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# Fraudulent Financial Reporting

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## RESTORING TRUST IN THE FINANCIAL REPORTING FRAMEWORK. DOES IT *NEED TO BE DONE?* *CAN IT BE DONE?*

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The failures of the Canadian Commercial Bank and Northland Bank spawned a Royal Commission, a multitude of lawsuits and a major outcry from investors and regulators. In what has been labelled the most important lawsuit in Canadian accounting history, Price Waterhouse, liquidator of the Canadian Commercial Bank, has launched a lawsuit against the bank's auditors, directors and officers, claiming damages of \$249 million plus interest and costs. Developments in the Principal Group affair appear to be following a similar course. In both situations the same questions are being asked:

- How could this happen?
- Who is to blame?
- What needs to be changed so this won't happen again?

In August of 1986 Congressman Ron Wyden introduced a revised version of Bill 5439 in the U.S. House of Representatives. The stated purpose of the draft legislation is as follows:

“To amend the Securities Exchange Act of 1934 to require audits performed under the Federal Securities laws to include reasonable procedures for financial fraud detection, to require reporting on internal control systems, and to require the reporting of fraudulent activities to appropriate enforcement and regulatory authorities.”

Uninitiated users of financial information may be thinking that surely this is simply a formalization of existing standards. Those who follow this area closely recognize that these proposals represent a major departure from existing security regulations.

Developments in Canada over the last five years also suggest the public is not completely satisfied with the existing reporting framework and related safeguards.

Is Bill 5439 or similar legislation the solution? Have the problems been clearly defined? Who is responsible for solving these problems?

Both U.S. and Canadian developments can be simplified and summarized as one basic issue:

- Many users have lost faith in the reliability and completeness of financial disclosures. Many have been hurt and are angry. To ensure the future viability and health of our securities markets trust must be restored - both in the U.S. and Canada.

### THE PROBLEM ACCORDING TO CONGRESSMAN WYDEN

In the U.S. the Subcommittee on Oversight and Investigations has conducted hearings into a multitude of financial failures. Congressman Wyden, a participant in the hearings, summarized his observations when introducing his revised bill in the House:

“Again and again, the subcommittee found that independent auditors have failed to detect or to report fraudulent activities at a number of major corporations and financial institutions in this country.

“In one financial disaster after another... the disaster struck virtually on the heels of clean audit certificates issued by audit firms indicating that the companies were financially

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sound. The result? Hundreds of thousands of investors and creditors were out hundreds of millions of dollars.

“Under current rules, when an auditor discovers a major financial fraud, the auditor is required to do nothing but inform corporate management and consider resigning. While this rule may help protect accounting firms from lawsuits, it does very little to protect the consumer from fraud and illegal activity.

“The problem of financial fraud is growing... Although the vast majority of business persons and auditors are honest, responsible citizens there is no question that a growing minority are trying to skirt or ignore our laws and take improper advantage of public investors.

“Mr. Speaker, such a system falls far short of providing the protection the American public deserves.”

It doesn't take a Rhodes scholar to discern that Mr. Wyden has decided the problem lies with the public accountants.

#### **THE PROBLEM ACCORDING TO TREADWAY**

The U.S. National Commission on Fraudulent Financial Reporting (better known as the Treadway Commission) was established, at least in part, in response to the initiatives of Mr. Wyden and the related subcommittee investigations. The Treadway Commission arrived at a somewhat broader definition of the problem. The report, which spans 187 pages, concludes:

“The responsibility for reliable financial reporting resides first and foremost at the corporate level. Top management- starting with the chief executive officer- sets the tone and establishes the financial reporting environment. Therefore, reducing the risk of fraudulent financial reporting must start within the reporting company.

“Prior efforts to reduce the risk of fraudulent financial reporting have tended to focus heavily on the independent public accountant and, as such, were inherently limited. Independent public accountants play a crucial, but secondary role. They are not guarantors of

the accuracy or the reliability of financial statements. Their role, however, can be enhanced, particularly with respect to detecting fraudulent financial reporting, and financial statement preparers and users should be made to understand the enhanced role.”

The report goes on to identify both deficiencies and opportunities for improvement with respect to existing regulatory law enforcement agencies and the current education systems.

A complete reading of the commission's report leaves little doubt that Treadway's overall conclusion is that weak corporate governance is the real problem to be addressed. Particular attention is focused on the role and responsibilities of senior management and audit committees in preventing and detecting fraudulent financial reporting.

#### **THE PROBLEM ACCORDING TO THE C.I.C.A**

The Canadian Institute of Chartered Accountants is once again studying what has been termed, “the expectation gap”. William MacDonald, a prominent Toronto corporate lawyer, chairs the C.I.C.A.'s Commission to Study the Expectations of Audits. The Commission has had an opinion poll performed, has surveyed senior members of the professional and business communities, held public hearings across Canada and received more than 100 written submissions from public accounting firms, industry, government, academe, regulators, financial institutions and the public at large. The report, although expected in the fall of 1987, is now due to be released in May. One would expect this Commission will not ignore the substantial efforts being expended south of the border.

#### **THE PROBLEM ACCORDING TO THE HONOURABLE WILLARD Z. ESTEY**

The Honourable Willard Z. Estey, in the remarkable forthright Report of the Inquiry into the Collapse of the CCB and Northland Bank, calls into question the role of management, the Board of Directors, the external auditors and the Office of the Inspector General for Banks. Estey states, in what must be one of the most quoted phrases of the decade:

“The Board of Directors must share some responsibility as well for the failure of the bank. They were susceptible to being

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mesmerized by management, and realization of the true state of affairs and its ramifications came too late. The key is their failure to insist upon simple and straightforward information from management.”

The report, which spans over 600 pages, contains 46 detailed recommendations to prevent similar problems in the future. It has been both praised and criticized on a wide variety of fronts. It certainly has not been ignored.

### **THE PROBLEM ACCORDING TO A LIQUIDATOR**

Following on the heels of the Estey Commission, Price Waterhouse Limited, in its capacity as Liquidator of the Canadian Commercial Bank, has sued members of the bank’s senior management, directors and the bank’s auditors. The statement of claim identifies numerous specific expectations that it alleges were relevant and were not met. The case, which is not expected to come to trial for some time, may well be an important step toward codifying the expectations to be met.

### **HOW CAN TRUST BE RESTORED?**

Since numerous prestigious, influential bodies are, and have been, examining the question, perhaps it is useful to overview the various solutions developed to date.

### **THE SOLUTION ACCORDING TO U.S. REGULATORS – BILL 5439**

- Requires that issuers shall:
  - devise and maintain a system of internal control;
  - periodically evaluate that system of control;
  - include an evaluation on the control system in annual reports; and
  - identify any weaknesses together with plans to correct and/or progress made to date.
- Requires that auditors:
  - conduct audits and perform procedures that reasonably ensure the detection and reporting of any material illegality or irregularity in the conduct of the issuer’s financial transactions by any director, officer, employee, or agent of, or other

person associated with, the issuer being audited;

- evaluate controls and evaluate the issuer’s evaluation of controls;
- evaluate controls to determine if they reasonably ensure receipts and disbursements comply with applicable law;
- issue a written report stating work done and results;
- perform extended procedures when the auditor becomes aware of information indicating that an illegality or irregularity (whether or not material) has or may have occurred;
- inform management of any concerns; and
- blow the whistle to regulatory and law enforcement if within 90 days their concerns have not been dispelled either by refuting the concern or correction of the problem.

- Includes a “safe harbour” provision for auditors.

### **THE SOLUTION ACCORDING TO THE NATIONAL COMMISSION ON FRAUDULENT FINANCIAL REPORTING**

The Treadway Commission’s recommendations are directed to public companies, independent public accountants, regulators and educators. Without a doubt the primary onus for providing reliable financial information has been put squarely on senior management and audit committees. For example:

“For the top management of a public company to discharge its obligations to oversee the financial reporting process, it must identify, understand and assess the factors that may cause the company’s financial statements to be fraudulently misstated.”

“A company’s audit committee should review annually the program management establishes to monitor compliance with the code (of conduct).”

“The Board of Directors should be required by SEC rule to establish audit committees composed solely of independent directors.”

“Audit committees should be informed, vigilant, and effective overseers of the

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financial reporting process and the company's internal controls."

"All public companies should be required by SEC rule to include in their annual reports to stockholders management reports signed by the chief executive officer and the chief accounting officer and/or the chief financial officer. The management report should acknowledge management's responsibility for the financial statements and internal controls, discuss how these responsibilities were fulfilled, and provide management's assessment of the effectiveness of the company's internal controls."

"All public companies should be required by SEC rule to include in their annual reports to stockholders a letter signed by the chairman of the audit committee describing the committee's responsibilities and activities during the year."

Recommendations for public accountants call for more clarity in their standard report as to the scope and limitations of their work.

Recommendations for regulators suggest more teeth and a tougher approach. Educators are called on to provide more guidance on internal control and on indicators of fraud.

### **THE SOLUTION ACCORDING TO THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTS**

In response to legislative and public pressures in the United States, the A.I.C.P.A.'s Auditing Standards Board issued nine important exposure drafts in February of 1987. These proposals have now been finalized and are to take effect January 1, 1989. In summary the revisions are:

- Increase the auditor's responsibility for detecting and reporting fraud and illegal acts, and for evaluating a company's ability to remain in business during the following year.
- Revamp the standard auditor's report to specify the auditor's role in reviewing the financial statements and clarify that the company, not the auditor, created the statements.
- Require greater communication between the auditor and a company's audit committee to aid the committee's oversight of the area.

These revisions directionally follow recommendations made by the Treadway Commission.

### **THE SOLUTION ACCORDING TO THE ESTEY COMMISSION**

The Commission's report contains 46 recommendations. The recommendations are comprehensive and apparently controversial. Many pertain strictly to the regulation of the banking industry. Some of the recommendations which can be considered to potentially have wider significance if applied to the corporate sector include:

"The Bank Act be amended to provide that directors owe their duty of care to the corporation itself, to the shareholders, and to the depositors. The enforcement of the right arising from the duty should be by way of civil action."

"The Bank Act be amended to state the terms of reference, in a general way, of the audit committee. These statutory responsibilities should include, as well as their existing responsibility to review the audited financial statements in consultation with the auditors, the review of the bank's policies in loan loss provisioning, asset valuation, income recognition by accrual or capitalization of interest and the taking of an accounting for fees, and the capability of the management information system to reveal problems in a timely fashion."

"As well, the audit committee should be under a duty to satisfy itself that the bank's internal audit and inspection systems are adequate and functioning properly."

### **CONCLUSION**

All of this activity is directed toward restoring trust in the reliability of financial information. To this objective must also be added a second fundamental business objective, namely that trust be restored through mechanisms and procedures that are both practical and cost effective. The following is a personal synthesis of the issues and changes required:

1. Public companies have a grave responsibility to the investing public concerning the integrity of financial information presented. Users must have

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- high levels of trust in this information for security markets to function effectively and efficiently.
2. Although management and boards of directors have always theoretically been responsible for developing and maintaining adequate internal control environments, this responsibility has not always been properly fulfilled. The accountability mechanisms and procedures to make sure this occurs have been weak, or even non-existent, in many companies.
  3. Boards of directors are the most appropriate and logical vehicles to commission the changes necessary to provide more assurance to users that reliable financial information is being provided. Audit committees must assume a key monitoring function.
  4. Management and boards of directors have not always fully understood the importance of a strong overall control environment. The lack of a comprehensive and generally accepted model for a strong internal control framework is a primary cause.
  5. Internal audit functions should play an important role in overseeing and reporting on the control environment. To do that job effectively, adequate resources, independence and well trained auditors are required.
  6. Canadian public accountants should immediately acknowledge and address the “expectation gap”. The MacDonald Commission should build on the recent U.S. initiatives and recommend even more aggressive and imaginative steps to close the ever widening gap between the public’s expectations and the product being delivered by accountants. The Canadian Institute of Chartered Accountants and other affected bodies must respond quickly to the Commission’s recommendations.
  7. Major work is required to upgrade education mechanisms and standards with respect to internal control and fraud as a prerequisite to better controlling the incidence of fraudulent financial reporting in the future.
- Trust can be restored. It will take a concerted effort on the part of management, board members, regulators, public accountants, internal auditors and educators, but it can and must be done.
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