

THE REGULATORS' CORNER

**ACCOUNTANT'S LIABILITY
NEW CHALLENGES AND FUTURE TRENDS
JUNE 13-14, 2002**

**JOSEPH GROIA
MATTHEW SCOTT**

**GROIA & COMPANY
LAWYERS
THE STERLING TOWER
372 BAY STREET
SUITE 1000
TORONTO, ONTARIO
M5H 2W9**

**TELEPHONE: (416) 203-2115
FAX: 416 203-9231**

“I swear if they put some of these people in jail or in orange suits...that would do more for killing the occurrence of future Enrons than writing 1,000 laws.”

Dominic D’Alessandro, CEO, Manulife Financial Corp.,
The Globe and Mail, May 1, 2002

I. INTRODUCTION

It goes without saying that all market participants but especially public accountants carry a special responsibility for engendering the confidence of the capital markets. The many varied roles that public accountants play can expose them to a wide range of liability from civil to regulatory to criminal. This short paper intends to examine the role of public accountants in the capital market, and how that role is regulated by their own regulatory bodies, such as the Public Accountants Council of Ontario (the “Council”) and the Chartered Accountant’s Institute of Ontario (the “Institute”), but also more importantly by the provincial securities regulatory bodies, such as the Ontario Securities Commission (the “OSC”).

The paper will also examine some of the recent directions from the OSC with respect to accounting and financial reporting, how current events might drive future reforms in financial disclosure requirements and in the oversight of public accountants, and our humble predictions about areas of new concern.

II. THE REGULATORY FRAMEWORK IN ONTARIO

The regulation of capital markets in Canada is the responsibility of provincial governments and is primarily legislated in Ontario through the *Securities Act*. These laws

govern the conduct of “market participants.” A “market participant” is defined by the *Securities Act* as:

a registrant, a person or company exempted from the requirement to be registered under this Act by a ruling of the Commission, a reporting issuer, a director, officer or promoter of a reporting issuer, a manager or custodian of assets, shares or units of a mutual fund, a recognized clearing agency, a recognized quotation and trade reporting system, a recognized stock exchange, a recognized commodity futures exchange, a recognized self-regulatory organization, a transfer agent or registrar for securities of a reporting issuer, the Canadian Investor Protection Fund, the Ontario Contingency Trust Fund, the general partner of a market participant or any other person or company or member of a class of persons or companies designated by the regulations;

A. Capital Adequacy

The *Securities Act* mandates that some of these market participants, or their members, employ the services of a public accountant to ensure that they are maintaining adequate capital in accordance with the specific rules of the regulatory body.

For example, s. 21.9 of the *Securities Act* requires every stock exchange and self-regulatory organization (“SRO”), like the Investment Dealer’s Association and the Mutual Fund Dealer’s Association, to have each of its members appoint an auditor “from a panel approved by the stock exchange or the self-regulatory body.” Similarly, s. 21.10 of the *Securities Act* requires every registrant under the Act to appoint an auditor “that satisfies such requirements as established by the OSC.” The auditor of the member or registrant is required to make an examination of the member or registrant’s annual financial statements and regulatory filings, in accordance with generally accepted

auditing standards, which the member or registrant must then file with the OSC, the stock exchange or the SRO.

B. Regulatory Filings

Another area in the regulation of capital markets where public accountants play an essential role is in the auditing of financial information of companies that issue securities to the public. The OSC requires numerous regulatory filings from companies that issue securities.

The OSC relies on the expertise of public accountants to ensure investors have full disclosure of material facts in financial statements to assist them in making investment decisions. The OSC governs disclosure in public offerings through rules like Rule 41-501 *General Prospectus Requirements* and National Instrument 44-101 *Short Form Prospectus Distributions*.

If any of the OSC's rules for financial disclosure and reporting are not followed, the OSC can take proceedings under the *Securities Act* against the corporations and individuals responsible for the management of those corporations, through administrative or quasi-criminal proceedings. Although the OSC has no clear authority to bring an action against a public accountant, it may still be able to do so under various secondary liability headings such as the parties to an offence provisions under the *Provincial Offences Act*, or under its public interest jurisdiction under the *Securities Act*. The primary responsibility for disciplining public accountants, however, is in the hands of the Institute and the Council.

C. Regulation of Public Accountants

The authority to regulate the practice of public accountancy in Ontario comes from the *Public Accountancy Act*. The *Public Accountancy Act* created the Council, which is responsible for administering the provisions of the *Public Accountancy Act*. The general purpose of the *Public Accountancy Act* is to ensure that, for the protection of the public, persons engaged in the public practice of accounting be licenced. The functions of the Council include, licencing, continuing education, advocacy on behalf of the profession, discipline of licencees and prosecution of offences under the *Public Accountancy Act*.

The offences that the Council has the authority to prosecute under the *Public Accountancy Act* mostly have to do with practicing as a public accountant without a licence. However, pursuant to the *Public Accountancy Act* and the Council's *Rules of Professional Conduct*, the Council has the authority to discipline accountants with a wide range of penalties, including the revocation of a public accountant's licence.

An interesting item to note is that over 99% of the Council's licences are currently held by members of the Institute.

The Institute is the provincial SRO of Chartered Accountants in Ontario. The role of the Institute is to coordinate the qualification process for Chartered Accountants and to monitor, investigate and discipline its members for negligence and misconduct. The liability that public accountants face with regards to the Council and the Institute will be discussed further below.

III. RECENT DIRECTIONS FROM THE REGULATORS ON DISCLOSURE AND FINANCIAL REPORTING

The OSC provides Accounting Communiqués on its website to assist reporting issuers and their financial advisers to understand more clearly the OSC's views on specific financial reporting issues.

In February of 2002, the OSC released *Staff Notice 52-713, Report on Staff's Review of Interim Financial Statements and Interim Management's Discussion and Analysis* ("Notice 52-713"). Notice 52-713 reported on compliance by reporting issuers with the requirements in *OSC Rule 52-501 - Financial Statements* ("Rule 52-501"), and section 1751 of the Canadian Institute of Chartered Accountant Handbook (the "Handbook") related to interim financial statements.

The OSC noted from their review that issuers and their advisors often failed to comply with Rule 52-501 and Generally Accepted Accounting Principals ("GAAP"). Specifically, issuers neglected to include interim balance sheets, notes to the interim financial statements, and balance sheets as at the end of the immediately preceding fiscal year as required. The OSC also voiced concerns that issuers have failed to comply with GAAP by failing to include basic disclosures required in interim financial statements by Handbook sections 1751.14 (a) and (b), a description of any seasonality or cyclicity of interim period operations, information about reportable segments, and failing to disclose changes in accounting policy or adoption of new accounting policies.

In January of 2002, the Canadian Securities Administrators (“CSA”) issued *Staff Notice 52-303: Non-GAAP Earnings Measures* (“Notice 52-303”) to address their concerns about investors being confused or misled by issuers that publish earnings measures other than those prescribed by GAAP. Since it has become common practice for many issuers to publish non-GAAP earnings measures, such as "pro forma earnings," "operating earnings," "cash earnings," "EBITDA," and "adjusted earnings", the CSA set out its expectations for issuers. The following are some of the recommendations of the CSA staff to issuers and their financial advisers:

- Present prominently with the non-GAAP earnings measures the earnings measures for the period determined in accordance with GAAP, and provide a clear reconciliation between the two.
- Describe the objectives of the non-GAAP earnings measures and discuss the reasons for excluding individual items required by GAAP to be included in determining net income or loss.
- Avoid including non-GAAP earnings measures within the financial statements.

The OSC also commented on a number of areas of accounting and financial reporting in November of 2001 in the OSC *Staff Notice 51-706, Continuous Disclosure Review Program Report* (“Notice 51-706”). One of the issues addressed in Notice 51-706 was the proper segment disclosures contained in the notes to the financial statements. The

OSC directed issuers and their financial advisors to EIC-115, *Segment Disclosures – Application of the Aggregation Criteria in CICA 1701*, which has clarified when operating segments would or would not have “similar economic characteristics” for purposes of applying the aggregation criteria.

Notice 51-706 also reminded issuers and their financial advisors to carefully consider the basis in Canadian authoritative literature for all revenue recognition policies that differ from the interpretations set out in US GAAP, and particularly from those set out in SEC *Staff Accounting Bulletin 101, Revenue Recognition*, as US GAAP contains numerous regulatory pronouncements on specific aspects of revenue recognition that have no direct counterpart in Canada.

Notice 51-706 also addressed the issue of restructuring and impairment charges and whether they have been appropriately recognized. The OSC reminded issuers and their financial advisors to be mindful that the OSC frequently requests detailed explanations of how an issuer applied the criteria set out in EIC-60, *Liability Recognition for Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring)*, including the application of all conditions relevant to determining a “commitment date” for an exit plan.

The OSC also noted that in cases where financial statements contain a reconciliation to US GAAP, and the treatment of a reconciling item for which the fundamental principles are similar in both Canada and the US, but for which more specific guidance is available

under US GAAP, it may question why the additional US literature was not considered in determining the appropriate application of Canadian principles.

Although the regulators' staff provides direction to issuers and their financial advisors on issues related to disclosure and financial reporting, the Accounting Communiqués do not address possible changes to the regulatory disclosure and financial reporting regime in Canadian capital markets. In particular, there is now considerable public debate about the adequacy of GAAP and GAAS in the public marketplace. Our cautious thoughts follow. The profession, the regulators and the legislators must address these fundamental changes.

IV. DOES THE CANADIAN SYSTEM NEED TO BE REFORMED?

Current events suggest that our financial and related disclosure systems need to be strengthened. Even before Enron, there were a number of high profile securities cases that had the affect of reducing the investing public's confidence in the capital markets. These included Sunbeam and Cendant in the United States and Livent and YBM Magnex in Canada.

David Smith, the President of the Canadian Institute of Chartered Accountants ("CICA"), has recently suggested that the accounting profession is already in consultation with regulators and will soon present new proposals to establish an independent body that will provide a more rigorous review of the firms that perform the vast majority of public company audits. What such a body will look like, and what they will do, is still to be determined.

Harvey L. Pitt, the Chairman of the SEC, has suggested that a similar body be created in the United States that would regulate the auditing function and enhance the oversight of the auditing profession. The regulatory body would be independent of the accounting profession, and would have two primary components: discipline and quality control. The SEC would have oversight over the regulatory body and it would be empowered to perform investigations, bring discipline proceedings, publicize results, and restrict individuals and firms from auditing public companies.

The compliance duties of such an organization would require the establishment of a permanent quality control staff consisting of knowledgeable people who are not affiliated with any accounting firm. This staff would be responsible for conducting periodic auditing of the quality and competence of the accounting firms.

The enforcement duties of any new organization would likely be similar to those of the Institute and the Council. We hope, however, that it would also be more proactive and thereby reduce the chances that the CSA members would begin an enforcement programme.

Currently, when auditors become the focus of disciplinary proceeding on issues related to improper financial disclosure and reporting as the result of one of their clients having a Notice of Hearing publicly issued by a provincial securities commission, the Institute or Council often treats the Notice of Hearing as a complaint against the accountant. If a new Canadian independent body was to be structured along the lines suggested by Harvey Pitt, with some appellate oversight by the provincial securities regulators (like the IDA), disciplinary proceedings would likely be investigated and conducted in parallel

with the any securities commission proceeding. We question, however, whether this duality would be fair to shareholders who, at the end of the day, are the real victims of poor disclosure practices.

The US proposal also included a component to oversee accounting standards. Canada is ahead of the United States in this area, as the Accounting Standards Oversight Council (“AcSOC”) was formed as an independent body two years ago to oversee accounting standards setting. AsSOC includes members from both inside and outside the accounting profession who have an oversight role in the development of accounting standards in Canada.

In addition to creating an independent body to oversee the audit function, we believe that the CICA and regulators also need to address what improvements may be required to improve the financial reporting process. The target goals of attacking the concerns for financial reporting suggested by participants in the recent *SEC Roundtable Discussion on Financial Disclosure and Auditor Oversight* were: (i) timeliness of information to the marketplace and (ii) the transparency of that information.

A. Timeliness

With public investors now having increased access to market information, they are also seeking real time-disclosure. In order to achieve more timely disclosure, the OSC will likely have to change its rules to advance the filing dates of issuer’s disclosures, such as their quarterly and annual reports.

One effect of such a reform on public accountants would be that they would be expected to analyze and present this information on an accelerated time basis. As the process becomes more time sensitive, auditors will face increased regulatory pressures. All stakeholders must be mindful that reflective presentation may not occur and the audit committees' participation may not be as complete as it ought to be if the information must be delivered on an accelerated basis.

B. Transparency of Information

The current system of financial reporting depends on several component parts for adequate dissemination and disclosure of substantive information. It depends on the GAAP process being applied to a set of financial statements prepared by management, management's discussion and analysis associated with those financial statements, and compliance with the rules set out in securities legislation.

The current system of financial reporting does not provide any standards that define or mandate reporting transparency in press releases or pro forma financial information. Pro forma financial information has not always been consistently presented. However, public companies use these disclosures to communicate what they believe to be operating realities and at certain times to put the best spin they can on a tough quarter or quarters. Auditors currently have no responsibility for reporting on these disclosures. However, having an auditor confirm that these documents present at least a fair picture of a company's financial situation may become part of the financial disclosure and reporting system in the future.

Another area where the issue of transparency arises is in the presentation of financial statements and management's discussion and analysis. The complex legalese and accountingese with which these materials are written have the affect of reducing transparency in financial reporting. Although there have been initiatives to convert prospectus language to plain English, lawyers and accountants alike have struggled with these concepts. An effort has begun to produce clearer and more intelligible language in those documents. However, both the legal and accounting professions must continue with their efforts to provide clearer and more intelligible disclosures in those documents.

Another issue that the accounting profession and the regulators need to be mindful of in their effort to make financial reporting more transparent is the danger of Canadian accountings standards becoming too rule-specific. Canada has a largely “principles-based” system of accounting standards compared to the United States, which relies more on a set of detailed and prescriptive rules. The principles-based approach requires public accountants in Canada to exercise considerable professional judgment in applying those principles. However, Canada is seeing more rules-based accounting standards with the convergence of North American business. Bill MacKinnon, Chairman and Chief Executive of KPMG LLP, suggested in a speech to the Empire Club of Canada on April 18, 2002, that Canada must preserve and enhance its principles-based approach, but it must also be careful not to create accounting standards that disadvantage Canadian companies in U.S. capital markets.

V. REGULATORY ISSUES FOR ACCOUNTANTS

A. Criminal Code

The most likely form of criminal liability for public accountants in Canada has traditionally fallen under the heads of fraud or misappropriation of funds. However, the Enron case in the United States has highlighted the possibility that accountants could face obstruction of justice charges for following their own firm's document retention policy. David Duncan, the former Arthur Andersen partner, plead guilty to obstruction of justice charges in April 2002 and testified in the criminal case against Arthur Andersen in May 2002. David Duncan testified: "I obstructed justice, I instructed people on the team to follow the document retention policy, which I know would result in the destruction of documents."

It might be inferred that the U.S. rules-based approach to the practice of accounting contributed to the behavior of the individuals involved in the destruction of documents at Arthur Andersen. However, that attitude would forsake the opportunity presented to the accounting profession in Canada to re-examine their policies and business practices to ensure that they are not contrary to Canadian laws or regulations. The accounting profession has a duty to the public and their employees to ensure that these issues are fairly and adequately addressed.

B. Regulatory

As was stated previously, the primary authority to discipline public accountants is in the hands of the Council and the Institute.

The Institute acts as an SRO for Chartered Accountants in Ontario. One responsibility of the Institute is to coordinate the qualification process, which is made up of education and examination requirements and supervised practical experience of accounting students. The Institute is also responsible for enforcing its own *Rules of Professional Conduct*, which includes investigating all complaints received about Institute members and students, as well as any other matter drawn to its attention that may indicate professional misconduct, and conducting formal hearings of all charges of professional misconduct. The Institute also conducts appeals from the finding of the discipline committee.

The rules that are specific to audits in the field of securities regulation are *Rule 206.1 – Expressing an Opinion Without Complying with Generally Accepted Auditing Standards* (“GAAS”) and *Rule 204.1 – Objectivity: Audit Engagements*. The penalties for failing to comply with these rules include written reprimands, orders that the member pay the costs of the prosecution, providing notice to the Council, the CICA and various publication in Canada, and suspension of membership.

The Council has a similar role to the Institute. The Council acts as the government’s regulator in respect of all public accountants in Ontario. As such, the Council has overlapping authority with the Institute. The Council has the power to revoke the licence of a public accountant on a number of grounds under section 18(1) of the *Public Accountancy Act*, as set out below:

Powers as to revocation of licence

18. (1) If a person licensed under this Act,
- (a) has been convicted of a criminal offence;

- (b) becomes of unsound mind;
- (c) has been adjudged bankrupt or has made arrangement with his or her creditors; or
- (d) has been found on inquiry held by the Council to be guilty of conduct disgraceful to the person in his or her capacity as a public accountant,

the Council may, subject to the provisions of this section, revoke the person's licence.

The *Public Accountancy Act* also provides for a number of quasi-criminal offences that affect licenced individuals and a number of offences that affect individuals who are carrying on an unauthorized practice. The offences under the *Public Accountancy Act* that relate to licenced individuals include obtaining a licence by false representation, failure to surrender a licence when revoked, and allowing a licence issued by the Council to be used by another person.

Currently, the OSC has little direct authority to discipline accountants for conduct failing to comply with GAAP and securities laws. However, the stock exchanges, the SROs, and the OSC all have the power to exclude accountants from acting as auditors for their members or registrants. This power will likely be used more widely, if a new regulatory body is established to oversee public accountants.

VI. CONCLUSION

Canadian capital markets are some of the most liquid in the world. They are not necessarily the most respected. Respect occurs when investors believe that our markets operate fairly. And for our markets to operate fairly, the disclosure and financial

reporting system must be timely and complete. Public accountants play an important role in this process of financial reporting and ensuring that the public receives fair financial disclosure from the participants in the capital markets.

The unfortunate events that have occurred in the capital markets over the past few years have provided a catalyst for the accounting profession and the regulators to strengthen Canada's system of financial disclosure and reporting. Hopefully, with the participation of the accounting profession, it is possible that the rules and regulations that make the Canadian capital markets efficient will eventually evolve to produce a system that will ensure that our markets are seen as fair and honest.

To some extent, however, we agree with Domenic D'Alessandro, but also with Don Quixote (Miguel de Cervantes): "The proof of the pudding is the eating".