General Corporate — Commentary — Articles — English — Vern Krishna —, 2013-03-023 -- Accounting and the rule of law

2013-03-13

Search Details

Search Query: Table of Contents

Delivery Details

Date: January 8, 2019 at 3:15 p.m.

Delivered By: VERN KRISHNA

Client File: GAAR

Vern Krishna discusses the acquittal of three senior Nortel executives on allegations of accounting fraud and manipulation of financial statements to affect public markets illustrates the fluidity of accounting principles, and the difficulties of discharging the burden of proof in criminal fraud prosecutions.

Accounting and the rule of law

Date: 03/13/2013

Accounting and the rule of law

Vern Krishna

The acquittal of three senior Nortel executives on allegations of accounting fraud and manipulation of financial statements to affect public markets illustrates the fluidity of accounting principles, and the difficulties of discharging the burden of proof in criminal fraud prosecutions. The decision, which ended a nine-year-long saga of criminal investigations by the RCMP, Ontario Securities Commission, the Securities and Exchange Commission and the U.S. Justice Department, highlights the rule of law in Canada.

In a learned treatise, Ontario Superior Court Judge Frank Marrocco outlines the requirements of the burden of proof and the principles of estimating accrued liabilities and their role in financial statements. The judgment should be mandatory reading in business schools.

Discouraging as the financial disasters of the past decade have been, capitalism rests on moral principles and will not tolerate those who undermine the integrity of its basic tenets. However, it also relies on the rule of law, which requires criminal prosecutors to establish their cases beyond a reasonable doubt, which they clearly failed to do in Nortel.

“Enron” is a synonym for corporate greed, fiduciary deception and accounting malfeasance. To be sure, the financial debacles of Livent, Madoff, WorldCom, Adelphia, Tyco, Bre-X, and YBM—to name just a few—are but a stepping stone in the long history and future of financial and accounting frauds. They should not be seen, however, as typical of the moral standards of the business community. Indeed, if anything, they represent a small minority of cases in which a few bad apples usurped the limelight, but which did not justify the regulatory overkill that followed.

It is not that governments do not act: They do, but always late and with a heavy hand. The *Sarbanes-Oxley Act* is the classic example of regulatory overreaction in political panic. The cost of implementing the rules that the US Congress legislated in *SOX* is enormous by any standard—the average large company is losing 70,000 hours to comply with the requirements of the statute, costs that consumers must eventually pay.

Are the incremental compliance costs producing the beneficial results that the legislators blindly assumed would flow naturally from enhanced regulatory compliance? In evaluating the effectiveness of *SOX*, it is important to remember that almost all of the high-profile prosecutions for criminal fraud involved activities that existing accounting rules and corporate fiduciary law clearly prohibited.

 © 2019 Thomson Reuters Canada Limited.

In WorldCom, for example, the corporation under the stewardship of CEO Bernie Ebbers—sentenced to 25 years—misclassified nearly $12-billion (U.S.) of current expenses as assets. By moving the expenses from the income statement to its balance sheet, the company exaggerated its profits, which caused its stock and its options to soar in value. The company's accountants and auditors violated a fundamental accounting principle that any first-year commerce student would have said was wrong and contrary to established standards.

Unlike WorldCom—which was simply a massive accounting fraud in which the company ignored its expenses—Enron was a sleek, modern version of the Ponzi scheme. Enron's shares fell from a high of $90 each to less than $1, leaving the company's employees, shareholders and pensioners to live with the losses. Enron did not technically violate any accounting principles *per se*. The company simply manipulated arcane accounting rules to advantage and misled investors by making up phony profits and hiding debts in offshore partnerships.

If the Enron accounting was complicated, it was only so for the accountants. It took a jury of eight women and four men a mere six days of deliberations to convict former Enron executives Kenneth Lay and Jeffrey Skilling of 24 counts of fraud and conspiracy, one count of insider trading and four counts of bank fraud.

Nor were the SEC regulators without blame for tolerating the obfuscation of the accountants in describing Enron's partnerships in its public filings as "share-settled costless collar arrangements" and "derivative instruments which eliminate the contingent nature of existing restricted forward contracts."

To be sure, there have been many financial scandals since *SOX* became law in the United States. That, however, merely confuses cause and effect. The prosecutions in all but a few of the cases were proceedings under general fiduciary laws that have been in place for a long time. Indeed, the only major prosecution under *SOX*—that of Richard Scrushy of HealthSouth—ended in his acquittal.

SOX and its tougher new accounting rules are unlikely to stop future frauds. Indeed, the next generation of corporate and accounting frauds resulting from accounting misstatements and inflated profits from nonexistent assets in China is percolating in the legal wings of class action lawyers. Ultimately, the judicial system, rather than regulatory zealots, must respond to each generation of accounting frauds to preserve the integrity of our capital markets within the rule of law.

Vern Krishna, CM, QC, FRSC is Tax Counsel, Borden Ladner Gervais, LLP, and Professor of Common Law and Executive Director of the Tax Research Centre, University of Ottawa.

vern.krishna@taxchambers.ca

Copyright © 2013 Vern Krishna. Reproduced with permission.

End of Document © 2019 Thomson Reuters Canada Limited.