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*Keynote Speech by*

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*at the*

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**“Transparency and Corporate Integrity”**

*on*

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*at*

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*at the*

**Metro Toronto Convention Centre**

It is my pleasure to address the Canadian Institute of Chartered Accountants; a group that is focused on good reporting, which as you may know is a subject near to my heart.

So I ask, is the current financial reporting really useful to the users? Is quantity replacing quality? Is the reporting timely? To get our answer, let's look at history. How did we get to where we are today in financial reporting?

### History of Financial Reporting

Did you know that 19<sup>th</sup> century American corporations disclosed very little to shareholders, preferred stockholders or bondholders? Why? Because owners or controlling shareholders did not see any benefit in sharing financial information... they thought they would be helping the competition by doing so....and in a way they did.

The railroads raised a lot of money in the 1800s through the sale of stocks and bonds. What is interesting is that investors acquired stocks and bonds based on the reputation of the investment bankers who were selling the securities. Obviously, investors had a better opinion of the impartiality of investment bankers then than they do today.

In both the US and in Europe, the bankers completed their due diligence before offering securities to the public. But like today, bankers had a conflict of interest. They only earned their commission if they sold the securities. They did not have to worry about the return on these securities; “caveat emptor” is not a new concept.

Without access to good accounting information many investors relied on the payment of dividends to assert the soundness of an investment. As we see daily with income trusts, it was as hard then as it is today to distinguish between return on capital and return of capital. If dividends

could not be paid out of the profits, it was very easy to use the capital paid in to pay these dividends, and like today's income trusts, many did just that.

The rating agencies were started to ensure accurate information for investors but after the recent sub-prime debacle and our own asset backed commercial paper problems, you know that they maybe part of the problem (more on this later). But more importantly, the profession of auditors was born at about the same time. But unlike today, early creditors paid the auditors directly. It was a good idea then; maybe it is a good idea now. It would certainly remind auditors who the client is, unlike in the 1990s and early 2000, when the question "who is your client" induced a sense of confusion among auditors. Confusion that was too often resolved in the favour of the payor and not in favor of users of financial statements.

The practice of ignoring depreciation charges also allowed the numbers to look better than reality. As a matter of fact, not until the age of railroads did accountants even consider depreciation on a systematic basis. You can already envision the amount of leeway management had in determining and smoothing profits. It was only when the US permitted the deduction of depreciation in the calculation of corporate taxable income that this change became more systematic.

I tell you all of this, not to say that accounting, auditing and reporting were better years ago; they were not but to demonstrate that the same conflicts applied, and the same excuses were given. While there have been improvements in accounting, auditing and reporting over the years, many of the issues became more sophisticated, therefore, generating new ways to confuse investors. The service to the public has improved, but is it the service that the public requires?

## Arthur Anderson

It is ironic that one of the firms that pushed for better accounting was Arthur Anderson. For many years, Anderson was the gold standard among auditors. Arthur Anderson himself was a well-known public speaker who used his skills to advocate an accountant's special responsibility. In a 1932 speech on business ethics, he said, "If the confidence of the public in the integrity of accountants' reports is shaken, their value is gone. To preserve the integrity of his reports, the accountant must insist upon absolute independence of judgment and action."

When Arthur Anderson died in late 1940, he was replaced by Leonard Spacek who was raised in a poor but hard-working family in Iowa. To demonstrate his independence he used to say, "I'm from Iowa and I can always go back there and plow corn."

In the 1950s he became the conscience of the industry. Even then, he felt that the industry needed reform. As far as he was concerned, GAAP meant generally Antiquated Accounting Principles. Like today, it was hard to compare the statements of two companies in the same industry. He said that "...accounting principles should be based upon a principle of accounting that is fair to the consumer, to labour, its management, to the investor and to the public."

The firm of Arthur Anderson had principles in the 1950s. It advocated a U.S. Court of Accounting Appeals, a higher, independent court that enforced a uniform code of accounting principles. Leonard Spacek was frustrated by the other members of the Big 8 accounting firms.

For ethical reasons, Anderson resigned all of its railroad accounts but two. The firm felt that railroads had overstated their earnings by up to 50% due to the rules of the Interstate Commerce Commission, which would not allow charges for the depreciation of rail ties and other

assets. The two railroads that the company kept as clients agreed to change their accounting practices.

For similar reasons, Anderson resigned all of its clients in the Savings and Loan industry.

Therefore, when the Savings and Loan crisis occurred, Anderson was not caught like the remaining Big 7.

### Government Accounting

The lead paragraph from a recent New York Times story (April 4, 2007) stated “In 2005, New Jersey put either \$551 million, \$56 million, or nothing at all into the pension fund for teachers. All three figures appeared in various state documents.” Why this confusion? For years, the state had diverted billions from its pension fund using a number of transactions authorized by the legislature.

This article is a classic. If it were a comedy it would be fun, worth a laugh. But there is nothing funny about playing with people's pensions. When you learn that a fund worth \$79 billion in assets is probably under funded by over \$50 billion (the number reported is \$18B) you can see that bad accounting and bad reporting are a huge problem. But remember, nothing was done illegally. Everything was done according to laws that were amended to fit the desire of the politicians. The fact that the state contributed nothing is conveniently well-hidden. The deputy director of the Division of Pension and Benefits knew about all these shenanigans but he describes himself as a 'bean counter'. The \$550 million in contributions to the healthcare plan as part of the pension contributions was convenient and deceived the public, but you can see how easy it is to make your financial condition look good when you can write the rules.

For those of you who know a bit about pensions, you may ask what about the Employee Pension Retirement Income Security Act, a law passed by the U.S. federal government to protect pensions. Well, the

short answer is that it does not apply to state sponsored plans. You may think that bad things only apply south of the border; but let me remind you that when Alberta's former premier bragged that the province was debt-free, it has a pension fund for teachers that is funded at only 35%. The deficit is \$7 billion. So much for being debt-free.

If you want another example of how governments balance books take a look at our own Ontario Teachers' Pension Plan annual report. On page 22 you will see that you can count \$1.9 billion of future contributions as an asset... but ignore future liabilities. This does wonders to your balance sheet but very little for taxpayers... or young active teachers who may be left to make up the difference through higher contributions or lower pension benefits. This new way of accounting was the result of a law passed in 2006 by the Ontario legislature for jointly sponsored plans. How many of our legislators really understood what they were doing.

Another example of creative accounting and reporting can be seen in how our government accounts for the cost of pensions and healthcare. If you are a corporation, you must show these liabilities as they are accrued. If you look in the books of our government, you will never see an entry in the books for these liabilities. Maybe because the numbers are too big? Well, yes, they are big.

Everyone is familiar with the federal government debt of approximately \$525 billion. You can increase this by another 50% (\$274B) to get an idea of the debt of all the provinces. But what is rarely talked about is the value of the unfunded liabilities of our social programs... which is approximately \$1.7 trillion or three times the federal government debt.

Fortunately, the Fraser Institute publishes these numbers every year. The last study was completed in 2006 and it was for the year 2003. Let's look at them.

The unfunded liabilities are:

- Old Age Security - \$470 billion
- CPP/QPP - \$670 billion
- Healthcare Programs - \$555 billion

TOTAL \$1.7 trillion

I would like to remind you that these numbers are at the end of 2003...

and since then real Canada bonds' yield has decreased by over 0.5%

That fact alone could increase the total liability to close to \$2 trillion.

Another big problem with government reporting is that capital expenditures and current expenditures are co-mingled.

Like the railroad example used earlier, there is no charge for depreciation; therefore it is very easy for our leaders to stop investing and maintaining our infrastructure and to spend this money on current expenditures. We have seen the results in an overpass that collapsed in Quebec and a bridge that fell down south of the boarder.

So when you think about the financial reporting being done by our governments, you're probably seeing the worst there is. Sadly, however, they are not alone. I have never analyzed the reporting of our municipalities or individual school boards, but I suspect it is probably not much better.

I have analyzed annual reports of hospitals, however. If you are on the board of a hospital, could you tell me from your annual report the cost of a room for a day and the trend over time? Could you tell me the depreciation and the average age of the equipment being used?

I could not in most of the annual reports I have looked at.

So you see, financial reporting is important, but in general the public is not very demanding when it comes to reporting by our public bodies and our politicians and bureaucrats are very happy to meet our expectations. All of this done according to the proper accounting and reporting principles.

## Private Industry

Now that we have established the importance of financial reporting by using examples in the public sector, I would like to turn to a world that is more familiar to most of us in the corporate world.

I would like to make three points about the subject of financial reporting in the private sector:

First as for governmental organizations, investors and the public deserve better information than they are getting. One of my pet peeves is the quarterly press release that a corporation sends out. It is the most important piece of financial information that a listed corporation sends. Why? It moves the market. Today before buying or selling securities people do not wait for a full set of financials with twenty pages of footnotes. In fact this weekend I reviewed an annual report of 275 pages and over 100 pages of footnotes -- I hope this enlightens small investors. You would expect that corporations would require their

auditor to attest to the accuracy of the quarterly press release. But it is not a very common practice.

Forget about SOX, forget about section 404, and look at what many corporations do with their quarterly press release.

Many of them are full of numbers that have no standard definition.

Think of operating income, EBITDA, or Free Cash Flow. What has been one of the most popular investments in Canada for over 10 years?

The answer is income trusts. They may be less popular in the future.

One of the most important facts to know about income trusts is distributable cash flow. How long has it taken for the CICA to have a draft on this? My answer is simple; it was just published last fall.

What is distributable cash flow? It is the maximum amount that the trust can safely distribute without encroaching on capital.

Today investors study corporations around the world. Hence, the need to have common accounting language. We are on the way to getting it. The International Financial Reporting System is a great step in this direction. Over 100 countries currently require it or have adapted a formal policy of convergence.

Canada is one of the leaders in adopting IFRS. Unfortunately, the European commission started a very bad precedent by not adopting IFRS in its entirety but instead by adopting a different standard for financial instruments. These will not have to be marked to market as requested by IFRS. This was a political decision reminding us of the decision made in the U.S. on the subject of accounting for options. So we could end up with many IFRS, which while better than the current system, is not ideal.

My second point is simple; the regulation of the accounting profession has changed and we may not like SOX, we may not like the PCAOB, or in Canada the equivalent, the Public Accountability Board.

But this change from self-policing by the profession was necessary. It is welcomed by the investing community. In Canada, the CPAB has concluded its third year of inspection. These audits are more rigorous than when the profession was self-regulated.

But, one has to hope that these audits continue to be substantive. The beauty of having the CPAB is that it reminds the auditors that someone is watching. This fact alone will lead to improved auditing and reporting.

The audit firm's main job is auditing. A few years ago if you were in the assurance business in one of the then Big 5, you practically had to apologize.

At Anderson, you were expected to bring a multiple of your assurance fees in consulting fees and in 1998, this was formalized by the then top partner Steve Samek in the 2x strategy.

The Wall Street Journal reported on June 7, 2002, that if you were an Anderson audit partner, you had to bring in 2x your revenue in work outside auditing. I can assure you that this was reflected in the performance evaluation of each auditor. The heroes were the ones who brought in the most and some of this work even involved doing internal audit work for a client or auditing the cleanliness of the Health South clinics.

We all know how that story ended.

Here is another way to get into trouble. Appoint young partners and require older partners to retire by age 60? This may appear smart from a Human Resources point of view, but the result is that if you are an investor who relies on the work of auditors, the most experienced, the most independent, the most knowledgeable people are out of the picture. They're not there to provide judgment and experience when the tough calls have to be made.....do we think that leaving it to the

people who still have a mortgage results in better decisions.

No wonder the U.S. Chamber of Commerce published a study in January 2006 entitled, “Auditing: A profession at risk”.

I’d like to tell you about one of the conclusions of the study. Many clients believe that they are receiving less overall advice and support from their auditors. My own philosophy is that if you run a business, you have to listen to the clients; but if you do not, you put your own survival at risk.

Today, one thing is certain: auditors can only do audit work for their clients. Arthur Levitt said many years ago that a noble profession was being undermined by being too close to many audit clients. That can be said about other professions.

Conflict of interests have always been with us but they have to be minimized, they have to be disclosed. Conflict of interests are one of the reasons the bond rating agencies are on the hot seat. Between 2002

and 2006 Moody's earned 3 billion from rating sub-prime businesses in the U.S. That is an interesting fact but not a mortal sin. What is a sin is the reason the SEC is now investigating the same agencies, the sin: their role in helping structure such paper. How about an investigation of DBRS.

By the way it is only since the 70s that rating agencies are paid by the issuers, before that investors had to pay to get the rating. A much better way in my view.

Being too close to the clients leads to some of the problems we are familiar with: Livent, YBM, Phillips Environmental, Cinar, Nortel, Atlas Cold Storage, Sunbeam, Adelphia, Enron and Worldcom.

My last point is that audit firms should stop writing engagement letters; these should be written by the audit committee. The audit committee should spend time defining what they want done, what aspects of the business prevent them from sleeping well at night. What are the issues

that they have doubts about? The engagement letter should be more than a standard piece of paper that each audit committee agrees to.

In Canada, there was a case decided by the Supreme Court on the purpose of audit reports. It is known as the Hercules Management case. This case was decided in 1997. The court held that the “purpose of providing reports is aimed not at protecting the interests of individual shareholders, but rather at enabling the shareholders to act as a group to safeguard the interest of the corporations themselves.”

The troubling fact was not the decision itself; it was that these arguments were made by a Big 4 accounting firm.

And it was a self-serving argument. It was put forward to limit the liability of the firm involved. You would hope that the profession would embrace the evolving needs of society. If we are to have democratization of capitalism, we need to help small investors to better understand a corporation’s financial position. The same investors

should also be able to rely on the numbers presented and yes, if management lies to the auditors, management should end up in jail.

Mind you, in Canada, white collar crime is treated lightly by our legislators and our courts. As the examples I stated a minute ago demonstrate, we have had our share of scandals. They occur regularly. We tolerate insider trading by not investigating cases when they occur, by not prosecuting them, or worse by asking for a level of proof in court that is next to impossible to achieve. Recently, (8/13/07) there was a chart in Canadian Business Magazine showing the number of convictions achieved by the multi-agency U.S. Fraud Task Force over the past 5 years.

214 Presidents and CEO's among them Conrad Black

53 CFOs

23 Corporate Counsels

129 Vice Presidents

This adds up to 1,236 convictions.

In Canada, how many did we have in the 4 years since IMET was started? Two. Michael Lee Minton was convicted on two counts of fraud and money laundering. The Allen Committee on the Task Force to Modernize Securities Legislation in Canada received more comments on the issue of enforcement than on any others. The investing public is right to ask, when will we see action?

When it comes to better governance, I am often asked are we there yet, and my answer is no. We are all familiar with option backdating in the U.S., where over 150 corporations are being investigated, and some of these are being prosecuted with at least one successfully. In Canada there is one trial under way, the RIM case. But do you know that the two lawyers involved with this case, Dimitri Lascaris and Michael Wright, tell me that there are at least another 25 cases where they demonstrate that option backdating occurred. It is a pity that academics were the ones to discover this. You have to ask where were the auditors?

## Conclusion

Financial reporting is not easy, and good financial reporting is rare.

My friend Allison Thomas of PwC London works on a wonderful study every year showing “Good Practices in Corporate Reporting”. You can find the results of this study at [www.corporatereporting.com](http://www.corporatereporting.com).

She is involved with the project because, as a financial analyst, she became frustrated with poor reporting. The PwC model is based on four pillars: Market, Strategy, Managing for Value, and Performance. It is worth reading.

The best reporting by a CEO is probably done by Warren Buffett who described his approach this way, “We will be candid in our reporting to you, emphasizing the pluses and minuses important in appraising business value. Our guideline is to tell you the business facts that we would want to know if our positions were reversed. We also believe candor benefits us as managers. The CEO who misleads others in

public may eventually mislead himself in private.” And that’s an ethical dilemma that is easily avoided. Tell it like it is, remember the truth always comes out. Recently, even the RCMP painfully learned this truth.

We should all remember that being a professional carries many obligations to society.

Thank you.