Islands. Half of the sales are to Russia and the Ukraine, which is where most of the senior managers come from. Apparently, demand for magnets is very strong in the former Soviet Union, despite a nine-year long collapse in industrial production. The auditors are Parente, Randolph, Orlando, Carey and Associates. There is no revenue recognition note in the financial statements. The company has indicated that since it never intends to repatriate the cash it earns from its operations, it is highly unlikely to pay income taxes in North America. In order for the company to succeed, its markets must exist, its cash flow must be real, and its management must be honest. [late 1997]

The organization of this company is very complex. Ultimately, Deloitte and Touche, who replaced the small auditing firm mentioned above, refused to issue an opinion on YBM because they found it impossible to untangle the flow of cash through the company accounts from sale of products to the company's bank accounts. That does not trouble us as much as the possibility that no one asked them to explain something as prosaic as the description of a typical transaction for the company. Such a question is absolutely basic to any financial analysis. And, of course, it is a pretty strange "investment" that will never return a dime of cash to shareholders because of tax reasons.

Another interesting question is why a company based in the U.S., with no apparent connection to Canada, finds it necessary to seek a listing here. The usual reason for this occurrence is that the company is unable to list in the U.S. and is seeking the lowest possible level of scrutiny of their business. And in Alberta, they certainly found that.

Concerns about the business practices of Russia and the Ukraine aside, it is highly unlikely that anyone who invested in YBM actually had knowledge of the track records of any of the senior managers. That is a huge omission for any investor.

We are, frankly, not all that familiar with the ins and outs of the YBM story, and we don't really care all that much. Those who were burned, unfortunately, deserved to get burned. A stock like this has disaster written all over it.

From its peak value to its delisting, YBM represented the loss of almost $900 million in market capitalization. Similar-sized investments were Metro-Richelieu, Cambridge Shopping Centres, Empire Company and Celanese Canada.

3. Philip Services is a provider of environmental services to various industries. The company has grown aggressively by acquisition over the past four years. Over that period, sales have grown at a compound rate of 91%, net income at a rate of 44% and earnings per share at a compound 26%. Nevertheless, the return on shareholders' equity in most years was only about 8%, and never over 11%. During 1996 and early 1997, the company made 10 acquisitions and two divestitures, a rate of almost one transaction per month. Acquisitions were the largest of the company's investing activities, with almost $270 million spent in the years 1994 to 1996. The other major areas of spending were inventories and receivables, where almost $300 million was spent in the past three years. The company has been public for several years. The President, Mr. Allen Fracassi, has a tendency to go wing-ding whenever a question about Philip is addressed to him in a tone that is anything less than fawning. The company has been known to threaten to sue analysts who have raised questions about their accounting. In order for the company to succeed, management must be able to integrate acquisitions into its strategy, ensure that controls are adequate and improve working capital management. [mid 1997]

This situation differs qualitatively from our first two examples in that it was a seasoned issue rather than a new listing. As well, the company was apparently victimized by an internal fraud without the participation of all its top management. But there were warning signs that Philip was not a good investment. First of all, frequent acquisitions are not a good sign. Anyone who has lived through a merger or acquisition can tell you that they are profoundly disruptive experiences. On average, close to two-thirds of all acquisitions do not add value for shareholders of the acquiring company. Often they subtract value, due to the management time that they devour. The Fracassis were ambitious, driven people, and it seems obvious that they overextended themselves.

Second, the ongoing investment in non-cash working capital, well above the levels apparently necessary to sustain sales growth, should have been a warning sign. Working capital management is an underestimated skill, which is part and parcel of a company's entire capital allocation strategy. The ballooning levels of inventories should have been a warning sign of inadequate controls, even if a large proportion of their increase had not later proven to be fraudulent.

Speaking of capital allocation, the gigantic increase in sales accompanied by a much more modest increase in earnings and earnings per share indicates that the company defined growth more as growth in sales and assets than as growth in shareholder value. Another indication of this is that return on shareholders' equity was virtually flat between 8% and 10% for the years 1993 to 1996. To us, high acquisition activity and low returns on equity are indicative of high purchase prices and looming problems. (Just ask shareholders of Loewen Group about that.) All of the above analysis uses the unrestated numbers from the 1996 annual report, before the discovery of the fraud in early 1998 that led to huge write-offs.

The issue of management's touchiness and aggressive treatment of perceived enemies is admittedly a rather subjective matter. But it is usually a sign of a nasty corporate culture, and reports of browbeating of Philip employees, especially accounting staff, would tend to reinforce that impression. Companies that sue analysts over accounting disagreements usually claim that the analyst simply did not understand the company's treatment, and that is not infrequently the case. But why was the treatment so difficult to understand in the first place? Companies must learn that they have a vested interest in transparency and simplicity. Investors must learn that if a company doesn't tell you what you need to know in a simple, straightforward manner, they probably don't want to tell you at all.

From the peak price of $27.80 in autumn of 1997, Philip has declined to its current status of a penny stock. The loss of value has been enormous, well in excess of $2 billion. The same investment could have bought Trimark, Fairfax Financial, Trans Alta Utilities or Canwest Global Communications.

4. Livent is the vehicle of Mr. Garth Drabinsky. Mr. Drabinsky was previously the CEO of Cineplex Odeon Corporation, which expanded rapidly in the 1980s and eventually floundered under a debt burden too large to be supported by the actual cash flows of the company. Livent has tapped into a trend towards lavish live musicals in the early 1990s. It has reported consistent profits since 1992. The reported cash flows are more than offset by capitalization of costs on the balance sheet, which annually exceed reported profits by 300-500%. The company has been increasing its exposure to large theatre projects in Toronto, Chicago and New York, with a corollary increase in fixed assets on the balance sheet. In fact, preproduction costs and fixed assets account for over two-thirds of the total assets of the company. The company believes that each successful musical it produces will have multi-year earning power, so preproduction costs are set aside and amortized against this presumed stream of income. In order for the company to succeed, the future cash flows generated by Livent's musicals must not fall short of the amortization provided against them, and virtually all of the programs the company produces must succeed at least modestly. [early 1997]

Well, there were certainly a few straws in the wind on this one. Mr. Drabinsky has been one of Canada's more flamboyant businessmen (not a crowded field, admittedly) since he first came on the scene in the early 1980s. There are a lot of good things about him – he thinks big, he is ambitious and he makes things happen. But Mr. Drabinsky is in show business. His companies appear to be run more for his personal satisfaction and the applause of the entertainment industry than for shareholder returns. And in the area of personal diplomacy, he makes Allen Fracassi look like Prince Talleyrand. There was no excuse for investors to be unacquainted with Mr. Drabinsky's track record and management style.

The accounting used by Livent was in accordance with Generally Accepted Accounting Principles (GAAP) and the financial statements received a clean opinion from Deloitte and Touche. Nonetheless, a cursory examination of the reported financial results shows that the company was never cash flow positive in any quarter during its period as a public company. And the increasing investment in fixed assets is a danger sign for any business, since capital intensity tends to detract from shareholder returns.

We make no comments about the case that the Securities and Exchange Commission has launched against Messrs. Drabinsky and Gottlieb, since there is a presumption of innocence. We only point out that even if we accept that the accounting was according to

GAAP, any seasoned analyst could have satisfied himself that Livent was a risky investment based on the excess of capitalized costs over apparent cash flows.

The erosion of market value from Livent has been about $300 million since its peak, the equivalent of the capitalization of Astral Communications, Uni-Select, Moffat or TVA Group.

So the price of our four disasters has been over $9 billion, a pretty steep tax on greed and incompetence.

Auditors Must Get Back to Basics

In the distant past, there was a basic accounting principle called the conservatism principle: anticipate no profits; provide for all losses. It was a wise principle for a profession that deals in estimates and allocations and must be forever on the lookout for fraud, defalcation and simple exaggeration of results. But in the 1970s, when conservatism had a bad ring to it, accountants began to abandon conservatism as a principle in favour of ideas like "matching of costs and revenues." It has proven to be a slippery slope.

The old emphasis on conservatism tended to minimize cost accruals by encouraging expensing rather than capitalization. It recognized the inherently uncertain nature of future cash flows and permitted a minimum of costs to be deferred against such streams of income. Incidentally, by expensing more outlays in the period in which they were undertaken, the resulting income statement demonstrated some relationship between accounting earnings and cash flows.

The New Age accounting that is now in vogue has reduced that connection. Essentially, in a lot of businesses, the relationship between cash flow and earnings is tenuous at best. Take Livent, for example. The company reported accounting profits every year from 1992 to 1996. The profits were never more than $12 million, but at the same time, the company was deferring $30-50 million per year in preproduction costs. We have already indicated that this treatment was in accordance with GAAP. Our only point is that a more conservative treatment would have given a truer picture of Livent's position to its investors. A real statement of cash flows where the top line was "Cash Received from Customers" and the bottom line was "Cash in the Bank" would be the best way to ensure that even the most story-prone investors are unable to deceive themselves about a company's liquidity.

The Canadian accounting profession could require such a statement if it wished. It is a little known fact that the *Canadian Institute of Chartered Accountants (CICA) Handbook*, the bible of the accounting profession, has the force of law for those sections of it that are in italics. This is because Canadian corporate laws specifically mention these sections in statute. But the CICA has been very loath to use these great powers. There are two reasons for this: first, the influence of the U.S. Financial Accounting Standards Board (FASB), and second, the tyranny of the financial statement "preparers."

The first problem is self-explanatory. In an economy as linked to the U.S. economy as Canada's, it would be unnecessarily burdensome to strike out into too many new directions for Canadian GAAP. Unfortunately, however, the CICA too often just follows along after the FASB's recommendations, and is often years behind. Comparing differences between U.S. and Canadian GAAP shows Canadian GAAP to be consistently both less conservative and less informative.

The dominance of the financial statement preparers requires a little more explanation. The CICA divides its constituencies into two segments: financial statement preparers and financial statement users. The preparers are the companies that must produce financial statements for regulatory or other purposes. The users are the financial analysts, regulators, bankers and others who read the statements and interpret them for business purposes.

Preparers have always tried to minimize disclosure and changes in accounting treatments, for reasons of secrecy and lower costs. They are a potent lobby group since they must execute all changes required by the CICA. At any meeting called to discuss accounting changes, the preparer groups will be well represented and vociferous in their opinions, usually in opposition to change, especially if the change leads to more disclosure. It is also true that a very large proportion of the CICA membership have careers in "preparer" jobs, like Controller and Vice President Finance.

Users, by contrast, are conspicuous by their absence from such controversies. Financial analysts in particular are reluctant to indulge in controversies about accounting, possibly because they would be tacitly admitting that they don't know absolutely everything about the companies they follow, and also because they often have very sketchy accounting knowledge. In fact, accounting matters. It is the language of business and the clearer and more reliable it is, the more useful it is.

More rigour, please, ladies and gentlemen of the accounting profession.

Too Many Regulators, Not Enough Regulation

Some free market ideologues would have us believe that regulation of all kinds is evil, and that the world would be a better place if markets were allowed to operate freely – in financial services as in everything. Tell it to the Russians. In the case of stock markets and financial systems, intelligent regulation is essential. The financial sector, with its vast amounts of the public's money sloshing around, attracts crooks like no other area. Stern and consistent regulation is necessary to protect the public and maintain its confidence in the country's financial system.

Canada's current regulatory regime is execrable. Ten provinces share the responsibility for regulating securities markets with five stock exchanges and the Investment Dealers Association, in a world where national borders, let alone provincial ones, are increasingly irrelevant. Penalties for violations of securities laws – which are rare as hens' teeth in any event – are applied on a province-by-province basis, meaning that scoundrels can always find a new playground. The money that is used to support small, inefficient and ineffective provincial securities commissions could be much better spent in ensuring that the public is not defrauded and bilked by any of the legions of flim-flammers who are attracted to any financial market, but especially a badly-regulated one like Canada's. The only law obeyed in Canada's capital markets on a national basis is Gresham's Law, as provincial regulators and stock exchanges indulge in "one-downmanship" and take their standards to the lowest common denominator.

There have been recent reports that the provincial securities regulators have agreed on a "virtual" national securities agency, to be called the Canadian Securities Regulatory System (CSRS). They will pool their scant resources to try to eliminate some of the waste and inefficiency that make the current system so burdensome to the law-abiders and so helpful to the others. More money would be available for such things as compliance and enforcement, and some standardization would be possible for prospectus filings. It might be progress compared to the current system, but it would still be less effective than a full national securities commission. The main reason for the "virtual" structure appears to be that Alberta fears the domination of Ontario in the securities field, and petty interprovincial rivalries are a poor basis for joint action. We doubt if the proposed CSRS will get us out of the bush leagues anytime soon.

Too Many Markets

The existence of five stock exchanges in Canada is a disservice to the public. Competition for listings means that there is a race for the bottom in listings standards. Both YBM and Bre-X took the route of an initial public offering on the Alberta Stock Exchange – where only your imagination restricts what you can say in a prospectus – to a Toronto Stock Exchange listing when the market capitalization and trading volumes became substantial. So great is the pressure on the Toronto Exchange to list "winners" that neither of these scams had to file a listing prospectus with the TSE. They came in through a loophole allowing the TSE to list any stock that has been previously listed on another Canadian exchange. In order to repair its badly tarnished credibility, the TSE should require that henceforth any company listed on Alberta or Vancouver that seeks a listing on the TSE must go through full prospectus disclosure.

The so-called venture capital markets in Calgary and Vancouver must be properly regulated in order to protect the public. Perhaps, as a first step, some purveyors of AIDS, common-cold and baldness cures could be sent to the crowbar hotel pour encourager les autres. The VSE has promised to clean up its act more often than Bill Clinton, and with comparable results.

But it all goes together – stock exchanges are lax because regulation is inconsistent and inefficient.

Lessons Learned – Analysts and Investors

So what lessons can we as analysts and investors draw from these distressing examples? We think there are four.

First, people matter. Top management is key. Their background and accomplishments, goals and methods are fundamental to our assessment of a company. The kind of managers we like are ones who are dedicated to their businesses, but are able to keep themselves in perspective – and their egos under control. Capitalism seems to punish hubris in a chief executive.

Second, simplicity matters. The organization should be easy to understand and the transaction flow should be as well. It should be easy to identify customers and market share, and to explain what the company does for its customers. Excessive complexity, even in pursuit of reduced taxes, is a warning sign. A good way to ensure that you understand a company is to use a Peter Lynch monologue about it.

Third, transparency matters. It is important that we as analysts are able to look through the financial reports of a company and identify its financial model, and be able to see where the cash goes and why. Pages and pages of notes to the financial statements always mean trouble for the analyst, and usually for the investor as well.

Fourth, capital allocation matters. What are the company's criteria for spending your – the shareholder's – money? Are they return-oriented or only growth-oriented? Anybody can grow a company's sales and assets, especially during a bull market. But attaining a high and consistent return on the shareholder's funds requires discipline, teamwork and focus.

Lessons Learned – Auditors

Auditors, we feel, should take the lessons of Livent, and to a lesser degree of Philip, to heart. Where there is fraud and collusion, as in Philip's case, it is difficult to catch the perpetrators quickly. Nevertheless, a rediscovery of the conservatism principle would make balance sheet values "harder," prevent aggressive accruals and improve the quality of earnings reports. A separate statement of cash flows, in addition to the current statement of changes in financial position, would help to alert users of financial statements to the liquidity of the companies whose financial statements they are examining. The CICA should mandate the preparation and disclosure of a true statement of cash flows for all public companies.

Frankly, if the CICA is unwilling or unable to act on these matters of pressing investor concern, Canadian investors might be better served by the wholesale application of U.S. GAAP. That would be a sad commentary on the Canadian accounting profession, and further depressing evidence of Canada's colonial mentality.

Lessons Learned – Regulators

A national securities commission is by far the best way to go. It is also, in the Canadian political context, probably an impossible dream. Quebec has not been in the habit recently of releasing any areas of control to the federal level, and Alberta's and British Columbia's fears of Ontarian hegemony in securities regulation (despite the smaller markets' lack of resources to do the job) has scuppered any recent attempts to centralize Canadian regulation.

We should point out that the problems with the Canadian regulatory system are structural in nature, and our remarks are not aimed at the many hard-working and well-meaning individuals who work for provincial securities regulators. We have had some exceptional people working at securities commissions in Canada, but they are usually people who are not career regulators. Often, they are fast-track lawyers, joining the securities commissions almost on a pro bono basis. What is needed is a seamless, national, full-time, fully funded, tough and consistent regulator for the securities industry, someone to "kick butt and take names" in the memorable American phrase. If the proposed Canadian Securities Regulatory System is able to do the job, we will be the first to give three cheers and congratulate Canada's provinces. But we hope that we can be forgiven for a degree of skepticism.

Lessons Learned – Stock Exchanges

Both Bre-X and YBM show that haste makes waste in listing procedures. Alberta claims that its status as a "venture market" means that companies whose businesses are little more than a gleam in someone's eye should be made available to the public through a public listing. We suppose that it is possible for reasonable people to disagree on the issue, although the U.S. has no such markets and the entrepreneurial spirit does not appear to have suffered there. But what is beyond question is that the Toronto Stock Exchange should not accept a stock for listing solely on the basis that it is listed on another Canadian exchange, if that exchange is Alberta or Vancouver.

Prospectuses are wonderful things. They are far from perfect, and are after all sales documents, but a well-prepared and current prospectus is the only resource of the investor in Initial Public Offerings. That is why we don't often invest in IPOs: the investor is at the mercy of the company managements and corporate financiers who prepare the document.

The Toronto Stock Exchange has everything to gain in terms of credibility and investor confidence if it shuts these loopholes and requires prospectuses for all listings, except where the company is listed on a stock exchange with high standards, like Montreal (usually) or New York.

Conclusion

If these lessons are applied by Canadian investors, auditors, regulators and stock exchanges, those of us who have suffered from our country's loss of reputation in 1997-1998 may be able to hold our heads up among our international peers, and our country will be able to start realizing its full potential. It's time for the Canadian capital markets to grow up.

Endnotes

1. Network [motion picture]. Directed by Sidney Lumet and produced by Fred Caruso and Howard Gottfried. MGM, 1976.
2. Lynch, Peter. One Up On Wall Street: How to Use What You Already Know to Make Money in the Market. New York: Fireside, 1989.

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