With Pro Forma, Almost Anything Is Possible

And The Resulting Events Have Created A Need For Change

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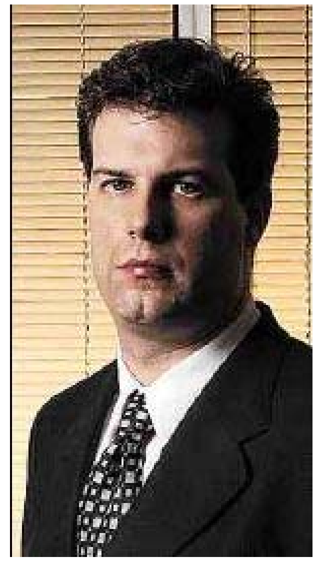

*(**ANTHONY**) **SCILIPOTI**: "The market is a wild beast -- whether bull or bear -- and not for the faint of heart."*

In the manic bull market of the late 1990s, the great minds of Wall Street and Bay Street realized companies didn't look as healthy under generally accepted accounting principles (GAAP) framework, so they simply changed the benchmark to "pro forma" reporting.

A great compromise had been reached; accountants could hang steadfast to their nearly 80-year-old historical cost-accrual system and at the same time investors could be fed "positive" results. Now the new economy had a new reporting framework. Best of all, companies could use catchy names for their new performance measures. Gone were the stodgy old net-loss figures and in their place arose "cash earnings," "operating earnings," "earnings from operations," "cash baseline earnings" and "recurring net income."

Executives realized that the exclusion of certain cash and so-called non-cash costs had extremely positive effects on reported "income" under the new benchmarks. In the world of pro forma anything is possible, even earnings before expenses.

Unfortunately, the pro forma game could only divert investor attention for a short time. Investors demanded constant growth, no atter how it was it attained. No problem, as it turned out, since GAAP provided ample room to sustain the illusion. Operational costs could, in certain instances, be swept from the income statement and capitalized to the balance sheet as, believe it not, assets.

Employment and other operating expenses could be met through the issuance of stock options, which never hit the income statement. Sales could be inflated through such devices as unbilled receivables or the exchange of useless, unlit fibre-optic networks. Failing that, a company could always finance its customers' purchases, regardless of their ability to pay and, if the accountants were really good, they could conjure the resulting liability right off the balance sheet. Accounting was alchemy and everybody made money; what was wrong with that?

Alas, as even Mr. Charles K. Ponzi discovered, cash in must exceed cash out. As the flow of capital declined, the market exacted its revenge.

So who is to blame? Investment bankers, accountants, brokers, analysts, the media? How could this happen? How could so much have gone so wrong? Sadly, everyone and no one is to blame. We all share blame in our own misfortune.

Now that the government as well as the investment industry has finally realized that much needs to be done to improve investor confidence, the changes must be far-reaching and concurrent.

Both accounting firms and brokerage firms must take steps to improve their independence not only in appearance but also in fact. The so-called Chinese wall is an illusion.

Accounting firms must sever their audit and consulting functions. Even if studies have shown that the interaction of the two groups does not infringe on auditor independence, perception is the foundation of the industry. Eventually, if accountants hold their ground, audit prices will rise and the lost revenue from the more lucrative consulting function will be mitigated. More importantly, the industry will regain its position at the forefront of investor confidence.

Brokerage firms must separate their research and underwriting functions. Too often the overpriced stock of underwriting clients makes its way into investment portfolios based on so-called "unbiased" research reports. The incentive is obvious -- underwriting commissions range between 1% and 10% of the gross proceeds, while institutional trading commissions amount to a meagre 2¢ to 5¢ per share. Of course, in order for brokerage powerhouses to entertain such a change, institutional investors must be the catalyst and institutional trading commissions must rise.

The difference between equity analysts and bond raters must be eliminated. Under the current system, bond raters are considered insiders and are therefore entitled to much more disclosure and information than equity analysts. Such a disparity creates a bias against equity investors. Too often, public companies brush off more difficult analysts' questions claiming that such disclosure is not required by GAAP. If equity analysis is to improve, analysts must be treated to an even playing field.

Executives of public companies should align their interests with those of outside shareholders by purchasing company stock using their own money in the open market, not via stock options. Key executives must be focused on the day-to-day running of their organizations, not stock price gyrations. Too often, "free options" give executives an easy and lucrative exit strategy.

Both the Canadian and U.S. accounting bodies must take firm steps to increase the transparency of operating activities that affect an organization's risk profile. Accounting is the language of business and, like any language, if it is spoken in broken or muffled tongue, confusion is created.

It is simply not enough to go through a checklist of criteria to ensure compliance with specific accounting pronouncements. Auditors must ask themselves if the inclusion or exclusion of information affects users' decisions. Therefore, more emphasis must be placed on professional judgment and auditors must be taught to realize the implications of their actions.

Much has been said about the lax nature of securities regulators and perhaps a case can be made for increased scrutiny and unity among jurisdictions. One area in particular is the reporting of insider trading. Regulators must immediately take steps to ensure such information is available on a real-time basis.

In addition, investors need to realize the OSC and SEC are not like their mothers and that investment is more of a caveat emptor decision. No regulation will take the place of sound investment research. If investors are not willing to roll up their sleeves, they should stick to risk-free government bonds.

The North American tax systems must be altered to treat dividends and capital gains equally. Under the current systems, capital gains are taxed at a lower rate than dividends. That creates a bias towards capital appreciation as opposed to income. At the corporate level, it means executives are more focused on activities that will drive their stock price higher than on actions that will generate long-term business growth. The tax bias also creates a disparity from an accounting standpoint. In general, accounting guidelines are designed to measure income, not deal with actions that inflate stock prices.

If there is any solace in the sad state of the accounting and the investment industries, it is the fact that the perfect opportunity to effect change has been created.

As for investors, they have traded their capital in the recent downturn for at least two valuable lessons. First, active investing requires active skepticism. If you are unwilling to do the work then you should not invest. Second, the market is a wild beast -- whether bull or bear -- and it is not for the faint of heart.
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