FINANCIAL POST

Self-dealing executives have power to deceive

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Chances are you know somebody who cheats the company they work for, whether through an exaggerated expense account, a misused car allowance, or even just skipping out early. In fact, you probably know more than a few guilty parties. So ask yourself what percentage of co-workers, friends, and acquaintances might cheat here and there. Now ask whether you think the same proportion of corporate executives are guilty of stealing from their company, and from you, the shareholders.

Sorry, what's that? You don't care whether Joe Smith, CEO, nicks the occasional stapler for home? It should change your mind to know that management fraud has everything to do with opportunity and nothing to do with staplers. The median loss suffered by shareholders in an executive level fraud is in excess of $1-million per incident, giving investors more than enough reason to be interested in cutting down the chances of management malfeasance.

While pundits crow about having the proper corporate governance culture in place, sometimes it just comes down to having sensible rules and oversight. It would certainly help if management was scrutinized much more in their personal financial dealings with the companies they run.

Considerable executive fraud is facilitated by weak financial reporting and auditing rules regarding what are known as related-party transactions (a. k. a. non-arm's-length deals). An example of a related-party transaction would be an executive or director who sells goods or services from one of his private companies into the public company that he heads.

Now, don't make the fatal mistake that many investors do and assume that such a deal has to be consummated at fair market value. Directors, officers and other related parties are being permitted to sell products or services to a public company at prices that are grossly in excess of what a non-related supplier would charge. Some boards are easily misled by executives who exploit weak accounting rules to inflate cost figures and make transactions appear legitimate.

Also, don't incorrectly assume that companies must inform investors when executives are receiving sweetheart deals. The accounting rules do not require companies to disclose the fair market value of insider deals, even though this is the most valuable piece of information investors could have.

The accountants have long argued that they cannot determine the fair market value of such transactions, even though they claim expertise in fair valuing practically everything else in financial statements these days, including complex derivative instruments and even spongy intangibles like goodwill.

Out of all the related party transaction cases that flow through our forensic accounting office, roughly two-thirds of the disputes are rooted in poor financial statement disclosures in which information crucial for investors was missing. These can be directly attributable to weak accounting and financial disclosure rules, which were written by the auditors of Canada.

In the other third of cases, the related party transactions have simply not been disclosed at all. The fault here lies with the weak auditing rules (as opposed to the accounting rules). In auditing, the supposed first line of defense for investors is that the auditors will ask management who are the related parties and what transactions have been consummated. From there, the auditor has to fall virtually ass backwards into a highly suspicious transaction for any warning bells to go off. Given the vague generalities of the rules, and the lack of any active searching for unusual deals, it's really no wonder that so much management misappropriation goes undetected.

The main reason that the weak rules have not been improved in Canada is the position of deliberate isolation that Canadian accounting rule-setters have adopted when it comes to investor needs. Related

party transaction rules are also weak in the United States and Europe, but the big difference is that our enforcement culture is seriously deficient compared to other leading countries.

Unfortunately, our accounting and auditing rule-setters routinely claim that improved corporate governance should take up the slack caused by the weak rules they set, even though they know that Canada's enforcement structure is not up to the task.

Another important issue that can't be ignored in this regard is the greater proportion of companies that are controlled by dominant shareholders in Canada. There is simply a greater chance for high-level executive fraud in this country.

While such inherent cultural factors can't be easily changed, something can certainly be done about the apathy that exists when it comes to laying out specific requirements and prohibitions in our accounting, auditing and securities rules. Why don't our securities commissions simply require companies to confirm that financial deals with insiders are carried out at fair market values? And if not, why not?

The push-back, unfortunately, comes from the accountants. They claim that Canada needs to be on the same level as other countries that don't require that level of disclosure. The argument doesn't hold water because it would simply be additional disclosure that would not affect so-called accounting comparability.

The real reason for no action being taken is that the auditors don't want the headache and heightened legal responsibility attached to vetting related-party transactions. It is better for them to just hope that management frauds continue to go undetected by our weak securities commissions. Unfortunately for investors, chances are they will.

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