Sarbanes-Oxley Act of 2002 and the Implications for Investigative and Forensic Accountants

Research Project for Emerging Issues/Advanced Topics Course

Diploma in Investigative and Forensic Accounting Program

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1. Introduction and Objectives

On July 30, 2002, the Sarbanes-Oxley Act ("SOX" or the "Act") was passed as a result of a number of corporate failures and frauds and the resulting loss of confidence in the American financial system. Amongst other reasons SOX was quickly enacted in an effort to restore investor confidence by raising the standards of corporate accountability and by punishing financial fraudsters.

An understanding of the Sarbanes-Oxley Act is essential for Investigative and Forensic Accountants ("IFA's") as the Act provides IFA's with a number of tools that can help fight fraud in the corporate board rooms. IFA's should be aware of the particulars found in the Act and its related rules, as it is likely that they are 'top of mind' or 'stay awake' issues for many corporate executives to whom IFA's either report to or have the potential of being engaged by. Furthermore, the rules and regulations of the Act continue to be proposed, finalized, and clarified by the SEC, as such, it is expected that both current and future IFA's, and the forensic accounting profession itself, will be impacted by the rules found in SOX.

As the Sarbanes-Oxely Act is a U.S. Act, it will likely have the biggest impact on American IFA's. For two reasons, however, it is expected that the Act will also have implications for Canadian IFA's. First, there are a number of U.S. subsidiaries based in Canada as well as there are a number of Canadian based companies that are SEC registrants, both of which are directly affected by SOX. Second, as will be discussed throughout this report, there are a number of Canadian corporate governance rules either under consideration or announced but not yet finalized, as such, it is possible that rules similar to SOX will be introduced in Canada.

This report will provide general details on what SOX is and what led up to its enactment in 2002. This report will then outline in sufficient detail the various sections of SOX that relate to IFA's and provide details regarding the corresponding rules found in Canada. Finally, this report will discuss the implications for forensic accountants and the forensic

accounting profession, both in the United States and in Canada as a result of the Sarbanes-Oxley Act.

In this report, unless otherwise noted, IFA's are referred to in general regardless of whether they are employed by, or partners in, public accounting firms, or whether they are employed by companies, regulators or prosecutors. Furthermore, as a typical IFA's 'skill set' is referred to throughout this report, Appendix A provides details related to the skills that an IFA is typically required to have.

2. The Sarbanes-Oxley Act

Enron's collapse was the first of many publicized corporate fraud cases in the United States that led to the U.S. Congress taking another look at corporate reform. The list of companies is long and includes many well-known U.S. companies including Adelphia Communications, WolrdCom Inc., AOL, K-Mart, Xerox, Qwest, ImClone, Dynergy, Global Crossing, Pergrine, and Tyco to name only a few. The list not only included corporations, but also brokerage firms, such as Merrill Lynch, and an accounting firm, Arthur Andersen.

With investors losing money as a result of a falling stock market, with daily revelations of corporate fraud and corporate scandals and indiscretions, the government realized that something had to be done to restore confidence in the marketplace. As a result, the U.S. Congress became involved and the 'Public Company Accounting Reform and Investor Protection Act' (also called the Sarbanes-Oxley Act) was passed on July 25, 2002, and signed into law by President Bush on July 30, 2002.

The Sarbanes-Oxley Act is named for its congressional sponsors, Sen. Paul Sarbanes and Rep. Michael Oxley. Quoting Sarbanes before the U.S. Congress passed the Act, "The problems originally laid bare by the collapse of Enron are by no means unique to one company, one industry, or even one profession...something needs to be done to restore confidence in the world's greatest marketplace".[1] It is not to say that legislation such as the Sarbanes-Oxley Act will make fraud a thing of the past. "However, investors do have the right to expect the system of publicly traded equities to weather the inevitable 'feast or famine' business cycles without major companies collapsing as a result of the failure of diligence, ethics, integrity, controls and transparency".[2]

[1] Martin T. Biegelman, "Sarbanes-Oxley Act – Stopping U.S. Corporate Crooks from Cooking the Books", The White Paper, Vol. 17, No.2, March/April 2003: 32.
[2] Maureen J. Sabi and James L. Goodfellow, *Integrity in the Spotlight: Opportunities for Audit Committees* (Canada: Canadian Institute of Chartered Accountants, 2002), 1.

SARBANES-OXLEY ACT AND THE IMPLICATIONS FOR IFA'S

SOX has been called by some the most comprehensive securities reform since the introduction of *Securities Act* of 1933 and the *Securities Exchange Act* of 1934. In fact, some of the reasons why Congress acted in 1930's are very similar to some of the reasons why Congress acted in 2002, over seventy years later, in introducing SOX. During the 1920's a large number of investors took advantage of postwar prosperity and invested in the stock market. However, as a result of the 1929 stock market crash many investors lost a great deal of money, "it is estimated that of the $50 billion in new securities offered during this period, half became worthless."[3] As a result, in an effort to restore public's faith in the capital markets, Congress held hearings that resulted in the introduction of the *Securities Act* and the *Securities Exchange Act* and the creation of the Securities Exchange Commission ("SEC") itself.

The passing of the Sarbanes-Oxley Act is significant, as previous efforts to curb corporate fraud and introduce accounting reform languished in Congress because of opposition from the accounting industry and politicians. For example, in 2000, the then Chairman of the SEC Arthur Levitt attempted to introduce rules barring auditors from performing non-audit services. However, the proposal was "...defeated by sustained lobbying by the accounting profession, represented by Mr. Pitt, then a securities lawyer, and, ironically, supported by Congress".[4] When Mr. Levitt conceded that he would not be able to force auditors to give up non-audit work in 2000, he and the auditors struck a compromise: they would have to disclose what they were paid for audit and non-audit work.

Although SOX became law on July 30, 2002, a number of the Act's provisions did not become effective immediately as the Act requires the SEC to adopt implementing rules. Most of the key reforms contemplated by the Act are now currently effective, with the remaining reforms to become effective in 2004 or 2005. In terms of applicability to Canadian companies, "...most of the SOX requirements apply to Canadian companies

[3] SEC, "The Investor's Advocate: How the SEC Protects Investors and Maintains Market Integrity", <www.sec.gov/about/whatwedo.shtml#create> (June 15, 2003).
[4] Economist Global Agenda, "Setting the Rules", The Economist, January 24, 2003, <www.economist.com/agenda/PrinterFriendly.cfm?Story_ID=1548541> (May 19, 2003).

that have securities listed on the NASDAQ, the New York Stock Exchange, or another U.S. stock exchange and to other Canadian companies that are subject to U.S. periodic reporting requirements because they have previously made registered offerings of debt or equity securities in the United States".[5]

As quoted from the Act itself the principal goal of SOX is "To protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes".[6] Other goals of the SOX include:

- Restoring trust and confidence in the public securities market and restoring trust in those individuals who run the public companies.
- Enhance transparency and completeness of financial statements and disclosures.
- Holding company management accountable for material information that is filed with the SEC and released to investors.
- To raise the standards of corporate accountability and punish financial fraudsters.

SOX impacts a great number of individuals including, corporate executives, company officers and directors, audit committees, accountants, auditors, lawyers, regulators, federal prosecutors, stock analysts and most importantly, employees, pension holders and investors. SOX is comprised of eleven titles covering the Public Company Oversight Board, auditor independence, corporate responsibility, enhanced financial disclosures, and analyst conflicts of interest. It also includes the Corporate and Criminal Fraud Accountability Act, the White-Collar Crime Penalty Enhancements Act of 2002 and the Corporate Fraud Accountability Act of 2002.

[5] Robert Lando and Francois Janson, "Canadian Companies Listed in the U.S. Must Act Immediately to Comply with New Investor Protection Legislation", Osler Updates, February 20, 2003, http://www.osler.com/index.asp?menuid=86&miid=344&layid=124&csid=3033&csid1=1170> (May 24, 2003).

[6] *Sarbanes-Oxley Act*

3. Sarbanes-Oxley Act and The Canadian Response

In order to fully explore the implications of SOX for IFA's, what is included in the Act should be sufficiently understood. As such, the following section details in general the rules related to SOX. The information found in this section is not intended, however, to be a complete guide of all of the rules found in SOX, rather, it is intended to provide information about those sections of the Act that may relate to IFA's. Therefore, only those sections of the Act that may have an impact on IFA's are detailed in this section. Finally, for each section of the Act the related Canadian response has been provided.

3.1 SOX Title I – Public Company Accounting Oversight Board

The Act creates an independent Public Company Accounting Oversight Board ("PCAOB"), a private, non-profit corporation, to oversee the audit of public companies that are subject to securities laws. "Audit means an examination of the financial statements of any issuer by an independent public accounting firm in accordance with the rules of the PCAOB or the SEC, for the purposes of expressing an opinion on such statements".[7] The Act requires that the PCOAB consist of five members, none of which can currently be connected with any public accounting firm, two of which must be or have been Certified Public Accountants ("CPA"), the remaining three must not be and cannot have been CPA's. Fees collected by public companies will principally fund the PCAOB.

The PCAOB will oversee the accounting industry, subject to supervision by the SEC, through a number of actions including, but not limited to:

- Establishing or adopting, or both, by rule, auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports for issuers.
- Registering public accounting firms that prepare audit reports for issuers.
- Conducting inspections of public accounting firms.

[7] Biegelman, 45.

- Conducting investigations and disciplinary proceedings imposing sanctions upon public accounting firms.

Of particular importance is that the PCAOB is independent of the American Institute of Certified Public Accountants ("AICPA"). The AICPA, a national organization for Certified Public Accountants, was the body that had previously been responsible for the setting of standards for auditors of public and private companies and for performing peer reviews for public accounting firms. As a result, in the United States it can no longer be said that the CPA's are responsible for monitoring, and setting the standards for, accountants and the accounting profession.

Note that the creation of the PCAOB will not impact the role of the Financial Accounting Standards Board ("FASB"), an independent privately run organization, which remains responsible for the setting of accounting rules (i.e. how companies can record income). On May 1, 2003 the SEC announced that FASB's financial and reporting standards are recognized as 'generally accepted' for the purposes of the federal securities laws and, as a result, public companies are required to continue to comply with those standards in preparing financial statements filed with the SEC.[8]

Of importance to Canadian public accounting firms, the Act requires foreign accounting firms who audit a U.S. company to register with the PCAOB and thereby be subject to inspections (SOX s. 106). This would include foreign firms that perform some audit work, such as a Canadian subsidiary of a U.S. company that is relied upon by the primary auditor in the U.S.

Canadian Response

[8] FedNet Government News, "Securities and Exchange Commission Statement of Policy Reaffirming the Status of FASB as a Designated Private-Sector Standard Setter", May 1, 2003.

Canadian Public Accountability Board ("CPAB")

On July 17, 2002, the Canadian Institute of Chartered Accountants ("CICA"), the Canadian Securities Administrators ("CSA"), and the Office of the Superintendent of Financial Institutions ("OSFI") created the CPAB.[9] Under the terms of the CPAB, accounting firms auditing public companies will subject themselves to a number of new requirements including:

- More rigorous inspection.
- Tougher auditor independence rules.
- New quality control requirements.

Similar to the PCAOB, the CPAB is not controlled by the accounting profession (i.e. the CICA), as the CPAB will be made up of eleven individuals, including seven from outside the CA profession. A newly created National Inspection Unit ("NIU") will carry out the inspections of the public accounting firms and will forward their inspection reports to the CPAB. An independent NIU is a change from the past in which the provincial CA Institutes were responsible for carrying out practice inspections.

Auditing Standards Oversight Council ("ASOC")

In Canada, unlike in the United States, the setting of auditing standards remains within the control of the accounting profession (i.e. the CICA), namely the Assurance Standards Board ("ASB"). In October 2002, however, the CICA created an independent body, the ASOC, to oversee the activities of the ASB. The ASOC will have between nine and twelve members, a majority of whom are not Chartered Accountants. The responsibilities of the ASOC will include[10]:

[9] CPAB Media Release, "New independent public oversight for auditors of public companies announced by Federal and Provincial regulators and Canada's Chartered Accountants", CPAB, July 17, 2002 < http://www.cpab-ccrc.ca/-/pdf/1%20Press%20Release.pdf> (May 5, 2003).

[10] CICA Media Release, "New Independent public body established to oversee Canadian auditing standards", CICA, October 24, 2002 < http://www.cica.ca/index.cfm/ci_id/9906/la_id/1.htm> (April 15, 2003).

- Providing input into the activities of the ASB, primarily in terms of its strategic direction and priorities.
- Being satisfied that the standard setting process is appropriate and responsive to the public interest.
- Overseeing the activities of the ASB, including monitoring and evaluating its performance, the fulfillment of its responsibilities, accomplishment of its work program and the use and adequacy of its resources.
- Reporting publicly on its and the ASB's activities at least annually.

3.2 SOX Title II – Auditor Independence

The Act promotes auditor independence by prohibiting an auditor from providing a number of non-audit services when performing an audit for a public company audit client. The Act lists nine prohibited services including expert services unrelated to the audit. The list of nine prohibited services are largely based on three basic principles, violations of which would impair the auditor's independence[11]:

1. An auditor cannot audit his or her own work.
2. An auditor cannot function in the role of management.
3. An auditor cannot serve in an advocacy role for his or her own client.

According to the Act the accounting firm can perform non-audit services, including tax services that are not described above, only if the audit committee of the issuer approves the activity in advance[12]. The SEC elaborated on what they meant to be expert services and focused on third principle detailed above, namely that an auditor cannot serve in an advocacy role for his or her own client, "...the rules we are adopting prohibit an accountant from providing expert opinions or other services to an audit client, or a legal representative of an audit client, for the purpose of advocating that audit client's interests

[11] SEC, "Final Rule: Strengthening the Commission's Requirements regarding auditor independence", January 28, 2003 < http://www.sec.gov/rules/final/33-8183.htm> (April 20, 2003).
[12] The Act describes an "Issuer" as an issuer of securities (as defined in Section 3 of the *Securities Exchange Act* of 1934) whose securities are registered under the *Securities Exchange Act*, the company, or the firm.

in litigation or regulatory, or administrative investigations or proceedings"[13]. The SEC further elaborated that forensic accountants are not always in a position of advocacy when performing forensic engagements, and as such, IFA's are not prohibited from performing all engagements for their firms' public attest clients.

The SEC indicated that the "...rules do not, however, preclude an audit committee or, at its direction, its legal counsel, from engaging the accountant to perform internal investigations or fact finding engagements. These types of engagements may include, among others, forensic or other fact-finding work that results in the issuance of a report to the audit client".[14] However, if subsequent to the completion of the engagement, should litigation arise or an investigation or regulatory proceeding begins, the IFA would not be able to provide additional services, other than providing factual accounts or testimony about the work performed, as this would result in the IFA becoming an advocate for his client.

Therefore, although the SEC was not explicit in detailing the exact situations where forensic accountants are prohibited from performing engagements for their firms public attest clients, it appears that if the engagement is as a result of litigation or an investigation or regulatory proceeding the forensic accountant would be prohibited from performing any services for their public attest clients.

Canadian Response

Auditor Independence

The CICA issued an exposure draft in September 2002 regarding independence standards that would apply to Canadian auditors and other assurance providers. Whereas the U.S. independence rules apply only to a public accounting firms public audit clients, the Canadian rules would apply to a public accounting firms public and private clients and

[13] SEC, "Final Rule: Auditor Independence", January 28, 2003.
[14] SEC, "Final Rule: Auditor Independence", January 28, 2003.

for both audit and review engagements. The exposure draft provides a combination of rules prohibiting certain non-assurance services and principles by which public accountants can determine whether there is a threat to independence if a service is to be provided. The CICA has announced that it plans to finalize the independence standards in 2003 to be effective for assurance engagements commencing after December 31, 2003.[15]

Unlike the rules found in SOX, the Canadian list of prohibited non-assurance services found in the exposure draft does not include expert services related to forensic accounting. However, in finalizing the independence rules, the CICA is reviewing the revised SEC regulations that were released in January 2003 (i.e. the 'Final Rules' issued by the SEC). As such it is expected that expert services related to forensic accounting will be included in the CICA's final independence standards as the CICA has announced that "...it would be desirable to incorporate the revised SEC regulations to protect the public interest in Canada and achieve convergence with the U.S. requirements for listed entities".[16]

Notwithstanding any changes to the final independence standards to be issued by the CICA, the independence standards exposure draft provides for a number of 'threats' that may result in the public accountant not being independent from their client. Two of the threats relate to forensic accountants:

1. Advocacy threat, which occurs when a practitioner promotes a client's position or opinion. An example provided in the exposure draft relates to when an accountant "...acts as an advocate on behalf of an assurance client in litigation or resolving disputes with third parties".[17]
2. Self-review threat, which occurs when a practitioner provides assurance on his or her own work. An example provided in the exposure draft relates to when an

[15] CICA, "Independence Standards Status Update January 31, 2003", http://www.cica.ca/index.cfm/ci_id/10600/la_id/1.htm (April 28, 2003).
[16] CICA, "Independence Standards Status Update March 18, 2003", http://www.cica.ca/index.cfm/ci_id/10600/la_id/1.htm (April 28, 2003).
[17] CICA, "Independence Standards Exposure Draft", September 2002 http://www.cica.ca/multimedia/Download_Library/Public_Interest/Independence.pdf (April 28, 2002), p 22.

> accountant "...provides to an audit or review client litigation support services that include the estimation of the possible outcome of a dispute or litigation and thereby affects the amounts or disclosures to be reflected in the clients financial statements".[18]

The Exposure Draft indicates that if the public accounting firm identifies a 'threat', then the firm is required to apply safeguards to eliminate the 'threats' or take action to reduce the 'threat' to a level that would pose no real or perceived compromise. Safeguards suggested in the Exposure Draft range from using a member of the firm who is not a member of the audit engagement team to perform the service to declining the engagement entirely.

Audit Committee Pre-Approval of Non-Audit Services

Audit committee pre-approval of non-audit services is not addressed in the CICA independence standards exposure draft as only the securities regulators or stock exchanges have authority to provide direction to audit committees.[19] It appears, however, that the rules for pre-approval of non-audit services by the audit committee will be the same in Ontario as those found in the U.S. as a result of SOX. The Ontario Securities Commission ("OSC") intends to introduce on June 27, 2003 three new rules for comment regarding corporate governance.[20] One of the rules relates to the role and the composition of audit committees. Specifically, that the audit committee must be responsible for pre-approving all non-audit services to be provided by external auditors. It is proposed that these rules would apply to those companies listed on the Toronto Stock Exchange (i.e. TSX).

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[18] CICA, "Independence Standards Exposure Draft", p 54.
[19] KPMG, "Comparison of US and Canadian Regulatory Changes", <http://www.kpmg.ca/english/services/docs/assurance/US_CDN%20Regulatory.pdf> 2003 (April 30, 2003).
[20] OSC, "Giving Investors Reason for Confidence: A Robust Response to the Financial Reporting Scandals, Remarks by David Brown, Chair, Ontario Securities Commission, at the Board of Trade", May 23, 2003 http://www.osc.gov.on.ca/en/About/News/Speeches/spch_20030523_investor-confidence.htm (May 24, 2003).

The ability for the OSC to introduce the new rules is as a result of the Government of the Province of Ontario announcing that certain of the *Ontario Securities Act* amendments will come into force on April 7, 2003.[21] One of the amendments empowers the OSC to make rules prescribing requirements relating to the functioning and responsibilities of audit committees.

Other Canadian Responses

To date, the response by the other Provincial regulators has not been finalized. Whereas the SEC presides over securities laws at the federal level in the U.S., some 13 provincial commissions oversee market regulation in Canada. The Canadian Securities Administrator ("CSA") assists in bringing the country's provincial regulators together on streamlining securities laws, however, it is only an umbrella organization, and as such, does not have any rule-making authority. It is likely that the other Provincial regulators, except for British Columbia, will introduce rules similar to the ones that are to be announced by the OSC on June 27, 2003.[22] The Provincial regulator from British Columbia has announced that they are not going to adopt the OSC rules as they intend to introduce a more 'principles' based approach.

From a Canadian federal perspective, the federal government is also proposing amendments to the Canada Business Corporations Act to impose higher corporate governance standards on CBCA companies.[23] For example, "...they are considering imposing through the CBCA mandatory requirements for the composition and duties of Board of Directors and audit committees plus mandating CEO and CFO certification of financial disclosure".[24] In an effort not to add an extra layer of regulatory burden on public companies through the CBCA, David Brown, OSC Chair, has indicated that if

[21] The amendments to the *Ontario Securities Act* are part of an omnibus Bill 198, *Keeping the Promise of a Strong Economy (Budget Measures), 2002,* that was passed by Ontario's provincial legislature in 2002.
[22] Peter Kennedy, "Regulators split over rule changes B.C. securities watchdog criticized for advocating 'principles based' system", *The Globe and Mail*, May 29, 2003, Metro B14.
[23] The CBCA is applicable to Canadian companies who are federally incorporated.
[24] OSC, "Law Society of Upper Canada, Program on Bill 198, Keynote Address, David Brown, Chair, OSC", March 19, 2003 < http://www.osc.gov.on.ca/en/About/News/Speeches/spch_20030319_bill-198_txt.htm> (May 2, 2003).

companies comply with the proposed OSC rules then they would be deemed to be in compliance with any changes to federal legislation.[25]

Finally, in November 2002, the Toronto Stock Exchange ("TSX") proposed revisions to the its TSX Company Manual that would affect its listed issuers. The proposed TSX Company Manual includes recommendations that the audit committee charter, among other things, set out the role and oversight responsibility to engage, evaluate, remunerate and terminate the external auditor and funding for the auditor and any other advisors.[26]

3.3 SOX Title III – Corporate Responsibility

Corporate Responsibility – Audit Committees (SOX s. 301)

As a result of the Act the Audit Committee's of public companies will be playing a larger role related the companies corporate governance. Under the Act the following relate to the Audit Committee[27]:

1. The Audit Committee must be directly responsible for appointing, compensating, retaining and overseeing the work of the outside auditors, as well as, pre-approving the non-audit services as detailed above. Furthermore, the accounting firm must report directly to the Audit Committee.
2. The Audit Committee must set up procedures for complaints about accounting, internal accounting controls, or auditing matters. The procedures must allow for an employee to complain in a confidential, anonymous manner.
3. The Audit Committee must be in charge of hiring the outside lawyers and other advisors it needs to carry out its duties.
4. Companies must supply 'appropriate' funding for the Audit Committee.

[25] OSC, "Law Society of Upper Canada, Program on Bill 198, David Brown", March 19, 2003.
[26] KPMG, "Comparison of US and Canadian Regulatory Changes".
[27] David M. Katz, "SEC Unveils Audit Committee Rules", April 3, 2003 <http://www.cfo.com/printarticle/0,5317,9142,00.html> (April 18, 2003).

Corporate Responsibility for Financial Reports (SOX s. 302)

The Act requires a public company's Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO") to personally certify the financial and other information contained in the quarterly and annual reports. Furthermore, the CEO and CFO must certify that they:

- Are responsible for establishing, maintaining and regularly evaluating the effectiveness of the issuer's disclosure controls and procedures.[28]
- Have evaluated the effectiveness of the company's disclosure controls and procedures as of a date within 90 days prior to the filing date of the report and included in the report their conclusions related thereto.

The Act also requires that the CEO and CFO must also disclose to the company's auditors and audit committee:

- All significant deficiencies in the design and operation of internal controls that could aversely affect the company's ability to record, process, summarize, and report financial data and have identified for the company's auditors any material weakness in internal controls.
- Any fraud, whether or not material, that involves management or other employees who have a significant role in the company's internal controls.

As part of SOX s. 302, the SEC also requires that requires the CEO and CFO to certify that they are responsible for establishing, maintaining and regularly evaluating the effectiveness of the issuer's internal controls for financial reporting.[29]

[28] The SEC defined disclosure controls in its Final Rule 33-8124, effective August 29, 2002, as those controls designed to ensure that information required to be disclosed by a company in the reports filed by it is recorded, processed, summarized, and reported within the time periods specified by the SEC. They include controls and procedures to help ensure that the required disclosed information is accumulated and communicated to executive management to allow timely decisions regarding required disclosure.

[29] SEC subsequently defined internal controls and procedures for financial reporting to mean a process designed by, or under the supervision of, senior executives to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

Disgorgement of Certain Bonuses and Profits (SOX s. 304)

The Act requires that if a company is required to restate its financial statement as a result of the misconduct, the CEO and the CFO must reimburse the company for:

1. Any bonuses or other compensation received during the twelve-month period following the first public issuance or filing with the SEC of the financial document.
2. Any profits realized from the sale of securities of the company during that twelve-month period.

Canadian Response

Corporate Responsibility – Audit Committees

The rules that the OSC intends to introduce on June 27, 2003 relating to the role and the composition of audit committees as detailed above is similar to the rules found in SOX s. 301. Specifically, the rules proposed by the OSC will require that each audit committee must be responsible for recommending to the board of directors the external auditors to be nominated for the purpose of preparing or issuing an audit report (and any related work), as well as the compensation to be paid to such auditors. Furthermore, the audit committee will be responsible for overseeing the work of external auditors engaged for the purpose of preparing or issuing an audit report and related work.[30]

In comparing the OSC's response to the U.S. rules, of note there is no specific requirement in Ontario for the audit committee to set up procedures for complaints about accounting, internal accounting controls, or auditing matters in an anonymous manner.

As detailed in the section 4.2 of this report, the proposed revisions to the TSX Company Manual includes recommendations that the audit committee charter, among other things, set out the role and oversight responsibility to engage, evaluate, remunerate and terminate

[30] OSC, "Giving Investors Reason for Confidence: Remarks by David Brown", May 23, 2003.

the external auditor and funding for the auditor and any other advisors. Furthermore, it recommends that the audit committee establish procedures to receive and handle complaints about accounting or audit matters.

Corporate Responsibility for Financial Reports

Another rule that the OSC intends to introduce on June 27, 2003 relates to the CEO and CFO certification of annual and interim disclosures and are similar to the rules found in SOX s. 302.[31] Specifically, the CEO and CFO of all Canadian public companies will have to personally certify that based on their knowledge:

- Their issuer's annual and interim filings do not contain a misrepresentation.
- Their issuer's annual and interim financial statements fairly present the financial condition of the issuer.

Furthermore, the proposed OSC rules will require the CEO and CFO to certify that they have reasonable internal controls in place, and the rule will specify that they must evaluate the effectiveness of these controls and disclose any deficiencies to the firm's audit committee and auditors.

In comparing the OSC response to the U.S. rules, of note the OSC rules do not differentiate between disclosure controls and internal controls and procedures for financial reporting. Furthermore, the OSC has not defined what are 'reasonable' internal controls, "...rather it will be left to the judgment of the issuer's CEO and CFO to ensure that adequate controls are in place".[32] At this time the OSC has not defined reasonable internal controls even though the Bill 198 empowers the OSC to make rules defining auditing standards for reporting on internal controls. Furthermore, the OSC's rules do not have the same requirement as found in SOX s. 302 that the CEO and CFO must disclose to the company's auditors and audit committee any fraud, whether or not material, that involves management or other employees who have a significant role in the

[31] OSC, "Giving Investors Reason for Confidence: Remarks by David Brown", May 23, 2003.
[32] OSC, "Giving Investors Reason for Confidence: Remarks by David Brown", May 23, 2003.

company's internal control.[33] It is possible that rules defining auditing standards and the requirement for the CEO and CFO to disclose any fraud to the company's auditors and audit committee will be included when the OSC rules are released for comment on June 27, 2003.

Disgorgement of Certain Bonuses and Profits

Bill 198 gives the OSC power to order a person or company to disgorge amounts obtained as a result of non-compliance with Ontario securities law.[34] The authority to order disgorgement is a first for a Canadian securities regulator. Currently, the OSC does not have guidelines as to how the profit will be determined or how the disgorgement will work in practice.[35]

3.4 SOX Title IV – Enhanced Financial Disclosures

Management Assessment of Internal Controls (SOX s. 404)

Each annual report issued by a company must contain[36]:

1. A statement of management's responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting.
2. Management's assessment, as of the end of the company's most recent fiscal year, of the effectiveness of the company's internal control structure and procedures for financial reporting. Management will have to disclose any material weaknesses.

Furthermore, the company's external auditor will be required to attest to, and report on management's assessment of the effectiveness of the company's internal controls and

[33] Although there is a requirement per CICA Handbook s. 5135 for auditors to discuss with management whether they are aware of any fraud or suspected fraud.
[34] Scott Bell, "Securities Act Amendments Coming into Force on April 7, 2003", *Mondaq Business Briefing*, April 7, 2003.
[35] OSC, "Law Society of Upper Canada, Program on Bill 198, David Brown", March 19, 2003.
[36] SEC, "SEC Implements Internal Control Provisions of Sarbanes-Oxely Act; Adopts Investment Company R&D Safe Harbour", May 27, 2003 <http://www.sec.gov/news/press/2003-66.htm>, (June 1, 2003).

procedures for financial reporting in accordance with standards established by the PCAOB.

The SEC has provided additional guidance regarding the definition of internal controls and procedures for financial reporting beyond what is detailed in footnote 29 to include policies and procedures that[37]:

- Pertain to the maintenance of records that accurately and fairly reflect the transactions and dispositions of the assets of the company.
- Provide reasonable assurance that receipts and expenditures of the registrant are being made only in accordance with authorizations of management and directors of the company.
- Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements.

The SEC will also require companies to perform quarterly evaluations of changes that have materially affected or are reasonably likely to materially affect the company's internal control over financial reporting. For large companies, Section 404 rules will be required to be complied with for fiscal years ending on or after June 2004. For all other issuers, the rules will be required to be complied with for fiscal years ending on or after April 15, 2005.

Code of Ethics for Senior Financial Officers (SOX s. 406)

The Act requires a company to disclose whether or not (and if not, why not) it has adopted a code of ethics that applies to the company's principal executive officer, principal financial officer, principal accounting officer or controller or persons performing similar functions. Moreover, the New York Stock Exchange proposed new corporate governance standards, if the SEC approves them, that would require listed companies to have a code of business conduct that applies to all employees.

[37] SEC, "SEC Implements Internal Control Provisions of Sarbanes-Oxely Act", May 27, 2003.

Disclosure of Audit Committee Financial Expert (SOX s. 407)

The Act requires a company to disclose whether it has at least one audit committee financial expert[38] serving on its audit committee. If there is no such person on the audit committee the company must disclose this fact and explain why it has no such expert.

Canadian Response

Management Assessment of Internal Controls

As detailed above, the proposed OSC rules would require the CEO and CFO to certify that they have reasonable internal controls in place, and that they must evaluate the effectiveness of these controls and disclose any deficiencies to the firm's audit committee and auditors. The OSC rules do not appear to go as far as SOX in that management will only have to disclose any deficiencies to the firm's audit committee and auditors as opposed to in the U.S. where management will have to disclose any material weaknesses in the annual report itself. Furthermore, and perhaps more significant, the proposed OSC rules do not include a requirement for the company's external auditor to attest to, and report on managements certification that they have reasonable internal controls in place. Again, it is possible that this requirement may be included when the OSC rules are released for comment on June 27, 2003.

Code of Ethics for Senior Financial Officers

The proposed TSX Company Manual requires that each issuer adopt a formal code of business ethics or conduct that applies to directors, officers and employees. The code

[38] The Act defines financial expert as a person who, through education and experience as a public accountant or auditor; or from serving as a principal financial officer, comptroller, or principal accounting officer of an issuer; or has from a position involving the performance of similar functions, has: an understanding of generally accepted accounting principles and financial statements; experience in the preparation or auditing of financial statements for generally comparable companies; experience with internal accounting controls; and an understanding of audit committee functions.

must be disclosed either in the annual report or information circular at least once every three years or on the issuer's website.[39]

Audit Committee Member with Financial Experience

The rules to be released for comment by the OSC indicate that each audit committee member must be financially literate and the company must disclose whether or not there is a financial expert serving on its audit committee. Financial literacy will be defined as the ability to read and understand a set of financial statements that are comparable to the issuers in terms of the complexity of the accounting issues. The definition of an audit committee financial expert will be virtually identical to the definition that has been adopted in the United States.[40] The proposed TSX Company Manual recommends that members of the audit committee should be financially literate and at least one member should have accounting or related financial experience. Note that the TSX definition of 'accounting or related experience' is less detailed than the SEC definition of 'audit committee financial expert'.

3.5 SOX Title VIII – Corporate and Criminal Fraud Accountability

Criminal Penalties for Altering Documents (SOX s. 802)

The Act indicates that the destruction, alteration, or falsification of records or documents with the intent to impede, obstruct, or influence a federal investigation is a new statute punishable by a fine, imprisonment of up to twenty years, or both. Note also that Section 1102 of the Act prohibits persons from corruptly altering or destroying documents with the intent to impair an official proceeding punishable by a fine, imprisonment of up to twenty years, or both.

[39] KPMG, "Comparison of US and Canadian Regulatory Changes".
[40] OSC, "Giving Investors Reason for Confidence: Remarks by David Brown", May 23, 2003.

An accountant who conducts an audit of an issuer of securities is now required to maintain all audit or review working papers for a period of five years from the end of the fiscal period which the audit or review was concluded. The new statute provides a fine, a maximum term of imprisonment of ten years, or both, for anyone who knowingly and willingly violates it. Note that the SEC amended this rule such that auditors are required to retain their audit files and working papers for a minimum of seven years after they file the audit with the SEC. This amendment brings Section 804 of the Act in line with the Acts rules related to the PCAOB which requires an auditor to retain audit working papers and other information related to any audit, in sufficient detail to support the conclusions reached in such a report for a period of seven years.

Statute of Limitations for Securities Fraud (SOX s. 804)

The Act requires that the statute of limitations for securities fraud be increased to two years after the discovery of the facts constituting the violation or five years after such violation. It was previously one year from discovery and three from the act.

Amendment to the Federal Sentencing Guidelines (SOX s. 805)

The Act ordered the U.S. Sentencing Commission to review and amend its sentencing guidelines for securities fraud, obstruction of justice, and extensive criminal fraud. As a result, effective January 25, 2003, the U.S. Sentencing Commission increased penalties for corporate crimes that affect a large number of victims or endanger the viability of publicly traded companies. A corporate officer who defrauds more than 250 employees or investors of more than $1 million will now face a sentence of 121 to 151 months in prison, more than double the previous sentencing guidelines. The penalty for obstruction of justice related to destroying documents or records related to an investigation has also been increased from 18 months in prison to 30 to 37 months.[41]

[41] Biegelman, 32.

Protection for Employees Who Provide Evidence of Fraud (SOX s. 806)

The Act provides enhanced 'whistleblower' protection for employees of publicly traded companies who are discharged, demoted, suspended, threatened, harassed, or discriminated after disclosing evidence of fraud and assisting in investigations to stop fraud. This rule only applies when an employee provides information to either (1) a federal regulatory or law enforcement agency, (2) a member of Congress, or (3) a person with supervisory authority over the employee.[42] If retaliated against, there are civil penalties in which a whistleblower may look to the U.S. Department of Labor and the district courts in an attempt to be awarded remedies such as being reinstated to the same position to, back pay, interest, compensatory damages and litigation costs.

These civil penalties are similar to those offered by existing U.S. state and U.S. federal protections of employees. However, the Acts shifts the primary burden of proof to the employer "...to prove by clear and convincing evidence that it would have taken the action at issue regardless of the employee's protected activity".[43] Finally, the Act now makes retaliation against a whistleblower a criminal act punishable by up to ten years in prison (SOX s. 1107).

Criminal Penalties for Defrauding Shareholders of Public Companies (SOX s. 807)

As detailed in the Act, this is a new statute that provides for criminal penalties for defrauding shareholders of a publicly traded company. This statute compliments existing securities law and provides a fine, a maximum imprisonment term of twenty-five years or both.

[42] G. Roger King, "New Concern to Publicly Held Companies: Protection of Whistleblowers under the Sarbanes-Oxley Act", *Derivatives Litigation Reporter*, Volume 09, Issue 10, April 21, 2003.
[43] King.

Additional U.S. Federal Government Response[44]

In July 2002, the U.S. Federal Government created the inter-agency 'Corporate Fraud Task Force'. The Task Force is made up of 17 individuals, headed by Deputy Attorney General Larry Thompson and includes seven U.S. Attorneys from major metropolitan areas, FBI head Robert Mueller, SEC Chairman William Donaldson, and Labour Secretary Elaine L. Chao, among others. Prior to the creation of the task force there was no 'home' for corporate fraud and white-collar crime cases within the Department of Justice, which relied on its various divisions including the FBI, white-collar crime units and local U.S. attorneys to handle the files. Now, as an interagency team, the Task Force has easier access to corporate cases and to topical expertise needed to prosecute a case.

Canadian Response

Government of the Province of Ontario – Bill 198[45]

Bill 198 will stiffen the penalties and enforcement procedures for white-collar crime in Canada by increasing the maximum penalties that can be imposed by the court for offences under the *Securities Act* (Ontario) from a fine of $1 million and imprisonment for two years to a fine of $5 million and imprisonment for five years, less one day. Bill 198 will also give the OSC the power to impose an "administrative penalty" on a person or a company of up to $1 million for each failure to comply with Ontario securities law. Finally, Bill 198 will give the OSC stronger powers to review the information that public companies disclose to investors.

Federal Government of Canada

On February 18, 2003 Finance Ministry Manley announced in the 2003 budget that up to $30 million of increased federal resources would be made available to create a

[44] Alix Nyber, "New CFO Career Risk: Dept. of Justice", CFO magazine, April 11, 2003 <http://www.CFO.com> (May 12, 2003).
[45] Bell.

coordinated national program to strengthen enforcement against serious securities and corporate fraud.[46] The announcement further indicated that this would be achieved through the creation of a new national enforcement unit to investigate and prosecute white-collar crime, the new unit being comprised of teams of investigators, forensic accountants and lawyers in major cities across Canada. "These teams will focus on the most serious cases of corporate fraud and market illegality, and will work closely with securities regulators as well as provincial and local police, the government said."[47] It is expected that the increased resources will be used for Royal Canadian Mounted Police ("RCMP") investigations and criminal prosecutions.

Furthermore, Canadian Federal Justice Department Officials are writing stronger corporate fraud laws as the foundation for Ottawa's plan to restore investor confidence. "The new legislation will have provisions for aggravated corporate fraud, fraudulent dealing in securities and insider trading, and will also protect corporate whistle-blowers from intimidation and permit targeted evidence gathering".[48] The new laws are also expected to include sentencing criteria for Canadian judges and to set out provisions for harsher jail terms.

Canada Business Corporations Act ("CBCA") & Business Corporations Act (Ontario)

The existing CBCA requires that a corporation retain the accounting records[49] for a period of six years after the end of the financial year to which the records relate. However, the penalty for failing to comply is a fine not exceeding five thousand dollars. The Business Corporations Act (Ontario) includes similar requirements for retaining

[46] Department of Finance Canada, "Building the Accountability Canadians Deserve", 2003 Budget Speech, February 18, 2003, <http://www.fin.gc.ca/budget03/pamph/paacde.htm> (May 19, 2003).
[47] Karen Howlett, "Ottawa to create national white-collar crime unit", *Globe & Mail*, Wednesday February 19, 2003, B7.
[48] Sandra Rubin, "Edging closer to hard U.S. approach", *National Post*, March 5, 2003.
[49] CBCA s. 20 (2) describes accounting records as accounting records and records containing minutes of meetings and resolutions of the directors and any committee thereof and s. 20 (1) describes accounting records to include (a) the articles and the by-laws, and all amendments thereto, and a copy of any unanimous shareholder agreement (b) minutes of meetings and resolutions of shareholders (c) copies of all notices required by section 106 or 113 and (d) a securities register that complies with section 50.

accounting records for six years after the end of the financial year to which the records relate.

3.6 SOX Title IX – White Collar Crime Penalty Enhancements

The Act provides for increased jail time for a number of existing criminal statutes including mail and wire fraud (SOX s. 903). Criminal penalties for mail and wire fraud increased under the Act from five years to twenty years.

Failure of Corporate Officers to Certify Financial Reports (SOX s. 906)

The Act created a new criminal statute relating to the certification of periodic financial reports filed by a company with the SEC. If the CEO or CFO falsely certifies any statement regarding the financial condition and results of operations of the company, he or she can face up to twenty years in prison and/or a $5 million fine.

Canadian Response

To date the OSC has not announced what the penalties will be to the CEO and CFO, if any, if one or both falsely certifies any statement regarding the financial condition and results of operations of the company. It is possible that such penalties will be included in the rules that are being released for comment on June 27, 2003.

4. Sarbanes-Oxley Act – Implications for IFA's

The passing of the Sarbanes-Oxley Act, as discussed previously, was the culmination of a series of events that resulted in large dollar losses for a large number of investors and generally a loss of trust in the public securities market. As a result, in 2002 the U.S. Congress passed the Act in an attempt to restore the trust of those who invest in the public markets and provide the ability to punish the wrongdoers more severely than in the past.

As the Sarbanes-Oxley Act has been in existence for less than one year and the majority of the rules related to the Act have only been in place for a number of months, one of the many unanswered questions at this time is what will be the impact of the Sarbanes-Oxley Act in the corporate community? Will SOX and corporate governance continue to be a 'hot topic' for years to come or will the issue of corporate governance be taken over by the next 'hot topic'? Will the return of double-digit stock market returns at some point in the future result in investors and others forgetting about the importance of corporate governance? Furthermore, if there is an economic slow-down in the U.S. and / or in Canada, will the corporate governance legislation be scaled back to help companies reduce the cost of complying with all of the corporate governance regulations?

Regardless of the impact that SOX will have in the corporate community in the future, SOX is currently having a significant impact not only in the Unites States as corporations are spending considerable time and resources in an effort to be SOX compliant, but, also throughout the world as countries, such as Canada, are determining whether they too should be passing legislation similar to the SOX. SOX and the related rules are topics for discussion and action by a number of parties including regulators, federal prosecutors and attorneys, corporate executives and employees throughout most levels of organizations, Boards of Directors including the audit committees, accountants, auditors, lawyers, security analysts, politicians, software developers, educators and IFA's.

SOX is an important development for IFA's as IFA's have the skills to help achieve some of the goals of SOX itself, that is, IFA's can provide assistance in raising the standards of corporate accountability and with the investigation and punishment of those that commit fraud. The section of the Report discusses the many implications for IFA's as a result of the Sarbanes-Oxley Act in the U.S. and the related responses that are currently in development in Canada.

4.1 Increased Importance of Corporate Governance and Impact on IFA's

Corporate governance was once a topic that would grace the back pages of the daily newspapers' business section or included in a trade magazine targeted to internal auditors or audit committees. For the past eighteen months however, corporate governance related articles have been found not only on the front cover of business magazines and the business section of daily newspapers, but also on the front cover of mainstream news magazines such as Time and Maclean's. Corporate governance related issues are in many ways as important to company executives and investors as earnings per share and EBITDA.[50]

This shift in thinking and attitudes in the business community towards the importance of corporate governance, truthfulness and trustworthiness of executives and financial statements is an important development for IFA's. The more the business community expects and demands that all efforts will be made to prevent and detect fraud and that fraudsters will be punished in an appropriate manner, in general, the more demand there will be for IFA's in all types of organizations. In fact, "...professional recruiters report an increase in demand for individuals who can detect fraud and financial mismanagement and institute appropriate controls.[51] The general increase in demand for IFA's is likely not due to an expectation that fraud will be occurring with more frequency in the future,

[50] EBITA meaning Earnings Before Interest, Taxes, Depreciation and Amortization.
[51] Biegelman, 44.

rather, it is the increasing importance of corporate governance that is the cause for the increase in demand for IFA's.

4.2 Requirement to Keep Abreast of Evolving Rules and Regulations and Impact on IFA's

The rules and regulations relating to corporate governance in the U.S. continue to be refined. For example, the SEC is continuing to issue the 'Final Rules' related to the various sections of the Act. In Canada, many rules and regulations related to corporate governance are to be announced or finalized in the coming twelve months. In the very near future the OSC will be setting out for comment corporate governance rules as a result of Bill 198 in Ontario. Other Provincial regulators are sure to follow the OSC in one manner or another. The Canadian Federal government is planning on making changes to the Canadian Business Corporations Act to improve corporate governance. Finally, the CICA is expected to finalize this year its independence related standards and the TSX has proposed guidelines that are to be finalized.

Keeping abreast of the evolving rules and regulations both in the U.S. and Canada will be important for IFA's as the provisions found in SOX provides IFA's with another tool to fight fraud in the corporate board rooms. Furthermore, the provisions found in SOX are important tools that IFA's can use to gather and protect evidence and assets that is required of them during typical IFA engagements.

The complexity of, and lack of clarity found in, the SOX rules and the related responses in Canada, will likely provide an opportunity for IFA's to provide assistance. A report by AMR Research found that nearly 77% of companies report that they will spend more on IT, business process change, corporate governance and/or consulting this year as a direct result of SOX compliance. The report reveals that the challenges and lack of clarity surrounding SOX compliance has instilled a sense of urgency for companies to identify

the best practices early on to help scope their SOX efforts.[52] Therefore, an IFA who is able to keep abreast of the evolving rules and regulations will be in a good position to assist companies, executives and Board members in meeting their corporate governance obligations.

4.3 Increased Role of Regulators and Impact on IFA's

As a result of the introduction of SOX and the increasing importance of corporate governance in the financial community, there has been the creation of new regulatory agencies and existing regulatory agencies that have been given increased powers. In both the United States and Canada regulatory agencies were created to oversee the audit of public companies, the PCAOB in the U.S. and the CPAB and the NIU in Canada.

In the United States, the SEC has been given more resources to carry out its duties. The Bush Administration's proposed 2004 budget includes $842 million for the SEC for the year beginning October 1 which is 92% more than the agency received last year and more than three times what was allocated as recently as 1994.[53] As a result, SEC officials said that the new money would enable it to add at least 710 jobs to its staff of 3,100. Furthermore, recently, the SEC Chairman, William Donaldson indicated "...the government's prosecution of corporate abuse and pursuit of redress for harmed investors has accelerated in recent months and will continue in a determined fashion".[54] In Ontario, as the OSC is a self-funding organization, the OSC budget will likely increase in the following years as the OSC now has the ability to impose administrative penalties on a person or a company of up to $1million as a result of Bill 198.

The simple corollary of the new regulatory agencies and the increased power and resources at the existing regulatory agencies is that the demand for IFA's will increase in a number of ways. First, there are increased employment opportunities for IFA's within

[52] "AMR Research reveals that companies will spend up to $2.5 Billion for SOX Compliance in 2003", PR Newswire, May 6, 2003.
[53] Dan Ackman, "The Tiny SEC Grows", Forbes.com, February 4, 2003 <http://www.forbes.com/2003/02/04/cx_da_0204topnews.html> (May 23, 2003).
[54] "SEC Chair Addresses Corporate Abuse Cases", Associated Press, June 5, 2003.

the PCAOB and the SEC in the United States and the CPAB and OSC in Canada. IFA's have the skill set required to fill the new positions at the newly created and existing regulatory agencies.

Second, there will likely be more regulatory investigations by the SEC and OSC as a result of the increased resources available to the SEC and the OSC. Consequently, the companies who are the target of these investigations may require assistance from IFA's in responding to these regulatory investigations. Furthermore, companies and their Boards may become more proactive in investigating certain regulatory issues before the SEC begins a formal inquiry. For example, in February 2003 grocery retailer Ahold announced that its U.S. Foodservice had overstated profits by about $800 million from 2000 to 2002 relating to a fraud around vendor rebates. Subsequently, other retailers in the U.S., such as Kroger and Albertson's, have been the targets of informal inquiry by the SEC concerning their treatment of allowances they received from their vendors.[55] It is not inconceivable that prudent executives, or their Board members, at other food retailers have started to review how their companies have accounted for vendor rebates, reviews that an IFA can provide assistance with.

4.4 Increased Criminal Prosecutions and Impact on IFA's

As a result of the provisions found in the Sarbanes-Oxley Act, there are more opportunities for prosecutors to put fraudsters in jail if they are found guilty. The Act provides for new statutes related to altering documents, not retaining documents, retaliation against whistleblowers and falsely certifying financial statements. Furthermore, the Act provides for a longer statute of limitations and longer sentencing guidelines for convicted fraudsters. In Ontario, with the introduction of Bill 198, the potential court sentence for fraudsters has been substantially increased. Furthermore, the Canadian Federal Government has indicated that it will provide more resources for the investigation and criminal prosecutions of fraudsters and the Federal Justice Department is in the process of writing stronger corporate fraud laws. Creating new criminal

[55] Lisa Fingeret Roth, "Kroger reveals SEC questions – News Digest", *Financial Times*, June 5, 2003, 21.

penalties and strengthening the existing ones is a good first step, however, the impact of the increased criminal laws on IFA's may be insignificant unless there is a greater appetite to prosecute these crimes.

In the U.S., it appears that this is in fact happening partly due to the fact that prosecuting cases related to accounting scandals is resulting in headlines in the media for the lead prosecutor. Furthermore, prosecutors are now realizing that many of the fraud cases are relatively straightforward once you get past the accounting terminology, as previously prosecutors tended to stay clear of accounting fraud cases for fear of their complexity.[56]

Additionally, there was a time when the SEC had difficulty persuading many prosecutors to follow up on its referrals of potential fraud cases. Now, however, "...a new emphasis at the Justice Department on accounting and securities fraud cases is already producing indictments and will almost certainly lead over the next several months to a wave of additional cases according to prosecutors, defense lawyers and independent legal experts".[57] For example, there have been indictments in a number of recent fraud cases including at HealthSouth Corporation and at Symbol Technologies. For IFA's in the U.S., this means there are increased opportunities to assist with the prosecution or the defense of the criminal actions.

In Canada however, the appetite for criminal prosecutions is less certain. On the one hand there has not been the same number of accounting fraud cases in Canada as there has recently been in the United States and the Federal Justice Department laws have yet to be announced. Furthermore, there has been some difficulty in having the judges treat financial fraud serious enough to warrant criminal penalties. Dave Brown at the OSC has commented "...we [*at the OSC*] are still faced with an attitude by the judges when we bring something under the Securities Act, that it's essentially an administrative or regulatory proceeding – not a criminal proceeding. We've been somewhat disappointed with the fines and jail terms awarded because they've been below the mid-point in the

[56] Alex Berenson, "A U.S. Push on Accounting Fraud", *The New York Times*, April 9, 2003, column 4, p 1.
[57] Berenson.

range set out in the statute for conduct that we thought was pretty egregious. Even though the penalties are not very high in the Securities Act, we thought we would get penalties higher in the range. We think that in a criminal context the courts will treat it as a criminal behaviour with the higher range of penalty, rather than a breach of securities regulation".[58] On the other hand, the 2003 Federal Budget has provided for increased resources for the RCMP to investigate financial fraud cases. Furthermore, with Bill 198, the Ontario Legislature appears to be sending a strong signal to the courts that stiffer sentences are needed for violations of the Securities Act.

Nevertheless, there will be practical considerations around regulators such as the OSC working in conjunction with the RCMP in cases that may ultimately result in criminal charges. The reason is that regulatory investigations and criminal prosecutions are very different with very different rules. For example, information obtained by the OSC in a regulatory investigation cannot be released to a police force. The OSC also has very broad powers to compel people to disclose information and submit to examination under oath, which differs sharply from a criminal proceeding, in which the accused has the right to avoid self-incrimination.[59] These practical difficulties may be worked out in the future, but at this time the outcome is not known. Therefore, the implications for Canadian IFA's to assist with criminal investigations on either the prosecution or defence side is less certain than in the United States.

4.5 Auditor Independence Rules and the Impact on IFA's

In the U.S. as a result of SOX, IFA's generally will be restricted from performing any service for their public attest clients for the purpose of advocating that client's interest in litigation, investigations, or regulatory proceedings. In Canada, the restrictions are similar, however, to date, the rules have not been finalized by the CICA. Nevertheless, it is expected that the final rules will be similar to those found in the United States, and for the purposes of this report have assumed this to be the case.

[58] Rubin.
[59] Rubin.

The IFA's that will be impacted the most by this rule are those that work for, or a partner in, a Big Four[60] public accounting firm, as these firms audit the large majority of public companies. Furthermore, the IFA's who specialize in litigation support and the quantification of damages will be most affected by the Independence Rules as in nearly all cases these types of engagements result in the IFA advocating their client's interest in litigation.[61] It appears that these IFA's would be able to assist their audit clients to perform such services as quantifying the possible losses prior to the commencement of litigation. However, these services would have to be completed with the knowledge that the IFA would not be able to assist the client further once litigation commences. Therefore, from a practical point of view, it is unlikely that client's would engage an IFA under these circumstances, as it would then require hiring a second IFA upon commencement of litigation.

The independence rules will have a reduced impact on those IFA's that specialize in forensic investigations. As detailed in Section 3.2 of this report, the SEC has recognized in their Final Rule relating to auditor independence, dated January 28, 2003, that IFA's are not always in a position of advocacy when performing forensic engagements, and as such, will not be prohibited from performing these types of engagements unless it relates to litigation, an investigation, or a regulatory proceeding. The SEC further elaborated and indicated that IFA's would not be prohibited from perform internal investigations or fact-finding work that results in the issuance of a report to the audit client. They further indicated, "...the involvement by the accountant in this capacity generally requires performing procedures that are consistent with, but more detailed or more comprehensive than, those required by GAAS.[62] Performing such procedures is consistent with the role of the independent auditor and should improve audit quality".[63]

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[60] Big Four refers to one of the following public accounting firms Deloitte & Touche ("D&T"), PricewaterhouseCoopers ("PWC"), Ernst & Young ("E&Y"), or KPMG.

[61] In assisting the courts, IFA's are to be unbiased and objective. Nevertheless, the SEC has indicated in their Final Rule relating to Auditor Independence, dated January 28, 2003, "...the provision of expert services by the accountant makes the accountant part of the 'team' that has been assembled to advance or defend the client's interests. The appearance of advocacy created by providing such expert services is sufficient to deem the accountant's independence impaired".

[62] GAAS refers to Generally Accepted Auditing Standards.

[63] SEC, "Final Rule: Auditor Independence", January 28, 2003.

IFA's Assisting Auditors with Investigations

The SEC did not specifically comment on situations where an IFA is asked to assist the firms' auditors in investigating a possible fraud that might affect prior period financial statements on which the auditor reported without reservation. It is possible that this creates an independence-impairing situation as the IFA may be put into an awkward position of determining the extent of the alleged fraud and the number of years that the fraud has been going on for.

This issue was addressed by Nick Hodson, Chair, IFA Board of Directors, in a letter[64] to Ms. Sherry Boothe, AICPA, addressing the Alliance for Excellence in Investigative and Forensic Accounting comments on the proposed statement on auditing standards, 'Consideration of Fraud in Financial Statement Audit', in which it was recommended that the auditing standard provide guidance for these type of situations. The proposed auditing standard and the final auditing standard issued by the AICPA, however, did not address this issue.

It can be argued that IFA's should not be permitted to perform the investigation in these types of situations if there is the possibility that auditors were negligent in not detecting the fraud in the first place. It also can be argued that section 5135.44 of the CICA Handbook requires an auditor to confirm or dispel suspicions of fraud or material misstatements and in discharging those responsibilities under GAAS an auditor is permitted to rely on the work of specialists. Finally, it can be argued the IFA's should be permitted to assist with the investigation only until it is determined that a fraud was committed and at that point, an independent IFA would have to be engaged to complete the investigation.

Although both the CICA and the SEC did not specifically comment on these situations, the SEC did comment that auditors do have obligations to search for fraud that is material

[64] Letter from Nick Hodson, Chair, IFA Board of Directors, to Ms. Sherry Boothe, AICPA, regarding "Proposed Statement on Auditing Standards – Consideration of Fraud in a Financial Statement Audit", June 6, 2002.

to the issuer's financial statements.[65] They further commented that "Auditors should conduct these procedures whether they become aware of a potential illegal act as a result of audit, review or attestation procedures they have performed or as a result of the audit committee expressing concerns about a part of the company's operations or compliance with the company's financial reporting system".[66] Therefore, at this time there is no requirement in either the United States or Canada for IFA's to be excluded from assisting auditors to confirm or dispel suspicions of fraud that might affect prior period financial statements on which the auditor reported without reservation.

Big Four Accounting Firms vs. Boutique Firms

The independence rules may result in a shift in who is awarded IFA engagements to either one of the non-Big Four accounting firms or to boutique IFA firms such as Kroll, which specializes, amongst other types of work, in forensic investigations. The non-Big Four accounting firms have a smaller audit base and as a result, would be prohibited from a smaller number of engagements as a result of the independence rules than Big Four accounting firms. Boutique firms such as Kroll would not be prohibited from any engagements as a result of the Independence Rules, as they do not perform any audit services.

Notwithstanding the potential for a shift away from the Big Four firms as a result of the independence rules, there may also be a desire in the market place for clients to obtain IFA related services from one of the Big Four firms as these clients want the brand name of one of the Big Four and the ability to say that they hired biggest and the best.[67] Furthermore, the Big Four firms have the ability of 'pulling in' a number of diverse specialists from throughout the world, such as pension tax or corporate finance specialists, to assist with clients' complex needs on a particular engagement that the non Big Four accounting firms and the boutique IFA firms may not be able to match. Therefore, the shift in who is awarded IFA engagements as a result of the independence

[65] SEC, "Final Rule: Auditor Independence", January 28, 2003.
[66] SEC, "Final Rule: Auditor Independence", January 28, 2003.
[67] "Accounting giants poise after regulatory onslaught", Global Finance, March 1, 2003.

rules may simply shift to one of the other Big Four Firms. As such, relationships between IFA's within the Big Four firms will become important as they may be valuable resources in terms of referring work when their firm is prohibited from accepting the engagement for independence reasons.

Finally, as a result of the independence rules, there is the possibility that the non-audit service professionals at the Big Four firms will split from their audit and tax service professions resulting in two firms that are unaffected by the independence rules. This type of split is conceivable given that the SEC[68] and the CICA[69] have identified approximately eight additional non-audit services that audit firms are prohibited from performing including, but limited to, the provision of internal audit services, corporate finance and similar activities, provision of information technology services, and valuation services. The decision to split would be a difficult one for the accounting firms, partly due to the amount of revenue that is derived from non-audit services and partly due to the fact that clients' needs for non-audit services are more easily identified during the audit and as a result of the relationship between the audit partner and company executives.

Requirement for Audit Committee Pre-Approval

The Sarbanes-Oxley Act, and the soon to be proposed OSC rules, require the audit committee to pre-approve all non-audit services. As such, regardless of the rules that indicate IFA's are permitted to perform engagements for their public company audit clients if the engagement is not as a result of litigation, an investigation or a regulatory proceeding, it is possible that audit committees will prohibit all non-audit and tax services in an effort to avoid any questions relating to this matter.

This was starting to occur somewhat prior to the implementation of SOX with the Walt Disney Company only allowing their auditing firm, PWC, to perform audit services and with Apple Computer only allowing their auditing firm, KPMG, to perform audit and tax

[68] SEC, "Final Rule: Auditor Independence", January 28, 2003.
[69] CICA, "Independence Standards Exposure Draft", September 2002.

services.[70] Time will tell if more audit committee's take on this attitude and only allow their audit firms to provide and audit and tax services.

Another impact for IFA's as a result of the requirement for audit committee's to pre-approve all non-audit services is that the relationship between audit committee members, and Board members in general, and IFA's is an important one that should be developed and maintained. This is especially important, as many Board members tend to sit on more than one Board. Furthermore, the relationship between IFA's and audit committee members is an important one as SOX and the TSX Company Manual requires and recommends respectively, that audit committees be in charge of hiring outside advisors and be supplied with the appropriate funding. As such, given the increased level of liability that Board members are faced with and the increased time requirements to fulfill their duties, it is inevitable that audit committees will require assistance in carrying out investigations, investigations that IFA's can provide assistance with.

4.6 Prevention & Detection of Fraud by Corporations and Impact on IFA's

In the U.S., Chief Executive Officer's and Chief Financial Officer's now have to personally certify the financial and other information contained in the quarterly and annual reports and their company's disclosure and internal controls (SOX s. 302). In Ontario, the OSC plans to introduce similar rules, although the full extent of the rules will not be fully known until they are released for comment on June 27, 2003. In the U.S., penalties for falsely certifying any statement regarding the financial condition and results of operations of the company can result in a significant prison sentence fine.

As a result of the required certifications CEO's and CFO's now have a much greater incentive to ensure that their companies have done all that they can to ensure that their certifications accurate. This will likely result in companies taking various steps in

[70] "Accounting giants poise after regulatory onslaught", Global Finance, March 1, 2003

attempting to prevent fraud from occurring in the first place and in detecting it faster than in the past.

Impact on Internal Audit

The internal audit group within companies will be one area that company executives and Board members will look to help ensure the company is doing all that it can to prevent fraud from occurring in the first place and detecting frauds on a timely basis. As a result, the internal audit group will likely command more respect in terms of being given additional funding and staffing that in the past may have been allocated to other departments. Moreover, in companies where cutbacks and layoffs are required, company executives will be hesitant to cut from the internal audit group as "...company executives and other responsible for corporate governance do not want any additional risk, particularly as a result of understaffing".[71] This increased role of internal audit departments is an opportunity for IFA's employed either within the company's internal audit group or within public accounting firms to assist the internal audit group in taking on this larger role.

Employed within the company, an IFA has the appropriate skill set to assist with the designing and testing of internal controls and to assist with any fraud investigations that are required. Note that one of the possible outcomes of having more IFA's working within the internal audit department is that companies may look to public accounting firms with less frequency to assist with their investigations.
For IFA's in public practice there is also an opportunity to assist, as many companies will be looking outside the company to assist their internal audit department. AMR Research reported that companies will spend up to $2.5 billion for SOX compliance in 2003 and that many companies are forming cross-functional SOX teams in addition to enlisting

[71] Paul McDonald, "New Regulations: Restoring Trust in accounting and accountants", Financial Executives International, <http://www.fei.org/mag/exclusives/mcd11103_2.cfm> (April 13, 2003).

help from external auditor/risk management consultants to define, analyze, and improve best practices for managing their internal controls.[72]

Although it is likely that all internal audit groups will be affected, it is likely that the biggest impact will be seen in mid-size public companies, as they may not have had an internal audit group in size relative to the rest of the company. For example, Carnell Companies, a U.S. mid-size company with 4,000 employees and $280 million in revenues, didn't have an internal audit group approximately 18 months ago. According to John Hendrix, CFO, "...he used Sarbox as a springboard to create an internal audit department. Previously he had used integrated financial systems, but lacked the documentation and internal reporting flow charts needed to satisfy the new law".[73]

Increase in Proactive Fraud Testing

One impact of the increased role of the internal audit group is that proactive fraud testing may become more prevalent in detecting fraud. Typically, forensic accounting engagements tend to be reactive in nature. That is, there is some sort of event that precedes the requirement for a need for an IFA to provide assistance. Receiving a tip from a whistleblower, determining that the physical amount of inventory is much less than what the accounting records indicate, or initiating a lawsuit as a result of a breach of contract are examples of 'events' that typically precede the requirement of assistance from an IFA. However, as companies now have even more of an incentive to detect fraud before it becomes widespread, proactive fraud testing may become more prevalent.

One of the difficulties in performing proactive fraud audits is the ability for an IFA to review the vast amounts of data inside computers and reports generated by the computers. However, there are now many software programs currently available that an IFA can use in performing proactive fraud engagements. These software programs allow the IFA to

[72] "AMR Research reveals that companies will spend up to $2.5 Billion for SOX Compliance in 2003", PR Newswire, May 6, 2003.
[73] Marie Leone, "Sarbox or Sarboon?", CFO.com, May 9, 2003 <http://www.cfo.com/printarticle/0,5317,9460,00.html> (June 12, 2003).

convert a large amount of data found in a company's records into manageable databases that can be queried and summarized and allow an IFA to quickly and easily analyze 100% of the transactions of companies of any size.[74] The software programs, for example, can be used to compare the vendor addresses found in the company's master vendor payable file with employee's address in attempting to determine whether an employee is committing a purchasing fraud or can be used to examine cheque amounts for unusual or repeating amounts.[75] The identification of a suspicious entry in the accounting records does not necessarily mean that a fraud has been perpetuated on the company. Rather, it is merely a 'red flag' that requires follow-up procedures to be performed by an IFA to confirm or dispel the suspicious entry.

One barrier for IFA's in public practice in completing more proactive fraud audits is the risk that the proactive fraud audit fails to detect an on-going fraud. If detected a later point, the IFA and the public accounting firm may be liable for not detecting the fraud. Although carefully worded engagement letters may reduce this risk, it is possible that the increase in proactive fraud auditing will be carried out more by those IFA's employed within the company's internal audit group.

Importance of Ethics Policies

Ethics polices are required not only for companies to be SOX compliant, but also, so that executives and Board members can be seen as doing all that they can to prevent fraud from occurring in the first place. Although the SOX rules only requires companies to disclose whether or not it has adopted a code of ethics that applies to the company's senior financial officers, it is expected prudent executives will ensure that this same code of ethics will be applicable to the entire company. Furthermore, the proposed NYSE and TSX rules require listed companies to have a code of ethics that applies to all employees.

[74] Phillip Levi, "Data mining for Assurance", *CA Magazine*, March 2003 <http://www.camagazine.com/index.cfm/ci_id/13984/la_id/1.htm> (April 10, 2003).
[75] Levi.

Other than in the situations where someone outside of the company perpetuates a fraud against the company, ultimately it is someone within the corporation who makes a conscious decision to defraud the company. A properly designed ethics policy is one of the ways in which corporations can help employees make the conscious decision not to defraud the company as these policies define what is acceptable behaviour on the part of the organization's employees and any consequences of any breaches. Furthermore, ethics policies are necessary in companies as what is ethical and moral to one person may be unethical or immoral to another. Notwithstanding the importance of ethics policies in companies, having one will not prevent all frauds from occurring. Enron had a substantial ethics policy however, its board of directors twice voted to suspend the code to allow the company's former CFO, Andrew Fastow, to start business activities that created for him, a conflict of interest.[76]

This is an opportunity for IFA's as they can be of assistance in the drafting and / or reviewing the ethics policies. For example, if one section of a company's ethics policy details what is considered to be fraudulent activity, an IFA can provide assistance in designing or reviewing such a section. Furthermore, an ethics policy typically contains one or all of the following: conflicts of interests, relationship with clients and suppliers, gifts and entertainment, kickbacks and secret commissions, and dealing with company funds[77], all of which an IFA can provide assistance in the drafting and / or reviewing of.

There may be a significant opportunity for IFA's to provide assistance in establishing ethics policies as based on an informal poll of 291 executives conducted by Christian & Timbers, New York City in August and September 2002, 44% of the respondents said their company did not have a formal code of ethics in place.[78] For larger companies, however, IFA's will likely provide assistance related to reviewing existing policies, as most already have ethics policies in place. A survey completed by Deloitte & Touche,

[76] Randy Myers, "Ensuring Ethical Effectiveness", *Journal of Accountancy (On-line issues)*, February 2003 <www.aicpa.org/pubs/jofa/feb2003/myers.htm> (May 12, 2003).
[77] AICPA, "Management Antifraud Programs and Controls: Guidance to Help Prevent, Deter, and Detect Fraud", <www.aicpa.org/antifraud/management/20g.htm> (June 15, 2003).
[78] Myers.

U.S., indicated that approximately 95% of '*Fortune* 1000' companies have code of conduct policies.[79]

4.7 SOX Section 404 and Impact on IFA's

The SOX requirement that the Annual Report must include a statement of management's responsibility regarding the company's internal control structure and what management's assessment is of the effectiveness of those controls (SOX s. 404) is one that companies will likely be spending a lot of time and resources ensuring that they are compliant with. This is partly due to the fact that this will not be a once a year or a once every couple of years exercise as the SEC requires companies to perform quarterly evaluations of changes that have materially affected or are reasonably likely to materially affect the company's internal control over financial reporting.

This is also due to the fact that the SOX rules require that the external auditors attest to management's assessment of the effectiveness of the controls. This is something new for the external auditors, as historically they have had to understand the company's internal control environment in deciding how best to audit the company. Now they have to be able to understand the control environment and be in a position to have to report publicly on the adequacy of the internal control structure.[80] As such, the company will want to do all that they can in attempting to minimize the work that will be required by the external auditors in attesting to management's assessment of the effectiveness of the controls.

Therefore, it is likely that depending on the size and complexity of the company, a section '404' team would be established. The team may include all or some of the following: senior personnel from operations, the CFO or controller, Chief Information Officer, internal audit director, an industry and investor relations Vice-President, internal legal counsel, and perhaps an outside 'SOX 404' specialist. Given an IFA's skill set

[79] Myers.
[80] "Head of PWC advocates more audit changes", The Dallas Morning News, May 5, 2003 <http://finance.pro2net.com/x38152.xml> (May 14, 2003).

regarding internal controls, IFA's employed either within the company or within a public accounting firm can be provide assistance in ensuring that the company is section 404 compliant. Specifically, IFA's can form part of the team that (1) plan's the Section 404 project, (2) trains the project teams around the appropriate control framework, scope documentation, and regulatory impacts, (3) assists with the documentation of controls, (4) assists in designing the appropriate tests and the appropriate amount of testing sufficient to support an ongoing assessment process by management as to the effectiveness of the key internal controls, and (5) assists in setting up a process that allows the certification of the reports by the CEO/CFO.

4.8 Whistleblower Rules and the Impact on IFA's

As per the SOX rules audit committees must set up procedures for complaints about accounting, internal accounting controls, or auditing matters in a confidential and anonymous manner. The proposed OSC rules, which will not be fully released until June 27, 2003, do not contain a similar rule. However, the Canadian Federal government is expected to bring out new legislation that provides protection for corporate whistleblowers. Furthermore, the TSX Company Manual, does recommend that the audit committee establish procedures to receive and handle complaints about accounting or audit matters, although does not recommend that the procedures allow for an employee to complain in a confidential, anonymous manner.

This provides an opportunity for IFA's to assist audit committee's with the preliminary reviews and the in-depth investigation if the preliminary review uncovers something for further investigation. The audit committee would not look to management of the company for assistance in performing the preliminary review given their lack of independence and the requirement in the U.S. for the employee to be able to complain in a confidential and anonymous manner. As the audit committee members will likely not be performing the preliminary reviews given the number of responsibilities that they now have, they will probably then look to either the internal auditors of the company, someone external to the company, or a combination of the two to assist them.

With the requirement in the U.S. for the employee to be able to complain in a confidential, anonymous manner, there are a number of outsourcers for corporate hotlines that are selling their services to companies (i.e. Edcor, Report it, Pinkerton Compliance Services and The Network).[81] The outsourcers set up a hotline that employees can call to report suspicious activity. The outsourcers would gather the information and pass on the information to someone for a preliminary review. One such Outsourcer, Pinkerton Compliance Services, "...has 100 employees taking 150,000 calls per year from employees with tips on everything from threats of workplace violence to financial fraud and theft", and their client list includes companies such as Duke Energy Corp., Microsoft Corp., Walt Disney Co., and Lowe's Companies".[82] This, therefore, also presents opportunities for IFA's as an IFA could be employed with the hotline outsourcers to perform the preliminary reviews or IFA's could partner with the outsourcers to market the IFA's services to either the corporate counsel, the audit committee or the compliance officer.

Whether or not the whistleblower rules will have a big impact on IFA's will depend on whether employees fear that they may be fired from their job if they go over their bosses head to complain about something. Even though the U.S. rules require confidentially, employees may still believe that their allegations will result in them being fired and as a result may not feel inclined to bring forward a complaint.

In a 1999 study by Joyce Rothschild and Terrance D. Miethe[83], of 300 whistleblowers interviewed, 69% said they had lost their jobs or were forced to retire as a result. In a more recent survey conducted in December 2002 by Time/CNN Survey/Harris Interactive[84], in response to the question 'how often does the public think whistleblowers face negative consequences at work, such as being fired or treated poorly', 57% responded 'most of the time', 30% responded 'some of the time', and only 8% responded

[81] Craig Schneider , "Dial 'M' for Malfeasance", CFO.com, March 12, 2003 <http://www.cfo.com/printarticle/0,5317,8879,00.html> (June 1, 2003).
[82] "Ethics Law Prompts Business Boom", The Charlotte Observer, May 25, 2003.
[83] "Whistleblower Disclosures and Management Retaliation", Work and Occupations, vol. 26, no. 1 (February 1999), p. 120, found in "Commission on Public Trust and Private Enterprise", The Conference Board, January 9, 2003.
[84] "Commission on Public Trust and Private Enterprise", The Conference Board, January 9, 2003

'not very often'. Furthermore, Sherron Watkins, the Enron whistleblower, testified that former Enron CFO Andy Fastow tried to get her fired for going directly to CEO Kenneth Lay with her email detailing her allegations.[85]

This type of attitude may change in the future as a result of the inclusion in SOX for criminal and civil penalties for those who retaliate against whistleblowers. Furthermore, whistleblowers are now being heralded as protectorates of the company. Time magazine named Sherron Watkins, Cynthia Cooper, and Coleen Rowley, whistleblowers at Enron, WorldCom, and the Federal Bureau of Investigation ("FBI"), respectively, as the 2002 persons of the year.[86] And finally, with the recent corporate failures such as Enron, WorldCom, and HealthSouth Corporation, employees are becoming more aware of the harm that unethical corporate behaviour can cause both to the company and to them personally via a loss of their job and / or a reduction in their pension and, as such, are more likely to be whistleblowers themselves.

4.9 Forensic Involvement in the External Audit and the Impact on IFA's

Current and Expected Requirement for Auditors to Detect Fraud

With the current Canadian auditing standards, section 5135 of the CICA Handbook *The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements*, an auditor is not responsible for detecting fraud nor is there a requirement for a forensic accountant to be part of the audit team.[87] Section 5135 "...clarifies that the likelihood of not detecting material fraud is higher than the likelihood of not detecting error because fraud may involve sophisticated and carefully organized schemes designed

[85] Schneider.
[86] Richard Lacayo and Amanda Ripley , "Persons of the year 2002", *Time Magazine*, December 22, 2002 <http://www.time.com/time/personoftheyear/2002/poyintro.html> (June 10, 2003).
[87] CICA Handbook section 5135.02 requires the auditor to consider the risk of material misstatements in the financial statements resulting from fraud or error.

to conceal it".[88] Section 5135, does, however, require that the auditor perform a number of procedures in considering fraud including, but not limited to (1) discussion with the other audit team members the entity's susceptibility of the entity's financial statements to material misstatement through fraud or error, (2) discussion with management about its assessment of the risk that fraud or error may occur, about controls they have implemented and whether they are aware of any fraud, suspected fraud or material error, and (3) when assessing inherent and control risk, consideration of how the financial statements might be materially misstated as a result of fraud and error, and of whether fraud risk factors are present.[89]

Subsequent to the CICA introducing its updated Section 5135 in April 2002, in October 2002 the AICPA in the U.S. introduced SAS no. 99, *Consideration of Fraud in a Financial Statement Audit*. The U.S. standard also does not require that an auditor be responsible for detecting fraud[90] nor is there a requirement for a forensic accountant to be part of the audit team. However, SAS no. 99 does go further than Section 5135 in regards to the steps that the auditor must take in considering fraud in a financial statement audit including, but not limited to (1) making inquiries of the audit committee, internal audit function, and others within the entity regarding the risk of fraud, (2) identifying revenue and accounts receivable accounts as specific identified risks and performing analytical review and audit procedures on the respective balances, (3) testing for management override of controls, and (4) testing journal entries.

It is expected that the CICA will be bringing out an update to Section 5135. It is not inconceivable that the updated section will match the requirements set out in the AICPA's SAS no. 99. Furthermore, with the announcement that the PCAOB will be rewriting the auditing standards for publicly held companies[91] there is the possibility that

[88] David C. Selley and Eric Turner, "Fraud and error", *CA Magazine*, August 2002 <http://www.camagazine.com/index.cfm/ci_id/6966/la_id/1.htm> (June 8, 2003).
[89] Selley and Turner.
[90] SAS no. 99 indicates that the auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud.
[91] "New public audit standards will be set by the PCAOB", Accounting Office Management and Administration Report, June 1, 2003.

the new standards could result in even stronger language related to the external auditors responsibility to detect fraud and possibly the required involvement of forensic accountants as part of the external audit team where warranted.

IFA Involvement in the External Audit

As detailed above, the current audit rules do not require auditors to detect fraud or have IFA's be part of the external audit team, however, require auditors to perform procedures in considering fraud in an audit of financial statements. Given the requirement to consider fraud, the question becomes who is the best person carry out those procedures – staff members from the audit team, which may lack experience in detecting fraud or IFA's, which have the appropriate skills to identify and investigate fraud, but are relatively costly? The answer will likely be a combination of providing increased fraud training for audit staff and including IFA's on selected audit engagements.

E&Y has said that it will require its auditors to undergo approximately 50,000 hours of fraud related training[92] and PWC has indicated that it hopes to start fraud training next year for all 14,000 of its U.S. based auditors[93]. Public accounting firms will likely look to IFA's for assistance in training the auditors, something that will likely have to occur on a yearly basis given that public accounting firms hire new auditors out of university typically on a yearly basis.

Furthermore, starting this year, "...PWC in the U.S. has indicated that it is identifying 50 high risk clients and will add at least one forensic auditor to each"[94] and Deloitte & Touche US has indicated "...the firm is overhauling the process by which it audits, to focus more on potential fraud by incorporating forensic auditors".[95] The decision by some of the public accounting firms to involve IFA's in the audit process is noteworthy

[92] Cassell Bryan-Low, "Accounting firms aim to dispel cloud of corporate fraud", The Associated Press, May 27, 2003, <nj.com> (June 6, 2003).
[93] Edward Iwata, "Accounting detectives in demand", *USA Today*, February 27, 2003 <http://www.usatoday.com/money/industries/2003-02-27-accounting_x.htm> (May 10, 2003).
[94] Bryan-Low.
[95] Bryan-Low.

because there is no current audit standard that requires them to do so. And as such, there are no explicit standards that govern what the IFA's involvement should be in carrying out the external audit other than the general audit standards found in the CICA Handbook including, but not limited to, that the audit should be carried out with due care, performed collectively by those that possess adequate knowledge of the subject matter, be adequately planned and properly executed, and that sufficient evidence is obtained. It is possible, therefore, that the desire by public accounting firms to include an IFA in the audit process is an attempt to minimize the risk that the financial statement audit does not detect a fraud that is occurring in the audited company, a risk that public accounting firms are likely trying to minimize in today's litigious environment.

The next question to be determined is exactly what the IFA's role will be in working with the external audit team. Typically, IFA's completing a focused investigation will spend a substantial amount of time reviewing documents, performing interviews and completing analyses in an effort to 'get to the bottom' of the allegation that is being made or the question that is being asked. However, having IFA's spend this much time on an external audit is not very likely to happen as conducting a generic fraud investigation of an entire company would be a physical impossibility unless the external auditors were on-site at the company for eleven months of the year.[96]

What is more likely is that IFA's will assist the audit team in carrying out the various procedures required of them in considering fraud during the financial statement audit as per Section 5135 in Canada and SAS no. 99 in the U.S. For example, IFA's could be of assistance in "...assessing the risk of material misstatements due to fraud, designing auditing procedures that respond to the assessed risk of fraud, and determining when a separate fraud investigation engagement is necessary".[97] IFA's have the benefit of experience in identifying control weaknesses and investigating frauds, experience that would be a benefit to an audit staff that may be better trained than in the past at

[96] Eric Krell, "Will Forensic go mainstream", BusinessFinanceMag.com, October 2002 <http://www.businessfinancemag.com/archives/appfiles/Article.cfm?IssueID=367&ArticleID=13909> (May 12, 2003).
[97] AICPA, "Fraud detection in a GAAS Audit: SAS No. 99 Implementation Guide", AICPA web site, <www.aicpa.org/antifraud/detection/understanding_new_sas/01.htm> (April 27, 2003).

identifying the 'red flags' that may be indicators of fraud, but having limited actual experience in carrying out fraud investigations. Furthermore, as SOX now requires that management must disclose any fraud, whether or not material, that involves management or other employees who have a significant role in the company's internal controls to its auditors and the audit committee, IFA's can provide assistance in reviewing management's response to the fraud to determine if their response was appropriate or not.[98]

4.10 IFA's as Board Members – Specifically Audit Committee Members

IFA's may be sought after to sit on public company Boards and become part of the Audit Committee. This is due to the SOX requirement, and the TSX Company Manual recommendation, to have a financial expert as part of their audit committee. Not only would IFA's meet the SOX definition of a financial expert, but they would also bring a 'questioning' mentality, that is part of an IFA's skill set, to the audit committee. "Sally Hoffman, a partner at Berdon LLP who is a co-director of Berdon's forensic accounting and investigative services, says she has been told by industry colleagues that her marketability would rise if she quit the respected Manhattan accounting firm and then resurfaced as a potential candidate for a slot on a public company audit committee".[99] Retired IFA's are most likely to become audit committee members given that most public accounting firms have policies in place restricting their partners from being a Board member while being an active partner.

Including IFA's on public company Board's would signal a shift from the past when accountants were not typically asked to be part of an audit committee. A report issued in October 2002 by Spencer Stuart, a U.S. board services practice leader, found that 48% of audit committee members are presidents, CEO's or active or retired chairman and

[98] Note that Section 5135, CICA Handbook, already requires the auditor to discuss with management whether they are aware of any fraud or suspected fraud.
[99] Cristina Merrill, "Regulatory Crunch puts more CPA's in boardrooms: Firms act to avoid getting crooked", Crain's New York Business, February 24, 2003, Vol.: 19, Num.: 8, 4.

Accountants and CFO's made up only 2% and 3% respectively.[100] It is not suggested that including an IFA on the audit committee will ensure that that audit committee will be 'successful'. Furthermore, the increased requirements of audit committee members, and the resulting increased liability, will likely result in difficulties in finding qualified individuals who will accept an invitation to become an audit committee member. Nevertheless, given the skill set of a typical IFA, it is likely that we will be seeing more IFA's as audit committee members in the future than we have seen in the past.

4.11 SOX and the Impact on Forensic Investigative Specialists vs. Damage Quantification Specialists

The types of work completed by Investigative and Forensic Accountants can typically be divided in to two main categories, work related to forensic investigations and work related to quantification of damages (notwithstanding that some engagements entail both a forensic and a quantification component). Many IFA's are considered to be 'generalists', working on both types of engagements, there are other IFA's who can be considered to be 'specialists', working primarily on either forensic investigations or damage quantification.

Based on the preceding it appears the IFA's who specialize in forensic investigations will be the ones who will be most impacted by the SOX rules and the related Canadian responses. This is due to the fact that SOX was enacted primarily due to the frauds that were happening in the corporate boardrooms. Therefore, it is not inconceivable that the IFA's who specialize in forensic investigations will be the ones who are most impacted by the SOX rules in terms of the number of new opportunities available to them.

However, there are a couple of areas in which IFA's who specialize in damage quantification will also be impacted. First, as has already been discussed, damage quantification IFA's will be more impacted forensic investigation IFA's as a result of the auditor independence rules in terms of whom, or which firms, can do the work.

[100] Merrill.

Second, SOX requires that if a company is required to restate its financial statements as a result of misconduct, the CEO and CFO must reimburse the company for certain bonuses received and for profits received on the sale of the company's securities. [Note that the proposed OSC rules will include a section on disgorgement of profits, however, the specifics of the rules have not been announced to date.] As a result, there may be an opportunity for damage quantification IFA's specialists to assist in calculating or verifying the correct amount to be disgorged.

Will SOX Impact All IFA's?

It is likely that there will be some IFA's that will never be impacted by SOX at all. For example, IFA's who operate out of smaller cities and who primarily work with private companies may not be impacted by the SOX rules. Furthermore, there may be specialist IFA's, such as those that specialize in business interruption insurance engagements and whose firm does not perform audit services, that are not affected by the SOX rules.

Notwithstanding that there may be a few IFA's who will never be impacted by SOX, it is likely that the majority of IFA's will be impacted by SOX and the related Canadian responses in some manner. The degree to which SOX impacts them will depend on the type of work they do and the type and size of clients they work with.

4.12 Private Companies and Impact on IFA's

As discussed previously, in the U.S. and Canada, the SOX and related Canadian rules relate only to public companies. As a result, the impact on IFA's as detailed in this report would not appear to apply to privately held companies. However, as listed below, there may be various reasons why privately held companies adopt some or all of the SOX related rules, thereby, leading to the same opportunities for IFA's as detailed throughout this report:

1. If a privately held company plans to be listed on a stock exchange at some point in the future, the company will subject the company to all of the SOX rules, many of

which will be difficult to comply with in a timely manner if not instituted well in advance of going public.[101]

2. Although the costs to set up are significant, many of the SOX related rules once implemented have the potential to strengthen a company's internal organization and procedures. Establishing codes of conduct, effective internal controls and the requirement for independent auditors can add value to private companies.[102]
3. With respect to the independent auditor rules, if an IFA provides services to a privately held company to which the IFA's firm also audits, this may create an opportunity for opposing counsel during cross examination at trial to question the IFA as to why the independence standard that applies to public companies would not be applicable to private companies.
4. Insurance companies' director and officer liability policies may require that some SOX provisions be followed in order to get favourable rates.[103]

Privately held companies in industries where there has recently been a financial fraud may also want to adopt some of the SOX rules in an effort to show that they treat corporate governance seriously. For example, as a result of the financial scandal at HeathSouth Corp., some of the U.S. private insurers, such as Highmark, Inc. and Private Healthcare Systems, Inc. have already put some of the SOX rules into effect.[104]

Finally, a whistleblower outsourcing company, National Hotline Service, has seen an increase in their business from privately held companies that are voluntarily setting up SOX hotlines even though they are not required to do so by the legislation. Since January 2003, their business has increased almost 30% and 15% of that increase are for companies or not-for-profit agencies that are not required to set up a whistleblower

[101] Andrew G. Humphrey, "The effect of Sarbanes-Oxley on private companies", Faegre & Benson LLP, <http://www.faegre.com/articles/article_838.asp> (May 12, 2003).
[102] Humphrey.
[103] "Private MCO's should follow public firms in adopting Sarbanes-Oxley controls", Managed Care Week, April 14, 2003, Volume 13; Issue 13.
[104] "Private MCO's should follow public firms in adopting Sarbanes-Oxley controls".

hotline.[105] As such, it may be that some of the rules found in SOX will become the new 'gold standard' for companies regardless of whether SOX applies to them or not.

Offsetting the fact that some private companies may adopt some of the SOX rules voluntarily is the development that some of the smaller public companies are de-listing and becoming privately held companies. Research compiled by USBX Advisory Services shows that since SOX came into effect in August 2002, more smaller companies are exiting the public domain citing higher external audit costs, higher directors' and officers' insurance premiums and the fact that corporate executives are now exposed to fine and imprisonment.[106] It appears that with a weak stock market, the costs related to SOX appear to be the 'straw that broke the camel's back' resulting in some companies deciding to go private.[107]

4.13 AICPA's Efforts in Promoting Anti-Fraud Awareness and Impact on IFA's

The AICPA has become quite active in promoting anti-fraud awareness in an effort in part to help "...re-establish confidence among investors, promoting ethics and integrity in the workplace, and establishing clarity in reporting procedures".[108] Their efforts are not only directed at accountants in public practice, but also at accountants employed by corporations and at students and educators.

In addition to the new fraud audit standard, SAS no. 99 discussed in this report, specific AICPA anti-fraud initiatives include[109]:

- Designing anti-fraud criteria and controls intended for public corporations. The AICPA developed the criteria and controls with six professional associations

[105] "SOX prompts hotlines for firms not covered by act", PR Newswire, June 9, 2003.
[106] Mark Cecil, "Sarbanes-Oxley propels more small companies to go private", Mergers and Acquisitions Report, May 19, 2003.
[107] Cecil.
[108] AICPA, "Anti-Fraud & Corporate Responsibility Resource Centre" AICPA website <http://www.aicpa.org/antifraud/> (May 31, 2003).
[109] AICPA, "Anti-Fraud & Corporate Responsibility Resource Centre".

including the Association of Certified Fraud Examiners, the Institute of Internal Auditors, and the Financial Executives International to name a few.

- Urging stock exchanges to mandate effective anti-fraud training for management, boards of directors and audit committees and making available training to directors and other corporate officials free of charge.
- Recommending the Auditing Standards Board to enhance existing attestation standards for Certified Public Accountant's to test and report on client anti-fraud controls and criteria.
- Providing web-based case studies and educational support materials for educators or for the business community. Various scenarios related to fraud, corporate governance, accounting issues, and ethics are provided as well as expert commentary.

The resulting increase in anti-fraud awareness in the business community and in schools as a result of the efforts by the AICPA can have nothing but positive impacts for IFA's.

4.14 Impact on the Education of IFA's

The increased demand for IFA's as detailed in this report as a result of SOX will likely lead to an increase in the availability of education for forensic accountants. In the past, very little education was available for those interested in forensic accounting in universities or college or for potential forensic accounts employed by accounting firms.[110] Based on a 1999 survey of U.S. universities with accounting programs, only 13 of 215 respondents offered a specific course on fraud.[111] As a result of the lack of educational programs available to IFA's, forensic accounts were required to learn their trade via on-the-job training and based on guidance from their superiors.

[110] Notwithstanding that those interested in specializing in damage quantifications were able to obtain education via the Chartered Business Valuators designation.

[111] AICPA, "Accounting Students Must Have Armor of Fraud Examination", <http://www.aicpa.org/antifraud/educators_students/Assess_Competencies/Accounting_Career_Paths/128.htm>, taken from The White Paper, January-February 2002, Vol. 16, No. 1 The survey referred to is entitled: "Fraud Education of Accounting Students: A Survey of Accounting Educators" by Peterson and Reider.

This however is beginning to change, in the U.S., additional AICPA anti-fraud initiatives related to education include (1) working to ensure college textbook authors incorporate anti-fraud education in programs and text materials and (2) establishing an Institute for Fraud Studies, in conjunction with the University of Texas at Austin and the Association of Certified Fraud Examiners, to explore the origin of and circumstances surrounding fraud so that its frequency and effects can be minimized.[112] Enrolment in accounting courses at universities around the U.S. increased in 2002 as "...suddenly the image of an accountant as either superhero or super-villain made it cool to be associated with accounting...with forensic accounting topping the lost of several national polls of the hottest job in decades".[113]

Furthermore, the American Board of Forensic Accounting announced the creation of a Certified Forensic Accountant (Cr.FA) designation.[114] "The Certified Forensic Accountant (Cr.FA) is an advanced credential that recognizes the expertise in Forensic Accounting for accountants who have achieved additional training, experience, education, knowledge or skill in forensic accounting and have met all of their State Board of Accountancy requirements".[115]

In Canada, the Rotman School of Management, the École des Hautes Etudes Commerciales in Montréal, and the Alliance for Excellence in Investigative and Forensic Accounting of the Canadian Institute of Chartered Accountants, have combined to offer a two-year Diploma program in investigative and forensic accounting. The program is open to both chartered accountants and non-chartered accountants. For the chartered accountants enrolled in the program, the Diploma may lead to a specialist designation, the CA•IFA.[116]

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[112] AICPA, "Anti-Fraud & Corporate Responsibility Resource Centre".
[113] "Accounting Web's 2002 – The Year in Review", <Accountingweb.com> (May 12, 2003).
[114] Krell.
[115] American College of Forensic Examiners International website, <http://www.acfei.com/certification_programs-crfa_invitation.php> (June 15, 2003).
[116] The CA•IFA is one of the education-focused specialist certification programs recently set up by the CICA.

5. Conclusion

As detailed throughout this report, the introduction of the Sarbanes-Oxley Act has presented IFA's with a number of opportunities to help achieve some of the goals of SOX itself. That is, IFA's have the skill set to help raise the standards of corporate accountability and help punish the financial fraudsters. Setting up internal controls to prevent and detect fraud is more important to corporate executives than ever before as a result of SOX. Gathering and protecting evidence to punish financial fraudsters as part of an investigation by regulators, prosecutors, or corporations is something that will be happening with more frequency as a result of SOX. Having the external auditors do all they can to detect fraud during the financial statement audit is something that will likely become even more important as the PCAOB in the U.S. rewrites the audit standards and the CICA introduces their updated Handbook section on the consideration of fraud. IFA's can provide assistance with all of the above. The Act is filled with powerful ammunition that IFA's can use in carrying out the work that they do. Corporations, audit committees, regulators, accounting firms, and prosecutors, being those that either are required to follow the rules found in SOX or are responsible for ensuring that the rules are being followed, will likely look to IFA's to be part of their 'SOX' team. The opportunities for IFA's are numerous, and as such, it is essential the IFA's be aware of, and have an understanding of, the Sarbanes-Oxley Act and the related rules.

The increased opportunities available to IFA's will likely to lead to an increase in demand for IFA's, with the probable result being an increase in the number of institutions providing education for potential IFA's. With more opportunities for IFA's to be employed within corporations, there may be a shift away from the public accounting firms performing investigations to these investigations being carried out by in-house investigators. Furthermore, the auditor independence rules may result in a shift away from the Big Four public accounting firms performing investigations to boutique firms that do not perform any audits. However, the Big Four name and reputation and the diverse talent that is available at these firms for complex engagements means that there

will likely always those that look to one of the Big Four public accounting firms for assistance.

In discussing the Sarbanes-Oxley Act, its many rules and the resulting implications for IFA's, it is easy to lose sight of the bigger picture in that it appears that the passing of the Sarbanes-Oxley Act was the result of a fundamental shift in the business community and the community at large. A shift towards holding individuals and corporations responsible for themselves and their companies and seriously punishing the greedy. The days of financial fraudsters going to 'country club' jails may be over as there have been more pictures of corporate executives being taken away in handcuffs in the media than ever before. A shift towards a stronger and more controlling regulatory environment that corporations are required to operate in. And finally, a shift back towards the importance of corporate governance, trust, honesty, and integrity in the financial marketplace. The short-term impact of this shift is positive for IFA's as they have the skills to be part of the team that attempts to achieve some of these goals. The long-term impact, however, is less certain as it depends on whether the current shift towards the importance of corporate governance is just a fad that will to be replaced when the 'next' big thing or event that comes along.

In the U.S., the long-term impact is less uncertain as the SOX rules are not just voluntary, but are legislated, and can only be changed if the legislation is changed. In Canada, however, the answers to these questions, and the resulting impact on IFA's, are less clear. Many of the equivalent SOX rules have yet to be announced or finalized in Canada. Although Canada has seen a few corporate frauds in the recent past, Bre-X, Livent, and YBM to name a few, Canada has so far been spared corporate scandals on the scale of Enron and WorldCom and spared the number of scandals that have occurred in the U.S. As such, it is unclear whether or not there will there be the incentive to introduce the tough rules in Canada similar to those found in SOX, especially given the high cost to businesses of complying with the rules. So far, it appears that Canada is going to match the rules found in SOX. The rules to be announced by David Brown, OSC, on June 27, 2003 appear to be as tough as the SOX rules, and the Canadian Federal government

intends to introduce legislation increasing the penalties for fraud and intends to provide more resources to fight fraud. Therefore, with the introduction of similar rules in Canada, many of the opportunities described in this report may be available to Canadian IFA's as well.

Appendix A – What is an IFA or a Forensic Accountant?

The term *forensic accountant*[117] refers to an accountant who performs an orderly analysis investigation, inquiry, test, inspection or examination in an attempt to obtain the truth and develop an expert opinion on a particular subject. The practice of forensic accounting requires a strong accounting background, a thorough knowledge of auditing, risk assessment control and fraud detection, and a basic understanding of the legal environment. A forensic accountant needs to have a strong set of communication skills, both written and oral as a forensic accountant is normally engaged in a combination of fraud detection and litigation support, including the ability to interview people and effectively elicit information from persons who may not be interested in providing truthful answers.

Because forensic accounting often involves legal issues, an accountant practicing in the forensic area needs to have an understanding of and experience in the legal process. The evidence a forensic accountant derives from an investigation may require him/her to help attorneys prepare for a case or be hired as an expert witness to provide testimony on the results of the findings. A forensic accountant also needs to be knowledgeable and experienced in a number of other areas such as corporate financial planning and management techniques. Advanced computer skills are required including the ability to understand and apply information technology and accounting systems to the particular matter under investigation. Furthermore, a forensic accountant must have the ability to evaluate financial and accounting information systems even when these are complex and disorganized.

A forensic accountant must have a keen sense of ethics and professional ethical behavior. Finally, the forensic accountant must be skeptical and have a suspicious mentality. Forensic accounting makes no assumption of management integrity as is present in an audit of financial statements.

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[117] The details found in this appendix were obtained from: "What is a forensic accountant", The Horty Group of Companies Brochures & eNewsletters <http://www.horty.com/What_is_ForensicAccountant.pdf> (June 14, 2003).

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