CANADIAN BUSINESS

Keep your eyes open

Accounting inequities can wipe out much of a stock's value

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Investors are on their own in this country and need to act accordingly. That's the undeniable conclusion from examining so many Canadian investor-protection shortfalls in this column over the past decade.

An important part of being on your own is the need for you (or your investment adviser) to critically analyze the accounting and financial reporting used by the companies you own. Not every accounting issue blows up à la Nortel. In reality, alleged accounting frauds are just a small part of what constitutes financial reporting concerns in the market. Most analysis focuses on the major gaps that exist between what is provided by the accounting rules, and what investors actually need in order to understand a company.

To be of any value to investors, research must clearly quantify and summarize the impact of accounting issues on the value of a company's stock price. Otherwise, investors can too easily dismiss the arcane arguments as just so much noise.

Many investors and advisers are surprised to see our research shows that correcting for accounting inequities can vaporize anywhere from 3% to 21% of the value of individual large-cap Canadian stocks.

In the past, I've provided an overview of areas that investors need to watch for, including capitalized costs, off-balance-sheet liabilities, and cookie-jar and understated liabilities. While it is important to know that such pitfalls exist, investors ultimately need the ammunition to do something about it.

The issue of capitalized costs can be examined with CAE, a world leader in flight simulation technology and training. With capitalization, a firm turns the cash it spends into an asset on the balance sheet, then usually expenses it as depreciation or amortization in later years. And Canadian accounting rules permit CAE to capitalize pre-operating costs incurred during the startup phase of a new training centre, as well as deferred development costs. U.S. accounting does not allow any of these costs to be capitalized, and International Financial Reporting Standards (IFRS) allow development costs to be deferred only.

Since the market likes to value CAE on an enterprise-value-to-EBITDA basis, the company gains an advantage because deferred costs do not reduce EBITDA results. We have estimated that levelling out the accounting differences for deferred costs would subtract 5% of CAE's value, relative to its peers that follow U.S. or IFRS accounting rules. And this is just one accounting adjustment. In total, we estimated that accounting adjustments could erase 15% of the value of the company.

The area of off-balance-sheet liabilities comprises many items, including defined-benefit pension plans. Canadian Pacific Railway follows Canadian accounting rules, and therefore does not need to reflect the full economic reality of its $2.2-billion pension gap on its balance sheet. All of the company's major peers, including Canadian National Railway, follow U.S. accounting rules, which require pension deficits to be recognized. Evening out the accounting in this case would result in CPR losing 18% of its value.

CPR and other companies that follow Canadian accounting rules will soon need to recognize these pension shortfalls on their balance sheets when they start using IFRS, a little more than a year from now. Investors can avoid some nasty surprises come switchover time by finding these hidden liabilities beforehand in the notes covering pension plans in company annual reports.

Another large category of accounting adjustments, cookie-jar and understated liabilities, can be examined via uranium producer Cameco. All mining companies make estimates for future site reclamation and decommissioning costs. Given that these are merely estimates, it is up to investors to assess the reasonableness of these accounting assumptions.

We believe Cameco is underestimating its reclamation expenses in light of its previous low expectations for labour and equipment costs, the fact that several of the company's projects are currently under review, and the ongoing potential for cost increases due to regulatory risks. In total, we think Cameco's value is overstated by roughly 6% as a result of accounting distortions.

These are just three examples of why investors should take a serious look at correcting the way in which they value large Canadian stocks. There are dozens and dozens more, and the task will only get harder once Canada moves to using IFRS.

However, as long as investors and their advisers recognize that they are on their own, they're already halfway to solving the problem. The rest comes through diligent analysis and realizing that a Nortel-sized fraud does not have to exist for accounting to have a major impact on stock prices.

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