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How Canadian companies can mislead investors with annual reporting.

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March 14, 2005

It's that time again: annual report season. Ever finished reading one and wondered: What on earth is going on at this company? We certainly have. Some management discussion and analyses offer little more than breathless cheerleading about a public corporation's purported accomplishments, while skilfully avoiding sensible discussion of genuine business challenges. Other reports deluge the reader with reams of opaque financial data, which leave investors no closer to understanding the opportunities and risks of the underlying business. Some entirely fail to mention things you'd really like to read about--you know, those wacky related-party transactions or the under-the-table payments to senior executives, for instance. And don't get us started on companies that encounter chronic difficulties getting their reports out accurately, or on time.

Not all reporting is so opaque. Every year, the Canadian Institute of Chartered Accountants hands out awards to those home-grown companies, but what of those operations that just don't cut the mustard? CICA doesn't point the finger. Canadian Business, however, canvassed a number of independent experts for examples of companies that aren't giving investors sufficient information on which to base decisions.

In the spirit of constructive criticism, here are some examples of poor or problematic reporting.

Nortel Networks Corp. (TSX: NT)

Nortel's last annual report made no mention of celebrity meltdowns, nor did it promote crash dieting schemes of dubious merit. And yet, the telecom equipment maker's financial statements have much in common with supermarket tabloids when it comes to reliability and utility. Its bean-counting department has the unenviable track record of filing both late and incorrectly. As Al Rosen puts it, Nortel's reporting has "no credibility whatsoever." The company's new management team faces a Herculean task in convincing sentient beings to have faith in any financial disclosure it might produce.

Bombardier Inc. (TSX: BBD.SV.B)

Critics claim that most Canadian companies offer lousy stock-option disclosure. Bombardier, which manufactures planes and trains, is among the worst in the S&P/TSX 60, according to a report by Accountability Research last summer.

A key challenge in accounting for stock options is that their actual cost will only be known at some point in the future. Current rules dictate that companies must attempt to calculate and record expenses today--and to do so, they must rely heavily on management's assumptions. Among them are the expected life of the options (i.e., how long the option will remain outstanding before it's cashed in, forfeited or otherwise terminated) and the expected volatility of the share price. Mark Rosen says that, ideally, a company's financial reporting should explain clearly the assumptions made and, more importantly, the basis for those assumptions. That way, investors can judge whether reported stock-option expenses are reasonable or overly optimistic.

Unlike most Canadian companies, Bombardier doesn't even spell out which method it uses to value and expense its stock options. (The most popular in Canada is Black-Scholes, a mathematical formula developed for this purpose in the early 1970s.) CICA's minimum disclosure guidelines require that firms reveal that information. Those requirements are "pretty weak altogether," says Mark Rosen. "So when [Bombardier] can't meet the basic ones, you can tell that they're not paying much attention."

Bombardier discloses its assumptions in the notes to its financial statements. Unfortunately, however, it only provides aggregate numbers for the entire year. "We don't know whether they used different assumptions for different dates or different groups of employees," explains Mark Rosen. Also, if you want to see what assumptions were made in previous years, you'll have to go find the annual reports for those years.

Another example of Bombardier's opaqueness can be found in a table that breaks out the number of stock options outstanding in various price ranges. The first range is $0 to $5, (1) which is not particularly helpful. After all, it's unlikely that Bombardier issued stock options with a strike price of exactly nothing.

Metro Inc. (TSX: MRU.SV.A)

The income statement in this food retailer and distributor's 2004 annual report contains very little information--just a line item on sales, and another that cobbles together the cost of sales and operating expenses (2). More lines show EBITDA (earnings before interest, taxes, depreciation and amortization) and operating income. "From an analysis or interpretive perspective, it's not very helpful," says Schwill. When that much information is lumped together in a single number,

understanding the company's performance can be tricky. For example, the "cost of sales and operating expenses" line could include everything from gains and losses on asset divestitures to stock-option plan costs to writeoffs--items Schwill would like to see broken out.

Metro's management discussion and analysis could also use some spiffing up. "If you go read the MD&A and ask yourself whether you understand if the business was doing better or worse from an operating earnings or margins perspective, you really won't be able to without a bunch of work," says Schwill.

Alimentation Couche-Tard Inc. (TSX: ATD.SV.B)

Jantzi Research rates Couche-Tard near the bottom of its sector on environmental and social issues. While other food and drug retailers demonstrate a better understanding of human rights issues in their supply chains, for example, Gross says Couche-Tard "hasn't woken up to the new reality."

So it should come as no surprise that Gross also dislikes the chain's environmental and social reporting. Couche-Tard's 2004 annual report offers little insight about its environmental performance; it vaguely claims to be committed to complying with government-imposed environmental laws and notes that it costs an unspecified amount of money to do so (3). The next section, titled "Social Commitment," goes on to detail various philanthropic, fundraising and volunteering efforts. "This is likely a case where the company thinks its social responsibility ends at writing cheques at the end of the year to whatever organizations it's decided to donate to," observes Gross.

Husky Energy Inc. (TSX: HSE)

Admirers of grizzlies may enjoy Husky's website. There, one can find a few paragraphs about the company's support for a project that collects data about the giant bears. There's also some discussion about philanthropic endeavours. But if one's appetite for information is not sated by those items, this company's reporting is bound to disappoint.

Take, for example, Husky's Environmental Management System. Because the company considers it an internal document, no information is provided about it. Jantzi Research isn't satisfied with the level of environmental performance information provided in the annual report, either. "You don't get a good sense of how they're doing overall," Bragg complains. "Whenever you see a report like this, you always wonder whether they're reporting only those things they think they're doing well."

A good example of Husky's approach is how it reports greenhouse-gas emissions. In its 2003 annual report, the company affirms its commitment to reduce emissions and boasts that its efforts "resulted in a reduction of 3.3 million tonnes of carbon dioxide equivalents over business-as-usual projections." (4) Bragg thinks the "business-as-usual" metric is bogus. A more appropriate measurement is emissions per unit of production, and on that front Bragg says Husky's historical performance is poor. "They're suggesting that they've actually reduced their emissions, when in fact they've gone up both on an absolute level and on a per-unit-of-production level," he says.

Husky officials agree that the per-unit-of-production measurement is the most important. However, manager of investor relations Colin Luciuk says: "The business-as-usual terminology is the term that has been used in a lot of government documents. So we've typically stuck to that [in the annual report]." He adds that the term is accepted industry-wide.

BCE Inc. (TSX: BCE)

Al Rosen describes BCE as "one of the worst in Canada" when it comes to financial reporting. For one thing, he alleges that the company does not provide enough information about its subsidiaries. And he points to a gaping chasm between the numbers it reports under Canadian and U.S. GAAP. "I have no confidence in BCE's reporting, simply on the basis of the number of issues we keep running into with them," says Rosen. But he's particularly concerned about the way BCE accounts for its pension obligations--which, he claims, has overstated the plan's assets and understated its liabilities for the past five years.

Pensions are a form of employment expense; one might expect that it would show up as a cost on BCE's financial statements. But using various adjustments and credits, BCE was actually able to record a pension credit in both 2001 and 2002. "How they managed to turn that into a gain is all in the accounting," Mark Rosen says.

One example of BCE's aggressive approach lies in management assumptions, which are as important in pension accounting as they are with stock options. BCE's 2003 annual report explains that the company expected a return on plan assets of 7.5% for 2003. (5) Mark Rosen says that's higher than most. "Where's the support for this 7.5%?" he asks. "You'd want an explanation of why they think they're better than average."

BCE's report observes that "over the long term, the actual rate of return has, on average, been substantially more than the rates we assumed." In 2003, at least, that seems to have been borne out--the actual return was 14%. But the plan has had losing years, too. "While they have turned things around in 2003, we still don't know the actual performance of the plan in 2001 and prior years," Rosen says. "Therefore, we cannot verify the performance of the plan over the past several years, and thus cannot assess the reasonableness of management's assumption." He concedes that BCE's pension disclosure has recently improved.

BCE is by no means alone in providing inadequate pension transparency. But Rosen believes that BCE has benefited more than most firms by taking advantage of "smoothing" tactics afforded by GAAP. "If an issue is that significant to a company, they should be expected to lead the way in terms of providing decent disclosure about it," he says. "A plain-

language explanation of what's going on would be sufficient for people."

WestJet Airlines Ltd. (TSX: WJA)

An airline's planes require constant maintenance. And eventually, they become sufficiently old and worn out that they must be replaced. Airlines express these realities in financial statements through two line items: maintenance and depreciation costs. The choices WestJet's accountants make when calculating these items have interesting implications for investors.

In recent years, WestJet has been retiring older Boeing 737-200 planes and replacing them with spiffy new 737-700s. The great thing about new aircraft is that they spend less time in the hangar, and therefore can generate more revenue than older planes. That helps explain why WestJet's maintenance costs declined in 2003 to $75.7 million from $82 million the previous year.

Under GAAP, airlines have considerable latitude when it comes to accounting for the gradual aging of their fleets. WestJet's 2003 annual report explains that the company depreciates each aircraft based on how many hours it's in the air. Accountability Research says that this approach is the most aggressive available, and serves to inflate the bottom line today--with possibly unfavourable consequences down the road.

WestJet is taking what amounts to a straight-line depreciation approach, Accountability argues. (In other words, a plane depreciates approximately the same amount in its first year as in its 20th.) A more conservative company would record more maintenance and depreciation in the aircraft's earlier years, Mark Rosen says. "What you're really trying to do is match your expenses to the revenue you're generating. If you're looking at [maintenance and depreciation costs] together, you should see a higher cost earlier in the aircraft's life, when you're earning more revenue."

Al Rosen says the shortcoming of WestJet's approach is visible in its first-ever reported loss. In February, the firm announced that it would accelerate the retirement of its 737-200s, and therefore incur a $47.6-million writedown on its 2004 fourth-quarter results. "Obviously, that loss should have been spread over prior years when they were reporting income," says Rosen.

Sierra Wireless Inc. (TSX: SW)

Schwill's concern is how the company discloses its research and development costs. In its 2003 annual report, Sierra reports "net" R&D expenses of US$16 million. Elsewhere, however, the company explains that the "net" figure is reduced by government R&D funding and investment tax credits. Granted, at just US$477,000, the R&D reduction isn't a big number. But Sierra's reporting doesn't reveal how much R&D funding the company has actually received, says Schwill. And because the terms of those arrangements aren't disclosed, more problems arise. "What you want to determine, really, is what's the probability that they're going to have to repay?" explains Schwill. "Is this money that's going to be owing in the future, or not?"